BAKER & MCKENZIE

Update

No. 32
September 2016

In This Update:

Prepared by:

Daniel L. Goelzer

+1 202 835 6191
Daniel.Goelzer@bakermckenzie.com

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.

Audit Committees Are Still Dubious About the PCAOB's Proposal to Expand Audit Reports

As discussed in the May 2016 Update ("PCAOB Re-Proposes Auditor Reporting on Critical Audit Matters"), the PCAOB has proposed a new auditing standard that would require public company audit reports to contain a discussion of critical audit matters (CAMs) that arose during the audit. A CAM would be defined as "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." The objective of CAM disclosure is to provide audit report readers with insight into the most difficult aspects of auditing the company's financial statements.

Public comments on the proposed standard were due by August 15, 2016, and, as of September 1, 88 comments had been posted to the Board's website – considerably fewer than the 248 comments submitted on the prior version of proposed CAM disclosure (See September 2013 Update, "PCAOB Proposes Fundamental Changes to the Auditor's Report"). Audit committee members that commented on the 2013 proposal were almost uniformly opposed to auditor CAM disclosure. See January 2014 Update ("Audit Committee Comments Oppose Auditor CAM Reporting"), and the same is true of audit committee reactions to the 2016 proposal. Among other things, comment letters from audit committee members suggested that CAM disclosure could inhibit auditor/audit committee communication, usurp management's role in determining what should be disclosed, and confuse financial statement users:

- Dennis R. Beresford, Executive in Residence, The University of Georgia, J.M. Tull School of Accounting (former audit committee chair of Fannie Mae, Kimberly-Clark Corporation, and Legg Mason, Inc.). "I would be concerned about any PCAOB action possibly having a chilling effect on communications between the committee and the independent auditors. * * * [The requirement to document in the audit work papers all matters communicated to the audit committee] could cause matters on the margin to be left out of communications so as to avoid even more documentation or PCAOB inspection second guessing of the documentation.

On the other hand, the fact that all matters communicated to the audit committee have to be documented would seem to encourage auditors to err on the side of including all such items in their reports [as CAMs] rather than leaving out some matters that qualify for communication but don't seem to require inclusion in the report. This seems to lead to a sort of 'damned if you do, damned if you don't' situation."

- John V. Faraci, Chair of the Audit and Finance Committee, ConocoPhillips Company. "Requiring the auditor to disclose CAMs, as determined by the auditor, autonomously in the auditor's report inappropriately magnifies the role of the auditor, expanding the auditor's responsibility into independently reporting on accounting policies, estimates, transactions and other matters, rather than purely attesting to a company's financial information through a pass/fail audit opinion. It inherently undermines the governance role of the audit committee and the disclosure role of management. It is also inconsistent with the principle underpinning our regulatory framework that an auditor should not be the source of disclosure about a company."

- The Audit Committee of CA, Inc. (Raymond J. Bromark, Chair, Jens Alder, Rohit Kapoor, and Jeffrey G. Katz). "We believe the proposed shift of responsibilities for original source of disclosure of company information from the company's management and audit committee to the auditors, as suggested in the Proposed Standard, inappropriately expands the role of the auditor and unavoidably takes away from the importance of management's responsibility to communicate important financial information and the governance role performed by the audit committee, thus essentially undermining the foundation of financial reporting."

- Patrick J. Condon, Chair of the Audit Committee, Entergy Corporation. "If management, the external auditors, and the audit committee fulfill their respective responsibilities, I believe the additional communications and requirements outlined in the PCAOB's re-proposed auditor reporting standard are unnecessary. Furthermore, I believe the additional communications and requirements are likely to result in disclosure overload, confusion regarding the roles of the various parties in the process and perhaps even less perceived quality of company-prepared financial statements."

In addition, several public company management comments warned that the proposal would undermine the work of the audit committee. For example:

- Michele A. Peppers, CPA, Vice President Accounting & Reporting, Chief Accounting Officer, Career Education Corporation. "An unintended consequence of CAMs is that it may provide a disincentive for topics to be brought to audit committees' attention. A company's management team may be inclined to discuss fewer items with the audit committee in order to reduce the number of CAMs disclosed in the audit report. This may result in additional audit procedures required as the auditors may have to find alternative procedures to test areas where management may be less forthcoming to discuss or provide information for."

