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"Audit Committees in Action: The Latest Developments"

Audio Archive

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As the burden on audit committees continues to grow, audit committees have been forced to change how they oversee, delegate and even how they meet. New audit report requirements, a focus on auditor attestations, ongoing implementation of revenue recognition & lease reporting obligations and other recent SEC, FASB & PCAOB guidance can also impact the audit committee/independent auditor dynamic. Learn how to navigate this minefield from those on the "front line."

Join these experts:

- **Consuelo Hitchcock**, Principal, Deloitte LLP
- **Josh Jones**, Partner, EY
- **Mike Scanlon**, Partner, Gibson Dunn & Crutcher LLP

John Jenkins, Editor, *TheCorporateCounsel.net*: Hi. It's John Jenkins, editor of TheCorporateCounsel.net. I'd like to welcome you to today's program, Audit Committees in Action: The Latest Developments.

Audit committees have a tough job. Everybody knows that, and the demands that are placed on them get greater with each passing year. Today, we've assembled a distinguished panel of experts to provide some insights to help audit committees and those who advise them navigate these demands.

Joining me today are Consuelo Hitchcock—she's a principal at Deloitte—and Josh Jones, who is a partner at EY and Mike Scanlon, who is a partner at Gibson, Dunn & Crutcher. So, with that, I'm going to turn things over to Mike to start today's discussion. Mike?

SEC Statement on Audit Committee Practices

Mike Scanlon, *Partner, Gibson, Dunn & Crutcher LLP*: Thanks a lot, John. It's exciting to be here today. This is our 5th rendition of this program with Josh and Consuelo, so we're excited to get through it and cover a lot of ground on this important subject.

Today, we're going to walk through some highlights around audit committee practices. We're going to dive into critical audit matters, some accounting related developments relevant for audit committees and then round it out with some highlights on auditor independence developments.

First, on audit committee practices, an excellent roadmap for audit committee oversight came out at the end of December, which was very timely. It's one that I think really will stand the test of time. It's a set of reminders that I think— practitioners and management, it's worth circulating to audit committees not just this year but likely in years going forward—really does encapsulate key areas of focus for the audit committees in a very digestible way.

We'll walk through that and provide some commentary around what audit committees should be doing in response. Just to recap briefly, it's a statement from the SEC Chairman, Jay Clayton, as well as the Chief Accountant, Sagar Teotia, and the Director of Corporation Finance, Bill Hinman, addressing the role of the audit committee and financial reporting, and highlighting some of the key oversight responsibilities they have.

It's important to note that none of these observations introduce any new requirements or require audit committees to do new things; rather it's a focus on really the fundamentals of what they do. It places emphasis on the fact that audit committees really should be actively engaged and underscores the benefits of clear communication among audit committee management and the outside auditor.

The statement is set out with several different observations. It starts with "tone at the top" and then emphasizes the importance that the audit committee has in setting the tone for the company's financial reporting and its relationship with the auditor.

It then goes on to underscore that the audit committee should send expectation for clear and candid communications and an expectation for management and the auditor that the audit committee will engage on financial reporting and control issues. It also highlights that the audit committee should proactively communicate with the auditors to understand audit strategy and status, and raise questions where issues crop up.

My commentary on this important observation is this: tone at the top is a broad, amorphous concept that can be interpreted in different ways depending on the circumstances. I don't think I've ever heard a tone at the top definition that is either all-encompassing or in many cases makes a lot of sense.

Be that as it may, it's still an important issue, and it's a helpful reminder for audit committees to consider the steps they are taking at the company to reinforce infective messaging around what it means for tone at the top at that company and the need to have integrity in the financial reporting process.

This can mean a variety of different things, but it should lead audit committees or audit committee chairs to think about whether they're having effective interactions with the controller's group. For example, are they walking the halls? Are they meeting in person with the controller's group in order to set some of these expectations?

Similarly, as they go through, for example, their annual self-assessment process, are they thinking about tone at the top issues as they go through that self-assessment process? Those are some important ways in which tone at the top can be thought about at the audit committee level and fed down to reinforce infective messaging.

The next broad area that the statement covers is auditor independence. Obviously, the audit committee plays a critical role in auditor independence, and what the statement says is that the audit committee should consider periodically assessing the sufficiency of the auditor's and the issuer's monitoring processes.

