

**INSIDE THIS PUBLICATION:**

CPAs will get new marching orders on spotting illegal acts

At 15, Sarbanes-Oxley Act inspires reflection, renewed attacks

Proposed rules would shore up auditing of estimates

10 reasons to be wary of new PCAOB auditor disclosure rules

Valuation specialists are rising to financial reporting challenge

ACL: Reducing the cost of SOX compliance

# Taking a revealing look at **Sarbanes-Oxley compliance**

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## Inside this e-Book

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CPAs will get new marching orders on spotting illegal acts	4
At 15, Sarbanes-Oxley Act inspires reflection, renewed attacks	8
Proposed rules would shore up auditing of estimates	10
10 reasons to be wary of new PCAOB auditor disclosure rules	14
Valuation specialists are rising to financial reporting challenge	18
ACL: Reducing the cost of SOX compliance	22



## CPAs get marching orders on spotting illegal acts

A professional accounting committee has opened a can of worms with a proposal regarding how accountants should respond when they stumble upon illegal activity.

**Tammy Whitehouse** reports.

A professional accounting committee has opened a can of worms with a proposal to revise its code of ethics addressing how accountants should respond when they stumble upon illegal activity.

When an accountant learns of some act that may be illegal, should they contact a supervisor? Communicate it to client management? Report it

to an outside authority? Consult an attorney? A proposed revision to the ethics code at the American Institute of Certified Public Accountants has touched off a sensitive ethical and legal debate.

The Public Company Accounting Oversight Board has its rules for auditors who are performing audits on public company clients. It points out auditors are not legal experts, so they can't know

in an instant if a particular rotten apple they've sniffed out might indeed be an illegal act.

Given that, the standard for auditors tells them to consider a number of possible actions, depending on what they've found. They need to consider the information within the context of their role as the independent external auditor, and they may need to consult legal counsel. Is it something that might be material to the company's financial statements? Does it affect financial statement assertions?

The guidance for auditors gives them a course of action that involves discussing the matter with the audit committee and possibly issuing an adverse opinion on financial statements or even quitting the audit engagement. For auditors, those are big sticks to wield. Companies that are listed need a clean audit opinion to remain in the good graces of securities regulators, so an auditor's actions along those lines is more likely to spur action within the company to address the matter.

But what if the accountant is an inside accountant or is engaged by the firm for a service other than an audit of financial statements? That individual can't hold a required audit opinion over management's head.

The first logical step is still to report the matter internally and let those with the authority to do so take action. If the information is not acted upon, however, or the situation remains unresolved, what's the accountant's next move? That's what the AICPA proposal, put forth by its Professional Ethics Executive Committee, is trying to determine. The Institute of Management Accountants recently addressed similar questions as well.

The AICPA project began as a convergence effort to decide whether to conform U.S. ethics standards to international ethics standards, says Lisa Snyder, who until very recently was the senior director in the professional ethics division at the AICPA.

The International Ethics Standards Board for Accountants issued a new standard on non-compliance with laws and regulations taking effect this summer, so the AICPA's PEEC considered whether a

similar standard was in order for AICPA members. "Anytime the IESBA issues a standard, we look at it for possible convergence, but we often need to tailor it to make it appropriate for the U.S. practice environment," she said.

In this particular case, the U.S. needs differed in some key ways because the United States has such a different legal system and litigation environment than many other countries. The whistleblower provisions instituted by the Securities and Exchange Commission under Dodd-Frank, for example, are very different from rules in place in other countries.

The significant difference between the IESBA code and the U.S. proposal centers on confidential information. How should accountants respond when they are bound by professional standards to keep confidential client information in confidence, yet they learn through the course of their work of some instance of non-compliance with laws or regulations?

That's where the international and U.S. standards needed to part ways. "Under the AICPA proposal, because of confidentiality laws, members would not be permitted to disclose a suspected NOCLAR to an outside authority unless required to do so by law or with the client's consent," says Snyder. "Under the IESBA standard, a member might be able to override confidentiality and disclose a NOCLAR to an authority. It depends on various circumstances and factors to consider."

One of those key factors, says Snyder, is whether or not there are any protections from liability or retaliation, either through whistleblower legislation or regulation or other legal provisions. As an example, Section 10A of the Securities Exchange Act of 1934 requires auditors of public companies to make disclosures to the SEC regarding certain illegal acts of their clients, but it also provides protection for the auditor against legal actions, says Snyder. "Part of the controversy is when is it appropriate to override client confidentiality if you believe the public interest may be threatened?"

The ideal path for any accountant who discov-



## ACCOUNTANTS' DUTY

Below, the AICPA proposal explains the responsibilities of senior professional accountants in business.

When responding to a NOCLAR, members in business are required to consider protocols and procedures that may exist within the members' employing organizations. Because of the role and sphere of influence of senior professional accountants in business, there is a greater expectation for them to take whatever action is appropriate in the public interest to respond to a NOCLAR.

For purposes of the interpretation, senior professional accountants in business are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources.

If a member who is a senior professional accountant in business discovers a NOCLAR, the member should obtain an understanding of the matter. The member should discuss the matter with the member's immediate superior to determine how the NOCLAR should be addressed. If the immediate superior is suspected of involvement, the member is required to discuss the matter with the next higher level of authority.

