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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

In This Update:

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

SEC Seeks Comment on Expanding Audit Committee Reporting

On July 1, the SEC issued a concept release inviting public comment on revisions to the Commission's audit committee reporting requirements. While the release does not make specific proposals, if all of the ideas discussed were adopted, the amount of information audit committees are required to disclose about their work would significantly increase.

At present, the audit committee reporting requirements are fairly limited. The audit committee is required to state, in a report including the names of the members, whether the committee has reviewed and discussed the audited financial statements with management; discussed with the auditor the matters required to be communicated under the auditing standards; received the PCAOB-required written communications concerning auditor independence and discussed independence with the auditor; and recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K. Certain other disclosures about the audit committee are also required, including whether the audit committee members are independent, the number of committee meetings held and member attendance, and whether the audit committee has a charter.

The eleven possible new reporting topics discussed in the concept release focus on the audit committee's oversight of the independent auditor. The reason for this focus is that, in the Commission's view, "[t]he reporting of additional information by the audit committee with respect to its oversight of the auditor may provide useful information to investors as they evaluate the audit committee's performance in connection with, among other things, their vote for or against directors who are members of the audit committee, the ratification of the auditor, or their investment decisions." The release asserts that disclosure about how audit committees discharge their auditor oversight responsibilities may "enable investors to differentiate between companies based on the quality of audit committee oversight, and determine whether such differences in quality of oversight may contribute to differences in performance or quality of financial reporting among companies."

The release divides the potential new audit committee disclosures into three groups: the audit committee's oversight of the auditor, the audit committee's process for selecting the auditor, and the audit committee's consideration of the qualifications of the audit firm and the engagement team. New audit committee reporting under consideration in each of these areas is summarized below:

Audit Committee's Oversight of the Auditor

1. Communications between the audit committee and the auditor. This disclosure might include discussion of the audit committee's consideration of required auditor communications (e.g., communications with the auditor related to the auditor's overall audit strategy, timing, and significant risks identified; nature and extent of specialized skill used in the audit; planned use of other accounting firms or other persons; planned use of internal audit; basis for determining that the auditor can serve as principal auditor; and results of the audit).

2. Frequency of auditor/audit committee meetings. While the number of audit committee meetings is already a required disclosure, the SEC states that "requiring additional disclosure [e.g., frequency of private meetings or topics discussed] about the specific meetings with the auditor may provide additional insight into the audit committee's oversight of the auditor."

3. Review and discussion of the auditor's internal quality review and PCAOB inspection report. Such disclosure might include the nature of any discussions held with the auditor about the results of the firm's internal quality review and most recent PCAOB inspection, such as whether the audit committee discussed with the auditor the inspection-report related matters recommended in PCAOB Release No. 2012-003, *Information for Audit Committees about the PCAOB Inspection Process* (August 1, 2012).

4. Whether and how the audit committee assesses, promotes and reinforces auditor objectivity and professional skepticism. The SEC states: "Heightened oversight by the audit committee of the auditor's objectivity and professional skepticism should promote greater audit quality."

Audit Committee's Process for Appointing or Retaining the Auditor

1. How the audit committee assessed the auditor and the audit committee's rational for selecting or retaining the auditor. This disclosure might include steps in the assessment process and specific elements or criteria the committee considered, such as consideration of "indicators or metrics." (As discussed in this Update, simultaneously with the issuance of the SEC's release, the PCAOB published a series of audit quality indicators for comment.)

2. If the audit committee sought proposals to perform the audit, the process undertaken and selection factors considered. This disclosure might include the number of auditors asked to propose, how they were selected, and information that the audit committee used in its decision.

3. Board policy regarding a shareholder vote on the auditor and the audit committee's consideration of the voting results. In the SEC's view, "[s]uch disclosure could provide useful information to shareholders as to how and why the board is seeking ratification of

the auditor, as well as the implication of the shareholder vote being solicited."

