AN OFFERING FROM THE BDO CENTER FOR CORPORATE GOVERNANCE AND FINANCIAL REPORTING

2018 AUDIT COMMITTEE ROUND-UP:

Focal Points, Tools & Resources

What's on the minds of audit committees now that 2018 has come to a close and we focus on the audit of the future? On the financial reporting and transparency front, matters range from continued implementation and adoption of significant accounting standards, impact assessment relative to U.S. tax reform, and opportunities to participate in dry runs for new auditor reporting around critical audit matters. Evolving technologies and analytic capabilities; cybersecurity and data governance; along with transparency and relevance in disclosures have audit committees further engaging in forward-looking, risk-based discussions with management and advisors. Finally, the need to critically assess evolving organizational talent and board composition – including the audit committee – to align with short-term and long-term business strategy is rising in importance. Learn how each of these may impact audit committees for both public and private companies for the foreseeable future.

BDO has compiled the following year-end snapshot of issues and select resources that audit committees will find helpful in addressing their oversight responsibilities and communications with management and auditors during the year-end audit cycle and related reporting. While the following is intended as a high-level reference, additional resources are forthcoming and include BDO's **Quarterly Technical Update - Q4 2018** webinars and our annual newsletters: **BDO Knows: 2018 Accounting Year in Review** and **2018 SEC Year in Review**, among others – all of which are or will be made available on **BDO's Center for Corporate Governance and Financial Reporting**.

Contents

Audit Quality and the Audit of the Future

A series of forces is at work to secure enhanced audit quality at the top of audit committee agendas. This includes significant changes in leadership in 2018 at the SEC and PCAOB, both of which have adopted reflective and forward-looking lenses in informing their respective strategic focus on how further improvements in audit quality can take into account impacts of changing market forces and technological advancements. Such forces further include a broad variety of activity in accounting, reporting, and auditing standard setting and how regulators, management, and auditors are reacting to, adapting to, and communicating the new related requirements.

SEC Chief Accountant Wes Bricker, along with colleagues from the SEC, recently participated in a panel discussion at the 2018 AICPA Conference on Current SEC and PCAOB Developments, sharing top of mind recommendations for improving audit quality. While the panel discussion focused on the audit profession, it further emphasized the role companies – management teams and audit committees – play in the financial reporting process. Each of these are explored in more detail in related sections elsewhere within this publication:

- **New GAAP Standards –** Companies are urged to not let their implementation, planning, or disclosure of the anticipated effects of the new standards lag during 2019, as the FASB continues to consider and respond to implementation questions… The SEC welcomes both domestic and international stakeholders to consult with them on the new GAAP standards.
- **Internal Controls –** Well-run public companies have adequate internal controls not just because internal controls are the first line of defense against preventing or detecting material errors or fraud in financial reporting, but also because strong internal controls are good for business and can have an impact on the companies' costs of capital.
- **Vital Role of Audit Committees –** Companies and directors should carefully choose who serves on their audit committees, selecting those who have the time, commitment, and experience to do the job well. Audit committee members must stay abreast of issues through adequate, tailored, and ongoing education.
- **Voluntary Audit Committee Disclosures –** The SEC notes positive trends in audit committees voluntarily providing enhanced disclosure regarding their role in overseeing the external auditor.
- **Critical Audit Matters –** The SEC believes that successful implementation of the PCAOB's auditing standard requiring auditor reporting of critical audit matters beginning in 2019 starts with proper planning, involvement, and communication by the PCAOB, audit firms, audit committees, investors, and regulators.
- **Auditor Communications –** Beyond required communications, audit firms in the U.S. commonly provide to the public generally, and audit committees specifically, information to assist in understanding how the quality control systems of the firm are designed and functioning. These reports can contribute substantially to the audit committee's oversight of the audit relationship.
- **Promoting Auditor Independence –** As audit firms consider how they can contribute to better financial reporting as part of the overall business landscape, the SEC encourages them to invest in their policies, procedures, and training, among other elements of a quality control system, that provide an audit firm with reasonable assurance that independence is maintained in both fact and appearance.
- **Risk and Innovation –** In both risk identification and remediation of control deficiencies, it is helpful for auditors to use their skills, their knowledge, and their control frameworks to help others to "pull the thread" all the way from the nature of the overall control environment to the nature of particular ongoing monitoring activities in order to completely evaluate a situation.

Readiness and Implementation of Significant New FASB Accounting Standards

REVENUE RECOGNITION

While public companies have been reporting under ASC 606 (revenue recognition) for the first three quarters of 2018, the accounting, disclosures, and the related controls will be the focus of auditors and regulators for the first full year of reporting for public entities. Regulators have been closely monitoring adoption and have expressed concerns that disclosures are perhaps not as robust as anticipated, and thus, will be continuing to monitor this into 2019.

With public company adoption of ASC 606, there are ample opportunities for lessons learned regarding controls around implementation and disclosure of new accounting standards. There is an immediate opportunity to utilize these improvements and refine controls with the implementation of ASC 842 (Leases), ASC 326 (Credit Losses), and ASC 825 (Financial Instruments) accounting guidance over the next several years.

LEASES

ASU 2016-02, Leases, establishes a comprehensive leasing model for both lessees and lessors. Under its core principle, a lessee will recognize right-of-use (ROU) assets and related lease liabilities on the balance sheet for all arrangements with terms longer than 12 months. The pattern of expense recognition in the income statement will depend on a lease's classification. Lessor accounting remains largely consistent with previous U.S. GAAP, but has been updated for consistency with the new lessee accounting model and with the new revenue standard under ASC 606.

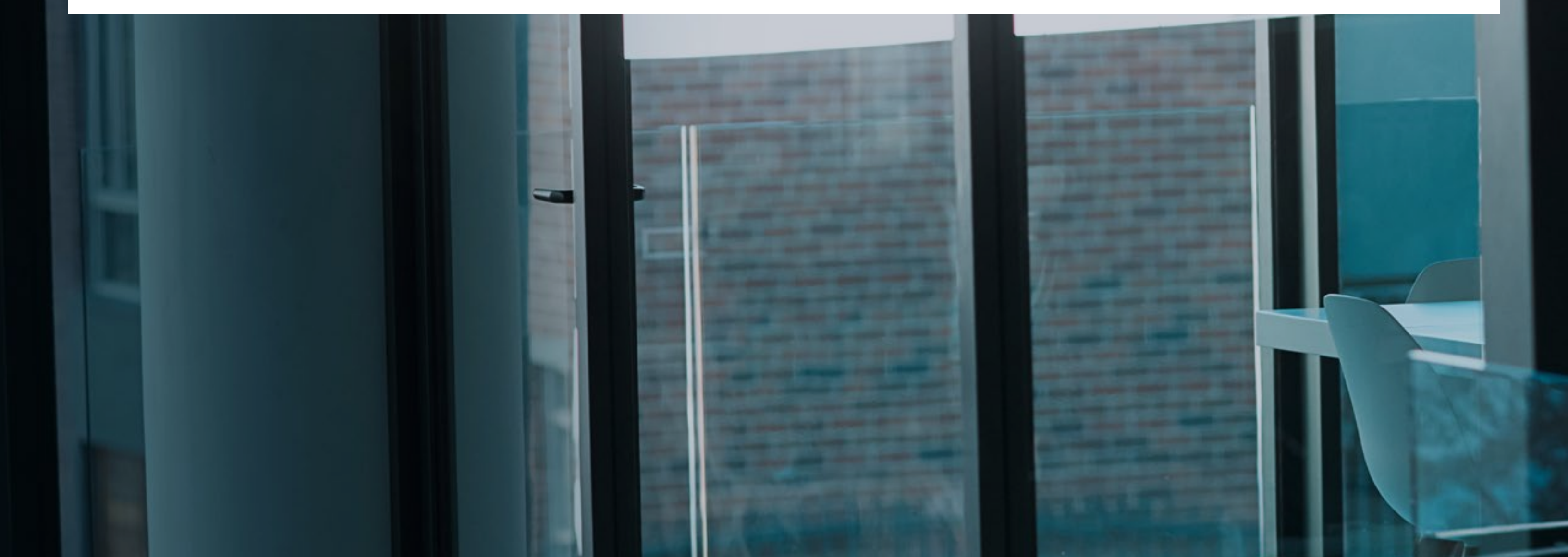
For calendar-year public business entities, the new standard takes effect for fiscal years beginning after December 15, 2018 (which is 2019 for calendar year-end companies), and interim periods within that year; for all other calendar year-end entities it takes effect in 2020, and interim periods in 2021.

For a comprehensive review of the guidance in the new leases standard, refer to BDO Knows: Topic 842, *Leases*. Additionally, the Center for Audit Quality (the CAQ) released a tool, *Preparing for the New Leases Accounting Standard – A Tool for Audit Committees*, as a resource for audit committees in their oversight of the implementation of ASC 842. The implementation of the new standard will take significant effort, will affect multiple functional areas, and comes on the heels of the extensive requirements of the new revenue recognition standard.


BDO KNOWS: FASB

TOPIC 842, LEASES

INTRODUCTION



FINANCIAL INSTRUMENTS - CREDIT LOSSES

ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, is not effective for public filers until years beginning after December 15, 2019, but all entities may elect to early adopt the amendments as of the fiscal year beginning after December 15, 2018, including interim periods within the fiscal year. The standard (i) significantly changes the impairment model for most financial assets that are measured at amortized cost and certain other instruments from an incurred loss model to an expected loss model; and (ii) provides for recording credit losses on available-for-sale (AFS) debt securities through an allowance account. The standard also requires certain incremental disclosures.

The standard requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument. In contrast, current U.S. GAAP is based on an incurred loss model that delays recognition of credit losses until it is probable the loss has been incurred. Accordingly, it is anticipated that credit losses will be recognized earlier under the CECL model than under the incurred loss model.

Adoption of the new CECL standard will require adequate planning and an implementation timeline. Companies are encouraged to begin this process now if they have not already done so. Planning considerations should include:

1. Reviewing the accounting and reporting requirements contained in the new standard.
2. Evaluating which of the company instruments are within the scope of the CECL.
3. Reviewing existing allowance/impairment models currently being used by the company.
4. Determining the data needed for the CECL model(s) and assess currently available data sources.
5. Determining the ability of the company's current IT applications to provide required data not currently available.
6. Determining how the adoption of CECL will impact the internal and external users of the company's financial information.
7. Determining and ensure that proper internal controls are in place and operating effectively over the implementation process.

GENERAL IMPLEMENTATION, CONTROLS, AND DISCLOSURE REMINDERS

We would like to remind audit committees, with respect to the implementation and the adoption of these new significant accounting standards, to ensure not only proper application of the accounting principles and preparation of thorough new disclosures upon adoption, but also to ensure transparency into the process is undertaken by management so that the resulting financial information is easily understood by analysts and the investing communities. Consideration of the controls that support the accounting is as important as the reporting for these new standards.

