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Audit Committee Update: 21 Financial Reporting Disclosure & Control Tips for 2021

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As audit committees move into overdrive to review the 2020 annual reports on Form 10-K of calendar-year companies, in this Alert we offer "tips" drawn from recent Securities and Exchange Commission ("SEC") rule changes, guidance, enforcement cases and staff comment letters. We also provide helpful insights for audit committees into the Public Company Accounting Oversight Board's ("PCAOB") views on how registered independent public accounting firms can deliver an effective integrated audit of issuer financial statements and internal control over financial reporting.

Under the Sarbanes-Oxley Act of 2002 amendments to the federal securities laws, audit committees of public companies are charged with overseeing each of the other two gatekeepers, the management preparers of financial statements and the accounting firms serving as independent auditors of those financial statements and related accounting controls. In 2020, the SEC and PCAOB delivered a carefully coordinated message to the triad of financial reporting "gatekeepers" – the audit committee, management, and accounting firms – that they must discharge their respective duties effectively to assure investors in the public markets of the accuracy, completeness and fundamental integrity of the SEC financial reporting system. The extraordinary pressures and uncertainties created by the COVID-19 pandemic have already heightened the importance of audit committee oversight, as the work of all three gatekeepers is judged by a critical investing public. With the advent of a Democratically-controlled Congress and a new set of top regulators, we believe this critical scrutiny will only intensify.

Tip #1: Oversee the Accuracy and Consistency of Disclosure of Current and Possible Future Effects of COVID-19

Tip #2: Oversee the "Well-Reasoned" Policies/Processes Governing Management's Significant Judgments and Estimates Relating to COVID-19

Tip #3: Revisit and Enhance the Company's "Corporate Hygiene" Control Systems

Tip #4: Be Aware of SEC "Hot Button" Accounting Areas

Tip #5: "Early Warning" Must be Given of Potential Substantial Doubt of Going Concern or Impending Restructuring

Tip # 6: Carefully Consider Timing of Goodwill Impairment Testing and the Need for "Early-Warning" Disclosure of Material Risks and Uncertainties

Tip #7: Accounting and Disclosure Controls must Provide Reasonable Assurance that Quarter-End Adjustments Comply with GAAP; Beware of Earnings Management

Tip #8: Non-GAAP Financial Measures Remain on the SEC Staff's Radar Screen

Tip #9: Key Performance Indicators and/or Operating Metrics Must be Accurately and Contextually Disclosed

Tip #10: Be Aware of "New GAAP" Revenue Recognition and Other Guidance Shared by SEC Staff at the December 2020 AICPA Conference

Tip #11: Review New Form 10-K Human Capital Resources Disclosure and Other Changes Resulting from Now-Effective Amendments to SEC Regulation S-K

Tip #12: Review MD&A for Primary Drivers of Company Business & Known Trends & Uncertainties
Tip #13: Consider Possible Expansion of Audit Committee Responsibilities for Oversight of ESG Risk Management and Disclosure
Tip #14: Refresh Key Risk Factors with New Information about Each Risk, and Explain How That Risk Applies to the Company
Tip #15: Update PSLRA Meaningful Cautionary Statements Accompanying Forward-Looking Statements to Afford the Company the Most Effective Antifraud Litigation Protection
Tip #16: Beware of Failing to Provide "Early Warning" of Material Loss Contingencies/Compliance with Relevant GAAP
Tip #17: Consider Heightened Pressures on Internal Control over Financial Reporting and Disclosure of COVID-19-related Challenges
Tip #18: Be Aware of PCAOB-Mandated Areas of Auditor Focus
Tip #19: Stay Attuned to Helpful PCAOB Reports of Conversations with Audit Committee Chairs and Guidance for Audit Committees
Tip #20: Oversee Disclosures of Operating Results and Guidance Based on Confidence in Business Modeling Given these Uncertain Times
Tip #21: Monitor New Pressures on Auditor Independence

Tip #1: Oversee the Accuracy and Consistency of Disclosure of Current and Possible Future Effects of COVID-19

- Companies must carefully consider and update prior disclosures of the effects and risks of COVID-19 on their businesses, financial condition and results of operations, as the total mix of material facts and circumstances changes (e.g., due to restructuring activities; lease renegotiations and deferrals; strategic initiatives; impact of an escalating number of cases of COVID-19 on employees, customers and suppliers/vendors; and the potential availability of vaccines).
- While some forward-looking disclosure may be voluntary, as urged by the now-former SEC Chair and Director of the SEC's Division of Corporation Finance in their statement here, disclosure of forward-looking information also is mandated by SEC rule and/or applicable Generally Accepted Accounting Principles ("GAAP"), whether that information is contained in material risk factors and/or in the MD&A (e.g., material known trends and uncertainties; critical accounting estimates), or in the footnotes to the financial statements (e.g., significant accounting policies; valuation of financial instruments).
- A helpful way to assess whether COVID-19-related disclosure is accurate and complete – focusing on the antifraud "baseline" liability standard that applies to all corporate communications actually or potentially aimed at investors – is to ask responsible members of management whether and how they have addressed the questions included in the two key SEC staff publications on COVID-19, CF Disclosure Guidance: Topic Nos. 9A, here, and 9, here, (see also our prior Alerts here on CF Topic 9A and here on CF Topic 9). Discrepancies in disclosures, whether they appear within or outside the four corners of SEC filings, may be caught by the Division of Corporation staff in the course of the regular review and comment process and, in this context, the staff may ask whether the audit committee is in the informational loop (see Tip # 2, below).
- Forward-looking information therefore should be consistent across all company messaging whether external or internal (e.g., SEC filed and furnished documents; earnings calls and releases; marketing materials and capital-raising initiatives; and even board presentations that might be requested by SEC staff reviewers), and accompanied by the requisite meaningful cautionary statements (as discussed further below in Tip #15).

- At the behest of the PCAOB, as indicated in its December 2020 COVID-19 Spotlight, available here, auditors will be reviewing COVID-19 disclosures in the upcoming Form 10-K – particularly those contained in Risk Factors and MD&A – to consider whether the information or the manner of its presentation is materially consistent with the financial statements. See, e.g., Tip #19, below.
- **Enforcement Case:** On December 4, 2020, without admitting or denying the SEC's findings, The Cheesecake Factory settled SEC charges that it had misled investors about the impact of COVID-19 by stating publicly that it was "operating sustainably," while failing to disclose that it was losing approximately $6 million in cash per week, was excluding expenses attributable to corporate operations and had informed landlords of its inability to pay rent. The SEC's order is available here.
- **SEC Comment Example:** "You state in your risk factor disclosures that COVID-19 will disrupt your operations and the operations of your partners and their customers for an indefinite period of time. You further state that COVID-19 will adversely impact your business, financial condition or results of operations. Please revise your MD&A and liquidity disclosures to address the reasonably known effect that the Coronavirus pandemic may have on your financial condition, operating results and/or liquidity."