Audit Committee Consideration of the Qualifications of the Audit Firm and Engagement Team

1. Engagement team members. Engagement team disclosure might include the name of the engagement partner, alone or with the names of other key members of the engagement team. (As discussed in this Update, simultaneously with the issuance of the SEC's release, the PCAOB proposed to require a public filing disclosing of the name of the engagement partner.) In addition, the committee might disclose how long such individuals have served in their roles and their relevant experience (e.g., "the number of prior audit engagements performed and whether they were in the same industry").

2. Audit committee input into engagement partner selection. The SEC states: "Disclosures about the involvement of the audit committee in this selection, and any input the audit committee had in the decision, may provide transparency and insight into the exercise of the audit committee's responsibilities in overseeing the auditor."

3. Auditor tenure. Tenure disclosure would involve the number of years the audit firm has audited the company. "In light of the public interest in the subject of auditor tenure, disclosure of this data could provide insight into the audit committee's overall decision to engage or retain the auditor." (As discussed in the September 2013 Update, the PCAOB has proposed to require tenure disclosure in the audit report.)

4. Other firms involved in the audit. The names, locations, and responsibilities of accounting firms affiliated with the signing auditor, non-affiliated accounting firms, and other third-party participants, such as tax advisors or actuaries, that will be involved in conducting a portion of the audit work. (As discussed in this Update, simultaneously with the issuance of the SEC's release, the PCAOB proposed to require a public filing disclosing of the names of other participating accounting firms.)

With respect to each of these disclosure topics, the SEC concept release poses questions aimed at eliciting information regarding the pros and cons of the disclosure and possible consequences. The release also asks a series of more general questions, such as whether disclosure of the types of matters discussed should remain voluntary, as it is today; where audit committee disclosure should appear (e.g., proxy statement, annual report, securities registration statements); and whether audit committee disclosure requirements should apply to all public companies or whether there should be differential requirements, such as for small or emerging growth companies. Finally, the release asks whether audit committees should also be required to report on their involvement in other areas of oversight, such as risk governance, whistleblower complaints, cyber risk, or information technology risk.

Comment: Although existing audit committee disclosure requirements are minimal, audit committees increasingly make some voluntary additional disclosure concerning their work. See December 2014 Update. A variety of private groups have called for increased audit committee disclosure, and, outside the United States, new audit committee disclosures have recently been proposed or mandated. Against this background, some expansion of what audit committees tell investors about their oversight of the auditor seems inevitable. The open question is whether the SEC will accomplish this by adopting detailed disclosure rules, by issuing general guidelines, or by encouraging disclosure to continue to evolve voluntarily. It seems likely that the SEC will adopt at least some additional specific disclosure requirements regarding objective matters, such as the name of the engagement partner and other audit participants or auditor tenure. It is less clear whether disclosure regarding more subjective matters, such as how the audit committee evaluates the auditor or the nature of communications between the auditor and audit committee, would lend themselves to rules. If this kind of disclosure becomes a matter of legal compliance, drafting is likely to be handled by lawyers, and there is a high risk of boilerplate.

Expanded audit committee reporting requirements could have a significant effect on what audit committees do and, possibly, on committee member liability exposure. The public comment period will run until early September, and audit committees should consider commenting on the SEC's disclosure concepts.

PCAOB Publishes Concept Release on Audit Quality Indicators

On July 1, the PCAOB issued a concept release inviting public comment on 28 audit quality indicators (AQIs). The Board describes these indicators as "a potential portfolio of quantitative measures that may provide new insights about how to evaluate the quality of audits and how high quality audits are achieved." The PCAOB envisions that audit committees would be one of the "potential primary users" of AQIs. The release notes that listed company audit committees are directly responsible for the appointment, level of compensation, and oversight of their companies' auditors and suggests that AQIs may give the audit committees "additional relevant data to explore these matters and enhance dialogue with their auditors."

The 28 indicators that comprise the AQI framework are organized under three topics (audit professionals, audit process, and audit results), each of which has several subtopics:

Audit professionals

- *Auditor availability*

    1. Staffing Leverage -- time of experienced senior personnel relative to the volume of audit work they oversee.

    2. Partner Workload -- data about the level of work for which the engagement partner is responsible and the claims on his or her attention.

