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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.

New Studies Find More Progress on Audit Committee Transparency

Audit committee disclosure about the committee's responsibility to oversee the external auditor and how it performs that role has been a major subject of discussion during the past several years. In 2013, several organizations with an interest in corporate governance issued a "Call to Action" urging audit committees to voluntarily strengthen their disclosures. See November-December 2013 Update. And, in 2015, the SEC invited comment on whether it should mandate increased audit committee disclosure. See July 2015 Update. Two recent studies indicate that audit committees are responding.

Audit Committee Transparency Barometer

On November 1, the Center For Audit Quality and research firm Audit Analytics released their third annual Audit Committee Transparency Barometer. The report finds "encouraging trends in 2016 with respect to voluntary, enhanced disclosure around external auditor oversight" and "double-digit growth" in the percentage of S&P 500 companies that voluntarily disclose information in several "key areas", including auditor appointment, audit firm tenure, engagement partner selection, engagement partner rotation, and criteria used to evaluate the audit firm. The Transparency Barometer is an effort to measure the robustness of public company audit committee disclosures by analyzing the proxy statements of the companies that comprise the S&P Composite 1500, which consists of the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600. The barometer initiative and the first annual report are described in the December 2014 Update; the second annual report was summarized in the December 2015 Update.

Some specific 2016 Transparency Barometer findings include:

- Thirty-one percent of S&P 500 proxy statements present "enhanced discussion" of the audit committee's considerations in recommending the appointment of the audit firm, up from 13 percent in 2014 and 25 percent in 2015. Twenty-two percent of MidCap companies made similar enhanced disclosures regarding the considerations underlying auditor appointments, up from 10 percent in 2014 and 16 percent in 2015. For SmallCap

companies, the comparable percentages were 17 percent in 2016, 11 percent in 2015, and 8 percent in 2014.

- Audit committee disclosure of the length of the auditor's service is close to becoming the norm, rather than the exception. In 2016, 59 percent of S&P 500 companies disclosed the auditor's tenure, while 45 percent of MidCap companies and 48 percent of SmallCap companies made tenure disclosure.

- In 2016, 17 percent of S&P 500 companies disclosed that the audit committee was responsible for negotiating audit fees, double the 8 percent that made this disclosure in 2014. Only 3 percent and 4 percent of Mid and SmallCap companies respectively disclosed the audit committee's role in fee negotiations (up from 1 percent in both cases in 2014). In contrast, roughly one-third of companies in all three size categories made 2016 disclosures concerning the reasons for changes in the audit fee.

- Forty-three percent of S&P 500 companies disclosed that the audit committee played a role in engagement partner selection, while 39 percent disclosed that the engagement partner rotates every five years. Both of these disclosures were far less common at MidCap and SmallCap companies.

EY Center for Board Matters Report

In mid-October, the EY Center for Board Matters (EYCBM) released its fifth annual report on audit committee disclosures, Audit Committee Reporting to Shareholders in 2016, based on the 2016 proxy statements of the 78 Fortune 100 companies that filed proxy statements each year from 2012 to 2016. (The 2015 EYCBM Report is summarized in the October-November 2015 Update.) Like the Transparency Barometer, the EYCBM Report finds that "voluntary audit-related disclosures continue to trend upward" at these large companies.

Highlights of the new EYCBM Report include:

- Half of the 78 Fortune 100 companies disclosed factors that the audit committee considered in assessing the "qualifications and work quality" of the external auditor. This reflects an increase from 42 percent in 2015 and only 17 percent in 2012.

- Seventy-three percent of the companies stated that the audit committee believed that the choice of external auditor was in the best interests of the company and/or the shareholders. In 2015, this percentage was 63 percent, while only 3 percent made a best-interests disclosure in 2012.

- The audit committees of 82 percent of the companies stated that the committee is responsible for the appointment, compensation, and oversight of the external auditor; in 2012, 42 percent provided such disclosure.

- Nearly a third of the companies disclosed the reasons for changes in fees paid to the external auditor (including one-time events, such as a merger or acquisition). In 2012, 9 percent of

Fortune 100 companies provided an explanation for changes in audit fees.

- Since 2012, disclosure that the audit committee was involved in the selection of the lead audit partner has grown dramatically. Seventy-three percent of the companies in the study made such disclosure in 2016, compared to 1 percent in 2012.

In one area, the EYCBM Report found that audit committees have become more reticent. In 2016, 6 percent of companies disclosed topics that the auditor and audit committee discussed. This reflects a decline from 8 percent that provided such disclosure in 2015. The report states that issues discussed included "testing and evaluation of internal controls, enterprise risk management, cybersecurity and other information technology matters, subsidiaries and accounts, tax and legal matters."