The interpretation requires certain steps be taken by a member who is a senior professional accountant, including having the matter communicated to those charged with governance to obtain concurrence regarding the appropriate actions to take to enable them to fulfill their responsibilities.

Source: AICPA

In responding to a NOCLAR, the member who is a senior professional accountant is required to determine whether disclosing the matter to the employing organization's external auditor is necessary, pursuant to the member's duty or legal obligation to provide all information necessary to enable the auditor to perform the audit.

### Determining Whether Further Action Is Necessary

If a member who is a senior professional accountant in business follows the guidance and determines that the response of management is not appropriate, the member is required to consider whether further action is necessary. The interpretation states that such further action could include informing management of the parent entity of the matter if the employing organization is a member of a group or, in extreme circumstances, resigning from the organization.

When making such determination, the member is required to exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the member at the time, would be likely to conclude that the member has acted appropriately and in the public interest.

In addition, the proposed guidance lists various factors for the member to consider in making the determination of whether further action might be necessary.

ers instances of non-compliance would be for the accountant to report the information through internal channels to those charged with governance and they would address it. That would spare the accountant the moral and legal conflict over whether to breach confidentiality and disclose to an outside authority. But if the accountant follows that course and the matter is left unaddressed or unresolved, what's the accountant's next move?

The issue for standard setters to decide is this: If an accountant has no legal requirement to report the instance, no consent from the client to report it, and no legal protections by law or regulation, should accountants be permitted to override client confidentiality? That's the legal/moral conundrum that PEEC is trying to navigate.

The National Association of States Boards of Accountancy, which licenses accountants at the state level, said it would like to see the standard land closer to the IESBA requirements, which compel accountants to a higher level of disclosure. "The AICPA's efforts on NOCLAR should be integrated with efforts of other regulators to provide better public protection," says Ken Bishop, president and CEO of NASBA. He notes the Uniform Accountancy Act governing all accountants doesn't prohibit CPAs from "compliance with applicable laws, government regulations, or PCAOB requirements."

So, what happens when there are no specific requirements? Some accountants fear the proposal would essentially deputize accountants, making them more responsible for sniffing out and chasing down potential acts of non-compliance.

"I don't think anyone is really taking issue with the idea of communication to the client that you found something, but there's a little concern around is it something we have qualifications as accountants to determine what's non-compliant," says Shelly Van Dyne, a partner at RSM.

Wendy Garrett, managing director in the area of independence at accounting firm Grant Thornton, echoes Van Dyne's main concern. "We're sensitive to the exposure that could be put in place by placing more requirements on members in the profession," she says. Whatever might be required of accountants, "it should fall within the scope of our normal work."

Andrew Fuchs, a litigation associate at law firm Skadden, Arps, Slate, Meagher & Flom, says it goes so far as to potentially put accountants in the position of practicing law.

"Whether an act constitutes compliance with a law or regulation is a legal determination beyond the accountant's typical professional expertise, yet this may require an accountant to actually make such a determination," he says. "This could broaden the obligations of accountants and potentially put them in the position of having to engage in the unauthorized practice of law. This could also heighten their exposure to lawsuits for failing to detect fraud and failing to advise the client to take appropriate remedial action."

The American Institute of Certified Public Accountants' Professional Ethics Executive Committee is expected to revisit the issue further before making any final determinations. ■

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Andrew Fuchs, Litigation Associate, Skadden, Arps, Slate, Meagher & Flom



# At 15, SOX inspires reflection, renewed attacks

The Sarbanes-Oxley Act, legislation that ushered in an era of refocused corporate compliance, is in the spotlight again. Has it worked? Or should it be chopped? **Joe Mont** explores.

It was 15 years ago, following massive accounting scandals and corporate culture free-falls at Enron and WorldCom, that Congress enacted the Sarbanes-Oxley Act (SOX).

Enacted on July 30, 2002, SOX required corporations' annual financial reports to include an Internal Control Report. It created the Public Company Accounting Oversight Board and made it a crime to destroy records to hide illicit behavior. The law also imposed criminal penalties for certifying misleading or fraudulent financial reports.

The big question: Is SOX working?

In time for the SOX anniversary, Deloitte has published new survey data on global corporate ethical behavior and compliance.

More than half (52.4 percent) of C-suite and other executives say global corporate ethical behavior has improved since the enactment of SOX in July 2002,

according to a recent Deloitte poll. Yet, challenges remain as only 41.3 percent of execs say their organizations' global ethics cultures are strong.

Executives say the biggest challenges to employees complying with global ethics programs include inconsistency of clear, concise, and frequent ethics program communications and training for all employees (28.5 percent); a lack of incentives for ethical behavior and repercussions for unethical behavior (16.3 percent); varied ethical postures of third parties with whom employees regularly interact (14.8 percent); and differing ethical standards for various employee groups (12.5 percent).

The results also reveal that only 32.5 percent of the C-suite and other executives who were polled are "highly confident" their organizations' employees will report unethical behavior.

"As we've seen for decades, no organization is im-



mune to unethical behavior,” Fancher says. “But, the field of ethics compliance is evolving as professionals’ skillsets, technologies to help hone and monitor programs, and multi-jurisdictional regulator coordination all improve. Now is a great time for global organizations to take a hard look at modernizing their ethical compliance programs—particularly for those relying heavily on employees to report misconduct.”

