Baker McKenzie.

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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 Issues Guidance on Cyber Disclosure, Including the Board's Oversight Role

On February 21, the Securities and Exchange Commission issued interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents. Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Securities Act Release No. 10459 (February 21, 2018). The guidance sets forth the Commission's views on both disclosure and on certain corporate policies and procedures, including those related to insider trading, in the cyber-security context. Among other things, the release notes the cyber-security oversight role of the board (which is frequently assigned to the audit committee) and the importance of disclosure concerning that role.

The release explains how existing rules apply in the context of cybersecurity incidents, but does not establish new disclosure or compliance requirements. With respect to disclosure, it largely repeats staff guidance issued in 2011. In a separate statement, SEC Chairman Clayton indicated that the Commission "will continue to evaluate developments in this area and consider feedback about whether any further guidance or rules are needed." While the interpretive release was approved unanimously, two Commissioners expressed disappointment that it did not go further in requiring disclosure.

Below is a high-level summary of the topics addressed in the release.

Disclosure of Cybersecurity Issues

1. Disclosure Obligations

Although no SEC disclosure requirements refer specifically refer to cybersecurity risks and incidents, the disclosure rules for various forms, including periodic reporting and registration statements, may create an obligation to disclose such risks and incidents, depending on the particular circumstances and whether information related to cybersecurity is material. Materiality is of course a highly fact-specific determination:

> "The materiality of cybersecurity risks or incidents depends upon their nature, extent, and potential magnitude, particularly as they relate to any compromised information or the business and scope of company operations. The materiality of cybersecurity risks and incidents also depends on the range of harm that such incidents could cause. This includes harm to a company's reputation, financial

> performance, and customer and vendor relationships, as well as the possibility of litigation or regulatory investigations or actions, including regulatory actions by state and federal governmental authorities and non-U.S. authorities." (footnotes omitted)

When disclosure is required, companies should avoid "generic cyber-security-related disclosure and provide specific information that is useful to investors."

2. Risk Factors

Companies should disclose cyber risks if they are among the factors that make investments in the company's securities speculative or risky. The release includes a series of considerations for making this determination and notes that "companies may need to disclose previous or ongoing cybersecurity incidents or other past events in order to place discussions of these risks in the appropriate context."

3. Management's Discussion and Analysis

MD&A requires a discussion of events, trends, or uncertainties that are reasonably likely to have a material effect on results of operations, liquidity, or financial condition. The cost of cybersecurity efforts, the costs and consequences of incidents, and the risks of potential future cyber breaches may fall into this category.

4. Description of Business

In discussing its products, services, and customer relationships, a company may need to discuss the effects of cybersecurity incidents on these aspects of its business, if they are material.

5. Legal Proceedings

Companies are required to disclose information concerning material pending legal proceedings. Cyber incidents may result in material litigation, such as suits against the company stemming from the theft of customer information.

6. Financial Statement Disclosures

The Commission points out that cybersecurity incidents may affect a company's financial statements in a variety of ways. For example:

- Expenses related to investigation, breach notification, remediation and litigation, including the costs of legal and other professional services;
- Loss of revenue, providing customers with incentives or a loss of customer relationship assets value;
- Claims related to warranties, breach of contract, product recall/replacement, indemnification of counterparties, and insurance premium increases; and
- Diminished future cash flows, impairment of intellectual, intangible or other assets; recognition of liabilities; or increased financing costs.

7. Board Risk Oversight

The Commission's rules require disclosure of the extent of the board's role in risk oversight, such as how the board administers its oversight function and the effect on the board's leadership structure. This disclosure is intended to "provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company." The release states:

> "To the extent cybersecurity risks are material to a company's business, we believe this discussion should include the nature of the board's role in overseeing the management of that risk. In addition, we believe disclosures regarding a company's cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues allow investors to assess how a board of directors is discharging its risk oversight responsibility in this increasingly important area."

<u>Policies and Procedures</u>

1. Disclosure Controls and Procedures

The Commission's rules require companies to maintain disclosure controls and procedures and require management to evaluate their effectiveness. Regarding the application of these rules to cybersecurity, the release states:

> "Companies should assess whether they have sufficient disclosure controls and procedures in place to ensure that relevant information about cybersecurity risks and incidents is processed and reported to the appropriate personnel, including up the corporate ladder, to enable senior management to make disclosure decisions and certifications and to facilitate policies and procedures designed to prohibit directors, officers, and other corporate insiders from trading on the basis of material nonpublic information about cybersecurity risks and incidents.
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> Controls and procedures should enable companies to identify cybersecurity risks and incidents, assess and analyze their impact on a company's business, evaluate the significance associated with such risks and incidents, provide for open communications between technical experts and disclosure advisors, and make timely disclosures regarding such risks and incidents."

