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In This Update:

Prepared by:

Daniel L. Goelzer

+1 202 835 6191
Daniel.Goelzer@bakermckenzie.com

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 Chief Accountant on Advancing the Role and Effectiveness of Audit Committees

Reiterating some of the themes in his address last year to the AICPA (see December 2016 Update), SEC Chief Accountant Wes Bricker delivered a speech on March 24 entitled Advancing the Role and Effectiveness of Audit Committees at the University of Tennessee's Warren Neel Corporate Governance Center. He offers a variety of suggestions for "ways to reinforce audit committee effectiveness for high quality financial reporting."

Mr. Bricker begins by noting that audit committees "play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company's culture and internal control over financial reporting." Six of his key suggestions to promote audit committee effectiveness are:

1. Understand the Business and the Impact of the Operating Environment. Mr. Bricker gives four examples of business/environment issues of which audit committee members should be aware:

    - Operating environment. "Changes in the operating environment can result in changes in competitive pressures and different financial reporting risks."

    - Rapid growth. "Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls."

    - New business models, products, or activities. "Entering into industries, business areas or transactions with which an entity has little experience may introduce new risks associated with financial reporting, including ICFR."

    - New accounting pronouncements. "The implementation of new GAAP standards may affect risks in preparing financial statements, particularly if implementation planning or execution is lacking."

2. Balance the Audit Committee's Workload. The board should be alert to identifying and managing the risk of audit committee overload so that that the committee can operate effectively. "While audit committees may be equipped to play a role in

overseeing risks that extend beyond financial reporting, such as cybersecurity and portions of enterprise risk management, I believe it is important for audit committees to not lose focus on their core roles and responsibilities."

3. Focus on Tone at the Top and Culture. A strong control environment supports the audit committee's work, particularly because accounting judgments must be made at many levels in the organization. "One way audit committees can focus on tone and culture is by working with management to obtain a clear and common understanding of what tone means, why tone is important, and what mechanisms are in place to assess the adequacy of [the] control environment, including across any relevant divisions and geographies."

4. Stay Current on Accounting and Financial Reporting Developments. Mr. Bricker points to developments in two areas with which audit committees should be familiar.

   - New GAAP Standards. Important changes have occurred and need to be implemented with respect to the accounting standards that apply to revenue recognition (see December 2016 Update and August-September 2015 Update), leasing (see next item in this Update), and financial instruments. (The financial instruments accounting changes include a change from the "incurred loss model" to an "expected credit loss approach" and improvements in the reporting for equity investments.)

   - Non-GAAP and Key Operational Metrics. Audit committees "are well positioned to exercise healthy oversight by understanding management's process and controls to calculate the non-GAAP and other key operational measures." That oversight should include understanding:

     - Disclosure controls and procedures over the accuracy of non-GAAP calculations and consistency of the measures with those of prior periods.

     - Corporate policy with respect to non-GAAP measures and, if such a policy does not exist, the reasons why.

     - Who at the company is responsible for administering the policy and "how many times have they approved changes in reporting, why, and should the change be communicated to investors through disclosure."

5. Monitor Implementation of Corporate Objectives that Could Conflict with Financial Reporting. "Audit committees should work with other board committees as needed to monitor that important corporate objectives, such as cost reduction plans, are not unintentionally implemented in ways that would be at cross purposes with management meeting its financial reporting responsibilities or the external auditor's appropriate audit scope, engagement terms, and compensation. Some of management's standard procurement policies and processes may not be appropriately designed if used in the audit committee's selection, retention, and compensation decisions for the external auditor."

6. Consider Increased Transparency. Audit committee members should "review their audit committee disclosures and consider whether providing additional insight into how the audit committee executes its responsibilities would make the disclosures more effective in communicating with investors." Mr. Bricker suggested that audit committees and their advisors refer to the 2015 SEC concept release on audit committee disclosure (see July 2015 Update), for ideas, such as describing "the nature of the audit committee's involvement in evaluating and approving the auditor's compensation, including how compensation is determined and evaluated."

Comment: Mr. Bricker's comments provide insight into how the SEC staff views the role of audit committees and what the staff may look for in situations in which the audit committee's performance is an issue. In this respect, Mr. Bricker's suggestions regarding audit committee oversight of non-GAAP measures; the importance of not letting company procurement policies geared to cost savings interfere with the audit committee's external auditor selection process; and expanded audit committee disclosure are perhaps the most significant parts of this speech. His points regarding these topics echo his comments in his December, 2016 AICPA address.

