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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.

SEC Enforcement Hits Company and CFO, CAO, Engagement Partner, and Consultant for Mis-Characterizing Internal Control Weaknesses

On March 10, the SEC announced the settlement of administrative enforcement proceedings against Magnum Hunter Resources (MHR), an oil and gas exploration and production company, along with the company's Chief Financial Officer, Chief Accounting Officer, audit engagement partner, and a consultant retained to assess the company's internal control over financial reporting (ICFR). The thrust of the case is that management, the consultant, and the auditor improperly concluded that certain ICFR deficiencies were only significant deficiencies and did not rise to the level of material weaknesses. The case underscores the importance the SEC places on the disclosure of material weaknesses, even when they are not accompanied by financial reporting violations.

Applying the SEC's definitions of "material weakness" and "significant deficiency" to particular facts and circumstances can require the exercise of considerable judgment. Under SEC Regulation S-X:

- A "material weakness" is a "deficiency, or a combination of deficiencies, in [ICFR] such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." In this context, "reasonably possible" means that the chance of a misstatement is "more than remote".

- A "significant deficiency" is a "deficiency, or a combination of deficiencies, in [ICFR] that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting."

If a material weakness in ICFR exists at the end of the company's fiscal year, ICFR is, by definition, not effective, and management's ICFR assessment and the auditor's opinion on ICFR must disclose the material weakness. On the other hand, if only significant deficiencies in ICFR exist, controls are effective and the deficiencies do not need to be disclosed, although they must be reported to the audit committee and steps taken to remediate the deficiencies.

According to the SEC's order against the company, between 2009 and 2011, MHR made several acquisitions, and this rapid growth imposed burdens on its accounting department. In February 2011, the external auditor advised the CFO, CAO, and audit committee that the accounting department was experiencing "manpower issues" and "lacked sufficient personnel to complete required tasks on a timely basis." Beginning in November 2011, the company failed to complete its standard monthly close process and began closing its books on a quarterly basis, with only sporadic monthly closes.

For the year ending December 31, 2011, MHR retained an outside consultant to document and test its controls. In February, 2012, the consultant issued a report to management and the audit committee. The report stated that the "accounting and financial reporting team has experienced significant delays in preparing financial statements and reports" and identified control deficiencies, including: "(a) instances in which reconciliations were not prepared, reviewed, or approved on a timely basis; (b) failures to document the completion of required monthly management reviews; and (c) significant delays in preparing financial statements and reports due to 'inadequate and inappropriately aligned staffing.'" The report also stated:

> "[T]he potential for error in such a compressed work environment presents substantial risk. With complex financial and reporting structures there are few individuals within the team with the capacity to perform many tasks and there is little time for senior reporting personnel to review, analyze, and evaluate because they are performing transaction level reporting tasks." (emphasis in SEC order)

The consultant concluded, however, that these control problems represented a significant deficiency, not a material weakness, in ICFR. The company accepted this conclusion, and management's 2011 ICFR assessment reported that ICFR was effective as of December 31, 2011.

In performing the 2011 audit, the outside auditor identified the same ICFR issues as did the consultant. The engagement partner reported to the audit committee that "there is not adequate internal control over financial reporting due to inadequate and inappropriately aligned staffing." He also noted that "this factor increases the possibility of a material error occurring and being undetected and reduces the Company's ability to file its 10-K on time." Nonetheless, the engagement partner also decided that these control deficiencies rose only to the level of significant deficiencies, rather than material weaknesses. The SEC order states that both management and the auditor based their conclusions, at least in part, on the fact that there were no material errors in the 2011 financial statements.

The severity of Magnum's ICFR issues came to light in late 2012. On November 14, the company restated it second quarter Form 10-Q to correct a material error related to stock-based compensation. In connection with the restatement, management disclosed that material weaknesses existed as of June 30, 2012 related to, among other things, "a lack of sufficient, qualified personnel to design and manage an effective control environment." In its 2012 Form 10-K, the company disclosed 14 material weaknesses, including that "[i]n certain areas the Company did not have sufficient personnel with an appropriate level of knowledge, experience and training commensurate with the growth of the

Company's corporate structure and financial reporting requirements" and not upgrading "resources around internal audit, tax, financial reporting and certain accounting areas."

