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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 Staff Will Give Companies a Pass on Conflict Minerals Reports this Year – But Not on the Rest of Form SD

On April 7, the staff of the SEC's Division of Corporation Finance announced that it will not recommend that the Commission bring enforcement action against companies that fail to file Conflict Minerals Reports this year. However, the staff will still expect companies subject to the conflict minerals disclosure rule to file Form SD describing their inquiry to determine whether conflict minerals necessary to their products originated in the Democratic Republic of the Congo (DRC) or neighboring countries.

Background

As discussed in several prior Updates (see, e.g., January-February 2017 Update), the Dodd-Frank Act directed the SEC to adopt disclosure requirements applicable to companies that make products containing "conflict minerals" (tin, tantalum, tungsten, or gold). Under the SEC rule implementing that directive, such companies must perform a reasonable country of origin inquiry (RCOI) to determine whether the conflict minerals necessary to the production or functionality of products they manufacture originated in the covered countries. If the company concludes that its conflict minerals did not originate in the covered countries, it must file Form SD disclosing that conclusion and describing its RCOI process. If the company concludes that its conflict minerals did (or may have) originated in the covered countries, it must perform due diligence to determine whether its supply chain includes groups engaged in forced labor or other violence and file (as part of Form SD) a Conflict Minerals Report describing the due diligence (including an independent private sector audit or "IPSA") and listing those products not found to be DRC conflict-free.

The National Association of Manufacturers challenged the validity of the conflict minerals rule, and, in 2014, the Court of Appeals for the District of Columbia Circuit held that the rule violated the First Amendment to the extent that it required companies "to report to the Commission and to state on their website that any of their products have 'not been found to be DRC conflict free.'" The SEC sought further review of that decision, but also issued guidance which provided that companies would not be required to describe products as "DRC conflict free" or "not found to be DRC conflict free." Further, it suspended the IPSA requirement, except in the case of companies that voluntarily chose to describe a product as "DRC conflict free" in their Conflict Minerals Report.

Earlier this month, on April 3, the District Court issued a final judgment in the conflict minerals litigation. The court remanded the rule to the Commission to determine how to address the 2014 Court of Appeals decision, including whether Congress's intent in requiring conflict minerals disclosure could be achieved in a way that does not violate the First Amendment.

New Staff Guidance

On April 7, three days after the entry of the final judgment, the staff of the Division of Corporation Finance issued new guidance on compliance with the conflict minerals rule. The guidance states that, in light of the uncertainty regarding how the Commission will resolve the issues raised by the litigation (and by recent comments the SEC solicited on the rule – see January-February 2017 Update), the Division:

> "has determined that it will not recommend enforcement action to the Commission if companies, including those that are subject to paragraph (c) of Item 1.01 of Form SD, only file disclosure under the provisions of paragraphs (a) and (b) of Item 1.01 of Form SD. This statement is subject to any further action that may be taken by the Commission, expresses the Division's position on enforcement action only, and does not express any legal conclusion on the rule."

Paragraphs (a) and (b) of Form SD Item 1.01 require companies to perform an RCOI and to disclosure the results. Paragraph (c) requires companies that conclude that their conflict mineral may have originated in the covered countries to also perform due diligence on their supply chain and to report their conclusions regarding the source of the conflict minerals. Therefore, the effect of the staff statement is to continue to require compliance with the Form SD RCOI disclosure requirements, but to indicate that the staff will not seek to impose consequences on companies that are also required under the rule to file a Conflict Minerals Report, but decline to do so.

In separate statement, Acting SEC Chairman Michael Piwowar noted that the "primary function of the extensive and costly requirements for due diligence on the source and chain of custody of conflict minerals" in the conflict minerals report requirement "is to enable companies to make the disclosure found to be unconstitutional." He added that, in light of the court's judgment, he had instructed the SEC staff to begin work on a recommendation for future Commission action regarding conflict minerals reporting. However, "until these issues are resolved, it is difficult to conceive of a circumstance that would counsel in favor of enforcing Item 1.01(c) of Form SD."

