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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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 Issues More Warnings and New Guidance on Non-GAAP Measures

As discussed in the April 2016 Update, senior SEC officials have made a series of public statements over the last few months expressing concern about the increasingly-frequent use of non-GAAP measures in public company reporting. These statements have included recommendations that audit committees review the company's selection and presentation of non-GAAP measures and the rationale for their use. (The SEC defines a non-GAAP financial measure as a numerical measure of historical or future financial performance, financial position or cash flows that excludes amounts that are included in, or includes amounts that are excluded from, the most directly comparable measure calculated under Generally Accepted Accounting Principles.)

The SEC is continuing its rhetorical war against misleading non-GAAP measures and has warned that some companies can expect to be asked in writing to justify their non-GAAP reporting. In addition, the SEC staff issued guidance, in the form of new and updated Compliance & Disclosure Interpretations (CD&Is), that tightens the standards the staff applies to the use of non-GAAP measures.

In remarks delivered on May 5 at the Baruch College Financial Reporting Conference, SEC Deputy Chief Accountant Wesley Bricker described the SEC staff's concerns. He pointed specifically to three things -- "the use of individually-tailored accounting principles to calculate non-GAAP earnings; providing per share data for non-GAAP performance measures that look like liquidity measures; and non-GAAP tax expense." To illustrate use of an individually-tailored accounting principle, he gave this example:

> '[C]onsider a company that has a subscription-based business. The company bills for the full subscription at the outset, but since it will deliver over time, it earns and recognizes GAAP revenue over that same period. Now assume this company calculates non-GAAP revenue as though it had a different business. That is, it calculates what revenue it would have had, had it not sold a subscription, but rather had sold a product.
>
> "The effect of the measure is that the company accelerates revenue recognition to the billing date and proceeds to calculate earnings

> based on this non-GAAP revenue. At that point, this company's GAAP results are based on revenues recognized as the service is provided and the non-GAAP results are based on revenues that are merely billed to the customer.
>
> "In this instance, the measure does not appear to help investors understand and analyze core operating results. Rather, it is a replacement of an important accounting principle with an alternate accounting model that does not match the company's subscriptions business or earnings process, which is over time."

Because revenue adjustments of this nature "change the very starting point" for other performance analyses, Mr. Bricker warned that companies that present adjusted revenue measures can expect to receive comments from the SEC. He added that the staff will look skeptically at explanations of non-GAAP revenue adjustments.

Mr. Bricker urged that "audit committees should be paying close attention to the non-GAAP measures a company presents, including the required related disclosures, and the processes it follows to consider both the appropriateness and reliability of the measures." He also recommended that companies "consider how their disclosure controls and procedures apply to the disclosure of non-GAAP measures."

The updated Non-GAAP Financial Measures CD&Is, issued on May 17, provide new stricter, guidance on the use of non-GAAP measures. Some of the issues addressed in the CD&Is include:

- Examples of non-GAAP presentations that could be misleading--
  - A performance measure that excludes normal, recurring, cash operating expenses necessary to operate the business.
  - A non-GAAP measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods, unless the change between periods is disclosed and the reasons for it explained.
  - A non-GAAP measure that is adjusted only for nonrecurring charges when there were non-recurring gains that occurred during the same period.
- Examples of non-GAAP presentations that fail to give "equal or greater prominence" to the comparable GAAP measure, as required in SEC filings and press releases--
  - Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures.
  - Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure.
  - A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption).

    - Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure.

    - Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table.

    - Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

- Disclosure of tax effects of non-GAAP measures--

    - If a liquidity measure includes income taxes, it "might be acceptable" to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the disclosure should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability.

    - Adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained.

Mark Kronfest, the Chief Accountant of the SEC's Division of Corporation Finance, discussed the staff's concerns and the updated CD&Is at the PCAOB's May 18 Standing Advisory Group meeting (webcast available here; Mr. Kronfest's comments begin at 1:34). He stated that there would soon be an "uptick" in SEC comment letters challenging the use of non-GAAP measures. He suggested that, to avoid additional SEC action, "I think the next quarter would be a great opportunity for companies to self-correct."