    3. Manager and Staff Workload -- information about the workload of audit managers and staff.

    4. Technical Accounting and Auditing Resources -- firm central personnel (or other resources engaged by the firm) available to provide engagement teams with advice on complex,

unusual, or unfamiliar issues and the extent to which they are used in a particular engagement.

5. Persons with Specialized Skill and Knowledge -- use in an audit engagement of persons with "specialized skill and knowledge," other than accounting and auditing personnel included under indicator #4.

- *Audit competence*

6. Experience of Audit Personnel -- level of experience of members of a particular engagement team and the weighted average experience of firm personnel generally.

7. Industry Expertise of Audit Personnel -- experience of senior members of the audit team, as well as specialists, in the industry in which the audited company operates.

8. Turnover of Audit Personnel -- transfers to other engagements or movement to other firms, at the engagement and, more generally, at the firm, level.

9. Amount of Audit Work Centralized at Service Centers -- degree to which audit work is centralized by the audit firm at service centers.

10. Training Hours per Audit Professional -- hours of relevant training (including industry-specific training) that members of the engagement team, and of the team's firm, have received.

- *Auditor focus*

11. Audit Hours and Risk Areas -- time spent by members of the audit team at all levels on risk areas identified during audit planning.

12. Allocation of Audit Hours to Phases of the Audit -- effort and staffing devoted to audit planning, interim field work, and audit completion.

<u>Audit process</u>

- *Tone at the top and leadership*

13. Results of Independent Survey of Firm Personnel -- audit firm's "tone at the top" as determined through use of a survey tool.

- *Incentives*

14. Quality Ratings and Compensation -- potential correlation between high quality ratings and compensation increases and the comparative relationship between low quality ratings and compensation increases or decreases.

15. Audit Fees, Effort, and Client Risk -- relationship between engagement or firm audit fees and hours and levels of client risk.

- *Independence*

16. Compliance with Independence Requirements -- elements of a firm's independence training and monitoring program and the importance it assigns to that program.

- *Infrastructure*

17. Investment in Infrastructure Supporting Quality Auditing -- amounts audit firm invests in people, process, and technology to support the base on which quality auditing depends.

- *Monitoring and Remediation*

18. Audit Firms' Internal Quality Review Results -- firm internal quality review results.

19. PCAOB Inspection Results -- PCAOB inspection results relating to the engagement or the audit firm.

20. Technical Competency Testing -- level of technical competence of audit personnel and the success of efforts to maintain that level of competence.

<u>Audit results</u>

- *Financial Statements*

21. Frequency and Impact of Financial Statement Restatements for Errors -- restatements for error of financial statements audited by the firm.

22. Fraud and other Financial Reporting Misconduct -- fraud and other financial reporting misconduct, at both the engagement and audit firm levels.

23. Inferring Audit Quality from Measures of Financial Reporting Quality -- whether (and which) measures of financial reporting quality used by investment analysts, academics, and regulators can also be used as measures of audit quality.

- *Internal Control*

24. Timely Reporting of Internal Control Weaknesses -- extent to which audit firm identifies material weaknesses in issuer's internal controls over financial reporting on a timely basis.

- *Going Concern*

25. Timely Reporting of Going Concern Issues -- timeliness of the auditor's use of a going concern paragraph in its opinions.

- *Communications Between Auditors and Audit Committees*

26. Results of Independent Surveys of Audit Committee Members -- effectiveness of auditor/audit committee communications measured through use of a survey tool.

- *Enforcement and Litigation*

27. Trends in PCAOB and SEC Enforcement Proceedings -- PCAOB or SEC audit and audit-related proceedings against the audit firm.

28. Trends in Private Litigation -- private litigation involving the audit firm.

The release includes illustrative calculations explaining how each indicator would be computed (although in some cases the release indicates that the calculation methodology "requires study"). For most indicators, an engagement-level and a firm-level calculation of the indicator could be performed.

Comments on the AQI concept release are due by September 28, 2015. The PCAOB has announced that it intends to hold a public roundtable on AQIs during the fourth quarter of 2015.