Tip #2: Oversee the "Well-Reasoned" Policies/Processes Governing Management's Significant Judgments and Estimates Relating to COVID-19

- On December 7, in the context of the 2020 AICPA Conference on Current SEC and PCAOB Developments ("AICPA Conference"), the SEC Chief Accountant issued a statement, available here, reinforcing two prior statements available here and here, about the importance of high-quality financial reporting for investors in light of the actual or potential effects of COVID-19, and emphasizing the critical roles played by preparers, audit committees and auditors in providing this information.
- Recognizing the challenges that companies face in making significant judgments and estimates in an environment of increased uncertainty and volatility, the Chief Accountant and other senior staff members of the SEC's Office of the Chief Accountant ("OCA") committed at the AICPA Conference to continue that office's previously-announced practice of not second-guessing "well-reasoned judgments" made in good faith, subject to the oversight of the audit committee, to assure the integrity and accuracy of a company's financial disclosures.
- Companies must disclose significant judgments and estimates "in a manner that is understandable and useful to investors," and to ensure that "resulting financial reporting reflects and is consistent with the company's specific facts and circumstances."
- To the extent that wider ranges of potentially reasonable measurements are believed to be necessary as a result of COVID-19, they must be made in good faith and have a reasonable basis in fact and GAAP, and be subject to effective internal controls. As the now-former SEC Chair and Division of Corporation Finance Director put it, echoing the reassuring words of OCA and encouraging companies to give investors a more expansive look into the future through the eyes of responsible senior management: "Given the uncertainty in our current business environment, we would not expect to second guess good-faith attempts to provide investors and other market participants appropriately framed forward-looking information."
- Audit committees should take steps to ensure that they are kept directly in the informational loop by asking tough questions of management, recognizing that it is management's job in the first instance to explain and support the basis for their judgments, assumptions and estimates often required by GAAP. In this connection, contemporaneous documentation substantiating management's material judgments, estimates and assumptions can be useful in answering tough questions from outside auditors and regulators alike.
- Keep in mind that OCA has continued to emphasize that it will make itself available for consultation to companies and their outside auditors on complex accounting/financial reporting questions, including those arising from the effects of COVID-19 and other emerging issues. In addition, as noted below, OCA staff members often consult and coordinate the resolution of such questions with their accounting staff counterparts in the Division of Corporation Finance.

Tip #3: Revisit and Enhance the Company's "Corporate Hygiene" Control Systems

- As part of their oversight responsibilities for ethics and compliance, audit committees should be aware of the SEC's renewed emphasis on good "corporate hygiene" to ensure that the company itself, and its officers and directors, are following the company's policies and procedures on insider trading (including tipping), and that these policies and procedures are robust and fully compliant with the federal securities laws.
- Bear in mind that whistleblowers and other constituencies (such as members of the Council of Institutional Investors, the press and/or members of SEC Congressional oversight committees) also are closely monitoring insider trading activity, and may bring any concerns to the SEC. Areas to focus on, which are discussed below, include: equity grants to top executives in advance of announcements of major corporate news; insider trading while information is being assessed to see if it constitutes material non-public information (MNPI); commencement and modification of executive 10b5-1 plans; and company buybacks. We discuss each of these areas and the issues they raise, below.
- First, with respect to equity grant practices, one example is the grant of stock options to senior management before the release of good news.
  - In a September 2020 letter to a member of Congress, available here, former SEC Chair Clayton acknowledged such concerns: "[I] believe that companies should consider carefully the wisdom of issuing stock options to … executives while in possession of material non-public information. Many equity compensation plans require stock options to be granted with stock prices that are no less than fair market value. Implicit in this structure is the premise that equity awards are intended to incent performance that will result in future increases in company value. When a company grants an award based on the trading price of the stock while the company is in possession of materially positive non-public information, this premise is diluted to the extent future increases in company stock value are attributable to the release of positive information rather than future performance. In addition, such a grant may not be consistent with the terms of the incentive plan approved by … shareholders. Similarly, such a grant may also be inconsistent with existing accounting standards because, in short, the trading price of its stock is not a good indicator of fair market value."
- The second corporate hygiene issue is trading activity during the so-called "8-K gap" – the time between the occurrence of a material event and the required widespread public disclosure of MNPI to the investing public via Regulation FD-compliant mechanisms such as a Form 8-K and/or press release.
  - Even if a particular executive is not aware of MNPI when the trading occurs, questions often are raised regarding the effectiveness of the company's insider pre-clearance procedures and/or draw critical commentary from the media or investors, including, for example, media articles that were published relating to sales made by senior Pfizer and Moderna executives under Rule 10b5-1(c) sales plans while vaccines were being developed under contracts with the federal government, because the trades occurred prior to the public availability of peer-reviewed studies on efficacy.
  - Consider whether corporate policies and procedures should go beyond the letter of applicable provisions of the federal securities laws to address even the appearance of impropriety by barring officers and directors (and their family members, affiliated trusts and other person subject to their control/influence, etc.) from trading (including tipping or selectively disclosing MNPI) in the public markets once someone in the company becomes aware of potential MNPI, even if those particular insiders or their affiliates do not yet have access to the information.
  - The point is that responsible senior management must assess such information for materiality and make timely public disclosure determinations subject to board or audit committee oversight, as we explain below.
  - The third issue is whether Rule 10b5-1(c) plans for insiders should have mandatory waiting periods after adoption (and/or modification, suspension or termination) before trading may commence.

    - Former SEC Chair Clayton's letter (referenced above) outlined his belief that "companies should strongly consider requiring all Rule 10b5-1 plans for senior executives and board members to include mandatory seasoning, or waiting periods after adoption, amendment or termination before trading under the plan may begin or recommence. In my view, these required seasoning periods are appropriate between the establishment of the plan and the date of the initial trade, as well as between any modification, suspension or termination of a plan and the resumption of trading or entry into a new plan. Such seasoning periods not only help demonstrate that a plan was executed in good faith, but they also can bolster investor confidence in management teams and in markets generally."
  - The final issue is that companies likewise need controls and procedures in order to make real-time MNPI assessments when administering the company's insider trading policy as well as determining whether the company itself can engage in securities transactions.
    - This has been a consistent theme of the Commission's messaging since its early 2018 publication of broad interpretive guidance, available here. In this interpretive release, the SEC made clear that insiders should not be buying or selling in the public securities markets while the materiality of a cyber-breach is being assessed by responsible top decision makers.
    - It is essential that a company's disclosure controls and procedures are designed and operate to ensure that information is flowing effectively throughout the organization around the globe to the company's responsible management and board-level decision makers, in order to identify potential MNPI before the company or its insiders incur an antifraud duty to disclose or abstain from trading in the public securities market.
    - As the following "message case" illustrates, it may be easier for the SEC to bring an accounting controls enforcement proceeding than to charge a company with antifraud violations requiring proof of scienter, or fraudulent intent.
- **Enforcement Case:** On October 15, 2020, without admitting or denying the SEC's findings, Andeavor LLC settled SEC charges alleging that the company lacked adequate internal accounting controls that should have prevented it from engaging in a significant stock buyback that was not in accordance with the board's authorization. Specifically, corporate policy prohibited repurchases when the company possessed MNPI. The SEC found that the company, which agreed to pay a $20 million penalty and entry of a cease-and-desist order, had an "abbreviated and informal process" to evaluate whether the company had MNPI, which did not include discussion with the CEO about the likelihood of the company being acquired under circumstances where merger negotiations had been halted. Interestingly, as the two dissenting Commissioners observed here, the SEC did not charge Andeavor with illegal insider trading. The SEC's press release and cease-and-desist order are available here.

