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In This Update:

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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.

PCAOB Starts an Audit Committee Dialogue

On May 7, 2015, the PCAOB issued a paper entitled Audit Committee Dialogue aimed at assisting audit committees in their "ongoing dialogue with and oversight of their auditors." According to the PCAOB, the paper is "the first in a series intended to provide insights from inspections of public company auditors that may be helpful to audit committee members in their oversight of their auditors."

The Dialogue is divided into two parts – "Key Recurring Areas of Concern" and "New Risks the PCAOB is Monitoring." The "Recurring Areas" section discusses four facets of auditing in which the PCAOB's inspection staff has found significant deficiencies during its recent inspections of the six largest global network audit firms. The recurring four deficiency areas are –

- Auditing internal control over financial reporting.
- Assessing and responding to risks of material misstatement.
- Auditing accounting estimates, including fair value measurement.
- Deficient work performed by other audit firms in cross-border audits.

For each of these topics, the Dialogue includes a short description of the nature of the deficiency and why it is important to audit committees. The PCAOB also suggests several questions that an audit committee may want to ask its auditor concerning each area. These questions are generally directed at helping the audit committee to understand how the auditor plans to address the challenges related to auditing in the recurring deficiency areas.

In contrast, the "New Risks" section of the Dialogue describes four "indicators of potential emerging risks" – that is, new areas that the PCAOB's inspection staff is focusing on in its current inspections. These emerging risks are –

- Increase in mergers and acquisitions. ("Inexperience [due to low levels of M&A in prior years] may lead to the auditor failing to detect material misstatements in the accounting for a business combination.").

- Falling oil prices. ("Specific areas of focus include impairment and valuation issues and the collectability of loans and receivables.").

- Undistributed foreign earnings. ("You should keep in mind that a conflict of interest between the company and your auditor could arise if the company faces legal liability or sanctions based on a tax strategy developed by your auditor" [e.g., strategies that involve cash transfers from foreign subsidiaries to the U.S. parent without income recognition]).

- Maintaining audit quality while growing other businesses. (If a firm's non-audit consulting revenue is increasing as a percentage of total audit firm revenue, "we are concerned about the effects such business developments may have on the firm's attention to audit quality" since a focus on consulting "could undermine the PCAOB's and the audit committees' interest in high quality audits.").

As in the case of the recurring areas, for each new risk, the Dialogue suggests questions that an audit committee may want to ask its auditor in order to determine whether, in performing the company's audit, the auditor is properly addressing the emerging risk.

Comment: Audit committee members should take a few minutes to review the Dialogue. The document is not lengthy and is written in a straight-forward, nontechnical style. Many of the topics discussed – particularly the recurring areas – are relevant to most public companies and, as the PCAOB suggests, may be the basis for useful discussion with the auditor as part of the audit committee's oversight. At the same time, audit committees should use the Dialogue as a tool to stimulate thinking about discussion topics, not as a checklist. Some of the suggested questions seem overly specific and may go beyond information that most audit committees could use or comprehend (e.g., "How will your auditor determine whether controls * * * operate at a level of precision the would prevent or detect a material misstatement?")

Study Finds That Disclosing Internal Control Weaknesses May Backfire

As noted in prior Updates, SEC officials have expressed concern that companies are not properly identifying and disclosing material weaknesses in internal controls, and that such weaknesses are too frequently disclosed only in conjunction with a restatement – after the damage is, in effect, done. See, e.g., January 2014 Update. However, an academic study in the May/June 2015 issue of The Accounting Review, published by the American Accounting Association, suggests that companies may have good reasons to be reticent about disclosing their control weaknesses: Companies that disclose material weaknesses in advance of a restatement are more likely to be penalized than those that do not. As summarized in an AAA press release, the study finds that there is --

> "[N]o evidence that penalties following a restatement are more likely for firms that fail to detect and disclose their control weakness as required. Instead, firms that do report their control weaknesses in a timely manner are generally more likely to face [varied] penalties in the event of a later restatement. These results are consistent with

> the disclosure of control weaknesses making it difficult for management to plausibly claim later that they had been unaware of the underlying conditions in the control environment that led to their restatements."

The study, entitled "Does SOX 404 Have Teeth? Consequences of the Failure to Report Existing Internal-Control Weaknesses," was authored by Sarah C. Rice of Texas of Texas A&M University and David P. Weber and Biyu Wu of the University of Connecticut. It is available for purchase on the AAA's website. According to the press release, the findings are based on analysis of the disclosures made by 659 companies that filed restatements between November 14, 2004 (when the internal control reporting requirements of SOX Section 404 became effective) and the end of 2010. During that period, 134 of the restating companies reported material weaknesses in their internal controls prior to announcing the restatement, while 525 did not report control weaknesses. Of those that did not disclose a material weakness prior to the restatement, 314 made after-the-fact disclosure of the existence of an internal control weaknesses at the time of the restatement.

