AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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In This Update:

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This Update summarizes recent developments relating to public company audit committees and their oversight of financial reporting and of the company's relationship with its auditor.

PCAOB Describes 2016 Inspection Objectives

On July 14, the Public Company Accounting Oversight Board issued a Staff Inspection Brief to provide information about the scope and objectives of its 2016 inspections of public company auditors. (A second Inspection Brief, issued the same day, describes the Board's inspection plans for auditors of securities broker-dealers.) The Inspection Brief is indicative of the PCAOB staff's current areas of concern, and audit firms are likely to respond by devoting additional attention to these aspects of their public company engagements. Although there have been some changes, the "Key Areas of Inspection Focus" described in the Inspection Brief are generally similar to those the PCAOB identified last year with respect to its 2015 inspections. See PCAOB Issues Inspection Brief and Risk Assessment Observations, October-November 2015 Update.

In 2016, the PCAOB plans to inspect approximately 210 firms that audit public companies, including ten firms that have more than 100 public company clients. The 210 inspected firms will also include 60 non-U.S. firms in 25 countries. The PCAOB staff lists seven areas on which it will focus in these inspections.

1. Recurring Audit Deficiencies

Inspectors will consider audit areas in which high levels of deficiencies were found in past inspections. (See PCAOB Previews 2015 Inspection Findings, May 2016 Update for a summary of the most significant deficiencies found in 2015). In that regard, the Inspection Brief states that the "most frequent and recurring audit deficiencies identified in recent inspection cycles" were:

- Internal control over financial reporting. The Inspection Brief refers specifically to the testing of controls that (1) address financial reporting areas in which the auditor has identified a risk of material misstatement, or (2) involve an element of management review (e.g., a control that requires a member of management to compare actual results with a forecast or budget).

- Assessing and responding to risks of material misstatement. Misstatement-risk inspection areas include (1) the sufficiency of the testing of controls over the accuracy and completeness of data and reports generated by the company's IT system; (2) whether audit procedures were responsive to fraud risks and other significant identified risks; (3) the accuracy and completeness of financial statement footnote disclosures; and (4) the evaluation of audit evidence that appears to contradict assertions in the financial statements.

- Auditing accounting estimates, including fair value measurements. PCAOB inspectors will focus on audit procedures that are performed to understand how estimates were developed, including auditor testing of data and management assumptions that are significant to estimates.

2. Audit Areas Potentially Affected by Economic Factors

Certain economic developments may affect companies in ways that make it more likely that their audit will be selected for review. These developments include –

- Effect of strengthening U.S. dollar on multinational issuers. A stronger dollar may result in "potential loss of market share to foreign competition, and negative effects on foreign currency translations."

- Increasing mergers and acquisition activity. M&A activity "may increase the risk of improper valuation of assets acquired and liabilities assumed given the large deal sizes, complexity of the transactions and fair value measurements, and high purchase prices."

- Search for higher-yielding investment returns in a low interest environment. Low interest rates may cause some companies to invest in higher-yielding securities that are complex and hard to value.

- Effect of the continuing fluctuations in oil and natural gas prices. Oil and gas prices affect the collectability of loans and receivables, and the ability of companies involved in the oil and gas industry to continue as going concerns.

3. Financial Reporting Areas

The Inspection Brief states that the most-frequently-selected financial reporting areas in 2015 included revenue and receivables, non-financial assets (including goodwill and other intangible assets), inventory, financial instruments, allowance for loan losses, income taxes, benefit-related liabilities, and equity transactions. Three other financial reporting areas on which inspectors will also focus in 2016 are evaluation of segment identification and disclosure; the auditor's consideration of the entity's ability to continue as a going concern; and evaluation of income tax accounting and disclosures.

4. Implementation of AS 2410, Related Parties

In 2014, the PCAOB adopted a new auditing standard with respect to relationships and transactions with related parties (including executive management) and significant unusual transactions. See June 2014 Update. The new standard, AS 2410, Related Parties, also expands the auditor's communications with the audit committee regarding related party transactions. As in 2015, the inspection staff will focused on audit firm implementation of AU 2410.

5. Information Technology

In 2016, the inspection staff will look at two aspects of the impact of information technology on public company audits. First, the staff will review the quality controls firms have in place with respect to technology that supports the audit process. Second, inspectors will "seek to understand the procedures performed and documentation prepared by engagement teams to determine whether certain cybersecurity risks pose risks of material misstatement to the company's financial statements."