The SEC found that MHR and the individuals failed to properly evaluate and apply applicable ICFR standards and improperly concluded that MHR had no material weaknesses as of December 31, 2011. As stated in the SEC's MHR order:

> "[W]hile actual errors may inform assessments of control deficiencies, the presence of an actual error is not a prerequisite to concluding that a material weakness exists. Rather, management is to consider whether there is a reasonable possibility that a material misstatement will not be timely detected or prevented. In addition, the effectiveness of a company's ICFR is assessed at a specific point in time—as of the end of the fiscal reporting period. Planned or anticipated remedial efforts are irrelevant to the analysis."

Without admitting or denying the violations, the company consented to the issuance of the SEC's order directing it to cease-and-desist from violating the reporting and internal control provisions of the Securities Exchange Act. The company also agreed to pay a civil penalty of $250,000. Cease-and-desist orders by consent were also entered against the CFO, CAO, engagement partner, and consultant. The consultant and CFO were also ordered to pay civil penalties of respectively $15,000 and $25,000. The engagement partner and CAO were barred from practicing before the Commission, with the right to seek reinstatement after one year.

Comment: As discussed in prior Updates (e.g., February-March 2016 Update and October-November 2014 Update), the SEC's enforcement program (like the PCAOB's inspection program) is focused on ICFR compliance. This case is a reminder that the requirement to maintain effective internal control is a statutory obligation, violations of which can result in enforcement action, independent of the existence of any financial reporting violations. The SEC staff has in the past raised questions about the fact that material weaknesses are seldom disclosed until the company is compelled to restate to correct a material error in its financial reporting. See January 2014 Update. This case illustrates the Commission's willingness to examine whether restating companies should have disclosed material weaknesses prior to the restatement and to impose penalties when it appears that individuals were aware of the weaknesses.

For audit committees, the lesson is that it is important to ask questions and understand management's rationale when the committee is informed that there are significant deficiencies in ICFR. While the committee should not be expected to substitute its judgment for that of experts as to whether a deficiency is material or significant, audit committees should recognize that the absence of material errors in the financial statements is not a basis for concluding that a control deficiency is not a material weakness.

SEC Chair and Chief Accountant are Concerned About the Growing Use of Non-GAAP Financial Measures and Warn that Audit Committees Should Be as Well

In recent public statements, senior SEC officials have expressed concern about the proliferating use of non-GAAP measures in public company financial reporting. These statements have often been accompanied by suggestions that the audit committee should be taking a close look at the company's selection and presentation of non-GAAP data.

Non-GAAP measures are numerical financial metrics that are created by adjusting a measurement computed under generally accepted accounting principles (GAAP) to eliminate elements of the GAAP figure. The objective, at least in theory, is to provide a more meaningful measure of some aspect of the company's activities. Earnings before interest, taxes, depreciation, and amortization (EBITDA) is a common (and uncontroversial) example. SEC Regulation G permits companies to disclose non-GAAP information that the company believes is relevant and useful to an understanding its performance and financial operations, but requires the non-GAAP disclosures to be reconciled to GAAP and given equal prominence with GAAP financial reporting.

In her December 9, 2015 address to the American Institute of Certified Public Accountants' Conference on SEC and PCAOB Developments (see January 2016 Update), SEC Chair Mary Jo White said that non-GAAP reporting "deserves close attention" and "in some instances, may be a source of confusion." Regarding company oversight of these disclosures she stated:

> "While your chief financial officer and investor relations team may be quite enamored of non-GAAP measures as useful market communication devices, your finance and legal teams, along with your audit committees, should carefully attend to the use of these measures and consider questions such as: Why are you using the non-GAAP measure, and how does it provide investors with useful information? Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules? Are your explanations of how you are using the non-GAAP measures – and why they are useful for your investors – accurate and complete, drafted without boilerplate? Are there appropriate controls over the calculation of non-GAAP measures?"