- Michael Hardesty, Corporate Vice President, Controller and Chief Accounting Officer, Northrop Grumman Corporation. "CAM disclosure in the auditor's report may result in the unintended consequence of changing the quantity and nature of information communicated by auditors to audit committees. In contemplation of the required disclosure in the auditor's report, auditor communications with audit committees may lack the depth of current communications and become more general or boilerplate in nature."

- Loretta V. Cangialosi, Senior Vice President and Controller, Pfizer Inc. "We believe that while using communications to audit committees as a source for CAMs appears to be a reasonable approach as those are generally the most important matters it is likely to have numerous unintended consequences including providing a potential disincentive to openness of interactions with the audit committee. As this is contrary to overall best practice and good corporate governance, we cannot support this proposed provision of the standard. Furthermore, there is a real and substantive cost to this proposal for which investors have not yet been able to articulate how they would use the information to make better investing decisions resulting in benefits which are intangible and amorphous."

Comment: While audit committee members and public companies generally do not support auditor CAM reporting, the comments from investors, accounting firms, and other commentators are, on the whole, more favorable to the PCAOB's proposal. The Board has indicated that it plans to act on expanded auditor reporting before the end of the year, and it is likely that the proposal will be adopted in substantially the form in which it was published in May. For audit committees, the focus will then shift to developing a protocol with the engagement partner under which the audit committee will learn, as far in advance of the issuance of the audit opinion as possible, (1) the issues that the auditor intends to disclose as CAMs; (2) what the auditor intends to say in the audit opinion regarding the CAMs; and (3) how the auditor's statements will compare to management's disclosures regarding the same issues.

SEC Charges Company and General Counsel With Failure to Disclose DOJ Investigation Loss Contingency

On September 9, the Securities and Exchange Commission filed an enforcement action against a public company and its general counsel for failing to disclose a material loss contingency, or record an accrual, for potential losses arising from an ongoing Department of Justice investigation into whether a company subsidiary had violated the False Claims Act by overcharging the government in connection with a contract. SEC v. RPM International Inc., Litigation Release No. 23639 (September 9, 2016). Ultimately, the company settled with the DOJ for nearly $61 million. While the case does not involve charges against the audit committee, the SEC's complaint alleges that statements made by the audit committee may have caused the general counsel to feel under pressure to avoid or delay disclosing the contingent loss.

GAAP requires disclosure of the underlying contingency when a loss is reasonably possible; the amount of the loss must be accrued and recorded on the books when the loss is both probable and reasonably estimable. Applying these concepts to potential losses arising from governmental investigations is challenging because the outcome is often difficult to predict and disclosure can impair the company's negotiating position. Because contingency disclosures and accruals require the exercise of judgment, SEC enforcement in this area is rare. However, the SEC's complaint against RPM illustrates the seriousness with which Commission takes the contingent loss disclosure and accrual requirements and the fact that companies are not free to delay disclosure when there is concrete evidence that a loss has been incurred.

According to the SEC's allegations, after learning that the DOJ was investigating the company subsidiary, RPM's general counsel obtained an analysis indicating that the subsidiary had, in fact, overcharged the government by at least $11 million and possibly more. Despite this information, the general counsel signed a management representation letter to the auditor stating that he was not aware of any loss contingencies exceeding the auditor's materiality threshold of $1.2 million. RPM omitted any information about the DOJ investigation from its Form 10-Q for the first quarter of FY 2013. With respect to litigation contingencies, the Form 10-Q merely stated, "We are party to various claims and lawsuits" and "we record provisions when we consider the liability probable and reasonably estimable." The SEC asserts that this statement was misleadingly because a material loss relating to the DOJ investigation was probable and reasonably estimable at the end of 2013 Q1.

