

Technical Updates – Spring 2022

Audit Committee Network

May 2022



Contents

Tax reminders

04

Fraud update

05

PwC's Restoring Trust series: A focus on the Audit & Assurance Policy and Fraud

08

Corporate reporting/Governance developments

09

Accounting/Regulatory reminders and areas of focus

12

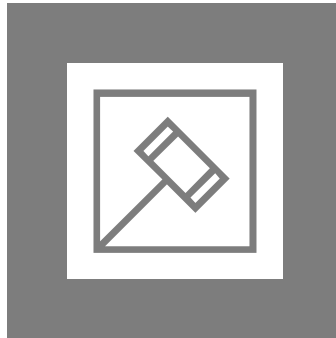


Tax reminders (1/2)

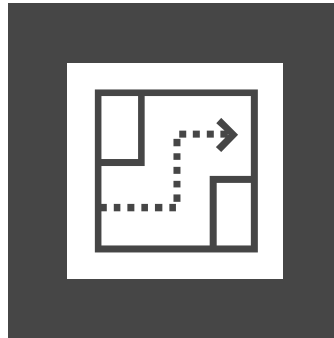
There are three key themes for tax now:



Areas of tax judgment and associated disclosures



A focus on controls and governance



The OECD/G20 inclusive framework

Focus on judgments

The FRC's focus on judgments and estimates is very relevant to tax. The two areas this typically covers are uncertain tax positions and deferred tax.

The COVID-19 pandemic and, to some extent, Brexit mean that uncertain tax positions are becoming more significant. That's partly due to tax authorities themselves because they've been redeployed to Brexit and COVID-19 support measures, so things have slowed down in terms of resolution. But governments have also got very large deficits because of those support measures that they need to fill and little latitude to raise tax rates. There's also the need to prevent disruption of the fragile recovery from the COVID-19 pandemic. So they have little option but to pursue the taxes they already have in place much more aggressively. That leads to bigger balances that are more material in accounts. In the UK, we now have a regime that requires disclosure to HMRC – that is very reliant on the provision-or-not-provision decision in your accounts. This is going to lead to more auditor scrutiny around your uncertain tax position decisions, and potentially to contingent liability disclosures as well in the event you don't decide to provide.

Regarding deferred tax, while different industries have been impacted differently by recent volatility, all groups have more significant judgments to make and support. These are associated with the growing complexity of tax rules around offset of balances and the strength of forecasts and whether they support recognition of net deferred tax assets on a balance sheet. In the UK, we have a rate rise coming, which means those judgments are bigger and more material.

The key takeaway here is that the size and complexity of judgments around tax are increasing, and auditors and regulators are likely to scrutinise in much more detail how accounting standards are applied. Now is a good time to understand the makeup of your tax balance sheet and what could drive those large swings.

A focus on tax controls

What's important to understand as a result of the BEIS report is whether you've got the right controls around tax accounting. Many tax departments focus heavily on the processes and controls around tax returns, and this is important, but controls around tax accounting can be more ad hoc.

The US experience around the implementation of the SOx rules has proven that tax controls are not straightforward either to design or implement, and tax continues to be a top 10 driver of restatements. Tax controls tend to be manual, and are often applied only annually. "Review" controls that are hard to design and inclined to throw up last-minute surprises.

This is a good reason to focus on controls early in your tax environment before any rule changes. Another good reason is the increasing importance of ESG. The governance element is relevant to tax.

It's also important that your tax impact is reflected in the modelling of climate change reporting. Ask boards how you are going to get auditors and other stakeholders, including tax authorities, comfortable with the statements you make in the front half of your accounts and elsewhere about your tax strategy and governance.

Tax reminders (2/2)

OECD/G20 framework

The OECD has undertaken an ambitious reform around international taxing rights.

Most international tax treaties and international tax law were developed in the 1920s, and haven't kept pace with business today, particularly in the context of digital and globally integrated business models. The OECD's effort gained real momentum in the second half of 2021.

The most imminent change is what's known as the 'pillar two' rules. They aim to apply an international "floor" on tax rates of 15%. While this might sound straightforward, it is not. Compliance will involve applying a series of complicated rules to generate your jurisdiction ETR. There is a lot that needs to be done to model and comply with those rules. The OECD and the EU drafted model rules and put those out in December. And the UK began a consultation on its implementation of those rules in January. The key trigger for any disclosures that might be required is coming relatively soon. In the UK, we could expect draft legislation to be published in July. So don't wait too long on the financial systems engineering and modelling that will be required for compliance.