Comment: At the May 18 PCAOB SAG meeting, SEC Deputy Chief Accountant Brian Croteau commented that audit committees should focus on non-GAAP measures because of the committee's "overarching responsibility relative to their oversight over financial reporting" (webcast available here; Mr. Croteau's comments begin at 1:32). As stated in the April 2016 Update, audit committees should be aware of the non-GAAP measures their company is disclosing and of the rationale for those measures. Attention should also be paid to the controls around the accuracy of the calculations involved. A useful reference is a recent publicly-available Deloitte publication, Top 10 Questions to Ask When Using a Non-GAAP Measure.

PCAOB Re-Proposes Auditor Reporting on Critical Audit Matters

On May 11, the PCAOB issued a release re-proposing a new "auditor's reporting model" that would require auditors to discuss, in their audit reports on public company financial statements, critical audit matters (CAMs) that arose during the audit. Under the new proposal, the lynchpin of the CAM definition would be that the matter "was communicated or required to be communicated to the audit committee."

If adopted, the new reporting standard would require that audit opinions contain disclosures tailored specifically to the particular audit engagement. The objective of CAM disclosure is to provide audit report readers with insight into the most challenging, subjective, or complex aspects of auditing the company's financial statements. The re-proposal also includes other changes to the auditor's report, such as requiring the auditor to disclose how long it has served as the company's auditor. Public comments on the re-proposed reporting model standard are due by August 15, 2016.

The PCAOB originally proposed changes to the auditor's report, including CAM disclosure, in 2013. See September 2013 Update. Under the 2013 proposal, CAMs were defined as those matters addressed during the performance of the audit that, in the auditor's judgment, involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements. The 2103 proposal also required the auditor's report to state that the auditor's responsibility was to obtain reasonable assurance that the financial statements were free of material misstatements "whether due to error or fraud"; to state the year in which the auditor began serving as the company's auditor; to include a description of the auditor's responsibility for "other information" (e.g., Management's Discussion and Analysis) in SEC-filed reports that contain the audited financial statements; and to describe the results of the auditor's evaluation of "other information."

The 2013 proposal received mixed reactions. Many investors and other financial statement users supported the proposal, and, in some cases, urged that it be broadened. In contrast, board and management comments were generally critical of CAM reporting. See January 2014 Update. Audit committee comments asserted that CAM disclosure would be costly, would be of little or no benefit to investors, would detract from the meaningfulness of the auditor's opinion, and would undermine management's fundamental responsibility to decide what should (and should not) be disclosed.

The Center for Audit Quality, in conjunction with nine accounting firms and 51 public companies, field tested the 2013 proposal. Among other things, the CAQ found that the number of potential CAMs per company ranged from one to 45. The number of actual, discloseable CAMs ranged from zero to eight, while the average number of actual CAMs per company was slightly under five. See July 2014 Update. The CAQ also reported that: "Feedback from audit engagement teams, as well as management and audit committees, was that the additional time and effort was likely to be incurred during the completion phase of the audit by senior members of the audit engagement teams. * * * Expanded discussions with management and the audit committee may also require additional time and effort in a 'live' audit environment versus the retrospective environment in which the field testing was conducted."

The revised proposal seeks to address some of these concerns by narrowing the definition of a CAM. As re-proposed, a critical audit matter would be:

> “any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.”

In determining whether a matter involved “especially challenging, subjective, or complex auditor judgment,” the auditor would be required to consider various factors, including:

- The auditor's assessment of the risks of material misstatement, including significant risks.
- The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures.
- The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter.
- The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty.
- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions.
- The nature of audit evidence obtained regarding the matter.

Once identified, each CAM would be disclosed in the auditor’s report. The auditor would also be required to describe the principal considerations that led the auditor to determine that the matter is a CAM, describe how the CAM was addressed in the audit, and refer to the relevant financial statement accounts and disclosures. If there are no CAMs, the auditor would be required to so state. However, the release indicates that the PCAOB expects that, in most audits, the auditor would determine that at least one matter “involved especially challenging, subjective, or complex auditor judgment.”

Some comments on the original proposal raised concerns that the auditor’s report would become a source for new, substantive information about the company that the company itself was not required to disclose. The revised proposal addresses this issue in a Note to the proposed auditing standard:

“When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.”