Prior to the second quarter report, the general counsel's understanding of the level of overcharges had increased, and he planned to submit a settlement offer of $27 million to the DOJ. Nevertheless, the general counsel is alleged to have stated orally to the auditors that "no loss contingency exists." Further, four days prior to the second quarter filing, at an audit committee meeting attended by the CEO, CFO, and audit firm, the general counsel provided an update on the DOJ investigation, but failed to disclose that overcharge estimates totaling $12 million had already been provided to the DOJ and that, within the next week, he intended to submit a settlement offer in the range of $27-28 million.

In its press release announcing the case, the SEC states:

> "As a result of [the general counsel's] conduct, the SEC alleges that RPM filed multiple false and misleading documents with the SEC. For example, among other things, RPM failed to disclose in its filings with the SEC any loss contingency related to the DOJ investigation, or to record an accrual on its books, when required to do so by governing accounting principles and the securities laws. RPM also failed to disclose in its SEC filings a material weakness in its internal control over financial reporting and its disclosure controls when in fact such weakness existed. Consequently, RPM did not provide investors with accurate information about RPM's financial condition."

The complaint also asserts that, in the SEC's view, the general counsel may have felt under pressure to avoid, or at least postpone, recording the losses related to the DOJ investigation. In a Form 8-K filed around the same time as the 2013 Q1 Form 10-Q, RPM disclosed certain one-time charges arising from matters unrelated to the DOJ investigation. According to the complaint, at an audit committee meeting the day before that filing was made, the audit committee communicated to management that "we're not going to be accepting of ongoing extraordinary charges or one-time charges. We [don't] think that that would bode well for the company and . . . the impression of our shareholders and others of how we run the business." Similarly, at RPM's annual shareholder meeting two days later, the CEO told shareholders that RPM would not "water torture them" with additional one-time "charges quarter after quarter."

It should be noted that the foregoing description is based on the allegations in the SEC's complaint. On September 12, RPM issued a press release stating that "the company's audit committee concluded that there was no intentional misconduct on the part of any of its officers" and quoting the company's chairman and CEO as stating: "We believe the allegations have absolutely no merit and are the product of prosecutorial overreach. We intend to vigorously defend ourselves and expect our position to be vindicated in court." Similarly, the general counsel's lawyer was quoted in the press as stating that he and his client "look forward to prevailing in court and demonstrating that the government's case is entirely baseless."

Comment: Companies facing governmental investigations need to be mindful of the need to disclose contingent losses arising from the investigation when they are reasonable possible and to record a liability when the loss becomes both probable and reasonably estimable. Given the uncertainty surrounding the outcome of most governmental investigations, particularly in their early stages, these can be difficult judgment calls. However, candor between the legal team, financial reporting management, the audit committee, and the auditor is essential to reaching a defensible decision

The allegations in the RPM case also demonstrate the importance of using care in the messages that the audit committee sends – intentionally or otherwise – to those involved in financial reporting. Presumably, the audit committee's alleged statement "we're not going to be accepting of ongoing extraordinary charges or one-time charges" was not intended as encouragement to ignore the accounting requirements applicable to contingent losses. This kind of statement could, however, be misunderstood.

ICFR Auditing is Improving, But Material Weaknesses are Going Up

On August 6, PCAOB Board Member Jeanette Franzel presented a PowerPoint update of issues and trends in audits of internal control over financial reporting (ICFR) at the annual meeting of the American Accounting Association. Several weeks later, on August 23, research firm Audit Analytics released a new report on trends in ICFR reporting, SOX 404 Disclosures: a Twelve Year Review (see Audit Analytics blog summary). Together, these two reports paint a picture of improving ICFR auditing. However, ICFR reporting does not yet seem to be playing the role of an early warning mechanism that alerts financial statement users to the risk of future misstatements. And, it is likely that, despite progress, ICFR reporting and auditing will continue to be an area of regulatory scrutiny.

Based on PCAOB inspection data, Ms. Franzel saw improvement in ICFR audits. She highlighted the following points:

- For the four largest U.S. accounting firms, "the level of audit deficiencies related to ICFR improved in the 2014 inspections (generally performed in 2015) when compared to the previous year." The PCAOB found deficiencies serious enough to include in the public portion of the firm's inspection report in 30 percent of the ICFR audits performed by these firms that the PCAOB inspected during 2015. By comparison, in inspections performed during the prior year, the comparable deficiency rate was 36 percent. On the other hand, in 2010, the first year of ICFR "heightened scrutiny," the deficiency rate was only 16 percent.

