Grant Thornton

Audit

Technology

Audit committee outlook for technology

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Next

Contents

Previous Next

Introduction

The information technology industry exists in a constant state of transformation. New product cycles are measured in weeks and months—no longer in years…and the pace of change is accelerating. Technological change permeates every department from product development through customers support and every function from finance to human resources. Directors and management must be constantly vigilant as "disruptors" can quickly become the "disrupted."

In today's world, technology is a ubiquitous part of business and consumer lives. The information managed, processes enabled, and supporting analytics are "musts" to compete. This has drawn the attention of regulators, raising the hurdles and costs for compliance. And it has also drawn the attention of criminals and hackers, raising the thresholds and costs of security and privacy.

This new environment challenges executives and directors to manage competitive risks, minimize regulatory and tax difficulties, and drive "customers-for-life." New tax laws, accounting rules, and risk strategies demand that audit committee members be more engaged than ever before. Our goal with this publication is to provide you a high-level review of current concerns facing audit committees that serve technology companies in order to help you focus on areas that may need increased oversight.

In particular, tax changes will drive much of the focus on key issues that directors need in 2018. Several provisions will affect the technology sector, including the reduction of the corporate tax rate, full expensing for asset purchases, R&D credit changes, repatriation of earnings held overseas, the Base Erosion Anti-Abuse Tax (BEAT), and others. Beyond 2018 these changes beg questions of appropriate corporate structures to support international operations. More information on the pivotal issues is provided in the following chapter on tax reform.

Grant Thornton is pleased to provide this Audit Committee Outlook for technology companies. We hope it will help committee members understand recent and near-future developments relative to their role overseeing corporate financial reporting and disclosure.

Additional resources and information about our programs for this industry can be found at gt.com/technology.

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Outlook on: Tax reform and the audit committee

President Trump signed into law a major tax overhaul on December 22, 2017. The new law includes provisions of significant interest to corporations. U.S. accounting standards require that companies record the effects of a law change in the period corresponding with **enactment** of the law. Therefore, the effect of these changes must be reflected in annual financial statements for calendar year 2017 and in quarterly statements from December 22, 2017 on. For example, even though the lower corporate tax rate is not effective until tax years beginning after December 31, 2017, it will impact the calculation of deferred taxes in any quarter that includes the enactment date of December 22, 2017.

The following is a high-level look at just a few of the provisions that may have a pronounced impact on tax accounting. (For a comprehensive look at all of the provisions as well as some deeper analysis of specific changes, please see additional information at gt.com/taxreform.)

1. **21% corporate tax rate**
   The effect of the rate change on deferred tax balances, including any resulting changes to valuation allowances, is recorded for accounting purposes as a component of income taxes in the period including December 22, 2017. The impact of the rate reduction should be recorded as a discrete item and included in income from continuing operations.

Questions for management

1. What plans or processes are in place to stay aware of new guidance as more information becomes available?
2. What tax accounting method changes, if any, are planned as a result of the new law? What is the timetable for filing with the IRS?
3. If we have AMT carryforwards that are anticipated to be refundable, is a portion being reclassified from deferred tax assets to current or noncurrent tax receivables?
4. How significant are our non-U.S. operations and subsidiaries? Does the company hold accumulated earnings overseas that will be subject to the one-time transition tax on unrepatriated earnings? Has the company historically asserted that unremitted earnings and other outside basis differences will be indefinitely reinvested? Has the company historically disclosed the amount of unrecognized deferred tax liability associated with indefinitely reinvested foreign earnings and other outside basis differences?

Questions/action items for audit committee discussion

1. Do we have the necessary expertise in both tax and accounting to understand the tax requirements posed by the new law and to evaluate management's judgments related to them?
2. How will the proposed changes impact our financial reporting and business strategy going forward?

Back to Table of Contents

Previous

Next

The new tax rate should be used to determine income taxes payable in the year the new tax rate becomes effective, in this case for tax years beginning after December 31, 2017.

2 Corporate alternative minimum tax (AMT)

The law repeals the corporate AMT for tax years beginning after December 31, 2017. The law also includes provisions for use of prior-year minimum tax credits to offset regular tax liability and for refunds of unused credits. Companies will need to consider whether a portion of the deferred tax asset associated with the AMT credit carryforward should be reclassified as a current and/or noncurrent income tax receivable. Additionally, companies will need to consider whether there is a change in their assessment of realizability of any deferred tax asset associated with AMT credit carryforwards.

