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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

In This Update:

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

SEC Chair and Chief Accountant Are Concerned About Audit Committee Overload, and Have Some Reminders Concerning Core Duties

On December 9, SEC Chair Mary Jo White and SEC Chief Accountant James Schnurr addressed the annual American Institute of Certified Public Accountants Conference on SEC and PCAOB Developments. While their remarks covered a range of topics, both highlighted the work of audit committees. In particular, they expressed concern that audit committees may be taking on too many extra duties that are not directly connected to financial reporting and auditor oversight.

In her remarks, Chair White characterized the audit committee as a "critical gatekeeper in the chain responsible for high-quality, reliable financial reporting" and acknowledged that listing requirements and SEC rules "are placing heavy demands on audit committees." She also noted that "many audit committees now being charged with overseeing additional risks, including incredibly important areas such as cybersecurity." In that environment, she warned against spreading the audit committee's attention too thin and against committee members dividing their time between too many boards --

> I have growing concerns about the amount of work required of some audit committees. The increasing workload may dilute an audit committee's ability to focus on its core responsibilities: selecting and overseeing the independent auditors; internal controls and auditing; setting up an appropriate system for the receipt and treatment of complaints about accounting; and reporting to shareholders. And when directors serve on multiple boards, including multiple audit committees, we must question whether they can do the job effectively.

Chair White also touched on audit committee membership qualifications and urged companies and directors to select "only those who have the time, commitment, and experience to do the job well." She noted that the necessary expertise can be quite specialized and that "[j]ust meeting the technical requirements of financial literacy may not be enough." Further, "[w]hile independent directors should have diversified backgrounds, a director with financial reporting experience limited to manufacturing firms, for example, may not be able to adequately oversee the reporting of a large financial services firm."

As to what audit committees should be concentrating on, Chair White cited three examples – reviewing how management is designing and implementing internal control over financial reporting; reviewing how management it is using non-GAAP measures; and "satisfy[ing] themselves of the job the auditors are doing, particularly when it is time to select the right auditor and recommend to shareholders that they ratify the company's choice." She also referred to the SEC's concept release on possible expanded audit committee reporting requirements (see July 2015 Update) and to the importance of communication: "Audit committees must also take seriously their reporting to shareholders, a critical responsibility on which the SEC is closely focused. * * * [T]he audit committee report serves as a place for engaging with shareholders on important subjects, and the report must continue to meet the needs of investors as their interests and expectations evolve with the marketplace."

Chief Accountant Schnurr expressed similar concerns about audit committee overload in his comments. He noted that "[k]een oversight of the preparers and auditors by qualified, committed, independent, and tough-minded audit committees can further enhance the quality of financial reporting." However --

> [O]ver the past several years, many audit committees have assumed a number of responsibilities that extend beyond their specific regulatory obligations. For example, audit committees are often charged by the board with oversight of a host of major risks facing the company, including cybersecurity, emerging technologies, and compliance risks posed by government regulation. Because the financial reporting implications of such risks are naturally of interest to audit committees, it's not surprising that some boards have sought to leverage these committees' skills, knowledge, and involvement in these areas. However, in this environment of growing audit committee agendas, it is important not to lose sight of the key SEC and exchange listing requirements for audit committee performance.

Mr. Schnurr advised audit committees to get "back to basics" including particularly –

- Appointment, compensation, and oversight of the independent auditor, including the required auditor communications;
- Preparation and disclosure of the audit committee charter; and
- Reporting by the audit committee to shareholders.

Mr. Schnurr has previously spoken about audit committee oversight of financial reporting (see December 2015 Update). In his most recent remarks, he emphasized auditor oversight. The Sarbanes-Oxley Act "is premised on the principle that audit committee members represent the interests of shareholders" and therefore, in "order to live up to this important tenet of our investor protection system, audit committee members should not act as management advocates." Instead, the audit committee –

> should be asking probing questions about, for example, judgments made by management related to critical accounting estimates or important financial statement disclosures. They should require follow-up on their questions and corrective actions, where necessary. Similarly, when it comes to the independent audit, the company's bottom-line or management's preference should not drive the audit committee's decision to hire or retain an auditor. Audit firms should compete for work on the basis of audit quality, keeping in mind that their responsibility is also to the shareholders rather than management of the company.