Comment: The practical impact of the new SEC staff guidance may be somewhat limited, and it is likely that many companies that are subject to the reporting requirement will file Conflict Minerals Reports, despite the staff's position. Audit committees of companies that are deciding how to proceed this year should consider several factors.

1. For many companies, conflict minerals reporting is as much a matter of customer and public relations as of legal compliance. Some types of customers will continue, for business reasons, to demand that their suppliers disclose the Conflict Minerals Report information concerning their supply chain, regardless of the

SEC's position. In addition, NGOs that are active in the human rights arena can be expected to insist that such information continue to be disclosed and may seek to pressure or embarrass companies that fail to do so.

2. The legal impact of the Division's statement is limited. The requirement in Item 1.01(c) that certain companies file a Conflict Minerals Report remains in effect. As the Division itself notes, the April 7 statement "is subject to any further action that may be taken by the Commission, expresses the Division's position on enforcement action only, and does not express any legal conclusion on the rule." At present only two of the five SEC Commissioner seats are filed, and only one of the sitting Commissioners (Acting Chairman Piwowar) has indicated that he agrees with the staff position. Further, the Division's statement is not binding on the federal courts, and it is conceivable that private parties will seek to devise theories under which litigation could be brought for failure to file a Conflict Minerals Report.

3. The 2017 Form SD May 31 filing deadline is only a few weeks away, and most companies subject to the reporting requirement will have already completed their due diligence. The incremental cost of reporting the due diligence results in a Conflict Minerals Report would not be significant in most cases. In this connection, it is important to note that the new staff guidance does not supersede or alter the staff's 2014 guidance. Therefore, companies can continue to refrain from using phrases like "DRC conflict-free" in their Conflict Minerals Reports and can avoid the need to obtain an IPSA from an external auditor.

PCAOB AuditorSearch Database is Up and Running

The Public Company Accounting Oversight Board has activated AuditorSearch, a public database of engagement partners and audit firms participating in audits of U.S. public companies. The tool is available in the "Information for Audit Committees" section of the PCAOB's website. The Board states: "Through AuditorSearch, audit committee members may find the names of the engagement partners on the audits of U.S. public companies. The names of other accounting firms that participate in the audits of public companies will be available beginning June 30, 2017."

AuditorSearch is part of the PCAOB's long-running initiative to require the public disclosure of the names of engagement partners and of the firms, in addition to the primary auditor, that participate in public company audits. See December 2015 Update. The AuditorSearch database is derived from Form AP, which an accounting firm is required to file with the Board for each audit report the firm issues with respect to the financial statements of a public company. At the time that the PCAOB adopted Form AP reporting, Board Member Harris stated: "The information in Form AP will be available on our website, which will provide investors, audit committee members, and other interested parties with an opportunity to evaluate and compare the performance of individual engagement partners as well as other participants in the audit." Chairman Doty made a similar statement. AuditorSearch fulfills that commitment.

AuditorSearch can be searched by engagement partner, public company, or PCAOB-registered audit firm. Therefore, it permits users to determine every audit reported on Form AP for which a particular engagement partner had responsibility, the name of the audit firm and engagement partner for any public company, and the public company audit engagements of any registered public accounting firm. After the requirement that participating firms be disclosed on Form AP takes effect on June 30, it will apparently also be possible to determine which firms (other than the primary auditor) participated in a public company's audit – for example, the non-U.S. affiliates of the U.S.-based primary auditor that participated in the audit of a U.S. multi-national.

