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In This Update:

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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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

SEC Chief Accountant Speaks on Audit Committees

Continuing his focus on the role of the audit committee in promoting reliable financial reporting (see SEC Chief Accountant on Advancing the Role and Effectiveness of Audit Committees, March 2017 Update), SEC Chief Accountant Wes Bricker recently addressed several audit committee issues. He also called for further research on audit committee effectiveness.

On June 8, Mr. Bricker delivered remarks at the University of Southern California's 36th Annual SEC and Financial Reporting Institute. At the outset, he emphasized the link between financial reporting and strong capital markets: "When companies produce high quality financial information with the oversight of an effective audit committee, it energizes our capital markets, which provide a marketplace for the purchase and sale of securities as well as a forum for the obtaining and granting of credit." The balance of the speech touched on a wide range of financial reporting topics. Those related to audit committees included:

- Auditor tenure. Mr. Bricker noted that the PCAOB's recently-adopted changes to the auditor's report (see PCAOB Adopts New Auditor's Reporting Model, May-June 2017 Update) will, if approved by the SEC, require disclosure of how long the company's auditor has served. He outlined several ways in which auditor tenure – "[r]egardless of where, or whether, prior years of service of an audit firm is disclosed" – could be relevant to the audit committee's selection and oversight of the auditor:

  > "[A]n audit committee might consider an audit firm's prior service experience in contributing to the firm's understanding of the company's business and audit risks. And, also, an audit committee may want to incorporate prior auditor service into its oversight of the auditor's expertise, incentives and, ultimately, appropriate performance in the conduct of the audit."
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  > "These are only several considerations, recognizing that years of service is often a matter to be evaluated in the context of company- and firm-specific facts and circumstances. In doing so, it is useful to keep in mind that the PCAOB's standard on ARM notes that existing research on any relationship between an auditor's tenure and either

audit quality or auditor independence has varied conclusions."

- Auditor independence. Mr. Bricker stated that audit committees play an important role in "protecting auditor objectivity, in part, through direct oversight of the audit relationship." Accordingly, the "audit committee must own the selection of the audit firm, make the final decision when it comes time to negotiate the audit fee, and oversee the auditor's independence." He also warned that independence issues may unexpectedly impact auditor selection because a successor auditor must be independent at both the start of the audit and during professional engagement period. In some situations, this requirement raises complexities, such as when the company is required to adjust prior financial statements. The auditor must be independent under the Commission's rules in order to audit the adjustments. "Accordingly, an audit committee may wish to consider those types of circumstances as part of its determinations about selecting a successor auditor and also keep this in mind before entering into any relationships that would impair the predecessor auditor's independence after the end of the predecessor's professional engagement period. OCA is available to consult on these matters, as necessary."

- Audit quality. Audit committees can also promote audit quality by working with the engagement team to help ensure that time and fee pressures don't adversely affect the audit. "Just as management needs to allocate sufficient time and resources to the preparation of their books and records (with good internal controls), so too should public accounting firms work with the audit committee (and management) to agree on appropriate deadlines and audit fees to ensure that audit quality is consistently maintained."

The following day, June 9, Mr. Bricker spoke at the 2017 Journal of Accounting and Public Policy Conference. In his keynote address, he urged academic researchers to "advance the understanding of the role of audit committees in fostering effective internal control over financial reporting, and the factors that strengthen or weaken audit committees' effectiveness." In the wake of the Sarbanes-Oxley Act, "studies consistently find that independence and expertise of audit committees are associated with enhanced financial reporting quality. However, there continues to be interest in further ways to advance the consistency in effectiveness of audit committees in corporate governance for companies of all sizes." For example –

> "In July 2015, the Commission issued a Concept Release on 'Possible Revisions to Audit Committee Disclosures.' The release sought input on understanding the types of disclosures about audit committees' work related to the audit committees' oversight of the external auditor that might be beneficial to investors. In this regard, an area where academic research might be of interest is further work on the characteristics and skills of audit committee members that contribute to their effective oversight of financial reporting."
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> "Studies could also examine the types of information that are informative to audit committee members in their oversight roles. For example, academic research finds that book-to-tax differences can

be a source of insight to potential earnings manipulation. Would more attention by some audit committees on the disclosures of book-to-tax differences already in the financial statements facilitate additional insight and understanding of management's financial reporting?"

