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Audit Committee Quarterly Update

FIRST QUARTER 2022

In this newsletter, we highlight some important 2022 first quarter issues facing audit committees. The content is not all-inclusive. You may also be interested in our quarterly publication that summarizes accounting, financial reporting, and regulatory matters that may impact both public and private companies.

Center for Audit Quality (CAQ) audit committee survey

The CAQ and Deloitte's Center for Board Effectiveness released a new report in January 2022. **Audit Committee Practices Report: Common Threads Across Audit Committees,** a survey of 246 audit committee members of primarily large-cap, public companies in the U.S. states that "audit committees are being challenged by increased complexity in their core responsibilities, as well as scope creep across other areas within their organizations."

The report provides information about how audit committee oversight is changing. In particular, the report shows that while nearly all respondents (96%) rank financial reporting and internal controls, including fraud risk, as their top priority, audit committees are also responsible for cybersecurity (53%), data privacy security (48%), ethics and compliance (48%), third-party risk (47%), and enterprise risk management (42%).

Audit committees are increasingly adding cybersecurity expertise and more than one-half (53%) of respondents said they have oversight responsibility for cybersecurity, while 69% anticipate spending more time on cybersecurity next year — more than any other area. At the same time, 35% of respondents reported their audit committee has a cybersecurity expert, with 41% acknowledging they needed additional expertise in this area.

The survey also demonstrates that audit quality among public companies remains high: 98% of respondent stated audit quality either increased or remained the same as the previous year — and that competence of the engagement team and strong communication between the engagement partner and the audit committee contribute most to audit quality.

The top areas of focus on the audit committee agenda are:

- 96% Financial reporting and internal controls, including fraud risk (86%)
- 53% Cyber and data privacy (48%) security
- 48% Ethics and compliance
- 47% Third-party risk
- 42% Enterprise risk management

Materiality assessment of errors

On March 9, 2022, Paul Munter, acting chief accountant, issued a **statement** regarding assessing the materiality of errors in financial statements. Mr. Munter and other SEC staff previously addressed this topic at the 2021 AICPA and CIMA Conference on Current SEC and PCAOB Developments. He noted that whenever a material error is identified in previously issued financial statements, investors must be notified promptly and the error must be corrected. Management's determination of whether an error is material is an objective assessment focused on whether there is a substantial likelihood it is important to the reasonable investor as discussed in Staff Accounting Bulletin (SAB) No. 99, *Materiality,* and SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.*

Mr. Munter indicated it is "important for registrants, auditors, and audit committees to carefully assess whether the error is material by applying a well-reasoned, holistic, objective approach from a reasonable investor's perspective based on the total mix of information. To be objective, those involved in the process must eliminate from the analysis their own biases, including those related to potential negative impacts of a restatement, that would be inconsistent with a reasonable investor's view. Additionally, the objective analysis should consider all relevant facts and circumstances including both quantitative and qualitative factors."

Mr. Munter discussed the following topics with key takeaways noted:

Concept of materiality and the correction of material errors

- The Supreme Court has held that a fact is "material" if there is "a substantial likelihood that the … fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."
- When an error is determined to be material to previously issued financial statements, the error must be corrected by restating the prior-period financial statements, which is sometimes referred to as a "Big R" restatement.
- When an error is not material to previously issued financial statements, but either correcting the error or leaving the error uncorrected would be material to the current period financial statements, the error must be corrected, but it can be corrected in the current period comparative financial statements by restating the prior-period information and disclosing the error. This type of restatement is sometimes referred to as a "little r" restatement.

Objective assessment of materiality

- Companies, auditors, and audit committees need to thoroughly and objectively evaluate the total mix of information considering all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors, to determine whether an error is material to investors.

- There is an increased need for objectivity in the assessment of qualitative factors. Mr. Munter noted that "as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error."

Observations from recent interactions with registrants and auditors on materiality

The following arguments were **not** found to be persuasive.

- Financial statements or specific line items in financial statements are irrelevant to investors' investment decisions. For example, some have argued that certain elements of financial statements prepared in accordance with U.S. GAAP or International Financial Reporting Standards (IFRS) do not provide useful information to investors, so an error in those elements cannot be material, or that historical financial statements or specific line items in those financial statements are irrelevant to investors' current investment decisions. It was noted that the effects of errors on certain key non-GAAP measures that are important to users of the registrant's financial statements should be performed in addition to, but not as a substitute for, the analysis of materiality to the financial statements.
- An error is not material to previously issued financial statements because the error was also made by other registrants, and therefore reflects a widely held view rather than an intention to misstate. This type of argument has been raised by registrants in various industries and with various structures, including special purpose acquisition companies.
- An error is not material because its effect is offset by other errors. SAB 99 provides direction that, each misstatement must be assessed to determine if it is material, without consideration of its effect when combined with other misstatements.