The Deloitte report includes questions to ask of global ethics programs:

- » Do all leaders support the program?
- » Is the whistleblower hotline or speak-up line evolving?
- » Are employees surveyed to gauge ethics culture?
- » Is third-party due diligence conducted annually at minimum?

There is definitely more that can be done or that should be done, but things are certainly better today than they were 15 years ago,” Fancher adds. “There is still the need to modernize compliance programs.”

That modernization, he says, needs to focus on culture risk within the organization.

“There is always going to be culture risk, but what are you doing to identify the hotspots for those areas of risk? Obviously, you need an active hotline. You need to have tone at the top in the organization that promotes the use of that speak-up line and really encourages employees and third parties, to use it,” Fancher says. “You also need to incorporate better and stronger analytics and technology to really assess the data that is coming back.”

“The more you promote a helpline, the more active it is,” he adds. “You need cognitive capabilities to segregate and parse out that data into what matters and what doesn’t, getting rid of the false positives so you can really focus on the important data, dive down into it, understand it, and really mitigate the risks.”

New, anniversary-driven research from Protiviti finds that time devoted to SOX compliance activities increased for a majority of organizations, and for two-thirds of these companies, hours increased

markedly, underscoring that compliance remains a key focus area of operations.

The study, conducted by the global consulting firm, polled more than 450 chief audit executives, and internal audit/finance leaders and professionals at U.S. listed public companies. It explores the impact of SOX on businesses and how they are dealing with the law in terms of regulatory compliance.

The key takeaway from the study is that the hours required for SOX compliance continue to go up for companies of all sizes. Meanwhile, responding to the continuing compliance burden, Republicans in Congress have initiated efforts to reconsider SOX.

In June, a subcommittee of the House Financial Services Committee held a hearing entitled “The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance.”

The hearing examined the benefits and costs and burdens, realized by public companies. It was also a stated prelude “for considering legislative proposals to promote capital formation and ease unnecessary regulatory burdens faced by U.S. public companies.”

Tom Farley, president of the New York Stock Exchange, testified that Congress should do away with the audit of internal control for all public companies.

“That’s something that exists today under the Jobs Act for emerging growth companies, and we’re suggesting let’s extend that to all companies,” he said.

In addition, Congress should “narrow the definition of internal control” under Sarbanes-Oxley to reduce the scope of the reporting requirements on public companies, he said. The PCAOB, in his opinion, should not pass any new rules or regulations that could in any way burden public companies.”

“Public companies must meet significantly more complex regulatory requirements than their private counterparts, both during the IPO process and after a company goes public,” Farley said. “While NYSE applauds smart regulation to ensure the protection of issuers and their investors, we also believe in a regulatory environment that supports a healthy, robust pipeline of companies that seek to become and remain public, which in turn will benefit job growth all across the nation.” ■



# Proposed regulations would shore up auditing of estimates

Proposed new regulations for auditors could lead to more documentation and evidence requests around accounting estimates—or not—depending on how auditors have already adapted. **Tammy Whitehouse** explores the Public Company Accounting Oversight Board standards.

**T**he Public Company Accounting Oversight Board is proposing two new standards for auditors that focus on the audit of accounting estimates, one on fair-value measurements and the other on the auditor's reliance on the work of specialists. Both proposals have been in development for a number of years, even as the board's inspectors have already been giving auditors grief on those areas through its inspection process and staff members have issued guidance to streamline practice.

"It's a little bit of the standards catching up to what best practices are," says Travis Harms, senior vice president and head of the financial reporting valuation group at Mercer Capital. "It's catching up to where at least many of the Big 4 firms already are in their engagements."

Accounting estimates have taken on a bigger role in the composition of many public companies' financial statements in recent years as an increasing number of accounting standards require management to arrive at more assumptions and exercise more judgment. The subjectivity associated with such estimates makes them prone to bias, even manipulation or fraud, which auditors are expected to curb with plenty of skepticism and testing.

As the PCAOB has developed its inspection program, the board has picked apart audit work around

accounting estimates and fair value to the point where auditors even appealed to the board to beef up the rules and make the requirements clearer. While the PCAOB took its time, the board has finally rolled out two new proposals meant to codify current expectations.

The PCAOB's first new proposal would build on existing requirements for the audit of accounting estimates by giving auditors some new marching orders in a handful of key areas. It would direct auditors to get more skeptical about the potential for management bias, and it would focus auditor attention on estimates with greater risk of material misstatement.

The proposal would extend some current requirements around the audit of fair-value measurements to all accounting estimates. It would also provide more specific requirements to certain aspects of auditing fair values for financial instruments, especially the use of information from pricing sources, which has been a sore spot in audit inspections the past several years.

The second proposal would beef up the rules auditors must follow when they are reviewing the work of specialists, whether employed by the company or the audit firm, that support financial statement assertions. Specialists would include valuation experts, for example, whose valuations become inputs

to the financial statements, but it might also include engineers, geologists, even legal experts offering views on various types of liabilities.

Auditors not only review the work of specialists employed by the company, but they often engage specialists of their own to assist with the audit work. The proposal would amend and align requirements around both groups of specialists, addressing issues such as skills, knowledge, supervision, and objectivity.