Comment: Mr. Bricker's has emphasized the role and responsibilities of audit committees in a series of speeches during the past several months. See March 2017 Update and December 2016 Update. As noted in these prior Updates, 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. The comments in these speeches may also have an impact on the SEC's future disclosure requirements. The Commission recently published an updated version of its regulatory agenda, including as an agenda item (under the responsibility of Mr. Bricker's office) rulemaking to revise the audit committee disclosure requirements.

How to Talk to Your Auditor About Form AP Disclosure

As described in prior Updates (see PCAOB Auditor Search Database is Up and Running, April 2017 Update and PCAOB Takes Final Action to Require Disclosure of Engagement Partner and Participating Accounting Firm Names, December 2015 Update), the PCAOB has adopted rules requiring disclosure, in a public filing on Form AP, of the identity of the engagement partner and the names of participating firms (such as non-U.S. affiliates of the principal audit firm) for all public company audits. These rules took effect earlier this year. The Center for Audit Quality (CAQ) has issued a guide for audit committees to assist them in discussing this information with their auditor.

The new CAQ publication, Form AP – Auditor Reporting of Certain Audit Participants: A Tool for Audit Committees, is intended to aid audit committees in understanding the transparency requirements, to assist audit committees in discussing the role of audit participants with their engagement partner, and to prepare audit committees for questions that may result from the disclosures. The tool consists of a general overview of the Form AP requirements and a list of questions the audit committee may wish to ask based on the disclosures regarding the company's audit. The publication also has two appendices. Appendix 1 is a detailed summary of Form AP reporting requirements. Appendix 2 is a sample Form AP.

With respect to disclosure of the name of the engagement partner, the CAQ suggests that audit committee members "may want to refresh their knowledge of the audit partner's qualifications, industry, and other experience, and to understand whether the audit partner is the lead engagement partner on other issuer audits." With respect to disclosure of other accounting firms and their extent of participation in the audit, the CAQ suggests questions concerning three general topics:

1. Consistency with planning communications

    a. Is the other accounting firm(s) disclosure on Form AP consistent with the audit committee's understanding of audit participants based on audit planning discussions, company operations, legal names, or other considerations?

b. Which other accounting firm(s) disclosed on Form AP are member firms (of the signing firm's global network)?

2. System of quality control

   a. How does the firm network's leadership, through its tone at the top, emphasize audit quality and integrity throughout its global network and among member firms? How is audit quality addressed with nonmember firms participating in the audit?

   b. How does the firm's network address quality control matters pertaining to ethics compliance, including independence, for other accounting firm(s) participating in the audit?

   c. How does the audit firm's system of quality control determine that other accounting firm(s) participating in the audit have the requisite competence and expertise related to PCAOB standards?

3. Oversight of other accounting firm(s)

   a. How does the engagement partner supervise the work of other accounting firm(s) and evaluate whether it has been performed in accordance with professional standards?

   b. Which members of the group engagement team meet with the members of the other accounting firm(s) performing work on the audit? How frequently?

   c. When was the last in-person visit conducted by the engagement partner or partners with other accounting firm(s) participating in the audit?

   d. Does supervision of and interactions with other accounting firm(s) vary if the other accounting firm is not a member firm? How does the signing partner take responsibility for their work?

   e. Have other accounting firm(s) participating in the audit recently been subject to internal or external inspection related to work performed on the issuer audit? If so, what was the result of the inspection and how has it impacted the engagement team's planned oversight of the other accounting firm(s)?

   f. How have other accounting firm(s) and participation levels changed since prior year(s)?

   g. Which of the other accounting firm(s), if any, are being used for the first time in the current year, and what incremental procedures are being performed to provide oversight of their audit work, if deemed necessary?