Comment: Audit committees should be aware of the types of voluntary disclosures concerning the committee's responsibilities and activities that their peers are making and consider expanding their own disclosures to match. The Transparency Barometer includes company-specific examples of actual disclosures in the areas surveyed, and companies and their audit committees may find it useful to review those precedents. Enhanced voluntary disclosure may head off shareholder demands (such as those made in recent years by the United Brotherhood of Carpenters Pension Fund) for more audit committee information, and is, in any event, becoming a best practice. Further, as discussed in the October-November 2015 Update, many commenters on the SEC's audit committee disclosure concept release pointed to the increase in voluntary audit committee transparency as evidence that the SEC should refrain from adding requirements in this area.

CAQ Highlights 2016 Audit Challenges

On October 4, the Center for Audit Quality issued an Alert discussing some of the key "judgmental or complex" audit areas likely to be significant during the upcoming audit cycle. The Alert, Select Auditing Considerations for the 2016 Audit Cycle, includes issues identified by the Public Company Accounting Oversight Board in recent PCAOB Staff Inspection Briefs. This is the CAQ's fourth annual Alert highlighting current audit challenges. (The 2015 Alert is summarized in the December 2015 Update.)

The CAQ's 2016 Alert identifies and discusses seven topics:

- Improving Transparency through Disclosure of Engagement Partner and Certain Other Participants in Audits. For audit opinions issued after January 31, 2017, a new PCAOB rule will require the auditor to file a report with the PCAOB identifying the engagement partner; for opinions issued after June 30, the report must also identify certain other accounting firms that participated in the audit. These PCAOB filings will be publicly-available. The new reporting requirement may impact audit committee oversight, and the CAQ observes that, while there are "no incremental requirements with respect to communications to the audit committee, auditors may consider briefing the audit committee" on

the new rule. (The PCAOB transparency provisions are discussed in the December 2015 Update.)

- Improper Alteration of Audit Documentation. The PCAOB has brought several enforcement actions involving situations in which auditors have altered their work papers after the completion of the audit in order to present a more favorable picture of the audit to the Board's inspection staff. The CAQ points out that "the PCAOB's rules require the auditor to cooperate with the Board's oversight activities and that failure to do so (including providing improperly altered documents or misleading information to the PCAOB's staff) can result in disciplinary actions with severe consequences."

- Effective Communication with Audit Committees. In 2012, the PCAOB adopted new requirements concerning the information that auditors must communicate to audit committees, and verifying compliance with those standards has been an element of subsequent PCAOB inspections. The CAQ warns that auditors "should continue to focus on their communication with audit committees" since the PCAOB has reported (see April 2016 Update) that its preliminary 2015 inspection results "indicate certain deficiencies in communication related to the overall audit strategy, timing of the audit, and all of the significant risks the firms had identified."

- Assessing and Responding to Risks of Material Misstatement. In 2015, the PCAOB issued a report on the observations of its inspections program with respect to auditor compliance with the Board's risk assessment auditing standards. See October-November 2015 Update. The CAQ notes that, in this report, the PCAOB staff recommended that, in order to strengthen audit quality, auditors should continue to focus on the application of the risk assessment standards.

- Internal Control over Financial Reporting (ICFR). ICFR auditing has been the major source of audit deficiencies in PCAOB inspection reports during the past several years and, accordingly, has become the subject of intensified audit effort. The CAQ advises auditors to "continue to focus on performing procedures to identify, test and evaluate controls that address the assessed risk of material misstatement, and in particular those controls that contain a review element." In addition, the CAQ cites recent SEC staff statements reminding companies and their auditors of the need to focus "on internal control-related implications of the implementation of new accounting standards, including those that relate to disclosures of the implementation status during the transition period, where applicable." New accounting requirements with ICFR implications include revenue recognition, leasing, and financial instruments. The CAQ also states that "testing of internal controls over income tax accounting and disclosures, another complex area, continues to warrant auditor attention."

- Segment Identification and Disclosure. The CAQ recommends that auditors "continue to focus on the design and operating effectiveness of management's controls over segment reporting"

since this is an area the SEC staff has recently emphasized. The CAQ points out that "[t]ests of controls related to management's determination of operating and reportable segments -- as well as controls over monitoring of events giving rise to changes in segment determination and disclosure controls -- were also identified as potential focus areas for 2016 PCAOB inspections."