The SEC enforcement risk associated with disclosing a material weakness is fairly small. The press release states that pre-restatement disclosure of a material weakness increases the likelihood of SEC enforcement action by about 6 percent, "probably because it aids the agency 'in identifying cases where potential enforcement actions are likely to succeed and make it difficult for management to claim they were unaware of the problems that led to the restatement.'" Companies that make pre-restatement disclosures may also suffer other consequences --

- Class action lawsuits are "5 to 10% more likely when firms report internal control weaknesses prior to restatements."
- "Top management turnover is 15 to 26% more likely."
- "Auditor turnover is 6 to 9% more likely."

Professor Weber summarizes the study in these terms:

> "For as long as anyone can recall, investors have complained about being blindsided by companies, where one day everything is fine and the next day it all falls apart. SOX 404 is supposed reduce the incidence of that sort of thing, but to do its job there has to be an incentive for top execs and auditors to divulge control problems in the company annual report, as mandated by the provision. I must admit that my colleagues and I were only mildly surprised that firms which fail to do so aren't penalized. What surprised us a lot more is that companies which evidently take SOX 404 to heart *are* penalized."

Comment: The study's findings may provide interesting insight into SEC enforcement policy. The study should not, however, be used as a guide to corporate disclosure policy. If the Commission were to uncover evidence that a company intentionally withheld disclosure of a known material weakness, it is quite likely that it would bring enforcement action against the individuals – including, if applicable, audit committee members who made that decision or were aware of it.

Although Restatement Frequency is Steady and Severity is Low, Class Actions Alleging Accounting Violations Are Increasing

On April 21, 2015, Audit Analytics released its annual report on financial restatement trends, Financial Restatements 2014--A Fourteen Year Comparison (available for purchase on Audit Analytics website). The study concludes that the absolute number of restatements is constant and the severity of restatements is relatively low, although there is a trend toward more restatements by large public companies. According to the report synopsis and AA's blog --

- During the last five years, the number of public company restatements has remained essentially flat. Restatements peaked at 1,842 in 2006. By 2009, restatements had fallen to 761. Restatements rose to 836 in 2010 and have remained near that number through 2014.

- While the overall number of restatements is relatively constant, the number of accelerated filers – the largest public companies – announcing restatements is rising. In 2009 and 2010, 171 accelerated filers restated. That number has increased each year since 2010. In 2014, 309 accelerated filers restated.

- The severity of restatements remained low in 2014, consistent with AA's findings during the past several years. In 2014, the average public company restatement resulted in an income adjustment of $1.9 million, the lowest adjustment amount in eight years. In addition, AA's blog states that "virtually all" of the severity indicators tracked by Audit Analytics remained low in 2014. The severity indicators are negative impact on net income; average cumulative impact on net income per restatement; percentage of restatements with no impact on income statement; average number of days restated; and average number of issues identified in restatement.

A somewhat different perspective emerges from a report released by Cornerstone Research on March 31, 2015. That report, entitled Accounting Class Action Filings and Settlements—2014 Review and Analysis, finds that securities class actions with accounting-related allegations increased in 2014; 69 new accounting cases were filed, an increase of 47 percent over 2013. (Cases are considered "accounting cases" if they involve allegations related to Generally Accepted Accounting Principles (GAAP) violations, auditing violations, or weaknesses in internal control over financial reporting.) Other highlights of the Cornerstone report include --

- More than one in four of the accounting class action complaints referred to an SEC inquiry or action. This is the highest level of private accounting suits that parallel SEC enforcement cases since Cornerstone began tracking this variable in 2010.

- Accounting cases involving restatements increased to the highest level in seven years – both in terms of the number of cases filed (29) and as a percentage of total accounting cases (42 percent).

- Since 2010, the majority of accounting cases have included allegations of internal control weaknesses. In 2014, 60 percent of cases filed involved internal control weaknesses.

- The "Disclosure Dollar Loss Index" for accounting cases involving restatements increased to its highest level since 2005. The Disclosure Dollar Loss Index is a measure of the decline in market capitalization at the end of the class period.

In Cornerstone's press release announcing the study, Dr. Elaine Harwood, a Cornerstone Research vice president and head of the firm's accounting practice, offered this explanation for the increase in class action litigation alleging accounting violations: "The increase appears to be, at least in part, a result of the SEC's heightened focus on accounting-related fraud as demonstrated by the substantial growth in accounting case filings that refer to inquiries or actions by the SEC." As to the reasons why more class actions relating to restatements were filed in 2014, Dr. Laura Simmons, a Cornerstone Research senior advisor, observed: "The increase in filings of cases involving restatements is consistent with our finding of a relative increase in negative stock price movements surrounding restatement announcements in 2014 as compared to recent years."

Comment: The Audit Analytics study is consistent with other research indicating that the reliability of financial reporting has increased post-Sarbanes-Oxley. However, as Cornerstone's research indicates, market-moving restatements, while rarer than in earlier years, still can have severe consequences, both in terms of SEC action and private litigation.