The Form AP tool also suggests questions related to implications of Form AP reporting that are more tangential to the audit itself:

1. Other employees impacted by Form AP

    a. Is company management--including investor relations, the office of general counsel, and the corporate secretary--aware of the new disclosures of Form AP?

    b. Have investor relations considered how to address questions from investors or other stakeholders (e.g., media) that may result from review of new disclosures, or from a regulatory sanction or inspection report?

    c. What is the process for investor relations to advise the audit committee of questions received, if any, from outside stakeholders?

2. Social media policy considerations

    a. Has the audit firm considered the impact, if any, of these new disclosures on its social media policy?

    b. How has the firm communicated its policy with engagement partners?

Comment: The CAQ's paper provides a useful checklist of issues that the audit committee may want to consider as a result of the new disclosures. As noted in prior Updates, audit committees will also 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 when events in other audits seem to reflect poorly on the partner. Further, the disclosures concerning participating firms will shine a spotlight on the performance and quality control of these firms, including their PCAOB inspection reports. As the CAQ's questions indicate, it may be prudent for audit committees to understand how the engagement team supervises the work of these other firms and how it assures itself that the work is subject to appropriate quality control.

After 15 Years, SOX Compliance Costs Are Leveling Off

On June 14, consulting firm Protiviti released its 2017 survey of Sarbanes-Oxley Act compliance costs, Fine-Tuning SOX Costs, Hours and Controls. Protiviti found that, for many companies, costs associated with SOX compliance have leveled off or declined, compared to 2106, although for others (particularly companies with many locations) costs continue to rise. Moreover, some SOX costs, such as external audit fees, appear to be increasing. And, similar to prior years (see, e.g., SOX Compliance Costs and Audit Fees Continue to Rise, August 2016 Update), significant numbers of respondents point to the PCAOB's inspection program as the cause of internal compliance cost increases.

Protiviti surveyed 468 respondents from publicly-held companies. The survey was conducted during the first quarter of 2017. Respondents held a variety of management positions, with the largest percentage (24 percent) self-identifying as "audit managers." Almost three-quarter of the respondents (72 percent) were associated with companies that had $1 billion or more in annual revenue. Survey findings include:

Compliance Costs

- Internal costs. The average annual internal cost of SOX compliance for the largest public companies (large accelerated filers) declined in 2017 to $1.142 million from $1.335 million in the 2016 survey. For the next tier of public companies (accelerated filers), average annual internal costs averaged $802,000, compared to $914,000 in the prior survey. Still-smaller companies (non-accelerated filers) averaged $700,000, down sharply from $1.219 million. As in the 2016 survey, the highest costs – $1.222 million – were incurred by emerging growth companies (certain recently-public companies with revenues of less than $1 billion), although EGC costs declined from $1.430 million in 2016. On an industry basis, companies in the financial services sector had the highest internal SOX compliance costs ($1.292 million), although this was significantly lower than the $2.31 million for the first-place industry last year (healthcare providers). [Prior year survey numbers are from the August 2016 Update.]

  Protiviti suggests that compliance cost decreases may reflect the fact that most organizations have completed implementation of the updated COSO internal control framework. Protiviti also notes that companies are making greater use of external resources to support compliance (which could result in a decrease in internal costs).

- External audit fee. For many companies, audit fees continue to rise. Half of large accelerated filers and half of accelerated filers reported that their external audit fee increased in fiscal 2015, while 6 percent and 8 percent respectively reported a decrease. For non-accelerated filers, 33 percent reported an increase, and 19 percent reported a decrease. The category with the highest percentage of audit fee increases – 55 percent – was emerging growth companies.