On March 16, Chair White reiterated her concerns about the use of non-GAAP measures during comments at the U.S. Chamber of Commerce's Capital Markets Summit (available as a video on the Chamber's website; discussion of non-GAAP measures begins at minute 33). Two days earlier, SEC Commissioner Kara Stein also raised questions about non-GAAP measures – which she referred to as "earnings before bad stuff" – in her statement at the SEC's March 14 public meeting on the PCAOB's 2016 budget. And, on March 22, in an address to the 12th Annual Life Sciences Accounting and Reporting Congress, SEC Chief Accountant James Schnurr discussed non-GAAP measures:

> "I am particularly troubled by the extent and nature of the adjustments to arrive at alternative financial measures of profitability,

> as compared to net income, and alternative measures of cash generation, as compared to the measures of liquidity or cash generation. In my view, preparers should carefully consider whether significant adjustments to profitability outside of customary measures such as EBITDA or non-recurring items or other charges to the business, such as the sale of portions of the business in order to provide the user with an understanding of how these events impact trends and future performance, are appropriate. As it relates to cash measures, I believe those measures should be reconciled to cash flow from operations."

Like Chair White, Chief Accountant Schnurr urged that the audit committee play a role in evaluating the use of non-GAAP measures. He stated that non-GAAP reporting "should warrant increased focus by management and the audit committee" and that this focus "should go beyond determinations that the measures comply with the Commission's rules and include probing questions on why, in contrast to the GAAP measure, the non-GAAP measure is an appropriate way to measure the company's performance and is useful to investors."

Comment: These comments by SEC officials signal that review of non-GAAP reporting is a priority issue for the SEC. Audit committees should be aware of the non-GAAP measures their company is disclosing and of the rationale for those measures. Attention should also be paid to the controls around the accuracy of the calculations involved, particularly when those calculations include metrics that are not within the scope of ICFR (e.g., changes in number of customers). The four questions suggested by Chair White (and quoted above) would be a good starting point for a discussion of non-GAAP measures. Another useful reference is a recent publicly-available Deloitte publication, Top 10 Questions to Ask When Using a Non-GAAP Measure.

81 Percent of the S&P 500 Published Sustainability Reports Last Year, and the SEC is Taking Notice; Institutional Investors, Not So Much

Voluntary sustainability reporting has become the norm for large public companies in the United States, and a new SEC release suggests that the Commission is considering whether to change its longstanding position and require sustainability disclosures. At the same time, a recent survey finds that most institutional investors do not use sustainability information in their decision-making.

G&A Annual Survey

On March 15, the Governance & Accountability Institute (G&A), a sustainability consulting firm, released the results of its fifth annual analysis of sustainability reporting by S&P 500 companies. G&A found that 81 percent of the companies in the S&P 500 index published a sustainability or corporate responsibility report in 2015. The popularity of voluntary sustainability reporting has increased dramatically during the past five years. According to G&A, in 2011, only 20 percent of S&P companies released such reports; 53 percent did so in 2012, 72 percent in 2013, and 75 percent in 2014.

G&A also reported that, by industry sector, the highest number of non-reporting companies were in the consumer discretionary sector (24 non-

reporters/28 percent of the sector), financials (24 non-reporters/27 percent of the sector), and information technology (15 non-reporters/22 percent of the sector). In contrast, the sectors with the lowest number of non-reporting companies were consumer staples (1 non-reporter/3 percent of the sector), telecommunications services (1 non-reporter/ 20 percent of the sector), and materials (no non-reporters). (Sector percentages in this paragraph were computed by the Update.)

Hank Boerner, G&A's Chairman, stated in a press release: "As we continue to see a steady increase in corporate sustainability and responsibility reporting, we wonder what the thinking is in the non-reporting enterprises. These companies are now clearly laggards in this important peer group (the S&P 500), which is a very important benchmark for institutional investors."

SEC Disclosure Effectiveness Concept Release

On April 15, the Securities and Exchange Commission published a concept release inviting comments on potential improvements to its business and financial disclosure requirements for public companies. While not the major thrust of the concept release, one interesting aspect is that it suggests that the Commission may consider requiring sustainability reporting.

In a press release, the SEC stated that it is seeking "input on whether the disclosure requirements continue to elicit the information that investors need for investment and voting decisions and how registrants can most effectively present the information." The Commission also invited comment on the costs and benefits of its disclosure requirements. The concept release is part of a broad SEC review of the disclosures that companies make to investors and how those disclosure are presented and delivered. (The topics addressed in the concept release do not include the governance and compensation disclosures that appear in proxy statements, although the Commission may invite comment on those topics in a later phase of the study. Similarly, audit committee disclosures are not included; however, the SEC invited comment on those disclosures last year (see July 2015 Update).