2. Insider Trading

The release points out that information about a company's cybersecurity risks and incidents may be material nonpublic information and that trading in the company's securities by corporate insiders who are in possession of such information may violate the antifraud provisions of the federal securities laws. Accordingly, while a company is investigating a cyber-security incident, it should consider implementing trading restrictions. "Company insider trading policies and procedures that include prophylactic measures can protect against directors, officers, and other corporate insiders trading on the basis of material nonpublic information before public disclosure of the cybersecurity incident."

3. Regulation FD

Regulation FD prohibits companies from making selective disclosure of material nonpublic information to certain persons, such as investment advisors and shareholders, before disclosing the information to the public. The Commission states that it "expect[s] companies to have policies and procedures to ensure that any disclosures of material nonpublic information related to cybersecurity risks and incidents are not made selectively * * * ."

Comment: Audit committees are often tasked with oversight of cyber-security risks (although this may not always be the best choice – see Audit Committee Overload Redux: Another Survey Finds that Audit Committee Members are Working Harder and Want Responsibility for Risk Assigned Elsewhere, January-February 2015 Update). In that regard, surveys consistently indicate that evaluating the company's management of cybersecurity risk is one of the top challenges audit committees face. See Audit Committee Members are Challenged By Risk Management and Think They Would Benefit From a Better Understanding of the Business, January-February 2107 Update.

In light of the Commission's emphasis on disclosure of how the board oversees cyber-security and how the board engages with management on that issue, many companies are likely to expand their discussion of these issues. The audit committee may have a special interest in ensuring that this disclosure is an accurate reflection of the board's (and committee's) activities. To the extent the audit committee has responsibility for compliance, it may also want to make sure the company's disclosure controls and its policies on insider trading and selective disclosure are consistent with the Commission's comments in the guidance.

CAQ Adds Another Chapter to its Audit Committee Non-GAAP Guidance

The Center for Audit Quality (CAQ) has issued guidance for audit committee oversight of non-GAAP financial measures. Since 2015, the SEC has increased its scrutiny of company disclosure of financial performance and condition measures that do not conform to generally accepted accounting principles. See SEC Chair and Chief Accountant are Concerned About the Growing Use of Non-GAAP Financial Measures and Warn that Audit Committees Should Be as Well, April 2016 Update. The CAQ has previously released two other papers to assist audit committees in their oversight of non-GAAP disclosures: Questions on Non-GAAP Measures: A Tool for Audit Committees (June 2016) and Non-GAAP Financial Measures: Continuing the Conversation (December 2016). See CAQ Issues Audit Committee Non-GAAP Oversight Tool, June-July 2016 Update.

The new publication, Non-GAAP Measures: A Roadmap for Audit Committees, is based on roundtable discussions convened by the CAQ in 2017 at which audit committee members, management representatives, investors, securities lawyers, and public company auditors discussed some of the challenges involved in the publication of non-GAAP measures. The CAQ also released a video which includes interviews with audit committee chairs and examples of how audit committees oversee the use of non-GAAP measures.

The CAQ press release announcing the release of the Roadmap highlights six recommendations that emerged from these discussions. The audit committee should:

- Put itself in the shoes of investors when evaluating if the presented non-GAAP measures and related disclosures align with the company's overall strategy and performance.

- Ask management whether it has an internal policy that provides guidelines for determining how non-GAAP measures are generated, calculated, and presented.

- Discuss with management how the company makes changes to the non-GAAP measures it presents and the rationale for why it would or would not make changes.

- Ask the company to compare or benchmark its non-GAAP measures to its peers.

- Leverage external auditors as a resource when evaluating non-GAAP measures.

- Engage with investors directly or through investor relations to ensure that the presented non-GAAP measures aid investors' understanding of the company's performance.