- External auditor reliance on the work of others. High percentages of companies of all sizes reported that their external auditor was relying "to the fullest extent possible" on the work of others (e.g., internal audit) to test controls over medium- and low-risk processes. For example, 79 percent of accelerated filers indicated that this was the case, as did 71 percent of non-accelerated filers. Interestingly, however, these percentages declined compared to 2016 in all categories. For example, last year 95 percent of non-accelerated filers reported maximum reliance.

- Automated controls. Many surveyed companies are automating additional controls. For example, only 8 percent of large accelerated filers reported that more than half of their key controls were automated during fiscal 2016. However, 14 percent of large accelerated filers said that they had "significant plans to automate a broad range of IT processes and controls" in

2017, and another 37 percent said that they had "moderate plans to automate numerous IT processes and controls."

- Outsourcing. As noted above, a significant number of companies rely on external resources for some of their SOX compliance activities. Forty-one percent of respondents said that they use "co-source providers" and 11 percent stated that they outsource their SOX activities. However, nearly half – 48 percent – do not use outside resources.

Role of the PCAOB

As was reported in last year's survey, many respondents blame increases in their Sarbanes-Oxley compliance costs on the PCAOB. Of those respondents who said that their audit firm required changes to the company's SOX compliance procedures in 2016, 42 percent attributed those changes to the PCAOB's inspection program "very much so", and 33 percent said the PCAOB's inspection was "probably" the cause. As to specific types of costs that respondents believed were affected by the PCAOB's inspection program, the following percentages of respondents thought that the PCAOB had an "extensive/substantial" cost impact on:

- Risk assessment and scoping (38 percent).
- Selecting controls to test (37 percent).
- Testing review controls (50 percent).
- Testing system reports and other information provided by the entity (56 percent).
- IT considerations (35 percent).
- Roll-forward of control testing from an interim date (37 percent).
- Using the work of others (49 percent).
- Evaluating identified control deficiencies (36 percent).

Current Issues: Revenue Recognition and Cyber Security

As discussed in prior Updates (see, e.g., Another Warning Bell Rings on Revenue Recognition, May-June 2017 Update), implementation of the new accounting standard on revenue recognition is a major issue for most companies. Control changes to support the standard are a key part of the process. Fifty-six percent of Protiviti's respondents indicated that their organization had started updating its control documentation to reflect the implementation of the new revenue recognition standard; 44 percent had not. Twenty-six percent said that they had noted extensive or substantial increases in testing of control over application of revenue recognition policies.

Protiviti also asked respondents about cybersecurity breaches and their impact on SOX compliance. One-third of respondents stated that their company made a cybersecurity disclosure in accordance with the SEC's staff's guidance on disclosure relating to cybersecurity risks and incidents. Only one-fifth reported such a disclosure in the prior survey.

(Sixty-seven percent stated that their company had either not made a cyber disclosure or they didn't know if such a disclosure had been made; in 2016, Protiviti reported that 42 percent of respondents didn't know whether or not there had been a cybersecurity disclosure.) Of those who reported a cybersecurity disclosure, over half (54 percent) said that total hours devoted to Sarbanes-Oxley compliance had increased 11 percent or more as a result.

SOX Compliance Benefits

Seventy-three percent of public company respondents believed that the company's internal control over financial reporting had "significantly" or "moderately" improved since ICFR auditing became required. (In 2016, 67 percent believed there was either a significant or moderate improvement.) Primary benefits of SOX compliance included "Improved ICFR structure" (70 percent), "Enhanced understanding of control design and control operating effectiveness" (65 percent), "Continuous improvement of business processes" (50 percent), "Ability to better identify duplicate of superfluous controls" (43 percent), "Compliance with SEC rules" (50 percent), and "Increased reliance by external audit on the work of internal audit" (43 percent).