After 13 Years, SOX Compliance Costs are Still Rising, Mostly Thanks to New COSO and the Regulatory Focus on Internal Control

According to consulting firm Protiviti's 2015 Sarbanes-Oxley Compliance Survey, the costs of Sarbanes-Oxley Act compliance continue to increase, even though the statute has been on the books for 13 years. Factors that have prevented SOX compliance costs from reaching a steady state include the new COSO internal control framework (see May 2013 Update) and fallout from PCAOB inspections. These conclusions are generally consistent with last year's survey (see June 2014 Update).

Protiviti states that four "notable findings" of its 2015 survey are –

- SOX compliance costs, together with external audit fees and scrutiny, are increasing. Nearly 75 percent of organizations reported that their audit firm is "placing more focus" on evaluation of ICFR. As a corollary, audit fees rose for 58 percent of companies in their most recent fiscal year. Internal compliance costs rose as well, although, not surprisingly, costs are a function of company size: 58 percent of large companies (with revenues over $1 billion) reported spending more than $1 million in their most recent fiscal year, and 25 percent reported spending over $2 million. At the same time, 95 percent of companies with revenues under $100 million spent less than $500,000.

- A strong majority of companies are now using the new COSO framework, and they required only ICFR refinements rather than

a rebuilding effort. Overall, 78 percent of companies in the survey reported that they used new COSO as their ICFR framework in fiscal year 2014. For 63 percent of those companies, the switch from old COSO involved only "refining" their existing controls, rather than an "overhaul" of internal control. However, ten percent of companies required some type of control remediation, and one percent had to rebuild their controls from scratch.

- Compliance programs are undergoing substantial changes, especially regarding high-risk processes, IT controls and entity-level controls. An increasing number of organizations have plans to automate more of their IT processes and controls. Last year, 40 percent of large company respondents reported having significant or moderate automation plans; this year, 58 percent of large organizations described such plans.

- While compliance mastery remains an elusive state, more companies are looking to generate value from their compliance activities. In this regard, 22 percent of respondents said that their ICFR reporting structure has "significantly improved" since the company became subject to the Sarbanes-Oxley ICFR external audit requirement, while an additional 30 percent believe that the company's reporting structure had "moderately improved."

As noted above, 58 percent of the 460 companies in the Protiviti study reported that their audit fees rose in 2014, while 12 percent said fees declined and 30 percent indicated that fees stayed the same. For six percent of the companies reporting an increase in audit fees, the amount of the increase was 20 percent or more; for 23 percent, the increase was five percent or less.

Significant numbers of respondents reported that the PCAOB's audit firms inspection reports were having an "extensive/substantial" impact on the costs of their organization's Sarbanes-Oxley compliance activities. The top three areas in which extensive/substantial cost impacts were reported were "testing review of controls" (51 percent), "testing system reports and other information produced by entity" (46 percent), and "evaluating identified control deficiencies" (31 percent).

Protiviti also asked who in the organization had primary responsibility for executive sponsorship of Sarbanes-Oxley compliance and who had primary responsibility for executing SOX compliance efforts. As to sponsorship, 26 percent identified executive management, while 25 percent pointed to the audit committee. "All others" – which excluded executive management, the audit committee, management and/or process owners, and internal audit -- placed first in terms of sponsorship at 29 percent. As to execution responsibility for SOX compliance, 52 percent of respondents identified internal audit; audit committees were deemed to have primary execution responsibility by only two percent.

Comment: Audit committees may have opportunities to consider whether there are ways to convert some of their company's SOX compliance costs into an investment in more effective and efficient financial reporting and information gathering processes. Protiviti observes that the companies that have been best able to respond to the challenges of new COSO and the regulatory scrutiny of ICFR "do not focus on perfecting individual compliance activities" but rather target

"improvements in upstream business processes affecting financial reporting, as well as achieving higher levels of maturity in their overall compliance efforts." The survey results indicated that large companies have done better than midsize and small companies at generating value from SOX compliance, although, in Protiviti's view "companies of all sizes have an opportunity to strengthen ICFR and leverage SOX efforts for business process improvements related to financial reporting over time."

PCAOB Inspection Report Scorecard

On June 2, 2015, the PCAOB issued the Report on 2014 Inspection of Deloitte & Touche LLP. This report is the first report that the PCAOB has released on the 2014 inspection of one of the major U.S. accounting firms.

For the 2014 inspection cycle, the PCAOB has expanded the information in the public portion of inspection reports to include more analysis than has been included in prior reports. The new information includes such matters as the most frequently-cited auditing standards underlying deficiency findings; whether deficiencies in particular engagements relate to the financial statement audit, the ICFR audit, or both; and the revenue ranges and industry classifications of the inspected issuers. The frequency-of-standards-cited ranking and financial statement v. ICFR deficiency data parallels information that has previously been included in these Updates when the PCAOB released a large firm report.

Accordingly, rather than present a summary of individual inspection reports, future Updates will include a "Scorecard" section listing the 2014 large firm inspection reports that have been released. Once the PCAOB has made all of the 2014 major firm inspection reports publicly available, the Update will present a tabular overview of the PCAOB's 2014 large firm reports.

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. An agenda for an audit committee discussion of the firm's PCAOB inspection report is available from the undersigned.

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