With respect to sustainability disclosure (referred to in the release as ESG – environmental, social, and governance), the Commission notes that it has "determined in the past that disclosure relating to environmental and other matters of social concern should not be required of all registrants unless appropriate to further a specific congressional mandate [e.g., conflict minerals disclosure – see August-September 2015 Update] or unless, under the particular facts and circumstances, such matters are material." The Commission is, however, apparently prepared to reconsider this position:

> "We are interested in receiving feedback on the importance of sustainability and public policy matters to informed investment and voting decisions. In particular, we seek feedback on which, if any, sustainability and public policy disclosures are important to an understanding of a registrant's business and financial condition and whether there are other considerations that make these disclosures important to investment and voting decisions. We also seek feedback on the potential challenges and costs associated with compiling and disclosing this information.

* * *

> "The role of sustainability and public policy information in investors' voting and investment decisions may be evolving as some investors are increasingly engaging on certain ESG matters. According to one study, investors are more likely to engage registrants on sustainability issues than on financial results or transactions and corporate strategy. One observer expressed the view that ESG is not only a public policy issue but also a financial issue, noting a positive correlation between a 'strong ESG record' and excellence in operations and management. Moreover, this observer specifically noted that regulatory risks posed by climate change are investment issues. Recent studies have also found that asset managers increasingly incorporate or have committed to incorporating ESG considerations into their financial analyses." (footnotes omitted)

The comment period on the SEC's concept release runs until mid-July.

<u>Oppenheimer Institutional/Pensions & Investments Investor Survey</u>

On March 30, OFI Global Asset Management (an affiliate of Oppenheimer Funds) and <u>Pensions & Investments</u>, a newspaper covering the money management industry, published the results of a joint survey of the "perceptions, attitudes and investment strategies" of 240 institutional investors. Survey respondents represented endowments and foundations, sponsors of corporate and public defined benefit pension plans, and sponsors of defined contribution pension plans.

With respect to the role of ESG in the decision-making, the survey report, <u>Institutional Investors: Shared Expectations, Divergent Paths</u>, finds:

> "Not least amongst this survey's compelling findings was the reported low rate of adoption of environmental, social and governance (ESG) criteria in investment decision-making principles. Of the institutional investors surveyed, 77% do not factor ESG considerations into their investment making decisions; with almost three quarter of respondents stating that either ESG's value proposition is unclear, or that they don't understand how to measure ESG's success.
>
> "While this might be read as a general lack of interest on the part of U.S. institutional investors in ESG, perhaps it is a sign that these investors are in the earliest stages of understanding and incorporating these principles in their investment decisions. Of those that do use ESG principles, the 30% that are driven by expectations of better returns may provide an opportunity for managers to hone their messages of how their approach to investing based on these principles can positively impact returns over time. More generally, it presents an opportunity for managers to refine the ways in which they articulate their commitment to, and application of, ESG principles generally."

The Oppenheimer/P&I survey presents a different picture of the role of ESG in investment decision-making than does a survey released last year by the CFA Institute. As discussed in the <u>August-September 2015 Update</u>, the CFA Institute reported that 73 percent of the 1,325 Institute members (primarily portfolio managers and research analysts) that

responded to an email survey stated that they take ESG issues into account as part of their investment decision-making.

Comment: Sustainability reporting is rapidly becoming the norm for large public (and many smaller and private) companies. Depending on the industry in which the company operates, it may face investor, customer, and/or supplier demands for more transparency concerning a variety of ESG issues, particularly those related to its supply chain and carbon foot-print. It is also likely that, over time, sustainability disclosures of various types will become mandatory, either as a result of the SEC expanding its definition of what is material for securities law reporting purposes or through direct Congressional mandates, such as the Dodd-Frank requirement regarding the use of conflict minerals. For audit committees, these types of disclosures will pose challenges involving oversight of compliance with new and possibly complex reporting requirements and of controls and procedures to assure the accuracy and reliability of these nontraditional disclosures.

PCAOB Finds High Level of Compliance With its Audit Committee Communications Standard

On April 5, the PCAOB issued a report entitled Inspection Observations Related to PCAOB Rules and Auditing Standards on Communications with Audit Committees. The report, which is based on the Board's 2014 and 2015 inspections, provides information on compliance with the standards governing the information that auditors are required to communicate to public company audit committees. In general, the report finds a high level of compliance with the communications requirements, although somewhat lower compliance among smaller audit firms.