The decisions you're making in your consolidated financial statements for the first time are going to drive an tax that's payable. This adds a new aspect to consider in the preparation of your consolidated financial statements.



Fraud update (1/3)

Why now is a good time to talk about fraud risk

We are in unprecedented times, whether because of the pandemic, the invasion of Ukraine, supply chain issues or tankers getting stuck in the Suez Canal. All these events cause disruption. And fraudsters have always tried to take advantage of emerging technology and disruptive events. We're seeing increasing fraud across the whole landscape.

The pandemic accelerated the move to hybrid working but few have made it work truly effectively. Turning to the threat of fraud from insiders many of the softer internal controls that allow some policing of teams and behaviours have disappeared because of hybrid working. Government support through loan schemes or grants has also been a recurring theme and we are seeing a few examples of furlough fraud. The wave of M&A activity is also driving diligence around fraud and economic crime risks.

And there is a lot of legislative change. We have yet to see the impact from the 2017 Corporate Criminal Offence bill to prevent the facilitation of tax evasion – that is to come and that will have a potentially significant effect. We have recently also seen the 'misleading-an-auditor' section of the Companies Act being used as a criminal offence and having an impact. If you are moving your supply chain, you might not be doing the diligence you would otherwise be doing.

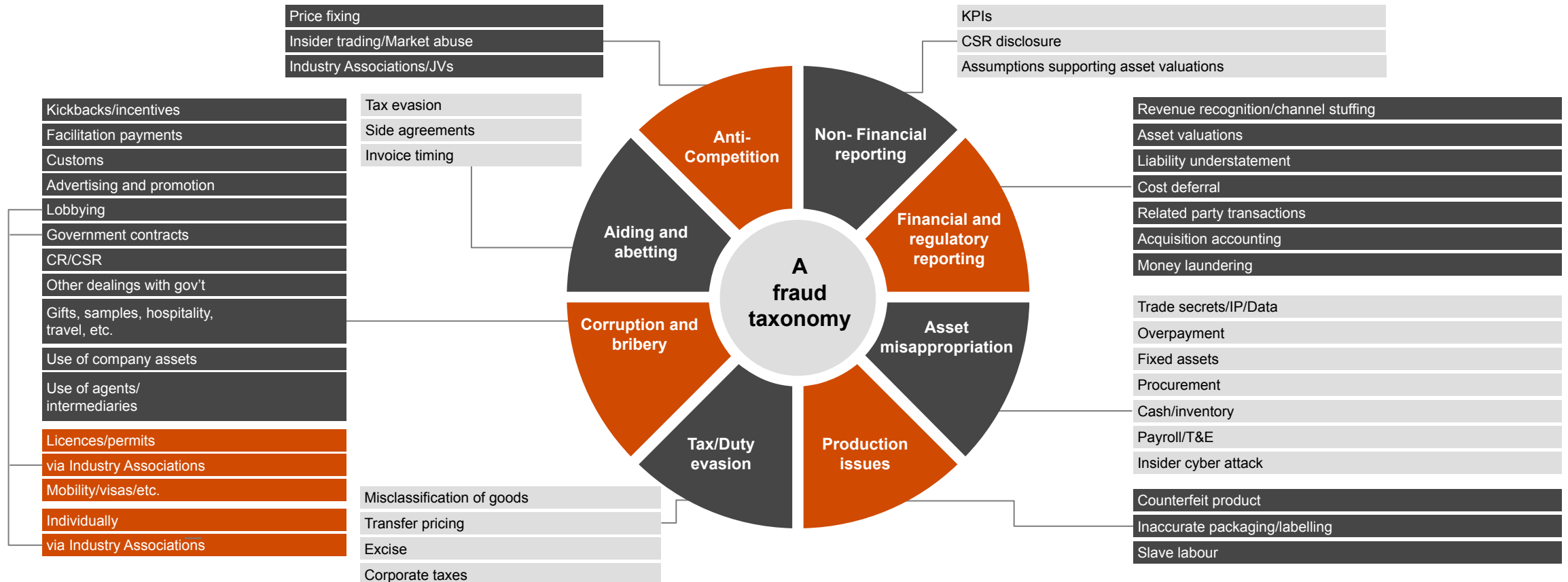
Protection from fraud

Often, when we talk to clients about fraud, they focus on extractive frauds – asset misappropriation, IP theft, inventory theft – or on financial misstatements. But these are just two parts of the fraud pie. Others include tax evasion, non-financial reporting issues like greenwashing, bribery and corruption, etc. The BEIS consultation that talks to director requirements about managing the risks of fraud isn't confined to just financial statement fraud, so you need clarity on this across your organisation.



