

Governance Considerations for Replacing External Auditors

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Companies disengage from their external auditors for a variety of reasons—in some cases, an auditor resigns following an irreconcilable disagreement, while in other cases, the auditor elects not to stand for reappointment, the company terminates the engagement or the company proactively changes auditors to preserve (or enhance) the appearance of independence. Regardless of the catalyst, a change in auditors triggers a series of governance, independence and disclosure obligations that requires careful coordination among the audit committee, management, counsel and the outgoing and newly engaged external auditor.

This Debevoise In Depth highlights key considerations for audit committees and management teams navigating an auditor transition.

Role of the Audit Committee

Section 301 of the Sarbanes-Oxley Act, Rule 10A-3 of the Securities Exchange Act of 1934, as amended, and the applicable NYSE and Nasdaq listing standards require that the audit committee be directly responsible for the appointment, compensation and oversight of the company's independent auditor. Consistent with these requirements, the auditor must be formally engaged by the audit committee. Following engagement, the audit committee typically recommends that the board ratify the appointment. While not legally required under U.S. laws, most companies also submit the auditor's appointment to shareholders for ratification as a matter of good governance (and to ensure a quorum at the annual meeting).

Engagement Letters

Although the audit committee must approve and engage the auditor, engagement letters may take different forms. In practice, the letter may be addressed to, and signed by, the audit committee chair (or, less commonly, the full audit committee), with

acknowledgment by the CEO and CFO. Alternatively, the letter may be addressed to and signed by the CEO and CFO, with copies provided to the audit committee.

The large audit firms maintain engagement letter templates accommodating each approach. Auditors often request management's signature or acknowledgment because engagement letters typically memorialize critical management responsibilities, including responsibility for the company's financial statements and disclosures and for establishing and maintaining effective internal controls. Companies should be aware of the possibility of independence concerns from the U.S. Securities and Exchange Commission when the engagement letter contains indemnification of the auditor.

PCAOB Auditing Standard 1301 (Communications with Audit Committees) provides that the auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company. Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate signatories.

Auditor Independence

The audit committee must evaluate whether a prospective audit firm will be independent during the audit engagement period. Importantly, a firm cannot audit financial statements for any period during which it was not independent. As a result, advance planning is critical to avoid inadvertently impairing a prospective auditor's ability to serve. The audit committee should discuss and thoroughly evaluate any potential independence issues, including reviewing the firm's existing relationships and services. Where appropriate, the committee may also wish to seek guidance from legal counsel, the prospective auditor, and, if necessary, the SEC's Office of the Chief Accountant.

Rule 2-01 of Regulation S-X sets forth the independence requirements for auditors. Generally, an auditor's independence is impaired if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the audit engagement.

In considering this standard, the SEC generally focuses on whether a relationship with or a service provided by an auditor does the following: (i) creates a mutual or conflicting interest with the audit client; (ii) places the auditor in the position of auditing its own work; (iii) results in the auditor acting as management or an employee of the audit client; or (iv) places the auditor in a position of being an advocate for the audit client.

Rule 2-01 of Regulation S-X also provides a non-exhaustive list of circumstances that violate the auditor independence rules. The rule lists three broad categories of auditor-client relationships that violate the independence rules. These relationships are: (i) employment relationships; (ii) financial relationships; and (iii) business relationships.

Disclosures

Item 304(a) disclosure is triggered when a company's independent auditor is dismissed, resigns or declines to stand for reelection. If the company does not engage a new auditor contemporaneously, a separate reporting obligation is triggered when one is engaged.

Form 8-K

If a company's principal independent auditor resigns, is dismissed or indicates it has declined to stand for reelection after the completion of the current audit, the company must disclose this by filing a Form 8-K under Item 4.01 within four business days. Unlike certain other items in Form 8-K, the Item 4.01 disclosure requirement cannot be satisfied by disclosure in a subsequently filed Form 10-K or Form 10-Q. SEC C&DI 214.02, which refers to Exchange Act Form 8-K C&DI 101.01, states that an Item 4.01 Form 8-K must be used to disclose the change.

The obligation to file a Form 8-K for the departure of an auditor under Item 4.01(a) is separate from the obligation to announce a new auditor under Item 4.01(b). However, as noted in the Instruction to Item 4.01, both of these announcements can be made on a single Form 8-K if the company can meet the filing deadline for both reportable events in a single filing.

Form 8-K/A

In some circumstances, an Item 4.01 Form 8-K may be triggered prior to the auditor completing its annual audit, in which case the auditor may continue working to complete the audit and any other unfinished work. In this situation, the company is required to announce the initial resignation or dismissal, then file an amended Form 8-K within four business days of when the former auditor completes the audit and its relationship has actually terminated. The amended filing must indicate whether there were any disagreements through that date.