NACD and ISA Issue New Cyber-Risk Oversight Handbook

Surveys of audit committee members consistently rank cybersecurity risk oversight as one of the top challenges they face. See, e.g., January-February 2017 Update. In response to the increased focus on the board's role in cybersecurity oversight, the National Association of Corporate Directors (NACD), and the Internet Security Alliance (ISA) have released the 2017 edition of the NACD Director's Handbook on Cyber-Risk Oversight. The Handbook, which is NACD's most frequently downloaded publication, is available here.

The Handbook is built around five core principles designed to enhance the cyber literacy and oversight capabilities of directors. These five principles, which are expressed as steps boards should consider as they seek to enhance their oversight of cyber risks, are listed below, along with a brief summary of each:

1. Directors need to understand and approach cybersecurity as an enterprise-wide risk management issue, not just an IT issue. Cyber risk should be evaluated in the same way an organization assesses physical security – as an "enterprise-wide risk management issue that needs to be addressed from a strategic, cross-departmental, and economic perspective." Assigning responsibility for cybersecurity to the IT department "inhibits critical analysis and communication about security issues, and hampers the implementation of effect security strategies."

2. Directors should understand the legal implications of cyber risk as they relate to their company's specific circumstances. These implications include required disclosures, privacy and data protection, information-sharing, and infrastructure protection.

Directors should also be aware that they could face personal liability for mismanaging cyber risks.

3. Boards should have adequate access to cybersecurity expertise, and discussions about cyber-risk management should be given regular and adequate time on board meeting agendas. Whether or not the board has a member with cyber expertise, directors should take steps to "bring knowledgeable perspectives on cybersecurity matters into the boardroom." These steps include briefings by third-party experts on whether the company's cybersecurity program is meeting its objectives; leveraging the board's independent advisors, such as the external auditor and outside counsel, who can provide "multiclient and industry-wide perspective on cyber-risk trends;" and participation in director education programs related to cybersecurity. Boards should also "set clear expectations with management about the format, frequency, and level of detail of the cybersecurity-related information they wish to receive."

4. Directors should set the expectation that management will establish an enterprise-wide cyber-risk management framework with adequate staffing and budget. Directors should seek assurance that management is taking an appropriate enterprise-wide approach to cybersecurity. The Handbook lays out a seven-step program for the establishment of an integrated approach to managing cyber risk against which the board could measure management's efforts.

5. Board-management discussions about cyber risk should include identification of which risks to avoid, which to accept, and which to mitigate or transfer through insurance, as well as specific plans associated with each approach. Since total cybersecurity is an unrealistic goal, directors and management "need to grapple with" five questions:

    - What data, and how much data, are we willing to lose or have compromised?
    - How should our cyber-risk mitigation investments be allocated among basic and advanced defenses?
    - What options are available to assist us in mitigating certain cyber risks?
    - What options are available to assist us in transferring certain cyber risks?

In addition to discussion of the five principles, the Handbook contains appendices to assist boards in overseeing cyber risk, including:

A -- Questions for the Board to Ask Management About Cybersecurity

B – Cybersecurity Consideration During M&A Phases

C -- Questions Directors Can Ask to Assess the Board's "Cyber Literacy"

D -- Assessing the Board's Cybersecurity Culture

E -- Board-Level Cybersecurity Metrics

F -- Sample Cyber-Risk Dashboards

Comment: Cyber-risk oversight is not uniformly an audit committee responsibility, and the NACD Handbook is not aimed specifically at audit committees. The Handbook is however an invaluable resource for committees that are concerned with this issue. It provides an excellent blueprint for boards to become more deeply involved in this critical area, regardless of their level of technical cyber expertise.

LeaseAccelerator Finds that Leasing Standard Implementation is Accelerating

Recent studies of the implementation of the Financial Accounting Standards Board's new leasing standard have found that many companies have taken only preliminary steps. See June-July 2016 Update. However, Lease Accounting: A 2017 Progress Report, the results of a recent survey by LeaseAccelerator, presents a somewhat more favorable picture. Among other things, LeaseAccelerator, a company that provides software solutions for compliance with accounting requirements, found that the implementation programs of roughly two-thirds of companies are on schedule.