Comment: The PCAOB's proposed indicators provide a comprehensive set of measures that could be useful to audit committees in evaluating their auditor or in selecting an auditor. At the same time, the indicators are numerous and would in some cases be complex to apply, since an indicator could be interpreted as either positive or negative. As with any set of objective measures, there is also a risk that audit firms will seek to improve there profile based on the indicators, which may not necessary translate into higher quality auditing. As the PCAOB recognizes, quantitative indicators will not result in a formula for determining audit quality. At best, they will serve as discussion points for developing a better understanding of the influences that affect the quality of a particular engagement team's work and of a particular audit firm.

In reviewing the indicators, audit committees should recognize that the PCAOB's AQI project has some potential overlap with the SEC's audit committee disclosure initiative. As noted above, one of the topics the SEC is considering for potential audit committee disclosure is how the audit committee evaluates the auditor and whether the committee uses particular quality indicators. For this reason, there is a possibility that the application of the PCAOB's AQIs could evolve into a topic that audit committees will be required to discuss in an expanded audit committee report.

PCAOB Tries Again on Disclosure of Engagement Partner and Participating Accounting Firms

For the fourth time since 2009, the PCAOB is soliciting comment on requiring public disclosure of the name of the engagement partner, and of certain other audit participants, in connection with audits performed under the PCAOB's jurisdiction. On June 30, the Board issued a supplemental request for comment on a new proposed rule that would require auditors to file a form with the PCAOB disclosing the name of the engagement partner and the names of accounting firms, in addition to the signing firm, that participated in the audit. Comment on the PCAOB's revised proposal is due by August 31, 2015.

This new proposal follows a 2009 PCAOB concept release on requiring engagement partners to sign audit reports in their own name; a 2011 proposed rule that would have required the name of the engagement partner, along with information concerning other participating firms, to be included in the audit report; and a 2013 release re-proposing the 2011 rule with somewhat narrower requirements regarding the disclosure of other audit participants. See November-December 2013 Update.

The PCAOB's latest approach to engagement partner and participating firm disclosure would require the information be filed on a new PCAOB form, Form AP. Unlike the 2013 proposal, auditors would not be required to include the partner and participant names in the auditor's report, although they could do so -- in addition to filing the new form -- if they desired. The auditor would be required to file Form AP each time it issued an audit report on the financial statements of a public company or an SEC-registered securities broker-dealer. Form AP would have to be filed 30 days after the auditor's report is included in an SEC filing; in the case of an initial public offering, the deadline would be reduced to 10 days so that the information would be available before any road show. Since the objective of Form AP is public disclosure, the data reported would be "accessible through a searchable database on the Board's website."

Supporters of engagement partner disclosure argue that personal identification strengthens accountability and provide an added incentive for the engagement partner to perform his or her responsibilities with a high degree of care. Partner identification would also permit financial statement users to determine other audits for which the engagement partner has been responsible and to compile information regarding quality incidents, such a restatements, in which partners have been involved. Participating firm identification would permit users to determine whether the other firms involved -- particularly non-U.S. firms -- were subject to PCAOB inspection and, if so, to review the participating firms' inspection reports.

The PCAOB's prior attempts to require this type of disclosure have foundered on concerns about new liabilities to which engagement partners and participating firms might become subject, and, as a corollary, delays that might result in the ability of companies to raise capital when audit opinions are incorporated into Securities Act public offering registration statements. In the case of a public offering, the engagement partner and the participating firms would have to file written consents to liability as a result of their names appearing in the audit opinion. In some cases, these consents might be difficult or impossible for the company seeking to make the public offering to obtain. The PCAOB believes that including partner and participant names in a filing, rather than in the audit report, will avoid the consent problem.