Comment: SOX compliance has imposed significant costs on companies of all sizes, and the high costs reported by emerging growth companies are particularly striking. Those costs do, however, appear to have created value by in the form of stronger and more reliable controls. And, the costs may now finally be leveling off, especially as more key controls become automated. As noted in the August 2016 Update, audit committees may want to consider whether there are additional opportunities to convert some of their company's SOX compliance costs into more effective and efficient financial reporting and information-gathering processes.

Restatements Hit a Another New Low, and SOX Could Be the Reason

In early June, Audit Analytics (AA) released its annual report on public company restatements, 2016 Financial Restatements: A Sixteen Year Comparison (available here for purchase on Audit Analytics website). The report concludes that the aggregate number of restatements in 2016 fell to 671, the lowest since the requirement to report restatements on Form 8-K took effect in 2004. Total restatements in 2016 were about 11 percent lower than in 2015 – previously the post-2004 all-time low. See Restatements Hit a New Low, May 2016 Update.

Restatements fall into two categories. When a company determines that users can no longer rely on previously-issued financial statements, it is required to disclose that determination by filing SEC Form 8-K within four business days of making the determination. The restated financial statements themselves would normally be filed sometime later, after the company has had the opportunity to analyze and correct the errors. The AA report refers to this type of restatement as a "Reissuance Restatement" or "Big R restatement". In contrast, if a company determines that previously issued financial statements contain errors, but that, despite the errors, users can continue to rely on the financial statements, it is not required to file Form 8-K. The corrected financial statements would simply be included in a periodic SEC filing. AA refers to these less significant restatements as "Revision Restatements" or "little r restatements".

Key points in AA's public summary of the 2016 restatement report include:

- In 2016, Reissuance Restatements declined for the tenth consecutive year. There were 130 of these Big R restatements, down from 163 in 2015 and from 941 in 2006 (the highest post-2004 year).

- Revision Restatements also declined in 2016, from 522 in 2015 to 470. However, as the total number of restatements has fallen, little r restatements have become a larger percentage. In 2016, 78.3 percent of all restatements were Revision Restatements.

- While accelerate filer (i.e., larger company) restatements increased from 2011 to 2014 (see May 2016 Update), restatements by these companies declined in both 2015 and 2016. Non-accelerated filer (i.e., smaller company) restatements also reached a new low of 284 in 2016.

- The severity of restatements continues to be low. In 2016, 59.1 percent of publicly-traded company restatements had no impact on earnings. Similarly, 55.2 percent of 2015 restatements had no impact on earnings; the comparable 2014 figure was 60 percent. (2015 and 2014 percentages are from the May 2016 Update.)

The AA public summary notes that the drop in restatements could be the result of "tighter controls over financial reporting in accordance with the Sarbanes-Oxley Act of 2002." In this regard, Don Whalen, AA's Director of Research, was quoted in the June 7 edition of the Wall Street Journal's CFO Journal, "Any improvement in internal controls over financial reporting is going to reduce the likelihood of a financial restatement, * * * [a]nd even if [a weakness] does happen, it's going to be found more quickly and have less impact."

Comment: The Audit Analytics findings are consistent with other research indicating that the quality of financial reporting (as measured by the frequency and severity of restatements) has increased significantly since the enactment of the Sarbanes-Oxley Act. This is likely the result of the substantial investment companies have made in strengthening and assessing the effectiveness of their internal control over financial reporting. See prior item in this Update. Ironically, however, class action litigation based on accounting and financial reporting issues are also increasing. See Do You Feel Lucky?, January-February 2017 Update.