- The most frequently-identified ICFR deficiencies fall into three categories -- selecting appropriate controls to test; testing control design effectiveness; and testing the operating effectiveness of controls. The PCAOB's inspection results reflect no change in the level of audit deficiencies related to control selection between 2014 and 2013. In contrast, inspectors found fewer deficiencies in 2014 with respect to testing design effectiveness and testing operating effectiveness, as compared to the prior year.

- Overall, the PCAOB's 2015 inspection results for the four largest accounting firms reflect improvements in ICFR auditing. The smaller number of ICFR audit deficiency findings is part of a larger trend of fewer deficiencies of all types in the public portion of the inspection reports of these firms.

Ms. Franzel also noted that, based on Audit Analytics data, the number of adverse ICFR opinions (i.e., opinions in which the auditor concluded that ICFR was not effective) increased between 2010 and 2014 from 3.4 percent of all ICFR opinions issued to approximately six percent. During the same period, the percentage of public companies subject to the ICFR audit requirement that announced restatements rose from 7.0 percent to 11.3 percent. In all of the years since 2010, the great majority of restating companies received clean ICFR opinions for year which was subsequently restated. For example, in 2015, 78.4 percent of companies that announced restatements had received an opinion from their auditor that controls over financial reporting were effective.

The Audit Analytics blog description of the 12-year retrospective report places these figures in a somewhat larger context. For example, while adverse auditor opinions on ICFR have, as Ms. Franzel notes, increased since 2010, 2010 represented the all-time low in adverse opinions. In 2004, the first year of ICFR auditing, 15.7 percent of companies received opinions that their controls were not effective; that percentage declined steadily until 2010. The increase since the 2010 low seems relatively modest by historical standards. The Audit Analytics blog states:

> "Overall, the percentage of adverse 404 auditor opinions has seen a steady decrease, from 15.7% in 2004, the first year the requirements went into effect, to 5.3% in 2015. However, a less encouraging trend - depending on one's perspective - is hidden in that overall view; the percentage actually hit its lowest point in 2010, at 3.4%. Since, we

have seen an increase in the percentage of adverse 404(b) audit opinions."

Comment: Ms. Franzel observes that the rate of ICFR audit deficiencies is "still high at 30 percent of the integrated audits inspected." The PCAOB attempts to select the most difficult or complex audits to inspect, and the overall quality of Big Four ICFR auditing is probably higher than the 30 percent deficiency rate suggests. However, it seems clear that, despite recent improvements, the PCAOB will continue to focus on ICFR auditing. Audit committees can, in turn, expect their auditors to continue to devote high levels of time and effort to ICFR issues in order to reduce the risk that the engagement team will receive adverse inspection comments from the PCAOB. It is also likely that the regulators will scrutinize situations in which companies and their auditors reported that internal control over financial reporting was effective during a particular period, but the company subsequently restated the financial statements for that same period. In anticipation of SEC inquiries, audit committees that face that situation may want to ask their own questions about the apparent contradiction.

Surprise! Executives With Pay Tied to the Stock Price Don't Like to Publicize Restatements

A recent academic study finds that, when executive compensation is linked to the company's stock price, restatements of previously-issued financial statements are likely to be disclosed in a manner that will attract as little market attention as possible. The research also suggests that there may be differences between how the CEO and CFO approach the issue of restatement disclosure, especially when there are differences in how they are compensated. The study, The Association between Executive Pay Structure and the Transparency of Restatement Disclosures, was conducted by Brian Hogan of the University of Pittsburgh and Gregory A. Jonas of Case Western Reserve University. It appears in the September 2016 edition of Accounting Horizons. The abstract is publicly available, and the full study is available for purchase.