Auditing Standard No. 16, effective for audits of fiscal years beginning after December 15, 2012, requires the auditor to communicate with the company's audit committee regarding certain matters related to the audit and to obtain certain information from the audit committee. In 2014, PCAOB conducted inspections of 219 accounting firms. These inspections involved reviewing portions of 789 public company audits, of which 551 were subject to Auditing Standard No. 16. Of these 551 audits, 335 were performed by member firms of the six largest global networks (i.e., the Big Four, plus Grant Thornton and BDO). In 140 of these inspections, the PCAOB staff interviewed the audit committee chair.

In 36 audits (or seven percent) of the 551 audits inspected in 2014, the PCAOB determined that there were deficiencies in complying with Auditing Standard No. 16. The Board states that these deficiencies "were more often identified in audits conducted by firms other than member firms of the six largest global networks". The deficiencies included instances in which firms did not:

- Communicate an overview of the overall audit strategy, timing of the audit, and all of the significant risks the firms had identified;

- Communicate, where applicable, that the firm believed there was substantial doubt about the issuer's ability to continue as a going concern and that it expected to include an explanatory paragraph to that effect in its audit report; and

- Sufficiently document oral communications made to the audit committee regarding certain matters related to the conduct of the audit.

With respect to the interviews of audit committee chairs, the report states:

> "Most audit committee chairs stated that the significant risks, including fraud risks, communicated by the auditor and the planned scope of the audit were appropriate. Audit committee chairs also noted that they focused their discussion on certain audit risks most applicable to the issuer, including revenue due to the presumed fraud risk, income taxes, emerging markets in foreign locations, and mergers and acquisitions."

The inspections staff also looked at compliance with auditor communications requirements, outside of Auditing Standard No. 16. As to those separate requirements, the most frequently-observed deficiencies (usually involving smaller audit firms) included instances in which the auditor:

- Did not make the required communications to the audit committee concerning independence;

- In required communications with audit committees regarding independence, inaccurately described PCAOB rules as requiring that the firm describe to the audit committee those relationships that, in the auditor's professional judgment, bear on independence, when in fact, the relevant rule is not qualified by reference to an auditor's professional judgment;

- Did not inquire of the audit committee about the risks of material misstatement, including fraud risks; and

- Insufficiently communicated to the audit committee the scope of tax services performed and the potential effects of all tax services on the independence of the firm.

Comment: Since auditor/audit committee communications are a PCAOB inspections priority, audit committees may want review the PCAOB's report (which is brief) to make sure they are generally comfortable that they are receiving the information required under the auditing standards. As the report reflects, this is more likely to be an issue with smaller accounting firms than with the major firms. Audit committee chairs should also be aware of the PCAOB's practice of interviewing chairs as part of the inspection of the audit firm in order to obtain insight regarding auditor/audit committee communications. Finally, it's useful not to lose sight of the purpose of the communications standards -- to provide the audit committee with insight into risks, including fraud risks, audit strategy, planned audit scope, and similar issues that are relevant to the audit committee's work. Rather than a check-the-box compliance step, these communications are intended to provide the audit committee with information and perspective from the auditor that will aid the committee in discharging its oversight responsibilities.

Securities Law Class Actions and SEC Enforcement Actions Were Both Up in 2015, Thanks in Part to Financial Reporting Cases

According to two recent studies, the size of class action settlements, and the number of securities law class actions filed, both increased in 2015. A significant share of the cases involved financial statement disclosures or accounting issues, and smaller companies in particular now seem to be in the cross-hairs. Further, the SEC brought a record number of enforcement actions in 2015 and is going strong in 2016, in part because it has deployed new analytical tools to identify possible financial reporting violations.

Cornerstone Research

Cornerstone's Research's annual report on class actions, Securities Class Action Settlements--2105 Review and Analysis, released on March 29, finds that there were 80 securities class action settlements in 2015, a 27 percent increase over 2014. This represents the highest number of settlements since 2010. The total dollar amount of settlements increased to $3 billion, 9 percent more than the average of the prior five years. The average settlement size was $37.9 million, a 123 percent increase from $17 million in 2014.

As to cases involving what Cornerstone characterizes as "accounting allegations", 52 percent of 2015 settled class actions alleged GAAP violations, a decrease from 67 percent in 2014. Restatements were involved in 22 percent of the cases. Compared to cases without restatements, restatement cases were associated with settlements that were higher as a percentage of the case's "estimated damages" (as computed by Cornerstone).