6. Multinational Audits

In many engagements, the principal auditor uses work performed by other firms, particularly with respect to non-U.S. affiliates of multinational companies. In 2016, the staff will "continue to evaluate how a firm that is using the work of another auditor in its audit evaluated the competence of, and the work performed by, the other auditor."

7. Audit Firm's System of Quality Control

The Inspection Brief highlights several aspects of audit firm quality control systems on which inspectors focus. For 2016, these will include root cause analysis (i.e., how the firm determines the underlying reasons for audit deficiencies); audit committee communications; compliance with the auditor independence requirements; engagement quality review (i.e., the review performed by a second or concurring partner); and professional skepticism.

Comment: The Inspection Brief provides insight that may be useful to audit committees in understanding what areas of the company's audit are likely to attract the attention of the PCAOB's inspection staff and whether the company's engagement is likely to be selected for review. In addition, the Inspection Brief is a predictor of the areas to which the company's auditor is likely to devote additional time and resources in anticipation of possible future PCAOB scrutiny. Some of the topics highlighted in the Inspection Brief mirror audit areas in which companies have questioned the level of audit effort in recent years. Related party transactions, management review controls, and assumptions underlying fair value determinations are examples. The Inspection Brief helps to explain why audit firms have felt compelled to emphasize these areas.

SOX Compliance Costs and Audit Fees Continue to Rise

On June 2, consulting firm Protiviti released its 2016 survey of Sarbanes-Oxley Act compliance costs, Understanding the Costs and Benefits of SOX Compliance. As in its 2015 and 2014 surveys, Protiviti found that, for many companies, costs associated with SOX compliance continue to rise. See After 13 Years, SOX Compliance Costs are Still Rising, June 2015 Update and June 2014 Update. And, similar to prior years, significant numbers of respondents point to the PCAOB's inspection program as the cause of these cost increases.

Survey Highlights

- Internal compliance costs. The average annual internal cost of SOX compliance for the largest public companies (large accelerated filers) was $1.335 million. For the next tier of public companies (accelerated filers), average annual internal costs averaged $914,000, while still smaller companies (non-accelerated filers) averaged $1.219 million. The highest costs were incurred by emerging growth companies –smaller, recently-public companies – at $1.430 million. On an industry basis, healthcare payers had the highest internal SOX compliance costs ($2.31 million), while media companies had the lowest ($856,000).

- External audit fee. Half of large accelerated filers reported that their external audit fee increased in fiscal 2015, while 8 percent reported a decrease, and 42 percent said the fee remained the same. For non-accelerated filers, 41 percent reported an increase, and 52 percent reported a decrease.

- External auditor reliance on the work of others. High percentages of companies of all sizes reported that their external auditor was relying "to the fullest extent possible" on the work of others (e.g., internal audit) for the testing of controls over medium- and low-risk processes. For example, 81 percent of accelerated filers indicated that this was the case, as did 95 percent of non-accelerated filers.

- Number of entity-level and process-level SOX controls. The average number of entity-level controls reported by survey respondents was 50, of which 60 percent were classified as "key." The average number of process-level controls reported was 96, of which 63 percent were deemed key.

- Changes in SOX compliance. The compliance area in which the highest percentage of respondents reported "extensive/substantial" change in 2016 was process control documentation for high-risk processes. In addition, 26 percent of respondents reported extensive/substantial increases in the testing of controls over management judgments and estimates.

- Cybersecurity disclosure impact. One-fifth of respondents stated that their company made a cybersecurity disclosure in fiscal 2015, in accordance with the SEC's staff's guidance on disclosure obligations relating to cybersecurity risks and cyber incidents. The significance of this figure is tempered by the fact that 42 percent of respondents didn't know whether or not such a disclosure had been made. Of those who reported a cybersecurity disclosure, 47 percent said that total hours devoted to Sarbanes-Oxley compliance increased 11 percent or more as a result.

Role of the PCAOB

As was reported in last year's survey, many respondents blame increases in their Sarbanes-Oxley compliance costs on the activities of the PCAOB. Of those respondents who said that their audit firm required changes to the company's Sarbanes-Oxley compliance procedures in 2015, 44 percent attributed those changes to the PCAOB's inspection program. Across all respondents, significant percentages thought that PCAOB inspection reports had an effect on the organization's Sarbanes-Oxley compliance costs in specific areas. For example, 50 percent thought that the PCAOB's inspections reports had an extensive/substantial impact on the costs of testing reports and other information generated by the company's systems; 46 percent thought that the PCAOB had caused increases in the testing of review controls.

