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New Accounting Standards and ICFR at the Forefront of 2018 AICPA Conference

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Capping off a busy year, the annual American Institute of Certified Public Accountants Conference on Current SEC and PCAOB Developments, held on December 10-12, 2018, revisited many familiar themes from prior years and highlighted current and future regulatory priorities. Similar to the prior year's conference, implementing new accounting standards and internal control over financial reporting were chief points of discussion for regulators. A Deputy Chief Accountant panel presentation featuring SEC Chief Accountant Wesley Bricker and other members of the SEC Office of the Chief Accountant's (OCA) staff captured primary themes from the conference. Highlights from the conference include:

- *New Accounting Standards*. Similar to the prior year's conference, adoption of new accounting standards dominated the discussion at the 2018 conference. With the majority of public companies having now filed their first financial statements that reflect adoption of the new revenue recognition standard, the focus at the 2018 conference addressed lessons learned from the revenue recognition standard and shifted toward implementation of the upcoming leases standard and current expected credit losses (CECL) standard, which for calendar year-end filers become effective for financial statements beginning on or after January 1, 2019 and 2020, respectively.

  Noting that "the remaining adoption runway is short" for the new leases standard, the OCA staff emphasized that "[i]t is also critical for companies to identify and resolve transition, application, and other implementation issues arising from the new leases standard. A lesson learned from the implementation of the new revenue standard is that entities benefit from an early and thorough discussion of implementation issues with their auditors and audit committees." While companies have more time to implement the new CECL standard, the OCA staff encouraged companies to continue focusing on implementing the new standard and mentioned that the OCA staff has observed progress on companies' implementation of the new CECL standard, noting "[m]ore generally, the nature of consultations received has shifted from scoping questions to more specific application questions, which we believe is a positive sign that companies are making progress on implementation."

As a reminder about implementing new accounting standards, the OCA staff again outlined the following general implementation steps:

- Understanding the accounting and disclosure requirements of the new standard;
- Identifying relevant arrangements and leases within those arrangements;
- Determining appropriate accounting policies, including applicable transition elections;
- Applying the guidance to arrangements within the standard's scope;
- Preparing transition and ongoing disclosures; and
- Establishing adequate and appropriate processes and controls to support implementing and applying the new standard, including preparing required disclosures.

As the OCA has previously discussed, "the audit committee plays a significant role in the financial reporting oversight of management's implementation of new accounting standards." It is important for audit committees to understand management's plans to implement new accounting standards. Proper audit committee oversight of management can enable management to develop "rigorous approaches" to:

- Establish appropriate controls and procedures over transition;
- Maintain appropriate controls and procedures over ongoing application of the new standard; and
- Understand how the effects of the new standard are communicated to investors at transition and on an ongoing basis.

– *Internal Control over Financial Reporting (ICFR)*. Hand in hand with the adoption of new accounting standards is a company's focus on ICFR, which contributes to reliable financial reporting, is a first line of defense for preventing or detecting material errors or fraud in financial reporting and is a good business practice more generally. As the OCA staff noted, "[i]t is essential for audit committees, auditors, and management to continue to have appropriate discussions of ICFR in all areas—from risk assessment to design and testing of controls, as well as the appropriate level of documentation. If left unidentified or unaddressed, internal control deficiencies can lead to lower-quality financial reporting which can ultimately lead to higher financial reporting restatement rates and higher cost of capital." While the OCA has seen improvements in the evaluation of the severity of internal control deficiencies, the OCA staff "encourage[s] ongoing attention, including audit committee participation and training as needed, regarding the adequacy of and basis for a company's effectiveness assessment, particularly where there are close calls in the assessment of whether a deficiency is a significant deficiency (and reported to the audit committee) or a material weakness (and reported also to investors)."

– *Audit Committees*. As in prior years, the OCA continues to emphasize the vital role of "strong, independent audit committees" and underscored the importance of clear and candid auditor-audit committee communications. Noting that boards of public companies in the U.S. assign their financial reporting oversight responsibilities to their audit committees, the OCA staff suggested that "[c]ompanies and directors should carefully choose who serves on their audit committees, selecting those who have the time, commitment and experience to do the job well. Just possessing financial literacy may not be enough to understand the financial reporting requirements fully or to challenge senior management on major, complex decisions." Further, the OCA staff advised that audit committee agendas should be properly balanced to enable an understanding of the accounting, ICFR and financial reporting requirements for a company. The OCA offered that in the context of ICFR, for instance, audit committees could deepen their understanding by gathering insights from conversations with auditors about whether, where and why auditors were unable to rely on certain internal controls in performing the audit.