Comment: AuditorSearch is part of the effort to focus more attention on engagement partners. As noted in the December 2015 Update and November-December 2013 Update, from an audit committee perspective, engagement partner identification may have several consequences. For example, audit committees will need to be aware of litigation, restatements or similar events arising in other audits for which their engagement partner was responsible, since the committee might face press or shareholder scrutiny regarding whether to change engagement partners when events in other audits seem to reflect poorly on the partner. In addition, partner identification could result in a rating, or "star," system in which particular engagement partners are in high demand (and command premium fees), while others are viewed as less desirable. This could add a new dimension to the task of evaluating an engagement partner.

CAQ Updates its Auditor Assessment Tool

On April 18, the Center for Audit Quality and the Audit Committee Collaboration released an updated version of the External Auditor Assessment Tool: A Reference for US Audit Committees. The assessment tool is designed to assist audit committees in evaluating the company's external auditor as part of assessing the quality of the audit or deciding whether to retain the firm. The prior version of the U.S. assessment tool (and the companion worldwide tool) are described in the July 2015 Update.

The U.S. assessment tool begins with an overview of the auditor assessment process. The balance of the tool contains sample questions that the audit committee could consider asking as part of its evaluation. These questions are grouped in four parts:

- Quality of Services and Sufficiency of Resources Provided by the External Auditor – The Engagement Team.
- Quality of Services and Sufficiency of Resources Provided by the External Auditor – The Audit Firm.
- Communication and Interaction with the External Auditor.
- Auditor Independence, Objectivity, and Professional Skepticism.

The online tool is formatted such that responses can be added to produce a record of the results of the information-gathering process.

The 2017 update to the assessment tool adds a section on "Recent Considerations For Discussion" which addresses three new topics:

- Implementation of New GAAP – Revenue Recognition, Leases, CECL (Current Expected Credit Losses).

- New and Proposed PCAOB Standards. The new and proposed PCAOB standards cited are Form AP reporting of engagement partner identity and certain other audit participant (see prior item in this Update) and the proposed PCAOB standard that would expand the scope of the auditor's report (see September 2016 Update).

- Other Risks. The updated tool includes discussion of two potential risks, outside the scope of the audit, that the audit committee may need to understand: Non-GAAP financial information and cybersecurity.

The tool also contains a section on "Obtaining Input from Company Personnel about the External Auditor." This part includes sample questions (and a rating system for weighing responses) that could be asked of company personnel in order to obtain their views concerning the auditor. Appendices to the assessment tool contain the text of U.S. requirements and standards that are relevant to auditor assessment and a bibliography of suggested reading.

Comment: The assessment tool provides an organized way for an audit committee to undertake an evaluation of the company's auditor. Even if the committee chose not to ask all of the sample questions, the tool is a useful framework for determining factors to consider and how to conduct an auditor evaluation.

Worldwide, 42 Percent of Inspected Audits are Deficient, and IFIAR is Exploring How Audit Committees Can Drive Improvement

The International Forum of Independent Audit Regulators (IFIAR), a group of audit regulators from 52 countries, has issued its annual report on its members' audit firm inspections, Report on 2016 Survey of Inspection Findings (March 2017). While the survey finds a slight decline in the percentage of deficient audits, the regulators conclude that "too many audit firms continue to have high rates of inspection findings." Shortly after releasing the 2016 Survey, IFIAR also issued a paper entitled Audit Committees and Audit Quality: Trends and Possible Areas for Further Consideration. That paper examines the role of audit committees worldwide and raises questions related to their oversight, their interaction with audit regulators, and how they might further enhance audit quality.

Report on 2016 Survey of Inspection Findings

Highlights of the 2016 Survey Report include:

- Thirty-six IFIAR members reported their inspection findings with respect to firm-wide quality controls. These findings included control deficiencies in the following areas (percentages indicate the percent of inspected firms with a finding in the specified

quality control area): Engagement Performance (49 percent); Independence and Ethical Requirements (40 percent); Human Resources (31 percent); Monitoring (28 percent); Client Risk Assessment, Acceptance, and Continuance (25 percent); Leadership Responsibilities for Quality within the Firm (12 percent).