- Going Concern. The CAQ highlights new accounting requirements relating to disclosures concerning whether the company is a going concern. Effective December 16, 2016, management is required to perform a going concern assessment and to make footnote disclosure when there is substantial doubt about the company's ability to continue as a going concern during the year following the issuance of the financial statements. The PCAOB has indicated that management's determination that no disclosure is required is "not conclusive as to whether an explanatory paragraph is required in the auditor's report."

In addition to these seven topics, the CAQ also identifies "Additional Considerations" that auditors should "continue to focus on." These additional areas, which largely parallel audit challenges included in the 2015 CAQ Alert, are:

- Auditing accounting estimates, including fair value measurements.

- Assessment of whether cybersecurity risks present risks of material misstatement to the issuer's financial statements.

- Auditor independence, including the impact of consulting, advisory and other services.

- Compliance with the PCAOB's standard on auditing transactions with related parties.

- Use of software audit tools to perform substantive testing and risk assessment procedures.

Comment: While the CAQ's Alert is aimed at auditors, not audit committees, it provides a road map for audit committees regarding the topics that auditors are likely to view as posing the greatest audit risks – and the highest likelihood of PCAOB inspection attention. As such, the Alert may help audit committees better understand the perspective from which their audit firms will approach 2016 engagements.

SEC Flags Impact of Personal Relationships on Auditor Independence

Two recent SEC enforcement actions underscore the risk that personal relationships between audit firm personnel and company staff may compromise the auditor's independence. These relationships are difficult to monitor, and the area is one that audit committees seldom explore as part of their consideration of the audit firm's compliance with independence requirements. The new SEC cases may, however, force audit committees to pay more attention to this type of independence risk.

Background

The SEC's auditor independence rules provide that an accountant is not independent if "a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment" based on "all relevant circumstances." The threats to independence that arise from financial or business relationships between the company and its affiliates and the audit firm and its affiliates are fairly well-recognized and are addressed with specificity in the rules. There are, however, no bright lines as to how the "reasonable investor" test of independence applies in the sphere of personal, nonfinancial relationships. The two recent cases provide some guidance, but also raise some new questions.

Romantic Relationship Case

The first case, Ernst & Young LLP, Robert J. Brehl, CPA, Pamela J. Hartford, CPA, and Michael T. Kamienski, CPA, involved a situation in which the accounting firm partner in charge of an engagement maintained a secret romantic relationship for several years with the audit client's chief accounting officer. Despite this relationship, the engagement partner participated in audit committee meetings at which the accounting firm represented that it was independent of the company. The chief accounting officer participated in the same audit committee meetings and also signed management representation letters stating that company management had no knowledge of facts or circumstances that would prevent the accounting firm from qualifying as independent of the company for purposes of the SEC's rules.

Although there were earlier red flags, the accounting firm did not actually become aware of the secret romance until a company vice president filed a whistleblower complaint, and the company conducted an internal investigation. The accounting firm then withdrew its opinions with respect to the prior two years, and the company was forced to obtain a re-audit from another accounting firm.

The SEC charged the firm, the engagement partner, and the chief accounting officer with independence violations, improper professional conduct, and with aiding and abetting violations of the public company reporting requirements. The case was settled by consents under which the engagement partner and the chief accounting officer were fined $25,000 each and barred from practicing before the Commission, with the right to reapply after, respectively, 3 years and 1 year. The accounting firm was ordered to pay disgorgement and penalties totaling $4.37 million.

Social Relationship Case

The second case, Ernst & Young LLP and Gregory S. Bednar, CPA, involved a different type of personal relationship. The accounting firm assigned one of its partners to serve as the coordinating partner of a troubled account with responsibility to "mend" the relationship. The coordinating partner accomplished this mission by developing a close personal relationship with the company's CFO and members of the CFO's family, including "frequent overnight, out-of-town trips, with the CFO and his family * * * all of which were social in nature and did not

have a valid business purpose." In addition, the coordinating partner and the CFO "attended sporting events and socialized near the Issuer's headquarters in the greater New York City area to an excessive degree," and the partner made gifts of tickets to sporting events and other things of value to the CFO. As a result of these and other activities, the coordinating partner incurred approximately $109,000 in entertainment-related expenses in connection with the 2012, 2013, and 2014 audits. The majority of these expenses were billed to the company as audit expenses.

The SEC found that, as a result of the coordinating partner's conduct, the partner and the firm lacked independence from the company. The SEC charged the accounting firm and the coordinating partner with violations of the independence rules and with engaging in improper professional conduct. The respondents consented to settlements, and the coordinating partner agreed to a fine of $45,000 and a bar from practicing before the Commission, with a right to reapply after three years. The accounting firm was ordered to pay disgorgement and penalties totaling $4.975 million.

