SEC Chief Accountant Discusses Audit Committee Effectiveness, Other Current Topics

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In a pair of recent speeches, SEC Chief Accountant Wesley Bricker discussed the critical role audit committees play in the financial reporting process, explored current challenges confronting audit committees, and offered suggestions for increasing audit committee effectiveness. He also addressed internal control over financial reporting, which continues to be a major area of interest for the SEC staff.

Audit Committee Effectiveness

In a March 24 speech at the University of Tennessee Corporate Governance Center, Mr. Bricker focused on the role and effectiveness of audit committees. While his wide-ranging remarks did not break new ground, he did provide insight into the SEC staff's perspective on key topics affecting audit committees. His principal points included:

Understanding the Business Operating Environment. Mr. Bricker stressed that audit committee members need to understand the business they serve and the environment in which it operates. According to Mr. Bricker, "Obtaining such an understanding of the entity and its environment is an essential aspect of serving in an audit committee role to oversee and counsel those having responsibility for preparing the financial statements, as well as overseeing the external audit of the financial statements." Such an understanding will better equip audit committees to identify areas requiring special consideration, including changes in the operating environment; rapid growth; new business models, products or activities; and new accounting pronouncements.

Composition. Mr. Bricker noted a strong interest and focus of investors on "diversity of thoughts within the board of directors." Such diversity "diminishes the extent of group thinking, and diversity of relevant skills (for example, industry or financial reporting expertise) enhances the audit committee's ability to monitor financial reporting." He strongly suggested that the level of diversity on US boards and audit committees should be increased.

Workload. For several years, agenda overload has been identified as an area of concern for audit committees. (See our blog post from April 6, 2015.) In contrast to nearly 75% of board directors that believe their workload is manageable, only 57% of audit committee members find their workload to be manageable. Variation exists among industries, with only 34% of audit committee members for companies in the banking and capital markets sector believing that their workload is manageable. Mr. Bricker advised directors to evaluate whether they are identifying the risk of audit committee overload and if they are appropriately managing this risk to enable the audit committee to operate effectively. Mr. Bricker noted, “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, . . . it is important for audit committees to not lose focus on their core roles and responsibilities.”

Tone at the Top. Referencing a recent accounting firm survey (see our blog post from February 23, 2017), Mr. Bricker noted that “roughly one in four [audit committee members] in a recent audit firm survey . . . ranked tone and culture as a top challenge in [the committee’s] oversight role.” In addition to encouraging “open and candid discussions between the external auditor and the audit committee,” Mr. Bricker also stressed that audit committees should engage 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 [the] control environment, including across any relevant divisions and geographies.”

Financial Reporting Developments. Mr. Bricker said that audit committees should consider training and education to make sure that members have the proper background and stay current as to recent developments in accounting and financial reporting. As in past statements, he noted that the Office of Chief Accountant continues to direct significant attention to companies’ implementation activities for new accounting standards, including revenue recognition, leases, financial instruments and credit losses. He also urged committees to exercise oversight of management’s use of non-GAAP measures.

Oversight of External Auditors. Mr. Bricker noted that audit committee responsibilities under the applicable listing standards include oversight of the auditor engagement terms and compensation. Mr. Bricker encouraged audit committees to “work with other board committees as needed to monitor that important corporate objectives, such as cost reduction plans, are not unintentionally implemented in ways that would be at cross purposes with management meeting its financial reporting responsibilities or the external auditor’s appropriate audit scope, engagement terms, and compensation.”

Audit Committee Reporting. Encouraged by the “momentum” of companies providing enhanced audit committee disclosures, Mr. Bricker suggested that audit committees and their advisors continue evaluating their disclosures, remarking that “[a]udit committees can help increase investor understanding of the reliability and quality of financial reporting when they provide additional insights into how the audit committee has fulfilled its responsibilities, particularly about the audit committee’s work in overseeing the independent auditor and the financial reporting process.”

Internal Control Over Financial Reporting (ICFR)

In a March 21 speech to the Annual Life Sciences Accounting & Reporting Conference, Mr. Bricker commented at length on the importance of effective ICFR, particularly as the new revenue recognition standard is implemented. He discussed how the new revenue recognition standard may affect ICFR, noting that the standard "may require changes to relevant business processes and the control activities within them" and that "it might also require a refresh of the other components of [ICFR], including professional competence." Most notably, Mr. Bricker discussed the impact of disclosures of ICFR deficiencies. He observed that "[i]nvestors tend to incorporate disclosure of ICFR deficiencies in the price they are willing to pay for a stock." He also cited academic research suggesting that "companies disclosing material weaknesses are more likely to experience increased cost of capital," while studies have also found that "[r]emediation of ineffective ICFR tends to be followed by improved financial reporting quality, reduced cost of capital, and improved operating performance." Mr. Bricker concluded, "If left unidentified or unaddressed, ICFR deficiencies can lead to lower-quality financial reporting and ultimately higher financial reporting restatement rates and higher cost of capital."

Authors

Alan J. Wilson

PARTNER

alan.wilson@wilmerhale.com

+1 202 663 6474

Thomas W. White

RETIRED PARTNER

+1 202 663 6000