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SEC Releases Statement on Key Reminders for Audit Committees

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On December 30, 2019, the Securities and Exchange Commission (the "SEC") released a statement (the "Statement") from Chairman Jay Clayton, Chief Accountant Sagar Teotia and the Director of the Division of Corporation Finance, William Hinman, addressing the role of the audit committee in financial reporting and highlighting key reminders regarding oversight responsibilities (available here). The Statement is intended to "assist audit committees [in] carrying out their year-end work, including promoting efficient and constructive dialogue among audit committees, management and independent auditors."

The observations included in the Statement do not introduce new requirements for audit committees, but the Statement is a helpful reminder for audit committees, management and outside auditors about audit committee practices that help to promote healthy oversight over financial reporting. Although the Statement covers a range of topics, a theme that runs through the observations is an emphasis on active engagement by the audit committee and on the benefits of clear communication among the audit committee, management and the outside auditor.

Below are the observations and reminders highlighted in the Statement. The Statement styles the first five topics as "general observations" and the last three as "more specific observations." Although most of the observations in the Statement speak for themselves in terms of next steps and practice pointers, we have provided some additional commentary in italicized text below on a few of the topics.

- **Tone at the Top**: The Statement emphasizes the role of the audit committee in "setting the tone for the company's financial reporting and the relationship with the independent auditor." As part of this, the Statement notes that it is important for the audit committee to "set an expectation for clear and candid communications to and from the auditor" and an expectation with management and the auditor that the audit committee will engage as financial reporting and control issues arise. Additionally, the Statement highlights the audit committee should proactively communicate with the independent auditor to understand the audit strategy and status, and raise questions regarding issues identified and understand the resolution of such issues.

Although "tone at the top" is an amorphous concept, this is a helpful reminder for audit committees to consider the steps they are taking to reinforce effective messaging about the need to have an environment that supports integrity in the financial reporting process. For example, as audit committees go through their own annual self-assessment processes, it would be worthwhile to incorporate this topic as an element of that process and then to evaluate and implement action steps, as appropriate, based on that self-assessment.

- **Auditor Independence**: The Statement notes that audit committees play a critical role in an auditor's compliance with the auditor independence rules and encourages "audit committees to consider periodically the sufficiency of the auditor's and the issuer's monitoring processes." As part of this, the Statement notes that audit committees should consider the processes that are in place to facilitate the timely communication to the auditor of corporate changes and other events at the company that could affect auditor independence, including changes or events that may result in new affiliate relationships.

Periodic review of processes in place at the company to monitor auditor independence matters – such as audit committee pre-approval policy and policies for hiring former audit firm personnel – is standard practice, but this is a helpful reminder to ensure those reviews take place. In light of this observation in the Statement, audit committees also should inquire of management and the auditor to make sure the committee understands the steps that are in place to communicate to the auditor about new affiliate relationships.

- **GAAP**: The Statement also addresses the audit committee's role in implementing new Generally Accepted Accounting Principles (“GAAP") standards, noting that the audit committee should promote “an environment for management's successful implementation of new standards." Specifically, the Statement observes that audit committees should proactively engage with management and the auditors to understand how management plans to implement new accounting standards, including “whether the plan provides sufficient time and resources to develop well-reasoned judgments and accounting policies." The Statement also encourages audit committees to take the time to understand the processes for establishing and monitoring internal controls related to adoption and transition to new GAAP standards.
- **Internal Control Over Financial Reporting**: In discussing the audit committee's responsibility for overseeing internal control over financial reporting (“ICFR"), the Statement notes that audit committees should have “a detailed understanding of identified ICFR issues and engage proactively to aid in their resolution." Additionally, the Statement observes that when there is a material weakness, audit committees should understand and monitor management's remediation plans and emphasizes that audit committees need to set an appropriate tone that prompt, effective remediation of the material weakness is a high priority.

Here, the Statement serves as a helpful reminder that where internal control issues are “identified” for the audit committee, the committee should proactively engage in seeking to resolve the issue. Even though the Statement focuses on steps audit committees should take when a material weakness is identified, the observations about understanding and monitoring remediation plans also serve as helpful reminders to consider when significant deficiencies are identified given that management has to bring both material weaknesses and significant deficiencies to the audit committee’s attention.

- **Communications to the Audit Committee from the Auditor**: PCAOB AS 1301, Communications with Audit Committees, requires the auditor to communicate with the audit committee regarding certain matters related to the conduct of the audit and to obtain certain information from the audit committee relevant to the audit, including matters related to certain accounting policies and practices, estimates and significant unusual transactions. The Statement reminds audit committees of this process and encourages them to be active participants in this dialogue with the auditor.
- **Non-GAAP Measures**: The Statement encourages audit committees to actively engage in the review of non-GAAP measures and metrics to understand: how management uses them to evaluate performance; whether they are consistently presented from period to period; and the company's related policies and disclosure controls and procedures in place for monitoring use of non-GAAP measures.
- **LIBOR**: The Statement also discusses the audit committee's role in monitoring risks associated with the discontinuation of LIBOR and encourages audit committees to understand how management plans to identify and address any such risks, including the “impact on accounting and financial reporting and any related issues associated with financial products and contracts that reference LIBOR."

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This observation continues the SEC's push to have public companies focus on managing their transition away from LIBOR and identifying relevant risks. Additionally, this reminds the audit committee that it should be involved in this process and discuss the transition away from LIBOR with management. For more information on the SEC staff's views on the LIBOR transition, see our previous blog post*.*

- **Critical Audit Matters**: With respect to critical audit matters (“CAMs"), the Statement encourages audit committees to engage in a “substantive dialogue" with auditors regarding the audit and expected CAMs in order 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."

Gibson Dunn’s lawyers are available to assist with any questions you may have regarding these issues. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work in the Securities Regulation and Corporate Governance practice group, or any of the following lawyers:

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