With respect to the second recommendation above, the Roadmap notes that not all companies that utilize non-GAAP measures have a written policy governing how the measures are generated, calculated, and presented, and setting forth the rationale for their use and the adjustments on which they are based. The CAQ advises audit committees of companies that lack such a policy to encourage management to create one. The Roadmap also recommends that audit committees consider making disclosure in the committee's report concerning this issue:

> "[G]iven the current regulatory environment and the fact that non-GAAP measures are important to investors and are central to their decision making, there could be benefits to an audit committee voluntarily disclosing that the company has non- GAAP policies (but not necessarily the relevant details of those policies). Such disclosure could demonstrate to investors the importance of this information to the audit committee and that policies are in place to support the metrics being consistent, transparent, and comparable."

Comment: The Roadmap states: "The audit committee has an important responsibility on behalf of company shareholders to oversee the financial reporting process and external audit. Given its role, the audit committee can act as a bridge between management and investors, and it can assess management's reasons for presenting non-GAAP measures and evaluate the sufficiency of the related disclosures. The audit committee can determine whether the measures present a fair and balanced view of the company's performance." In light of this responsibility, the suggestion that audit committees make sure that their companies have a written non-

GAAP policy is a good one. The policy should be reviewed periodically to make sure it is consistent with company practice.

Supreme Court Decision May Accelerate Whistleblower Reporting to the SEC

On February 21, in Digital Realty Trust v. Somers, the U.S. Supreme Court issued a unanimous opinion holding that the whistleblower anti-retaliation provisions of the Dodd-Frank Act apply only to employees who report alleged misconduct to the SEC. Those who report their concerns only internally, such as on a company hotline, do not enjoy certain special rights afforded in Dodd-Frank. The Sarbanes-Oxley Act also contains anti-retaliation provisions. However, to invoke their right to recover under SOX in the event of retaliation, whistleblowers must first go through an administrative process involving presentation of their retaliation claim to the Department of Labor. In contrast, Dodd-Frank permits a whistleblower to sue a current or former employer directly and permits a court to award double back-pay, with interest. Most whistleblowers (and their lawyers) would of course prefer to have the leverage afforded by an immediate option to sue for damages, rather than to become enmeshed in a DOL administrative proceeding.

By limiting the more favorable treatment of retaliation claims to those who do so, the Digital Reality decision adds an incentive for employees with concerns about company conduct to report their suspicions immediately to the SEC, rather then just internally. Companies prefer that whistleblowers report internally and delay going to the SEC because it affords the company more latitude in addressing the issue before the government becomes aware of the problem and minimizes the risk of an SEC investigation.

Prior to the Digital Realty decision, delayed reporting seems to have been the norm. According to the SEC's 2017 Annual Report to Congress on its whistleblower program, of the 46 individuals who have received monetary awards under the SEC's program since its inception, 83 percent of those recipients who were current or former employees of the entity that was the subject of their whistleblower claim "raised their concerns internally to their supervisors, compliance personnel, or through internal reporting mechanisms, or understood that their supervisor or relevant compliance personnel knew of the violations, before reporting their information of wrongdoing to the Commission." As a result of the Supreme Court's decision, whistleblowers (or their lawyers) may re-think whether it is prudent to report internally without simultaneously bringing their concerns to the SEC's attention in order to facilitate the ability to recover damages in the event that the company takes action against them that could be construed as retaliation.

Comment: Under the Sarbanes-Oxley Act, audit committees are responsible for establishing procedures for the receipt of complaints regarding accounting, internal accounting controls, or auditing matters. As a result of Digital Realty, audit committees should assume that complaints submitted through the process they oversee have also been brought to the attention of the SEC. Complaints should be taken seriously and internal investigations, where appropriate, should be conducted in a thorough and professional manner. Also, audit committees need to be vigilant for company conduct that could be characterized as retaliation against the whistleblower, regardless of whether the individual has reported to the SEC.

Despite Progress, Some Companies Are Still Behind Schedule on Lease Accounting

Three new surveys underscore the progress many companies are making on preparing for the fundamental changes in lease accounting that will take effect for public companies at the beginning of next year. These surveys also indicate, however, that a significant minority of companies could miss the deadline.

As described in the February-March 2016 Update, the Financial Accounting Standards Board has adopted new standards governing financial reporting for leasing activities. ASU No. 2016-02, Leases (Topic 842) will require financial statement recognition of assets and liabilities for leases with terms of more than 12 months. The new standards 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 almost all companies to some degree. The standards are intended to increasing transparency and comparability with respect to leasing, but implementation will have far-reaching implications, including for internal controls and IT.