Fraud update (2/3)

What does fraud mean to you?



Fraud update (3/3)

A good fraud risk management strategy is divided into five areas: governance, risk assessment, prevention, detection and response. With governance, the biggest challenge is making sure there is a common understanding, a consistent view and central accountability. Risk assessment is the linchpin of getting this right: If you don't understand your risks, you will not be able to handle them, and you need to keep refreshing your understanding. Many organisations don't have risk assessments and those that do exist are often disappointing. Once you have identified controls, you have a good chance of putting in protective measures. Another key is detecting. The enforcement agencies are becoming more interested in understanding how companies deal with mitigation and show they are taking issues seriously, and whether they're being proactive about detection. You could spend a lot of time and effort searching for fraud, so you need to search for it in areas where it is most painful to you. That allows you to prioritise efforts and allocate limited resources to focus on the right ones. Being prepared when fraud does occur saves a lot of time and worry.

To assess fraud risk, consider the likelihood of the fraud occurring and the impact it will have if it did. Also consider risks that are extremely unlikely to happen but can be catastrophic. There are also unusual events that you can't quite anticipate: shipping containers getting stuck, wars being launched, etc but you can reflect on likely impacts.

Fraud detection

Technology is a friend here. The ability to synthesise data from various sources, analyse it and look at patterns, is one of the best ways to find fraud and anomalous activity. Clients are turning more and more towards this technology to detect and potentially prevent fraud. It's not business as usual yet for most companies but it's starting to go in that direction.

Whistleblowing is also a hot topic and is one of the top three ways of finding fraud. Having a whistleblowing procedure is a standard part of the toolkit for responding to potential fraud. The EU whistleblowing Directive is going to provide protections for whistleblowing across the EU. In the US, being a whistleblower can be lucrative: \$564 million went to 108 whistleblowers in 2021. There's a growing need for companies to find a mechanism to use whistleblowing effectively and make sure it's working.

Responding to suspected fraud

What does an investigation look like, especially when we are acting as external auditors? We want to see:

	Independent and competent investigators		Assessment of knowledge and/or involvement of senior management
	Clear governance and reporting lines		Consideration of whether similar issues exist elsewhere
	Thorough scope that is allowed to evolve		A sound basis to conclude whether the full impact of the issues has been quantified
	Securing of potentially relevant data/evidence		A way to ensure remedial steps are identified, if appropriate

The facets of an investigation can include a review of communications, interviews, desk and building searches, review of file storage, review of accounting records and other documentation as well as corporate intelligence.

It's helpful to escalate swiftly, consult with legal advisers, secure potential evidence and document relevant discussions and key decisions. What's unhelpful? Contaminating the evidence chain, 'tipping off' potential suspects, discussing matters with individuals outside the investigations team and assuming that only one person within the organisation is involved.

PwC's Restoring Trust series: A focus on the Audit and Assurance Policy and Fraud

Update on the 'Restoring Trust' agenda

At the time of writing, we are still awaiting the Government's response to the BEIS consultation on reforming audit and corporate governance. There is a high risk that this will not be a part of the Queen's Speech in May and therefore will not make it onto the legislation to-do list for the next year. That said, we believe the reforms are not going to disappear and will resurface as a priority in time. Rather than waiting for future rules, Audit Committees and Boards should consider opportunities for getting ahead of the changes that will come with the reform. There follows two areas that companies could start to prepare for.

The Audit and Assurance Policy

There is a large amount of new, evolving information that sits in the front half of the annual report and for now is subject to less rigorous standards of reporting and less assurance. This will not necessarily be as reliable as information that's in the audited financial statements. Audit Committees should be transparent with shareholders around what has been done to ensure information is reliable: this could be internal processes around controls, reviews, internal audits and projects or it could be external assurance that's been obtained over that information. You can find further information on developing an Audit and Assurance Policy through our guide: [Restoring trust through an Audit and Assurance Policy](#).

Enhanced reporting and responsibilities around fraud

The proposal for enhanced responsibilities and reporting around fraud is for directors of public interest entities to disclose the steps they have taken to prevent and detect fraud and for auditors to report on that. This is more than a disclosure requirement. It's a reason to think overall, "What's my fraud risk management programme? If I did have to make this disclosure, do I feel comfortable with the statement and would my auditor also be comfortable?". Again, another area worth making a head start on. You can find further information in our guide [Restoring trust through enhanced fraud risk management](#).