On an industry basis, 11 of the 80 settled cases involved companies in the financial sector, up 57 percent over 2014. Pharmaceutical sector settlements rose from 10 percent in 2014 to 14 percent in 2015.

PWC

During April, PWC released its annual analysis of securities law class actions, Small companies, big targets: 2015 Securities Litigation Study. PWC finds that there were 195 new federal securities law class action filings in 2015, an increase over both 2014 and 2013. Two-thirds of the 2015 cases were filed against micro-cap and small-cap companies. Smaller companies were especially prone to accounting-related allegations. "While only one-quarter of the federal securities class action cases filed in 2015 alleged some form of accounting irregularity, nearly 70% of those accounting-related suits targeted small- and micro-cap companies." PWC predicts that accounting litigation against smaller companies will continue to increase for two reasons: (1) the new GAAP revenue recognition standard, which requires the exercise of considerable judgment in revenue accounting, will take effect next year (see August-September 2015 Update), and (2) the relaxation in the JOBS Act of reporting requirements applicable to certain smaller companies, including the requirement for external auditor ICFR attestation.

Other significant points in the PWC study include:

- Accounting-related cases. Fifty of the federal securities class actions filed in 2015 included accounting-related allegations (26 percent of total cases). Seventy-four percent of those cases also included allegations that the accounting irregularities exposed, or arose from, a failure to establish adequate internal controls over financial reporting. In 2014, 58 percent of case included ICFR allegations.

  The most common accounting allegations were improper revenue recognition (21 cases) and understatement of liabilities and expenses. Eleven of the 21 revenue recognition cases (42 percent) alleged that fictitious revenue was recorded. The remaining ten cases alleged that revenue was fraudulently accelerated prior to meeting all GAAP criteria for recognizing revenue. PWC observes that this "is particularly noteworthy given that GAAP rules surrounding revenue recognition are set to change (and become more subjective) over the next year."

- Non-accounting cases. The great majority of the securities class actions filed in 2015 (145 cases or 74 percent of the total) did not include accounting-related allegations. These cases fell into four categories: initial public offerings (23 cases); M&A transactions (25 cases); allegedly false or misleading disclosures by public companies (60 cases); and allegedly late disclosure of negative information including investigations and poor product performance (37 cases).

- Officers and directors as defendants. PWC reports that one or more directors were named as defendants in 55 percent of the federal securities class actions filed in 2015 – the same percentage as in 2014. PWC also reports that the audit committee was named in 9 percent of the cases, as compared to 4 percent in 2014.

SEC Enforcement

Not to be outdone by the class action bar, the SEC's enforcement program is operating at historically high levels. According to an article in Law 360, on March 10, SEC Director of Enforcement Andrew Ceresney told a conference at the Georgetown University Law Center that the agency brought a record number of enforcement actions in 2015 and "shows no signs of slowing down in 2016." In fiscal 2015, the SEC brought 807 enforcement actions, the highest number in its history, and collected $4.19 billion in sanctions; the comparable numbers in 2014 were 755 enforcement actions and sanctions of $4.16 billion. Of the 2015 SEC actions, 135 were accounting and disclosure cases.

The Law 360 article also states that Mr. Ceresney noted that "new data analytics tools make it easier to detect insider trading and financial reporting fraud" and that "the SEC has also developed new ways to analyze financial reporting to clue the agency to potential misconduct." He is quoted as having said: "We've got this tool that allows us to look at the financial statements of companies and compare them to the financial statements of other companies, particularly in the industry in which they're in. Where we see aberrant results, it might suggest that there's a potential issue." The enforcement staff has apparently been using these analytical tools for several years. See July 2013 Update.

The enforcement staff's interest in bringing financial reporting cases does not seem to be abating. On the contrary, Mr. Ceresney said that financial reporting "is an area that we are very focused on and I think we've done well to focus on."

Comment: The PWC report offers the following as the lesson of the 2015 litigation environment:

> "A small market capitalization does not shield a public company from the large attention of a shareholder suit, nor is regulatory protection from disclosure and attestation a defense to inadequate internal controls. Any potential accounting issue or disclosure, no matter how small, may catch the attention of investors. Issuers must, therefore, be open and transparent regarding their business operations and financial results, and continuously evaluate the effectiveness of their accounting controls and financial reporting and disclosure procedures--no matter their size."