Exhibits to Form 8-K

In addition to disclosing the information in Form 8-K and Item 304(a)(1) or (a)(2) of Regulation S-K, Item 4.01 of Form 8-K requires companies reporting an auditor's

departure to comply with the process in Item 304(a)(3) of Regulation S-K. This includes providing the former auditor with a copy of the disclosures and requesting the former auditor to provide a letter indicating whether it agrees with those disclosures, a copy of which must be filed as an exhibit.

Exchange Notifications

NYSE and Nasdaq listing standards generally require advance notice to the exchange of any public disclosure relating to an auditor change, including the filing of an Item 4.01 Form 8-K.

Form 10-K

Form 10-K Item 9 is used to report certain information when there has been an auditor change previously reported on Form 8-K, the auditor change involved “disagreements or reportable events” that continue to affect the company’s financial statements, and the company’s new auditor does not require the company to account for these matters in the way the former auditor thought was in accordance with GAAP. In the event that disclosure under Form 10-K Item 9 is required, the company must disclose what the financial statements would have looked like had it followed the treatment the former auditor thought was required by GAAP.

Disagreements and Reportable Events

Disagreements

Item 304(a) of Regulation S-K requires detailed disclosure of the circumstances of the auditor’s departure as well as disclosure of certain circumstances pertaining to the engagement of the new auditor. This includes disclosure about both “disagreements” and “reportable events.”

A “disagreement” for purposes of Item 304 is defined broadly. Regulation S-K Item 304(a)(1)(iv) provides that a disagreement occurs at the decision-making level—between company personnel responsible for financial statement presentation and accounting firm personnel responsible for rendering the audit report. The SEC’s instructions clarify that a disagreement includes any difference of opinion concerning accounting principles or practices, financial statement disclosure or auditing scope or procedures that, if not resolved to the former auditor’s satisfaction, would have resulted in reference to the matter in the audit report. By contrast, initial differences of opinion based on incomplete facts or preliminary information that is later resolved based on additional information do not constitute reportable disagreements.

Instruction 5 to Item 304 also clarifies that “an oral communication from the engagement partner or another person responsible for rendering the accounting firm’s opinion (or their designee) will generally suffice as [to] the auditor advising the registrant of a reportable event or as a statement of a disagreement” such that Item 304(a) would require disclosure of the disagreement.

Where a disagreement exists, there are additional disclosure requirements regarding the nature of any disagreements with respect to issues that arise in specifically enumerated areas: (i) internal control over financial reporting; (ii) management representations; (iii) the need to expand the scope of the audit based on information suggesting issues with prior audit reports; and (iv) questions regarding the reliability of previous audit reports.

Reportable Events

Even in the absence of a “disagreement,” Item 304(a)(1)(v) of Regulation S-K requires disclosure of certain specified “reportable events” that occurred during the two most recent fiscal years and any subsequent interim period preceding the auditor’s resignation, dismissal or decision not to stand for reappointment. These events include circumstances in which: (i) the former auditor advised the company that internal controls necessary for the company to develop reliable financial statements do not exist; (ii) information has come to the attention of the former auditor that has led it to be unwilling to rely on management’s representations or to be associated with the company’s financial statements; (iii) the former auditor advised the company of the need to expand significantly the scope of its audit or that information has come to its attention that materially affects the fairness or reliability of a previously issued audit report, and the issue was not resolved to the auditor’s satisfaction; or (iv) the former auditor advised the company that newly discovered information would have materially affected its prior audit reports. These disclosure obligations apply regardless of whether the company and the auditor characterized the underlying issue as a “disagreement,” and companies should carefully evaluate communications from the auditor to determine whether any reportable event has occurred.

Capital Markets Considerations

Companies should also consider the potential impact of an auditor transition on pending or anticipated capital markets transactions. In connection with a registered offering, a company must obtain the consent of an auditor whose report is included or incorporated by reference in the registration statement as well as a comfort letter from the company’s independent auditor(s) for the periods included or incorporated by reference into the offering document. If an auditor change occurs in the audit

engagement lookback period for a securities offering, the company will need to obtain consents from the former auditor with respect to previously issued audit reports and a comfort letter from both the former and the new auditor covering the financial statements included in the offering documents. These requirements can create timing and coordination challenges, particularly where the new auditor has not yet completed the audit or review procedures necessary to provide comfort.

Key Takeaways

An auditor transition is more than a routine change in service provider—it is a governance event that implicates the audit committee’s statutory responsibilities, complex independence considerations and detailed disclosure obligations under the federal securities laws and exchange rules. Early planning, careful documentation and coordination among the audit committee, management, counsel and both the outgoing and incoming auditors can help ensure a smooth transition and mitigate regulatory and reputational risk.

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