- Thirty-four IFIAR members reported engagement-specific findings from their inspections of 855 audits of listed companies and systemically important financial institutions. (These companies are referred to as public interest entities or "PIEs".) The 855 audits were performed by 121 audit firms. Forty-two percent of these audits had at least one deficiency finding; in the 2015 Survey, the comparable figure was 43 percent.

- "Inspection themes" with the findings in excess of ten percent of inspected engagements were:

    - Accounting Estimates, including Fair Value Measurement (32 percent). The Report states: "Nearly half of the findings related to failures to assess the reasonableness of assumptions including consideration of contrary or inconsistent evidence where applicable. Other areas with findings include failures to perform sufficient risk assessment procedures, to test sufficiently the accuracy of data used, or to take relevant variables into account."

    - Internal Control Testing (18 percent). The report states: "The category of internal control testing with the most findings was the failure to obtain sufficient persuasive evidence to support reliance on manual internal controls. The failure to sufficiently test controls over, or the accuracy and completeness of, data or reports produced by management was observed in a number of cases and, to a lesser extent, the failure to test sufficiently information technology general and application controls."

    - Audit Sampling (17 percent).

    - Revenue Recognition (13 percent). The report states: "Findings in this area were less concentrated by type. Reported findings relate to the failure: to appropriately assess and respond to the risk of fraud in revenue recognition; to perform procedures to determine whether revenue was recorded in the appropriate period; and to understand sufficiently the terms and conditions of complex arrangements and the impact on the accounting."

    - Substantive Analytical Procedures (13 percent).

    - Inventory Procedures (12 percent).

    - Group Audits (11 percent).

In its press release announcing the 2016 Survey Report, IFIAR states that it "will continue to work directly with audit network leadership and the profession to discuss inspection findings, recurring audit quality themes and the firms' strategies and actions to improve audit quality overall."

Audit Committees and Audit Quality

The IFIAR paper on audit committees reports the results of a 2016 survey conducted by the International Organization of Securities Commissions (IOSCO) concerning worldwide requirements related to the audit committee oversight of the auditor and the audit process of publicly-listed entities. Based on the results of the IOSCO survey, IFIAR poses three groups of questions "for further consideration about how to improve the oversight role of audit committees in order to further enhance audit quality globally."

- In order to enhance audit quality, to what extent should audit committee requirements address independence and special skills and expertise? Some of the possibilities mentioned are audit committee member term limits, maximum share ownership limits, required competencies or qualifications for audit committee membership, and continuing education requirements.

- What factors should be taken into account in the periodic assessment of the auditor's performance? Auditor committee auditor assessment issues raised in the report include the need for audit quality indicators ("AQIs") for audit committee use in evaluating audit quality; the nature of consultation between audit firms and audit committees regarding the findings of the firm's independent audit regulator; and "asking audit committees to make use of other sources of information besides their own experiences and information from the company's management, which may not always be complete and objective."

- How can communications with the audit committee serve to improve audit quality? The report asks whether audit regulators should share their inspections findings directly with audit committees, whether audit committees should communicate with shareholders regarding auditor performance, and whether audit committees would benefit from more information about the activities of internal auditors, including internal audit's interactions with the external audit firm.

Comment: In many parts of the world, the quality of regulatory auditor oversight and of audit committee engagement with the auditor is less formal and less developed than in the U.S. and Europe. To some extent, the IFIAR inspection survey report and audit committee report can be seen as efforts to raise the quality of auditing and audit committee oversight. The SEC is a member of IOSCO and the PCAOB is a member of IFIAR, and the audit committee report may also be an indicator of changes in the regulatory framework that are on the horizon – or at least on the regulators' wish list.