3 Temporary 100% expensing for certain business assets

The new law initially allows 100 percent expensing of property placed in service after September 27, 2017. Beginning with property placed in service after December 31, 2022, the percentage is gradually reduced. Property placed in service after December 31, 2026, will no longer qualify for bonus expensing. Companies should review capital expenditures made after September 27, 2017, to determine if they qualify for immediate expensing and consider the effect of this accelerated depreciation on current and deferred income tax balances.

4 Limitation on business interest deduction

The new rules impose a limit on the deduction for net interest expense by a business. The deduction is limited to the sum of 30 percent of the business's adjusted taxable income, the business interest income, and the floor plan financing interest. Before January 1, 2022, the calculation of adjusted taxable income is similar to earnings before interest, taxes, depreciation, and amortization (EBITDA). After January 1, 2022, that calculation is equivalent to earnings before interest and taxes (EBIT). Any disallowed interest expense can be carried forward indefinitely. Companies will need to disclose any determination related to the realizability of any excess interest carryforwards, given that the disallowed interest expense carryforward is indefinite.

5 Net operating loss (NOL) deduction

The law limits the deduction for NOL arising in tax years beginning after December 31, 2017 to 80 percent of taxable income, eliminates most carrybacks, and allows unused NOLs to be carried forward indefinitely. This change will require companies to determine if existing NOL carryforwards can be used before the lower corporate income tax rate takes effect. Companies will also need to remeasure existing NOL carryforwards at the reduced 21 percent tax rate if they are not anticipated to be utilized at pre-act rates.

6 Transition tax on unrepatriated foreign earnings

The act imposes a one-time transition tax on unrepatriated foreign earnings and profits (E&P) at a rate of 15.5 percent for amounts attributable to cash and liquid assets and 8 percent for all other E&P. U.S. accounting guidance requires that the estimated future tax effects of undistributed earnings held in foreign subsidiaries and joint ventures be recognized as a deferred tax liability unless the company can show specific, definite plans to indefinitely invest those earnings in the foreign entity. The one-time tax is assessed as of the company's last taxable year beginning before 2018. The effect of the one-time transition tax on unrepatriated foreign earnings, as well as the effect on previously recognized deferred tax liabilities, will need to be shown as a component of income tax expense in income from continuing operations for the period that includes December 31, 2017 for a calendar year taxpayer. Companies should also evaluate the impacts of the one-time transition tax on any unrecognized deferred tax liability associated with indefinitely reinvested accumulated earnings and other basis differences.

7 Minimum tax and incentives for intangible income

The Act imposes a minimum tax on certain foreign income deemed to be in excess of a routine return based on tangible asset investment, which is designed to discourage income

Back to Table of Contents

Previous Next

shifting by subjecting certain foreign intangible and other income to current U.S. tax. Effective for tax years beginning after 2017, U.S. shareholders of controlled foreign corporations (CFCs) are subject to current U.S. tax on their global intangible low-taxed income (GILTI). In general, GILTI is defined as the excess of a U.S. shareholder's aggregated net "tested income" from CFCs over a routine return on certain qualified tangible assets. The "tested income" is the excess of the gross income of a foreign subsidiary net of allocable deductions and certain gross income exclusions and the routine return is computed as 10 percent of the average aggregate adjusted tax bases in depreciable tangible property adjusted downward for certain interest expense.

The Act calls for including GILTI in a U.S. shareholder's income in a similar fashion to Subpart F income. Foreign taxes are available as a credit, and limited to 80 percent of the amount that would otherwise be creditable. The Act creates a separate foreign tax credit basket for GILTI, with no carryforward or carryback available for excess credits. It provides domestic corporations with a 50 percent deduction of the GILTI amount (37.5 percent for tax years beginning after 2025).