As described in the February-March 2016 Update, the FASB has adopted new standards governing financial reporting regarding leasing activities. ASU No. 2016-02, Leases (Topic 842) will require lessees to recognize assets and liabilities for leases with terms of more than 12 months and will affect the financial statements of most companies that engage in significant leasing, whether as lessees or lessors. For public companies, the new leasing ASU will take effect for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For other organizations, it is effective for fiscal years beginning after December 15, 2019, and for interim periods beginning after December 15, 2020. See December 2015 Update. Because of the widespread use of leases, the new standards potentially impact financial reporting at many companies.

The LeaseAccelerator survey included over 250 accounting and finance leaders from US-based public and private companies, most with revenues of $1 billion or higher. Respondents were asked to assess implementation progress in areas such as project leadership, resource staffing, budget allocation, data collection and systems strategy. Key survey findings, as set forth in the executive summary, include:

- More than Two-Thirds of Companies Are On Schedule. Approximately, 70 percent of companies have assigned a project manager, "indicating an executive-level commitment towards resourcing the project." However, fewer than 30 percent have assigned a formal budget for the project, and 25 percent of companies have not started on implementation.

- Most are Finding the Project More Complex than Anticipated. The top implementation challenge is modifying business processes, policies, and controls to support the new standard. Other challenges include collecting and analyzing leasing data; upgrading and deploying new software; and managing the cross-functional work effort.

- Equipment Leases are Proving Most Difficult to Collect and Analyze. More than half of respondents have defined the data that needs to be collected and have inventoried their lease portfolio. "Leases from the IT, fleet and other equipment categories are proving to be the most challenging to analyze, along with leases embedded in service contracts and outsourcing agreements."

- Most Have Defined a Software Strategy. Approximately 70 percent of companies reported having "defined a systems strategy." The majority plan to replace spreadsheet-driven tools with a lease accounting software application. However, less than one-third have issued an RFP, selected a vendor, or started loading data into a software application.

- Few Companies Have Extended the Project Beyond Accounting. The accounting and financial reporting groups are leading the lease accounting implementation project at most companies, although about one-third of respondents have included the corporate real estate and IT groups as members of the project team. "Fewer companies have organized a true enterprise-wide team that includes critical functions such as procurement, treasury. and operations."

LeaseAccelerator's report concludes with this warning:

> "The first year of the lease accounting may prove to have been the easiest for many companies as the early phases of the project involved getting organized, securing resources and plotting a strategy. As we embark on the second year, much of the hard work begins. Companies will need to track down all of their leases and associated data. In many cases, the data will be incomplete or inconsistent, requiring additional research and cleansing. Changes to business processes and corporate controls will need to be introduced to ensure that the accounting remains accurate and up-to-date. These changes will require end-users to adopt behavior changes and take on additional responsibilities. Considerable collaboration will be required between corporate functions such as Accounting, Procurement, Treasury and the asset owners in Real Estate, IT, Operations and Logistics to overcome these hurdles."

Comment: As noted in SEC Chief Accountant Bricker's March 24 speech (see first item in this Update), implementation of the new leasing standard is one of the accounting oversight challenges audit committees currently face. Companies that engage in any significant amount of leasing should analyze the new standard and formulate an implementation plan as soon as possible. The June-July 2016 Update sets out a series of "early steps" recommended by Deloitte & Touche to evaluate the implications of the leasing standard. Audit committees should monitor the company's progress on leasing standard implementation in order to avoid last-minute surprises.

What's on Your Shareholders' Minds? Predicted Annual Meeting Questions

Two major accounting firms – PwC and BDO -- have issued their annual publications that seek to anticipate questions that shareholders are likely to raise at 2017 annual meetings. (See April 2014 Update for an example of these firms' prior lists.) Both lists include several topics related to financial reporting and other areas of audit committee responsibility.

PwC

PwC's publication, Shareholder questions: Management's considerations for 2017 annual meetings, includes questions that may arise in eight areas. The PwC topics that relate to areas under the audit committee's oversight are:

- Non-GAAP financial measures and key performance indicators (KPIs). Questions PwC foresees regarding non-GAAP measures include: "Does the company maintain a formal policy regarding non-GAAP financial measures, and have relevant disclosure controls and procedures in place? Does the company include non-GAAP measures in its earnings release that were specifically requested by investors or analysts? Has the company changed any non-GAAP measures as a result of the SEC's updated Compliance and Disclosure Interpretations (C&DIs)? Has the SEC requested the company to change or stop presenting a non-GAAP measure? If so, how was the matter resolved?"