The compliance cost impact of the PCAOB's new related party auditing standard also seems to have been significant. Fifty-eight percent of respondents reported that the company was required to update its documentation to identify related parties as a result of Auditing Standard No. 18 (ASC 2410, which governs the auditing of related party transactions). This documentation updating increased total Sarbanes-Oxley compliance hours by an average of 8 percent.

Not surprisingly in light of the cost impact that respondents thought the PCAOB was having, 75 percent of public company respondents reported that someone in the company was "keeping abreast of guidance on PCAOB inspections issued by the PCAOB."

<u>Role of the Audit Committee</u>

Protiviti also asked who in the organization had primary responsibility for "executive sponsorship" of Sarbanes-Oxley compliance and who had primary responsibility for "execution." As to executive sponsorship, 46 percent indicated that the audit committee was the sponsor, while 39 percent identified executive management. These numbers reflect a surprising shift to audit committee responsibility during the past 12 months. In the 2015, only 25 percent pointed to the audit committee as the executive sponsor. With respect to execution responsibility for Sarbanes-Oxley compliance, 14 percent of respondents identified the audit committee in 2016, compared to only 2 percent last year.

<u>Comment</u>: Audit committees may have opportunities to consider whether there are ways to convert some of their company's SOX compliance costs into an investment in more effective and efficient financial reporting and information gathering processes. Sixty-seven percent of public company respondents believe that the company's internal control over financial reporting has "significantly/moderately improved" since ICFR auditing was required. Broken down by size, majorities of companies with revenues over $5 billion and under $500 million agreed with that statement. The survey results indicate that large companies have done better than midsize companies at generating value from SOX compliance. In Protiviti's view "SOX compliance requires a significant investment for many organizations in terms of budget and hours. But the results reflected [in the 2016 survey] * * * reinforce the reasons these investments are needed and the value they create."

EY Suggestions for Audit Committee Multinational Tax Risk Oversight

The EY Center for Board Matters (EY Center) has released a paper suggesting issues that the audit committees of multinational companies should consider with respect to tax risk. The type of risk that this paper, Tax Risk and the Audit Committee, deals with arises from public concerns that multinational companies may be engaged in "aggressive tax planning" which involves shifting income to low tax jurisdictions or using other devices to avoid paying what critics deem to be a fair level of taxes. These concerns have lead to demands for more transparency regarding the taxation of multinationals and to efforts by governments to work cooperatively in the area of multinational business taxation. The Organisation for Economic Co-operation and Development's Base Erosion and Profit Sharing (BEPS) project is an example of this type of international cooperation. According to the OECD, "BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity."

The EY Center divides the risks that audit committees should be aware of into three categories:

- Increasing requirements for country-by-country (CbC) reporting. Under the OECD's BEPS action plan, companies with group revenues of more than €750 million will be required to report to local tax authorities in each jurisdiction in which the company does business revenues, profit before income tax, income tax paid and accrued, total employment, capital, retained earnings and tangible assets in all jurisdictions. The OECD recommends that this reporting take effect for fiscal years beginning January 1, 2016. However, since each jurisdiction must implement the proposal, effective dates will vary from country to country. The EY Center states that "[a]udit committees will need to be aware of the new tax-related disclosures that are required, make sure that the appropriate data are available and understand the consequences of the information being shared among tax authorities."

- Greater disclosure of information to the public. While the OECD recommendation does not call for public disclosure of the CbC information reported to tax authorities, the EY Center believes that public disclosure is "a likely outcome" in many countries. In this regard, EU legislation has been introduced to require companies in Europe (including European subsidiaries of multinational companies) with revenues over €750 million to disclosure country-by-country tax and profit information, along with information concerning employees and the nature of activities performed in each jurisdiction. Audit committee members "should assume that financial information will be made public and determine whether there are likely to be any issues to deal with when this happens. They need to help establish the right approach — balancing the desire for reducing tax with reputational concerns — which will involve integrating tax strategy with risk management."

- State aid investigations. Another tax-related concern stems from favorable tax arrangements that that certain countries may have entered into with the company. The EY Center states that the European Commission "has highlighted preferential tax agreements that it argues constitute illegal state subsidies." Accordingly, audit committee members "will want to know whether the particular tax treatment of their EU companies could

> be construed as state aid" (which could possibly be subject to repayment) and could have implications for "past and future tax liabilities and could also affect decisions on mergers and acquisitions."