Chief Accountant Schnurr also urged audit committee members to pay attention to two regulatory initiatives. First, "the PCAOB's project on AQIs [audit quality indicators -- see July 2015 Update] is particularly important. * * * I encourage all audit committee members to look at the PCAOB release for insights regarding factors they may find useful to consider when evaluating audit quality. I also encourage all of you to follow this project and provide your perspectives and insights to the PCAOB." In addition, like Chair White, Mr. Schnurr emphasized the audit committee's responsibility "to report to investors on its work and conclusions" and referred to the SEC's concept release on expanding the reporting requirements.

Comment: While the SEC doesn't directly regulate the activities of audit committees, the views of its Chair and Chief Accountant are, of course, important in understanding the Commission's expectations of the audit committee's role as a securities market "gatekeeper." And, in extreme situations, the SEC has been willing to enforce those expectations in cases when it believes that deficient audit committee oversight has been a cause of securities law reporting violations. See April 2014 Update. Concerns about audit committee overload are, of course, not new (see October-November 2015 Update, January-February 2015 Update, and December 2014 Update). However, the fact that both Chair White and Mr. Schnurr chose to discuss the issue may suggest that the SEC could, in an appropriate case, be willing to examine whether other responsibilities detracted from an audit committee's primary function of overseeing financial reporting and the work of the external auditor.

Big Four 2014 Inspection Reports Summary

With the issuance of the KPMG report on November 10, the PCAOB has released reports on the 2014 inspections of the four largest accounting firms. Below is a tabular summary of the 2014 inspection results for these firms and, for comparison, a similar summary with respect to 2013 inspections

2014 Inspections (Reports Issued in 2015)

Firm	# of Engm'ts Inspected	All Part I Deficiencies #	All Part I Deficiencies % of Engm'ts Insp'd	Part I ICFR Deficiencies #	Part I ICFR Deficiencies % of Engm'ts Insp'd	Part I ICFR Deficiencies % of Part I Def's
Deloitte & Touche	53	11	21%	7	13%	64%
Ernst & Young	56	20	36%	19	34%	95%
KPMG	52	28	54%	27	52%	96%
PWC	58	17	29%	11	19%	65%
2014 Total	219	76		64		
2014 Firm Average	55	19	35%	16	25%	84%

2013 Inspections (Reports Issued in 2014)

Firm	# of Engm'ts Inspected	All Part I Deficiencies #	All Part I Deficiencies % of Engm'ts Insp'd	Part I ICFR Deficiencies #	Part I ICFR Deficiencies % of Engm'ts Insp'd	Part I ICFR Deficiencies % of Part I Def's
Deloitte & Touche	53	15	28%	12	23%	80%
Ernst & Young	57	28	49%	27	47%	96%
KPMG	50	23	46%	20	40%	87%
PWC	59	19	32%	17	29%	89%
2013 Total	219	85		76		
2013 Firm Average	55	21	39%	19	35%	89%

Excluding auditing standards that impose broad, general requirements, the standards most frequently cited in Part I findings (i.e., cited in four or more Part I findings) in the 2014 inspection reports on the four largest firms are listed in the following table.

PCAOB Auditing Standard	# of Part I Findings Citing this St'rd	% of Inspected Engagements	% of All Part I Findings
AS No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements	64	29%	84%
AS No. 13, The Auditor's Response to the Risks of Material Misstatement	29	13%	38%
AU Section 342, Auditing Accounting Estimates	22	10%	29%
AS No. 14, Evaluating Audit Results	20	9%	26%
AU 328, Auditing Fair Value Measurements and Disclosures	18	8%	24%
AU Section 350, Audit Sampling	14	6%	18%
AS No. 15, Audit Evidence	10	5%	13%
AU Section 329, Substantive Analytical Procedures	6	3%	8%
AU 331, Inventories	6	3%	8%
AU Section 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	4	2%	5%

In each Big Four inspection report issued during 2015, the PCAOB included a list of the most frequently identified audit deficiencies. The table below aggregates the “frequently identified” deficiencies lists in these four 2014 inspection reports.

Description	Part I Findings That Include this Deficiency
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing.	51 (67%)
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate.	32 (42%)
Failure to sufficiently test controls over, or sufficiently test the accuracy and completeness of, issuer-produced data or reports.	29 (38%)
Failure to identify and test any controls that addressed the risks related to a particular account or assertion.	27 (36%)
Failure to perform sufficient testing related to an account, or significant portion of an account, or to address an identified risk.	23 (30%)
Failure to sufficiently evaluate control deficiencies.	8 (11%)

Comment: On an aggregate basis, the deficiency rate for these four firms declined slightly in 2014. In 2013, the Board concluded that 39 percent of the engagements it reviewed were deficient, while, in 2014 inspections, it found comparable problems in 35 percent of engagements. At the same time, the gap between the firm with the lowest deficiency percentage and the firm with the highest increased, from a 21 percent spread in 2013 to a 33 percent differential in 2014.