Companies need to evaluate their liabilities under the GILTI regime to determine whether they have captured all of their tax positions and recorded them appropriately. With respect to GILTI, a company that anticipates perpetually being subject to GILTI may adopt an accounting policy to recognize incremental deferred taxes associated with basis differences associated with GILTI. Alternatively, companies may adopt an accounting policy to treat incremental tax associated with these provisions as tax expense in the period in which it is incurred. Companies should consider whether this should be disclosed as a significant accounting policy.

8 Base erosion and anti-abuse

The provision of the Act referred to as the "Base Erosion Anti-Abuse Tax" (BEAT) imposes a tax on deductible payments to any "foreign-related party" and a minimum tax on certain domestic corporations' "modified taxable income." The tax is phased in at a rate of 5 percent for tax years beginning in 2018, 10 percent for tax years beginning in 2019 through 2025, and 12.5 percent for tax years beginning after December 31, 2025. For purposes of the BEAT, the term "foreign-related party" is broadly defined using current rules and includes any 25 percent foreign shareholder or any person related to the domestic corporation or to a 25 percent foreign shareholder. Constructive ownership rules, with some modifications, apply when determining whether foreign parties are "related."

Companies need to evaluate the impacts of this tax. While BEAT does not result in credit carryforwards and therefore cannot be used to offset taxes under the regular tax system, it operates in a manner most analogous to the alternative minimum tax system. As a result, companies may pay tax under the ordinary tax system one year and under the BEAT in the next. Based on existing accounting guidance related to the AMT tax regime, companies should not record incremental deferred tax assets or liabilities associated with BEAT. Instead, companies should recognize any incremental tax associated with BEAT in the period in which the tax is incurred

The complexity of these new rules and their effect on corporate income tax accounting present a steep learning curve for tax professionals and full-time corporate executives and staffers, as well as the audit committee members charged with evaluating their implementation efforts and any resulting risks to the corporation. In addition, the enactment of the new law will be followed by guidance on implementation that may again shift some of the assumptions made by management. These changes demand that audit committees carefully evaluate their knowledge and skillsets as well as those of the executives who manage the company's compliance with these rules on a daily basis. Transitions like these often require support from external resources in order to protect against the possibility of tax-related financial restatements in the future.

Back to Table of Contents

Previous Next

Outlook on: Accounting for the audit committee

The technical requirements for financial statement audits are ever changing. Beyond the new revenue standard, perhaps no accounting issue will affect more businesses than the upcoming changes to lease accounting. Lessees will see the greatest change, as the new leasing standard aims to recognize a lessee's financial obligations under a lease on the balance sheet.
The new standard is required for almost all leases and it goes into effect for public companies in fiscal years starting after December 15, 2018 (one year later for private companies).
It presents a number of current discussion issues for audit committees and management to verify that the organization understands the impact, is prepared for adoption, and can implement it smoothly.

Four key concepts to understand about the new standard

1 Definition of lease

The new standard defines a lease as a:

- a contract, or part of a contract, that
- b transfers the right to control use of an identified asset
- c for a period of time
- d in exchange for consideration.

A notable change in this standard is that a contract will no longer be deemed a lease simply because a customer takes substantially all of an asset's output, depending on pricing.

Questions for management

1. What is our company's plan for adoption of the leasing standard? Are you planning early adoption? If so, when? If not, has it been considered?
2. Do our legacy accounting systems have a complete inventory of leases and identify and track the lease components necessary to comply with the new rules? Can they be upgraded or do they need to be replaced?
3. How are service agreements currently structured in our leases? Do our current agreements include the information necessary to account separately for lease and nonlease components? Is additional information needed from the lessor? Can future service agreements be structured in ways that make it easier to identify and measure the components of the lease?

Discussion items/actions for audit committee discussion

1. Review lease administration. Many businesses have used decentralized lease administration because costs are attributable to various units. With the new standard requiring all leases to be on the balance sheet, would a more centralized process for lease accounting be useful?
2. Review policies and procedures for the separation of lease and nonlease components within the agreement.

2 Separation of lease and nonlease components

When a lease includes “nonlease” components, such as a service agreement for maintenance of leased equipment, the nonlease costs must be reported separately and not included in the lease figures shown on the balance sheet.

3 Transition relief

The new rules allow several types of relief. A lessor or lessee can elect to not reassess the following on transition, but all three must be elected as a package applied to all leases:

a. Whether expired or existing contracts contain leases.
b. Whether to reclassify any expired or existing leases.
c. Whether initial direct costs for existing leases should be capitalized under the new standard.

