January 6, 2020

SEC Staff Issues Statement Addressed to Audit Committees

On December 30, 2019, the SEC Chairman, Jay Clayton, the SEC's Chief Accountant, Sagar Teotia, and the Director of the SEC's Division of Corporation Finance, William Hinman, issued a joint statement (the "Statement") (available here) setting forth various observations and various reminders on potential areas of focus for audit committees of SEC registrants. While the SEC and its Staff use a variety of methods to highlight issues that should be of particular concern to registrants and their advisors, a written statement by three of the most senior members of the SEC staff on the disclosure side is unique and underscores the importance of audit committees in the preparation and review of financial disclosure.

The Statement notes that audit committees of registrants play an important role in the financial reporting system through their oversight of financial reporting, which includes oversight of the system of internal control over financial reporting (ICFR) and the external, independent audit process. The Statement also notes that effecting oversight by "strong, active, knowledgeable and independent audit committees significantly furthers the collective goal of providing high-quality, reliable financial information to investors and our markets." This is consistent with the presentation made by the Chief Accountant at the December 2019 AICPA Conference on Current SEC and PCAOB Developments (*see* our client alert, available here), in which he urged audit committees to continue "to regularly challenge management and auditors about the accuracy and quality" of a registrant's financial reporting.

The Statement encourages registrants and their independent auditors to be mindful of the following considerations and to ensure that audit committees have the necessary resources and support needed to fulfil their respective obligations.

The Statement is divided into two parts: general observations in respect of financial reporting and auditing, and more specific topical observations.

General Observations

Tone at the top. The audit committee is "instrumental in setting the tone for the financial reporting process as well as the relationship with the independent auditor." The Statement encourages audit committees to focus on the "tone at the top" with the goal of creating and maintaining an environment that supports the integrity of the financial reporting process and independence of the audit. Specifically, the Statement emphasizes the importance of clear and candid communications between management and the auditor, and among the audit committee, management and the auditor. The audit committee should be proactive in communicating with the auditor to understand the strategy and status of the audit, and in making inquiries regarding both the issues identified by the auditor and their ultimate resolution.

Auditor independence. The Statement notes that compliance with the rules on auditor independence is a "shared responsibility" of the registrant, its audit committee and the audit firm. The role of the audit committee in this respect flows largely from the fact that the Sarbanes-Oxley Act imposes on audit committees the responsibility for oversight of the audit engagement. The audit committee should consider on a periodic basis both the independence question as well as the efficacy of the registrant's processes to monitor auditor independence. In addition, the audit committee should consider how corporate changes or other events could impair auditor independence and should facilitate the timely communication of these events to the auditor.

Understanding GAAP. The Statement notes that the audit committee plays a key role on promoting an environment for management to successfully implement new accounting standards (whether under US GAAP or IFRS). The audit committee should engage proactively with management and the auditor in the implementation process of new accounting standards to understand the implementation plan, and in particular whether management has budgeted sufficient time and resources "to develop well-reasoned judgments and accounting policies." The audit committee should also understand management's processes for its controls and procedures in respect of adoption and transition. This focus is especially important in view of the recent effectiveness of new revenue recognition and lease accounting standards.

ICFR. The Statement reminds audit committees of their responsibilities for overseeing ICFR, including as part of their consideration of management's assessment of the effectiveness of ICFR and, where applicable, the auditor attestation. The audit committee should have a detailed understanding of ICFR issues that have been identified and should be proactive in participating in the resolution of any such issues. If any material weaknesses have been identified, the audit committee should understand, and monitor, management's remediation plans and should make clear that prompt and effective remediation is a priority.

Auditor communications with the audit committee. The Statement encourages audit committees to incorporate in their efforts a dialogue around the communications relating to the year-end reporting process mandated by PCAOB AS 1301 (Communications with Audit Committees). This standard imposes on the auditor obligations to communicate with the audit committee regarding certain matters relating to the conduct of the audit and to obtain certain information from the audit committee relevant to the audit. These include matters related to certain accounting policies and practices, estimates and significant unusual transactions.

More Specific Observations

The Statement identifies a few specific issues that figure prominently among the SEC Staff's disclosure "hot buttons," as reflected in recent comment letters, as well as recent speeches and presentations.

Non-GAAP/IFRS financial measures. The Statement reminds audit committees of the importance of understanding whether, how and why management uses non-GAAP/IFRS financial measures and performance metrics, as well as understanding how the measures are used in financial reporting and in internal decision-making. The audit committee should be actively engaged in the review and presentation of these measures and metrics, in order to understand how they are used to evaluate performance and whether they are prepared and presented consistently from period to period. The audit committee should also understand how these measures and metrics are evaluated as part of disclosure controls and procedures.

Reference Rate Reform. Given the significant financial risks surrounding the expected transition away from the London Interbank Offered Rate (LIBOR) by the end of 2021, not surprisingly, the Statement encourages audit committees to understand management's plan to identify and address the risks associated with reference rate reform and, in particular, the impact on accounting and financial reporting and any related issues associated with financial products and contracts that reference LIBOR.

Critical Audit Matters ("CAMs"). The Statement encourages audit committees to engage in a substantive dialogue with the auditor regarding the audit and expected CAMs to understand the nature of each CAM, the auditor's basis for the determination of each CAM and how each CAM is expected to be described in the auditor's report. The audit committee should understand the new CAM obligations of the auditor and remain engaged with the auditor as it implements the new CAM requirements.

Concluding Thoughts

The Statement is a clear reminder that audit committees should be proactive, communicative and collaborative with key stakeholders. Audit committees should consider the various themes covered by the Statement as they set their agendas for the next reporting cycle.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman	Tong Yu
+44-20-7367-1601	+81-3-3597-6306
mbergman@paulweiss.com	tyu@paulweiss.com

Associate Sofia D. Martos contributed to this Client Memorandum.