What's the Value of an Audit? Executives and Audit Committee Members Respond

Traditionally, the value proposition of the audit (apart from compliance with a legal requirement) has been based on the confidence that it provides to investors and support for their willingness to commit capital to the reporting company. A new study, Audit Evolved, commissioned by Deloitte and conducted by Wakefield Research, suggests that executives

and audit committee members also believe that the audit provides them with insights and information that is useful in running the business and that would not otherwise have come to their attention.

Wakefield surveyed 300 C-suite executives and 100 audit committee members concerning the value and impact of financial statement audits. Findings include:

- Seventy-nine percent of executives and 91 percent of audit committee members believe that audits reveal things their companies could be doing differently or better. Further, 46 percent of executives and 62 percent of audit committee members whose audits "delivered information about market or industry insights, inefficiencies, or risks" believe they would "very likely" or "somewhat likely" have missed the information if not for the audit.

- Half of executives and 56 percent of audit committee members responded that the ability of the information from a financial statement audit to deliver "new and innovative insights" was "excellent" or "very good." Only 16 percent of executives and 12 percent of audit committee members thought it was "fair" or "poor."

- Similarly, 55 percent of executives and 65 percent of audit committee members thought that the usefulness of the information from a financial statement audit "in improving company performance" was "excellent" or "very good." Nineteen percent of executives and 14 percent of audit committee members said the utility of the information was "fair" or "poor."

The survey also asked respondents what type of information they would like to get from their audit. Audit committee members identified the following as top objectives with respect to the insights they most wanted to receive:

- Inform on spending patterns (14 percent).

- Assess effectiveness of company's business processes (13 percent).

- Uncover financial errors and mistakes (10 percent).

- Greater transparency to build trust with banks or investors (8 percent).

- Assess how well management structure is operating (7 percent).

- Ensure compliance with laws and regulations (7 percent).

Despite generally positive views of the potential value of information that can be provided as a byproduct of the audit process, many respondents conceded that their companies were not taking full advantage of this source of insight and information. Thirty-one percent of executives said that their company leveraged the information received from the financial statement audit "all or most of the time;" 35 percent said this occurred "rarely or never." Audit committee members were only slightly more

positive about whether information derived from the audit was being used; 39 percent thought that it was put to use “all or most of the time,” while 34 percent thought the company took advantage of audit insights “rarely or never.”

Comment: Whatever one’s reaction to the findings of this particular study, the fact that these questions were asked reflects the leading edge of what may potentially be a fundamental change in how companies and audit committees view the audit. As auditing relies more heavily on technology and big data, the auditor’s ability to provide the audit committee with data and analytics on the business will increase exponentially. As a corollary, auditors, because of their insight into the operations of many different companies, may be able to refine these analytical techniques and the information they generate in ways that would be difficult for the company alone. Audit committees may want to have more in-depth conversations with their auditor concerning the data that is gathered as part of the audit process and how that data can be used to create insights and information for the company that will be useful in improving the way the business is run.

Institutional Investors Say They Use ESG Disclosure, But Aren’t Satisfied with What They are Getting

As discussed in several prior Updates (see, e.g., October-November 2016 Update), surveys consistently show that increasing numbers of investors want companies to provide non-financial information concerning environmental, social and governance (ESG) matters to assist them in evaluating the company’s risk profile and strategy. Correspondingly, increasing numbers of companies make these kinds of disclosures – for example, 81 percent of the S&P 500 issued a sustainability report in 2015 – but frequently not in a way that investors regard as responsive or decision-useful. A new survey adds more data-points on these issues.

Ernst & Young (EY) and Institutional Investor (II) recently released Is your nonfinancial performance revealing the true value of your business to investors?, their third annual survey of institutional investor interest in nonfinancial disclosures. EY and II collected responses from 320 senior decision-makers at buy-side investment institutions around the world. Respondents were located in Europe/Middle East/India/Africa (42 percent), the Americas (27 percent), and Asia-Pacific including Australia/New Zealand (30 percent). Seventeen percent of respondents had $50 billion or more under management, and an additional 16 percent had between $10 billion and $50 billion. Roughly one quarter of respondents were employed by banks, while another quarter worked for third-party investment managers.

