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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 Releases Inspection Brief and Risk Assessment Observations

The Public Company Accounting Oversight Board has issued two new reports, both aimed, at least in part, at helping audit committees understand the PCAOB's inspection process, the issues that are likely to attract its attention in an inspection, and questions that the audit committee may want to ask its auditor as part of the audit committee's oversight. These two reports are summarized below.

Staff Inspection Brief

On October 1, 2015, the PCAOB published a Staff Inspection Brief ("Inspection Brief") highlighting the objectives, focus, and scope of its 2015 public company audit inspections. The Inspection Brief provides general information concerning the audit engagements and audit issues that are currently attracting the attention of the Board's inspection staff and is intended to "assist auditors, audit committees, investors and preparers in further understanding the inspection process and its results." The Inspection Brief lists the following eight areas of current "key inspection focus."

1. Recurring Audit Deficiencies.

Inspectors consider audit areas in which high levels of deficiencies were found in past inspections. In that regard, the "most frequent and recurring audit deficiencies identified in the 2013 and 2014 inspection cycles" were –

- Internal control over financial reporting, particularly related to the testing of the design and/or operating effectiveness of controls.

- Assessing and responding to risks of material misstatement. "Some auditors did not always sufficiently identify the risks or respond effectively to existing risks that they have identified, such as performing tests that are not sufficiently responsive to the assessed risks." This issue is discussed in more detail in a new PCAOB report concerning implementation of the risk assessment auditing standards (see below).

- Accounting estimates and fair value measurements (particularly testing of data and assumptions used by management to develop estimates).

2. Economic Risks.

Inspectors also consider economic developments in selecting engagements to review. For 2015, economic developments that the inspection staff considers relevant to engagement selection include –

- The high pace of mergers and acquisitions activity. "[R]isks of material misstatement associated with business combinations may include complex fair value measurements of acquired assets and liabilities assumed, identification of all intangible assets, assigning goodwill to reporting units, and contingent consideration measurements."

- The search for higher-yielding investment returns. The Inspection Brief states that financial reporting risks associated with issuers' investment portfolios include "risks of overvalued assets, errors in valuing 'hard-to-value' securities, etc."

- The recent fluctuation in oil prices and its varying effects on the financial reporting risks of different industries. "Specific areas of focus include impairment and valuation risks and the collectability of loans and receivables." These risks are applicable to both companies in the oil and gas industry and to other types of companies, "regardless of whether they are directly or indirectly part of the supply chain to the oil and gas industry."

3. Industry Sector Risks.

Elevated audit risk associated with particular industries is a factor in engagement selection. While the Inspection Brief does not indicate the industries that the PCAOB currently considers risky from an audit standpoint, in 2014, approximately 70 percent of the engagements selected for inspection were in the consumer and industrial products, financial services, information technology, and telecom sectors.

4. Financial Reporting Areas.

The financial reporting areas most frequently selected for review by the inspection staff in 2014 included revenue and receivables, non-financial assets (assets acquired in business combinations, including goodwill and other intangible assets, and other long-lived assets), inventory, financial instruments, allowance for loan losses, income taxes, benefit related liabilities, and equity transactions. In 2015, additional financial reporting focus areas on which the staff is focusing include the statement of cash flows and income tax accruals (including issues arising from undistributed earnings and cash held overseas).

5. Audit Committee Communications.

The inspection staff has focused on the implementation of the PCAOB's standard concerning the information that auditors are required to communicate to audit committees (AS No. 16). In 2014, the staff found that "some engagement teams needed to improve their documentation of matters required by AS No. 16, and some had not communicated all of the matters required by AS No. 16 to audit committees, including overview of the audit strategy, timing of the audit, and all of the significant risks identified during the auditor's risk assessment procedures (primarily within Non-Affiliate Firms)."

6. Information Technology.

The inspection staff looks at the audit firm's use of technology to support the audit process, at cyber-security incidents that affected the audit clients, and at how engagement teams "evaluate "the risks of material misstatement associated with cyber-security and the related controls in the integrated audit."

7. Multinational Audits.

PCAOB inspectors "routinely inspects portions of multinational audits, including the multi-firm audit work performed by both domestic and non-U.S. firms."