Comment: These kinds of personal relationships are hard to detect and audit committees must necessarily rely on the accounting firm as the first line of defense against relationships that compromise independence. Close non-romantic relationships between auditors and financial reporting staff are especially difficult to evaluate because some level of business development or relationship building entertainment is common, and the question of when such activity crosses the line into erosion of auditor independence is a matter of judgment. Nonetheless, there are steps that companies and audit committees can take to police this area. For example:

- While it isn't feasible to identify and provide training with respect to every possible type of financial reporting misconduct, employees should be periodically reminded of the existence of company hotlines and other avenues for whistleblowing, and complaints received should be carefully reviewed. In the first case above, the SEC alleges that rumors of the illicit affair were rampant at the company, and the matter was ultimately uncovered as a result of a whistleblower complaint.

- Some companies prohibit employees from accepting anything of value from suppliers, and enforcement of such a policy with respect to the outside auditor would provide a bright line standard. Alternatively, a reporting system could be implemented under which financial reporting personnel are required to memorialize their nonbusiness interactions with members of the audit firm so that these contacts can be reviewed and evaluated.

- Entertainment costs that the auditor bills to the company should be scrutinized. While asking the company to reimburse the auditor for socializing with the company's staff is unusual, if it occurs, it would be prudent to inquire into the circumstances and evaluate the underlying activities from an auditor independence stand-point.

SEC Continues to Ramp Up Financial Reporting and Auditing Enforcement

On October 11, the SEC announced the results of its fiscal year 2016 enforcement program. Financial reporting and auditing cases continued to play a prominent role on the enforcement docket.

The agency stated that it filed 868 enforcement actions – a record number for a single year – "exposing financial reporting-related misconduct by companies and their executives and misconduct by registrants and gatekeepers" and that this total reflected the SEC's continuing efforts "to enhance its use of data to detect illegal conduct and expedite investigations." In these 868 cases, the SEC asserts that it obtained "over $4 billion" in disgorgement and monetary penalties; this compares with 807 enforcement actions and $4.19 billion in fiscal 2015, and 755 actions in which $4.16 billion was ordered to be paid in 2014.

With respect to public company financial reporting, the SEC cites the following –

- "Important actions against auditing firms for violating auditor independence rules," including "first-of-its kind" independence cases predicated on close personal relationships with audit clients (see the prior item in this Update).

- A series of financial fraud/disclosure cases against public companies and/or their executives.

- The "second non-independence case against a major audit firm since 2009" in which the firm and two partners were charged with "ignoring red flags and fraud risks."

- Cases holding "attorney, accountants and other gatekeepers accountable for failures to comply with professional standards."

- Sanctions imposed against "a consultant to a Texas-based oil company based on charges that he improperly evaluated the severity of the company's internal control deficiencies (in addition to charges against the company, senior executives, and an outside auditor)." See April 2016 Update.

- Successful litigation against the former CEO of a biopharmaceutical company in a case alleging that the CEO, among other things, falsified certifications included with the company's annual and quarterly reports filed with the SEC.

On September 22, shortly before the FY 2016 enforcement statistics were released, the SEC's Director of the Division of Enforcement, Andrew Ceresney, delivered a speech which provides some context for the SEC's financial reporting enforcement program, particularly as it relates to auditing and auditors. He points out that, as described in several prior Updates, when current SEC Chair Mary Jo White arrived at the SEC in 2013, she implemented a plan to refocus the enforcement program on financial reporting issues and gatekeepers. As part of that initiative, the SEC created the Financial Reporting and Audit Task Force to concentrate on developing these types of cases and announced "Operation Broken Gate" to identify cases against auditors and other

financial reporting gatekeepers (such as attorneys and corporate directors).

Mr. Ceresney notes that "our renewed focus on financial reporting issues has resulted in a significant increase in the quality and quantity of financial reporting cases, and in numerous cases against auditors and audit firms, including smaller, mid-size, and national audit firms." After reviewing recent cases against public company auditors, he concludes with five lessons learned:

- First, before engaging with an audit client, auditors should ensure that the firm and its assigned personnel have sufficient capacity and competence to audit the client according to professional standards.

- Second, audits need to be properly planned and executed, with significant risks identified and addressed through adequate audit procedures. The planning process is key to the success of the audit and must be given adequate attention.

- Third, auditors need to exercise appropriate professional skepticism, gather sufficient appropriate audit evidence, adequately document work, and, particularly when there are red flags, require more sufficient evidential matter than representations from management.

- Fourth, auditors should consult internally when particularly troublesome issues arise. Firms must have knowledgeable personnel ready to assist in sensitive areas and those personnel, as well as the audit personnel, must be ready to hold the line against the client when their concerns are not addressed.