During the December 2018 AICPA Conference on Current SEC and PCAOB Developments, SEC Chief Accountant Wes Bricker **stated** that in reflecting on best practices from implementation of the new revenue standard, "*The audit committee plays a significant role in the financial reporting oversight of management's implementation of new accounting standards. Audit committees should understand management's implementation plans to help achieve a high-quality implementation and ongoing application of the new standard. Oversight by the audit committee can foster rigorous approaches by management to:*

- *establish appropriate controls and procedures over transition;*
- *maintain appropriate controls and procedures over ongoing application of the new standard; and*
- *understand how the effects of the new standard are communicated to investors at transition and on an ongoing basis.*"

Chief Accountant Bricker went on to indicate the SEC is encouraging "*ongoing attention, including audit committee participation and training as needed, regarding the adequacy of and basis for a company's internal control over financial reporting (ICFR) effectiveness assessment, particularly where there are close calls in the assessment of whether a deficiency is a significant deficiency (and reported to the audit committee) or a material weakness (and reported also to investors).*" Additionally, we refer you to the December speeches delivered by **Emily Fitts** and **Tom Collens**, Professional Accounting Fellows within the SEC's Office of the Chief Accountant, related to evaluating the operating effectiveness of ICFR, material weaknesses, control deficiencies, and other pitfalls, which may serve as good reminders in the consideration of reliable financial reporting information. BDO continues to provide training on new accounting standards as well as ICFR considerations in a variety of media, including webinars and in-person training to our client audit committees and management teams.

As a further reminder, **SAB 74** requires filers to disclose the status of implementation of new accounting standards, among other quantitative and qualitative effects of adoption, as they become known. Regulators are following the evolution of such disclosures closely and expect companies to be making concerted efforts in this area.

The following summarizes effective dates of some of the significant new standards and related resources for audit committees to consider:

Standard	Effective Dates - For Public Companies	Effective Dates – For Private Entities	Recommended Resources
FASB ASU 2016-02, *Leases (Topic 842)*	Effective for fiscal years beginning after 12/15/18, including interim periods within those fiscal years. Early adoption is permitted. Specific transition requirements apply.	Effective for fiscal years beginning after 12/15/19, and interim periods within fiscal years beginning after 12/15/20. Early adoption is permitted. Specific transition requirements apply.	▶ BDO Flash Report: Definition of a Lease: What's In and Out of ASC 842 ▶ BDO Flash Report: Preparing for the Leases Accounting Standard: A Tool For Audit Committees ▶ BDO Knowledge Webinar: The New Leases Standard – Are You Ready? ▶ BDO Newsletter: Topic 842, Leases ▶ BDO Lease Accounting Services ▶ FASB Issues Targeted Improvements to Leases Standard ▶ FASB Issues Clarifications to Leases Standard
FASB ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*	For public business entities that are SEC filers, amendments are effective for fiscal years beginning after 12/15/19, including interim periods within those fiscal years. For all other public business entities, amendments are effective for fiscal years beginning after 12/15/20, including interim periods within those fiscal years.	Effective for fiscal years beginning after 12/15/21, including interim periods within those years.	▶ BDO Knowledge Webinar: Financial Instruments Update – Credit Losses and Recognition & Measurement ▶ BDO Flash Report: FASB Issues ASU on Credit Losses on Financial Instruments ▶ BDO Flash Report: FASB Updates Its Recent Credit Loss Standard

Standard	Effective Dates - For Public Companies	Effective Dates – For Private Entities	Recommended Resources
FASB ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Liabilities*	Effective for fiscal years, and interim periods within those fiscal years, beginning after 12/15/17. Certain provisions of the ASU are eligible for early adoption.	Effective for fiscal years beginning after 12/15/18, and interim periods within fiscal years beginning after 12/15/19 with early adoption permitted for fiscal years beginning after 12/15/17 including interim periods within those years. Certain provisions of the ASU are eligible for early adoption prior to 12/15/17.	▶ BDO Flash Report: FASB Issues Technical Corrections & Improvements to its Recent Financial Instruments Guidance ▶ BDO Knowledge Webinar: Financial Instruments Update – Credit Losses and Recognition & Measurement ▶ BDO Flash Report: FASB Issues Targeted Amendments to the Recognition and Measurement Guidance for Financial Instruments
FASB ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*	Effective for fiscal years, and interim periods within those fiscal years, beginning after 12/15/18, with early application permitted.	Effective for fiscal years beginning after 12/15/19, and interim periods beginning after 12/15/20. Early application is permitted in any interim period after issuance of the amendments for existing hedging relationships on the date of adoption.	▶ BDO Flash Report: FASB Issues Targeted Improvements to Hedge Accounting ▶ BDO Knowledge Webinar: Understanding the New Hedging Standard
FASB ASU 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*	The amendments must be adopted concurrently with the amendments in ASU 2017-12 and an entity should apply the amendments in this ASU on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption.	The amendments must be adopted concurrently with the amendments in ASU 2017-12 and an entity should apply the amendments in this ASU on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption.	▶ BDO Flash Report: FASB Expands List of Benchmark Interest Rates for Hedge Accounting

See BDO's 2018 Accounting Year in Review publication for a more in depth discussion of these and other newly released accounting guidance.

SEC 2019 Priorities

In December, SEC Chair Jay Clayton **outlined** where the SEC stands on its rulemaking agenda as well as its priorities for 2019. Certain of these priorities for audit committees to take note of include:

- **Improving the Proxy Process –** The SEC is looking at several initiatives including overhaul of "proxy plumbing" that considers how technology may be used to improve areas related to: (1) proxy solicitation and voting; (2) shareholder engagement through the shareholder proposal process; and (3) the role of proxy advisory firms. Specific actions include:
  - Reviewing ownership and resubmission thresholds for shareholder proposals and determining whether there are factors in addition to the amount of money invested and length of holding period that would reasonably demonstrate the shareholders' interests are aligned with those of long-term investors.
  - Proxy advisor reforms to provide greater clarity and transparency between proxy advisors and the investment advisors they serve; consideration of whether certain matters should be analyzed on a company-specific basis (rather than industry-specific), and a framework for addressing conflicts of interest and ensuring investor access to issuer responses to proxy advisory reports.
- **Cybersecurity –** This is being viewed by the SEC from several perspectives, including: (1) disclosures about material cybersecurity risks and incidents along with disclosure controls and procedures, and insider trading policies; (2) market oversight in reviewing companies' risk governance, access controls, data loss prevention, vendor management and training, etc.; (3) enforcement; (4) investor education on cybersecurity and cyber fraud "red flags"; and (5) emphasis on the SEC's own cyber-risk profile to "promote a culture that emphasizes the importance of data security throughout our divisions and offices."
- **Market Risks –** Potential effects of Brexit on U.S. investors and securities markets are not well understood and may be underestimated. Chair Clayton states, "*I would like to see companies providing more robust disclosure about how management is considering Brexit and the impact it may have on the company and its operations.*" Additionally, companies need to consider transition of LIBOR disclosures given that banks currently reporting information used to set LIBOR will stop doing so after 2021 when their commitment to reporting such information ends.
- **Distributed Ledger Technology, Digital Assets and Initial Coin Offerings (ICOs) –** The SEC is continuing 2018 efforts to enhance investor protection.

Other SEC Developments

VOLUNTARY DISCLOSURE OF NON-GAAP MEASURES AND KEY PERFORMANCE INDICATORS

We have reported frequently on the SEC's focus on non-GAAP measures and key performance indicator (KPI) reporting. In an **address** made in October 2018, former SEC Commissioner Kara Stein acknowledged the continued "explosive growth" of non-GAAP metrics being voluntarily disclosed by both public and private companies and expressed continued concern by the SEC that such measures lack uniform standards to govern them and make them comparable, which may result in presentations that are not fairly balanced or fairly presented.

Earlier this year, the SEC issued **two new Compliance & Disclosure Interpretations (C&DIs)** related to the disclosure of forecasts to others in connection with business combinations.

The National Law Review published an article **Audit Committees Bridging the GAAP**, which highlights the importance of the audit committee's oversight role "in bridging the gap between management and investors when providing non-GAAP financial information."

In March, a new tool was issued by the CAQ as a **Non-GAAP Roadmap for Audit Committees** to follow in their oversight of the financial reporting process. Key themes that emerged from a recent CAQ series of stakeholder discussions paved the way for the creation of this tool. Refer to BDO's summary **here**.


BDO
MARCH 2018
AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE
BDO FLASH REPORT
CORPORATE GOVERNANCE
SUBJECT
NON-GAAP MEASURES – A ROADMAP FOR AUDIT COMMITTEES
SUMMARY
DETAILS
CONTACT

Recently issued tools and resources audit committees may find helpful include:

- **SEC Compliance & Disclosure Interpretations**
- **BDO Flash: Non-GAAP Measures – A Roadmap For Audit Committees**
- **Audit Analytics Look at Top SEC Comment Letter Issues in 2017**
- **CAQ Questions on Non-GAAP Measures – A Tool for Audit Committees**

REQUEST FOR COMMENTS ON QUARTERLY REPORTING

In December, the SEC released a **Request for Comment** that solicits input on the nature, content, timing, and frequency of earnings releases and quarterly reports. The request follows a tweet made by President Trump in August, who directed the SEC to study the frequency of reporting and consider a semi-annual system. However, this is not the first time the SEC has considered the issue – public commentary had previously been requested within the SEC **Concept Release** on the business and financial disclosure requirements of Regulation S-K in April 2016.

Broadly speaking, this latest request seeks input on how the SEC might simplify the process associated with the release of quarterly earnings and reports while maintaining the investor protection benefits of disclosure. The SEC also seeks input on how the periodic reporting process, earnings releases, and earnings guidance affect corporate decision making and strategic decisions – i.e., does the process lead to an overemphasis on short-term thinking by registrants and other stakeholders? Refer to BDO's **alert** for further information.

Vital Role of Independent Audit Committees

SEC Chief Accountant Bricker delivered multiple addresses[1] throughout 2018 focused on the vital role of independent audit committees in the financial reporting process. Recurring themes, in addition to those discussed elsewhere in this publication, include:

- **Audit Committee Composition –** ensuring members have the time, commitment and experience to serve their respective companies. "Just possessing financial literacy may not be enough to understand the financial reporting requirements fully or to challenge senior management on major, complex decisions."
- **Audit Committee Effectiveness –** emphasizing the demand for an organizational and committee culture focused on integrity, ethics, and professional skepticism. This includes a properly balanced agenda toward understanding the accounting, ICFR, and reporting requirements.
- **Oversight of Management –** fully understanding business reasons for management's changes to policies and corrections of errors as well as compliance.
- **Oversight of Controls –** ensuring organizational and financial reporting controls are put into place to help achieve good business goals and are not to be viewed simply as a compliance exercise. For example: "Does the audit committee understand management's approach to attract, develop, and retain competent individuals who have responsibility for the design and operation of manual control activities, which are applicable when reasonable judgment and discretion is required, such as may arise in the application of the revenue recognition standard?"
- **Evaluation of Audit Committee Workload and Independence –** encouraging continual evaluation of the workload and independence of its members and ensuring they have access to and are leveraging experts, as necessary, as best practices.
- **Auditor Communications –** setting the appropriate tone with the auditors and leveraging clear and candid communications with the auditors, which may involve asking good and tough questions about:
  - the quality of management's financial reporting;
  - whether there are additional resources that the external auditor or management may require;
  - timeliness of information being received from management; and
  - if the audit were expanded – say by even 5% – what additional procedures would be applied by the auditor (e.g., within those marginal judgment areas that could perhaps be indicative of areas to be mindful of).
- **Audit Committee Voluntary Disclosures –** considering enhancing disclosures with respect to the oversight of the external auditor. Refer to additional information and tools elsewhere in this report.