8. Audit Firm's System of Quality Control.

The Inspection Brief highlights several aspects of the quality control systems of audit firms on which inspectors focus: analysis of the "root causes" of audit deficiencies; impact of firm non-audit (i.e., consulting) services on independence from audit clients; engagement quality review (i.e., second partner or concurring review of audit opinions); and implementation of the PCAOB auditing standard on related parties.

Inspection Observations on Risk Assessment

On October 15, the PCAOB released a report, Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards (No. 8 through No. 15), on how audit firms have implemented the Board's auditing standards on risk assessment. While this report appears to be aimed primarily at accounting firms, the Board states that "audit committees may find this report useful in fulfilling their responsibilities with respect to independent auditors." The report also suggests three risk assessment-related questions that audit committees may want to pose to their auditor.

The risk assessment standards -- AS No. 8 through No. 15 — were adopted in 2010. These standards govern the auditor's assessment of the risk that the financial statements may contain material misstatements, how the auditor responds to that risk in conducting the audit, and how the auditor evaluates the results of the procedures performed in an audit. The report states that the "procedures required by these standards underlie the entire audit process" and that "non-compliance with these standards can have serious implications for the audit of internal control over financial reporting ("ICFR") or the audit of the financial statements and may affect whether the auditor performs enough work to support the auditor's opinion."

In the Board's view, based on PCAOB inspections during 2012-2014, the number of audit deficiencies related to non-compliance with the risk assessment standards is high. In 2012 and 2013 respectively, the inspection staff concluded that 26 and 27 percent of audits inspected for compliance with the risk assessment standards did not in fact comply with one or more of the standards. Examples of common risk assessment standards deficiency findings included in the public portion of PCAOB inspection reports include –

- Firms did not perform substantive procedures, including tests of details, that were specifically responsive to fraud risks and other significant risks that were identified. (AS No. 13)

- Firms did not perform sufficient testing of the design and operating effectiveness of controls to support their planned level of control reliance, including testing controls over the system-generated data and reports that were used to support important controls or substantive procedures performed in response to the assessed risks of material misstatement. (AS No. 13 and AS No. 15)

- Firms did not evaluate the accuracy and completeness of financial statement disclosures. (AS No. 14)

- Firms did not take into account relevant audit evidence that appeared to contradict certain assertions in the financial statements. (AS No. 14)

The report discusses in detail the requirements of the risk assessment standards, the types of deficiencies the PCAOB's inspectors have found, the causes of those deficiencies, and steps the firms have taken to implement the standards and improve compliance. It suggests that audit committees consider asking the company's auditor several questions related to risk assessment –

- Have the PCAOB's inspections or firm's internal inspections identified any significant deficiencies in the firm's compliance with the Risk Assessment Standards, and if so, what actions has the firm taken to address these?

- Which audit areas have been identified by the auditor as having significant risks of material misstatement and, at a high level, how does the audit plan address those risks?

- In the auditor's view, how have the areas of significant risk of material misstatement changed since the prior year and why? What new risks has the auditor identified?

Comment: Both the Inspection Brief and the risk assessment standards report may be useful to audit committees in understanding what areas of the company's audit may potential attract PCAOB inspection attention and, as a corollary, the audit areas to which their auditor is likely to devote additional resources in anticipation of possible PCAOB scrutiny. Like the Audit Committee Dialogue published in May 2015 (see June 2015 Update), these documents, particularly the Inspection Brief, are part of an ongoing PCAOB initiative to help audit committees understand the inspection program and equipment them to ask their auditor more informed questions regarding inspection results and audit risk.

Audit Committee SEC Comments Urge, At Most, Principles-Based Audit Committee Reporting

As described in the July 2015 Update, on July 1, the SEC issued a concept release inviting public comment on a wide range of potential new disclosure requirements regarding audit committee oversight of the company's external auditor. 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 potential new audit committee disclosure topics fall 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.

As of October 31, the Commission had received and posted on its website 101 comments on the concept release. Roughly 20 of these comments were filed by individuals who identified themselves as current members of a public company audit committee. In some cases, letters were submitted on behalf of all members of a particular audit committee.

These comments almost uniformly oppose additional audit committee reporting requirements. Many of the comments urge that, if the SEC decides to act in this area, it should promulgate "principles-based" disclosure guidance, rather than specific requirements. Under a principles-based approach, the SEC would set out general topics as to which it expects disclosure and the objectives of that disclosure, but would afford companies and their audit committees latitude to decide what specifically to disclose, based on the company's circumstances.