KPMG

KPMG retained a third party to survey 150 companies concerning their progress. Survey participants "included finance and accounting professionals in financial services, manufacturing, retail, telecom, and media industries." More than half had annual revenue between $500 million and $50 billion. The KPMG survey found:

- Fifteen percent of respondents have completed implementation.
- Implementation is in process at 45 percent.
- Nineteen 19 percent are still in the "planning phase."
- Sixteen percent are "assessing the impact" of the new standard.
- Five percent have not started transition.

Prior KPMG survey results on leasing accounting progress are discussed in KPMG Sounds the Alarm on Revenue Recognition and Leasing Accounting Implementation, August 2016 Update.

D&T

In January, Deloitte & Touche surveyed 3,890 professional who participated in a webcast on lease accounting implementation. This survey is similar to online polls conducted in 2016 and 2017 (see New Lease Accounting Implementation May be Challenging, June-July 2016 Update). Lease accounting implementation enters the final stretch, which reports the results of Deloitte's most recent poll, indicates that over 21 percent of respondents said that their companies were either "extremely" or "very" prepared for the new standard. The comparable percentage was only 9.8 percent in early 2016. However, 18.2 percent responded that they were either "not too prepared" or "not prepared at all."

Consistent with other surveys, Deloitte's respondents confirmed that gathering data on existing leases was their biggest problem. Almost one third thought that "collecting necessary data on all organizational leases in a centralized, electronic inventory" was the largest implementation challenge. Apparently, however, convincing senior management that implementing the new leasing standards will be a major project is not generally a problem: Only 3.6 percent thought the largest challenge would be "overcoming board and executive assumptions that implementation will have little or no impact on financial reporting and operations."

LeaseAccelerator

LeaseAccelerator, a lease accounting software provider, also conducted its survey in January 2018. Respondents were "over 300 senior leaders from finance and accounting organizations at large private and public companies." Most came from companies with more than $1 billion in annual revenues. Approximately 40 percent of the survey companies had fewer than 500 leases, while roughly 13 percent had more than 5,000. LeaseAccelerator's prior survey of the state of implementation was described in LeaseAccelerator Finds that Leasing Standard Implementation is Accelerating, March 2017 Update.

Some highlights of Lease Accounting: A 2018 Progress Report, LeaseAccelerator's survey findings, include:

- "The good news is that the industry appears to be largely on track with their lease accounting projects. We will likely avoid what many were worried might turn into "leasepocalypse" at year end." Six percent of respondents said that implementation was completed, while about 8 percent said they were ahead of schedule. Roughly 55 percent indicated that their implementation was on schedule. Slightly over 20 percent of companies responded that they were behind schedule, and a little over 10 percent had not started implementation.

- The majority of companies would like an extension. Approximately 60 percent of companies think that FASB should extend the compliance date. LeaseAccelerator observes that "the desire for additional time is not solely driven by the complexity of the ASC 842 [leasing] standard, but rather the combined work effort required to comply with both the new leasing and revenue recognition standards in such close proximity."

- Implementing the new leasing standard rivals the transition to the new revenue recognition requirements. Seventy-five percent of respondents said that the new leasing standard was "just as complex or more challenging" than revenue recognition.

- The hard part is not the accounting, but the data-gathering. Half of respondents said that "finding and collecting the necessary data" was the greatest difficulty; other problems cited were "modifying business processes, policies, and controls; upgrading software applications; and project managing the overall work effort." Over half of companies have taken an inventory of their lease portfolios, and 30 percent are "more than half way done" with data collection.

- The hunt for embedded leases. "Accounting organizations are finding embedded leases contained in service agreements with contract manufacturing, third party logistics, and data center outsourcing vendors to be the most challenging to find and analyze. Non-real estate leases such as IT, fleet, material handling, rail car, transportation, and other equipment leases are also proving challenging to find and analyze."

- Lease accounting software is replacing spread-sheets. More than one third of companies have selected a software vendor to support the new lease accounting standards, in most cases replacing "the historically-used, spreadsheet-based accounting approach" to tracking leases.

- The accounting staff leads the way. About 80 percent of companies "have assigned a formal project manager from the accounting or financial reporting team to lead the initiative, which for many companies will be one of the largest accounting change initiatives in the past 50 years." Less than 30 percent of survey respondents plan to retain external consultants.

