Regulators Focus on Audit Quality, New Accounting Standards and Other Developments at 2017 AICPA Conference

DECEMBER 29, 2017

*A*lways a fertile source of guidance, this year's American Institute of Certified Public Accountants Conference on Current SEC and PCAOB Developments, held on December 4-6, was no exception. Discussions during this year's conference expanded on several topics from prior AICPA conferences, focusing on audit quality and the implementation of new accounting standards that will become effective over the next few years. Setting the stage for the upcoming year, the SEC Office of the Chief Accountant's (OCA) priorities were discussed during a Deputy Chief Accountant panel presentation featuring SEC Chief Accountant Wesley Bricker and other members of the OCA staff. The OCA's priorities include supporting successful implementation of new accounting standards, monitoring internal control over financial reporting, and advancing the effectiveness of audit committees in financial reporting. Notable discussion points during the conference included:

- *New Accounting Standards.* Top of mind for most conference presenters was the implementation of new accounting standards for revenue recognition, leases and current expected credit losses, and many speakers from the SEC offered technical guidance regarding these new standards. Among other things, the new accounting standards will require companies to provide new disclosures, including transition disclosures, and will involve the application of reasonable judgments in certain areas. The OCA staff observed that audit committees play an important role in this regard and "can contribute to an effective implementation by setting a tone at the top, establishing expectations for implementation dialogue, and understanding management's response to any auditor concerns." Particularly with respect to the new revenue recognition standard, which takes effect for most companies in 2018, "the first item to emphasize is the positive impact on implementation of an audit committee's understanding of management's implementation plans and understanding the status of progress, including any required updates to internal control over financial reporting."
- *Internal Control Over Financial Reporting (ICFR)*. Several conference presenters reemphasized the importance of ICFR over the next several years as companies

implement new accounting standards. The OCA staff noted, “It is important for audit committees, auditors, and management to continue to have appropriately detailed discussions of ICFR in all areas—from risk assessment to design and testing of controls, as well as the appropriate level of documentation.” The OCA staff also stated that it is important for other stakeholders, including the Committee of Sponsoring Organizations of the Treadway Commission, to “actively monitor and consider whether changes in the financial reporting environment warrant updates or guidance to the control frameworks used in the evaluation of ICFR.”

- *Audit Committees*. Members of the OCA staff also discussed, more generally, the important role of the audit committee in promoting high quality financial reporting. They stressed that audit committees “must stay current as to relevant developments in accounting and financial reporting, whether financial, control, or disclosure related.” In addition to considering continuing education, in addressing certain “important issues,” some audit committees may need expert advisors to assist in carrying out the duties of the audit committee. The OCA staff also emphasized the audit committee’s oversight authority and responsibility over the external auditor, stating that “[t]he audit committee helps set the tone for the company’s relationship with the external auditor.” Noting that audit committees are responsible for directly overseeing auditor engagement terms and compensation, the staff observed, as they have before, that “the design and operation of some of management’s vendor procurement and monitoring approaches may be inappropriate if applied to the auditor selection, retention, and compensation decisions because of the direct oversight role of the audit committee.” In the staff’s view, audit scope and fees “should be designed to be responsive over the course of the audit cycle to sufficiently identify and address audit risk arising in the financial statement audit.”
- *Audit Quality*. This year’s conference devoted significant attention to initiatives designed to improve audit quality, another recurrent theme throughout PCAOB and SEC speeches. Outgoing PCAOB Chairman James Doty and board member Jeanette Franzel both focused their comments around audit quality. Ms. Franzel noted that audit quality has significantly improved since the PCAOB opened its doors, and she observed that in the fifteen years since the passage of the Sarbanes-Oxley Act, “the PCAOB has helped to restore the trust that was lost [in the capital markets] over 15 years ago.” Among other things, Mr. Doty pointed to the PCAOB’s new standard-setting process, which includes an active research agenda and interdivisional teams to study and monitor current and emerging issues. At the same time, Mr. Doty commented that the existence of the accounting profession’s “statutory franchise since 1933 has in some respects dulled the natural instincts that should exist to innovate and compete for investor trust.”
- *Enhanced Auditor Reports*. Members of the OCA and PCAOB staffs highlighted the PCAOB’s revisions to the auditor’s report, which requires, among other things, disclosure of critical audit matters (see our October 30, 2017 post). PCAOB Director of Registration and Inspections Helen Munter encouraged audit firms to “proactively plan for the implementation of the new standard and really think about the objective of the new standard, which is to provide investors with a better understanding of the unique judgments that go into an auditor’s opinion, not a boilerplate copy that looks just like any

