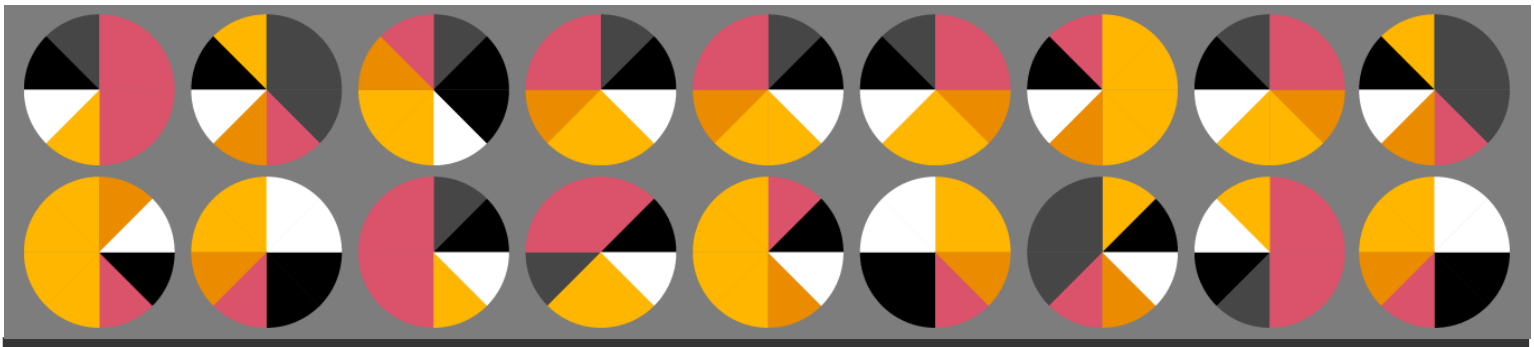


PwC's Governance Insights Center

Q1 2021 Audit committee newsletter: Helping you prepare for your next meeting

Financial reporting

1. Simplification of accounting for income taxes, effective in Q1 for public filers

In December 2019, the FASB issued guidance that simplifies the accounting for income taxes as part of the board's overall initiative to reduce complexity in accounting standards. The guidance is required to be adopted by public filers for years beginning after December 15, 2020 (and after December 15, 2021 for other entities). The amendments include the removal of certain exceptions to the general principles of ASC 740, *Income taxes*, and simplification in several other areas. Upon adoption, organizations will no longer be required to consider:

- the exception to intraperiod tax allocation when there is a loss in continuing operations and income in other components;
- the exception in interim period income tax accounting that limits the benefit for year-to-date losses that exceed anticipated losses for the year; and
- exceptions to accounting for outside basis differences of equity method investments and foreign subsidiaries.

The guidance also simplifies accounting for:

- a franchise tax (or similar tax) that is partially based on income;
- tax rate changes in an interim period;
- the allocation of taxes to separate company financial statements for entities both not subject to tax and disregarded by the taxing authority; and

- when a step-up in the tax basis of goodwill should be considered part of a business combination versus a separate transaction.

Audit committees will want to understand how management expects the new guidance to impact the company's intraperiod tax allocation and related disclosures.

Where to go for more information:

- PwC: FASB simplifies accounting for income taxes

2. Applying new guidance for equity investments, now effective

When an investor signs an agreement to acquire an equity investment that will be accounted for using the equity method, the closing of the transaction may occur at a future date. Many of these arrangements do not meet the definition of a derivative under ASC 815 and, historically, were frequently viewed as executory in nature and were not accounted for prior to closing.

ASU 2020-01, *Clarifying the Interactions between Topic 321, Topic 323, and Topic 815*, clarified that forward or option contracts to purchase investments that will be accounted for using the equity method that do not meet the definition of a derivative under ASC 815 are in the scope of ASC 321. Therefore, when the purchase contract is considered a forward or option contract in the scope of this guidance, the investor would account for changes in the contract's fair value prior to closing through earnings, unless the contract qualifies for the measurement alternative and it is elected. If the measurement alternative is elected, the change in the fair value of the contract would be reflected in earnings upon closing. In addition, if there are observable transactions or impairments before closing, the guidance would require remeasurement of the contract to fair value. The guidance in ASU 2020-01 also specifies that when applying the measurement alternative in ASC 321, observable transactions include those transactions by the investor that result in the application or discontinuation of the equity method of accounting.