Identification of an accounting error also impacts management's assessment of the effectiveness of ICFR, and the statement provides considerations for this assessment.

Cybersecurity-related proposals

SEC proposes rules on cybersecurity disclosures for public companies

On March 9, 2022, the SEC **proposed amendments** to its rules to enhance and standardize disclosures regarding cybersecurity risk management, strategy, governance, and incident reporting by public companies. The proposed amendments are intended to better inform investors about a registrant's risk management, strategy, and governance and to provide timely notification to investors of material cybersecurity incidents.

The proposed amendments would require current reporting about material cybersecurity incidents and periodic reporting of, among other things:

- Registrant's policies and procedures to identify and manage cybersecurity risks
- Registrant's board of directors' oversight of cybersecurity risk
- Management's role and expertise in assessing and managing cybersecurity risk and implementing cybersecurity policies and procedures

The proposal would also require annual reporting or certain proxy disclosure about the board of directors' cybersecurity expertise, if any.

SEC proposes cybersecurity risk management rules and amendments for registered investment advisers and funds

On Feb. 9, 2022, the SEC proposed rules related to cybersecurity risk management for registered investment advisers, and registered investment companies and business development companies (funds), as well as amendments to certain rules that govern investment adviser and fund disclosures. SEC Chair Gary Gensler stated: "The proposed rules and amendments are designed to enhance cybersecurity preparedness and could improve investor confidence in the resiliency of advisers and funds against cybersecurity threats and attacks."

The proposal would require advisers and funds to:

- Adopt and implement written cybersecurity policies and procedures designed to address cybersecurity risks that could harm advisory clients and fund investors.
- Publicly disclose cybersecurity risks and significant cybersecurity incidents that occurred in the last two fiscal years in their brochures and registration statements.
- Meet new recordkeeping requirements that are designed to improve the availability of cybersecurity-related information and help facilitate the SEC's inspection and enforcement capabilities.

The proposed rules also would require advisers to report significant cybersecurity incidents affecting the adviser or its fund or private fund clients to the SEC on a new confidential form.

SEC proposes rules to enhance and standardize climate-related disclosures

As discussed in previous quarterly updates, climate change disclosures have been a concern of the SEC as evidenced in various statements and comments letters. In September 2021, the staff in the Division of Corporation Finance (Corp Fin) published an illustrative letter containing sample comments that it may issue to companies regarding their climate-related disclosure or the absence of such disclosure. As stated in the sample comment letter, depending on the particular facts and circumstances, these disclosures may be required as part of a company's description of business, legal proceedings, risk factors, and management's discussion and analysis of financial condition and results of operations.

On March 21, 2022, the SEC proposed rule changes that would require registrants to include **certain climate-related disclosures** in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements. The required information about climate-related risks also would include disclosure of a registrant's greenhouse gas emissions, which have become a commonly used metric to assess a registrant's exposure to such risks.

The proposed rule changes would require a registrant to disclose information about (1) its governance of climate-related risks and relevant risk management processes; (2) how any identified climate-related risks have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term; (3) how any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook; and (4) the impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a registrant's consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements.

The proposed rules would also require a registrant to disclose information about its direct greenhouse gas (GHG) emissions (Scope 1) and indirect emissions from purchased electricity or other forms of energy (Scope 2). In addition, a registrant would be required to disclose GHG emissions from upstream and downstream activities in its value chain (Scope 3), if material, or if the registrant has set a GHG emissions target or goal that includes Scope 3 emissions. The proposed rules would provide a safe harbor for liability from Scope 3 emissions disclosure and an exemption from the Scope 3 emissions disclosure requirement for smaller reporting companies.

Under the proposed rule changes, accelerated filers and large accelerated filers would be required to include an attestation report from an independent attestation service provider covering Scopes 1 and 2 emissions disclosures, with a phase-in over time, to promote the reliability of GHG emissions disclosures for investors.

The proposed rules would include a phase-in period for all registrants, with the compliance date dependent on the registrant's filer status, and an additional phase-in period for Scope 3 emissions disclosure.