In addition to making disclosure in the auditor’s report, the auditor would be required to include documentation regarding CAMs in the work papers. For every matter that (1) was communicated or required to be communicated to the audit committee, and (2) relates to accounts or disclosures that are material to the financial statements, the work papers would be required to set forth the auditor's basis for determining that the matter was or was not a CAM.

The re-proposal, like the 2013 proposal, would also require several other additions to the auditor's report, including:

- A statement that the auditor is required to be independent in accordance with SEC and PCAOB rules.

- An acknowledge of the auditor's responsibility to plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatements, "whether caused by error or fraud."

- The year that the auditor began serving consecutively as the company's auditor.

As noted above, the 2013 proposal would have required a statement in the auditor's report regarding its responsibility to evaluate accompanying disclosures outside of the financial statements (such as MD&A) and would have increased the level of auditor review of such disclosures. The re-proposal does not address these topics.

Comment: The new auditor's reporting model that the PCAOB has under consideration would result in a fundamental change to the traditional pass/fail auditor's report and to the auditor's role. Public companies and their board members may want to review the PCAOB's proposal and consider commenting by the August 15 deadline. Three issues that audit committees, in particular, may want to address are:

- Is the CAM definition focused and workable? The PCAOB has tried to address some of the objections to the breadth of its original CAM definition by adding the requirement that a CAM must "relate to accounts or disclosures that are material to the financial statements." The 2013 proposal was not limited to material matters (i.e., matters as to which there is "a substantial likelihood" the matter "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."). The 2013 definition was also not explicitly tied to financial statement accounts or disclosures. As a result of these changes, the revised definition should eliminate from the list of potential CAMs some matters that were challenging and time-consuming for the auditor, but that would be of limited interest to investors (e.g., whistleblower complaints that proved to be unfounded or immaterial internal control issues). However, the core concept of identifying matters that involve "especially challenging, subjective, or complex auditor judgment" may still be difficult to apply in practice and open to differing opinions between the company and the auditor.

- Will CAM reporting chill auditor/audit committee communication? Under the new CAM definition (and the documentation requirements) all material financial statement matters communicated to the audit committee are potential CAMs.

Making communications with the audit committee the trigger for CAM analysis could have the unintended – and undesirable -- effect of inhibiting auditor/audit committee dialogue. Auditor/audit committee communications may become more formal and scripted, and auditors will have an incentive to refrain from bringing matters to the audit committee's attention, if the need to do so under the auditing standards is a close call. Conversely, if the audit committee asks the auditor a question regarding the financial statements, the auditor may be required to consider (and document in the work papers) whether information he or she communicates in response must be publicly disclosed as a CAM. This may cause audit committee members to think twice before asking spontaneous questions.

- Will auditors become original information sources? As mentioned above, the PCAOB asserts, in a Note to the new reporting standard, that the auditor "is not expected to provide information about the company" in its CAM discussion that the company itself is not required to disclose. However, the Note also includes an exception to this "expectation" if original disclosure is necessary to the auditor's description of why the matter was deemed to be a CAM or of how the CAM was addressed in the audit. In practice, it may sometimes be difficult for auditors to fulfill their new disclosure responsibilities without providing company information that is not otherwise disclosed. Audit committees may want to consider this possibility and the ramifications of shifting a measure of original disclosure decision-making power to the auditor.

SEC Approves New PCAOB Reporting Requirement on Audit Engagement Transparency

On May 9, the SEC issued an order approving the PCAOB's "transparency" rules that require, for all public company audits, the disclosure of the name of the engagement partner, along with information about firms that participated in the audit in addition to the firm that issued the audit opinion. The PCAOB adopted these rules, which had been under consideration for several years, in December 2015. See December 2015 Update.

The transparency rules will take effect early next year. For all public company audit reports that are issued on or after January 31, 2017, the audit firm will be required to file with the PCAOB a new form (Form AP) disclosing the name of the engagement partner. For audit reports issued on or after June 30, 2017, Form AP will also have to include information about other firms participating in the audit. The filing deadline for Form AP is 35 days after the date the auditor's report is first included in a document filed with the SEC. However, in the case of an audit opinion included in a registration statement for a public offering, Form AP must be filed within ten days after the registration statement is filed with the SEC.