82 Percent of the S&P 500 Are Now Publishing Sustainability Reports

The Governance & Accountability Institute (G&AI), a sustainability consulting firm, released the results of its sixth annual analysis of S&P 500® company sustainability reporting. G&AI found that 82 percent of the companies in the S&P 500 index published a sustainability or corporate responsibility report in 2016, a one percent increase over 2016. While the change in the percentage of reporting companies between 2015 and 2016 was small, voluntary sustainability reporting by these 500 large publicly-traded companies has increased dramatically during the past six years. See 81 Percent of the S&P 500 Published Sustainability Reports Last Year, and the SEC is Taking Notice, April 2016 Update. According to G&AI, 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&AI also reported that, by industry sector, the highest number of non-reporting companies were in the consumer discretionary sector (24 non-reporters/30 percent of the sector), the financials sector (15 non-reporters/22 percent of the sector), and the health care sector (14 non-reporters/23 percent of the sector). In contrast, the sectors with the lowest number of non-reporting companies were telecommunications services (1 non-reporter/ 25 percent of the sector), materials (no non-reporters), and utilities (no non-reporters). The industry sector with the greatest increase in sustainability reporting was information technology, in which five additional companies (7 percent of the sector) began reporting in 2016. (Sector percentages in this paragraph were computed by the Update.) In contrast, the number of companies issuing sustainability reports in each of the consumer staples and health care sectors declined by one.

Hank Boerner, G&AI'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. * * * Do they not understand the rising expectations of stakeholders seeking much more comprehensive information about their company's ESG performance? At the least, the companies seem to be firmly resistant to the demands of shareholders for more information about their ESG policies and performance."

Comment: Sustainability reporting has become 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 possible 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 (see April 2016 Update) 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.

Companies That Change Auditors After the Fourth of July May Be Heading For Trouble

An academic study finds that auditor dismissals after the end of the second quarter of the year are a strong predictor of future restatement risk and material internal control weaknesses. As one of the study's authors, Notre Dame Accounting Professor Jeffrey J. Burks, states in a summary on the University's website, "Our findings suggest that dismissals occurring after the second fiscal quarter are symptomatic of companies that have something to hide. Common sense would probably lead investors to be suspicious of extremely late dismissals, such as those that happen when auditors are deep into their year-end fieldwork. But we find that investors should apply a similar level of suspicion to dismissals occurring any time after the second quarter."

The study, "Auditor Dismissals: Opaque Disclosures and the Light of Timing" was prepared by Professor Burks and Jennifer Sustersic Stevens of Ohio University. They examined auditor dismissals during the period 2001-2012. After various adjustments, they developed a base sample of 1,820 dismissals with the objective of determining whether the timing of the dismissal was a signal of the likelihood of a future "adverse outcome", such as a restatement, material control weakness, or delisting. They find that dismissal timing is a predictor of restatements and material weaknesses, but not of delisting: "Incremental to other predictors, dismissals occurring after the second fiscal quarter roughly double the odds of a restatement and more than quadruple the odds of a material weakness over the next two years."

The study also examined whether the reasons given in the company's SEC filing for replacing the auditor had predictive power. Quoting prior research by other academics, the authors observe that the reasons companies provide for changing auditors "tend to involve seemingly innocuous factors such as mergers, audit fees, or desire for a larger or geographically closer auditor" and "tend to convey little credible information about the reasons for the dismissal or the implications of the dismissal." Burks and Stevens find that "the negative circumstances discussed in dismissal disclosures have no incremental predictive power for future restatements or material weaknesses."

Finally, the authors concluded that the market does not treat dismissal announcements as conveying much information. "Stock price drifts following the mandatory disclosures indicate that the market tends to underreact to them." As a result, they believe that their study will "help capital market participants understand and deal with the ambiguity of auditor dismissals and the opaqueness of dismissal disclosures. Improved understanding of the implications of dismissal timing may help investors and analysts compensate for the dismissal disclosures' lack of predictive power."

Comment: Burks and Stevens state that the findings of their study may "help auditors in assessing the risk posed by new and unfamiliar potential clients who are dismissing their prior auditors, and may help boards of directors in evaluating management requests for auditor dismissals." While each situation would have to be examined based on its unique facts, a management recommendation to make a change in auditors during the second half of the year may suggest a need for the audit committee to dig deeper into the reasons for the proposal.

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

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