Chief Accountant Bricker further recognized the increasing importance of the audit committee in the global environment and cited a **consultation report** issued by the International Organization of Securities Commissions (IOSCO) that proposes good practices for audit committees to consider.

For more on SEC developments, refer to BDO's **2018 SEC Year in Review** publication .

1 For purposes of this publication, BDO references speeches and discussions provided during the National Association of Corporate Directors (NACD) Global Board Leaders' Summit, the Association of Audit Committee Members, Inc. (AACMI) Annual Meeting, and the 2018 AICPA Conference on Current SEC and PCAOB Developments.

PCAOB Developments

The **leadership** of the PCAOB has undergone significant change in 2018, featuring an entirely new board and chair along with replacements or entirely new leadership positions in key areas, including: registration and inspections, international affairs, external affairs, internal oversight and performance, and other operational areas.

PCAOB FIVE YEAR STRATEGIC PLAN

With the new leadership came a new approach to developing the PCAOB's five-year strategic plan: namely, significant outreach that sought the perspectives of auditors, audit committees, and investors, while continuing to seek input from within. According to PCAOB board member Kathleen Hamm, the SEC had tasked the new board with assessing the PCAOB's activities and operations and determining a new strategic direction. The overall goal of the strategic plan is to drive continuous improvement in audit quality and improve communication with investors, audit committees, preparers, and other stakeholders, while transforming into a more "agile, innovative regulator."

PCAOB CORE VALUES:

In the 2018-2022 Strategic Plan, the PCAOB laid out five core values:

Integrity: We adhere to the highest standards of ethical and professional conduct. We engage internally and externally in a manner that is consistent, honest, and fair.

Excellence: We pursue excellence in all we do. We are committed to further developing the many talents of our people so that we can improve our oversight and operations.

Effectiveness: We manage our resources effectively and efficiently. We respond to a changing environment by implementing relevant, timely, and innovative solutions to achieve our mission.

Collaboration: We are dedicated to a culture of collaboration and inclusiveness, which we foster by encouraging openness, accessibility, trust, and respect. We embrace a diverse set of experiences, skills, perspectives, and backgrounds, which enriches our work and enhances the effectiveness of our efforts.

Accountability: We depend on the diligence and dedication of our people to accomplish our mission and implement our vision. We owe each other our very best effort and expect to be held accountable. We recognize and reward outstanding performance.

Images courtesy of ***PCAOB***

The five strategic goals highlighted in the PCAOB's strategic plan include:

1. Drive improvement in the quality of audit services through a combination of prevention, detection, deterrence, and remediation.
2. Anticipate and respond to the changing environment, including emerging technologies and related risks and opportunities.
3. Enhance transparency and accessibility through proactive stakeholder engagement.
4. Pursue operational excellence through efficient and effective use of our resources, information, and technology.
5. Develop, empower, and reward our people to achieve our shared goals.

You can access the PCAOB's strategic plan **here**.

PCAOB RECENTLY ISSUED AUDITING STANDARDS

Auditing Accounting Estimates, Including Fair Value Measurements

In December 2018, the PCAOB adopted a new auditing standard, *Auditing Accounting Estimates, Including Fair Value Measurements*, along with related amendments to the risk assessment standards, to enhance the requirements applicable to auditing accounting estimates, including fair value measurements. Once approved by the SEC, this standard will replace three existing auditing standards: AS 2501, *Auditing Accounting Estimates*, AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. The single standard also includes a special topics appendix that addresses auditing the fair value of financial instruments that are based on information from pricing services.

The adopted standard and related amendments strengthen existing requirements by:

- Prompting auditors to devote more attention to addressing potential management bias in accounting estimates, while emphasizing the importance of professional skepticism;
- Extending certain key requirements in the extant standard on auditing fair value measurements to all accounting estimates in significant accounts and disclosures, to reflect a uniform approach to substantive testing;
- Prompting auditors to focus on estimates with a greater risk of material misstatement;
- Updating other requirements for auditing accounting estimates to provide clarity and specificity; and
- Providing specific requirements to address certain unique aspects of auditing fair values of financial instruments, including the use of pricing information from third parties (e.g., pricing services and brokers or dealers).

Subject to approval by the SEC, the final standard and amendments will become effective for audits of financial statements for fiscal years ending on or after December 15, 2020.

The PCAOB release adopting the standard and related amendments can be accessed **here** and a fact sheet that summarizes the main provisions of the standard and related amendments can be accessed **here**.

Using the Work of Specialists

Also in December, the PCAOB adopted amendments to strengthen requirements regarding when auditors use the work of specialists in an audit. These amendments apply a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists, as well as strengthens requirements for evaluating the work of a company's specialist. The amendments, once approved by the SEC, will add a new appendix to AS 1105, *Audit Evidence*. The appendix will address using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards. AS 1201, *Supervision of the Audit Engagement*, will also be amended to add a new appendix on supervising the work of auditor-employed specialists. Further, the amendments will replace extant AS 1210, *Using the Work of a Specialist*, and retitle it to *Using the Work of an Auditor-Engaged Specialist*, to set forth requirements for using the work of auditor-engaged specialists.

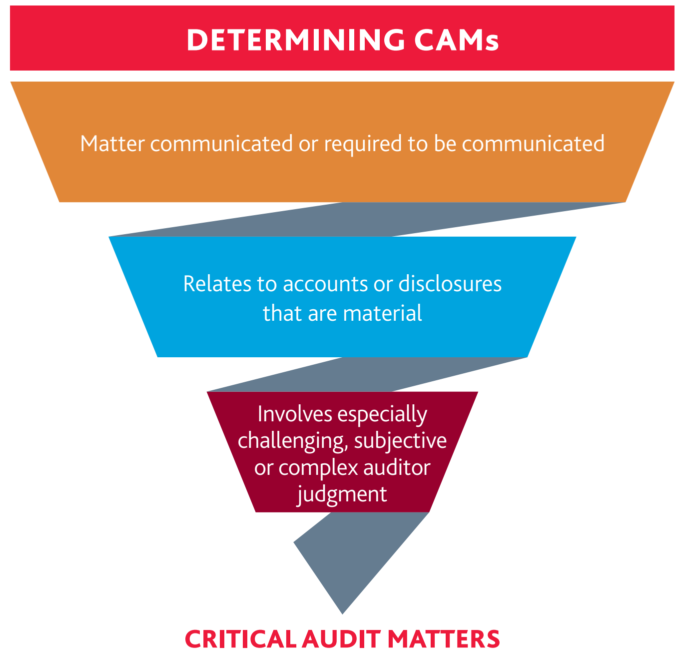
Subject to approval by the SEC, the amendments will become effective for audits of financial statements for fiscal years ending on or after December 15, 2020.

The amendments can be accessed **here** and a fact sheet that summarizes the main provisions of the amendments can be accessed **here**.

AUDITOR REPORTING MODEL - CRITICAL AUDIT MATTERS

In October 2017, the SEC approved the new PCAOB auditing standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. This is the first significant change to the U.S. auditor's report in over 70 years, and follows recent international reporting initiatives to provide transparency into the audit. As a reminder, the changes to the auditor's report are being rolled out in phases and are primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements, provide additional information about the audit, and make the auditor's report easier to read.

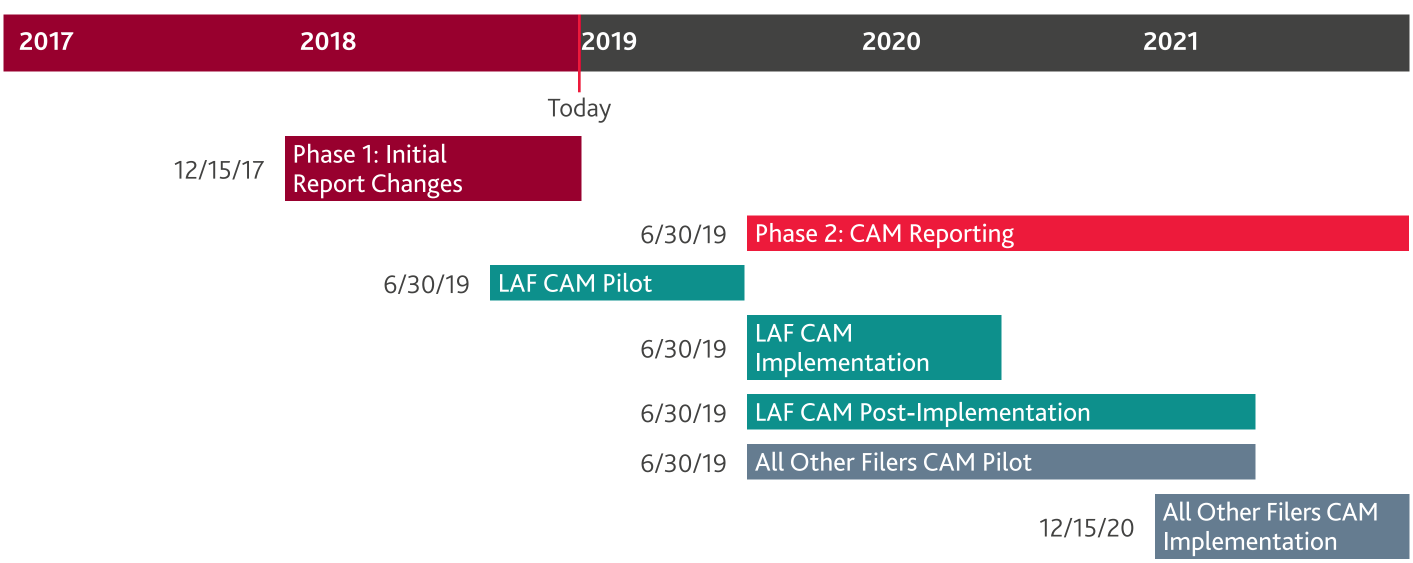
As reported previously, with the first phase of implementation relating to initial report changes of AS 3101 complete, auditors are now focused on the second and more significant phase of implementation: required communications regarding critical audit matters (CAMs). These become effective for audits of fiscal years ended on or after to the dates indicated as follows:



CAM IMPLEMENTATION AND REPORTING TIMELINE

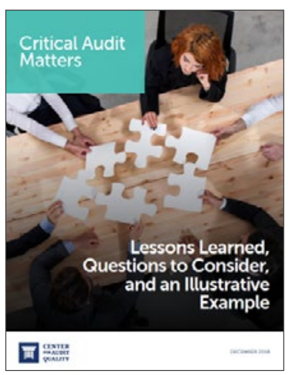
KEY:

- **Phase 1 –** Initial Report Changes effective for ALL filers: **12/15/2017**
- **Phase 2 –** Critical Audit Matters (CAM) Reporting effective for:
  - **Large Accelerated Filers (LAF): 6/30/2019**
  - **All Other Filers: 12/15/2020**



Earlier this year, the CAQ released a tool to assist users of financial statements in better understanding the identification and communication of CAMs. **Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Key Stakeholders** defines a CAM and gives an overview of how auditors will identify and determine whether a matter is a CAM. The U.S. is adopting the concept of including matters within the auditor's report with the benefit of the experience of expanded auditor reporting in other jurisdictions. The CAQ summarizes these past experiences from various international jurisdictions and compares their regulations to the PCAOB standard. Finally, the CAQ answers some frequently asked questions regarding the implementation.