Excerpts from some representative audit committee comments appear below.

- Norfolk Southern Corporation Audit Committee Chair on behalf of the Audit Committee: "While we agree with the Release's underlying theme that audit committee reporting could be enhanced, we believe that such disclosures should be voluntary and most importantly, company-specific. * * * Specifically, we believe that requiring mandatory disclosures surrounding audit committee oversight over external auditors might have the result of overshadowing and diminishing other equally important responsibilities that we as an audit committee must perform."

- Northrop Grumman Corporation Audit Committee Chair and Corporate Vice President, Controller and Chief Accounting Officer: "Although we have only had limited inquiries from our investors about this topic, we believe certain financial statement users could benefit from additional insight into processes followed by audit committees as they oversee the independent auditor, depending on the circumstances." Among other things, this comment supports disclosure of the frequency of audit committee meetings with the independent auditor and disclosure of the audit committee's processes for reviewing matters identified during PCAOB or internal firm inspections, for assessing auditor independence, objectivity, and audit quality, and for selecting a lead engagement partner.

- The Home Depot, Inc. Audit Committee: "[T]he Committee believes that the Commission's proposed disclosures may unnecessarily expand the responsibilities of and overburden audit committees, impair the audit committee's ability to use flexibility and judgment in exercising its duties, potentially hinder open, candid communications between audit committees and auditors, and discourage qualified individuals from serving on audit committees. In addition, we believe that certain proposed disclosures are unnecessary and/or would have little meaning to investors."

- Microsoft Audit Committee: "[W]e believe the SEC should appoint a Blue Ribbon Committee consisting of investors, audit committee members, independent auditors, company management and governance organizations to develop principles-based best practices without becoming overly prescriptive. Our concern with SEC rule making on this topic at this time is that it could drive a compliance-minded approach that would result in standardized, one-size-fits-all language that fails to effectively communicate how the audit committee fulfills its responsibilities."

- Entergy Corporation Audit Committee Chair (comments are solely his own and should not be ascribed to any other entity): "Entergy's investors do not request additional information or disclosure regarding audit committee oversight of its independent auditors. Investors appear primarily to be concerned that the audit firm is reputable and well-known and that the directors serving on audit committees are competent and independent. Therefore, I believe that further mandatory disclosures such as those referred to in the Concept Release would be of little to no value or interest to investors."

- Weyerhaeuser Company Audit Committee: "Instead of requiring the disclosures proposed in the Release, we believe the commission should advocate for best practices in additional voluntary disclosure from audit committees, which would result in more meaningful and succinct disclosure that could provide maximum value and insight to shareholders and cover the breadth of activities and responsibilities of the committee's work."

- Comcast Corporation Audit Committee Chair and Executive Vice President and Chief Accounting Officer: "We urge you to consider the use of disclosure objectives or principles rather than detailed requirements. Through the use of objectives, the SEC could convey the substance of what an audit committee should communicate to investors, without requiring in detail how an audit committee should disclose such information. This disclosure objectives/principles-based approach would allow an audit committee to tell its own story, focused on the most important and relevant information, given a company's particular facts and circumstances, that it would expect an investor may find relevant. In this way, part of the value for an investor may be in understanding how different companies approach their disclosure objectives."

- CoreLogic Audit Committee Chair on behalf of the Audit Committee: "Rather than a prescriptive, rules-based, one-size-fits-all approach to audit committee disclosures, we believe the Commission should instead consider a principles-based approach that informs audit committees of the various types of information that may be useful for investors under various circumstances. This could enable audit committees to then make informed, company specific decisions of what additional information would be truly informative and beneficial to stockholders in a particular report."

Comment: Although the comment period on the SEC's concept release closed in September, the Commission has not announced any plan or timetable for further action on expanding audit committee disclosure. The SEC accepts and considers late comment letters, and any audit committee that would like to have its views included in the public file can still submit a comment. At this time, it is unclear whether the SEC intends to propose new audit committee disclosure rules prior to the likely change in SEC leadership following the 2016 Presidential election.