Corporate reporting/Governance developments (1/3)

A spotlight on climate change

What investors are looking for

Investors are increasingly scrutinising how organisations respond to climate-related risks and opportunities. They expect high-quality reporting and audits, and are beginning to be more vocal on what they expect from companies, challenging what companies report, and voting with their feet when they don't see what they want.

UK regulatory model

At the heart of the UK regulatory model is the Task Force on Climate-related Financial Disclosures (TCFD) framework developed in 2017. Most larger UK companies will be within the scope of mandatory TCFD reporting by 2025. Premium listed companies were required to report against the TCFD from December 2021 year ends. Companies with standard listed equity will have that requirement from December 2022. Earlier this year, the scope for climate-related reporting was extended to include large LLPs, AIM-listed companies and private companies and specific requirements exist for pension schemes, banks and insurers as well. With a large proportion of corporate UK already affected, Audit Committees should ensure management is on top of the regulatory developments and how they apply to their organisation.

At the heart of an effective response to the TCFD framework is the need for strong governance and robust risk management. It requires a focus on the medium to long term as well as the short term and it's important to integrate the climate risk management process into ongoing risk management processes. Companies then need to ensure they report appropriate metrics on how they are monitoring or measuring climate-related risks. Audit Committees should use these key elements as a useful litmus test in challenging their own processes.

FRC expectations

The FRC Reporting Lab has recently published reviews and guidance on climate reporting, setting the bar on what they want to see in TCFD reports. They have also confirmed their intention to publish a thematic review on TCFD disclosures later this year. Audit Committees should ensure management is checking their disclosures against these expectations.

TCFD disclosures so far

Our ongoing review of TCFD disclosures from premium listed companies in the current reporting season shows companies are making positive steps. However, it is leading to a substantial increase of content in the annual report. Disclosures are too often driven by compliance and process, and it is difficult to tell what climate change actually means for an organisation and how material it is. More work needs to be done to properly set out the financial impacts of climate change. There has been little quantification and this is bound to be an area of increasing scrutiny going forward over the next few reporting seasons.

In an attempt to comply, many companies have been in danger of giving the impression they have done more, or think climate change is more material than it really is. On the other hand, the agenda is moving fast – developing understanding of the issue, quality of data, changing expectations and so on mean that companies, like wider society, are on a journey, and in many cases there's a lot more to be done that isn't yet reflected in reporting. We therefore encourage Audit Committees to ensure that their companies' disclosures are clear about what progress has been made and what is still on the agenda in their particular circumstances.

Corporate reporting/Governance developments (2/3)

International Sustainability Standards Board and sustainability disclosures

Several developments over the next two to three years should also be on your management's radar:



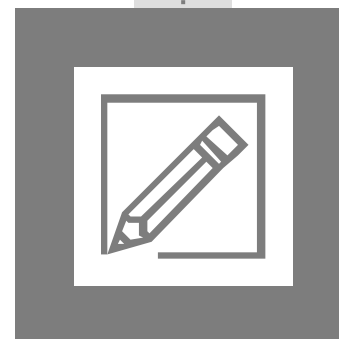
The International Sustainability Standards Board (ISSB) has recently published exposure drafts, including one on climate-related reporting, with a four month consultation period.



Closer to home, the UK Government has also set out proposals for sustainability disclosure requirements which include: a commitment to using the ISSB standards as a baseline; and the requirement for companies to report against the UK green taxonomy that will require them to be more transparent on their environmentally-eligible activities. The UK Government will also expect companies to report their net zero transition strategies – a consultation on these developments is expected in 2022.



Finally, in the US the SEC recently published proposals for new rules that would significantly increase required disclosures about climate-related risks. Many of the proposals are based on the TCFD framework but nuances that differ from the current UK model include requirements to disclose Scope 3 emissions (phased in over time), and certain climate-related financial statement metrics and related information in a note to the audited financial statements. Some companies would also be required to obtain assurance over scope 1 and 2 emissions. The consultation period closes on 20 May, with potential implementation from 2024.



The EU has also been busy developing proposals for extensive new sustainability reporting requirements that will have the potential to impact UK companies with overseas subsidiaries or holding companies, or that are subsidiaries of an EU parent. Their proposed requirements are more far-reaching than those in the UK at the moment and will require mandatory assurance.