Now, taking a step back from that, I think we're all well familiar with what issuers have in place typically to handle the audit in auditor independence issues that they regularly deal with - that is audit committee preapproval policies and policies for hiring former audit firm personnel.

Again, the statement does a good job at reminding audit committees that they should engage in a periodic review of those particularly because some of those policies can be stale. There are helpful updates that are worth taking a look at, so doing a periodic review of those policies is worthwhile.

Interestingly, what the statement also says is to consider going beyond those standard policies around independence and monitoring more broadly. It's not entirely clear what that means from an issuer perspective, but what the statement is trying to do is to say — particularly if you're in an organization with a complex structure whether it's a private equity organization and you're a portfolio company within it, a financial institution or insurance company, an investment company complex, a company that has multiple JV relationships— is that audit committee should understand what management is doing to monitor their changing affiliate relationships in those types of organizational structures.

Next, the statement addresses the audit committee's role in implementing. As we all know, there has been a series of important changes in GAAP in recent years, and again, the statement highlights that the audit committee should play a role in promoting an environment for management to make those implementations of new requirements successful. Of course, this is a goal that makes sense. It's also a higher hurdle.

One of the things the standard does is - and Consuelo will talk a little bit more about this one - encourage audit committees to take the time to understand the processes that management has in place for establishing and monitoring internal controls related to the adoption and transition to new GAAP standards, which is an important foundational step in terms of implementation. The statement has a section on internal controls and the audit committee's responsibility for overseeing internal controls and highlights proactive engagement in this area.

Specifically, what the statement observes is that audit committees should understand and monitor management's remediation plans. It emphasizes that audit committees need to set an appropriate tone for prompt effective remediation of material weaknesses where they crop up.

You know my commentary on this issue is that these are good, sensible reminders for proactive engagement. I think audit committees would be well served to take it a step beyond what's in the statement too. That is to say that the observations about understanding and monitoring remediation plans should consider it and take steps to extend that, not just where it's a material weakness, but also a significant deficiency particularly given that management and the auditor have the obligation to report such significant deficiencies to the audit - or bring it to the audit committee's attention.

We'll talk a little bit more about one of the observations highlighted by the staff, which goes to communications between the audit committee and the auditor. There's a lot that goes into the communication standard, and the statement basically underscores that audit committees shouldn't just be on the receiving end of those communications.

They should be participants. It should be an active dialogue. One of those types of communications that the auditor makes to audit committees is specifically the independence communication; we'll come back to that towards the end of the discussion.

The last observation in the statement that I'm going to talk about goes to non-GAAP measures, again highlighting the audit committee. The audit committee should be actively reviewing non-GAAP metrics - understanding how management uses them to evaluate performance, what types of disclosure controls are in place for monitoring the use of the measures and also changes in the measures, which can be an important piece.

Before turning it over to Josh, I just want to briefly touch on two separate topics: One, disclosure committees. This is not an area that was touched on in depth in the statement. But as we're talking about audit committee practices, an area where I see an emerging dynamic is between the audit committee and disclosure committees for a host of reasons.

It's an area of increasing importance, and I think disclosure committees would be well served in this context not to focus on siloed activities and thinking about getting the 10-K out, but also thinking about what they're doing and how they're going to present it if indeed they are asked to present to the audit committee. Audit committee should be looking to disclosure committees for an overview of the key issues that are arising in those disclosure committee meetings, maybe even receiving some type of a report, a memo or agenda that details some of this.

Obviously, there's a lot that goes into that including important process issues around privilege and whether the auditor participates in the meeting. But just to flag that disclosure committee practices vis-à-vis audit committee, I think is an important emerging issue.

And then lastly, I'm getting a lot of questions around audit committee charters and whether they need to be updated for steps that the audit committee takes to review critical audit matters. In a nutshell, I would say that's not necessary. There is abundant language that covers that review and dynamic generally.

Of course, if an audit committee really wants to have it in there, there is nothing that says they shouldn't do that. But as a general matter, I would say it's not necessary. So, with that, I'm going to turn it over to Josh to talk a little bit more in detail on critical audit matters.

CAMs: Lessons learned

Josh Jones, *Partner, Ernst & Young*: Yes. Thanks, Mike. Maybe my comeback from a charter perspective and maybe as a result of some interactions we've had, it might make sense to put a reference to CAMs in proxy reports and things like that as well because we've had that question come up a little bit. And I think we haven't seen a lot of practice on that.