SEC proposes rules to enhance disclosure and investor protection relating to special purpose acquisition companies, shell companies, and projections

On March 30, 2022, the SEC proposed new rules and amendments to enhance disclosure and investor protection in initial public offerings by special purpose acquisition companies (SPACs) and in business combination transactions involving shell companies, such as SPACs, and private operating companies.

The proposed new rules and amendments, among other things are to:

- Require additional disclosures about SPAC sponsors, conflicts of interest, and sources of dilution.
- Require additional disclosures regarding business combination transactions between SPACs and private operating companies, including disclosures relating to the fairness of these transactions.
- Address issues relating to projections made by SPACs and their target companies, including the Private Securities Litigation Reform Act safe harbor for forward-looking statements and the use of projections in Commission filings and in business combination transactions.
- Address the status of SPACs under the Investment Company Act of 1940, which is designed to increase attention among SPACs about this important assessment. Under the proposed rule, SPACs that satisfy certain conditions that limit their duration, asset composition, business purpose, and activities would not be required to register under the Investment Company Act.

If adopted, the proposed rules would more closely align the required financial statements of private operating companies in transactions involving shell companies with those required in registration statements for an initial public offering.

SEC issues proposal to reduce risks in clearance and settlement of securities

On Feb. 9, 2022, the SEC proposed rule changes to reduce risks in the clearance and settlement of securities, including by shortening the standard settlement cycle for most broker-dealer transactions in securities from two business days after the trade date (T+2) to one business day after the trade date (T+1). The proposed changes are designed to reduce the credit, market, and liquidity risks in securities transactions faced by market participants and U.S. investors.

In addition to shortening the standard settlement cycle, the proposal includes rules directed at broker-dealers and registered investment advisers to shorten the process of confirming and affirming the trade information necessary to prepare a transaction for settlement so that it can be completed by the end of the trade date. Further, the proposal includes a new requirement to facilitate straight-through processing, which would apply to certain types of clearing agencies that provide central matching services. Central matching service providers help facilitate the processing of institutional trades between broker-dealers and their institutional customers. The proposed rule would require new policies and procedures directed to straight-through processing and require an annual report on progress with the process.

With the goal of shortening the settlement cycle further, the proposal solicits comments on challenges associated with and potential paths to achieving a same-day settlement cycle.

The SEC's published fact sheet notes that "reducing time between the execution of a securities transaction and its settlement reduces risk. Two recent episodes of increased market volatility — in March 2020 following the outbreak of the COVID-19 pandemic, and in January 2021 following heightened interest in certain "meme" stocks — highlighted potential vulnerabilities in the U.S. securities market that shortening the standard settlement cycle and improving institutional trade processing can mitigate. In the future, it may be beneficial to further shorten the standard settlement cycle beyond T+1. The proposal solicits comments on potential paths to and challenges associated with achieving a same-day settlement cycle."

Other SEC proposals

Whistleblower program rules

On Feb. 10, 2022, the SEC proposed **two amendments** to the rules governing its whistleblower program. The first proposed amendment concerns award claims for related actions that would be otherwise covered by an alternative whistleblower program and the second affirms the SEC's authority to consider the dollar amount of a potential award for the limited purpose of increasing an award but not to lower an award.

Modernize beneficial ownership reporting

On Feb. 10, 2022, the SEC proposed rule **amendments** governing beneficial ownership reporting under Exchange Act Sections 13(d) and 13(g) to provide more timely information to meet the needs of today's financial markets.

The proposed amendments to Regulation 13D-G would accelerate the filing deadlines for Schedules 13D beneficial ownership reports from 10 days to five days and require that amendments be filed within one business day; generally accelerate the filing deadlines for Schedule 13G beneficial ownership reports (which differ based on the type of filer); expand the application of Regulation 13D-G to certain derivative securities; clarify the circumstances under which two or more persons have formed a "group" that would be subject to beneficial ownership reporting obligations; provide new exemptions to permit certain persons to communicate and consult with one another, jointly engage issuers, and execute certain transactions without being subject to regulation as a "group;" and require that Schedules 13D and 13G be filed using a structured, machine-readable data language.

Short sale disclosure rule, order marking requirement, and CAT amendments

On Feb. 25, 2022, the SEC proposed **changes** that would provide greater transparency to investors and regulators by increasing the public availability of short sale-related data.

Accounting and reporting implications of the Russia/Ukraine war

As the impacts of Russia's invasion of Ukraine are being felt throughout the world, there will also be accounting and financial reporting implications that entities need to consider in addition to the humanitarian considerations.