The EY Center distills these three risk categories into six questions for audit committees to consider:

- Do you know what tax strategy the company is adopting or the parameters by which it is deciding that strategy?
- Does management know what the CbC report will look like and what questions it will give rise to if and when it goes public?
- What is the company's exposure to state aid risk?
- Does the tax department have enough resources to operate effectively?
- Are you confident that the tax function is able to clearly identify and manage ongoing risks, disputes and litigation?
- Is adequate investment being made into the tax function to allow the company to meet tax compliance and reporting obligations, and to take advantage of tax planning opportunities?

Comment: The EY Center's paper highlights the emerging reputational risks that multinational companies may face as a result of lawful efforts to minimize tax. Audit committees should assume that taxation will be both "a reputational, as well as a financial, issue" and that "[a]dditional public disclosure is inevitable." Managements and boards of multinationals will find themselves in the unfamiliar position of having to balance their fiduciary duty to benefit shareholders by legally minimizing taxes against the importance of protecting the company's image and standing with the public. The EY Center also suggests that, at a practical level, audit committees should consider whether the company has a "robust and transparent" relationship with the tax authorities and whether tax departments have the adequate resources to deal with these issues.

Six Things Audit Committees Can Do to Make Internal Audit More Effective

On July 18, the Global Internal Audit Common Body of Knowledge (CBOK), released a report, Six Audit Committee Imperatives: Enabling Internal Audit to Make a Difference, which outlines steps audit committees could take to strengthen and support the internal audit function. The report, prepared by Jim DeLoach and Charlotta Lofstrand Hjelm, is based on survey responses from directors serving on audit committees. These responses were part of CBOK's 2015 stakeholder study of perspectives about internal audit performance. CBOK, which is administered through the IIA Research Foundation, is an ongoing study of the internal audit profession. The IIA Research Foundation is the research arm of the Institute of Internal Auditors.

The report states that three "broad themes" emerged from the 2015 stakeholder study. These themes are that audit committees should:

- Enable internal auditors to think more broadly and strategically as they plan for, execute, and report on their work.

- Encourage internal audit to move beyond assurance to enhance its value proposition.

- Take steps to ensure the Chief Audit Executive (CAE) and the internal audit function are effectively positioned to deliver to expectations.

The report identified six audit committee "imperatives" to support these themes:

1. <u>Provide Perspective by Elevating the CAE's Stature</u>. The internal audit function benefits from a "big-picture perspective." To obtain that perspective, "[a]ttending board meetings, when coupled with attending key management meetings, is critical for a CAE." Over half of board members also recommended that the CAE report directly to the audit committee.

2. <u>Assist the CAE with Aligning Stakeholder Expectations</u>. The audit committee should seek to ensure that internal audit's performance is measured in a manner that is consistent with how the board and management evaluate performance generally. The top four factors that stakeholders consider in assessing internal audit performance are:

    - Useful recommendations that address the root cause of identified issues.

    - Quality audit work and reliable results on key risk areas.

    - Timely communication of identified risks to appropriate stakeholders.

    - Consultative guidance−helpful suggestions on new emerging risk areas.

3. <u>Encourage Thinking Beyond Scope</u>. "Audit committees should encourage internal auditors to think beyond the scope of the audit plan." In this regard, directors should ask the internal auditor staff broad questions, such as:

    - What is the real meaning of these findings? Is there a broader message we should be aware of?

    - How are we driving value out of our compliance and assurance activities? For example, are there improvements to our processes that we need to make?

    - How do these findings relate to other areas of our business? As leaders of the organization, what are we missing?

    - Are there potential crisis events that we have not thought about and for which we are unprepared to respond?

4. Direct Internal Auditors to Perform More Than Assurance Work. Survey respondents recommended that internal audit consult and advise on business process improvements. Additional non-assurance areas of potential internal audit involvement include operational risk management and the design and effectiveness of the organization's governance processes.

5. Put Strategic Risks on the Table. "Two out of 3 board members believe internal audit should have a more active role in connection with assessing and evaluating the organization's strategic risks."

6. Prioritize High-Quality, Effective Communications. The report emphasizes the importance of communication between the audit committee and the internal audit staff. "Effective communications enable the audit committee to work with internal audit leaders to better understand the internal audit process."