Corporate reporting/Governance developments (3/3)

Corporate governance reporting update

The current reporting season

The FRC has been much more active in the governance reporting space recently, and is now writing to companies about their governance reports as part of Corporate Reporting Review Team (CRRT) letters. It has also been giving a clearer steer on what is in line with the UK Corporate Governance Code or a departure from it. Two issues in particular are now much more often identified as departures: alignment of directors' pension contributions with the wider workforce (Provision 38) and the need for engagement on how executive pay aligns with wider company pay policy (part of Provision 41). Audit Committees should check where their organisations stand on these.

This does not mean that companies are all now complying more fully with the Code, however. It is noticeable every year how some refuse to come into line on areas such as board or committee composition, or the tenure of the chair. This is part of the flexibility of the comply-or-explain system – providing that the departures can be properly justified.

Principal decisions seem to be emerging as a significant disclosure, often generating some of the most company-specific content in reports. They also provide an opportunity to cover various aspects of s172 and stakeholder engagement.

Finally, we have seen a significant trend for companies to report – albeit briefly – on how they are preparing for whatever framework is introduced to strengthen internal control as a result of the Department for Business, Energy and Industrial Strategy's (BEIS) 'Restoring Trust' consultation, including in some cases new processes for providing assurance to the directors.

Diversity and diversity reporting

Diversity is another area that can be challenging for companies to report on under the Code. The Code provision covers a lot of different elements and companies sometimes find it difficult to explain why the subject is relevant to their strategy.

The FCA has now confirmed that it is for the first time creating targets around diversity, such as 40% of the board to be women and at least one senior board position to be held by a woman. It is also establishing targets on ethnic diversity.

The latest FTSE Women Leaders review shows that the FCA requirements are consistent with the direction that the successor to Davies and Hampton-Alexander has taken. They are looking for much the same targets to be achieved by 2025.

Beyond the FTSE 350 space, the scope of monitoring of gender diversity reporting under the Women Leaders review is also being extended to the largest 50 private companies.

Governance reporting by very large private companies

The FRC has been working with a number of business schools to see how this reporting is progressing. This showed that the majority of in-scope companies have adopted a specific governance code and about 75% of those have adopted the Wates Principles. In terms of the quality of the reporting against Wates, there is still more work to do. Based on the methodology used by the business schools, the FRC scored the quality at only around 35%, with purpose and leadership scoring the lowest. The general sense is that, like governance reporting generally, there is a preference to describe process and procedure without showing what these were applied to achieve. The overall message from the FRC is that there is certainly room for further improvement in this area of reporting.

Accounting/Regulatory reminders and areas of focus

Previous FRC advice stands

Last autumn the Financial Reporting Council (FRC) identified areas that Audit Committee members need to focus on in the coming reporting cycle, including COVID-19 and climate change. These remain valid areas to think about as boards approach signoff of annual reports or think about later reporting in 2022.

Ukraine

There's general agreement that for December 2021 year ends the current situation in Ukraine is a non-adjusting, post-balance sheet event. This does not mean companies shouldn't be thinking about it. In some cases, the impacts could prove highly material. This will vary depending on a company's operations in Russia, Belarus or Ukraine and the extent of its exposure to events in that part of the world. There should be challenges at the board level around the extent to which disclosure might be required in subsequent events. These include: the extent of risk, impacts on foreign exchange rates, whether the value of Russian operations have been diminished, restricted cash, energy prices, etc. Clearly, for years ending since the invasion (ie February and later year ends), the accounting implications will need to be considered.

Cash flow statements

The FRC continues to voice concern at the amount of errors that arise in cash flow statements. Audit Committees should be challenging their CFOs and executives over the scrutiny of cash flow statements.

Cloud computing arrangements

These considerations apply to large-scale ERP systems and similar systems. The IFRS Interpretations Committee (IFRIC) previously concluded that, in most cases, no intangible asset is created when entering into cloud computing arrangements and therefore there is nothing to amortise. The IFRIC in September 2021 also addressed configuration and customisation (setup) costs, and again concluded that often this was not creating an asset. Some companies now might need to change the way they are accounting for cloud computing setup costs – perhaps what was an asset before is now having to be written off. Audit Committees should be asking at board meetings whether someone in the company is monitoring what the IFRIC does. If you have a substantial cloud computing project under way, make sure someone in the organisation is on top of what the accounting for that should be.



Thank you

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2022 PricewaterhouseCoopers LLP. All rights reserved. 'PwC' refers to the UK member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.