

# To the Point

## SEC Chief Accountant provides guidance on how audit committees can be more effective

'Audit committees also play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company's culture and internal control over financial reporting...'

– Wesley Bricker

### What you need to know

- ▶ SEC Chief Accountant Wesley Bricker provided guidance for audit committees in a recent speech on how they can effectively discharge their oversight responsibilities.
- ▶ Among the audit committee responsibilities he highlighted are two that we believe are especially important right now – understanding the financial reporting risks related to implementing new accounting standards on revenue recognition, leases and credit losses and supporting controls over a company's use of non-GAAP financial measures.
- ▶ He also discussed the importance of understanding changes in the business and operating environments, setting a positive tone at the top to support internal control over financial reporting, overseeing the external audit and making sure the committee isn't overloaded, among other topics.

### Overview

Securities and Exchange Commission (SEC) Chief Accountant Wesley Bricker discussed how audit committees can effectively discharge their oversight responsibilities in a recent speech<sup>1</sup> at the University of Tennessee's C. Warren Neel Corporate Governance Center.

"Audit committees also play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company's culture and internal control over financial reporting (ICFR), the quality of financial reporting, and the quality of audits performed on behalf of investors," he said.

Mr. Bricker highlighted seven areas in which audit committees can improve in their oversight of a company's financial reporting, echoing comments he and other SEC officials have made in recent years.

## Key considerations

### Understand the business and operating environment

"Audit committees should understand the businesses they serve and the impact of the operating environment – the economic, technological, and societal changes – on corporate strategies," he said, citing the following risks:

- ▶ "Changes in the operating environment can result in changes in competitive pressures and different financial reporting risks."
- ▶ "Significant and rapid expansion of operations can strain controls and increase the risk of breakdown in controls."
- ▶ "Entering into industries, business areas or transactions with which an entity has little experience may introduce new risks associated with financial reporting, including ICFR."
- ▶ "The implementation of new GAAP standards may affect risks in preparing financial statements, particularly if implementation planning or execution is lacking."

### How we see it

Right now, we are especially concerned about implementation of the new revenue recognition standard. While most public companies we have surveyed have started implementing the standard, many of them are at risk of not successfully completing implementation by the effective date (i.e., 1 January 2018 for calendar-year public companies). Audit committees should actively engage in discussions with management and the auditor about the company's progress.

### Promote board diversity

Mr. Bricker noted that investors have expressed "strong interest" in board composition, including with regard to diversity.<sup>2</sup> He said that "diversity of thoughts diminishes the extent of group thinking, and diversity of relevant skills...enhances the audit committee's ability to monitor financial reporting." He added that "[g]iven the importance of diversity to audit committee effectiveness, there is an opportunity to increase the level of diversity on U.S. boards and audit committees."

### How we see it

In our view, diversity underpins good business. Research by EY and others demonstrates a link between board diversity and economic results. Investors also tell us that board diversity is a priority for them.

### Balance the audit committee workload and keep current on financial reporting developments

Mr. Bricker expressed concerns about the capacity of audit committees to balance their workloads, given all of the demands on their time. He said boards should also consider whether they are identifying and managing any risks of audit committee overload.

“While audit committees may be equipped to play a role in overseeing risks that extend beyond financial reporting, such as cybersecurity and portions of enterprise risk management, I believe it is important for audit committees to not lose focus on their core roles and responsibilities,” he said.

Mr. Bricker said audit committees should also consider providing training programs to help their members stay current on accounting and financial reporting developments, especially new accounting standards that have a significant effect.

### **Set a positive tone at the top and culture**

A strong control environment is especially important because new accounting standards require management to make more judgments than they have in the past. He said audit committees may directly affect the control environment, which influences the behavior of management and other personnel. He also noted that tone at the top is a key element of the internal control framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

“One way audit committees can focus on tone and culture is by working with management to obtain a clear and common understanding of what tone means, why tone is important, and what mechanisms are in place to assess the adequacy of control environment, including across any relevant divisions and geographies,” he said. Mr. Bricker also suggested that it is critical for audit committees to discuss tone with the external auditor.

### **Understand disclosure controls and procedures over non-GAAP financial measures**

“Audit committees are well positioned to exercise healthy oversight by understanding management’s process and controls to calculate the non-GAAP and other key operational measures,” Mr. Bricker said. That oversight should include understanding:

- ▶ Procedures in place over the accuracy of the calculation and the consistency of the measures with those provided in prior periods
- ▶ Any non-GAAP policies in place, and if no policies exist, why that is the case
- ▶ The individual(s) in the organization responsible for administering any non-GAAP policy and “how many times have they approved changes in reporting” as well as the reasons for such changes

Mr. Bricker’s comments were consistent with his remarks at the 2016 AICPA National Conference on Current SEC and PCAOB Developments.

### **How we see it**

Audit committees should review the SEC staff’s recent guidance on appropriate uses of non-GAAP financial measures and monitor trends in SEC staff comments on company filings and earnings releases.

### **Monitor corporate objectives that could conflict with effective oversight of external auditors**

Mr. Bricker said audit committees should work with other board committees to make sure important corporate objectives, such as cost reduction plans, are not implemented in ways that might adversely affect management’s financial reporting responsibilities or inappropriately limit the scope of the external audit, the engagement terms or the auditor’s compensation.

Mr. Bricker said audit committees should oversee a company’s use of non-GAAP financial measures.

“The audit committee responsibilities under the listing standards include the authority and responsibility to directly oversee auditor engagement terms (including proposed scope) and compensation.” he said. Repeating comments made in a previous speech, Mr. Bricker added that “[s]ome of management’s standard procurement policies and processes may not be appropriately designed if used in the audit committee’s selection, retention and compensation decisions for the external auditor.”

### **Consider enhanced voluntary reporting**

Mr. Bricker pointed to the SEC’s 2015 concept release about possible revisions to audit committee disclosure requirements<sup>3,4</sup> and to a recent survey<sup>5</sup> of Fortune 100 audit committees that demonstrated significant growth in voluntary disclosures in the past several years to encourage audit committees to “continue to consider reviewing their audit committee disclosures and consider whether providing additional insight into how the audit committee executes its responsibilities would make the disclosures more effective in communicating with investors.”

### **Endnotes:**

- <sup>1</sup> Speech by Wesley R. Bricker, 24 March 2017. <https://www.sec.gov/news/speech/bricker-university-tennessee-032417>.
- <sup>2</sup> See EY Center for Board Matters, *2017 proxy season preview: What we’re hearing from investors*, [http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-preview/\\$FILE/ey-2017-proxy-season-preview.pdf](http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-preview/$FILE/ey-2017-proxy-season-preview.pdf).
- <sup>3</sup> See SEC release no. 33-9862, *Possible Revisions to Audit Committee Disclosures*, <https://www.sec.gov/rules/concept/2015/33-9862.pdf>.
- <sup>4</sup> See our comment letter on SEC release no. 33-9862, *Possible Revisions to Audit Committee Disclosures*, <https://www.sec.gov/comments/s7-13-15/s71315-66.pdf>.
- <sup>5</sup> See EY Center for Board Matters, *Sample audit committee disclosures in 2016*, [http://www.ey.com/Publication/vwLUAssets/ey-sample-audit-committee-disclosures-in-2016/\\$FILE/ey-sample-audit-committee-disclosures-in-2016.pdf](http://www.ey.com/Publication/vwLUAssets/ey-sample-audit-committee-disclosures-in-2016/$FILE/ey-sample-audit-committee-disclosures-in-2016.pdf).

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