- Finally, firms must have robust monitoring processes and training on independence issues so that firms comply with independence requirements and so that individual auditors are aware of, and well-versed on, areas of potential independence violations.

Comment: The SEC's focus on financial reporting and financial reporting gatekeepers has been a major aspect of the Commission's enforcement program over the last several years. The risk that financial reporting lapses and internal control break-downs will trigger SEC enforcement action remains elevated. Although a few cases have been brought against audit committee members (see, e.g., April 2014 Update), companies, financial reporting management, and auditors remain the principal targets. An important issue to watch in 2017 is whether an new, post-election administration at the SEC will continue to treat financial reporting as an enforcement priority.

The New Expectations Gap: ESG Disclosure

According to a new PwC study, Investors, corporates, and ESG: bridging the gap, increasing numbers of investors want companies to provide non-financial information concerning environmental, social and governance (ESG) matters to assist them in evaluating the company's risk profile and strategy. And, increasing numbers of companies make these kinds of disclosures – in fact, 81 percent of the S&P 500

issued a sustainability report in 2015. However, there are significant differences between the ESG disclosures that investors say they would find useful and what companies actually provide. The PwC report, released October 25, finds: "Investors realize that ESG factors are important, but there is a disconnect between what they want to know and what corporates disclose."

PwC surveyed 28 U.S.-based institutional investors, pension funds, and companies. The companies were in a variety of sectors, including technology, banking, industrial products, healthcare, retail and consumer, energy, and utilities. Roughly half of the corporate respondents had revenues in excess of $30 billion, and just under 30 percent of the investor respondents had $25 billion or more under management.

PwC findings that highlight the gap between investor expectations and company ESG disclosures include:

- Comparability of disclosure. Only 8 percent of institutional investors said that the ESG data disclosed by the companies in which they invested allowed them to make comparisons to other companies. In contrast, 60 percent of companies responded that the ESG data they disclose "make[s] it easy for investors to compare to other companies."

- Disclosure standards. While companies tend to use GRI's reporting model, investors seem to prefer SASB's standards:

  - Eighty percent of companies reported that they follow GRI standards when disclosing ESG information. However, only 21 percent of investors said that they "would like to see information reported using GRI standards."

  - Attitudes regarding SASB standards were reversed: Forty-three percent of investors would prefer disclosures based on SASB's standards, while none of the responding companies use SASB standards (which are currently provisional).

  (The Global Reporting Initiative (GRI) has developed a reporting framework under which organizations of all types can disclose ESG information. The Sustainability Accounting Standards Board (SASB) has developed industry-specific ESG reporting standards designed to dovetail with materiality under the federal securities laws. See May 2014 Update.)

- Barriers to ESG disclosure. Twenty-one percent of companies said that a barrier to disclosing more ESG information was that investors won't act on the information, and 29 percent said that the company has only "limited data to share." Similarly, 29 percent of investors said that a barrier to more disclosure was the fact that companies think investors won't use the information. But, 21 percent of investors thought that "companies track other ESG data, but they're not sure what to disclose to satisfy investors."

- Quality of disclosure. All of the corporations surveyed said they were confident in the quality of the data they were releasing. Only 29 percent of investors shared that confidence.

- Improving confidence. Forty-three percent of companies said that the company has ESG information certified or audited by an independent third party as a way of demonstrating that the information is of "acceptable quality." Surprisingly, however, only 36 percent of investors said that having ESG disclosures audited would make them "feel more confident in the quality of the ESG information" they receive. Instead, 36 percent of investors thought that having ESG disclosures incorporated into SEC filings would increase confidence in its quality. However, only seven percent of companies reported that they do in fact incorporate ESG claims into SEC filings "to signal higher quality."

Comment: Sustainability or ESG reporting has become common practice, and investor demand for these types of disclosures is like to continue to grow. Further, there is a possibility that some ESG reporting will become mandatory. As discussed in the April 2016 Update, the SEC has invited comment on its Regulation S-K disclosure requirements, including the possible mandatory sustainability reporting, and a many of the public comments urged the agency to adopt ESG disclosure rules. While a new, post-election leadership at the SEC may not follow this advice, it seems inevitable that ESG reporting, voluntary or mandatory, will be a major public company reporting issue in the future. Audit committees should give thought to what types of ESG information are most relevant to their investors and how to provide that information in a way that meets investor needs.

PCAOB 2015 Inspections Status Report

As of November 9, the Board had not issued any additional 2015 inspection reports on the largest U.S. firms since the September 2016 Update. The two reports the Board has made public with respect to its 2015 inspections of the four largest U.S. accounting firms 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.

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.

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

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