The authors reviewed 1,178 public company restatements disclosed between 2004 and 2013. They divided the restatements into two groups – re-issuance (or "Big R") restatements, which are disclosed by the filing of a Form 8-K with the SEC, and revision (or "Little R") restatements, which are only reflected in a regular periodic filing, such as annual Form 10-K. Because re-issuance restatements attract a higher level of public attention, they tend to have a more dramatic impact on stock prices. Whether a restatement requires Big R or Little R treatment depends on the materiality of the error that is being corrected, and, in many cases, that determination requires the exercise of judgment. See May 2016 Update ("Restatements Hit a New Low").

Hogan and Jonas find that, as the stock portion of executive pay increases, the likelihood of a Big R restatement decreases. They observe that "even after managers determine a restatement is required, managers with pay structures favoring equity are more likely to judge a restatement as not material enough to trigger an 8-K filing."

Interestingly, however, the study also finds that the decision about how to disclose a restatement is influenced by the existence of differences between the way in which the CEO and the CFO are compensated and that, “as the difference in pay structure between the CEO and CFO increases, the likelihood of a high-transparency disclosure increases.” The authors state that CFOs are more likely than CEOs to suffer severe career damage, such firing and/or loss of a CPA certificate, in the event of a disclosure violation. Therefore, “[f]acing more severe deterrents, CFOs may not be willing to risk supporting a low-transparency restatement disclosure.” The difference in perspective on how a restatement should be disclosed is particularly acute when the CEO’s compensation is more heavily stock-based than is the CFO’s:

> “Another way to view the findings for disparity in pay structure is as a risk-reward opportunity set for these two executives. This opportunity set is substantially different for the CEO versus the CFO. CFOs are more likely to be terminated following a restatement * * * and have less potential to benefit from a low-transparency disclosure due to having less equity-based pay than the CEO. This imbalance in the risk-reward opportunity set might reasonably be the source for tension in choosing the restatement disclosure method, with CFOs motivated to be more conservative (high-transparency choice). However, as CFO compensation becomes more aligned with the CEO, in terms of equity-based pay, tension in choosing the disclosure method (and potential for a more transparent disclosure) may diminish.”

Comment: Audit committees reviewing management decisions about the materiality of a restatement and how to disclose it might want to keep the results of this research in mind. Further, in setting CFO compensation, it may be prudent to consider the possible financial reporting risks associated with heavily aligning the CFO’s compensation with the stock price.

PCAOB 2015 Inspections Status Report

On August 30, the PCAOB released its report on the 2015 inspections of Deloitte & Touche and its report on the 2015 inspection of PricewaterhouseCoopers. These are the first two reports the Board has made public with respect to its 2015 inspections of the four largest U.S. accounting firms. The results of these inspections are summarized in the table below.

2015 Big Four Inspections (Reports Issued in 2016)

Firm	Report Date	Engagements Inspected	Part I Deficiencies*	Percentage
Deloitte & Touche	August 10, 2016	55	13	24%
PwC	August 10, 2016	55	12	22%

* The PCAOB describes deficiencies that are included in Part I of an inspection report as “of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion” on the financial statements or on internal control over financial reporting.

After the PCAOB has made all of the 2015 Big Four firm inspection reports publicly available, the Update will present an overview of the PCAOB’s inspection findings concerning these firms.

On August 31, the PCAOB also released its 2105 inspection report on Crowe Horwath, another large accounting firm subject to annual PCAOB inspection. In its 2015 inspection of Crowe, the PCAOB reviewed portions of 14 public company audits. The report describes Part I deficiencies in three (21 percent) of those engagements.

Comment: Audit committees should discuss the results of the firm's most recent PCAOB inspection with their engagement partner. If the company's audit is mentioned in either the public or nonpublic portion of the inspection report, the audit committee should understand the reasons for the reference to the audit and how it will affect the engagement in the future. If the company's audit is not cited in the report, the audit committee should explore with the auditor how deficiencies identified in other audits might have affected the company's audit and how changes in the firm's procedures might affect future audits. Audit committees should also have an understanding of how the firm intends to remediate quality control deficiencies described in the nonpublic portion of the report.

www.bakermckenzie.com

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

For further information please contact

www.bakermckenzie.com

Daniel L. Goelzer
+1 202 835 6191
Daniel.Goelzer@bakermckenzie.com

815 Connecticut Avenue
Washington, DC 20006-4078
United States