Comment: It is debatable whether the SEC or the PCAOB should have primary responsibility for requiring these types of audit-related public disclosures. As discussed earlier in this Update, the SEC audit committee disclosure concept release, issued at the same time as the new PCAOB proposal, raises the possibility of an SEC rule requiring the audit committee to disclose the name of the engagement partner and information concerning other accounting firms that participated in the company's audit. If the SEC were to decide to adopt such a requirement, there seems to be no reason for the PCAOB to require the same disclosure in a PCAOB filing. In light of the SEC's broad statutory responsibility for disclosure-based investor protection, the issue of whether and how this type of information should be disclosed would seem to fall squarely within its jurisdiction.

From an audit committee perspective, mandatory engagement partner identification – regardless of the source of the requirement – could have several consequences. As noted in the November-December 2013 Update, there is some evidence that partner identification results in increased audit costs. Further, audit committees would 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 shareholder scrutiny regarding whether to change engagement partners when such events in other audits seem to reflect poorly on the partner. In addition, as the PCAOB's release acknowledges, partner identification could result in a rating, or "star," system in which particular engagement partners were in high demand and others viewed as less desirable. This would add a new dimension to the task of selecting an auditor and require deeper audit committee involvement in the choice of the engagement partner.

The Audit Committee Collaboration Publishes External Auditor Assessment Tools

On June 2, the Center for Audit Quality (CAQ) announced that the Audit Committee Collaboration had released the External Auditor Assessment Tool: A Reference for Audit Committees Worldwide and an updated version of its parallel External Auditor Assessment Tool: A Reference for U.S. Audit Committees. These assessment tools are designed to assist audit committees in evaluating the company's external auditor as part of assessing the quality of the audit or selecting, or recommending the retention of, the audit firm. The Audit Committee Collaboration is a group of organizations with an interest in strengthening audit committee performance and transparency, including the Association of Audit Committee Members, CAQ, Independent Directors Council, National Association of Corporate Directors, NYSE Governance Services, and Tapestry Networks.

The U.S. assessment tool contains sample questions that the audit committee could consider asking as part of its evaluation process. These questions are organized under three topics:

- Quality of services and sufficiency of resources provided by the auditor (these questions are subdivided into two parts, focused respectively on the engagement team and the audit firm).
- Communication and interaction with the auditor.
- Auditor independence, objectivity, and professional skepticism.

The U.S. assessment tool also includes sample questions that could be asked of company personnel in order to obtain their input concerning the external auditor with a rating system for responses. The U.S. version also has two appendices containing U.S. requirements and standards that are relevant to auditor assessment and a bibliography of suggested reading. The worldwide tool is similar, except for the U.S. requirements appendix.

Comment: The Collaboration's assessment tools provide an organized way for an audit committee to undertake an evaluation of the company's auditor. Even if the committee chose not to ask all of the sample questions, the tools are a useful way of thinking about what factors to consider and how to conduct such an evaluation. Not surprisingly, the Collaboration's tools have some similarities to the AQI's discussed in the

PCAOB concept release (described earlier in this Update), although the assessment tools do not seek to reduce the evaluation factors to quantifiable measures to the same extend as do the PCAOB's AQIs.

SEC Proposes To Require Companies to "Claw Back" Executive Compensation Following a Restatement

On July 1, the SEC proposed rules that would compel all U.S. securities exchanges to adopt listing standards directing every listed company to adopt a policy requiring recovery, on a no-fault basis, of any incentive compensation paid to an executive officer on the basis of accounting measures that were subsequently restated. The 2010 Dodd-Frank Act directed the SEC to impose such listing requirements. In a press release announcing the proposals, SEC Chair White stated that the rules "would result in increased accountability and greater focus on the quality of financial reporting."

Under proposed Securities Exchange Act Rule 10D-1, each listed company would be required to develop a compensation recovery policy. That policy would have to provide that, in the event of an accounting restatement to correct a material error, the company will recover or "claw back" from current and former executive officers any incentive-based compensation received during the prior three fiscal years that exceeds the amount that would have been received under the restatement. Recovery would be required regardless of whether the officers required to make the repayment were responsible for the errors that resulted in the restatement and regardless of whether the inaccurate financial reporting was the result of misconduct by anyone. A company would be subject to delisting if it failed to adopt such a compensation recovery policy or to enforce the policy's recovery provisions.