Similar to other larger audit firms, BDO has begun conducting a CAM dry-run initiative in 2018 through early 2019 with our large accelerated filer clients. This initiative is designed to inform BDO and our clients in our development of best practices prior to the effective date of the standard. The purpose of the CAM dry runs is to allow auditors to apply the provisions of the standard and engage with management, audit committees, and regulators in advance of the effective date to ensure a successful implementation.



Observations (and questions) from these experiences to date were compiled by the CAQ, and shared within a second CAQ publication, **Critical Audit Matters: Lessons Learned, Questions to Consider, and an Illustrative Example**, in order to support those involved in upcoming formal implementation. The CAQ further highlights the following areas for possible discussion between auditors and audit committees:

- **Management Disclosures Outside Financial Statements.** Management disclosures outside the financial statements (e.g., MD&A) may relate to information in a CAM description; however, a CAM is defined as relating to an account or disclosure that is material to the financial statements.
- **Critical Accounting Estimates.** Critical accounting estimates disclosed by management are not necessarily a CAM. A CAM must involve especially challenging, subjective, or complex auditor judgment.
- **Significant Risks.** All significant risks must be communicated to the audit committee, but not all matters determined to be significant risks may involve especially challenging, subjective, or complex auditor judgment and therefore would not be reported in the audit report as a CAM.
- **Significant Deficiency.** Significant deficiencies, in and of themselves, cannot be a CAM, as no disclosure of the determination is required. However, a significant deficiency could be a principal consideration when determining whether the matter to which the deficiency relates is a CAM. Similarly, if a CAM discusses a control-related issue, it should not be assumed that there was a significant deficiency.
- **Matters More Likely to Be CAMs.** The more likely CAM are those areas involving high degrees of estimation uncertainty, such as: goodwill impairment, intangible asset impairment, business combinations, aspects of revenue recognition, income taxes, legal contingencies, and hard to value fair value financial instruments.
- **CAM Across an Industry Group.** CAM are specific to a particular audit. However, the matters that are CAMs may be relatively similar among companies in the same industry.
- **Relationship of CAM to Key Audit Matters (KAM).** KAM are based on International Standards on Auditing set by the International Auditing and Assurance Standards Board (IAASB) and, while the concepts are similar in many ways and have similar intent to provide users of auditors' reports with more audit-specific information, there are differences in the processes of identifying these matters, which may result in different communications.
- **Expectation of the Identification of at Least One CAM.** It is possible that an auditor will determine that there are no CAMs; however, the PCAOB has indicated that it expects that in most audits at least one CAM will be identified.
- **Process for Drafting CAM.** Auditors, management, and audit committee members should work together to establish a process for discussing CAM.
- **Company Preparation for Investors' Questions.** Audit committee members and management should seek to understand the auditor's responsibilities with respect to identifying and communicating CAM. Audit committees and management should further ask their auditors questions about the CAM to fully understand why those matters involved especially challenging, subjective, or complex auditor judgments.

The SEC has indicated their focus on the implementation activities related to CAM and have **expressly encouraged** auditors and registrants to:

- Conduct (or participate in) a dry run this year, especially for those engagements that will be adopting the CAM requirements in 2019 – practice builds confidence and improves results. These dry runs are occurring with constructive dialogue among auditors and audit committees about the value of starting the conversation early in the audit cycle, keeping the discussion current for changes and close calls throughout the year, and building into the plan how and to whom a draft of the report will be provided in advance of completing the audit. This dialogue should help prevent mistakes in reports prepared for investors next year.
- Share implementation questions and other observations with the PCAOB staff and the SEC. Information sharing allows the PCAOB to consider whether any additional communications or guidance is needed and contributes to a post-implementation review the PCAOB is undertaking.
- Understand similarities and differences in various disclosure requirements and standards. For example, management is required to provide disclosures of critical accounting estimates in MD&A – accounting estimates and assumptions that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. CAMs are not designed to duplicate management's disclosures.

Recently issued tools and resources audit committees may find helpful include:

- **CAQ's Critical Audit Matters Lessons Learned, Questions to Consider, and an Illustrative Example**
- **CAQ Issues "Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Stakeholders"**
- **PCAOB Webinar: New Auditor's Report – Overview of Changes Effective in 2017**
- **PCAOB Staff Guidance on "Changes to the Auditor's Report"**
- **CAQ Tool: The Auditor's Report: Considerations for Audit Committees**
- **BDO: The Future of Audit Reporting is Here**
- **PCAOB AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

PCAOB AUDITOR INSPECTIONS OUTLOOK FOR 2019

Early in December 2018, the PCAOB issued an **Outlook** on its objectives and potential focus areas for planned 2019 inspections of audits of issuers and brokers and dealers. This Outlook outlines ongoing inspections transformation efforts and provides an overview of various areas of inspection focus for 2019 to be aware of in consideration of ever enhancing audit quality initiatives to bolster the capital markets. We encourage audit committees to review BDO's **alert**, which summarizes the PCAOB's intended activities and provides insights with regard to additional resources and how BDO anticipates the PCAOB's approach will impact our audits and our own focus on the execution of audit quality.

The PCAOB has placed significant emphasis on driving inspection finding rates down through cultivation of strong preventative controls within firms' systems of quality controls. As such, the 2019 inspection process will include the PCAOB's consideration of topics such as the procedures inspection teams perform on the review of specific audit engagements and a deeper focus on audit firm systems of quality control, the approach to selecting engagements for inspection and areas of inspection focus, and how and what the PCAOB communicates about such inspections. The PCAOB is further considering how to make the process forward-looking and how to more effectively consider evolving risks, environmental factors, and the changing needs of stakeholders. Many of these projects are noted as being long-term in nature, with the expectation that certain other projects are to have an effect on the 2019 inspections cycle.

The PCAOB has indicated the following potential areas of focus for inspections performed in 2019 and are each explored further in BDO's **alert**:

- Audit Firms' Systems of Quality Control
- Independence
- Recurring Inspection Deficiencies
- External Considerations
- Cybersecurity Risks
- Software Audit Tools
- Digital Assets
- Audit Quality Indicators
- Changes in the Auditor's Report
- Implementation of New Accounting Standards

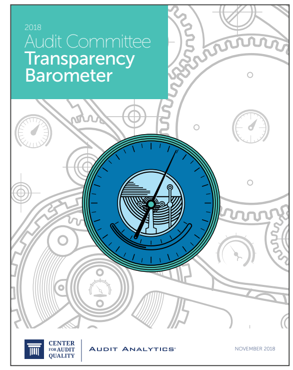
George Botic, recently appointed PCAOB Director, Division of Registration and Inspections, gave a **speech** highlighting how the PCAOB is intent on protecting investors through change and the means of taking a "clean sheet" approach with respect to the inspection process. He spoke specifically on how the inspections teams were being transformed and additional leadership positions created to oversee inspection activities. One of the items addressed was the PCAOB's intention to increase the level of engagement with audit committee chairs to provide insight into the inspection process and gather views of the audit committees. Additionally, commencing in 2019, the PCAOB plans to share publicly practices it identifies that are being employed by audit firms that promote or enhance the quality of audits. The PCAOB further intends to change both how it reports inspection results and ensures timeliness of such communications.

In November, as part of the PCAOB's focus on changes to quality control standards for audit firms, the PCAOB's Standing Advisory Group (SAG) was asked for input with respect to how development of principles-based standards should consider audit firm governance and leadership responsibilities toward audit quality. Specifically, SAG members were asked about matters including: culture, organization, assignment of authority and responsibilities, and accountability and incentives.

We encourage audit committees to read both Director Botic's speech along with the PCAOB's 2019 Inspection Outlook, as well as reference **SAG Meeting information**, and discuss with your audit engagement teams.

Enhancing Voluntary Audit Committee and Auditor Communications

AUDIT COMMITTEE COMMUNICATIONS



In November, BDO issued the *Voluntary Audit Committee Disclosures Continue to Evolve* alert, highlighting a variety of resources including the CAQ's and Audit Analytics' annual *Audit Committee Transparency Barometer* along with certain BDO insights. In brief, the Barometer indicates that public companies of all sizes continue to expand voluntary audit committee disclosures within their proxy statements to provide stakeholders with further insight into the oversight responsibilities, particularly with regard to the external auditor and the audit process.

Categories of disclosure considered within the report include:

- audit firm selection and ratification;
- length of audit firm engagement;
- audit firm compensation;
- audit firm evaluation and supervision; and
- audit engagement partner selection.

Key findings shared and comparatives from prior years, include :

40%
S&P 500 companies disclose considerations in appointing the audit firm

(Figure 1)
+3% from 2017
+27% from 2014

- S&P MidCap: 27%
- S&P SmallCap: 19%

70%
S&P 500 companies disclose length of audit firm engagement

(Figure 2)
+7% from 2017
+23% from 2014

- S&P MidCap: 52%
- S&P SmallCap: 51%

28%
S&P 500 companies provide explanation of a change in fees paid to the audit firm

(Figure 4)
-3% from 2017
+0% from 2014

- S&P MidCap: 26%
- S&P SmallCap: 30%

46%
S&P 500 companies discuss criteria considered when evaluating the audit firm

(Figure 5)
+8% from 2017
+38% from 2014

- S&P MidCap: 36%
- S&P SmallCap: 32%

52%
S&P 500 companies state that audit committee is involved in audit partner selection

(Figure 7)
+3% from 2017
+39% from 2014

- S&P MidCap: 20%
- S&P SmallCap: 10%

Refer previously to SEC public acknowledgment of positive trends associated with noted voluntary audit committee disclosures. We continue to educate our audit committee member contacts about developments in this area. We further encourage audit committees to reference available tools as they annually assess their public disclosures within their respective proxy statements.