EY Study Highlights Increase in Voluntary Audit Committee Disclosure

Ernst & Young's Center for Board Matters has released a report on Audit committee reporting to shareholders in 2015. Since 2012, the Center has reviewed the proxy statements of the Fortune 100 to assess disclosures relating to the audit committee. (The 2014 EY report was summarized in the September 2014 Update.) The 2015 report finds that "the previously observed trend of Fortune 100 companies going beyond minimum disclosure requirements and providing voluntary audit-related disclosures has continued and expanded even further." The report states that there has been a "steady pace of increasing voluntary disclosures on a year-over-year basis from 2012 to 2015 amid investor and policymaker interest in this area."

Some of the report's key findings concerning 2015 proxy disclosure include –

- 71 percent of companies stated that the audit committee is responsible for the appointment, compensation and oversight of the auditor (compared to 41 percent in 2012).
- 61 percent of companies disclosed that the audit committee was involved in the selection of the audit firm's lead engagement partner (compared to zero in 2012).
- 80 percent of companies noted that they consider non-audit services and fees when assessing the independence of the external auditor (compared to 11 percent in 2012).
- 21 percent of companies disclosed that the audit committee was responsible for audit fee negotiations (compared to zero in 2012). .
- 9 percent of companies explained the reasons for year-over-year changes in fees paid to the auditor (compared to less than 5 percent in 2012).
- 59 percent of companies disclosed the tenure of the audit firm (compared to 25 percent in 2012). Median disclosed tenure was 18 years. The report states that there is "an emerging approach to retention disclosure * * * as some companies discussed the benefits of longer tenure while providing a description of measures to protect auditor independence."
- 58 percent of companies explicitly stated that the selection of the auditor was in the best interests of the company and/or shareholders (compared to 3 percent in 2012).
- 41 percent of companies disclosed that the audit committee considers the potential impact of rotating auditors (compared to 3 percent in 2012).

- 39 percent of companies explained the rationale for appointing the auditor, including the factors used in assessing the auditor's quality and qualifications (compared to 17 percent in 2012).

The report also refers to several developments that have had the effect of encouraging companies to expand their audit committee reporting. These include --

- Letters that the United Brotherhood of Carpenters Pension Funds have sent to various S&P 500 companies during the last several years seeking additional disclosures regarding the audit committee's oversight of the audit relationship its efforts to protect auditor independence.

- BlackRock's Proxy Voting Guidelines of U.S. Securities (February 2015), which state that BlackRock "looks to the audit committee report for insight into the scope of the audit committee's responsibilities, including an overview of audit committee processes, issues on the audit committee's agenda and key decisions taken by the audit committee."

- The Audit Committee Transparency Barometer, published in December 2014, by Audit Analytics and the Center for Audit Quality and Audit Analytics, which seeks to measure the content of disclosures on audit committee oversight of the auditor. See December 2014 Update.

- The SEC's concept release on whether to require more disclosure about audit committee oversight of the independent auditor. See the prior item in this Update and the July 2015 Update.

Comment: As noted in the November-December 2013 Update, there is increasing interest in expanded audit committee reporting. The Center for Audit Quality and other organizations with an interest in strengthening audit committees have urged that companies broaden their disclosures voluntarily. The EY study confirms that many companies and their audit committees are in fact disclosing more information about the audit committee's work and about the company's relationship with its auditor. Audit committees should consider enhancing the content of their report along the lines of the CAQ recommendations and of the additional disclosures other companies are already making. Companies that fail to do so proactively are likely to face investor demands for more disclosure (like the United Brotherhood of Carpenters initiative) and possibly SEC rulemaking.

PwC's Annual Survey Finds That Directors are Concerned About Activist Intervention, While Audit Committee Members Worry Even More About Workload and Cyber Regulation

On October 6, PwC released its 2015 Annual Corporate Directors Survey. The survey, which was conducted this Summer, is based on responses from 783 public company directors. Seventeen percent of respondents serve on the board of a company with more than $10 billion in revenue, while an additional 12 percent serve on the board of a company with revenue between $5 and $10 billion. Sixty-three percent of respondents were audit committee members. Respondents' gender breakdown was 14 percent women/86 percent men.

In terms of the issues that concern directors, 47 percent of respondents are substantially or somewhat concerned about activist intervention in company strategy. This concern attracted the highest percentage of "substantial" or "somewhat" concerned responses from all respondents. In contrast, respondents that are audit committee members were most concerned about increasing workload demands on their committee and about potential cyber-security regulation.