These amendments are effective prospectively on January 1, 2021 for calendar year-end public business entities. Early adoption is permitted for all other companies.

The audit committee will want to understand how this new guidance may impact management's elections regarding measurement and the corresponding impact on the company's earnings.

Where to go for more information:

- FASB: FASB ASU 2020-01

3. Calendar year-end companies can early adopt the FASB's new guidance on liabilities and equity this quarter

A number of companies are considering early adoption of the FASB's recently-issued guidance on liabilities and equity. ASU 2020-06 simplifies the accounting for certain financial instruments with characteristics of liabilities and equity by reducing the number of accounting models for convertible debt and convertible preferred stock instruments. In addition, the FASB amended the derivative guidance for the "own stock" scope exception and certain aspects when calculating earnings per share (EPS).

The adoption of ASU 2020-06 may have unexpected consequences related to how certain instruments are reflected on a company's balance sheet and treated for EPS. Before electing to early adopt the standard, some key areas to consider include:

- **Net cash settlement and balance sheet classification:** Under current guidance, an instrument indexed to a company's own stock that could require cash settlement outside of the entity's control is usually required to be reported as an asset or liability. ASU 2020-06 provides exceptions such that three of the conditions necessary for equity classification do not need to be considered in evaluating settlement provisions for instruments indexed to an entity's own stock. However, the guidance did not amend the SEC's mezzanine equity guidance, and as a result, the three conditions still require consideration for determining if the instrument should be classified as mezzanine equity.
- **Diluted EPS:** The new guidance requires a company to assume share settlement when an instrument can be settled in cash or shares at the company's option. For some instruments for which the company is asserting cash settlement, the adoption of the guidance may reduce diluted EPS.
- **Income tax accounting implications:** If upon adoption of the ASU, a company recombines the liability and equity components of a convertible debt instrument into a single unit of account, the company may need to adjust or remove the deferred tax liabilities that were initially recorded. Deferred tax liability changes may also affect valuation allowance assessments, as future reversals of the deferred tax liability related to convertible debt may have served as a source of future taxable income. Depending on the facts and circumstances, a company may increase or decrease its valuation allowance as either a direct or indirect effect.
- **Expanded disclosure requirements:** While the FASB concluded that the existing disclosure requirements for convertible instruments and contracts in an entity's own equity did not need substantial revision, ASU 2020-06 does create some additional disclosure requirements.
- **Other adoption considerations:** Companies should also consider the implications of adoption related to capitalized interest, debt covenants, financial ratios, and conversion versus extinguishment accounting.

As the company considers the decision to early adopt, the audit committee will want to understand management's consideration of the impacts to the company's financial statements and disclosures.

Where to go for more information:

- PwC: Adopting the new liability and equity guidance early
- PwC: Accounting for convertible instruments and own equity contracts

4. Preparing for the impacts of reference rate reform

There may still be work to be done in advance of the discontinuance of LIBOR. One-week and two-month USD LIBOR settings as well as all non-USD LIBOR settings will stop being published on December 31, 2021 while the remaining USD LIBOR settings will be discontinued on June 30, 2023. Companies should ensure that they have the proper processes and controls in place to identify all contracts that will be affected by the cessation of LIBOR and evaluate and execute any necessary contract modifications. Companies also need to ensure that all accounting considerations related to these modifications are understood and assessed.