Tip #4: Be Aware of SEC "Hot Button" Accounting Areas

- OCA's list of SEC accounting hot button areas identified, both during the AICPA Conference and in speeches and statements issued throughout 2020, include:
  - use of non-GAAP financial measures both within and outside SEC filings;
  - use of key performance indicators;
  - judgments and estimates around impairment of goodwill and other intangible assets, long-lived assets, and inventory;
  - future cash flows;
  - tax; and
  - segment structure.

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- **SEC Comment Example:** "Reference is made to your disclosure that your income tax valuation analysis decreased $[XXX] million in fiscal 2019. Please tell us the impact this decrease had on earnings and explain to us why this is not discussed in MD&A."
- **SEC Comment Example:** "Please more fully explain to us how you determined your new operating segments, how segment management was realigned, how you identified your chief operating decision maker (CODM), and what information is used by management to allocate resources and assess performance."
- Some of the above were also significant areas of concern identified by audit committee members, according to the results of a KPMG survey, available here, published in October 2020: (risk factors, MD&A: liquidity, results of operations, known trends & uncertainties) (79%); forward-looking cash estimates (48%); impairments (43%); accounting for financial assets (23%); use of non-GAAP measures (17%); and valuation of pension plan assets and funding requirements (6%).
- SEC Division of Corporation Finance Chief Accountant Lindsay McCord and Deputy Chief Pat Gilmore discussed, during a Division of Corporation Finance panel at the AICPA Conference, the misuse of non-GAAP financial measures under the guise of applying GAAP accounting for segments. Other hot topics that have captured the attention of Division staff accountants in 2020, which the Division's staff plans to scrutinize closely in the context of the 2021 review and comment process, are:
  - disclosure regarding the looming transition away from LIBOR, whether presented in Risk Factors, the MD&A or elsewhere in the Form 10-K;
  - compliance with recent amendments to Regulation S-K Items 101, 103 and 105 that became effective on November 9, 2020 (discussed below in Tip #11);
  - the topics addressed in CF Disclosure Guidance Topics 9A and 9 – including non-GAAP and other points discussed below; and
  - implementation of/compliance with recent amendments to Regulation S-X (significant acquisitions and dispositions, Rules 3-05 and Article 11, and guarantor financial statements, Article 13, Rules 3-10, 13-01, and 13-02).

Tip #5: "Early Warning" Must be Given of Potential Substantial Doubt of Going Concern or Impending Restructuring

- In Disclosure Topic No. 9, referenced above, which was issued in March 2020 just as companies and regulators alike were first coming to grips with the potential impact of the pandemic, the SEC's Division of Corporation Finance reminded management to consider, on a quarterly basis, whether relevant conditions and events, taken as a whole, raise substantial doubt about their company's ability to meet its obligations as they become due within one year after the issuance of the financial statements.
- When preparing its fiscal 2020 Form 10-K and related earnings release, management should consider the impact of COVID-19 on the estimates and judgments underpinning both historical results and the 2021 outlook, including liquidity and covenant compliance, and recognize that the outside auditor likewise will be taking a very close look at the urging of the PCAOB and its oversight agency, the SEC.
  - The audit committee therefore should be asking tough questions about management estimates and judgments already proven wrong for fiscal 2020, as well as the outlook over at least the next 12 months (see Tip #2).
- If, based on that twin analysis under GAAP and PCAOB requirements, substantial doubt exists about the company's ability to continue as a going concern, management and the outside auditor will need to consider management's plans to mitigate these conditions and make judgments as to whether these plans are likely to succeed.

- In this case, expect that the outside auditor will identify going concern accounting as a critical audit matter "CAM". While there was some initial unease about auditors identifying CAMs leading up to the PCAOB's adoption and implementation of the relevant audit standard, there hasn't been much concern in the implementation or any fall-out whatsoever. Having said that, the PCAOB has indicated, available here, that it believes investor awareness of CAMs is still developing and noted that some investors did find the information helpful. At the AICPA Conference, SEC staff observed, available here, that OCA has and will continue to monitor PCAOB implementation efforts, and made clear during a panel discussion that the most helpful CAMs were those that included "audit specific" language in lieu of boilerplate (e.g., identifying the specific input(s) and/or assumption(s) considered).

- Similarly, in drafting risk factors, forward-looking statements, MD&A, and subsequent development footnotes to the financial statements, management preparers should consider the need to provide "early warning" to investors of the possible need for restructuring and/or asset/intangibles impairment as discussed below.
- **SEC Comment Example**: "Disclose that the Company's auditors have expressed substantial doubt that it will be able to continue as a going concern. Discuss management's plans to address recurring net losses, negative cash flows from operations, and substantial indebtedness."

Tip # 6: Carefully Consider Timing of Goodwill Impairment Testing and the Need for "Early-Warning" Disclosure of Material Risks and Uncertainties

- In light of COVID-19, audit committees should closely monitor evolving facts and circumstances that could trigger interim impairment testing of goodwill and other intangible assets.
- In its end-of-year report, available here, PwC identified the following events as possible impairment triggers under applicable GAAP:
  - Negative or declining earnings or cash flows compared to budget or prior years
  - Significant, adverse change in overall macroeconomic conditions
  - Deterioration in industry conditions or market multiples
  - Constraints on supply chain, sourcing of inputs, and/or workforce availability
  - Loss of key management, personnel or customers
  - Impairments of other assets or establishment of valuation allowances
  - Sustained decline in market capitalization below book value
- This is another area ripe for a CAM appearing in the auditor's report. On December 3, 2020, the Center for Audit Quality reported here that the four areas that stand out as CAM predicates are taxes (16%), goodwill and intangibles (14%), other contingent liabilities (12%) and revenue (9%).
- **Enforcement Case:** While the facts pre-date the COVID-19 era, the SEC's enforcement case brought in federal district court on December 11, 2020 against Sequential Brands has particular relevance now. The SEC charged the company with failing to timely impair goodwill as a result of ignoring objective evidence of impairment, including a sustained decrease in its stock price and other adverse developments. The SEC alleged that the company instead applied what the SEC termed a "strained, biased and outcome-driven qualitative analysis" that led it to unreasonably conclude that goodwill was not impaired and therefore materially misstated its financial statements for almost a year. The SEC's complaint is available here. Needless to say, this is a case to watch.

- **SEC Comment Example:** "In cases where the fair value of intangible assets did not substantially exceed the carrying value of the assets, disclose the percentage that the fair value exceeded the carrying value."

Tip #7: Accounting and Disclosure Controls must Provide Reasonable Assurance that Quarter-End Adjustments Comply with GAAP; Beware of Earnings Management

- The Enforcement Division has been using risk-based data analytic tools in the financial fraud and issuer disclosure areas. Specifically, the Enforcement Division is looking for potentially illegal earnings management practices by analyzing anomalous patterns of reporting of quarterly EPS metrics that indicate that a company is an outlier as compared to industry peers.
- **Enforcement Cases:** On September 28, 2020, the SEC announced settled actions, here, against Interface, Inc. and Fulton Financial Corporation, and their former executives, relating to their earnings management practices. In Interface, the SEC charged that the company had in multiple quarters in 2015 and 2016 made unsupported, manual accounting adjustments that were not compliant with GAAP to boost the company's income and avoid falling short of analyst consensus EPS estimates. In Fulton, the SEC charged that the company inaccurately presented its financial performance in late 2016 and early 2017 by including a valuation allowance for its mortgage servicing rights that was at odds with the valuation methodology in its filings in order to be on track to meet or beat analyst consensus EPS estimates. Both companies settled without admitting or denying the SEC's findings. See also the Valeant/Bausch Health enforcement settlement involving (among other offenses charged) quarterly earnings adjustments the SEC deemed materially misleading, and the HP Inc. settlement, discussed more extensively in Tip # 8 and #9, below.
- The Enforcement Division also has been willing and will continue to use these techniques in the executive compensation and proxy disclosure space; an example is the "perks" enforcement proceeding against Hilton Worldwide Holdings, Inc., available here, which we will discuss in more detail in our upcoming 2021 proxy season alert.