Similarly, although the Board continued to find fault with a significant percentage of the audits of internal control over financial reporting (ICFR) that it reviewed, the level of ICFR deficiencies fell. In 2014, it found ICFR deficiencies in 25 percent of all inspected engagements, and 86 percent of all engagements with a deficiency included an ICFR lapse. By contrast, in 2013, the PCAOB found ICFR auditing breakdowns in 35 percent of inspected engagements, and 89 percent of all engagements cited in Part I included an ICFR failure. In past years, we have noted that auditors were likely to respond to the PCAOB’s emphasis on ICFR by devoting more time and effort to the ICFR audit – and quite possibly by increasing fees as a result. Auditors are certainly likely to remain focused on ICFR. However, improvements in ICFR audit methodologies over the last several years now seem to be having a positive effect.

With respect to auditing standards other than AS No. 5 (which governs ICFR auditing), Board inspectors found the most deficiencies in the areas of response to risk of misstatement (AS No. 13) and auditing accounting estimates (AU 342). This is consistent with prior years. As further insight into deficiencies in applying AU 342, “failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate" was the second-most frequent Part I deficiency, exceeded only by "failure to sufficiently test the design and/or operating effectiveness" of a selected control. Auditing of fair value measurements and disclosures (AU 328) was also a common problem area.

The audit deficiency description and auditing standard deficiency tables could be used as something of checklist for topics audit committees may want to discuss with the auditor in order to understand how the auditor addressed, or plans to address, the most challenging areas in the company's audit.

CAQ Stakeholder Advisory Panel: AQIs May Be Helpful, But Assessing Audit Quality is an Art, not a Science

On January 12, the Center for Audit Quality (CAQ) issued a report, Audit Quality Indicators: The Journey and Path Ahead, which summarizes the views expressed at a series of roundtable discussions with audit committee members and others regarding audit quality indicators (AQIs). The report states that the CAQ found that determining audit quality "is more art than science" and that audit committee members believe that discussion of AQIs has the greatest impact on quality "when audit committees have the flexibility to tailor the discussion around the facts and circumstances of their particular audit."

In 2014, following several years of information-gathering and research, the CAQ published a paper discussing various possible AQIs (see May 2014 Update). The potential AQIs in that paper are intended as engagement-level metrics that could aid audit committees in their oversight and enhance discussion between auditor and audit committees. The CAQ's AQIs fall into four areas:

1. Firm leadership and tone at the top

2. Engagement team knowledge, experience, and workload

3. Monitoring

4. Auditor reporting

At round the same time, the PCAOB also began to develop AQIs. In July, 2015, the PCAOB published its list of possible quantifiable measures of audit quality and invited public comment (see July 2015 Update). While the PCAOB has not yet taken further action, the AQI project remains on its agenda. (A "PCAOB Dialogues Podcast" in which PCAOB staff members Greg Jonas and Samantha Ross discuss the AQI project with Comcast audit committee chair Mike Cook is available here.)

In order to evaluate the usefulness and feasibility of its indicators, the CAQ undertook a pilot testing program that included 30 audit engagements covering a range of different industries. In addition, in the summer of 2015, the CAQ convened four roundtables with audit committee members in London, Chicago, New York, and Singapore. The purpose of the roundtables was to obtain perspectives of audit committee members on AQIs and to gather information on current practices on the identification and communication of AQIs. According to the report, key findings of these roundtables include the existence of --

- Desire for information that can assist audit committees in their assessment of the more qualitative aspects of the audit, such as the engagement team having the right mindset to bring forth professional skepticism and auditor judgment, which cannot be adequately captured in a quantitative AQI, and is best achieved through dialogue.

- Recognition that although AQIs can help audit committees oversee the quality of their external audit, the external audit is just one aspect of quality financial reporting.

- Endorsement of a flexible approach that allows an audit committee, working with the external auditor, to tailor or customize the selection and portfolio of AQIs that best suit its specific information needs.

- General support for the concept of AQIs and recognition of their potential value to audit committees' auditor oversight responsibilities, although some participants felt they already have the tools necessary for them to gauge the quality of their audit.