ASU 2020-04, *Reference Rate Reform*, provides optional relief from the accounting analysis and impacts that may otherwise be required for modifications to agreements resulting from the discontinuation of LIBOR. Additionally, this guidance provides optional expedients to enable companies to continue to apply hedge accounting to certain hedging relationships impacted by reference rate reform. These relief provisions must be affirmatively elected by companies in order to be applied. In addition to this guidance, the FASB has continued to monitor market developments and issued ASU 2021-01 to clarify the scope of the guidance and allow

derivatives impacted by the changing of interest rates used for margining, discounting, or contract price alignment to qualify for certain relief.

Audit committees will want to understand the company's progress in its preparation for LIBOR discontinuance and how these recent events and new guidance may impact management's plans, including the related financial statement impacts and disclosures.

Where to go for more information:

- PwC: Contracts filled with LIBOR references? Now what?

The audit committee may want to consider discussing the above topics with management to understand how they are being addressed. For an in depth discussion and more insights on these topics, see PwC's *The quarter close – First quarter 2021*.

Other items

5. New year; new administration: changes coming your way

President Biden has laid out his administration's top priorities in the near-term with a focus on four key areas: the COVID-19 pandemic, the economic fallout resulting from the pandemic, climate change, and racial equity. In addition to changes in the White House and Congress, confirmation hearings have already begun for Gary Gensler, President Biden's pick to lead the SEC. He is expected to be confirmed as early as this month.

With the potential for broad changes for tax, trade, and regulatory policy, it will be important for companies to understand and manage the opportunities and challenges. Audit committees will want to understand how management is keeping abreast of these changes and the impact on the company.

Where to go for more information:

- PwC: Forecast 2021: What to expect from the new administration
- PwC: Summary of the administration's top priorities
- PwC: Top Policy Trends 2021
- PwC: 2021 Tax Policy Outlook

6. Connecting with the external auditors

Audit committees of companies that just experienced their first audit while working remotely may want to debrief on what worked well and what could work differently as well as initiate early discussions with the external auditor regarding its plans for coordinated project management to keep the 2021 interim reviews and annual audit on track. Based on lessons learned from 2020, this year will continue to require that audit committees get ongoing updates from the external auditor to understand any changes to their audit planning,

the current status of audit execution, any issues related to auditors or company personnel working remotely, and if any other issues have been identified. These communications should include a discussion on risk assessment, technology tools utilized, and other topical areas.

- **Risk assessment:** The external auditor is responsible for performing risk assessment procedures to identify and assess the risk of material misstatement of the financial statements whether due to fraud or error to drive the right work at the right time and avoid unnecessary work. For example, the external auditor's risk assessment can affect which audit components might be visited and which accounts would be included in the audit scope. The continued uncertainty derived from the ongoing health, economic, and social crises may give rise to event-driven re-evaluation of the risk of material misstatement by the external auditor over the course of the year. Similarly, companies will continue to evaluate, and possibly modify, their own internal risk assessment because of impacts from these crises. Furthermore, the audit committee will want to have their own perspective on risk assessment, including risks of fraud, and share that with the external auditors. The audit committee may also want to inquire of the external auditors about how their risk assessment aligns with management's risk assessment, and what impacts, if any, that may have on planned audit procedures.
- **Technology tools:** By this time, nearly every audit over the last twelve months will have been completed in a virtual environment. As external auditors prepare for the upcoming audit, audit committees will want to understand any new technology tools, or expansion of the use of existing tools, the external auditor is planning to utilize to support a quality, efficient audit. Audit committees should also understand how the external auditor maintains the security of the company's data when leveraging these tools.
- **Other topical areas:** It is likely at least some elements of this year's audit will continue to be conducted remotely. The audit committee should be comfortable that the external auditor can perform its necessary audit procedures. As some companies begin to transition back to the office during the year, there is the likelihood that the company's control environment may change. It is important for audit committees to understand management's expected changes early in the process and get the auditor's perspective regarding such changes. Does management expect any changes to its processes for deriving significant estimates and judgments? How might critical audit matters change in the coming year? How has the determination of materiality been impacted?

As we experienced last year, it is best to flush out these discussions early in the year and establish a cadence for updates over the course of the year. Lastly, the audit committee should ask the external auditor to provide its view on any impacts to the company's culture of the extended pandemic and the remote work environment. The external auditor's insights into any trends in ethics and safety complaints and attitudes toward risk and compliance can assist the audit committee in assessing the impact on the company's culture.