Tip #8: Non-GAAP Financial Measures Remain on the SEC Staff's Radar Screen

- Use of non-GAAP financial measures should comply with applicable rules and staff guidance (available here), be limited to show the way management runs its business, and be consistent period over period. As discussed, consistency across corporate messaging is equally important.
- As it pertains to COVID-19, senior SEC staff members have emphasized (most recently at the AICPA Conference) that companies may not use non-GAAP measures to "adjust out" the impact of COVID-19 (e.g., adding back revenue that a company assumes would have been earned absent the pandemic).
  - On the other hand, the SEC staff also said that expenses that can be isolated (that would not have occurred absent COVID-19) can be disclosed as excluded in non-GAAP measures, unless and until they become recurring. We would recommend careful audit committee oversight and questioning, however, of whether such expenses have crossed over the line and become "recurring"
- **Enforcement Cases:** On September 30, 2020, without admitting or denying the findings, BGC Partners, Inc. settled SEC allegations described in the order here, that BGC made false and misleading disclosures concerning how it calculated a key non-GAAP financial measure it called "post-tax distributable earnings" or Post-Tax DE. Post-Tax DE was to be the product of pre-tax distributable earnings, Pre-Tax DE, multiplied by a tax rate. However, BGC excluded certain expenses from Pre-Tax DE while factoring in the benefit of the tax deduction associated with these expenses in calculating the DE tax provision and therefore Post-Tax DE. On July 31, 2020, the SEC announced, available here, that Bausch Health Companies Inc., formerly known as Valeant Pharmaceuticals International, Inc., without admitting or denying the SEC's findings, had settled an administrative proceeding that included a non-GAAP violation (Rule 100(b) of Reg. G)). According to the uncontested SEC charges, "Valeant, through its earnings management, knew or should have known that its disclosures did not reveal the material impact of [specified] sales on certain of Valeant's GAAP and non-GAAP

financial measures." Additionally, as we discussed here, in December 2018, the SEC settled an enforcement action with ADT Inc. stemming from the company's inclusion of non-GAAP financial measures such as "adjusted EBITDA," "adjusted net income" and "free cash flow before special items" more prominently than comparable GAAP financial measures in headlines and other locations of its fiscal 2017 and Q1 2018 earnings releases. All are worth reviewing as companies prepare their 10-K's.

- **SEC Comment Example:** "We note your computations of non-GAAP measures Adjusted Operating Earnings, Adjusted Net Income and Adjusted EPS exclude acquisition-related intangible assets amortization. Please tell us how you determined the adjustments to certain acquired intangible assets do not substitute individually tailored income or expense recognition methods for those of GAAP. Refer to Question 100.04 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretations."
- Note that non-GAAP disclosures also have become the basis of demand letters from plaintiff attorneys to boards of directors, alleging non-compliance with the non-GAAP rules, such as failure to disclose GAAP measures with equal or greater prominence than non-GAAP financial measures in earnings releases.

Tip #9: Key Performance Indicators and/or Operating Metrics Must be Accurately and Contextually Disclosed

- When management believes that Key Performance Indicators (KPIs) are useful to provide a better understanding of the Company's business – whether by including them in earnings materials or in the MD&A -- preparers should consider the SEC's guidance issued on January 31, 2020, available here.
- KPIs consist of operating and other statistical measures. While they differ from non-GAAP financial measures and can be used if appropriately explained, KPIs equally need controls and procedures to assure accuracy and consistency in disclosures.
  - Examples of KPIs include metrics relating to external or macro-economic or industry-specific matters, metrics combining external and internal information, specialized, company-specific sales metrics (such as same store sales or revenue per subscriber) and environmental metrics (an example cited by the SEC is the observed effect of prior environmental effects on the particular company's business operations).
- A KPI, wherever used, should be accompanied by disclosure of: how the particular metric is defined; how it is calculated; the reasons why the metric is useful to investors; how management uses the metric; estimates or assumptions underlying the metric; changes to the metric; and any other information necessary to make the metric not misleading.
- **Enforcement Cases:** On February 21, 2020, Wells Fargo & Co. agreed to pay $500 million (part of a combined $3 billion settlement with the SEC and the Department of Justice) to settle allegations by the SEC, available here, that it committed fraud by misleading investors about the success of its "cross-sell" strategy and inflating its "cross-sell" performance metrics. On November 13, 2020, the SEC settled related charges against Wells Fargo's former CEO, who neither admitted nor denied the SEC's findings, available here, and announced litigation against the former head of its community bank, available here. On September 24, 2020, without admitting or denying the findings, BMW AG and two of its U.S. subsidiaries settled SEC charges, available here, stemming from disclosure of a key performance indicator – U.S. retail sales volume – in connection with raising a total of $18 billion in 144A bond offerings. Last but not least, as described in the SEC Order here, HP Inc. settled charges that it accelerated, or "pulled-in" to the current quarter, sales of printing supplies that managers otherwise expected to materialize in later quarters. According to the SEC, the purpose of such sales practices was to meet quarterly sales and revenue targets, thus misleading investors. HP agreed to entry of an administrative cease-and-desist order barring such practices and payment of a $6 million penalty, without admitting or denying the SEC's charges of negligence-based antifraud and accounting controls and procedures violations.

- **SEC Comment Example:** "We note in your earnings calls that you discuss net revenue per client … and inventory turnover. If these metrics are used by management to manage the business, and promote an understanding of the company's operating performance, they should be identified as key performance indicators and discussed pursuant to instruction 1 of paragraph 303(a) of Regulation S-K and Section iii.b.1 of SEC Release No. 33-8350. Please tell us your consideration of disclosing these metrics, or other key performance indicators used."

Tip #10: Be Aware of "New GAAP" Revenue Recognition and Other Guidance Shared by SEC Staff at the December 2020 AICPA Conference

- At the AICPA Conference, the SEC staff shared observations about specific fact-based scenarios that formed the basis for consultation with OCA. Many, if not all, of these shared observations are posted on the SEC website in the form of speeches and are worthy of audit committee review, particularly given that many of them cover New GAAP adoption and/or implementation issues companies are now wrestling with.
- For example, a number of speeches related to performance obligations under the new revenue recognition/disclosure standard, ASC Topic 606, and lessons learned included:
  - a software license, along with updates to the software license, represented a single performance obligation, when, as described in much more detail here, the nature of each of the updates was critical to maintaining the utility of the software because if not provided to the customer, the software would not be able to access and analyze the customer's data.
  - a company that operated a platform that facilitated an advertiser's purchase of advertising space from a publisher could conclude that it was an agent given, as described here, that it did not have the ability to direct the use of, and obtain substantially all the remaining benefits from, the publisher's advertising space; and
  - a company that had the contractual right to market and sell 100 percent of a commodity produced by a related party, as described here, could not conclude that it was an agent and not a principal.
- Other OCA staff observations on "hot accounting topics" delivered at the AICPA Conference in written speeches available on the SEC's website related to:
  - whether it would be acceptable to report cash outflows to a vendor net of cash inflows arising from payments from the vendor, available here;
  - a corporate customer's accounting for consideration received from a vendor as a reduction in the purchase price, available here;
  - accounting for the right-of-use assets under the new GAAP leasing standard, in a situation where the company was planning to abandon certain right-of-use assets at some unspecified time in the future, but prior to the end of each lease term, available here;
  - consolidation of variable interest entities under the voting rights model and the variable interest entity model under GAAP, available here; and
  - consultation on equity method investments, available here.