AUDITOR COMMUNICATIONS: AUDIT QUALITY DISCLOSURE FRAMEWORK

The CAQ has released the ***Audit Quality Disclosure Framework*** to assist audit firms in their ongoing efforts to determine, assess, and communicate information that may be useful to stakeholders in understanding how audit quality is supported and monitored at the firm level. This initiative has been a collaborative effort with the audit profession, inclusive of BDO, to foster transparency and continue to build upon the bedrock of investor confidence in capital markets. The development of the framework continues prior work spearheaded by the CAQ related to audit quality indicators (AQIs) and the resulting framework centers around six elements of audit quality that are further enhanced by points of focus:

1. Leadership, culture, and firm governance
2. Ethics and independence
3. Acceptance and continuance of clients and engagements
4. Engagement team management
5. Audit engagement performance
6. Monitoring

The framework is intentionally voluntary and principles-based and not prescriptive, but rather supportive of the development of and discussion around robust metrics that can help stakeholders in better understanding how an audit firm seeks to manage risks to audit quality. The framework relates to disclosure of a system of quality control at the firm level and also includes an exhibit of example firm-level AQIs and other qualitative information.

Many public company auditing firms describe publicly how they promote audit quality via annual mandated transparency reports and/or via voluntary audit quality reports. BDO has previously embraced elements of this new framework within our own **2018 Audit Quality Report**, and looks forward to further incorporating the framework more comprehensively into our anticipated 2019 Audit Quality Report to be released later this year.

Tax Reform and Tax Liability Considerations

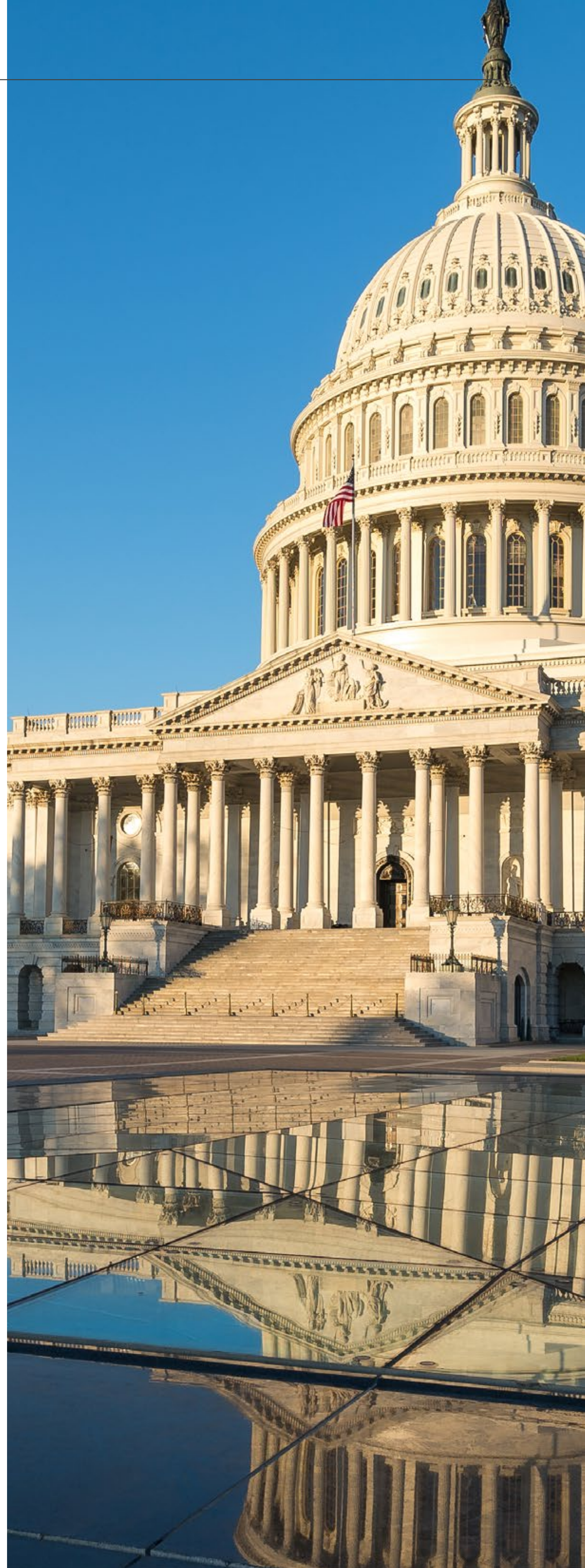
December 22, 2018 marked one year since enactment of the biggest tax reform legislation in 26 years. The impact will continue to be felt for many individuals and businesses during year-end planning season. BDO's **2018 Year-End Tax Planning Letter** helps to prepare businesses of all sizes and across all industries in dealing with the impact of the monumental changes to the federal tax code. We have provided links to additional detailed resources below for your reference.

Because the "2017 Tax Cuts and Jobs Act" (the Act) was enacted before December 31, 2017, companies were required to include the tax effects of reform in their financial statements for the period through December 31, 2017. Throughout 2018, companies were required to continue to true-up provisional amounts originally recorded relating to the enactment period tax effects. In addition, companies have had to also focus their attention on other provisions of the Act that became effective on January 1, 2018.

SEC STAFF ACCOUNTING BULLETIN (SAB) 118

As a reminder, at the same time the Act was enacted, the SEC issued Staff Accounting Bulletin (SAB) 118 to provide some temporary transition relief to companies. If elected, SAB 118 provided registrants up to 12 months from the enactment date (e.g., December 2017 to December 2018 for calendar year entities) to complete the accounting for some or all of the income tax effects of the provisions that were enacted and effective before January 1, 2018 (e.g., transition tax and deferred remeasurement).

During the 2018 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff remarked that the issuance of SAB 118 in December 2017 enabled registrants to present useful estimates to investors as soon as possible, while also allowing them the time to fully understand the Act. The staff also reaffirmed that the effects of the Act must be finalized by the end of the measurement period on December 22, 2018. Registrants should follow the guidance in ASC 740 for any adjustments after that date.



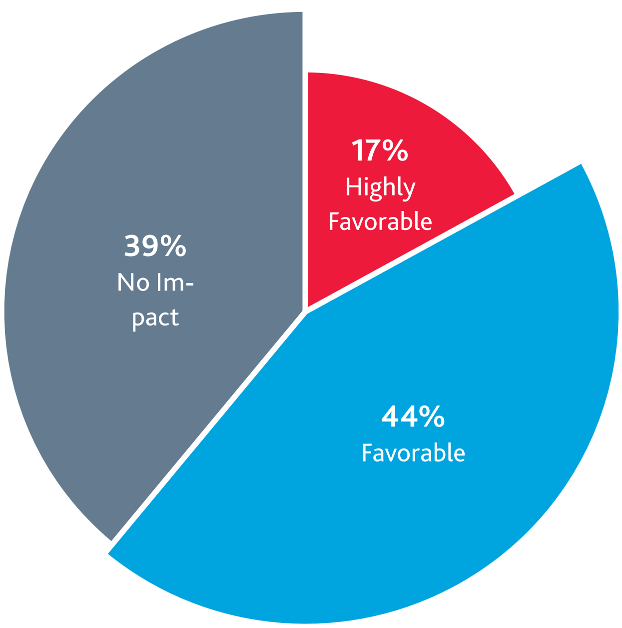
Given the significance of tax reform, it has become evident that in order for boards to work effectively, understanding tax changes and their impacts is essential. However, based on the opinions and insights of 140 public company corporate directors, the [2018 BDO Board Survey] indicates that less than half of the directors had a strong understanding of the legislation.

Additionally, while there are some exceptions, the impact of the Act was largely favorable to the business world. And yet, our survey findings of more than a third (39 percent) of public company board directors say the tax law changes had no impact at all on their business.

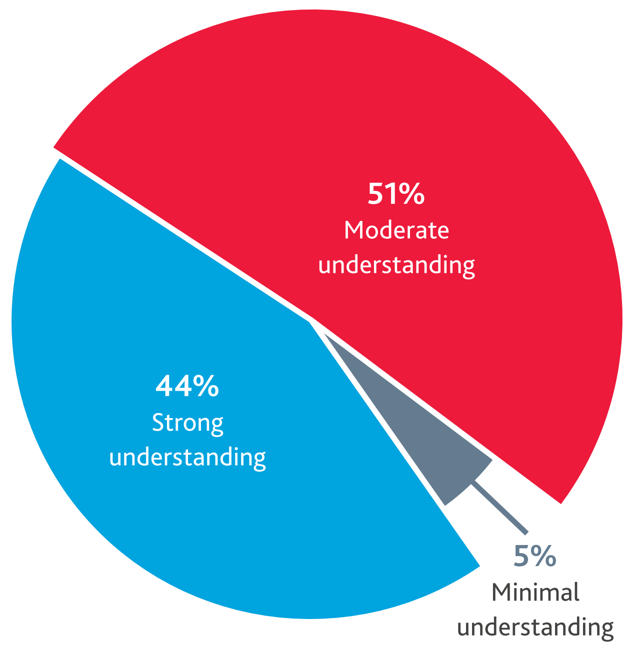
That is in contrast to the optimism shown [last year], when an overwhelming majority (94 percent) of public company board members anticipated federal tax reform would have a favorable effect. There clearly is a significant opportunity here for further education of directors, including the audit committee, to ensure that taxation considerations impacting business strategy and financial accounting and reporting are well understood and being considered as part of governance oversight.

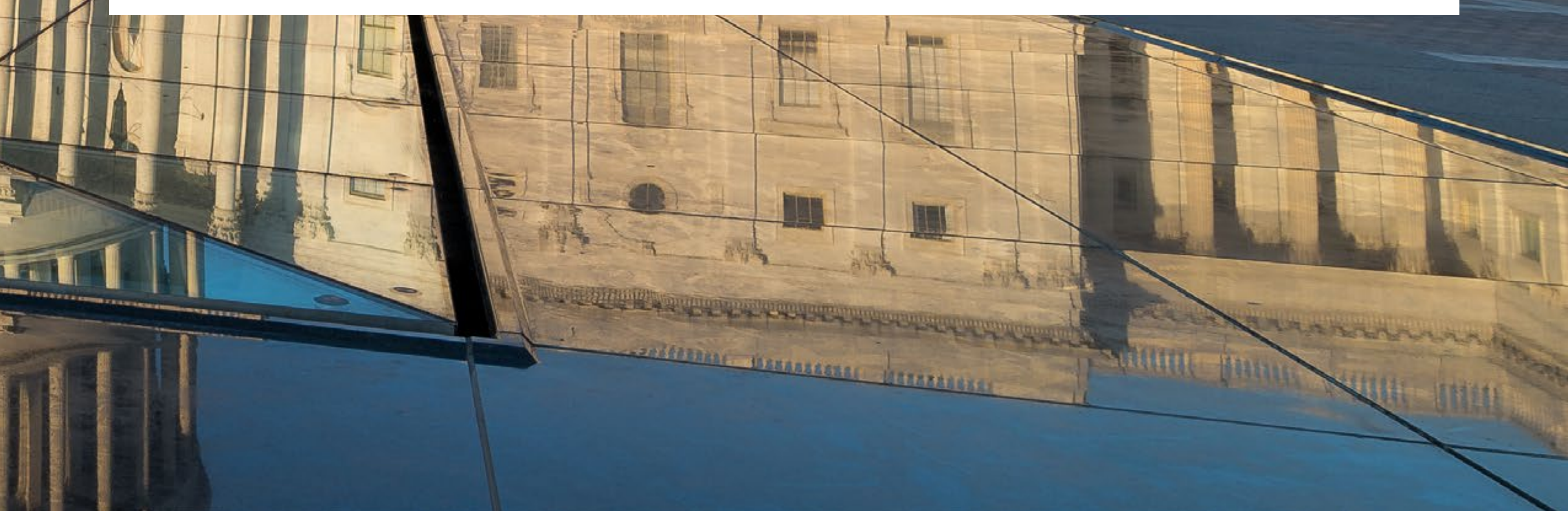
Source: BDO 2018 Board Governance Survey

What impact has the new U.S. tax law had on your business?