Consuelo Hitchcock, *Principal, Deloitte & Touche LLP*: Yes. We've seen a few that do it, and they seemed to range from mentioning that the audit commmittee talked about CAMs, to actually defining what a CAM is. But we've only seen a small number. It doesn't seem to have developed into a best practice. It seems to be few people that have done it. And again, to the same point, Mike, that you made on charters, it generally falls under the oversight of the auditor.

Jones: Exactly.

Hitchcock: So that specific mention might not be viewed as necessary, but some audit committees seemed to want to highlight it.

Jones: Yes. We've had a couple of situations like, but as you said, Consuelo, where the questions have come up. The practice we've seen is, "hey, we reviewed them with the auditor." Given that the audit report is required, the audit report is kind of a deliverable and auditors have to make sure it complies.

We've not discouraged audit committees from including the reference but also kind of encouraged them to be - to be clear that maybe they haven't reviewed and approved those as well since that is - you know the audit standards require very explicit kind of communications back and forth, but it is obviously the auditor's conclusion.

So, we haven't - certainly discouraged - in that purview of the activities, the audit committees engage with the auditor on to discourage that. We haven't seen to your point a lot of activity in that regard. But when the questions have come up, the only tidbit we'd provided incrementally was, "hey, look, probably just best to highlight your interactions and maybe not to imply that maybe there were some reviewed approval at the risk of getting your auditor maybe in trouble for how they may have handled it."

Scanlon: Yes. I'm not seeing a lot of it myself in terms of inclusion in the proxy report. I agree with what you're both saying. I think at most you'd want to say something along the lines of the audit committee has had communications with the auditor including required communications and discussion of critical audit matters, something like that.

Jones: Absolutely. Makes sense. I thought I'd give everyone just a quick kind of overview as to the experiences to date, maybe lessons learned and a couple of things to think about as — depending on where you are, if you're winding up or kind of gearing up for year two — with respect to CAM reporting.

You know sitting here today, toward the end of February, I think we're not unique in terms of our interest in tracking experiences with CAMs both amongst our firms and then seeing what our peers have done. I think we look kind of broadly across filings to date, the average number of CAMs that we've seen per auditor report still roughly around two.

The topics I think we still continue to find are ones that you would normally expect, so we see typical CAMs around things like asset impairment, goodwill and tangible asset impairment situations.

We see a fair number of CAMs related to revenue recognition, either the application of the policy, transition to ASC 606, things like percentage of completion, other things like that. Sometimes, those are concentrated in more specific industries like the software or maybe construction business. You will see things like significant unusual transactions, like business combinations and some restructurings or things that you'll see with some frequency in the income taxes.

Income taxes kind of runs the gamut from uncertain tax positions to the valuation of deferred tax assets to maybe the recognition of maybe some particular positions in response to some tax structuring kind of transactions. You'll see those types of things with some regularity.

And then kind of crossing through that, you'll see some industries, you'll see some trends. Pretty commonly, you see a lot - aspects of allowance for loan loss type of analysis showing up very commonly in financial institutions. And some might be broad. Many of them are focused on maybe some - certain aspects of the allowance provision as well.

We've stepped back and reflected on those, we haven't seen many items show up that we thought were unusual per se. I think often the things we've seen at least that come in our teams are things we spend a lot of time discussing with audit committees in the context of the audit. From that perspective, I think things have gone kind of as expected.

I think kind of things that we've observed during the course of this year that I thought I would highlight, I guess one is I think we've as we've reflected - and certainly I think you can see it in some of the comments that the SEC and the PCAOB have made - I think internally I guess the practice of going through a dry run like we did last year was really helpful.

I think that PCAOB was a seven-year process, and they had contemplated a number of different things, so having a year to kind of sit and reflect with companies around, "hey, look, let's remind everybody what this actually is, what these things actually will look like, what they're going to say" was all very helpful to go through at least for us in 2018 and added - some call it "smoothness" if you will - to the process that we undertook obviously when we had implemented for it in 2019.

A few things coming out of that implementation process that we thought were particularly helpful was the process of discussing CAMs with company management and the audit committee, and I think that led to some very interesting interactions.

And we might have touched on this a little bit last year as maybe an intended benefit of the dry run. I think we saw this come to life maybe a little more than we expected, which is the process of evaluating and discussing with management and the audit committee on what matters - where CAMs in many cases led to kind of a reflection on all the things you cover in the audit. In particular, maybe using the critical accounting estimates as a focus point: "let's talk about the matters that are the especially challenging or the most challenging."