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Tip #11: Review New Form 10-K Human Capital Resources Disclosure and Other Changes Resulting from Now-Effective Amendments to SEC Regulation S-K

- Effective November 9, 2020, the SEC modernized various disclosure requirements in Regulation S-K, available here, in an effort to make the rules more flexible and principles-based for the benefit of investors and public companies alike. More specifically, the SEC amended Form 10-K (and 10-Q) disclosure requirements set forth in S-K Items 101 (description of business), Item 103 (legal proceedings), and Item 105 (risk factors). We discuss each briefly in other tips below. We emphasize the new human capital resources disclosure requirement here and in Tip # 13 on ESG. Other recently adopted Regulation S-K amendments that have not yet become effective are covered in the next Tip #12.
- Changes to the business description mandated by amendments to Item 101 of Regulation S-K are designed to allow today's businesses to move away (without abandoning entirely) the "old" disclosure requirements originating in the manufacturing era that focus primarily on property, plant and equipment and number of employees. The change recognizes the realities of contemporary companies whose key value drivers may be intangible assets such as employee expertise and creativity. Existing S-K 101 mainstays have either been updated (e.g., focus on "dominant segment or each reportable segment about which financial information is presented in the financial statements"), or retained without modification (e.g., seasonality, government contracts).
- The highlight of these changes to the business description section is a new obligation to disclose information regarding human capital resources to the extent material to an understanding of the particular business. In drafting the new human capital disclosure, companies should keep in mind the plain text of the amended rule: "A description of the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel)."
  - Consider how this new human capital disclosure might intersect or overlap with ESG disclosure in your proxy statement; for example, if executive compensation is tied to ESG performance metrics and addressed in the Compensation Discussion and Analysis, make sure the disclosure in the 10-K is consistent with the corresponding disclosure in the proxy statement.
  - Also consider the company's messaging outside of SEC filed or furnished documents, such as a separate sustainability report posted on your company's website, bearing in mind that the antifraud provisions of the federal securities laws potentially apply to all corporate communications that could be viewed, with 20/20 hindsight, as aimed at the investor and/or analyst communities.
  - Word choice is important here. In a July 2020 shareholder derivative lawsuit brought against Facebook, available here, the plaintiff claimed, among other things, that Facebook had violated Section 14(a) of the Securities Exchange Act of 1934, as amended ("Exchange Act") by making false assertions about the company's commitment to diversity. It goes without saying that the outcome of cases like this bear careful monitoring.
  - Avoid boilerplate. Tailor the disclosure to the particular business and remember the importance of company-specific risk factors and meaningful cautionary statements. See Tip ## 14 and 15, below.
- Audit committees should ensure that adequate disclosure controls and procedures and internal control over financial reporting are applied in drafting the new human capital disclosure presented in the Form 10-K, as well as the other S-K modernization changes discussed here or below.

Tip #12 Review MD&A for Primary Drivers of Company Business & Known Trends & Uncertainties

- Audit committees should be aware of recent Regulation S-K amendments, available here, intended to "modernize, simplify and enhance" disclosure in the MD&A (S-K Item 303), selected financial data (S-K 301) and quarterly financial data (S-K Item 302) sections of periodic reports on Form 10-K and Form 10-Q.
  - Like the human capital disclosure and other S-K amendments that became effective on November 9, 2020, the latest amendments were adopted by a 3-2 vote of the SEC.
  - Voluntary early compliance is permitted beginning February 10, 2021, subject to certain conditions. Mandatory compliance is not required for companies with fiscal years ending before August 9, 2021.
- In a nutshell, the latest round of S-K amendments will allow companies to:
  - Dispense entirely with disclosure of selected financial data for each of the last five fiscal years (or such shorter time as the company and its predecessors have been in existence).
  - Rather than disclose two years of tabular selected quarterly financial data, provide principles-based disclosure of certain quarterly retrospective changes such as discontinued operations, error correction or change in accounting principle.
  - Provide more principles-based disclosure in the MD&A section of annual and quarterly reports, focusing on:
    - Material cash requirements, including but not limited to capital expenditure commitments, as of the latest fiscal period, the anticipated source of funds needed to meet them, and the general purpose of these requirements.
    - Known trends that are reasonably likely to cause a change in the relationship between costs and revenues, such as known or reasonably likely increases in the costs of labor or materials, price increases or inventory adjustments.
    - Material change disclosure, including decreases as well as increases in sales or revenue.
    - Streamlined disclosure of material off-balance sheet arrangements that eliminates the Sarbanes-Oxley era caption and reduces GAAP redundancy.
    - Narrative rather than tabular disclosure of material contractual commitments, both short- and long-term, which must be integrated into the enhanced discussion and analysis of liquidity and capital resources.
    - Critical accounting estimates, which MUST be discussed and analyzed in the MD&A under the amended rule. Note that this may be a good place to address CAMs identified in the outside auditor's report.
- Whether or not the latest round of S-K amendments will survive in a President Biden administration is difficult to predict. That said, if your company is filing its Form 10-K after February 10, 2021, the company may wish to rely on one or more of the deregulatory amended items if they are still in place. In that event, audit committees should ensure that a key condition to early voluntary application is met: full compliance with all requirements of a particular amended S-K item. To illustrate, management cannot elect to comply with amended Item 303 in most respects, while retaining the "old" contractual obligations table simply to avoid complying with the "new" duty to discuss/analyze material cash requirements from known contractual and other commitments.
- Whatever the ultimate fate of this round of S-K amendments with new sheriffs at the helm at the SEC and Congress, it is clear that the SEC will not hesitate to bring enforcement proceedings under current S-K 303 if the facts are viewed as egregious. Besides careful consideration of whether known trends and uncertainties are disclosed, the audit committee also must consider whether MD&A encompasses disclosure of the factual underpinnings of auditor-identified CAMs, whether in the critical accountings estimates section or elsewhere in MD&A or otherwise (e.g. disclosure of material risks, ICFR, or the financial statement footnotes).

- **Enforcement Cases:** We have discussed the settled HP Inc. case above in Tip #9 relating to KPIs, which also included uncontested charges of failure to disclose a known trend: "In its 2015 Form 10-K, HP failed to disclose the known trend of increased quarter-end discounting leading to margin erosion and an increase in channel inventory, and the unfavorable impact that the trend would have on HP's sales and income from continuing operations, causing HP's reported results to not necessarily be indicative of its future operating results. The failure to disclose that material trend caused HP's 2015 Form 10-K to be materially misleading." Additionally, in December 2020, the SEC announced, available here, that, without admitting or denying the SEC's findings, Dentsply Sirona Inc. settled administrative charges for (among other violations) failing to provide required MD&A disclosure of "material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operation results or of future financial condition."
- **SEC Comment Example:** "Your discussion of operating cash flows appears to be a recitation of the changes disclosed on the consolidated statement of cash flows. Please revise and expand this discussion to include the primary drivers of, and other material factors necessary to understand the company's cash flows from operating activities. Refer to Section IV.B. of SEC Release 33-8350."