- New accounting standards. Public companies must implement the new accounting standards applicable to revenue recognition and leasing in 2018 and 2019, respectively. PwC believes shareholders may ask:

    - How will the company's financial reporting change when it implements the new standards for revenue recognition and leases?

    - Has the company taken steps to prepare for the impact of the new standards on its accounting policies, systems, processes, and controls?

    - Has the company considered how the new standards will impact its financial statement disclosures?

    - What are the expected costs of implementing the new standards?

- Cybersecurity. PwC states that management should be prepared to discuss how the company approaches cybersecurity, who is responsible for it, its approach to mitigating related risks, and the components of its response plan in the event of a cyber attack. "Management might want to describe how it has enhanced its cybersecurity program, including describing any assessment against an industry framework and updates to training. If relevant, management might want to describe how it follows global regulatory changes related to data privacy."

The other five topics on the PwC list are:

- Board composition. Questions that PwC thinks may arise include: "What attributes does the board look for when selecting nominees? How does the board's nomination process consider diversity? How does diversity rank as a priority compared with other director attributes (e.g., experience)? Is the board considering enhancing its diversity disclosures?"

- Executive compensation. Topics concerning compensation may include the clarity of the company's proxy statement Compensation Disclosure and Analysis; preparations for disclosure of the CEO/median employee pay ratio (see January-February 2017 Update); how the company ties executive pay to company performance; and whether the company has claw-back policies to permit recovery of incentive compensation in the event of a restatement (see July 2015 Update).

- Geopolitical environment. Questions in this area could cover a broad range of topics currently in the news, such as: "Is the company prepared for potential shifts in U.S. tax policy? Will the company be affected by treaties and trade agreements that may now be subject to renegotiation? Has the company assessed the sufficiency of disclosures about risks related to Brexit?"

- Proxy access. Proxy access provides a way for shareholders to nominate director candidates to be included in the company's proxy statement and proxy card. Shareholders may ask whether the company has adopted a proxy access bylaw, and, if not, how it would address a shareholder proposal on that topic.

- Shareholder engagement. Direct engagement with shareholders has become more common, and annual meeting participants may ask whether the company has a shareholder engagement program; which investors it engages with; and whether directors participate in such discussions.

BDO

The BDO Center for Corporate Governance and Financial Reporting has also published an annual Shareholder Meeting Alert discussing topics that corporate management and boards of directors should be prepared to address in connection with the annual shareholders meeting. There are nine items on BDO's 2017 topics list, five of which are germane to audit committees:

- Cybersecurity. BDO has compiled a series of questions that boards should consider in discussions with management, and the Center states that "answers to these and other questions can better prepare boards when shareholders ask if the company has policies and controls in place, particularly for reporting material cyber-breaches to the proper authorities."

- New GAAP. "New accounting standards for revenue recognition (ASC 606) and lease accounting (ASC 842) will have a major impact on financial statements and profitability. * * * Management, with board oversight, needs to communicate with shareholders, regulators and others on these changes, to avoid surprises when they impact financial statements."

- Non-GAAP. "[W]hen providing non-GAAP disclosures in financial statements, management should communicate the reason for presenting the non-GAAP measure, be sure the information is not misleading or positioned as prominently as GAAP disclosures, and that the metric is applied consistently across reporting periods and across relative industries."

- Whistleblower Policies. Shareholders may ask:

    - "What the company is doing to communicate with employees about ethical standards?"

    - "Whether the board and/or audit committee receive regular reports on internal whistleblowing complaints?"

    - "What the board is doing to ensure that employee tips are not ignored or buried by management?"

- Director Expertise, Diversity, and Time. The BDO Center notes that audit committees now "grapple with issues ranging from cybersecurity to foreign corrupt practices to whistleblower claims." Accordingly, shareholders may inquire whether the audit committee "has the appropriate experience, access to resources, and time to address these increased responsibilities."

The remaining topics BDO highlights are:

- Trump Administration. The BDO Center states that the "most notable changes from our prior year Shareholder Alert stem from the 2016 U.S. election results and how the new administration under President Trump is positioning itself to work with congress." Specific issues that may be raised include deregulation, trade, tax reform, and risks associated with presidential tweets.

- Virtual-Only Shareholder Meetings. Boards that conduct virtual (i.e., online) shareholder meetings "should consider communicating the cost savings and flexibility of the new technology, how it allows for more shareholders to attend the meetings and steps taken by the company to ensure full transparency."

- Global Economic Concerns. In light of Brexit and rising economic protectionism, shareholders may ask whether companies with exposure to these risks "are prepared for worst case scenarios."