The impacts from the war in Ukraine have already begun for many entities both directly and indirectly. We recommend that management and audit committees consider the potential accounting and disclosure implications. Some of the areas where entities may be impacted include (not all-inclusive):

Asset impairment

Asset impairments will be a common area that require consideration as a result of the war in Ukraine. Some of the different classes of assets where impairment considerations may be required include (not all-inclusive):

- Financing receivables, including accounts receivable and loans receivable, entities with financing receivables will need to assess if those assets are impaired. Impairments may occur due to customers or borrowers being physically located in Ukraine or Russia, or due to these customers and borrowers being affected by some of the indirect impacts from the war, including supply chain issues, volatility in energy prices, etc.
- Investment securities: Investment securities will need to be evaluated if the war or its direct and indirect effects have significantly impacted the entity issuing the security. The accounting implications will depend on the classification of the investment security:
  - Marketable equity securities with a readily determinable fair value and debt securities classified as trading are measured at fair value with changes in fair value recorded in income. Increased volatility may be seen for securities that continue to trade in active markets. Consideration should also be given to whether the primary market in which a security trades is no longer active, or whether trading of the security has been restricted. In these circumstances, classification of the security may change.

  - Marketable equity securities without a readily determinable fair value are required to be written down to fair value if a qualitative assessment of the security indicates the fair value of the investment is less than its carrying value.
  - Available-for-sale and held-to-maturity debt securities are required to be assessed for impairment with an impairment loss recorded when other than temporary impairment exists.
- Inventory: Entities with inventory located in Russia or Ukraine, or inventory that was intended for sale to customers in Russia or Ukraine, will need to assess whether that inventory will still be able to be sold as intended. If the inventory has been damaged in the war or will not be able to be sold due to the war and the related sanctions imposed by different worldwide governments, an additional reserve for the inventory may be required.
- Goodwill and other intangibles: Entities that have experienced significant financial impacts, or expect significant financial impacts in the future, may need to assess if there are any impairments of goodwill or other intangible assets. Indefinite lived intangible assets and goodwill are required to be tested for impairment annually and more frequently if there are indicators that fair value of goodwill or intangibles may be less than the carrying value.
- Property, plant, and equipment and right-of-use assets: Entities with long-lived assets in countries impacted by the war will need to evaluate if the assets located within those countries may be impaired. ASC 360, *Property Plant, and Equipment,* includes guidance on recognizing and measuring impairment losses on long-lived assets, including right-of-use assets from leases.

Equity method investments

Entities with equity method investments in Ukraine or Russia may need to assess if changes have occurred that have resulted in the entity losing the ability to exercise significant influence over the investee. Equity method investments are also subject to the impairment assessment.

Discontinued operations

Entities with subsidiaries or operations in Russia or Ukraine may need to consider the discontinued operations guidance if they plan to cease their operations in Eastern Europe as a result of the war. Determining whether the ceasing operations qualifies for reporting as a discontinued operation can require significant judgment.

Exit/Disposal costs

Entities that do not continue operations in Russia or Ukraine, will need to evaluate if there are any exit or disposal costs that need to be recognized. This can include costs to terminate a contract (including leases accounted for under ASC 840), costs to close a facility or dispose of fixed assets, and employee termination benefit costs.

Consolidation

Entities with consolidated subsidiaries (or consolidated variable interest entities) located in Russia or Ukraine may need to reassess if consolidation of those entities is still appropriate. The impact of the war and the related economic sanctions may result in situations where an entity is no longer able to control a subsidiary or variable interest entity. If an entity loses control of a previously consolidated subsidiary or variable interest entity, it will need to deconsolidate that entity for financial reporting purposes and assess its ongoing relationship with that entity to determine the proper accounting going forward.

Contingencies

Entities should also consider if there are any contingencies that have arisen as a result of the war, including the related sanctions. If there are contingent losses that have arisen, they are required to be accrued if they are both probable and reasonably estimable. Even if a loss is not probable, and no liability needs to be recorded, entities are required to disclose the nature of a loss contingency when it is at least reasonably possible that a loss has been incurred.

Other considerations

In addition to the items discussed above, entities should also consider other financial statement disclosures that may be appropriate. Entities that may be impacted should consider whether disclosure should be included in their risks and uncertainties disclosures or as a subsequent event. Also, consideration should be given for any impacts to MD&A and risks in SEC filings.

SEC registrants considering including non-GAAP financial metrics in their filings as a result of the war in Ukraine, should consider the SEC's rules and guidance on including non-GAAP metrics within their Form 10Q or Form 10K.