The PCAOB plans to make the information in Form AP easily available to the public by creating a database. Users will be able to search this database by engagement partner name, public company name, or by audit firm. Database users also will be able to search for the name, location, and extent of participation of other audit firms that participated in an audit.

Comment: As noted in the December 2015 Update, audit committees will need to be aware of litigation, restatements or similar events arising in other audits for which their engagement partner was responsible, since the committee might face press or shareholder scrutiny regarding whether to change engagement partners when such events in other audits seem to reflect poorly on the partner. In addition, partner identification could result in a rating, or "star," system in which particular engagement partners are in high demand (and command premium fees), while others are viewed as less desirable. This could add a new dimension to the task of selecting or retaining an auditor and require deeper audit committee involvement in the choice of the engagement partner.

PCAOB Previews 2015 Inspection Findings: Many of the Same Deficiencies, But Fewer of Them

On April 19, the PCAOB staff issued a Staff Inspection Brief describing deficiencies identified during its 2015 inspections of public company audits. While the PCAOB has not yet issued 2015 inspection reports to the major accounting firms, the SIB is “intended to provide insights from these inspections to audit committees, investors, issuers, and others.”

The SIB states that the results of the 2015 inspections indicate that, for the large firms, the number of audit deficiencies has decreased, compared to the results in the 2014 inspection cycle. However, the three most frequent audit deficiency areas are the same as in prior years -- auditing internal control over financial reporting; assessing and responding to risks of material misstatement; and auditing accounting estimates, including fair value measurements. Examples of the deficiencies in these areas include:

- Testing management review controls. Management reviews may be performed as controls to monitor the results of operations, such as by comparing actual results to forecasted revenues or budgeted expenses. The PCAOB staff found that, in some cases, auditors “did not obtain an understanding of the actions performed by management during the review, the criteria used to identify deviations requiring investigation, or the actions taken to investigate and resolve those deviations, in order to address the risk of material misstatement.”

- Assessing and responding to the risk of material misstatement. In some instances, the inspections staff concluded that auditors did not take into account audit evidence that appeared to contradict assertions in the financial statements. “For example, an auditor concluded there were no indicators of impairment related to certain long-lived assets, but the auditor did not consider and evaluate if the net losses, negative cash flows from operations and substantial doubt about an issuer’s ability to continue as a going concern could be indicators of impairment.”

- Understanding how estimates were developed, including testing significant inputs and evaluating assumptions. The inspectors identified instances in which auditors did not fully understand how estimates were developed or did not sufficiently test inputs and underlying assumptions. "For example, there were instances where [financial institution] auditors did not evaluate the issuer's credit risk ratings that formed part of the basis for management's qualitative assessment of the ALL [allowance for loan losses]. These auditors also did not test the accuracy and completeness of the underlying loan data that the issuer used to derive default assumptions to estimate the ALL ranges and midpoints."

In addition to these perennial PCAOB focus areas, the SIB highlights common, but less pervasive, audit deficiencies involving such matters as:

- Testing of fair value measurements associated with business combinations. In some audits of financial statements reflecting business combinations, auditors failed to sufficiently test the design and operating effectiveness of controls over the valuation of the purchase price consideration, and acquired assets and liabilities.

- Testing investment portfolios. Deficiencies in this area included failures to sufficiently test the design and operating effectiveness of controls related to pricing hard-to-value investment securities and management's review of valuation models.

- Asset impairment testing related to fluctuating oil prices. In one inspection, the staff found that the auditor "failed to sufficiently evaluate the adverse effects of certain events and conditions, which included falling oil prices, on the issuer's ability to continue as a going concern and whether the issuer should have tested for impairment its assets related to oil and natural gas properties."

- Testing controls related to income taxes, including the valuation allowance for net deferred tax assets. The SIB notes that "income taxes continue to be an area of interest to investors, companies, audit committees, auditors, and regulators alike."

- Audit committee communications. Deficiencies noted in this area include the failure "to communicate an overview of the overall audit strategy, timing of the audit, and all of the significant risks the firms had identified."

Finally, the SIB indicates that the PCAOB inspections staff has identified deficiencies related to non-compliance with the independence rules (although the SIB indicates that the majority of these issues arose at smaller accounting firms). Examples included:

- Providing impermissible non-audit services during the period under audit, including bookkeeping services and management functions.