- M&A Opportunities. Shareholders may want to know if the company is seeking opportunities to achieve growth through acquisitions.

Comment: These lists provide a good overview of the kinds of issues that could be on the minds of shareholders and that could arise at the annual meeting. With respect to areas that are – or may be – under the audit committee's responsibility, both firms agree that non-GAAP measures, implementation of new accounting standards, and cybersecurity are likely to be priorities. Apart from whatever predictive value lists of this type may have as to shareholder questions, they provide good checklists as to the issues on which the audit committee should be focused.

Advice from the U.K. on Inviting Proposals from Auditors

The Financial Reporting Council (FRC), the U.K. regulator responsible for corporate governance and financial reporting, has released a report entitled Audit Tenders: Notes on Best Practices. Since 2012, FTSE 350 companies, have been required to put their audit out for tenders (i.e., invite proposals) every 10 years. Subsequent EU legislation, effective in 2016, requires all listed companies to conduct a tender at least every 10 years and rotate auditors after no more than 20 years. The FRC's responsibilities include monitoring the effectiveness of audit committees, and, based on its experience with the U.K. mandatory tendering requirement, the Council decided to publish the Audit Tenders report to reflect what it considers best practices in soliciting and reviewing proposals to perform a public company's audit.

Areas in which the FRC identified lessons that could be applied by audit committees include:

- Timing of a tender. Factors to consider when determining the timing of the tender include: future timing of changes in the composition of the board, particularly the audit committee chair, and in the CFO; operational or strategic changes in the business, including significant acquisitions and dispositions or major IT system changes; allowing for an adequate handover period from the old to new audit firms; co-coordinating the tender with the provision of conflicting non-audit services by tendering firms; aligning the timetable for auditor changes with related entities; and competition factors, including when competitors are likely to be conducting their own tenders.

- Which firms to invite to tender. The FRC recommends that "[a]udit committees should consider a range of firms, both Big 4 and non-Big 4 and engage with investors on this topic" and that "[a]udit committees should ask firms for their most recent FRC Audit Quality Review report at an early stage in the process to gain an understanding of the FRC's assessment of the firms' audit quality." (These reports are comparable to PCAOB inspection reports for U.S. firms.) Other factors that are relevant to selecting firms to participate in the tender include industry experience and the "geographical spread" of the company. Firms should be asked to perform conflict checks at the early stages of the process, at the time of the RFP, and immediately before the final selection.

- Balancing professional services. "Companies that use several firms for different advice, should develop a long-term strategy for the procurement of professional services which ensures that at least two firms are able to participate in the audit tender process, and satisfy auditor independence requirements by the time of appointment, without unforeseen impacts on other services received by the company."

- Engagement with investors. The "ultimate clients" of the audit are investors, not companies. Significant shareholders therefore have an interest in "a transparent tender process."

- Getting the right audit team. Companies should be clear regarding the skills and experience they are seeking in the engagement partner. Firms should be asked to put forward two or three partners at the start of the process for the audit committee to choose who should lead the tender process.

- Decision-making approaches. The FRC notes that audit committees frequently develop a "scorecard approach" to rate the audit quality offering of the firms. The FRC states: "This can be used during the process, for example to collect feedback from audit teams' meetings with management, as well as during the final presentation and review of proposal document. Audit Committees should consider what weight is given to management's assessment of the audit teams – obtained from interactions during the pitch process."

Shortly after the issuance of the Audit Tendering report, the FRC also issued a report on audit quality and steps need to improve audit quality. That report, Developments in Audit: February 2017 Update, finds that audit committee chairmen surveyed by the FRC are "overwhelmingly positive as to tendering developments and audit quality." Of those entities responding to the survey that invited tenders, 70 percent changed auditors, and 18 percent of those thought there had been "a significant change for the better in audit approach and quality."

Comment: Mandatory audit firm rotation and mandatory tendering are unlikely to become U.S. regulatory requirements in the foreseeable future. (As to the PCAOB's interest in mandatory firm rotation, see March 2014 Update.) However, in response to increasing investor interest, and evolving concepts of best practice, periodic retendering is likely to become more common. The U.K. experience may be a helpful guide for audit committees that elect to solicit bids for their audit.

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

www.bakermckenzie.com

For further information please contact:

Daniel L. Goelzer
+1 202 835 6191
Daniel.Goelzer@bakermckenzie.com

815 Connecticut Avenue
Washington, DC 20006-4078
United States