- Agreement that AQIs alone, without context, cannot adequately communicate factors relevant to any particular audit engagement or audit firm.

- Agreement that the process of identifying and evaluating AQIs needs to be audit committee-driven and iterative, and will require continuous assessment and refinement in order to meet the changing information needs of audit committees.

- Belief that mandated public disclosure of engagement-level AQIs could lead to unintended consequences and that any disclosures of engagement-level AQI information should be voluntary.

The CAQ concludes that "[a]llowing audit committees to continue to explore AQIs in an audit committee-driven, voluntary environment could facilitate the development of a common principles-based framework that could promote consistency in application of AQI use and reporting while maintaining the flexibility audit committees need to tailor approaches to their specific information needs."

<u>Comment</u>: The use of standardized measures as a tool in the audit committee's evaluation of the work of its auditor is becoming something of a regulatory theme (see, e.g., comments of Jim Schnurr, discussed earlier in this <u>Update</u>). It would be prudent for audit committees to begin thinking about how they might use such indicators as part of their auditor oversight. Both the PCAOB's concept release on AQIs and the CAQ's approach provide useful suggestions. Audit committees may want to review these documents as part of developing their own methodology and stay abreast of the PCAOB's AQI proceeding.

Resource Extraction Payments Disclosure is Reborn, Political Contributions Disclosure is Off-Limits, and Board Cyber Expertise Disclosure is in the Wings

During the past several years, Congress has taken an increasing interest in use of the SEC's processes to encourage or discourage particular types of corporate activity by requiring new disclosures. These kinds of disclosure typically involve information that might be viewed as socially significant, but would likely not be deemed economically material under the securities laws. There were three developments during the past month that illustrate the ongoing Congressional debate about the appropriate role and scope of SEC disclosure in changing corporate behavior.

Resource Extraction Payments. On December 11, by a 3-1 vote, the SEC proposed Rule 13q-1 to require public companies that engage in "resource extraction" to file a report with the SEC disclosing payments made to the U.S. federal government or to foreign governments for the commercial development of oil, natural gas or minerals. The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010, required the SEC to issue such a rule, and the Commission initially adopted Rule 13q-1 in 2012. That version of the rule was judicially challenged by the American Petroleum Institute and the U.S. Chamber of Commerce. In 2013, the U.S. District Court for the District of Columbia vacated the rule the ground that the SEC's reasons for requiring the Rule 13q-1 reports to be public were arbitrary and capacious, particularly because in some cases public disclosure would violate the law of the country in which the resource extraction payment was made. (Part of Congress's rationale for the disclosure requirement was the belief that, in some countries, governments conceal these payments from the public in order to hid their diversion to corrupt officials.)

The new proposal is similar to the prior version, although it explicitly recognizes that the Commission could provide relief from Rule 13q-1 on a case-by-case basis – for example, if a company claiming that a foreign law prohibits the required payment disclosure could show that it would "suffer substantial commercial or financial harm if relief is not granted." Also, companies could use reports prepared for foreign regulatory purposes or for the U.S. Extractive Industries Transparency Initiative to comply with the rule, if the Commission determined that such reports were substantially similar to a Rule 13q-1 report.

Corporate Political Contributions. On December 18, the President signed the Consolidated Appropriations Act, 2016, an omnibus spending bill, which funds the federal government for the balance of fiscal 2016. The legislation also contains a provision that prohibits the SEC from expending any of its resources "to finalize, issue, or implement" rules "regarding the disclosure of political contributions, contributions to tax exempt organizations, or dues paid to trade associations." Several years ago, a petition was filed with the SEC asking that the agency adopt a political spending disclosure requirement, and the petitioners sued the Commission for failing to act on their request. (The suit was recently dismissed.)

SEC Chair White has publicly stated that this type of rulemaking is not on the Commission's agenda. Thus, the affect of the spending prohibition is to prevent the SEC from doing something that its Chair did not intend to do in the first place. Not to be deterred, on December 22, 94 House and Senate members sent a letter to Chair White demanding that she press ahead with a political spending disclosure rule. The signers of the letter, all of whom are Democrats, argue that the limitation in the appropriations bill "does not bar the SEC from discussing, planning, investigating, or developing plans or possible proposals for a rule or regulation relating to the disclosure of political contributions." They add that "we expect the SEC to move forward with such plans, including, but not limited to, a public roundtable" and that "[p]er that expectation, we will periodically ask for updates on this issue."