What level of understanding do you have of the total tax liability of your business and its impact on your corporate tax strategy?





The following are reminders, included within our prior 2017 Audit Committee in Focus publication, that remain relevant for companies to discuss with their management teams, auditors, and tax advisors as they wrap up their year-end reporting:

Certain Corporate Tax Reform Changes and Tax Accounting Complexities

- **SEC Staff Accounting Bulletin (SAB) 118 –** If elected, SAB 118 provided registrants up to 12 months from the enactment date (e.g., December 2017 to December 2018 for calendar year entities) to complete the accounting for some or all of the income tax effects of the provisions that were enacted and effective before January 1, 2018 (e.g., transition tax and deferred remeasurement).

- **Introduction of annual NOL deduction limitation –** This may be particularly challenging for companies with volatile earnings, as the elimination of the carryback and restriction on use of NOLs could present a significant cash flow obstacle. Additionally, a new annual limitation on NOL utilization could result in more complexity regarding valuation allowance considerations under ASC 740.

- **Introduction of annual interest expense deduction limitation –** The new annual limitation on interest deduction will introduce complexity into the determination of interest deductibility. This may be particularly challenging for companies that highly leverage both related and unrelated party debt arrangements, as the restrictions on interest expense deduction could result in significant increases to taxable income. Additionally, the new indefinite carryforward period of disallowed interest expense could present more complexity regarding valuation allowance considerations under ASC 740.

- **Introduction of annual executive compensation deduction limitation –** The new annual limitation on the allowable executive compensation deduction introduced new complexity into the determination of the deduction. This may be particularly challenging for companies who had commissions and performance-based compensation included in their executive compensation arrangements, as the new provision removes the exceptions on those arrangements. Additionally, the executive compensation deduction limitation could present new complexity to the measurement of deferred tax assets under ASC 740.

- **Repeal of the alternative minimum tax (AMT) –** AMT for corporations has been repealed and companies with AMT credit carryforwards need to consider the balance sheet implications of the recoverability of the AMT credits previously recorded.

- **Introduction of a Territorial Tax System & Transition Tax –** This portion of the tax legislation has moved the U.S. toward an international system in which income earned in other countries would generally not be subject to U.S. taxation with the exception of certain foreign income subject to U.S. anti-deferral rules and new anti-base erosion rules. However, accumulated foreign earnings of U.S. shareholders of specified foreign corporations was subject to a one-time transition tax in 2017. This transition tax could be paid over a period of 8 years at specified increasing rates or paid in one lump sum. NOL and foreign tax credit (FTC) carryforwards can be used to offset the transition tax liability.

- **Introduction of Global Intangible Low-Taxed Income (GILTI) tax –** A provision that provides a new Subpart F regime as companies that own a Controlled Foreign Corporation (CFC) will have to include in taxable income their share of the CFC's GILTI. The GILTI inclusion is determined by taking the non-Subpart F net income of the CFC in excess of 10% return on depreciable tangible assets.

- **Introduction of Deduction for Foreign-Derived Intangible Income (FDII) –** A provision that provides U.S. corporations that generate gross receipts from sales of goods or services to any person who is not a U.S. person and is for foreign use only (i.e., U.S. export sales) a permanent tax deduction and benefit on their effective tax rate.

- **Introduction of Base Erosion and Anti-abuse Tax (BEAT) –** A provision that provides a new additional tax on certain payments made by a domestic corporation to a foreign related party. This may be particularly challenging for companies that have U.S. effectively connected gross receipts of at least $500 million and foreign based deductions in excess of three percent of their total deductions.

Tax Reform: Internal Controls and Audit Considerations

- The internal control framework and environment within an organization has been affected by U.S. tax reform. New controls or revisions to existing controls might have to be designed and implemented. Auditors will need to evaluate the design of these controls and when applicable, test the operating effectiveness of such controls. If management intends to use certain permissible estimates within their calculations, it should be clear how the estimates were developed, the contradictory information that was considered, and how management challenged the estimate. If estimates are used for the initial assessment of certain provisions, those estimates will need to be adjusted with actual balances in the subsequent period.

  As a reminder, auditing standards require an assessment of the overall risk of material misstatement to plan and perform an effective audit. Tax reform legislation has resulted in additional audit risk considerations for the majority of preparers and their external auditors. Preparers should continue to expect targeted audit procedures to address these additional risks and provide audit evidence necessary to support reported amounts. This will include providing detailed calculations and documentation. Early discussion and sharing of information with external auditors concerning the underlying accounting impact in advance of management's final assessment is a best practice.

Income Tax Disclosures Should Not Be Overlooked

- **Financial Statements –** Financial statement tax footnote disclosures are expected to provide sufficient information on the impact of tax reform. Significant components of income tax expense from continuing operations, including the effect of a tax law and tax rate changes, are required disclosures. These disclosures would also include the effect of valuation allowance due to tax reform enactment. For many public companies, the income tax footnote's effective tax rate disclosure, which reconciles statutory rate to effective rate, would have a reconciling item or items for the cumulative effect of the tax reform enactment. The various balance-sheet related disclosures of the inventory of deferred taxes, NOL and credit carryforwards, and uncertain tax benefit liabilities could also be affected.

- **MD&A -** Registrants are cautioned to consider the impact of tax reform measures within their MD&A, specifically as it relates to liquidity, the results of operations, and critical accounting estimates. A discussion is required of known trends, commitments, events, or uncertainties associated with Tax Reform that are reasonably likely to result in liquidity increasing or decreasing in any material way, on both a short-term and a long-term basis. A registrant with significant foreign earnings must consider the impact of the one-time transition tax, including any changes to its contractual obligations table if the liability is to be paid in annual installments. Furthermore, the ongoing effects of other changes (e.g., the reduced corporate tax rate, among others) should be discussed.

- A discussion of the impact of the Tax Reform on the results of operations should include (i) a one-time impact of the change in the corporate tax rate on deferred tax assets and liabilities (DTAs and DTLs), (ii) the one-time transition tax if the registrant has material foreign operations, and (iii) the ongoing impact of the reduced corporate tax rate. The first two items above should be consistent with amounts reflected in the effective rate reconciliation in the footnotes to the financial statements. A discussion will need to be updated to address the material uncertainties associated with the estimates made within the tax provision, including a discussion surrounding the estimate of the one-time transition tax if the registrant has material foreign operations and there are significant uncertainties around the amount reflected in the financial statements.

- **Other SEC rules -** Additionally, registrants will need to consider the income tax disclosures required under Regulation S-X, Rule 4-08(h), including disclosure of the amounts of income tax expense (benefit) applicable to United States Federal income taxes, foreign income taxes, and each other major component of income taxes as well as a reconciliation between the amount of reported income tax expense (benefit) and the amount computed by multiplying the income (loss) before tax by the applicable statutory Federal income tax rate including detail of the underlying causes for the difference in the two amounts.

Major business decisions often hinge on the tax implications, while seemingly small changes in approach can come with significant tax consequences. As domestic and global tax dynamics continue to shift and grow in complexity, boards and audit committees are encouraged to seek out informed strategic advisors both internally and externally that will help keep those charged with governance forward-thinking with respect to tax planning in their business decisions.

As companies look to assess their tax planning strategies for year-end 2018 and beyond, audit committees and their management teams are invited to remain abreast on breaking developments with respect to income taxes through the following:

Recommended Resources

- BDO Knows Tax Reform Resources Page*
- The Business Impacts of Wayfair*
- Tax Transformation Maturity Continuum
- BDO's 2018 Year-End Tax Planning
- BDO Board Survey: Lessons for Tax Executives
- The GILTI Effect: Tax Reform and Global Intangible Low-Taxed Income
- Tax Reform Deduction: What Foreign-Derived Intangible Income Means to C-Corporations
- BDO Archived Webinar: Planning for Tax Reform
- BDO Archived Webinar: Tax Reform and the Board's Role
- 2017 Year End Tax Planning for Businesses
- SEC Staff Provides Regulatory Guidance for Accounting Impacts of the Tax Cuts and Jobs Act
- SEC SAB 118
- SEC C&DI 110.02

* Timely tax reform resources continue to be added regularly.

Wayfair Decision

On June 21, 2018, the U.S. Supreme Court issued its widely anticipated decision in *South Dakota v. Wayfair*, Doc. No. 17-494. The Court held that states may require a business to collect and remit sales and use taxes even if the business has no in-state physical presence. The Wayfair decision means that states are now free to subject businesses to state taxes based on an "economic" presence within their state. Overnight, remote sellers, licensors of software, and other businesses that provide services or deliver their products to customers from an out-of-state location may have to start complying with state and local taxes. The Wayfair decision also supports states that subject out-of-state businesses to income taxes based on economic "factor-presence" nexus statutes that some states have enacted in recent years.

CERTAIN TAX ACCOUNTING COMPLEXITIES

- **ASC 450 Implications –** The Wayfair decision will impact the accounting for sales and use tax contingent liabilities.
- **ASC 740 Implications –** Under ASC 740, existing income tax positions must be reassessed at each balance sheet date to determine whether an income tax benefit should be recognized, or continue to be recognized, and if so, how much of the benefit should be recognized based on new information. Depending on a corporation's specific facts, an analysis should be performed so that existing state income tax positions after Wayfair are reassessed during the financial statement period that includes the June 21st court decision. Given that a company may have taken a historic position in reliance on constitutional arguments that a physical presence was required before a state may impose an income tax, this position will now need to be re-evaluated in light of Wayfair.