According to PwC's press release announcing the survey, key findings included:

- Directors are less satisfied with their peers' performance. Nearly 40 percent of respondents said that someone on their board should be replaced – an increase from 31 percent in 2012. Directors cited "diminished performance due to aging, unpreparedness for meetings and lack of expertise" as the top reasons.

- Directors are taking action in anticipation of shareholder activism. Almost 70 percent of respondents said that their board regularly communicated with the company's largest investors during the past year. Fifty-six percent are using a stock-monitoring service to provide updates on changes to the company's ownership.

- There was an increase in the percentage of directors who say their board has interacted with activists. About one-third of respondents interacted with activists during the last year and held extensive board discussions about activism; 17 percent extensively discussed the topic this year even though they have had no activist interaction – up from 14 percent in 2014.

- There are significant differences in male and female director views on the impact of board diversity. Female directors are twice as likely to "very much" believe diversity leads to enhanced board effectiveness. Similarly, 74 percent of female directors "very much" agree that board diversity leads to enhanced company performance, compared to only 31 percent of male directors.

- Director engagement with IT issues has increased. Eighty-three percent of directors are at least moderately engaged in understanding the status of major IT implementations. Similarly, 83 percent of directors describe themselves as at least moderately engaged with overseeing the risk of cyber-attacks.

- Directors rate IT strategy expertise as a bigger priority than having a director with a cyber-risk background. Eighty-nine percent of respondents said that IT strategy expertise was at least "somewhat" important.

- Managements could improve their communications. Fifty-five percent of directors at least somewhat wish their dialogue with management was less formal and more spontaneous. Almost half of directors at least "somewhat" wish these discussions were less scripted or controlled.

Several survey findings focus specifically on the audit committee and its work –

- Sixty-four percent of audit committee members are substantially or somewhat concerned about increasing demands on the audit committee.

- Fifty-one percent of audit committee members are substantially or somewhat concerned about the potential for additional federal/state cyber regulation.

- Fifty-four percent of respondents said that the audit committee had primary responsibility for oversight of IT risks. This represents a slight decline – from 56 percent – in 2012.

- Audit committee members are generally satisfied with the company's internal audit function. For example, 91 percent thought that the quality of internal audit leadership was excellent or good; 95 percent rated internal audit excellent or good on "willingness to stand their ground; and 92 percent thought that internal audit's "stature within the organization", "quality of skills", and "quality of resources" were excellent or good.

- A significant number of companies voluntarily disclose information regarding the audit committee's oversight of the external auditor (see prior item in this Update), and additional companies are considering more disclosure on auditor oversight issues. For example, 37 percent of respondents said that their companies disclose the responsibility/rational for selecting the auditor, while ten percent said they were considering such disclosure.

Comment: The PwC survey findings are largely consistent with the results of similar recent surveys of directors' concerns. See December 2014 Update ("Board Members Want Responsibility for Risk Reassigned and More and Better Information on IT – and They are Working Harder") and January-February 2015 Update ("Audit Committee Overload Redux"). In addition, the survey (like the EY report above) contains still more evidence of the momentum behind voluntary increased disclosure regarding the audit committee's work. It also confirms that audit committee workloads are increasing and that many board members see a need for greater IT expertise.

FASB Materiality Proposal: Omitting Immaterial Information is Not an Accounting Error

On September 24, the Financial Accounting Standards Board issued for public comment exposure drafts proposing amendments to the Conceptual Framework for Financial Reporting and issuance of an Accounting Standards Update (ASU) entitled Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material. According to the FASB, the objective of these exposure drafts is to improve disclosure in financial statement footnotes by making clear that companies may omit information that is not relevant – i.e., "to promote the appropriate use of discretion by organizations when deciding which disclosures should be considered material in their particular circumstances." However, critics have suggested that the effect of the FASB proposals would be to significantly reduce disclosure, including the elimination of useful information. The proposals would also reduce the scope of the information auditors must provide to audit committees, although whether or not that would impair audit committee oversight is also in dispute.

The FASB Proposals

FASB Concepts Statement 8 currently states that information is material "if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity." This statement – particularly the words "could influence" -- appears to be inconsistent with, and potentially broader than, the Supreme Court case law holding that information is material for purposes of the federal securities "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding" whether to purchase or sell a security or how to vote a proxy. However, the FASB asserts that Concepts Statement 8 was "not intended to conflict with the legal definition of materiality." Therefore, "in order to avoid creating uncertainty or confusion" the FASB is proposing to delete the discussion of materiality and replace it with a general reference to the Supreme Court's materiality definition.