Tip #13 Consider Possible Expansion of Audit Committee Responsibilities for Oversight of ESG Risk Management and Disclosure

- Although many ESG risk management and disclosure topics are often overseen by a Board committee other than the audit committee (e.g., nominating and governance and/or compensation committees), it may be more logical to at least share such oversight responsibility with the audit committee. Companies are increasingly being pressed by influential institutional investors and proxy advisory firms to disclose more comprehensive ESG metrics (including but not limited to non-GAAP financial measures and KPIs), whether in complying with the SEC's new human capital disclosure requirement, explaining the link between executive pay and corporate performance in proxy statements, or otherwise. Boards are now facing significant pressure to satisfy often-conflicting stakeholder expectations.
- According to a recent KPMG survey, available here, audit committees expect the Board to address the following areas in response to COVID-19 and ongoing protests over systemic racism: employee/workforce safety and well-being (85%); diversity within the company, including the boardroom (56%); supply chain resilience, including health safety and well-being (53%); and corporate reputation among stakeholders (39%). At least some of these topics are within the audit committee's traditional purview (compliance and financial reporting), or intersect with the oversight responsibilities of other important Board committees.
- Particularly given a more ESG-focused Biden administration and Democratically-controlled Congress, there must be coordinated board-level oversight of the ESG topics that will be disclosed in company reports filed with the SEC or made widely available to the public via web-posted sustainability reports. Compliance with Regulation FD and antifraud prohibitions requires the same careful oversight of ESG topics company personnel discuss informally with investors and other external stakeholders. If goals or metrics are going to be shared either internally or externally, they must be chosen carefully and be consistent with the company's own business strategies and priorities for the reasons previously discussed (see Tip ## 1-3, above).
  - ESG metrics that are key performance indicators warrant particular attention by the audit committee, both for effective oversight of the design and administration of the controls and procedures applicable to company decisions to disclose such metrics, and to ensure consistency in disclosure.
- Audit committees should decide on their confidence level in the company's ESG disclosure. While some audit committees may not believe it is necessary, Deloitte in its ESG publication available here, suggests that audit committees should obtain and oversee external assurance from their outside auditors to enable the company to have more confidence in the quality and integrity of its disclosure.

- Statistics indicate, however, that only 29 percent of S&P reporting companies obtained external assurance on their sustainability or ESG reports as of 2019, and of those companies, not all included human capital metrics within the scope of assurance.
- In short, this is a matter of audit committee judgment. Sarbanes-Oxley imposes specific oversight duties on the audit committees of listed companies, and empowers them to hire their own expert advisors to facilitate the discharge of these duties.

Tip #14: Refresh Key Risk Factors with New Information about Each Risk, and Explain How That Risk Applies to the Company

- The SEC's modernization of Item 105 of Regulation S-K governing risk factor disclosure, effective November 9, 2020, involves (i) adding a category for general risk factors that could apply to any company in any industry, (ii) requiring specific risk factor captions to discourage the use of boilerplate and (iii) requiring a risk factor summary of no more than two pages if the risk factor disclosure exceeds 15 pages. In addition, amended S-K 105 replaces the term "significant" with the word "material" which in turn is defined in terms of the basic definition of "materiality" for antifraud purposes formulated by the U.S. Supreme Court: information the "reasonable investor" would consider important in deciding how to vote or make an investment decision, or there is a substantial likelihood that disclosure of an omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of available information.
- From what we have seen thus far in company filings, most companies that have included a risk factor summary used a company-specific caption for each of the risk factors. We believe this should be fine so long as the title adequately describes the risk, which is an important caveat.
- Consider whether the company's risk factors focus on meaningful risks and not mere boilerplate. To the extent some risks are sufficiently broad to apply to any company (which should be kept to a minimum because the SEC prefers, and investors expect, tailored risk factors), use the SEC-mandated "general risk factor" caption.
- While "tightening" risk factor disclosure is a good exercise, don't eliminate risks the company actually faces solely to avoid the new requirement for a risk factor summary. A helpful benchmark in this context takes the form of the PSLRA safe harbor discussed below in Tip #15. It is more important to cover the full spectrum of risks facing the company, whether external or internal, to mitigate liability exposure.
- Some of the key risks to be addressed by most multinational companies chartered in the United States continue to be COVID-19, LIBOR, BREXIT and the effects of each of the foregoing on the particular company's liquidity and results of operation, and cybersecurity.
  - For LIBOR, keep in mind that companies must evaluate exposure to LIBOR-based contracts and accounting issues raised by the transition away from LIBOR.
    - At the AICPA Conference last December, staff member Jillian Pearce shared here OCA's observations relating to the expected discontinuation of LIBOR (interest-rate reset). FASB has also been refining relevant accounting guidance.
  - For cybersecurity, many companies will be grappling with disclosure relating to the massive SolarWinds Corp. cyber-hack first revealed in December 2020 by (among others) well-known cybersecurity firm FireEye. FireEye later issued a public statement in a Form 8-K filed December 14, 2020, available here, describing "a global campaign … introduc[ing] a compromise into the networks of public and private organizations through IT infrastructure management software… [which] demonstrates top-tier operational tradecraft and resourcing consistent with state-sponsored threat actors." Media reports indicate that among the victims of this stealth, "back-door" attack dating back to the Spring of 2020 were large U.S. government agencies such as the Departments of State, Treasury and Commerce, along with major Fortune 500 companies.

   - Experts have indicated that ransomware will continue to be the top cyber threat and financial concern for public companies in 2021, given the pervasive use of remote servers for storage of critical financial and operational data.
   - According to the PCAOB conversations with audit committee chairs, the transition to remote work was made easier by storing most of the issuer's data in the cloud. But this is a two-edged sword. Because of the audit committee's broad responsibility to oversee financial reporting and legal compliance, we recommend that at least one member of the audit committee understand the risks related to cloud usage.
- For BREXIT, affected companies must update their risk factor to reflect the trade and cooperation agreement signed by the UK and the EU on December 24, 2020, and address the risks or uncertainties raised by the new agreement. Note in this regard that the Division of Corporation Finance will be monitoring disclosures in this area.

Tip #15: Update PSLRA Meaningful Cautionary Statements Accompanying Forward-Looking Statements to Afford the Company the Most Effective Antifraud Litigation Protection

- In the 2020 10-K and each 202110-Q and in press releases and other communications, companies should take a fresh look at the sufficiency of the cautionary statements legend they are using even as they are updating their risk factors.
- If a Risk Factors Summary has been prepared, compare the cautionary statements legend to the Risk Factor Summary to ensure consistency.
- Most S&P 500 companies are, at a minimum, prominently adding an explicit bullet related to COVID-19 and are also referencing COVID-19 in other enumerated cautionary factors as a specific example of how the factor would be impacted (e.g., the bullet on supply chain).
- Updating this legend to reflect the extraordinary environment in which companies are now operating is particularly important for companies that are providing guidance or, otherwise providing an unusual degree of forward-looking information in the Q4 earnings release and/or on the earnings call.