Citing a recent Center for Audit Quality report (see our November 6, 2018 post), the OCA staff commended audit committees of S&P 1500 companies for positive trends regarding audit committees voluntarily providing enhanced disclosures, particularly concerning the "appointment, compensation, and oversight of the work of any registered public accounting firm . . . ." The OCA staff noted, however, that opportunities for improvement in this area exist for mid- and small-cap companies.

- *Audit Quality*. Observing that audit quality has improved over time, the OCA staff noted that regulatory inspections continue to identify a prevalent number of deficiencies. Efforts to improve audit quality include audit firm governance and collaboration among audit firms. Both serve to foster audit quality and safeguard against noncompliance risks. For audit committees to evaluate how an audit firm's systems of quality control are functioning, many audit firms provide reports on such matters beyond required audit committee communications. The OCA staff observed that the most useful versions of such reports "include robust information, such as three-year comparative data, discussion and analysis of results and trends, and are presented annually and updated on an interim basis, as needed." These voluntary reports frequently are a helpful companion to PCAOB inspection reports.

  In the context of the global environment, the OCA continues to participate, through the International Organization of Securities Commissions (IOSCO), in the development of a report on good audit committee practices that promote and support audit quality. Topics covered in an April 2018 consultation report included recommending the appointment of an external auditor, assessing potential and continuing external auditors, matters to consider in setting audit fees, facilitating the audit process, evaluating external auditor independence, communicating with external auditors, and assessing audit quality. Comments on the consultation report will shape the final report issued by IOSCO, which is expected to offer helpful suggestions for audit committees on a global basis.

- *Auditor Independence*. Also similar to prior years, auditor independence remains among the top areas of focus for the OCA. Fundamentally, auditor independence, in fact and appearance, is essential to confidence in an audit. Auditor independence consultations with the OCA remain steady and continue to inform the OCA's thinking as to whether an update to existing staff guidance or a recommendation to the Commission is necessary to modernize the existing auditor independence rules. In May 2018, the SEC proposed amendments to the auditor independence rules to clarify the analysis that must be performed when an auditor has a lending relationship with certain shareholders of an audit client. In addition to supporting the SEC's recommendations, comments on the proposed rule suggested other changes to the independence rules, which the SEC staff continues to analyze. The OCA staff reminded that ensuring auditor independence is a shared responsibility of both the audit firm and the company and its audit committee. To help promote compliance with auditor independence rules, companies can regularly monitor and communicate to its auditors about corporate structural changes and operational events that may result in new affiliates or business relationships. More broadly, the OCA staff "encourage[s] management and audit committees, along with audit firms, to evaluate the sufficiency of their monitoring processes and practices" with respect to corporate structural changes and operational events affecting auditor independence.

- *Critical Audit Matters*. The OCA also remains focused on implementation activities concerning disclosure of critical audit matters (CAMs), which first becomes effective for large accelerated filers for fiscal years ending on or after June 30, 2019 (i.e., for calendar year-end companies, for audit reports filed in 2020). Based on its involvement during the year on CAMs, the OCA encourages auditors and registrants to:
    - Conduct dry runs during the upcoming year, which should include constructive dialogue among auditors and audit committees and may help prevent mistakes in reports prepared for investors;
    - Share implementation questions and observations with the PCAOB staff and OCA staff, which will help inform whether additional guidance is necessary; and
    - Develop an understanding of the similarities and differences in different disclosure requirements, including those with respect to critical accounting estimates that management provides in MD&A and critical audit matters that will be communicated by the auditor in the audit report.

- *International Accounting and Auditing Matters*. Although U.S. GAAP continues to serve the interests of investors and other stakeholders, the OCA staff observed that U.S. investors and the SEC continue to have an ongoing interest in IFRS quality and reducing differences between IFRS and U.S. GAAP. In this regard, "at the end of 2017, U.S. investors had invested $12.4 trillion . . . in equity and debt securities listed in non-U.S. jurisdictions." In the interest of U.S. investors going forward, the OCA "will continue to encourage the FASB and the IASB to work together to keep converged standards converged, to reduce differences in standards where they continue to exist, and to continually look for opportunities to improve standards in producing decision-useful information for investors." Such an approach benefits not only market investing, but also cross-border transactions, involving acquisitions of companies whose financial statements are prepared in accordance with IFRS.

Similarly, the OCA staff commented on the OCA's interest in maintaining high-quality international auditing standards, which are also relevant to the U.S. and investors in its capital markets. For example, U.S.-based multinational companies may have local country statutory and other reporting obligations in jurisdictions outside of the U.S. that are satisfied by the audit reports from audit firms that applied international audit-related standards. These audit reports may be used by the U.S.-based audit team of such clients as part of their audit risk assessment for the audit of the consolidated financial statements.

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