Auditors are generally expected to welcome both new standards to codify the direction the profession and regulators have been driving for the past several years. "Most in the profession are supportive of the PCAOB's efforts and believe change is needed," said Paul Drogosch, senior audit partner at Deloitte & Touche. The new standards provide a single framework for auditing estimates and provide auditors with greater clarity, he says. "These proposals will drive better use of professional judgment, objectivity, and execution in auditing."

In terms of how the standards will change current audit practices, Drogosch agrees many firms, especially larger firms, have already responded to the PCAOB's direction through staff guidance and inspections the past several years to adopt many of the practices that would be required under the new standards. "The PCAOB even notes the bigger firms have spent five-plus years making significant changes to processes, policies, and procedures to respond to the significant number of deficiencies we've been getting in these areas," he said.

Where firms have not already adapted to the PCAOB's direction through inspections and staff guidance, that suggests companies could see new demands from auditors for documentation and audit evidence to support estimates and to substantiate the work of specialists. "It would likely increase the workload for auditors and for outside specialists," says Mark Zyla, managing director at valuation firm Acuitas.

Sara Lord, national director of assurance services at audit firm RSM, says if the standards were adopted as written, companies would not notice a signifi-

cant difference in how auditors audit estimates from a foundational standpoint. The standard directs auditors to audit estimates by one of the three methods they already employ today—testing management's process for arriving at a given estimate, developing an independent estimate, or reviewing events or transactions after the estimate to see if they are consistent with the assertions.

Depending on how auditors have adapted already to the regulatory direction of the past several years, companies could face more questions from auditors asking for more specificity around estimates, especially with respect to the sensitivity analysis, Lord says.

The guidance on auditor reliance on pricing sources is especially welcome, says Mike Santay, national partner in auditing standards at Grant Thornton. The PCAOB and even the Securities and Exchange Commission have raised concerns both with management and auditors regarding easy acceptance of third-party information from pricing services and broker-dealers without giving enough thought to whether they are reliable.

The standard would give auditors more specific instruction on how to audit information that comes from third-party pricing services, says Santay. "Some seem pretty prescriptive," he said. "That could create some additional documentation around how management has arrived at terms and conditions."

Auditors says there may be some back-and-forth with the PCAOB during its comment and deliberation process about a proposed amendment to audit evidence rules that would affect how auditors approach documentation of equity-method investments in other entities. If an auditor is relying on evidence provided by the investee company to support the investment valuation, the language seems to suggest the auditor will need to dig into that entity's audit work papers. "That would be a huge change from current practice," says Lord.

Another possible concern for auditors is focused on international standards. The PCAOB's proposals for public company audit work are generally consistent with current professional standards for private



company audits in the United States and for audits in other jurisdictions under the International Auditing and Assurance Standards Board.

The IAASB is in the middle of changing its standards, however, which are meant to address audits for both public and private organizations, large and small, in numerous countries around

the world. The IAASB proposal would differ from the PCAOB in some key ways, especially in terms of how to work through risk assessments, says Lord. That raises potential concerns about how to navigate different sets of standards when auditing entities that do business in both the United States and abroad. ■

## RULE SUMMARY

Below is an excerpt from the PCAOB proposed rule summary.

The increasing prevalence and significance of accounting estimates, many with subjective assumptions, measurement uncertainty, and complex processes; the growing use of third-party pricing sources; and the results of the PCAOB's outreach indicate that improvements in the standards for auditing accounting estimates may be needed ... the number of audit deficiencies identified in the Board's oversight activities has led the PCAOB to consider whether changes to the existing standards could more effectively prompt the appropriate application of professional skepticism and consideration of potential management bias.

The Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, Proposed AS 2501, Auditing Accounting Estimates, Including Fair Value Measurements, and to amend the risk assessment standards to more specifically address certain aspects of auditing accounting estimates. The proposed standard would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of information from pricing services.

The proposal builds on the common approaches in the three existing standards and is intended

to strengthen PCAOB auditing standards in the following respects:

- » Add or revise requirements and provide direction to prompt auditors to devote greater attention to addressing potential management bias in accounting estimates, while reinforcing the need for professional skepticism.
- » Extend certain key requirements in the existing standard on auditing fair value measurements, the newest and most comprehensive of the existing standards on auditing accounting estimates and fair value measurements, to all accounting estimates in significant accounts and disclosures to reflect a more uniform approach to substantive testing.
- » Further integrate the risk assessment standards to focus auditors on estimates with greater risk of material misstatement.
- » Make other updates to the requirements for auditing accounting estimates to provide additional clarity and specificity.
- » Provide specific requirements and direction to address certain aspects unique to auditing fair values of financial instruments, including the use of information from pricing sources (e.g., pricing services and brokers or dealers).

Source: PCAOB





## 10 reasons to be wary of new PCAOB auditor disclosure rules

New disclosures required by auditors don't produce any direct new rules for the public firms they audit, but organizations can probably expect at least 10 potentially serious consequences.

**Tammy Whitehouse** illustrates possible outcomes from the new Public Company Accounting Oversight Board transparency rules.

New disclosures now required by auditors don't produce any direct new requirements for the public companies they audit, but companies can expect plenty of potentially serious consequences from the new auditing standard—at least 10 issues to beware as a starting point.