Where to go for more information:

- Center for Audit Quality (CAQ): Focus on the Auditor's Risk Assessment

7. Weighing in on ESG

There is a growing move toward more disclosures related to environmental, social, and governance (ESG) matters. Investors see it as a window into a company's future. The SEC is revisiting climate disclosures, and proxy advisory firms have it high on their priority list. What role does the audit committee play in terms of ESG? Whether ESG oversight rests with the full board or even another committee, there is likely a role for the audit committee given its core competencies and oversight role over financial reporting. At a minimum, we see the audit committee having an oversight role in the following:

- **Disclosures**: Are the ESG disclosures (both qualitative and quantitative) investor grade? Which ESG frameworks and/or standards are the company using?

- **Processes and controls**: Are there processes and controls in place to ensure ESG disclosures are accurate, comparable, and consistent?
- **Assurance**: Is internal audit playing a role in reviewing processes and controls related to reporting? Would independent assurance make the disclosures more reliable?

Given that board oversight of ESG varies from company to company, the audit committee should understand its specific role in the broader spectrum of ESG oversight. Additionally, given the expected pace of change in the ESG space, audit committees will want to have regular "check-ins" with management and share their perspectives regarding reporting and disclosure.

Where to go for more information:

- PwC: ESG oversight: The corporate director's guide
- PwC: Sustainability/ESG reporting – Why audit committees need to pay attention
- PwC: Shareholders' 2021 corporate governance priorities come into focus
- PwC: The board's role in confronting climate risk
- PwC: Boards, investors, execs: Take heed. ESG reporting matters.

8. Keeping committee meetings efficient

Audit committees continue to have a lot on their plates, a condition not likely to change. Periodically revisiting some of the fundamental elements of audit committee meetings can ensure that they are functioning as efficiently as possible. As you plan your 2021 calendars, take time to take a fresh look at the following:

- **The agenda:** The agenda plan for the year should cover every item in the committee's charter. It should also consider the appropriate times for the committee to get a "deep dive" from management on complex and/or high-risk areas, including tax, significant estimates and judgments by management, IT, climate risks, and ERM, just to name a few. Does the agenda reflect the prioritization of topics and level of risk associated with each? Is the time allotment for sessions/presentations appropriate?
- **The pre-read materials:** The volume of pre-read materials continues to expand. Streamlining reporting in order to draw attention to key issues, trends, and themes continues to be one of the top priorities we hear from audit committee members. Executive summaries and dashboard reporting are a must these days. Challenge management to identify clear, concise messaging that allows committee members to focus on items that may require action. Furthermore, highlighting key changes from prior packages will allow the committee to easily identify where to focus, thereby making pre-read materials more effective.
- **Meeting presentations:** Are critical areas of focus for the committee highlighted? Is the presentation short and crisp with more time spent on questions and discussions than on presentation? Is the committee asking the right questions? If presenters identified issues in past presentations, does the current presentation provide a summary of that issue and the status of its resolution?

Where to go for more information:

- PwC: Audit committee effectiveness: practical tips for the chair
- PwC: Audit committee oversight checklist
- PwC: Getting the most out of internal audit (for examples of dashboard reporting and executive summaries)
- PwC: Ethics & compliance dashboard reporting example

9. Recurring items for the audit committee agenda

There are certain items that due to their importance should be on the agenda of every audit committee meeting or at least at scheduled intervals:

- Hotline complaints and code of conduct violations
- Changes in the regulatory environment
- Private and executive sessions
- Related-party transactions
- Internal and external audit plan reviews
- Discussions with CIO, CISO, and GC as needed.

Contacts

Maria Castañón Moats
Leader, PwC's Governance Insights Center
maria.castanon.moats@pwc.com

Stephen G. Parker
Partner, PwC's Governance Insights Center
stephen.g.parker@pwc.com

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