AUDIT COMMITTEE ALERT: EMPHASIS AND FOCUS ON CONTROLS, INCLUDING REVENUE, LEASES, MANAGEMENT REVIEW CONTROLS, AND NON-GAAP MEASURES

During the December 2016 AICPA Conference on Current SEC and PCAOB Developments, multiple regulators emphasized the continued need for company vigilance around internal controls over financial reporting (“ICFR”) on areas requiring significant judgment and/or subject to significant complexities. Audit areas where deficiencies have been identified in previous PCAOB inspection cycles of public company audits: ICFR, responding to risks of material misstatement and accounting for estimates, including fair value measurements – particularly in valuation of assets and liabilities associated with business combinations – remain high on the PCAOB’s watch list. Additionally, management review controls, non-GAAP measures, revenue-related estimates and reserves – including new FASB standards encompassing revenue recognition, leases, financial instruments, and credit losses – will continue to require management, audit committee, and auditor attention and focus.

Earlier this year, the PCAOB issued staff inspection briefs previewing the 2015 inspection findings and highlighting their 2016 inspection areas of focus. PCAOB Chairman Doty, addressing the PCAOB’s Role in Enhancing Public Trust and Integrity in Audits, stated that inspections [of public company audit engagements] have resulted in improved audits and, where deficiencies were noted, have led to engagement teams “raising their game”. Jay Hanson, a PCAOB Board member, in an address to the Association of Audit Committee Members, Inc., in October 2016, noted that PCAOB outreach to audit committees has found that many audit committees are regularly discussing PCAOB inspection findings and other activities around audit quality with their auditors.
Hanson highlighted encouraging emerging practices whereby audit firms are implementing more robust engagement management and allocation of more experienced resources in addressing the most difficult areas of the audit. **BDO advises our client audit committees to seek out and encourage more robust dialogues with engagement partners about the similarities and differences in approaches undertaken by management and the auditors in assessing internal controls, particularly management review controls, and to discuss the audit procedures and work being performed in these areas.**

SEC Chief Accountant Wes Bricker **expressed sentiments** regarding the continued attention by regulators on ICFR assessments and the importance of ICFR in providing high-quality financial information on which investors can rely. He indicated that over the next few years, updating and maintaining internal controls will be particularly important as companies work through the implementation of significant new accounting standards – revenue recognition, leases, financial instruments, and credit loss standards. Such implementation and execution “will require careful planning and execution, as well as sound judgment from management…” In December the Center for Audit Quality released **Preparing for the New Revenue Recognition Standard**, a tool comprised of a series of questions and resources for audit committees to use as an aid in their assessment of their organizations’ readiness in implementing FASB ASC 606. **BDO advises our clients to review existing tools and resources, carefully analyze and assess controls around the implementation of new accounting standards, and ensure such controls are robustly documented along with documentation supporting compliance with such controls.**

On the non-GAAP front, the SEC has cast a brighter light on companies’ proper use and presentation of non-GAAP financial measures, expressing concerns about and providing guidance to prevent the misuse of such measures. Bricker further indicated that a premium should be placed on the audit committee’s understanding of the company’s non-GAAP policies, procedures, and controls. **BDO advises our client audit committees to ensure they are well-versed in management’s use of non-GAAP measures and are comfortable that strong disclosure controls are in place to ensure that such measures are used only within acceptable parameters.**

The release of additional guidance and tools in the form of the SEC’s **May 2016 Compliance & Disclosure Interpretations guidance** and the CAQ’s "**Questions on Non-GAAP Measures: A Tool for Audit Committees**" seems to be having a positive impact on the use of non-GAAP disclosures. Mark Kronforst, SEC Chief Accountant for the Division of Corporation Finance, indicated that he was encouraged by the seriousness with which companies have taken the SEC’s guidance in this area and the self-correction that appears to have occurred within subsequent quarterly filings in the areas of chief concern expressed by the SEC in regard to transparency, prominence and comparability. During a non-GAAP panel at the 2016 AICPA conference, emphasis was placed on the need for companies to employ sound practices, such as instituting policies that are approved by audit committees on the use of non-GAAP measures, use of tools such as the CAQ’s questionnaire, and close reviews by appropriately qualified personnel of earnings releases and other communication vehicles outside the financial statements.

Under current PCAOB standards, auditors are required to read other information (e.g., non-GAAP measures) included in documents that contain annual or interim financial statements for material inconsistency with the financial statements, but are not required to perform any other procedures over this information in situations where no inconsistencies are identified. However, audit committees are being encouraged to engage with both auditors and management and ask direct questions about the company’s compliance with regulations and the appropriateness of presentation of such measures.

Building upon the audit committee questionnaire related to non-GAAP measures, in December the CAQ published "**Non-GAAP Financial Measures: Continuing the Conversation**" to further explore the issue of non-GAAP information, providing context on its definition and use, pertinent regulatory developments, and the current level of auditor involvement. Additionally, the paper compiles sets of suggested questions for a broad range of key stakeholder groups – including management, investors, analysts, securities counselors, audit committee members, internal auditors, independent auditors, regulators, accounting standard setters, and academics - to consider regarding their preparation or use of non-GAAP financial measures.

**BDO encourages our client management teams and audit committees to review the resources highlighted in this alert, continue to dialogue in these areas, and consult with their internal auditors and external audit engagement teams.** Planning for yearend audits should ensure that both the audit committee and the auditors have a firm understanding of the company’s internal control, including underlying information systems relevant to financial reporting; management’s assessment of internal controls; relevant business processes and current economic factors; and timely identification of significant risks.

For additional audit committee tools and resources, visit the BDO’s Center for Corporate Governance and Financial Reporting at: [www.bdo.com/resource-centers/governance](http://www.bdo.com/resource-centers/governance).