First, here's what's new for auditors. The Public Company Accounting Oversight Board has adopted a new auditing standard that requires auditors to disclose, among other things, the "critical audit matters" they identified and wrestled during the course of the audit. CAMs are defined as issues auditors discussed or should have discussed with the audit committee. They would relate to material accounts or disclosures in financial statements, and they would involve "especially challenging, subjective, or complex auditor judgment," the standard says.

The PCAOB has given auditors some guidance on the factors they should consider in deciding whether to regard a particular issue as a CAM. They should take into account, for example, the risk of material misstatement, the degree of auditor judgment surrounding a management estimate, especially when there's big uncertainty involved, the nature and timing around significant unusual transactions, the degree of auditor subjectivity, the nature and extent of audit effort or specialized skill required, and the nature of audit evidence.

Once auditors identify CAMs that should be disclosed under the standard, they'll be required to provide some narrative text in their audit reports to explain them. What led the auditor to identify this as a CAM? How was it addressed in the audit? Where can a reader find the relevant data or disclosures in the financial statements? Audit firms generally supported the idea of doing CAM disclosures while audit committees and preparers were not as enthusiastic.

"The new standard does not impose new performance requirements on the auditor other than the determination, communication, and documentation of critical audit matters, which will be based on work the auditor has already performed and on matters already communicated to the audit committee," said

PCAOB Chief Auditor Marty Baumann. "Additionally, our research has shown that similar auditor reporting introduced in the United Kingdom has not significantly increased audit fees and has not resulted in increased time to issue the auditor's report."

What does all that mean for the public companies whose audits will be subject to these new audit disclosures? Plenty, says Nicolas Grabar, partner at law firm Cleary Gottlieb. "Companies should expect to spend quite a lot of time with auditors on the drafting of this new information in the audit report," he says. "It will be a grueling process."

**1. Audits will take more time.** The standard doesn't change the fundamental requirements of the audit activity itself, says Leonard Combs, PwC's U.S. chief auditor, but auditors will need more face time with the company. "We do expect there to be more dialogue with management and the audit committee about the nature of items we're reporting, how we talk about them, how we report," he says.

"You can imagine situations where there will be differences of opinion," says Dan Goelzer, senior counsel at law firm Baker & McKenzie and a former member and acting chair at the PCAOB. "It will take time to discuss and work that out."

**2. Audits will cost more money.** Auditors will need to spend additional time producing documentation and work papers showing how they made CAM determinations and drafting those disclosures. "It's going to happen at the end of the period, and it's going to involve senior people in the engagement," says Goelzer. Those folks bill at the highest hourly rates, of course. "I would expect cost increases," he says.

**3. Audit work will happen earlier.** Auditors are already making efforts to do more work earlier in the audit cycle to reduce the rush as filing deadlines approach. "This change only magnifies that need," says Jeff Burgess, national managing partner of audit services at Grant Thornton.

Audit committees will want to know early in the process what will be identified as a CAM, and auditors will want time to work out those determinations

and draft those disclosures. “All of that will drive us to communicate more often, and earlier in the process,” says Burgess.

**4. Management may rethink its own disclosures.** Imagine “close calls” in the financial reporting process where management believes a particular disclosure need not be made, but auditors identify it as a CAM. Auditors and preparers tend to agree that no one wants to see auditors going out with disclosures that management has not made.

“The audit report shouldn’t be the single source

of information,” says Burgess. “We’re required to report what we’re required to report, and we’ll do that, but I could see this creating situations where management may make a decision to disclose or report things they wouldn’t have otherwise.”

**5. That might even include immaterial disclosures.** The standard does not direct auditors to identify CAMs from among matters that are material themselves, but matters related to material accounts or disclosures, says Michael Scanlon, a partner at law firm Gibson, Dunn & Crutcher. “So it doesn’t focus

## DOTY DISCUSSES STANDARD

Below is an excerpt from PCAOB Chair James Doty’s speech at an open board meeting on the new audit standard.

Investors have long called for enhancing the auditor’s report, given the effort involved and the value the auditor brings to investor confidence. With a global economy, companies’ operations have become more complex, and financial reporting frameworks have evolved toward an increasing use of estimates. As a result, auditors must frequently make challenging, subjective or complex judgments. These evolutionary developments are the reason investors want more information about the auditor’s work. The new auditing standard before the Board today is the first significant change to the standard form auditor’s report in more than 70 years. It will make the auditor’s report more relevant, useful and informative to investors and other financial statement users in light of the progress of history. The new standard will breathe new life into a formulaic reporting model. The standard before the board today is grounded in considerable outreach to investors, auditors, capital-seeking securities issuers, academics and others, plus three extended public comment periods over a period of more than six years. It is backed up by a robust economic analysis of the impact of making audit

reports more informative to our capital markets. In today’s complex economy, and particularly in light of lessons learned after the financial crisis, investors in our public capital markets want a better understanding of the judgments that go into an auditor’s opinion – not a recitation of the standard procedures that apply to any audit, but the specific judgments that were most critical to the auditor in arriving at the opinion.