The FASB is also seeking to make clear that companies are not required to include financial statement footnote disclosures that are required by the FASB's standards if, in the company's circumstances, the disclosure in question would not be material. To accomplish this, the proposed ASU would –

- State that materiality is applied to quantitative and qualitative disclosures individually and in the aggregate, in the context of the financial statements taken as a whole. Therefore, some, all, or none of the requirements in a disclosure may be material.

- Refer to materiality as a legal concept.

- State specifically that an omission of immaterial information is not an accounting error.

The FASB is also proposing to change all of its existing disclosure requirements by including in each an explicit statement that an entity must provide the required disclosures only if they are material. In addition, some disclosure requirements include a statement that "an entity shall at a minimum provide" the required disclosure. The FASB believes that this phraseology "may make it difficult to justify omitting immaterial information" and accordingly is proposing to delete it.

SEC Investor Advisory Committee Reactions

In announcing these proposals, the FASB stated that they were "clarifications" and noted that they would not "change any specific disclosure requirements." However, during discussion at the October 15 meeting of the SEC's Investor Advisory Committee, some committee members took a different view. MarketWatch quoted Professor J. Robert Brown, of the University of Denver School of Law, as stating: "FASB says it's just a clarification. This is anything but just a clarification. There's no way this cannot be seen as an effort to reduce disclosure. * * * Disclosures will be increasingly subject to legal review, and lawyers tend to err on the side of 'less is more.' Disclosures considered non-material based on the legal standard may potentially be seen as a liability risk for the company." Similarly, IAC member Professor Joseph Carcello, of the University of Tennessee, questioned the FASB's proposal and told

MarketWatch: “The proposed language is very different than what is currently there. Accepting the proposal would be backtracking in the United States on a fuller disclosure approach the rest of the world required.”

Impact on Auditor/Audit Committee Communications

One collateral effect of the FASB proposal would be to eliminate the need for the auditor to inform the audit committee of management’s determination that a disclosure required by the accounting standards has been omitted from the financial statements because is immaterial.

The PCAOB’s auditor/audit committee communications standard requires the auditor to inform the audit committee of “uncorrected misstatements related to accounts and disclosures.” Uncorrected misstatements include required disclosures that are omitted from the financial statements, and these omissions, even if immaterial, must therefore be reported to the audit committee. Since the proposed ASU would state that the omission of an immaterial disclosure is not an accounting error, these omissions would no longer be included in the list of uncorrected misstatements that the auditor must present to the audit committee. That could, in turn, have a significant impact on disclosure. The FASB found that the need to inform the audit committee deterred companies from omitting disclosures, even when management believed they were clearly immaterial. Some companies told the FASB that they would be inclined to retain immaterial disclosures, rather than “incur the costs of defending to the auditor or communicating to the audit committee the removal of the disclosure.”

Whether the audit committee’s oversight benefits from receiving information about immaterial disclosure omissions is open to debate. Dennis R. Beresford, Executive in Residence at the University of Georgia’s JM Tull School of Accounting, stated, in a letter to the FASB supporting the proposals:

> My real concern here is that the PCAOB has included such a long list of matters in required communications with audit committees that such communications may have lost their real value. At a recent meeting with a number of current audit committee members, one observed (with much head shaking agreement from the others in the room), that he gets these "42 page letters from auditors that no one really reads or understands." That should be a call to make such communications more efficient and effective. But by analogy, it might be a good observation on the state of today's footnotes to financial statements. Have they become so long and detailed that they've lost at least some of their real power to inform?

Comment: The controversy surrounding the FASB’s proposals highlights the fact that financial statement footnotes may contain information that management believes is immaterial. Audit committees may want to consider discussing with financial reporting management whether they are making these kinds of disclosures simply to avoid having to explain to the audit committee why the information is immaterial or to avoid the embarrassment of the auditor reporting the omission to the audit committee. As Professor Beresford suggests, the disclosure of irrelevant information in lengthy footnotes detracts from the ability of financial statement users to focus on what is truly important. Audit committees can help management address that problem, regardless the outcome of the FASB’s proposals.

PCAOB 2014 Inspections Status Report

The PCAOB has released three of the reports 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%
PwC	June 30, 2015	58	17	29%

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 related 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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