As a separate form of relief, lessors and lessees may use hindsight to determine lease terms with respect to renewals and purchase options, and to evaluate impairment of right-of-use assets.

Note that in January 2018 the FASB proposed additional relief that would allow an additional method of adoption and, for lessors, an option to forgo separating lease and nonlease components. Stay tuned for developments in 2018, as the FASB intends further relief through an additional adoption method and, for lessors, an option to forgo separating lease and nonlease components.

4 FASB and IASB differences

Our discussion focuses on FASB standards. If your company follows IFRS, the new lease guidance under those standards includes a significant difference for lessees—all leases will be finance leases—a change from current IFRS that have both operating and finance leases.

In our experience, we have found that detailed planning, adequate resourcing, and generous lead times are the key elements of a smooth implementation for this new accounting standard. For more insights on accounting updates and changes, please visit gt.com/audit.

Outlook on: The audit committee and risk

Each of us has a different tolerance for risk, but sooner or later there's a level of risk that will stop anyone from undertaking a particular endeavor. Similarly, companies have different tolerance levels for risk. Management must constantly weigh the risks of potential actions against the possible benefits that could result from success. Shareholders and other investors count on directors to carefully review the risks that management accepts and the steps taken to minimize risk where possible. The audit committee's focus on the financial reports of a business gives it a unique viewpoint from which to evaluate a company's risk management efforts.

To effectively understand and evaluate executive decisions, directors need to have a clear understanding of the organization's cultural values and its risk appetite. The question directors need to ask is not "Would I do this?". Directors need to ask if risks are evaluated and accepted in accordance with the company's public statements that investors rely on when they decide where to put their money.

1 Risk 101

Businesses face many common risks every day. The more common a risk, and the more days that pass without a failure related to that risk, the more likely it is that management and directors might become jaded into thinking they've got this one figured out. That's why the audit committee, and the board in general, should frequently review some of the most basic risks that a business manages and make sure that nothing has been overlooked. Some of the risks that businesses manage in daily operations include:

a. Cybersecurity risk. This may be the most challenging risk facing businesses today. So many people, businesses and governments are trying to hack into private information that it's almost impossible to stay ahead of them. Data breaches have become so common that risk management in this area has two components. First, a business must find the optimal balance between the cost of security and the level of protection it delivers, and second, it must prepare and maintain an action plan for the steps it will take in the event a breach occurs. (Please see "Reputational risk" below.)

b. Business interruption risk. This risk can be as large-scale as a category 4 or 5 hurricane like Harvey or Irma, or as local as a water main break. Man-made crises such as embargoes and political sanctions can also set a business back. What level of interruption insurance does your business need? Are plans for expansion going to expose the company to a disproportionate increase in interruption risk?

c. Fraud and error risk. These risks are on the rise as U.S. accounting standards shift to a model that allows more subjective judgments by management. Changes in revenue recognition and lease accounting, to name a few, will increase the types of risk that the audit committee is best-suited to help leadership manage. Last-minute changes in tax law will require accountants and audit committees to understand the impact on tax provisions almost immediately.

d. Reputational risk. Some companies can go for years, even an entire corporate lifespan, without ever facing a crisis that will damage their reputation. But no company can afford to assume it will be that lucky. While it's impossible to model every possible event that could tarnish the reputation of a business, it's still critical to map out some key strategies for limiting the damage from a negative situation. What are the best channels to reach your customers? Who needs to be notified when potential problems arise? Who is responsible for crafting the response?