Board Cyber Expertise. In contrast to the partisan split on corporate political spending, on December 17 a Democrat and a Republican jointly introduced the Cybersecurity Disclosure Act of 2015. If enacted, the bill would direct the SEC to require each reporting company, in either its the annual report or its proxy statement, to disclose "whether any member of the governing body, such as the board of directors or general partner, of the reporting company has expertise or experience in cybersecurity and in such detail as necessary to fully describe the nature of the expertise or experience." If no board member has such expertise, the company would have "to describe what other cybersecurity steps taken by the reporting company were taken into account by such persons responsible for identifying and evaluating nominees for any member of the governing body, such as a nominating committee."

In a Senate floor statement on behalf of himself and co-sponsor Susan Collins of Maine, Rhode Island Senator Jack Reed said that the legislation seeks to encourage public companies to be more transparent to "investors and customers on whether and how their Boards of Directors are prioritizing cybersecurity."

Comment: The resource extraction and political contribution disclosures highlight the debate about using SEC disclosure as a vehicle to promote goals or influence corporate behavior in areas not directly related to traditional investor protection. The specifics of these ideas aside, it seems likely that this type of disclosure will increase. Audit committees will, in turn, need to make sure that management has appropriate controls and procedures are in place to assure the accuracy and completeness of the information The cyber expertise proposal is somewhat different. It underscores the national ramifications of cyber security and that Congress could use a disclosure requirement to encourage companies to prioritize the issue.

PCAOB Expects to Re-Propose Expanded Auditor Reporting by Mid-2016

According to an update of its Standard-Setting Agenda released on December 31, the staff of the PCAOB's Office of the Chief Auditor plans to recommend that the Board issue for public comment a revised version of its 2013 proposal to expand the content of the auditor's report. The re-proposal will be presented for a vote during the second quarter of 2016. However, a companion proposal to enhance the auditor's responsibility with respect to information outside of the audited financial statements is still being evaluated. The updated agenda says that the staff will make a further recommendation concerning that proposal “at a later date.”

As described in the September 2013 Update, in August 2013, the PCAOB issued for public comment two new auditing standards – one related to the content of the auditor’s report and the other related to the auditor’s responsibilities for information outside the financial statements. The proposed auditor’s report standard would require the audit opinion to include a discussion of "critical audit matters" (CAMs). CAMs are those matters addressed during the audit that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining audit evidence or in forming an opinion on the financial statements. The proposed auditor’s report standard would also expand the existing opinion language regarding the auditor's responsibility to detect fraud; require disclosure of the year in which the auditor began serving as the company's auditor; and add a statement that the auditor must be independent of the company.

The second proposed new standard would expand the auditor’s responsibility for information – such as Management’s Discussion and Analysis – that is outside of the financial statements, but is included with the audited statements in the company's annual report filed with the SEC. The auditor would be required to “evaluate” such information to determine whether it is inconsistent with evidence gathered in the audit. If the auditor identifies inconsistencies between the other information and the audit evidence, the auditor would be required to discuss the inconsistencies with management and, if necessary, request changes in the other information. If management failed to make the changes, the auditor could be required to withdraw from the engagement or to disclose the inconsistencies in its audit report.

Audit committee members that have commented on these proposals have generally opposed CAM reporting. See January 2014 Update and May 2014 Update. Among other things, they have argued that requiring auditors to identify and disclose CAMs would not provide useful information to investors; would raise audit costs without any offsetting benefits; would dilute the significance of a clean audit opinion; would undermine management’s role as the source of disclosures about the company’s financial reporting; and would impair the relationship between the audit committee and the auditor.

The Center for Audit Quality conducted field testing of the PCAOB’s proposal. See July 2014 Update. The CAQ concluded that, under the criteria in the proposal, the number of CAMs that would be disclosed was potentially quite large and recommended that the PCAOB include materiality as a factor in determining whether a matter is a CAM. The CAQ also recommended that the PCAOB limit potential CAMs to matters that the auditor had communicated to the audit committee.

Comment: As noted in 2013 when the PCAOB initially published its proposal, CAM reporting would fundamentally alter the auditor’s traditional role of providing an attestation as to management’s financial disclosures by turning the auditor into an independent source of substantive information about the company’s financial reporting. Because of the judgmental nature of CAMs, it seems inevitable that managements and their auditors would sometimes disagree regarding the auditor's disclosures. Whatever the benefits to financial statement users, the relationship between auditors and their public company clients would change as a result. Audit committees should follow the progress of the PCAOB's proceeding and may wish to consider commenting.

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

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