How does the discussion around those matters correlate to how maybe the company has described the various critical accounting estimates in their MD&A? We talked about little bit last year as we've kind of reflected on our client base and some of the 10-Ks, you know practices over at MD&A, critical accounting estimates probably had varied. And you'll see lots of matters being highlighted as critical accounting estimates with lots of descriptions around significant - subject to significant fluctuations and subject to material change.

When you step back and look at it from an audit perspective, you know sometimes our lens based on the company's history and maybe the basis of those estimates themselves have tended to - or even the materiality, the magnitude of them by themselves tended to - maybe in some cases cause you to believe that they're not quite of the magnitude or severity of those estimates relative to the sensitivity, maybe not as much.

We have some interesting discussions. We've seen through discussions between our teams and the company ran, "hey, look, is this an opportunity to really challenge kind of the number of matters we've identified as critical accounting estimates and maybe more importantly how we've captured" - for the ones we think still are particularly relevant, how we've captured where that sensitivity relates.

I can't say that has happened universally. But we have had some instances where those discussions have led to changes to the way they're described, the number of which they've identified and things like that. We found that to be pretty positive.

Scanlon: What about sort of segmentation of CAMs? Have you seen in a particular industry that the CAMs for companies in that industry tend to be the same types of CAMs? Or is it even within an industry, that there is just a variety of what's rising to the level of a CAM?

Jones: You know it's interesting, Mike, because I think in certain industries, you'll see pretty common number of CAMs or these common types of CAMs. Like I mentioned earlier, in the financial services industry. I think every bank or bank like industry and company that we audit will have some type of allowance related CAM associated with it.

You see other things like in the real estate industry; you'll see things like asset impairment pretty commonly. Given that those entities are having to make those judgments on maybe a property-by-property type basis and those properties generally are fairly expensive, right, and so the impact of those decisions are pretty meaningful to the financial statements.

You'll see some trends, but I will say you do see a fair bit of variation. I think one of the common questions we've had come up through our discussions with the company in the audit committees are "how do our CAMs compare to our peers?" which has been a little bit challenging too because you'll hear we've had experiences from our dry run but nothing on file, right?

As a firm, we took surveys of our teams and did it by industry and just to give our team some perspective on where maybe other teams may be headed. And you know there are differences. I think teams - you know, companies are structured differently.

There is an element for better or for worse that the teams kind of experienced could lend itself to thinking certain matters are more complicated than others, so you do see maybe some disparity.

Hitchcock: Yes. And business model -- if they're very acquisitive companies you might have a lot of transactional issues that come up. I think for us, for everyone in the profession, it's been sort of a balance because on the one hand you would expect to see certain trends in industries. Some of ones that Josh mentioned make sense. On the other hand, it is meant to be company by company.

Scanlon: That's right.

Hitchcock: We don't want to drive it to be where you just sort of have the same set of CAMs and the same language. I think striking that balance between having consistency that makes sense while having this actually customized -- I think the dry runs really helped because we were able to kind of go through with our people what they should be looking for, what they should be thinking about.

Scanlon: Yes. I think one thing there was obviously the caution in the PCAOB adoption release. We don't want to see boilerplate CAMs. And I think obviously it's still early days. One thing that's interesting is the way the standard is set up; it doesn't really lend itself to boilerplate, because the first part of the CAM disclosure is in a sense going to be repeating what the company's accounting for it is, and I think that's appropriate. And you want to hew closely to that. Companies obviously may account for things differently even within a particular industry, and then what the auditor is doing to audit to that CAM may vary as you say by engagement team.

I mean you're going to have some generalities there, but there may be varied, quite different and distinct step. The boilerplate issue, I think that's again early days, but it does seem like that's not going to be a real concern.

Jones: Yes. I think that's been our experience, Mike. You will see, as Consuelo said, some common themes. And we've tried to make sure through the judicious use of examples that a CAM that comes from any audit of E&Y kind of sounds like E&Y.

But you know at the same time, if you have an allowance full on loss at bank audit A, you're not reading basically a cut and paste with a change in name. So how - and to your point, how the company has described the matter, how each team articulates the particular elements that were challenging for them typically varies.

And then you know while you don't generally want there to be - for an allowance to be vast differences in how you described maybe your response to some of those you do want - how teams have articulated how they've gone about approaching those responses have varied enough that certainly I think it reflects the nature of that audit but also lends itself to maybe some unique discussion as opposed to must be in the same.