INTERNAL CONTROLS AND AUDIT CONSIDERATIONS

- The internal control framework and environment within an organization will also be affected by Wayfair. New controls or revisions to existing controls might have to be designed and implemented. Auditors will need to evaluate the design of these controls and when applicable, test the operating effectiveness of such controls. If management intends to use certain permissible estimates within their calculations, it should be clear how the estimates were developed, the contradictory information that was considered, and how management challenged the estimate. If estimates are used for the initial assessment of certain provisions, those estimates will need to be adjusted with actual balances in the subsequent period.

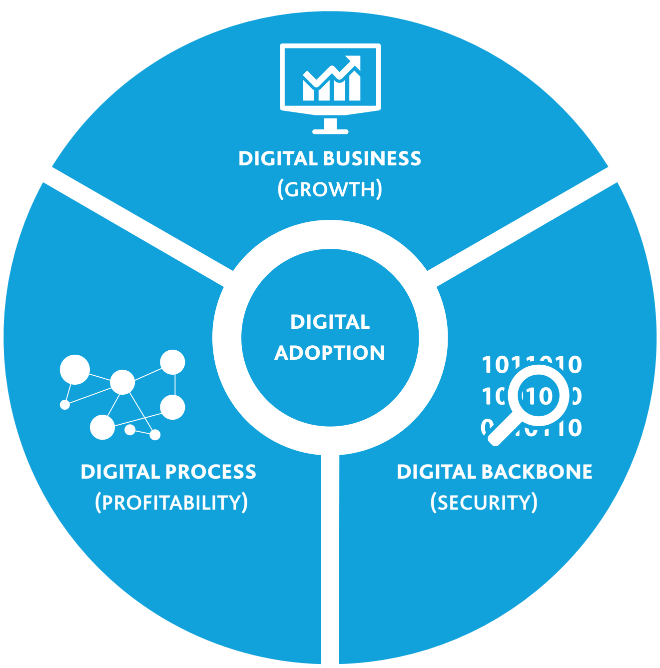
  As a reminder, auditing standards require an assessment of the overall risk of material misstatement to plan and perform an effective audit. The Wayfair decision will likely result in additional audit risk considerations for all preparers and their external auditors. Preparers should expect targeted audit procedures to address these additional risks and provide audit evidence necessary to support reported amounts. This will include providing detailed calculations and documentation. Early discussion and sharing of information with external auditors concerning the underlying accounting impact in advance of management's final assessment will help prevent last minute audit surprises.

Please visit **BDO Knows the Business Impacts of Wayfair** for all the latest resources including BDO thought leadership, industry implications, webinars, and live events along with Economic Nexus Standards by state.

Digital Disruption and Transformation

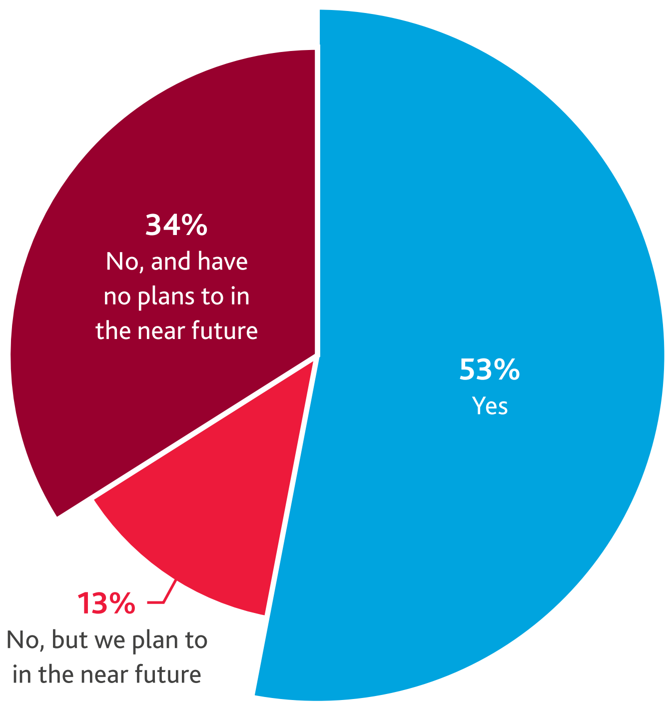
Disruption is inescapable. Every aspect of business—from the way we work, to where we work, to the work we do—is fundamentally different than it was as little as five years ago. To put it into perspective: In 2013, the Apple Watch was still in production and Uber had just launched the first drive-for hire service using nonprofessional drivers and their personal vehicles. Another five years into the future may feel like a different lifetime. True disruption—the kind that marks lasting paradigm shifts in the predominant way things are done—is more than a technology story. It's a virtuous circle in which technology innovation spawns changes in market and competitive dynamics, and vice versa. To stay on the right side of disruption, businesses need to anticipate the signals and adapt and reinvent themselves before disruption upends them. Disruption can be turned from threat to opportunity, but only with a combination of foresight and focus. This means establishing a digital strategy that balances the long-term vision with realistic short-term goals.

Digital transformation can be boiled down to three foundational areas of future value creation: **Digital Business**, **Digital Process**, and **Digital Backbone**.



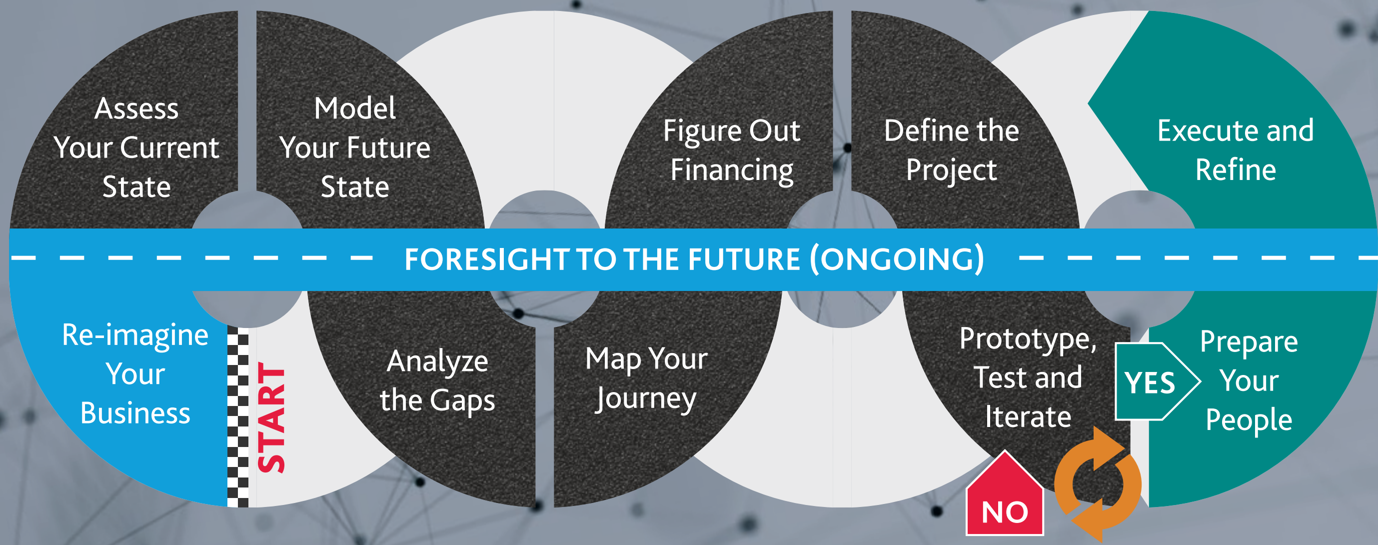
BDO's annual board survey revealed that a significant number (47%) of public company board members indicated that their organizations did not currently have a digital transformation strategy.

Does your organization have a digital transformation strategy in place?



With or without a strategy, it is important for audit committees to understand the transformational landscape and be asking questions to ensure their companies are keeping up.

THE 10-STEP GUIDE TO DIGITAL TRANSFORMATION



BDO regularly produces resources to keep those charged with governance, particularly for small- and mid-sized companies, informed about the latest developments that may impact their business, including The Digital Transformation Playbook for the Middle Market and Digital Transformation: The Middle Market Goes "Back to the Future" on how middle market organizations are re-imagining business and operations for the future digital economy. In November, BDO teamed with the National Association of Corporate Directors (NACD) and several highly experienced directors to present a webinar on Digital Transformation Strategy Oversight for Small-Cap Boards.

Additionally, a new resource from the CAQ, Emerging Technologies: An Oversight Tool for Audit Committees, provides a framework and questions audit committees may ask management and auditors to help inform their oversight of financial reporting as emerging technologies take hold.

Recently issued tools and resources audit committees may find helpful include:

- CAQ Tool Emerging Technologies: An Oversight Tool for Audit Committees
- The Digital Transformation Playbook for the Middle Market
- Archived Webinar: Digital Transformation Strategy Oversight for Small-Cap Boards
- The Middle Market Goes "Back to the Future" A Digital Transformation Journey
- 2018 Cyber Governance Survey

Cybersecurity Preparedness

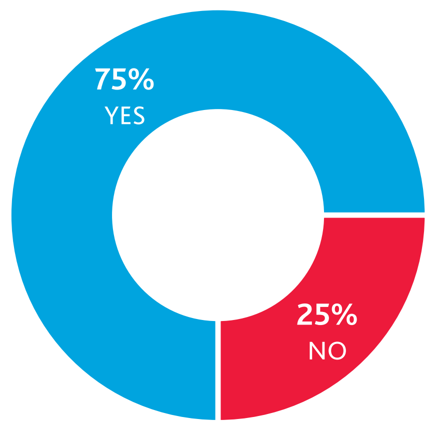
Cybersecurity continues to be at the forefront of boards' concerns. For all the doors digital innovation opens, it also invites a host of new threats in the form of increasingly sophisticated cyberattacks, such as zero-day exploits against software flaws, botnets capable of creating IoT "armies" to overwhelm servers, and "cryptojacking," or the malicious mining of cryptocurrency by breaching systems and siphoning computing power. Hackers are not just stealing data; they are messing with democratic processes, releasing volumes of classified data, and threatening to bring organizations to a standstill. And as the cyber threat environment evolves, organizations will need to evolve their cybersecurity and data privacy programs, with significant oversight from the board.

Our **2018 BDO Cyber Governance Survey** indicated that while nearly eight-in-ten (79 percent) directors claim they have avoided a data breach or incident in the past two years, public company boards are becoming more involved in cyber oversight, with 72 percent of board members saying the board is more involved with cybersecurity now than they were 12 months ago.

With boards increasingly more involved in discussions around cybersecurity, especially due to regulatory changes and the potential for reputational damage, the cadence of reporting on cybersecurity is increasing, with nearly one-third (32 percent) of board members saying they are briefed at least quarterly on cybersecurity, while 54 percent are briefed at least annually. However, nine percent of boards indicate that they are not being briefed on cybersecurity at all. During the initial four years BDO conducted this survey, the percentage of directors reporting no cybersecurity briefings dropped consistently, and during the past year, that number has held steady. We strongly encourage all boards to reflect on potential cybersecurity risks and work with their management teams to foster communications in this area.