- Failure to comply with the engagement partner rotation requirement (i.e., service as lead engagement partner for more than five consecutive years).

- Failure to obtain audit committee pre-approval prior to performing non-audit services.

- Insufficient communication to the audit committee concerning the scope of tax consulting services performed and the potential effects on independence.

- Failure to make required communications to the audit committee concerning independence.

Comment: The Staff Inspections Brief provides insight into financial reporting and internal control areas that are most likely to attract the attention of the PCAOB's inspection staff. As a corollary, the SIB may also be helpful to audit committees in understanding their auditor's risk assessment and resource allocation decisions. For example, during the last several audit cycles, managements and audit committees have sometimes complained that auditors seem unduly focused on the mechanics of management review controls. As the SIB illustrates, from the auditor's perspective, obtaining an in-depth understanding of how review controls operate is a necessary response to a common PCAOB inspection finding. The SIB might also provide the audit committee with a checklist of the areas that auditors are likely to regard as PCAOB priorities and to which they are therefore likely to devote enhanced audit attention.

Restatements Hit a New Low

On May 24, Audit Analytics released its annual report on public company restatements, Financial Restatements 2015 – A Fifteen Year Comparison (available here for purchase on Audit Analytics website). The report concludes that the aggregate number of restatements declined by 13.8 percent in 2015, as compared to 2014. The 2015 restatement total was the lowest since the requirement to report restatements on Form 8-K took effect in 2004. The 2015 results are something of a change in trend from recent years, during which total restatements were essentially flat. See June 2015 Update.

Restatements fall into two categories. When a company determines that users can no longer rely on previously-issued financial statements, it is required to disclose that determination by filing SEC Form 8-K within four business days of making the determination. The restated financial statements themselves would normally be filed sometime later, after the company has had the opportunity to analyze and correct the errors. The AA report refers to this type of restatement as a Reissuance Restatement. In contrast, if a company determines that previously issued financial statements contain errors, but that, despite the errors, users can continue to rely on the financial statements, it is not required to file Form 8-K. The corrected financial statements would simply be included in a periodic SEC filing. AA refers to these less significant restatements as Revision Restatements.

Some key points in the 2015 AA restatement report include:

- During 2015, Revision Restatements were 76.2% of total restatements. This percentage is the same as in 2014. Prior to

2014, Revisions Restatements as a percentage of total restatements had risen each year since 2008.

  - 737 restatements of all types were disclosed in 2015. This is the lowest number of restatements since 2002. In 2015, there were 161 Reissuance Restatements and 576 Revision Restatements.

  - There were 264 accelerated filer (i.e., large company) restatements in 2015, compared to 353 in 2014.

- By the various measures that AA uses to gauge the severity of restatements, the impact of 2015 restatements was low in comparison to prior years. For example—

  - In 2015, the average number of issues implicated in each restatement was 1.57. In 2014, the average was 1.72.

  - In 2015, the average time period covered by restatements was 498 days. In 2014, the average restatement period was 533 days.

  - For companies traded on the Amex, NASDAQ, or NYSE, 55.2 percent of 2015 restatements had no impact on earnings. The comparable 2014 figure was 60 percent. However, the average restatement income adjustment for these exchange-traded companies was negative $5.2 million in 2015. In 2014, the average income adjustment was only negative $3.1 million.

- The accounting issues most frequently implicated in 2015 restatement were:

  - Debit, quasi-debt, warrants and equity (including beneficial conversion features) security issues (21.8 percent).

  - Cash flow statement (Statement of Financial Accounting Standards No. 95) classification errors (16.7 percent).

  - Tax expense/benefit/deferral/other (Statement of Financial Accounting Standards No. 109) issues (12.8 percent).

  - Liabilities, payables, reserves and accrual estimate failures (11.3 percent).

  - Foreign, related party, affiliate, or subsidiary issues (11.1 percent).

  - Revenue recognition issues (11 percent).

  - Expense (payroll, SGA, other) recording issues (10 percent).

  (Some restatements involved more than one accounting issue. Only those accounting issues that AA classified as involved in 10 percent or more of 2015 restatements are listed above.)