other issuer's audit opinion." The OCA staff reiterated the importance of effectively implementing the new standard for it to achieve its full potential and reminded audit committees to engage with their auditors before the new standard becomes effective (see our November 21, 2017 post). Ms. Munter indicated that PCAOB inspections staff will be evaluating implementation of the new standard and plans to discuss what firms are doing in terms of "dry-runs" to help the PCAOB provide feedback throughout the process. Mr. Doty stated that, as needed, the PCAOB "will develop additional guidance and report on areas where we find common compliance weaknesses."

- *Auditor Independence*. Regarding auditor independence, Ms. Munter emphasized that it is important for audit firms to assess systems of quality control to ensure their independence from audit clients. In this regard, Ms. Munter "continue[s] to be concerned by the number of deficiencies we see related to noncompliance with PCAOB rules or SEC rules and regulations related to independence." Examples of these deficiencies include "insufficient communications to the audit committee regarding the scope of tax consulting services performed and the potential effects of all tax services on the independence of the firm, and failure to make the required communications to the audit committee concerning independence."
- *International Accounting, Audit, and Disclosure Matters*. Although the United States has not implemented International Financial Reporting Standards (IFRS), the OCA staff noted that many US companies and investors have an ongoing interest in the quality of IFRS and in reducing differences among the two sets of standards. The staff "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." Separately, over the coming year, the International Organization of Securities Commissions' Committee on Issuer Accounting, Audit and Disclosure (Committee 1), on which the OCA participates and has a leadership role, will be developing a report on good practices of audit committees in promoting and supporting audit quality. The report will cover how audit committees:
  - determine whether to appoint, reappoint, or dismiss the external auditors;
  - assess the performance of the external auditors;
  - consider and approve audit fees;
  - evaluate auditor independence; and
  - engage in communications with external auditors about key risks and judgment areas.
- *New Technologies*. Many of the regulators discussed the rapid expansion of new, potentially disruptive, technologies affecting financial reporting, accounting and auditing. Ms. Franzel, for example, surmised that "[t]hese potentially disruptive changes will present challenges and threats, along with tremendous opportunity across the auditing profession."

Members of the OCA staff emphasized three points regarding new technology, particularly in the context of distributed ledger, or "blockchain" technology:

- **Considering the Possible Effects of Innovations**. As a foundational matter, "it is a role of the SEC staff and of the accounting profession to consider the possible effects of innovations in technology and commerce on the financial reporting obligations of issuers of securities to those who invest in the public capital markets." Using the distributed ledger example, consideration should be given to this technology's potential application to an issuer's books and records, ICFR, application of accounting standards, and the audit of its financial statements.
- **Understanding the Nature of Innovations**. An issuer's management and its auditors must understand the nature of the issuer's innovations "to appropriately report the financial statement effects of its innovation efforts to investors."
- **Applying Accounting and Auditing Standards to Financial Reporting Effects of Innovations**. As is evident from the definitions provided by the OCA staff, "innovations in technology and commerce that the monies of those who invest in the public capital markets help to bring about can, not surprisingly, prompt questions regarding aspects of how management should prepare and how auditors should audit an issuer's financial statements in accordance with the respective accounting and auditing standards." The staff noted that, of course, "innovations in technology can be the ally of an issuer's financial reporting activities, not their opponent." Further, the advent of new technologies does not alter the "fundamental responsibility" to "take what is learned and then act appropriately within the parameters of the existing internal control and financial reporting requirements of the securities laws." Similarly, auditors must still assess the issuer's application of the financial reporting framework to prepare its financial statements and must determine the nature and extent of audit procedures to be performed based on the issuer's circumstances and auditing standards applied.