Hitchcock: Obviously, it's the same audit standards and within that firm the same audit methodology, so the commonalities make sense. But right now, I don't think it's useful to investors unless you're really distinguishing and explaining.

Jones: Yes. The only couple things I'll mention that - or something to think about I guess as we move forward this year - is we have started to get questions although I don't think we've heard of a lot of interest coming up on investor calls and shareholder meetings.

Kind of what we've encouraged our teams to do. Make sure they interact with management, the audit committee around, hey, look, since CAMs are new, since those are new statements being made by the auditor in the audit report, questions might come up through investor relations or at shareholder meetings around what those matters are and how the company feels about those and things like that.

We have encouraged our teams to reach out to the company and work to establish some protocols around how those questions should be dealt with when they come in.

You know it's not typically, the auditor. Investors don't have a direct line to the auditor. And quite frankly, I think what investors will find interesting about CAMs is what it tells them about matters in the financial statements.

As we've kind of thought about it and worked with companies, we think that questions come up because that's likely their interest, the company probably could and should work with the auditor. But probably the best position to take, kind of the first path, is really trying to get at the underlying investor's kind of question.

But at the same time, there are reports. If there are questions we can be helpful with, you'd be mindful that we don't want to be speaking about matters that the company has already spoken about. We'd want to stay close to what our requirements are, how we got to that judgment and likely just highlight kind of how the procedures we did are intended to respond.

Having that protocol now versus reacting to it later we thought was pretty helpful, and we're continuing to emphasize the discussion of these matters early in the year because as we talked about, the discussions around the impact to MD&A, as matters come up, that could be CAMs.

You mentioned how the first paragraph fires off with the company's disclosure. We did see situations where the CAM probably was a component of a matter in a footnote or somewhere that may not have previously gotten a lot of attention in the financial statements, and so you know understanding what those pieces are early on can help everyone plan and prepare for the financial statements and the reports to sync up as best as possible.

Areas of Focus for Audit Committees in SEC reporting

Hitchcock: Well, then, I was going to cover a few more things really more on the company's financial reporting that should be on the audit committee's radar in addition to just the general, financial reporting. Obviously, that's a main job, but as Mike alluded to in talking in detail about that SEC statement that came out in December, the audit committee's role is still very much on the SEC's mind.

I think in the December conference that the AICPA has every year, the chief accountant said the independent audit committee was arguably the most effective and cost-effective financial reporting enhancement in Sarbanes-Oxley. So all audit committees should be happy that they're not only doing well, but apparently, they're cost effective.

But I think they very much - you know Mike went through their general guidance there. But I think the SEC has put a lot of attention on challenging management and auditors and audit committees to all be working together on the financial reporting issues.

A couple of the specific reporting topics that I think audit committees should have in mind this year, in addition to the general ones that would normally be on the plate with the company. One is the novel Coronavirus, which I think is now called COVID-19, or so I keep seeing in articles. The SEC has actually made two different announcements about this, one at the end of January and one actually that just came out today that are relevant to this.

And from the perspective of an issuer reporting, I would say they made a few key points. One is that issuers should really make sure that they are working with their audit committee and auditor to ensure that any effect this might have on their financial reporting or the audit and review process is sort of as robust as practicable in light of the circumstances - so that they're meeting the requirements even if they have China components that they're not actually in the office or they're having trouble accessing things in China.

The second is the need to consider a potential disclosure of subsequent events in the notes of the financial statements if in fact there is going to be an impact on the reporting because of operations in China and trouble accessing information. And then the third general point that they made in the release was the SEC has encouraged people to contact the staff regarding the need for any relief or any guidance on any of these issues.

As a general policy, the SEC will grant appropriate relief from filing deadlines in situations where there are circumstances beyond their control that make it hard to complete the filing on time. So, those are just things to keep in mind if your company might have a lot of China operations or otherwise is affected by Coronavirus, which I think might be true even outside of China operations in a few industries.

The other thing that they continue to emphasize, and we've talked a little bit about it, Mike did, so I won't go into a lot of detail, but is new GAAP standards and what the audit committee's role should be in the implementation of new GAAP, and obviously, this year's focus is on CECL.

You know people just finished leases. And before that revenue, I think that this is just one area where the SEC does continue to emphasize that audit committees need to make sure they have a role. In addition to what Mike was saying - you know just making sure you understand where that stands - make sure management has gotten started early, that they're thinking about internal controls.