Comment: Audit committees should be monitoring monitor the company's progress on leasing standard implementation in order to avoid last-minute surprises. As SEC Chief Accountant Wes Bricker has pointed out, implementation of the new leasing standard is one of the major accounting oversight challenges audit committees currently face. See SEC Chief Accountant on Advancing the Role and Effectiveness of Audit Committees, March 2017 Update. Companies that engage in any significant amount of leasing should already be nearly done with their implementation effort. For those companies that are farther behind, 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 Fees Continue to Rise, But More Slowly, For Most SEC Filers

The Financial Executives Research Foundation (FERF), the research affiliate of Financial Executives International (FEI), has released the results of its annual survey of audit fees. The 2017 Audit Fee Survey Report, which was sponsored by Workiva, a provider of cloud-based reporting, compliance, and data-management solutions, indicates that public company audit fees overall continue to rise, although at a somewhat lower rate than reported last year. (The 2015 FERF audit fee survey is discussed in Audit Fees and SOX Compliance Cost are Increasing, But Many Companies Think They are Getting Their Money's Worth, December 2015 Update.)

The FERF/Workiva report is based on responses from 508 financial executives at a mix of public companies, private companies, and non-profit organizations. The report also examines publicly-reported audit fees for 6,394 SEC filers.

- Public company survey respondents. The 2017 FERF survey, which covers 2016 audit costs, found that, for 161 public company survey respondents, audit fees averaged $7.4 million, with a median fee of $2.8 million. The median audit fee rose 1.3 percent, compared to a 1.6 percent increase in 2015. The survey respondent average audit fee was up 6.9 percent, compared to a 2015 increase of 4.5 percent.

- All SEC filers. The results for all SEC filers, not just FEI survey respondents, are directionally similar, but the magnitude of the changes is larger. (The universe of all SEC filers is weighted more heavily toward small companies than are the FEI public company survey respondents.) For all filers, the 2016 median audit fee was $523,694, and the average fee was $1.8 million. The median audit fee rose 2.6 percent, compared to a 3.5 percent increase in 2015, while the average fee rose 21.5 percent, compared to 35 percent in the prior year.

- Private companies. Private companies in the survey reported a median fee increase of 3.7 percent, compared with 2.9 percent for 2015 audits. Audit fees paid by the 281 private companies responding to the survey averaged $163,993, with a median of $70,000.

- Non-profits. Non-profit survey respondents reported a median fee increase of 1.6 percent, compared with 2.3 percent in 2015. The median non-profit fee was $52,388, while the average fee was $181,403.

When asked to identify the primary factors that contributed to an increase in their audit fee –

- Seventy percent of public company survey respondents indicated that “acquisition” was a reason for an audit fee increase; this was more than double the percentage that cited an acquisition in the 2016 survey.

- Sixty percent selected “new FASB standards” as a fee increase cause, while 38 percent identified “focus on revenue recognition”.

- “Review of manual controls resulting from PCAOB inspections” was chosen by 25 percent of respondents, up from 20 percent last year. (In addition, 52 percent of respondents indicated that the company had made changes to its control documentation as a result of PCAOB requirements or inspection feedback.)

- Other reasons given for audit fee increases included inflation (34 percent), changes to internal controls (30 percent), divestiture (24 percent), and new SEC reporting requirements (18 percent).

Forty-seven (about 9 percent) of the public company survey participants reported that their audit fee declined in 2016. The primary reason given for a decrease in audit fees was "negotiation with primary auditor," which was cited by 40 percent of these respondents. Twenty-one percent cited changes to internal controls as the reason for the fee decline.

FEI also asked respondents what strategies they were pursuing in order to mitigate audit fees. The top four responses were:

- Reviewed our audit hours and fees and negotiated with our auditors (47 percent).

- Improved our internal controls (45 percent).

- Increased our audit preparedness (45 percent).

- Reviewed our current audit focus areas to identify areas for improvement (43 percent).

Comment: Increasing M&A activity and the focus on revenue (resulting perhaps from the implementation of the FASB's new revenue recognition standard) seem to have been important drivers of audit fee increases last year. Also, more than 15 years after it came into existence, the PCAOB continues to play a role in fee increases. One would expect the system-wide fee impacts of PCAOB inspections and ICFR auditing to level off, as audit firms and their clients adjust to these requirements and compliance becomes institutionalized. See June 2015 Update. However, survey respondents continue to cite the PCAOB as a cause of fee increases. In the long run, increasing company and audit firm use of artificial intelligence may reduce audit costs, although this does not yet appear to be a major factor.