Comment: Audit committee members may want to consider how these imperatives apply in the context of their relationship with the company's internal audit function. As the CBOK report states: "Through these imperatives, audit committees can invigorate the internal audit function by positioning the CAE to think more broadly and strategically, move beyond assurance to provide value-added advisory services, and deliver to expectations. These actions will allow the audit committee to better leverage the insights delivered by internal audit."

Commonsense Corporate Governance Principles Include Buffet's Audit Committee Question

On July 21, a group of CEOs and institutional investors released Commonsense Principles of Corporate Governance (Principles), a series of corporate governance guidelines for public companies, boards of directors and shareholders. The proponents also issued an open letter explaining their reasons for formulating the Principles. While the Principles are broadly-stated, and do not focus in detail on audit committees, several aspects are relevant to the work of the audit committee.

The Principles address eight topics: (I) Board of Directors – Composition and Internal Governance; (II) Board of Directors' Responsibilities; (III) Shareholder Rights; (IV) Public Reporting; (V) Board Leadership (including the Lead Independent Director's Role); (VI) Management Succession Planning; (VII) Compensation of Management; and (VIII) Asset Managers' Role in Corporate Governance. They are intended "to provide a basic framework for sound, long-term-oriented governance" while also recognizing that company circumstances vary, and flexibility is necessary because "not every principle (or every part of every principle) will work for every company." As stated in the open letter, the underlying philosophy of the authors is that, "[t]o ensure their continued strength – to maintain our global competitiveness and to provide opportunities for all Americans – we think it essential that our public companies take a long-term approach to the management and governance of their business (the sort of approach you'd take if you owned 100% of a company)."

<u>Buffet Question</u>

With respect to the audit committee, subpart b. of Principle II (Board of Directors' Responsibilities) includes:

- In addition to its other responsibilities, the Audit Committee should focus on whether the company's financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation.

This Principle reflects the question that Warren Buffet, one of the members of the group that issued the Principles, has long recommended that audit committees ask of the auditor. Although not included in the Principles, Buffet has also urged that audit committees ask three additional, related questions:

(1) If the auditor were an investor, would he or she have received the information essential to a proper understanding of the company's financial performance during the reporting period?

(2) Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO?

(3) Is the auditor aware of any actions—either accounting or operational—that have had the purpose and effect of moving revenues or expenses from one reporting period to another?

<u>Earnings Guidance and Non-GAAP Measures</u>

The Principles include two points that are related to financial reporting issues in the scope of the audit committee's responsibilities. Subparts b. and f. of Principle IV (Public Reporting) state:

b. Companies should frame their required quarterly reporting in the broader context of their articulated strategy and provide an outlook, as appropriate, for trends and metrics that reflect progress (or not) on long-term goals. A company should not feel obligated to provide earnings guidance – and should determine whether providing earnings guidance for the company's shareholders does more harm than good. If a company does provide earnings guidance, the company should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run.

f. Companies are required to report their results in accordance with Generally Accepted Accounting Principles ("GAAP"). While it is acceptable in certain instances to use non-GAAP measures to explain and clarify results for shareholders, such measures should be sensible and should not be used to obscure GAAP results. In this regard, it is important to note that *all* compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings.

Principle IV.f. is broadly consistent with the SEC's recent guidance on the use of non-GAAP measures. See SEC Issues More Warnings and New Guidance on Non-GAAP Measures, May 2016 Update. However, the explicit statement that all compensation should be included in any non-GAAP earnings measure is new.

Comment: The Principles have attracted considerable attention in the media. Audit committees may want to consider whether the elements of the Principles that relate to the work of the audit committee are consistent with their current practices.

KPMG Sounds the Alarm on Revenue Recognition and Lease Accounting Implementation

Two looming challenges facing many public companies are the implementation of the new accounting standards on revenue recognition and on lease accounting. As discussed in several prior Updates, many companies appear to be behind schedule in understanding how these accounting changes will affect their financial reporting and in making the systems and other changes necessary to comply by the effective dates. See New Lease Accounting Implementation May Be Challenging, June–July 2016 Update and FASB Defers New Revenue Recognition Standard for One Year, August-September 2015 Update.

In June, KPMG released its 2016 Accounting Change Survey, The Great Accounting Challenge, which seems to confirm that the implementation effort for both standards is threatening to become a last-minute, crash project for many companies.