2 The risk of doing nothing

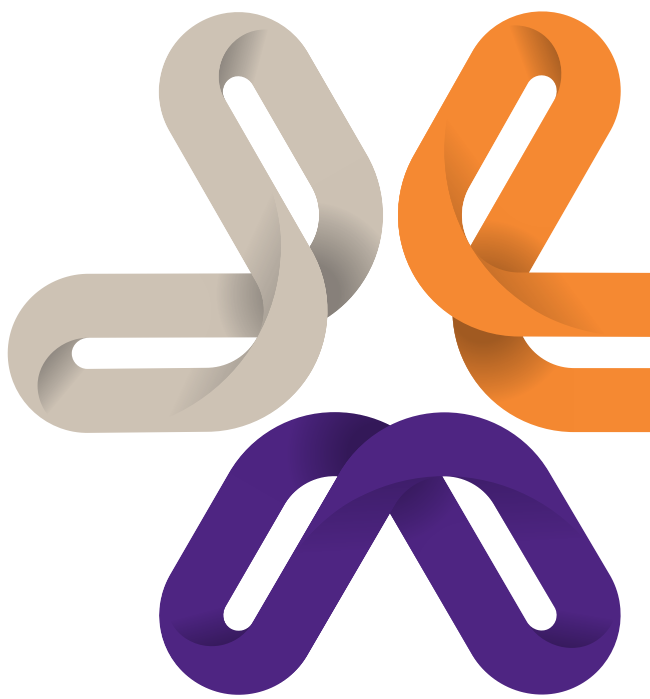
Management and directors can never afford to overlook the risks associated with inaction. Technology decisions often present some of the hardest choices in this area. At what point do the benefits of a systems improvement outweigh the costs to buy and implement a new technology solution? How much risk is the business willing to bear as an early adopter of a new system? If improvement works, it can deliver a competitive advantage for months or years. But if the vendor has created a flawed product, your business could be dead in the water until a fix is created.

3 A culture of risk management

A company's culture of risk management can be evaluated on a spectrum. At one end, risk management is purely procedural and emphasizes form over substance. Risks are listed, charted, graphed, and circulated. Boxes are checked and forms are signed to document compliance with a process. The good news is you'll always know who signed off on something. The bad news is that few people will understand how their task helps to protect against the larger risk that the process is intended to manage.

At the other end, risk management can be totally decentralized across divisions, functions, and process owners. Divisions and units might be better empowered to manage specific risks within their purview under this model. On the other hand, it's hard for management to see how these siloed risk management processes work together across the company to keep enterprise-wide risk within specified tolerances.

The audit committee can help management determine how to empower employees with the understanding of their contribution to enterprise-wide risk management without micro-managing the process to the point that people spend more time filling out forms than creating value.



Back to Table of Contents

Previous

Next

Questions for management

1 What are the key risks now posed to implementation of our strategies and achievement of our goals?

2 How would we characterize our organization's appetite for risk? How is it communicated/demonstrated throughout the company? Are we taking enough of the right risks? How do we know?

3 How does our organization:
   a Identify emerging risks, and
   b Prepare for and manage those risks?

4 Is our management team integrating risk management into real-time operations?

5 What is our organization's risk management culture? How do we assess its soundness and effectiveness? Do all relevant employees understand overall risk tolerance and the role they play in managing risk?

6 Is our management team striking the right balance between compliance and risk management? Is it devoting enough resources to strategic risk management? How does our organization balance compliance-driven activities with performance-driven risk management?

7 Is our organization effectively integrating cyber-risk management into its overall risk framework? Have executives done exercises modeling a cybersecurity crisis in order to evaluate the organization's response?

8 What have we done to make our organization risk-resilient, both to major disruptive events like hurricanes and hacks as well as disruptors such as new technologies and competitors?

9 Who in our organization is responsible for business interruption risk assessment and response? Have recovery plans been tested?

10 Have the risks of artificial intelligence and process automation, including ethical decision making, been evaluated and tested?

11 Has management modeled reputational impairment recovery costs and timelines?

12 Has management challenged our existing business model to determine sensitivity to technological obsolescence?

13 How are we monetizing the value of intellectual property generated by our employees?

14 Do we have a clear statement of our company's cultural values? Do we understand the desired behaviors that reflect those values and the likely business outcomes if the values are lived? Are those values communicated effectively to all employees, customers and vendors?

Action items/questions for audit committee discussion

1 Are we comfortable that the company's tolerance for risk is aligned with strategic goals? (Optimal situation is tolerate no more or less than the minimum amount of risk necessary to achieve stated goals.)

2 If we asked managers and staff to characterize the organization's approach to risk, would we get the same answer as we did from executives?

3 For each question above, does our audit committee have internal resources to answer the question or is an external adviser needed?

Back to Table of Contents

Previous

Next

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