Other features of the proposed rule include –

- Current and former "executive officers" would be subject to the clawback requirement. For this purpose, "executive office" would be defined in a manner similar to the definition of an "officer" under the trade reporting and short-swing profit recovery provisions of Exchange Act Section 16. That definition includes the company's president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division or function, and any other person who performs policy-making functions for the company.

- Incentive-based compensation "granted, earned or vested" based on the attainment of any financial reporting measure would be subject to recovery. A "financial reporting measure" is a measure that is based, in whole or in part, on the accounting principles that are used in preparing the company's financial statements. Incentive compensation based on stock price or on total shareholder return would be included. For incentive-based compensation based on stock price or total shareholder return, companies could use a reasonable estimate of the effect of the restatement on the applicable measure to determine the recovery amount.

- A company could decline to pursue recovery only if the compensation committee (or a majority of the independent directors) determined, after reasonable attempts to collect, that further recovery efforts would impose undue costs on the company or its shareholders. A company would also be excused from collection if doing so would violate home country law.

- Each listed company would be required to file its recovery policy as an exhibit to its annual Form 10-K report. In addition, companies would be required to disclose actions taken to recover compensation in Form 10-K and in any proxy statement that requires executive compensation disclosure. These disclosures would be triggered if, during the fiscal year, a restatement requiring recovery of excess incentive-based compensation occurred, or if there was an outstanding recovery balance from a prior restatement.

The proposal was published by a 3-2 SEC vote.   Among other things, dissenting Commissioner Gallagher stated that the definition of executive officer and the no-fault recovery feature went beyond the requirements of the Dodd-Frank Act and made the proposed rule unduly broad and not "equitable." He also argued that the rule should have afforded boards discretion whether to pursue a claw back and whether to settle a claim for less than the full amount.

Comment: Assuming it is adopted in the form proposed, the claw back rule will change the stakes when management and the audit committee face decisions regarding restatements, particularly in "close call" cases. Engagement partner identification (discussed earlier in this Update) may also impact the restatement environment, if, as some have predicted, association with a restatement becomes a career-limiting event for the engagement partner. As the disincentives to restate increase, audit committees will need to become more vigilant in making sure that they are fully and evenhandedly informed in situations in which a restatement is a possibility. The claw back rule is also likely to have an impact on compensation policy. Executive officers may seek to receive more of their compensation as base salary or in other forms that are not linked to the attainment of financial reporting measures.

Center for Capital Markets Competitiveness Wants to Talk About the Unintended Consequences of ICFR Inspections

On May 29, the U.S. Chamber of Commerce's Center for Capital Markets Competeveness (CMC) sent a letter to SEC Chief Accountant James Schnurr and PCAOB Chairman James Doty requesting a meeting "to jumpstart a dialogue" with the business community on "issues impacting internal controls and audits that may erode judgment and impair capital formation." Specifically, the CMC is concerned that "the unintended consequences of the PCAOB inspection process and corresponding changes to internal control processes are eroding judgment, as well as increasing costs and burdens for work that may in some instances not lead to more effective audits or controls."

The bulk of the 19-page letter is a listing of "illustrative examples", presented in bullet-point form, of situations companies have encountered in three specific areas -- management review controls, a "checklist" or "one-size-fits-all" approach, and materiality -- that demonstrate the CMC's concerns. These include:

- It does not appear that auditors are allowed to exercise their own professional judgment, as PCAOB inspectors conclude that, if something is not documented, it did not occur. As a result, companies and auditors spend an extensive amount of time attempting to document every judgment and decision made in complex accounts to avoid having auditors receive PCAOB inspection comments. In turn, auditors end up focusing on documentation rather than substance. (Example of documentation issues related to management review controls)

- The company has certain liability accounts that require significant judgment. As part of our SOX control process, management meets on a quarterly basis to discuss the assumptions and review the appropriateness of the liability balances. Although we previously did not document meeting minutes, this meeting is evidenced by a comprehensive presentation document that is discussed during the meeting. The auditors have asked that we now document the meeting minutes or if that was not feasible, they suggested the auditors could attend the meeting as evidence of what was being discussed. (Example of documentation issues related to management review controls)