The new standard provides a clear, well-vetted description of what should be included as “critical audit matters”—or “CAMs”—as well as a list of six factors the auditor should take into account in determining the CAMs to include. The standard envisions that auditors describe their critical audit judgments. It does not put them in the position of speaking for management. By focusing on auditor judgments, the new standard delivers on the Congress’s intention, expressed in Section 101(a) of the Sarbanes-Oxley Act, to further the public interest in the preparation of more informative audit reports for public investors.

Source: PCAOB

auditors only to material information,” he says. “It could be immaterial information related to material accounts.”

**6. Management may feel compelled to make more concessions to auditors.** If management finds itself in a contentious debate with auditors, that increases the likelihood it will end up on the audit committee agenda and eventually in a CAM disclosure. The easier management makes the audit for auditors, the less auditors will have to disclose.

“Everyone will agree that management and auditors should work things out first and then take it to the audit committee,” says Grabar. “I would assume we’ll see more concessions between auditors and management.”

**7. Audit committees may get more guarded in what they say to auditors.** Anything discussed between the audit committee and the auditor is a candidate for CAM disclosure. Discussing an issue doesn’t mean it’s automatically a CAM, but it’s automatically added to the pool of potential CAMs.

That may give audit committees some pause about initiating dialogue with auditors. Goelzer is even cautioning audit committees to be “thoughtful” about issues they raise with auditors, both in nature and in scope.

**8. Audit committees will want to initiate dialogue with auditors early.** Discussing matters early reduces the likelihood for surprises, contentious discussions, and rushed analysis late in the financial reporting process. Audit committees could even ask auditors to go through a dry run of the CAM disclosure process using historical financial statements. “Get an understanding of what the auditor sees as CAMs and how we may change our cadence with respect to the timing and number of meetings and conversations that take place between the audit committee and auditors,” says Burgess.

**9. Audit committees may choose to rethink auditor selection.** In addition to the CAM disclosures, the new standard also requires auditors to say in their audit reports how long they’ve served continuously as the company’s auditor. Views and research are mixed on whether that has any bearing whatso-

ever on the fitness of the auditor to continue to serve, but the number will now be out there and easily visible to investors.

Goelzer is advising audit committees to be prepared to answer questions from shareholders about their decision to stick with the same audit firm year after year. “It does put some pressure on audit committees about whether to retain the auditor and how to evaluate auditor performance,” he says.

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“Everyone will agree that management and auditors should work things out first and then take it to the audit committee.”

Nicolas Grabar, Partner, Cleary Gottlieb

**10. The rules could still change yet again.** All PCAOB standards are subject to approval of the Securities and Exchange Commission. While not common for the SEC to pick apart PCAOB standards before approving them, it’s not unprecedented, says Scanlon. “It’s widely acknowledged even in the adopting release that this standard will inject significant complexity into the disclosure regime,” he says.

The PCAOB has been developing the standard for several years under the watchful eye of SEC staff, but SEC leadership is still in significant transition under a new chair appointed by a deregulation-minded administration. Scanlon is hopeful the standard will get a fresh look from a full commission to determine “whether this is a sound policy decision.”

According to its normal due process, the SEC will issue the PCAOB’s final standard for another round of public comment. Scanlon is urging companies with concerns to speak up. “Consider commenting to the SEC even if you already commented to the PCAOB,” he says. “This could be the last bite at the apple.” ■







# Valuation specialists are rising to financial reporting challenge

Companies can expect some shift in how valuation specialists produce and document valuations underpinning financial statement assertions. **Tammy Whitehouse** reports.

Companies can expect to see some shifting in how valuation specialists produce and document valuations underpinning financial statement assertions as the profession adapts to increasing demands for consistency.

Whether companies employ valuation experts inside or rely on third-party services, valuation professionals are starting to steer toward new standards and new expectations for how they arrive at their conclusions and how they present their findings. New standards, a new performance framework, and a new professional credential, for example, are expected to help narrow the guardrails around how valuations are produced and make them more audit-ready.

That's good news for companies that have been caught in the crossfire between an unorganized, unregulated valuation profession and increasingly aggressive regulators demanding more management ownership over valuation outcomes and more audit evidence. It's also just in time as regulators seem poised to raise the bar a little higher on what auditors will be expected to do to arrive at their audit opinions.

On the valuation side, fair-value measurement is common in accounting for business combinations, financial instruments, and impairments, and it will get even more common as new accounting standards come on board in the next few years. A growing number of accounting standards have called for more valuation work to get more current values into

financial statements, and scrutiny on estimates and judgments have risen across the board.

Valuation professionals are not regulated. They're not even brought together by a predominant professional organization. Dozens of professional groups, globally and domestically, provide different standards and credentials that are not compulsory for anyone.

Yet, valuation professionals have felt increasing pressure for several years as the Securities and Exchange Commission and the Public Company Accounting Oversight Board have raised their expectations on companies and auditors to scrutinize valuations. The SEC, in fact, brought the problem to the American Institute of Certified Public Accountants in 2011 and asked the profession to get more organized and more proactive on creating better-supported valuations that could stand up to a skeptical audit.

That prompted the AICPA to join forces with two valuation groups, the American Society of Appraisers (ASA) and the Royal Institution of Chartered Surveyors (RICS), to collaborate. The result is a new mandatory performance framework and new certification observed by all three groups as the global baseline for how much work is necessary to produce a supportable, auditable fair-value measurement.