Study Finds that, Outside the U.S., KAM Reporting Has Improved Auditing

Despite objections from many audit committees, last year the PCAOB adopted a requirement for auditors of SEC-registered companies to include in their audit opinions discussion of critical audit matters (CAMs) – the most challenging or judgmental aspects of the audit. See PCAOB Adopts New Auditor's Reporting Model, May-June 2017 Update. While this requirement will not begin to take effect until mid-2019, the International Auditing and Assurance Standards Board (IAASB) adopted a similar requirement in 2015, which is already effective in some countries. (The IAASB refers to the matters that must be disclosed under its standard as "key audit matters" or KAMs).

The Association of Chartered Certified Accountants (ACCA), a global accounting organization, recently released a study on the effects of KAM reporting. ACCA's report, Key audit matters: unlocking the secrets of the audit, concludes that "the impact of KAMs was not limited to improving the quality of information for investors" but also improved auditor communications with those charged with governance, improved audit quality, and strengthened financial reporting.

ACCA reviewed 560 expanded audit reports under the IAASB standard in eleven countries (Brazil, Cyprus, Greece, Romania, Kenya, Nigeria, Oman, Romania, South Africa, the UAE, and Zimbabwe). ACCA found that, in addition to providing more information to investors, KAM reporting had three collateral benefits:

- Disclosure of KAMs stimulates better governance. "Publication of KAMs has provided new focus for discussions between the auditor and the audit committee. For the first time, there is transparency in the most important audit issues that were discussed between the audit engagement partner and the audit committee. As a result, feedback from audit committee members shows that disclosure of KAMs has resulted in improvements in corporate governance."

- Disclosure of KAMs supports better audit quality. "The process of reporting outputs from the auditor's reporting to the audit committee appears to have had a positive impact on audit quality."

- Disclosure of KAMs encourages better corporate reporting. "[R]eporting by the auditor in relation to part of the financial statements has, in some cases, led companies to add to the disclosures in the financial statements made in previous years. In this way, KAMs have catalysed better financial reporting."

The ACCA report also provides information concerning the frequency of KAMs and the audit areas that caused them. There were 1,321 KAMs reported in the 560 audit reports ACCA reviewed (roughly 2.4 KAMs per audit). Asset impairment was the most common KAM; this issue was cited in slightly over 25 percent of the disclosures. Revenue recognition was the second most common KAM area, followed by allowance for doubtful receivables, goodwill impairment, and taxation, including the valuation of deferred tax assets.

Comment: It is far from clear that the experience in the eleven emerging market countries ACCA studied is a good predictor of the likely impact of CAM reporting in the United States. Further, while some of the participants in the roundtable discussions ACCA describes in its report expressed reservations about the expanded auditor reporting requirement, the overall tone of the report is supportive of – almost to the point of advocacy for – auditor reporting concerning audit challenges. In any event, the ACCA study is a good reminder that CAM reporting in the U.S. is likely to be closely scrutinized by both proponents and opponents. Audit committees should be taking advantage of the phase-in period in the U.S. and should be working closely with their auditors to understand what the company's CAMs will be, whether they can be mitigated before reporting begins, and how the auditor's discussion of CAMs will compare to the company's disclosures regarding the same issues. See SEC Approves New Auditor Reporting Model and Shifts the Discussion to Implementation, November-December 2017 Update.

Securities Law Class Actions are Mushrooming, But More Cases are Being Dismissed and the Survivors are Settling for Less

Cornerstone Research has released two reports on class action litigation under the securities laws. Together, the reports suggest that, while the number of cases is rapidly growing, the quality and size is falling – more cases are being dismissed and settlement amounts are declining. And, as the over-all number of filed cases increases, the percentage involving

GAAP violations, restatements, and internal control weaknesses, is decreasing, as is the number of settled GAAP violation cases.

2017 Securities Law Class Actions Filed

As reported in Securities Class Action Filings—2017 Year in Review, 412 securities class actions were filed in 2017 – an increase of more than 50 percent over 2016, which set a record with 271 filings. M&A cases were the primary cause of the up-swing in filings. Almost half of the 2017 cases – 198 – involved merger and acquisition activity.

Another way of looking at these numbers is as a measure of the risk that a public company will become a defendant in a securities law class action. In 2017, more than 8 percent of companies listed on U.S. exchanges were the subject of a class action filing. Larger companies face a slightly smaller risk; about one out of every fifteen S&P 500 companies was sued. By comparison, in 2016, 3.9 percent of U.S. exchange-listed securities were subject to class action filings. See Do You Feel Lucky? Exchange-Traded Companies Have a 1-in-26 chance of being Targeted in a Federal Securities Law Class Action, January-February 2017 Update. (The 2017 increase in the odds of being sued resulted from both more class action filings and a smaller universe of public companies.)

