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Audit Committee Quarterly Update

FIRST QUARTER 2023

In this newsletter, we highlight some important 2023 first quarter issues facing audit committees. The content is not all-inclusive. You may also be interested in our quarterly publication that summarizes accounting, financial reporting, and regulatory matters that may impact both public and private companies.

Regulatory update

Rules to reduce risks in clearance and settlement

On Feb. 15, 2023, the SEC adopted rule changes to shorten the standard settlement cycle for most broker-dealer transactions in securities from two business days after the trade date (T+2) to one (T+1). The final rule is designed to benefit investors and reduce the credit, market, and liquidity risks in securities transactions faced by market participants.

In addition to shortening the standard settlement cycle, the final rules will improve the processing of institutional trades by requiring a broker-dealer to either enter into written agreements or establish, maintain, and enforce written policies and procedures reasonably designed to ensure the completion of allocations, confirmations, and affirmations as soon as technologically practicable and no later than the end of trade date. The final rules also require registered investment advisers to make and keep records of the allocations, confirmations, and affirmations for certain securities transactions.

Further, the final rules add a new requirement to facilitate straight-through processing, which applies to certain types of clearing agencies that provide central matching services. The final **rules** will become effective 60 days after publication in the Federal Register and the compliance date is May 28, 2024.

Non-GAAP financial measures

On Dec. 13, 2022, the SEC updated Compliance and Disclosure Interpretations (C&DIs), related to non-GAAP financial measures to reflect the staff's views that have been communicated in comment letters in recent years and emphasize the staff's position that the determination of whether an adjustment results in a misleading non-GAAP measure depends on a company's individual facts and circumstances.

In January 2023, the Center for Audit Quality (CAQ) issued **Alert 2023-01**, *Updates to SEC Non-GAAP Financial Measures Compliance and Disclosure Interpretations (C&DIs),* to provide an overview of the updates as well as a detailed comparison of the previous and new C&DIs.

Financial Reporting Manual (FRM) updates

Recent revisions to the FRM include updating contact information for the staff, as well as financial disclosures about guarantors and issuers of guaranteed securities and affiliates whose securities collateralize a registrant's securities, updates for ASU 2018-12, *Financial Services — Insurance,* and removal of information no longer applicable.

Audit Committee Practices Report: Priorities and committee composition

The Center for Audit Quality (CAQ) announced the second edition of the **Audit Committee Practices Report**, a collaborative effort between Deloitte's Center for Board Effectiveness and the CAQ. A total of 164 individuals participated in the entire survey from predominantly large U.S.-based public companies. The survey inquired about:

- Audit committee composition
- Areas of oversight
- Key risks
- Audit committee practices

This report provides insight into shifting priorities as well as trends and practices related to audit committee composition. The survey results and related analysis can also serve as a benchmarking resource for gauging an audit committee's development. Many boards are taking a fresh look at their audit committee structures and practices in light of emerging corporate reporting areas and increased risks, according to this report. In addition, cybersecurity; enterprise risk management (ERM); and environmental, social, and governance reporting top many audit committee agendas. *The Audit Committee Practices Report: Priorities and Committee Composition* provides insight into shifting oversight priorities and practices related to audit committee composition. Key insights include:

- 28% of respondents anticipate replacing the current audit committee chair in the next 12 months. A portion of those expecting to change the chair (19%) plan to do so with a current audit committee member and 3% with a current director who is not an audit committee member.
- Beyond the chair, an even greater percentage of respondents (42%) anticipate replacing one or more members of the audit committee in the next 12 months. Of these, about 24% expect to do so with current board members, while 18% plan to do so with new directors who are not presently on the board.

- 74% of respondents don't have a policy (formal or informal) to rotate the chair and/or members of their audit committees, and only 4% require new directors to serve on their audit committees (17% recommend it).

Outside of financial reporting and internal controls, respondents anticipate cybersecurity (63%); ERM (45%); and environmental, social, and governance disclosure and reporting (39%) as being among their top three areas of focus in the next 12 months.

Impact of current economic environment

SEC chair comments

On March 13, 2023, SEC Chair Gary Gensler issued a statement addressing the current market events: "In times of increased volatility and uncertainty, we at the SEC are particularly focused on monitoring for market stability and identifying and prosecuting any form of misconduct that might threaten investors, capital formation, or the markets more broadly. Without speaking to any individual entity or person, we will investigate and bring enforcement actions if we find violations of the federal securities laws."

In the March 15, 2023 SEC open meeting, he also addressed the events of the prior week in the context of enforcement and market stability.

As to enforcement, he noted, "Our staff is particularly focused on identifying and prosecuting any form of misconduct that might threaten investors, capital formation, or the markets more broadly. Without speaking to any individual entity or person, we will investigate and bring enforcement actions if we find violations of the federal securities laws."

As to market stability, he noted, "History is replete with times when tremors starting at one financial institution or corner of the financial system spill out to the broader economy."

He then discussed the SEC's focus on resiliency projects, relating to the U.S. Treasury markets, money market funds, open-end funds, private funds, and clearinghouses.

Impact on financial reporting

Many entities continue to be affected by the current economic environment. In addition to the impact these factors are having on an entity's operations, it's also important to consider the impact on financial reporting.

INFLATION

While inflation has decreased from levels seen in 2022, it remains above the Federal Reserve Bank's target long-term inflation rate. In addition to the impact inflation has on current costs, entities also must consider expectations of future inflation when they are required to use projected financial information. Those projections will need to take into account estimates of future impacts of inflation on an entity's costs and revenue, which becomes more difficult in period of economic uncertainty. Some common areas where projected financial information is required to be used include:

- Goodwill impairment
- Long-lived asset impairment
- Loan or investment impairment
- Going-concern assessments
- Valuations of assets acquired and liabilities assumed in a business combination or asset acquisition
- Fair value measurements of derivatives and other financial instruments
- Fair value measurements of share-based payment arrangements
- Realizability of deferred tax assets
- Other valuations that rely on financial projections

INTEREST RATES

Many entities have been impacted by the rising interest rates and the resulting increased borrowing costs and interest expense. In addition to these direct impacts, rising interest rates can also impact financial reporting by causing an increase in discount rates, which are a significant input into discounted cash flow models. Common areas where discounted cash flow models can affect financial reporting include:

- Goodwill impairment
- Long-lived asset impairment
- Calculation of lease liabilities and right-of-use assets
- Valuations of intangible assets
- Valuation of share-based payment arrangements
- Valuations of investments in debt and equity securities

OTHER FACTORS

The continued economic uncertainty may also impact entities in other ways, including:

- Accounting for severance pay and terminationbenefits if there are layoffs or employee terminations
- Potential modifications of share-based payment arrangements
- Changes in estimates for contingent consideration
- Conclusions on the intent and ability to hold held-to-maturity debt securities until maturity
- Conclusions on the intent and ability to hold available-for-sale debt securities in an unrealized loss position until they recover in value