- Auditors have been required to significantly reduce their reliance on work performed by internal auditors. Despite the fact that both internal and external auditors typically report directly to the audit committee, external auditors are now required to re-perform work done by internal audit. The conclusion not to rely on the work of internal audit is not based on the merits of the facts and circumstances of the particular company, but rather is a rule that applies across the board to all companies. (Example of "checklist" or "one-size-fits all" regardless of risk approach)

- In implementing Auditing Standard No. 18 (regarding auditing of related party transactions), auditors are now asking companies to provide them with a list of the names of all related parties (even if the company has no related party transactions) and also with assurance that there are no side agreements or other arrangements (oral or written) undisclosed to the auditors. Given the GAAP definition of related parties, companies are facing challenges in putting together a complete list of related parties and side agreements. For example, companies are being told to identify all entities in which a member of management controls, or has significant influence over, or serves in a leadership role. Board members are also scoped into this listing and companies are facing challenges in being able to identify all family members who might control or influence. (Example of "checklist" or "one-size-fits all" approach to related party transactions)

- Auditors are required to accumulate information on items that are clearly immaterial at the consolidated level and, in many cases, report this information to audit committees. The PCAOB concluded about three years ago that there was a single threshold for evaluating errors in the balance sheet and income statement. As a result, auditors must accumulate information for balance sheet reclassifications at a threshold as is applied to a net earnings impact and present these to the audit committee in the "Summary of Unadjusted Audit Differences." This seems wholly inconsistent with views expressed by the SEC on materiality and leads to non-value added work by auditors, management, and the audit committee. (Example of PCAOB approach to materiality as related to reclassifications and disclosures)

- In the past year, auditors have begun to extend the "single quantitative threshold" to disclosures. In addition, they have started insisting that if one disclosure item is material than all required disclosures must be presented, regardless of materiality. These disclosure changes have been attributed to the PCAOB inspection staff. These changes have the effect of making the disclosures more detailed without providing material information to investors and are placing additional burdens on audit committees by having to review longer reports and immaterial errors or immaterial information in disclosures. There is a fundamental conflict between these changes and work underway by the SEC and FASB on disclosure effectiveness. (Example of PCAOB approach to materiality as related to reclassifications and disclosures)

The CMC believes that these examples illustrate "the overarching need to obtain the right balance in the current environment" and are the result of a lack of a dialogue between the business community and the PCAOB.

Comment: Many companies report having encountered the kinds of issues described in the CMC's letter during the last several years. The CMC's efforts to collect examples, publicize them, and start a discussion with the regulators is a positive step. It seems clear, as the CMC asserts, that the PCAOB's focus on ICFR auditing, and the PCAOB inspection staff's interpretations of Auditing Standard No. 5 and the related SEC ICFR guidance have had a major impact on audit firm practice in this area. What is less clear is whether – as the CMC seems to implicitly assume – the SEC staff would take a different view of these issues and whether a dialogue between the PCAOB, SEC, and the business community will result in any changes. For the time being, audit committees should assume that their auditor, as a result of the ICFR focus in inspections, will continue to approach these issues with the kind of rigor that has become standard.

PCAOB 2014 Inspections Status Report

On June 30, the PCAOB issued the Report on 2014 Inspection of Ernst & Young LLP. This is the second report that the PCAOB has released on its 2014 inspections of the major U.S. accounting firms. The reports issued to date are:

2014 Inspections (Reports Issued in 2015)

Firm	Report Date	Engagements Inspected	Part I Deficiencies	Percentage
Deloitte & Touche	May 12, 2015	53	11	21%
Ernst & Young	June 16, 2015	56	20	36%

For the 2014 inspection cycle, the PCAOB has expanded the information in the public portion of inspection reports to include more summary analysis than in prior reports. The new information includes such matters as tables presenting 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/ICFR deficiency data parallels information that has previously been included in these Updates. 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.

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

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