The report, which was prepared by Cornerstone and the Stanford Law School Securities Class Action Clearing House, also found that, of those complaints alleging securities fraud (Rule 10b-5), false Securities Act registration statements (Section 11), or false securities sales material (Section 12(2)), 100 percent included allegation of misrepresentations in "financial documents." However, allegations relating specifically to accounting and internal control are declining sharply. Twenty-two percent of new cases alleged GAAP violations (down from 30 percent in 2016), six percent involved announced restatements (down from 10 percent in 2016), and 14 percent alleged internal control weaknesses (down from 21 percent).

Other highlights of the 2017 class action filings report, include:

- The number of filings against non-U.S. issuers continued to increase. As a percentage of total cases, complaints against non-U.S. issuers were filed at the highest rate since 2011.

- For the S&P 500, the lowest rate of filings was against companies in the Financial/Real Estate sector (1.6 percent). The highest filing rate was against companies in the Industrial sector (22.3 percent). Last year's most-frequently sued sector, Energy/Materials fell to second from last (a decline from 19.8 percent in 2016 to 2.3 percent in 2017).

Cornerstone and Stanford also studied the rate at which cases are dismissed within the first three years after filing. Over half (54 percent) of cases filed in 2015 were dismissed before three years had passed from the date the case was filed; this was the highest three-year dismissal rate since Cornerstone began compiling data. This trend appears likely to continue. The report states that early "dismissal rates for filings in cohort years 2016 and 2017 are comparable to the record high dismissal rate of the 2015 filing cohort" and that 2017 cases may turn out to be thrown out of court at a rate in excess of 2015. In the press release announcing the 2017 report, Professor Joseph Grundfest, director of the Stanford Law School Securities Class Action Clearinghouse, observed that, while legislation enacted in 1995 "was designed to deter plaintiffs from filing low-quality complaints, * * * this surge in complaints that are dismissed with greater frequency suggests that the law is no longer having its intended quality-enhancing effect."

2017 Securities Law Class Actions Settled

In Securities Class Action Settlements—2017 Review and Analysis, Cornerstone looks at class actions that were settled last year. (According to the 2017 filings report, for cases filed between 1997 and 2016, 50 percent were settled, 43 percent were dismissed, 1 percent ended with a trial, and 6 percent are still pending.) Cornerstone finds that the dollar value of settlements "dipped dramatically" in 2017. Specifically –

- Eighty-one securities class actions were settled in 2017, a decrease of 4 from the 85 settlements approved by courts in 2016.

- The total value of the 81 settlements was $1.5 billion, compared to $6.1 billion in 2016. Therefore, while the number of 2017 settlements was 95 percent of the 2016 count, the aggregate value was only 25 percent.

- The median amount for which cases settled in 2017 was $5 million, 40 percent of the 2016 median of $8.7 million. The average settlement declined 75 percent to $18.2 million.

The percentage of settled cases involving accounting allegations continued to decline. In the press release announcing the settlement report, Cornerstone states: "The proportion of settled cases alleging GAAP violations in 2017 was 53 percent, continuing a three-year decline from a high of 67 percent in 2014. Of cases with accounting allegations settling in the preceding nine years, 23 percent involved named auditor codefendants. In 2017, this dropped to 13 percent."

Comment: Clearly, the risk that a public company will be named in a securities law class action is increasing, particularly for companies engaged in M&A activity. While the risk that a class action suit will raise accounting issues seems to be declining, financial reporting and disclosure continue to be significant lines of attack for the plaintiff's bar. The best protection against litigation is diligence and care in overseeing the company's financial reporting. Audit committees may also want to be especially sensitive to issues arising in the areas that have traditionally attracted the attention of the plaintiffs bar and the SEC, particularly revenue recognition.

Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture

Two recent reports highlight the widespread acceptance of public company sustainability reporting and the increasing role that the risks and opportunities associated with environmental, social, and governance (ESG) issues play in the boardroom.

G&A Annual Survey

On March 20, the Governance & Accountability Institute (G&A), a sustainability consulting firm, released the results of its seventh annual analysis of sustainability reporting by S&P 500 Index® companies. G&A found that 85 percent of the companies in the index published a sustainability or corporate responsibility report in 2017. The popularity of voluntary sustainability reporting has increased dramatically during the past seven years. According to G&A, in 2011, only 20 percent of S&P companies released such reports; 53 percent did so in 2012, 72 percent in 2013, and 75 percent in 2014.