The other thing to keep in mind is that there are disclosure requirements, sometimes both within the new standards but also what they would call the transition disclosure under SAB 74, the disclosure that you might need to be disclosing about the upcoming impact.

One of the things you could think about with audit committees is that when talking to management about their update is also to add this to your separate discussions with the auditors and get a view as to whether they think management is on track or have any insight that they would want to share with you about how management is working on implementation.

Another one that the SEC staff continues to emphasize and is also mentioned in the audit committee release in December is the transition away from LIBOR, which will cease being the measurement of choice in December 2021. So, the SEC has emphasized that the company needs to consider disclosures. It might be an MD&A, risk factors, their liquidity in capital resources, but they need to anticipate and think about disclosures around transitions to LIBOR.

This is going to affect multiple industries. Real estate, banking and insurance especially might be impacted by the transition away. They need to sort of go ahead of it and identify where that might be affecting the company and what management is planning to do about it, understand their plans, what they're planning to transition to and those types of things.

Then, just keeping on the London theme, the other one that the SEC keeps talking about too is to really make sure companies have on their radar the potential impact of Brexit to their disclosures and make sure that companies are giving investors sufficient information about the potential implications of Brexit to reporting and their planning and preparation for this.

They really need to disclose how management is assessing that risk, what management's doing to mitigate it if you're talking about it in terms of a risk.

I mean some of the specific things you might think about or ask management about or you might think, well, if we don't have big EU operations, maybe it's not relevant. In early 2019, Corp Fin Director Bill Hinman shared topics that they thought you really need to think about, which includes the uncertainty of loss and risks that come that way, supply chain risks, loss of customers, currency devaluations, contractual risks if you have a lot of contracts that could be affected with the UK and then financial statement recognition issues.

It's something to keep in mind and to make sure management has thought about it and to get at least a sense of where that might affect your company.

Non-GAAP continues to be a perennial topic for the SEC. You know we've talked about this in previous years, but basically in late 2016, early 2017, the SEC really started increasing their focus on non-GAAP and gave guidance. I think that the SEC's acknowledged they've seen a lot of improvement in this area.

It's definitely something that they're still highlighting. And in fact, again, this was also in the December audit committee release that Mike mentioned - it's one of the two or three things they mentioned that audit committees should be focused on.

They have continued to comment. I think their comments are probably getting a little bit more focused as they're seeing some of the low hanging fruit bad practices go away. Some of the things now they're looking at is what disclosure will aid the purpose and use of that non-GAAP measure? A lot of the reconciliation requirements and then clear labeling, I think, are some of the things we're still seeing a lot of comments from the SEC staff on.

The other thing that I think we've seen comments on especially in the IPO area is the use of key performance indicators and other metrics, so beyond GAAP to actually look at the other things that are disclosed about the size and growth of the business, same-store sales, occupancy rates, things like that.

That's another thing that I think the audit committee should have on their radar - to think about disclosures about these and think about the controls around making sure that those are also effective.

Scanlon: Yes. On that one, I don't think it was specifically called out in the statement around disclosure controls for key performance metrics. But I do think that is something that the audit committee should be attuned to particularly is year over year consistency in terms of what the measure is, how it's being described and what inputs go into that measure - particularly because those metrics are gaining some increased prominence.

Hitchcock: Yes. The SEC has a proposal out now about some changes it's considering in MD&A that I won't go into now since it's just the proposal - to not confuse you with what you should focus on this year - but at the same time, they put out some guidance about how people should be thinking about some of those.

And the other thing that's come up a lot I would say with the SEC, without any real specifics around it, but it's clearly something they're focused on, is ESG disclosure and environmental risks -- especially how companies are looking at that and thinking about that from a risk perspective in their financial reporting.

And then I would say the final item I was going to mention that I think is perennial on their list, and keeps coming up on the top list, is the cybersecurity risk and how they're looking at that.

They continue to emphasize the importance of the disclosures about these risks and incidents and specific to financial reporting, if there is anything, that any cyber risks to the financial reporting process that the audit committee especially needs to be attentive to those.

That was my highlights on the financial reporting side. Mike, I know you were going to talk about auditor independence.