Tip #16: Beware of Failing to Provide "Early Warning" of Material Loss Contingencies/Compliance with Relevant GAAP

- When it comes to loss contingencies, the SEC wants to know "what did you know and when did you know it".
- Possibly more than any other area, the SEC scrutinizes disclosure of civil or criminal penalties and private litigation settlements to determine whether "early warning" could have been given in prior reports.
- The SEC's basis for disclosure of such contingencies lies in both Item 103 of Regulation S-K and ASC Topic 450. Item 103 was recently amended, effective November 9, 2020, to allow hyperlinks or cross-references between the legal proceedings disclosure and financial statement contingencies footnote and vice versa. However, the underlying disclosure requirements are not identical as discussed below.
- As amended, Item 103 also raises the threshold for disclosing environmental proceedings when the government is a party from $100,000 to $300,000, while providing for selection of a higher alternative threshold capped at the lesser of $1 million or 1 percent of the current assets of the company and its subsidiaries on a consolidated basis. If the higher threshold is used, companies must disclose the higher threshold, which could lead investors to draw conclusions about the company's materiality threshold more generally.
- Beyond Item 103, it is critical for audit committees and financial statement preparers to understand the three different rungs of ASC 450 that govern whether a company must disclose or accrue a contingent liability, as described by the federal trial judge in a case brought by the SEC against RPM International, Inc.:

- "ASC 450 requires disclosure (e.g., in one or more footnotes to the financial statements) when an identified loss contingency is "reasonably possible," or "more than remote but less than likely." If an unfavorable outcome is determined to be "probable" – which means more than likely to occur – and the amount of loss can be reasonably estimated, an issuer must record an accrual for a loss contingency as a charge against income." (SEC v. RPM International, Inc., 282 F. Supp. 3d 1 (D.D.C. 2017)).

On December 23, 2020, the SEC settled the charges against RPM International, Inc. and its General Counsel and Chief Compliance Officer, as described here, See also RPM's Form 10-Q filed Jan. 7, 2021, here, disclosing the terms of the settlement.

- In determining whether a loss is "probable" in connection with litigation, claims and assessments, ASC 450 lists a number of factors the company may consider, including: (1) the nature of the litigation, claim or assessment; (2) the progress of the case; (3) the opinions or views of legal counsel and other advisors (including the basis for conclusions and any qualifications or conditions counsel has identified); (4) the experience of the company or other companies with similar litigation; and (5) "any decision of the entity's management on how the entity intends to respond …(for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement)."
- As the responsible oversight committee of the board, the audit committee may decide, as authorized by Sarbanes-Oxley, to hire its own expert legal and accounting advisors to facilitate and inform the committee's decision-making, depending on the totality of relevant facts and circumstances. That decision covers company disclosures made under both amended S-K Item 103 and ASC 450. At a minimum, the audit committee may want to hear directly from inside or outside counsel handling the litigation or contingency to assure themselves that disclosure is in keeping with the rungs of the ASC 450 ladder, without impairing the company's ability to invoke attorney-client privilege and work product protections.
- **SEC Comment Example:** "Please expand your disclosure to specify your estimate of reasonably possible loss or the range of reasonably possible loss pertaining to this matter. If you have not prepared an estimate and are unable to estimate such amount or range, you must include a statement that such an estimate cannot be made to comply with FASB ASC 450-20-50-3 and 4. If this is the case, disclose the amount of damages that are being sought and which have been quantified, and identify any aspects of the litigation for which the amount of damages claimed remain unspecified."

Tip #17: Consider Heightened Pressures on Internal Control over Financial Reporting and Disclosure of COVID-19-related Challenges

- While audit committees must oversee internal control over financial reporting (ICFR) at all times, COVID-19 has created special challenges, as the Chief Accountant has recognized, particularly with respect to financial reporting processes in a remote work environment.
- OCA has reminded companies to consider thoughtfully any such changes, and their materiality, in determining whether there is an obligation to disclose whether, during the last quarter, there have been changes that materially affect, or are reasonably likely to materially affect, ICFR effectiveness. Many companies have made COVID-19-related disclosure in response to either Item 9 of Form 10-K (management annual report on ICFR effectiveness) or Item 4 of Form 10-Q (material change in ICFR).
- Major U.S. accounting firms have urged audit committees to consider the heightened potential for control deficiencies and the elevated fraud risk arising from COVID-19 developments such as furloughs, terminations, new hires, reorganizations, and the remote work environment.
    - For example, E&Y identified here the following important considerations: key controls related to processes and accounts affected by accounting estimates; potential incentives, pressures or opportunities for fraud; heightened risk of cyber incidents and safeguarding of assets; impacts of the pandemic on critical service organizations, including how potential modifications to Systems and Organizations Controls (SOC) reporting and delays in the issuance of these service auditor's reports may impact the organization's ICFR.

- According to the KPMG survey, available here, the most commonly cited internal control areas warranting heightened scrutiny are: return to work plans (73%); IT system access and authentication to enable a remote/virtual workplace (69%); and cybersecurity (56%).
- **Enforcement Cases:** Note that both of the Andeavor and Valeant cases discussed above in Tip #3 and Tip #8, respectively, are internal accounting controls settlements.
- **SEC Comment Example:** "Please describe in detail your evaluation of the severity of the key control deficiency. Refer to the guidance for evaluation of control deficiencies beginning on p. 34 of SEC Release No. 33-8810 'Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934.' Include in your analysis a description of the maximum potential amount or total of transactions exposed to the deficiency and how that determination was made."

Tip #18: Be Aware of PCAOB-Mandated Areas of Auditor Focus

- Based on the December 2020 PCAOB report regarding staff observations during the COVID-19 pandemic, available here, we expect auditors to be particularly focused on understanding the company's processes for formulating accounting estimates, including methods, data and assumptions (as previously discussed), as well as the extent to which the company uses third parties, as discussed here and in the next tip. Auditors will be discussing these issues with both the audit committee and management preparers of financial statements.
- With respect to significant assumptions (e.g. revenue projections, cash flow estimates, charge-off rates, or projected rate of return), auditors were reminded by the PCAOB that they must evaluate whether:
  - the company has a reasonable basis for the significant assumptions used and, when applicable, for its selection of assumptions from a range of potential assumptions; and
  - the significant assumptions are consistent with relevant industry, regulatory, and other external factors, including economic conditions, and with other significant assumptions used by the public company in other estimates tested.
    - A company must be prepared to support assumptions by sharing relevant evidence, regardless of whether it corroborates or contradicts the company's assumption.
    - Keep in mind that assumptions based on past experience and management expectations may not reflect current market information or be representative of expected future conditions or events.
- Also keep in mind the important role of the audit committee in oversight of estimates/valuations (see Tip #19). Do not be surprised if your outside auditor identifies a CAM tied to significant management judgments, estimates or assumptions.