Comment: As was the case in 2014, Audit Analytics 2015 findings are consistent with other research indicating that the quality of financial reporting (as measured by the frequency and severity of restatements) has increased significantly since the enactment of the Sarbanes-Oxley Act. This is likely the result of the substantial investment companies have made in strengthening and assessing the effectiveness of their internal control over financial reporting. Ironically, however, as discussed in the April 2016 Update, both class action litigation based on accounting and financial reporting issues and SEC enforcement actions involving financial reporting are at historically high levels.

Study Finds that Companies Can – and Do – Shop for Favorable ICFR Opinions

A recently-published academic study (available here for purchase) finds evidence that opinion shopping – selecting an auditor based on the auditor's willingness to provide the company with a favorable opinion – may explain the frequency with which companies receive clean opinions on their internal controls, despite subsequent restatements. The study also concludes that, the more competitive the market for auditors, the higher the likelihood of opinion shopping.

The research paper, Internal Control Opinion Shopping and Audit Market Competition, by Nathan J. Newton (University of Missouri), Julie S. Persellin (Trinity University), Dechun Wang (Texas A&M University), and Michael S. Wilkins (Trinity University), appears in the March 2016 edition of The Accounting Review. According the article's abstract, the authors reach three conclusions:

> "Our empirical results suggest that clients are successful in shopping for clean internal control opinions. In addition, we find evidence that internal control opinion shopping occurs primarily in competitive audit markets. Finally, our results indicate that among auditor dismissal clients [i.e., clients that replaced their auditor], opinion shopping is more likely to occur when dismissals are made relatively late during a reporting period and when audit market competition is high."

The study analyzes publicly-available auditor opinions on internal control over financial reporting (ICFR) between 2005 and 2011. The authors focused on the possibility of opinion shopping by companies that were initially Big Four audit clients (and therefore excluded companies audited by a non-Big Four auditors in the year prior to the ICFR reporting year). With respect to the impact of switches from Big Four to non-Big Four firms, the study states:

> "[A] conservative interpretation of the evidence would suggest that opinion shopping may be most likely among clients that do not prefer or require the services of Big 4 auditors. As such, this portion of our ''what-if'' analysis lends credence to the idea that opinion leniency may be more likely among non-Big 4 auditors * * *."

And, with respect to the impact of competition, the study finds:

> "[T]he results suggest that audit market competition affects auditor dismissal decisions to a greater extent for clients that are able to switch to Big 4, mid-tier, or smaller auditors than for clients that may be limited to switching to another Big 4 auditor. This finding is intuitively appealing

Given that auditor dismissals, regardless of motive, should be more likely in the presence of a larger viable auditor pool."

SEC officials have expressed concern that ICFR opinions only infrequently provide early notice of the potential for accounting errors that could result in restatements (see January 2014 Update), and a recent SEC enforcement case charged that, prior to a restatement, material ICFR weaknesses were mischaracterized as merely significant deficiencies in order to avoid disclosure (see April 2016 Update). In this regard, the Newton/Persellin/Wang/Wilkins study finds evidence that "significant opinion shopping activity appears to exist among firms that have clean internal control opinions in advance of financial statement restatements." Therefore, the study "results also corroborate recent academic research indicating that material weakness disclosures cannot reliably be used as advance warning systems for financial reporting problems * * * and that the costs of disclosing material weaknesses seem to outweigh the corresponding benefits * * *."

Finally, the study is consistent with other research (see June 2015 Update) finding that companies may face disincentives to disclosing material weaknesses. "[G]iven that material weakness disclosures are costly and that it may be difficult for external users to predict them (unlike going concern opinions), audit clients have an incentive to attempt to manage the audit process to maximize the probability of receiving a clean internal control opinion."

Comment: As noted above, SEC officials have voiced concern that material weaknesses are under-reported, and the failure to report material weaknesses was the basis of a recent enforcement action. Because of the growing risks involved, audit committees should be alert to situations in which known control deficiencies are deemed not to rise to the level of material weaknesses. Audit committees should also be alert for situations in which they are asked to approve an auditor change where there are indicia that the incoming auditor has agreed in advance to give a favorable opinion on ICFR that the incumbent firm was not prepared to give.

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

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