Auditor Independence: SEC proposal, PCAOB guidance

Scanlon: Yes. Sort of covering the waterfront here for audit committees, we're going to wrap it up with some relatively significant developments in the auditor independence world in the past year. Most significantly, and clearly, the Commission was quite busy towards the end of the year. They came out with a proposal on December 30th to amend a number of important aspects of their auditor independence requirement.

This is a welcome review because really since Sarbanes-Oxley, there has only been one minor, relatively minor, set of changes to the auditor independence requirements. At a high level, the objective here was to more effectively focus the independence analysis on relationships and services that are likely to pose threats to the auditor's objectivity and impartiality, and trying to weed out some of the noise in the system so to speak.

The deadline for providing comments on this one is March 16th of this year, and I do think for particularly private equity firms, portfolio companies, investment company complexes, there's an opportunity to provide views on the proposal here.

The reason I mentioned those entities in particular is because one of the important changes goes to what's the definition of an affiliate of an audit client. As I think most of you know, the independence rules and restrictions on services and relationships applies not just to the entity under audit but also to the range of affiliates of that entity under audit.

In a private equity or investment company complex structure, the number of affiliates can explode. And it's quite hard to not just monitor and manage those changing relationships for the auditor and for management of the relevant entity under audit but also there is sort of a scratch your head and ask "what is the potential threat to objectivity and our impartiality where you have a commonly controlled sister entity 20 light years away?"

It's immaterial to the controlling entity, and it doesn't really make sense that that should be an affiliate that poses an independence concern. The Commission, I think, practically has come up with a tailored modification that would take out those immaterial sister entities from the affiliate definition.

Another notable change in the proposal is in the IPO context. So right now, if you are an auditor for a domestic private company seeking to go public, the financials included in that registration statement have to be SEC independent for all years covered in the registration statement and which typically would be two or three years depending on the type of filer.

There is an exception for foreign private issuers that says they have to be independent only for the immediately preceding year under SEC rules and then for prior periods under whatever their relevant home country standard, maybe IAS there or otherwise. I think the commission made a practical proposal to try to, among other things, facilitate capital formation here to extend this exception for foreign private issuers to domestic first-time filers so that they have the benefit of the foreign private exception.

There's an analog for this in the context of merger and acquisition transactions where so long as the audit firm has in place a robust quality control system, so long as they're trying to dispose of a relationship or disentangle themselves from a relationship that springs upon the occurrence of a merger or acquisition, that if they practically can't get out of the relationship by the time of the closing, the proposal would say, "You should do it as quickly as possible but in any event within six months." Again, this provides some practical transition relief for independence issues that arise in the context of mergers and acquisitions.

Some important changes from the staff here on the auditor independence front, practical ones, ones that I think are based on experience of issuers, the firms and the SEC staff and seeing how these things have evolved over the past 20 years.

And then lastly, I'm going to turn briefly to some guidance that the PCAOB put out at the end of 2019. Again, I think this is important for audit committees to just have in mind and advisors for audit committees to have in mind. This guidance relates to what are known as 3526 communications, the communication that an auditor has to make to the audit committee around independence issues at least once a year.

The staff recognized that, among other things, if there has been a 3526 communication with an independence issue disclosed in it, that there is not a lot of sensibility in having to disclose that same issue year over year. This guidance says the staff really doesn't have to repeat that 3526, that independence issue in next year's 3526 communication assuming there is no change in facts.

The guidance also provides a pretty specific framework for what the auditor has to communicate to the audit committee about the issue and then also what it expects the audit committee to do. This is where it's relevant for our presentation here and audit committee considerations.

Specifically, the audit committee has to separately evaluate the issue that's at hand, consider whether reasonable investor would view that to impact the auditor's objectivity and impartiality.

That point, there, is consistent with the staff's view both from the SEC and the PCAOB that this is a shared responsibility around independence, and then the audit committee has to agree that the audit engagement can continue.

Among other things, the PCAOB staff underscored that this level of communication, this level of thought around an independence issue - if it does arise - will promote both effective oversight from the audit committee and effective assessment of the independence issue. I think that is the correct view, and this is an important piece of practical guidance from the PCAOB.

Just to underscore again if, for audit committees and their advisors, it's important to pull out this guidance when an issue around auditor independence surfaces. With that, I will turn it back to John to wrap it up for us.

Jenkins: All right. Thanks very much, Mike, and thanks again to everyone on the panel. There is never a shortage of topics for this webcast. I really appreciate the insights that our panel provided today, and I also thank all of our listeners for participating in today's webcast.