Tip #19: Stay Attuned to Helpful PCAOB Reports of Conversations with Audit Committee Chairs and Guidance for Audit Committees

- Helpful hints about the questions audit committee chairs are asking amidst COVID-19 can be gleaned from the PCAOB's publication on conversations with audit committee chairs. The half year report was published in July 2020, available here, and the PCAOB also will be publishing a report on its end of year conversations on an unspecified date. In the July 2020 report, across industries, the PCAOB identified these top-of-mind issues for audit committee chairs:
  - cybersecurity;
  - employee safety and mental health;
  - going concern analyses;
  - accounting estimates;

  - impairments;
  - international operations; and
  - accounting implications of the Coronavirus Aid, Relief, and Economic Security (CARES) Act (which has been modified and/or augmented by recently enacted legislation).
- Questions related to remote work included whether additional time will be needed for the audit, whether there are changes to the audit plan, the impacts of remote work on internal control over financial reporting, tips from the auditor's interim reviews, any need for technological enhancements or collaborative tools for working with the auditor, whether the auditor has tested risk of material misstatement relating to cybersecurity and how the auditor plans to respond to those risks.
- Audit committee chairs reported increased communication with auditors, discussions of trends auditors are seeing, particularly if there are trends for the company's peers, and having the auditor present on areas of the audit that may or will warrant increased attention due to the effects of COVID-19 and how the auditor plans to approach those areas.
- Along with gathering insights from members of public company audit committees, the PCAOB also publishes practical guidance intended to assist these directors to understand, and thus to assess, the adequacy of the outside auditor's compliance with PCAOB rules and auditing standards. A good example takes the form of a recent audit committee resource publication describing a new standard on the audit of accounting estimates (including fair-value measurements), and the auditor's use of the work of specialists, which is available on the PCAOB's website, here, at Audit Committee Resource: New PCAOB Requirements Regarding Auditing Estimates and Use of Specialists (Nov. 2020).

Tip #20: Oversee Disclosures of Operating Results and Guidance Based on Confidence in Business Modeling Given these Uncertain Times

- As discussed in tips above and as urged by the SEC, companies must disclose drivers of their operating performance in earnings releases and in MD&A.
- If operating results look better because of unusual timing of sales due to COVID-19 or because of rent deferrals from landlords, these factors much be disclosed.
- In addition to presenting an accurate picture of operating results, companies must take care to make guidance decisions depending upon their confidence in business modeling, and disclose the uncertainties and assumptions if guidance is given.
- Before COVID-19, many companies provided quarterly or annual guidance, or both, to allow analysts and investors to compare their own projections for the company to management's projections.
  - When there are too many misses, the veracity of management has been called into question.
- Many companies withdrew guidance already given or suspended future guidance in view of the uncertainties related to COVID-19, with some companies' suspension relating only to quarterly guidance and others to annual guidance, or both.
  - According to a Wall Street Journal article in June 2020, available here, 40% of S&P 500 companies pulled their guidance and their shares in the aggregate fell further than the broader index. According to the article, on average, shares for the companies that withdrew or withheld guidance were down 18.2% over the period from January to June 2020. By comparison, the S&P 500 was down 6.9%.
- Some companies that suspended guidance did so with respect to specific GAAP financial or non-GAAP financial measures, but narratively provided some idea of management's view of the company's prospects, which, as discussed above, they were encouraged to do by the SEC staff (see discussion of Guidance Topic 9A and 9 in Tip #1).

- To the extent that management believes it is time to resume guidance once suspended or withdrawn, or even to continue if guidance was never suspended, audit committee oversight is critical. Specifically, the audit committee should consider taking these steps:
  - Ensure that the culture of the company is not such that earnings management is encouraged;
  - If guidance being proposed by management seems overly conservative or aggressive, beware of underlying judgments and/or assumptions;
  - Question management about the assumptions and estimates that underlie the guidance to be given and whether such assumptions and estimates will be disclosed;
  - If there have been misses in the past, require an explanation of why management believes that more accurate predictions can be made now;
  - Ensure that disclosure controls and internal accounting controls have been applied in processing information that makes up the basis for the guidance; and
  - Review disclosure surrounding the guidance to confirm that the requirements discussed above with respect to non-GAAP financial measures (Tip #8) and key performance indicators (Tip #9) have been followed.
- **Enforcement Cases:** Although not related to COVID, the enforcement cases brought in 2020 against each of HP, discussed in more detail in Tip # 9, and General Electric, discussed here, are instructive in signaling the SEC's focus on policing earnings management practices. We do not anticipate any change in this aggressive enforcement approach under a new SEC Chair's leadership in 2021. On December 9, 2020, the SEC charged, here, that in 2017 and 2018, GE misled investors by describing its GE Power profits without explaining reductions in prior cost estimates and that a reported increase in current industrial cash collections was coming at the expense of cash in future years from another of its businesses. The SEC also alleged that GE lowered projected costs for claims against its long-term care insurance portfolio and failed to disclose uncertainties from lower estimates of future insurance liabilities at a time of rising costs from long-term health insurance claims. Importantly, all charges involved negligence-based violations, which GE neither admitted nor denied in connection with the settlement.

Tip #21: Monitor New Pressures on Auditor Independence

- In light of COVID-19, carefully monitor new or evolving situations that could threaten auditor independence. See the PCAOB's Observations, available here, identifying examples of such situations, such as unpaid professional fees or increased calls for non-audit services, and urging auditors to evaluate carefully all potential threats to auditor independence while complying with the applicable rules of the PCAOB and its oversight agency, the SEC.
- SEC Deputy Chief Accountant Diana Stoltzfus emphasized, during the AICPA Conference, the "foundational" importance of auditor independence, seen by the SEC and PCAOB as a shared responsibility of corporate audit committees, management members and outside auditors.
- In October 2020, a divided SEC (by a 3-2 vote) adopted final amendments, available here, to the key SEC auditor independence provision, Rule 2-01 of Regulation S-X, which are widely perceived as injecting much-desired flexibility into this prescriptive rule. The amendments will become effective on June 9, 2021, or an earlier compliance date selected by the auditor subject to a prohibition against retroactive application that may be designed to mitigate the risk of a Congressional clawback (under the Congressional Review Act of 1996). If the strong views of dissenting Commissioners Herren Lee (who just yesterday was designated as SEC Acting Chair) and Crenshaw, as described here, are any guide, however, the odds are that a Biden-era SEC will re-tighten the auditor independence rules in the future.

Summary and Conclusion: As the above tips make clear, the burden on audit committees is arguably as high as it has ever been. President Biden's nomination of Gary Gensler as the next SEC Chair – with Commissioner Herren Lee designated just yesterday as Acting Chair pending Mr. Gensler's confirmation -- signals even choppier seas ahead for the triad of financial reporting gatekeepers – the audit committee, management, and accounting firms. It is therefore crucial that audit committees – as perhaps first among equals given their dual Sarbanes-Oxley oversight role with respect to both management and accounting firms – adapt to heightened regulatory expectations that companies provide full and fair disclosure for the benefit of the investing public. We also expect the SEC's bar to be raised for oversight of the work – as well as the independence – of the outside auditor. It remains to be seen whether the Biden administration will replace the previous administration's principles-based disclosure requirements and/or, as anticipated, mandate more sweeping and prescriptive disclosures on climate change and other ESG topics, which in turn will require enhanced attention to the effectiveness of corporate internal control over financial reporting and disclosure controls and procedures. Additional uncertainties lurk ahead as the markets and the world shift to what is hopefully a post-COVID environment which, whatever it becomes, is unlikely to be the same as it was before COVID. In any case, we hope these tips help a well-informed audit committee face the challenges on the horizon.

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