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The framework is not a new standard for how to perform valuations. Accounting rules already have a chapter in GAAP for how to perform fair-value measurements. "It's guidance to substantiate what valuation professions are doing to arrive at their conclusions," says Eva Simpson, director of valuation services at the AICPA. "What we're really doing here is asking professionals to show their work. It allows someone who wasn't involved in the engagement to review and understand the process. An auditor can look at the documentation and know what was done."

Gary Roland, managing director at Duff & Phelps and one of the earliest to earn the new CEIV (Certified in Entity and Intangible Valuations) credential, says he expects auditors to look for the credential on valuation work that is relied on for financial statement assertions. "It's broadly considered a best practice in the profession, so the general expectation from auditors is that the mandatory performance framework should be followed," he says.

At the same time the AICPA, ASA, and RICS have joined forces to launch their new framework and certification, the International Valuation Standards Council—which represents a number of valuation and accounting groups globally. The 2017 edition provides revised standards for valuing intangible assets and new guidance on the selection of approaches and methodologies and the applica-



tion of frequently used methods.

With dozens of technical groups issuing different standards and credentials, the IVSC sought with its 2017 updates to establish some common ground across all those groups. “We are trying to issue a set of standards that everyone can agree on,” says Andreas Ohl, a partner at PwC who chairs

the IVSC.

Particularly for the sake of audits performed in the United States, where the PCAOB flags one-fourth or more of the audits it inspects for problems with valuation work, Ohl is hopeful new standards will lead to greater consistency. “Maybe it was the model that didn’t make sense, or maybe there was not enough critical thinking around the inputs,” he

## DOCUMENTATION REQUIREMENTS

Below is an excerpt from the AICPA Mandatory Performance Framework illustrating some documentation mandates.

2.3 The valuation professional must conduct and document each engagement or part of an engagement to estimate fair value of a subject interest to assist in management’s preparation of financial statements for financial reporting purposes in accordance with the applicable guidance within this framework. Composition of Valuation Documentation

2.4 Documentation is the written record within the final valuation report, supporting working papers, or both, used to support a valuation conclusion used by management in their assertions of fair value and their preparation of financial statements issued for financial reporting purposes.

2.5 Appropriate documentation provides evidence that the valuation engagement was completed in accordance with this framework.

2.6 Written documentation may include paper, electronic files, or other forms of recorded media. Examples include, but are not limited to, letters of engagement, correspondence with clients (for example, email, recordings of calls, voice messages), client-provided documents, representation letters, field notes, electronic spreadsheets, and internally prepared memoranda to the work file. 2.7 Documentation comprises two key components:

2.7.1 Source documents include, but are not limited to, data and information (including interview notes) collected from both company sources and external third-party data accumulation resources relating to the company, its financial position, its competitors, the industry it competes in, its customers and suppliers, the state of the economy, financial markets, and risk factors.

2.7.2 Analysis documents include, but are not limited to, exhibits, schedules, and working papers that numerically set forth the analysis that was performed, and memos to file or other narratives that document and explain the valuation professional’s reasoning behind such matters as the selection of methods, selection of inputs used in applying methods, and judgments made regarding valuation assumptions.

Source: AICPA

# Reducing the cost of SOX Compliance

The cost of SOX compliance remains high for most corporations, many spending \$1–2 million in directly identifiable costs. It would be reasonable to assume that after dealing with SOX for 15 years, most organizations now have a well-managed and optimized process in place and would have seen a decrease in resource requirements. However, a recent 2017 report by Protiviti, “Fine-Tuning SOX Costs, Hours and Controls,” indicates that the hours spent on SOX compliance activities by the majority of organizations has actually increased over the prior year.

SOX compliance remains a significant burden that to some extent is not easy to alleviate. Many organizations have identified at least 30 entity-level controls and hundreds of process-level controls, most of which are classified as key controls. Updating documentation and re-evaluating and testing this many controls is no simple task. The question is whether organizations are doing enough to make these processes as efficient as possible. It's not that SOX compliance

and control testing should be turned into a check-box activity. Most finance leaders acknowledge that SOX has had an overall beneficial effect on the integrity and quality of financial reporting systems, including reductions in fraud and error. The challenge is holding on to the benefits of designing and maintaining effective controls, while reducing the amount of non-productive effort spent in the process.

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## TOP 3 PRIMARY WAYS TO REDUCE SOX COSTS

A closer examination of how organizations perform their SOX compliance processes often reveals several areas for potential improvement. In some cases, control rationalization—making sure that duplicative or redundant controls are identified—reduces the volume of testing required. In others, better use of technology makes the whole process more efficient. There are multiple ways technology can help, depending on the current state of software usage. For many organizations however, the greatest immediate and sustained benefits from technology result from an integrated approach to three areas: improved collaboration, increased automation and data analytics for control testing.

### 1. Prioritizing collaboration

The extent to which each of the three lines of defense is involved in SOX work varies by organization (though the trend is towards increasing involvement of the frontline, the first line of defense) in finance, accounting and business processes. No matter where the specific responsibilities lie, each of the three lines, to varying extents, needs to be able to be aware of the current status of activities throughout the SOX compliance process. This is often a challenge to achieve when, for example, status tracking is performed using spreadsheets.