The best protection against litigation is diligence and care in overseeing the company's financial reporting. At the same time, audit committees may want to be especially sensitive to issues arising in the areas that have traditionally attracted the attention of the plaintiffs bar and the SEC, particularly revenue recognition. Thoughtful implementation of the new revenue recognition standard should also be a priority.

Worldwide, Audit Committees and Internal Audit Departments are Working Better Together, But There is Room for Improvement

On February 26, the Institute of Internal Auditors announced the release of a report, Interacting with Audit Committees: The Way Forward for Internal Audit, which examines, on a worldwide basis, communications between internal audit departments and audit committees. The report, authored by former COSO Chair Larry Rittenberg, is based in part on the CBOK 2015 Practitioner Survey in which 14,500 internal audit professionals in 166 countries and territories participated. The Global Internal Audit Common Body of Knowledge (CBOK) is an ongoing study of the internal audit profession.

The premise of the report is that internal audit's interaction with an audit committee (or equivalent board committee) is "one of the hallmarks of good governance, as well as an important relationship that supports internal audit independence and objectivity." The IIA's standards require that the chief audit executive (CAE) communicate and interact directly with the board, and, as the report notes, "where an audit committee exists, the board usually delegates audit and control oversight responsibility to the audit committee."

The report identifies four "key themes" regarding the relationship between internal audit and audit committees:

- While audit committee relationships have improved, there are too many organizations without effective audit committees. "CAEs need a direct reporting line to the board (or audit committee of the board), and the board needs to 1) truly be objective (and not

automatically defer to executive management, 2) understand the challenging role of internal audit, 3) have sufficient experience and judgment to exercise their fiduciary role, and 4) be knowledgeable about the risks of the organization."

- The frequency of [audit committee/CAE] meetings varies substantially by geographic region and by industry. "Many organizations start with very active, hands-on committees with direct oversight over their mandated responsibilities. Over time, the audit committees mature as a) the mandate becomes clarified, b) needed oversight skills are identified, c) internal audit is identified as a key asset, and d) the geographic area from which audit committee members are selected is expanded. These items, coupled with a strong audit committee chair who stays in contact with the CAE, may lead to fewer but more effective meetings during the year." (footnote omitted)

- Executive sessions [between the audit committee and the CAE] have increased, but there are differences between industries and regions. "It is surprising that 25% of the respondents that report to audit committees do not have executive sessions with the audit committee. This low percentage is partially explained by culture, particularly in Asia where the culture values management views, and management power often cannot be questioned. This is an area where internal auditors must build their relationships with audit committee chairs and ensure that executive sessions become part of the audit committee charter as well as the internal audit charter. That relationship is crucial to ensure that the internal audit activity is structured to add value to the organization."

- Boundaries for management and internal audit are changing. "Too often, we find that internal audit functions are 'aiming' to improve their value-added services in the context of the current environment. * * * In working with the audit committee, internal auditors need to understand the bigger picture and not just what is true today. * * * The changing boundaries of audit committees can also be seen by examining the agendas of audit committees, many of which have been expanded to include topics such as * * * [risk management; cybersecurity; internal control over financial reporting; compliance; ethics/tone at the top; regulation and compliance; oversight of legal processes].

  "As their agenda increases, the audit committee needs to either a) expand the number of functions that report to the audit committee (for example, a compliance group), or b) look to internal audit to provide the audit committee with "combined assurance. The combined assurance model presents an opportunity for the internal audit profession to leverage its presence to the audit committee and to streamline and enhance communications with the audit committee." (footnotes omitted)

The report concludes that, "[t]o succeed in the future, internal auditors need to increase the focus on where their organizations are going and invest in talent and tools to meet the needs of management and the

board. Otherwise, there is a risk that the profession may miss opportunities to increase its value proposition."

Comment: While the IIA report covers audit committee/internal audit relationships across a wide range of countries and cultures, the conclusion regarding the need for internal audit to focus on the changing responsibilities of the audit committee seems particularly relevant in the U.S. The 2014 TRA survey of internal audit practitioners (see August 2014 Update) reached a similar conclusion regarding the need to internal audit to align its priorities with those of the audit committee. Audit committees should consider whether the resources, responsibilities, and skills of their company's internal audit function are evolving in step with changes in the issues and risks facing the company.

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

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