Background

As described in FASB Defers Implementation of Converged Revenue Recognition Standard, March-April 2015 Update, the Financial Accounting Standards Board (FASB) and its international counter-part, the International Accounting Standards Board, adopted the new revenue recognition standard on May 28, 2014. The standard, which is principles-based (as compared to the more detailed guidance in current GAAP), creates a framework under which revenue is recognized by identifying contracts between the company and its customers and determining when the company has fulfilled its performance obligations under those contracts. As a result of an FASB decision in 2015, public companies are required to apply the new standard to annual and interim reporting periods beginning after December 15, 2017. For other companies, the effective date is one year later.

As described in FASB Adopts New Leasing Standard, February-March 2016 Update, the FASB adopted new accounting rules governing leasing on February 25, 2016. The new standard will require lessees to recognize assets and liabilities for leases with terms of more than 12 months and will affect the financial statements of most companies that engage in significant leasing, whether as lessees or lessors. For public companies, the new standard will take effect for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For other companies, the effective date is one year later.

Survey Results

KPMG surveyed more than 140 companies in the Spring of 2016. Nearly 80 percent of respondents reported revenue of $1 billion or more. Seventy-six percent of the companies represented were public, while 24 percent were privately-held. KPMG states that the companies represented "all major industries." Key findings include:

A. Revenue Recognition

- Assessment of accounting impacts. Seventy-one percent of companies surveyed are still in the assessment phase. Eight percent have not yet even begun to assess the impact of the new revenue recognition standard on the company's accounting.

- Meeting company timetable. Sixty-three percent of companies reported that they were behind their own revenue recognition implementation schedule.

- Systems changes. Approximately one-third of respondents are not sure yet whether they will need to implement changes to their accounting system. Approximately one-third are expecting to make systems changes, while the remaining one-third do not believe changes will be necessary.

- Cost of revenue recognition standard implementation. Fifty-one percent of respondents estimate that the cost of implementing the new standard will be $500,000 or less, while 34 percent think the cost will exceed $1 million. Ten percent believe the cost will exceed $5 million (including 1 percent that anticipate costs in excess of $20 million).

B. Lease Accounting

- Assessment of accounting impacts. Slightly less than half of companies reported that they have begun to assess the impact of the lease accounting changes. Only 14 percent have completed a lease inventory (which is a logical first step), and only 5 percent have performed an accounting assessment.

- Cost of lease accounting standard implementation. Forty-six percent of respondents do not yet have an estimate of the cost of implementing the leasing standard. Of those respondents that have made an estimate, 70 percent believe the cost will be less than $500,000, while 10 percent believe the cost will exceed $2.5 million. KPMG observes that, because many of the companies that have made estimates have not yet assessed the impact on IT systems, "many companies may be setting unrealistic budget projections for their implementation efforts."

- Tax impacts. Nine percent of respondents believe the new leasing accounting standard will have significant impact on tax reporting (e.g., book-to-tax reporting differences that may affect deferred tax items). Fifty-five percent think there will be moderate impact, and 37 percent foresee minimal to no impact.

- Impact on financing. Many respondents anticipate that the balance sheet effects of recognizing lease-related assets and liabilities will affect company financing:
    - Bankers will adjust debt covenants (54 percent).
    - Negotiation of new terms with bankers will be necessary (24 percent).
    - Impacts on financial ratios will negatively affect existing debt covenants (20 percent).
    - It will be difficult to obtain debt financing (3 percent).

Comment: Audit committees should be actively monitoring the company's plans and progress with respect to implementation of these new standards. Given the importance of revenue recognition to virtually all companies, and the fast-approaching effective date, a realistic work plan and adequate resources for implementation of that standard are becoming critical priorities. KPMG states:

> "[I]t is becoming increasingly evident that some companies will be forced to implement the standard using manual processes and controls with the ability to introduce system changes until sometime after the effective date. As reliance on manual processes increases, companies will be faced with heightened risk of errors, increased costs, and less efficient operations."

While there is somewhat more time available for implementation of the leasing standard, audit committees of companies that engage in any significant amount of leasing should make sure that the company has an implementation plan and has begun its assessment efforts. New Lease Accounting Implementation May Be Challenging in the June-July 2016 Update includes a list of initial steps to evaluate the impact of the leasing standard and actions necessary to implement its requirements.

Prior editions of the Audit Committee and Auditor Oversight Update are available here.

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