In terms of capital investments, three-quarters (75 percent) of directors say their organization has increased its investment in cybersecurity during the past 12 months. This is the fifth consecutive year that board members have reported increases in time and dollars devoted to cybersecurity.

Has your company increased its investment in cybersecurity during the past 12 months?



At a recent PCAOB Standing Advisory Group (SAG) **meeting**, Bill Powers, the PCAOB's Deputy Director of Technology, indicated that cybersecurity is a focus of the PCAOB Board, and that it is working with audit firms to understand activities being undertaken by companies to protect data against cyber-attacks. He further noted that this year's PCAOB inspections program would be expanded to focus on what audit firms are doing to protect the client data that they retain. The staff will be reviewing cyber strategies, governance polices in place to oversee and manage such strategies, how companies identify and prioritize risks, and the establishment and monitoring of related controls.

The PCAOB is also gathering information about how companies respond to cyber incidents and how they establish, maintain, and conduct timely communications both internally and externally. Additionally, the Board will be focused on what companies have done, or will do, to recover from cyber incidents.

A tool issued by the CAQ aims to assist board members in their oversight of data security and cybersecurity risks and disclosures by providing key questions board members can use in their discussions with management and auditors. The tool further provides key resources from leaders in the area of cybersecurity. The goal of this tool is two-fold. First, it is intended to better educate board members and others charged with governance and provide discussion starters for them to properly evaluate their cyber risks. Second, it is meant to be a tool for their auditors to help them assess how actively involved the board members and others charged with governance are in assessing these risks.

Recently issued tools and resources audit committees may find helpful include:

- BDO Webinar: What's on the Minds of Boards? – BDO 2018 Cyber Governance Survey
- BDO Webinar: 2018 BDO Cyber Governance Survey
- BDO Webinar: Cybersecurity – Resources Boards Want to Know About
- CAQ's Cybersecurity Risk Management Oversight : A Tool for Board Members
- SEC Commission Statement and Guidance on Public Company Cybersecurity Disclosures

Data Governance and Global Data Privacy Regulation

In recent years, the explosion of data has created new, unprecedented business challenges, including increased risk and cost. Regulations are driving more stringent information governance requirements. Central to navigating these regulations is the ability for an organization to understand where its data resides, how it's managed, who can access it, and how it can be defensibly destroyed.

GDPR

The **European Union's General Data Protection Regulation (GDPR)**, which went into effect on May 25, 2018, is the most significant overhaul to the EU's data privacy policies in over 20 years. Our BDO cyber governance survey revealed that more than two-thirds (69 percent) of board directors said their company is not impacted by the GDPR. However, chances are, many of them may be wrong. More muted impact among corporate directors may reflect lack of awareness or misunderstanding that still underlies many aspects of this new regulation. Any U.S. company that deals with the personal data of EU citizens and residents could be subject to the GDPR's stringent requirements, even if the company does not operate in any of the 28 EU member states.

Among respondents who say they are impacted, 78 percent report their organizations have conducted a GDPR gap assessment; another 78 percent have implemented or updated privacy notices; and 43 percent have updated their breach notification policies. Just under a third (32 percent) report increasing data privacy budgets, while about one-third (32 percent) have appointed a Data Protection Officer, a requirement under the GDPR for organizations that engage in certain types of data processing activities.

The GDPR compliance journey is just beginning, as prudent and responsible data privacy governance goes beyond checking the box on implementation day. Data privacy governance is an ongoing process and a commitment to safeguarding personal data and other sensitive data that your organization collects, processes, transfers, or stores. The GDPR is designed with the evolving nature of data privacy in mind, and how it is monitored and enforced will change over time.

CALIFORNIA CONSUMER PRIVACY ACT

Data privacy regulation is also still evolving. The passage of the ***California Consumer Privacy Act***, which goes into effect on January 1, 2020, is the first of what will likely be many new, more stringent rules governing data privacy at the state level. This privacy law contains a broader definition of personal data, establishes broad rights for California residents to direct deletion of data, establishes broad rights to access personal data without certain exceptions, and requires that organizations give consumers the right to know how their data is used and why it is being collected.

DATA GOVERNANCE: SPOTLIGHT ON CHINA

In December 2018, a **joint statement** was issued by William Duhnke, the Chairman of the PCAOB, SEC Chair Jay Clayton, and SEC Chief Accountant Wes Bricker reminding stakeholders in the financial reporting chain of the challenges with respect to U.S.-listed companies with significant operations in China. The statement stressed that high quality and reliable financial information are the bedrock of the capital market system, which relies on quality audit services and regulator oversight.

U.S.-listed companies accounted for approximately 40% of the market capitalization of global public companies in 2017, and that level of interconnectedness creates regulatory challenges, including that information does not always flow to U.S. capital markets regulators from foreign jurisdictions to the extent it should. There exist various barriers to information including data protection, privacy, confidentiality, bank secrecy, state secrecy, or national security laws.

While regulators continue to make progress in this area, new information access issues continue to arise. For example, there are issues relating to the PCAOB's ability to inspect the audit work and practices of PCAOB-registered auditing firms in China, which amounts to 224 U.S.-listed companies with a $1.8 trillion combined market cap. Efforts to ensure access to this information stress that external audits of multinational companies require global coordination and that regulatory oversight of international financial reporting and auditing requires significant cross-border regulatory cooperation. While restrictions are often designed to achieve national objectives, they complicate and in some instances impede the ability to carry out regulatory responsibilities. Addressing these concerns is a complex task that requires extensive cooperation and on-going attention.

While the statement cites efforts with Chinese regulators have improved, there remains significant concern regarding information access and the ongoing ability to inspect audits. The SEC and PCAOB warn that depending on various facts and circumstances, including company-specific considerations, if significant information barriers persist, remedial actions involving U.S.-listed companies may be necessary or appropriate. In the past, remedial measures have included, as examples, requiring affected companies to make additional disclosures and placing additional restrictions on new securities issuances.

DATA GOVERNANCE: WHAT'S IN A TWEET?

In the age of instant information and ready access to a broad variety of media through which to convey information, an organization's ability to establish appropriate disclosure controls is becoming increasingly more important. This is best underscored by the SEC's $40 million **settlement** with Tesla and Elon Musk earlier this year, whereby the SEC charged Tesla with failing to have required disclosure controls and procedures relative to its Chairman's August 2018 tweets about taking the company private and the resulting disruptive impact to Tesla's stock price. To paraphrase comments made by Chief Accountant Wes Bricker during an audit committee breakout session at the NACD Global Board Leaders' Summit, *"Good controls are put in place to achieve business objectives… when they are poor or, in the case of Tesla, where no controls are in place, the negative impact both financially and from a reputational perspective can be significant to the company and its shareholders."*

Recently issued tools and resources audit committees may find helpful include:

- **Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China**
- **Elon Musk Settles SEC Fraud Charges; Tesla Charged With and Resolves Securities Law Charge**
- **GDPR: What U.S. Boards of Directors Need to Know**
- **The Top Three Things You Need to Know About GDPR**
- **Countdown to GDPR: How Will the GDPR Affect Information Management?**
- **Countdown to GDPR: Hidden Data within My Organization**
- **BDO's GDPR Checklist**
- **BDO's Technology and Business Transformation Services Group - GDPR**

Sustainability Reporting

Traditional financial statements only go so far in capturing all factors that contribute to a company's ability to create value over time. Sustainability reporting, along with other types of similar reporting known as **triple bottom line reporting** and/or **corporate social responsibility (CSR) reporting**, has evolved out of the perceived need to provide additional information about how companies manage environmental, social and human capitals, as well as corporate governance, to enhance a decision maker's understanding of all of the company's material risks and opportunities. Providing such information, over time, may provide investors and key stakeholders with a more complete view of the ability of a company to manage risks and sustain value creation. Additionally, with a goal of broad disclosure across an industry, investors and key stakeholders may be better able to more fully understand the interrelated nature between financial and nonfinancial factors and risks that impact a company's future financial position and how sustainability issues are managed across the supply chain. This better enables comparison and the ability to distinguish companies based on their strategies and operations with respect to these types of issues.

In November 2018, the **[Sustainability Accounting Standards Board (SASB)]** issued codified sustainability standards applicable across 77 industries following six years of development, leveraging evidence-based research and broad stakeholder input. While the SASB is not an authoritative standard setting body and use of such standards is not required, SASB standards are intended as a guide for voluntary reporting use by public companies in making disclosures on material sustainability factors in Forms 10-K, 20-F, and 40-F as required by existing U.S. regulation. SASB standards may also be applicable to the disclosure of material sustainability information by other types of organizations, including privately held corporations and foreign corporations publicly listed in other jurisdictions.

In December, SEC Chair Clayton provided **remarks** to the SEC Investor Advisory Committee on sustainability and environmental, social, and governance (ESG) disclosures. He indicated, *"Although third-party standards relating to ESG topics may allow for comparability across companies, which does not mean that issuers should be required to follow these frameworks in order to comply with SEC rules. Each company, and each sector, has its own circumstances, which may or may not fit within a standard framework. That does not mean the standards do not have value. They do, in some cases, in much the same way that appropriately presented non-GAAP financial measures and key performance indicators (KPIs) add value to the mix of information."*

He further underscored that when considering these types of disclosures, two principles should be remembered: *"first, in complying with our disclosure rules, companies should focus on providing material disclosure that a reasonable investor needs to make informed investment and voting decisions based on each company's particular facts and circumstances; and, second, investors—and here I'm thinking about asset managers who are required to vote in the best interest of their clients—should also focus on each company's particular facts and circumstances… Advisers cannot put their own interests ahead of the interests of their clients."*

BDO has developed a **tool** that we encourage audit committees to reference to better understand the sustainability landscape and how such reporting is being done and used domestically as well as internationally. Within the tool, we further reference a discussion and tools from a session BDO hosted for small cap companies during the 2018 NACD Global Board Leaders' Summit, where we engaged expert directors on this topic and shared findings from our recent BDO Board Survey. We will continue to provide thought leadership and additional education opportunities in this developing area.

The BDO Center for Corporate Governance and Financial Reporting

A dynamic and searchable on-line resource for board of directors and financial executives

AN INCREDIBLE RESOURCE AT YOUR FINGERTIPS

The BDO Center for Corporate Governance and Financial Reporting was born from the need to have a comprehensive, online, and easy-to-use resource for topics relevant to boards of directors and financial executives. We encourage you to visit the Center often for up-to-date information and insights you can rely on.

What you will find includes:

- Thought leadership, practice aids, tools, newsletters, and comment letters
- Technical updates and insights on emerging business issues
- Evolving curriculum consisting of upcoming webinars and archived self-study content
- Opportunities to engage with BDO thought leaders
- External governance community resources

"A resource center with the continual education needs of those charged with governance and financial reporting in mind!"

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For more information about BDO's Center for Corporate Governance, please go to: **www.bdo.com/resource-centers/governance**.

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