Spreadsheets are also limited in their ability to unearth a comprehensive view of the interrelationships among controls across multiple locations and entities. Someone in the second

or third line of defense needs to be able to look at the bigger picture and easily identify control connections, overlaps and redundancies.

It's critical to have the ability to collaborate in a secure way with a variety of organizational roles and departments in order, for example, to request confirmation or evidence for the validity of a suspect transaction or control breakdown.

Collaboration, at both the detailed and big picture level, is an area where specialized compliance technology provides distinct benefits and avoids the inefficiencies and headaches of managing multiple spreadsheets and document versions. All of this has the added benefit of reducing overall costs.

## 2. Increased automation

How much automation can be achieved in SOX compliance processes? To answer this important question, we must determine where automation provides the greatest benefits and which aspects of workflow are best driven by pre-determined rules and response activities. Ultimately, automation frees up resources to be applied elsewhere, often on more productive activities, and is frequently the most effective way to drive down overall SOX costs.

When comparing a traditional workflow to an automated workflow (e.g., action notifications for complete/incomplete process stages,) the latter is far better at moving multiple aspects of the SOX compliance process forward more quickly and reliably to the stage of control certification. Automated triggers, for example, can initiate certification and assurance requests on a quarterly basis. Responses and outstanding requests can be managed and escalated as needed. Response data can be automatically compiled and aggregated through multiple levels. The entire process can be supported through a comprehensive audit trail of changes, comments and document attachments.

Automated preventive controls can also have a major impact on the work effort involved in SOX compliance. The Protiviti report reveals most companies have automated less than 25% of controls but these same companies plan to increase this number in the future.

One way to increase automation is by applying data analytics to test the compliance of individual transactions. This is also a powerful means of testing whether or not preventive controls are working efficiently. If control testing does include transaction-level compliance monitoring, then red flags and anomalies can be automatically managed and routed to appropriate individuals for response, with escalation for action when needed.

*Between 14 and 52 % of organizations "have significant plans to automate a broad range of IT processes and controls" – Protiviti SOX Survey*

## 3. Data analysis

In many ways, the use of data analysis in SOX compliance is one more aspect of process automation and improvement through the use of technology. However, because of its particularly valuable and specialized role, it is worth addressing separately.

In spite of the major impact that data analytics can have on business areas such as marketing, customer service and product management, many organizations are doing little to apply data analysis anywhere close to its full potential in many compliance areas, including SOX.

Testing and monitoring controls are often the most labor-intensive activity. The Protiviti report indicates that this also consumes the most time in the compliance process, with companies spending an average of 6.4 hours per control. For companies with many hundreds, or sometimes thousands, of controls this is an area worth particular attention.

Data analysis is well-proven in the audit world as a means to:

1. test entire populations of financial and operational transactions in order to determine their compliance with controls.
2. test whether the types of controls are effective.

This form of testing and analysis can be performed as required—usually automated—so it can take place on a repeated or continual basis. Continuous controls monitoring and automated testing delivers the benefits of reduced costs and rapid notification of control problems and anomalies with transactions, before they escalate into more serious problems.



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## ENTERPRISE-WIDE INTEGRATION

One of the usual goals of collaborative and automated SOX processes is to achieve better integration. This leads to more efficient, less duplicative processes that are in turn more cost effective. While this applies within SOX processes, it should also be considered in the enterprise-wide context of risk management and compliance processes.

This is another area where specialized software has a valuable role to play. At the purely SOX level of compliance management, a well-integrated approach means that it's relatively easy to achieve an ongoing view of the overall status of all SOX compliance activities.

When considering risk and compliance management at the enterprise level, it quickly becomes apparent that SOX compliance processes have a lot in common with other compliance processes. So it often makes sense to use software that can support multiple types of compliance processes. This helps to avoid duplication of efforts and the potential for "silo" mentalities. This also enables the creation of integrated views of all risk and compliance activities across all organizational entities, which is important to support decision making at the C-suite and board levels, while also driving down risks and costs.

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## EVEN AFTER ALL THESE YEARS, THERE ARE STILL BETTER WAYS TO DEAL WITH SOX

In the years since SOX came into effect, many organizations have done their best to reduce the effort and costs involved. Yet these same organizations have not always taken the time to rethink and rework overall compliance processes. They've maintained the status quo, using the same compliance support technology for most of that time. However, in the past few years, compliance management software has evolved and improved dramatically, so the time could be right for your organization to consider whether current technology can be the catalyst for a big step forward in productivity and cost efficiency of SOX activities.

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## ABOUT THE AUTHOR

### **John Verver, CPA, CISA, CMC, Advisor to ACL**

John Verver is an acknowledged thought leader, writer and speaker on the application of technology for audit, fraud detection, risk management and compliance. He is recognized internationally as a leading innovator in continuous controls monitoring and continuous auditing, and as a contributor to professional publications. He is currently an advisor to ACL, where he has also held vice president responsibilities for product strategy, as well as ACL's professional services organization. Previously, John was a principal with Deloitte in Canada. Learn how ACL's SOX Compliance software solution can help you automate compliance workflow, model your complex entity structure, catalog your control framework, engage control owners for assessments, and report on entity and issue performance.

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