The 2017 EY/II survey report confirms both the growing level of interest in ESG information and investor dissatisfaction with the type and amount of nonfinancial information they are currently receiving. Some key findings of the 2017 report regarding demand for ESG disclosure were:

- Forty-two percent of respondents strongly agreed with the statement, “Over the long term, ESG issues – ranging from climate change to diversity to board effectiveness – have real

and quantifiable impacts." An additional 50 percent agreed. Six percent disagreed, and 2 percent strongly disagreed.

- Thirty-eight percent strongly agreed that "Generating sustainable returns over time requires a sharper focus not only on governance, but also on environmental and social factors." Fifty-one percent agreed; 10 percent disagreed, and 1 percent strongly disagreed.

- Eighty-two percent of respondents either strongly agreed or agreed that "Environmental and social issues offer both risks and opportunities, but for too long, companies have not considered them core to the their business." Only 18 percent disagreed or strongly disagreed.

- Ninety-two percent of survey participants though that public company CEOs should lay out an explicit strategy each year for long-term value creation and directly affirm that the company's board has reviewed it. Eight percent disagreed with this concept.

- Twenty-seven percent of respondents said that, in the past 12 months, a company's nonfinancial performance "frequently" played a "pivotal role" in their investment decision-making. Forty-one percent said this had occurred "occasionally," while 32 percent reported that nonfinancial performance played a pivotal role "seldom" or "never."

This excerpt from the report summarizes the survey findings regarding growth in the demand for ESG information among institutional investors:

> "In each of our three studies, we asked investors how frequently a company's nonfinancial performance had played a pivotal role in their investment decisions in the previous 12 months. In 2016, 68% responded that nonfinancial information played a pivotal role frequently or occasionally, up from 52% and 58% in 2015 and 2013, respectively. * * * [T]he proportion who dismiss nonfinancial and ESG information as immaterial or trivial has fallen. We asked about why investors wouldn't consider ESG issues in their decision-making, and 16% said that it was unclear whether nonfinancial disclosures are material or have a financial impact. That sentiment was down dramatically from 2015, when 52% of the respondents weren't sold on ESG materiality, and 2013, when 60% of the investors in the survey were unclear as to the potential materiality."

However, regarding the quality of ESG information available, the institutions surveyed by EY/II saw considerable room for improvement. When asked whether "companies adequately disclose their ESG risks that could affect their current business models," only 12 percent responded affirmatively. Eighty-one percent answered either "no" or "no, but companies should disclose these risks more fully." Seven percent said they didn't know the answer. In addition:

> "When asked about why they wouldn't consider ESG issues in their decision-making, 42% of respondents in 2016 indicated that

nonfinancial information is often inconsistent, unavailable or not verified, up from 32% in 2015 and 20% in 2013. Similarly, a growing plurality of respondents say nonfinancial measurements are seldom available for comparison with those of other companies, which garnered a 42% response in the 2016 survey, up from 16% in 2015 and 20% in 2013."

Comment: Sustainability or ESG reporting has become common practice, and investor demand for this kind of disclosure is continuing to grow. As a result, providing credible and reliable ESG information is likely to be a major challenge for public companies during the next few years. As discussed in the April 2016 Update, the SEC has invited comment on its Regulation S-K disclosure requirements, including the possible mandatory sustainability reporting, and a many of the public comments urged the agency to adopt ESG disclosure rules. Whether or not ESG disclosure becomes mandatory, producing the underlying information raises judgmental issues regarding what to disclosure and how to structure the information systems and internal controls necessary to ensure that the information is accurate and verifiable. Audit committees should be involved in the company's processes for addressing these questions and should make sure that management is giving thought to what types of ESG information are most relevant to their investors and how to provide that information in a way that meets investor needs.

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

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