G&A also reported that, by industry sector, the highest percentage of non-reporting companies were in real estate (7 non-reporters/24.2 percent of the sector), health care (13 non-reporters/21.3 percent of the sector), and financials (14 non-reporters/20.9 percent of the sector). In contrast, the sectors with the lowest non-reporting rates were utilities and telecommunications services (no non-reporting companies in either sector), materials (1 non-reporter/4 percent of the sector), and consumer staples (2 non-reporters/5.9 percent of the sector).

In the "flash report" announcing the survey results, Louis Coppola, G&A's Executive Vice President and Co-Founder, attributed the surge in sustainability reporting to investor demand:

> "One of the most powerful driving forces behind the rise in reporting is an increasing demand from all categories of investors for material, relevant, comparable, accurate and actionable ESG disclosure from companies they invest in. Mainstream investors constantly searching for larger returns have come to the conclusion that a company that considers their material Environmental, Social, and Governance opportunities and risks in their long-term strategies will outperform and outcompete those firms that do not."

Ceres Turning Point Report

A report issued at the end of February by Ceres, a nonprofit organization that works with investors and companies to address sustainability challenges, provides another perspective on the sustainability reporting and performance of large U.S. companies. In Turning Point: Corporate Progress on the Ceres Roadmap for Sustainability, Ceres analyses the practices of "more than 600 of the largest publicly traded companies in the U.S." with respect to twenty governance, disclosure, stakeholder engagement, and environmental and social performance expectations in The Ceres Roadmap for Sustainability. Ceres's findings related to disclosure and board oversight include:

- Sustainability disclosure is improving, but has a long way to go. "While more companies disclose sustainability risks in annual financial disclosures, most stick to boilerplate language, failing to provide investors decision-useful information." Specifically, Ceres found that 51 percent of companies discuss climate change risks in annual SEC filings, compared to 42 percent in 2014. However, 32 percent of companies only address this issue from the perspective of regulatory risk.

- Materiality. As a result of investor pressure to disclose material sustainability risks, "more companies are taking steps to prioritize the environmental and social issues of greatest importance." Thirty-two percent of companies "conduct sustainability materiality assessments," compared to only 7 percent in 2014. However, only six percent "publicly disclose how their assessment guides strategic planning and decision-making."

- Executive accountability for sustainability issues is increasing. Sixty-five percent of the surveyed companies hold senior-level executives accountable for sustainability performance, an increase from 42 percent in 2014. Eight percent link executive compensation to sustainability issues beyond compliance, compared to three percent in 2014.

- Board responsibility is becoming more explicit. Thirty-one percent of companies have integrated sustainability into board committee charters. (Ceres states that this indicates that, "[a]lthough accountability for these material issues has increased among senior executives, oversight among corporate boards has not kept pace."

The Ceres report also discuses progress with respect to a variety of specific sustainability issues, such as greenhouse gas emissions, water, diversity, human rights, and supply chain integrity management. The bulk of the report analyzes progress against Ceres expectations in various industries, and includes company-specific examples.

Comment: As noted in prior Updates, sustainability reporting is rapidly becoming the norm for large public (and many smaller and private) companies. Most companies face some level of investor, customer, and/or supplier demand for more transparency concerning a variety of ESG issues, particularly those related to its supply chain integrity and climate change response. Over time, sustainability disclosures of various types may become mandatory, either as a result of the application of traditional securities law materiality to ESG issues or through direct regulatory or statutory disclosure mandates. For audit committees, these types of disclosures will pose oversight challenges involving compliance with new reporting requirements and controls and procedures to assure the accuracy and reliability of non-traditional disclosures.

The Ceres report also foreshadows a trend that goes beyond disclosure: The explicit incorporation of ESG issues into the responsibilities of directors. This could occur through change in board committee charters, as Ceres notes, or through litigation applying traditional concepts of director fiduciary duty to a broad range of non-financial risks and opportunities.

PCAOB 2016 Inspections Status Report

The PCAOB inspection status report is unchanged from last month: The PCAOB has released the public portion of the 2016 inspections reports with respect to three of the four largest U.S. accounting firms: Report on 2016 Inspection of Deloitte & Touche LLP, Report on 2016 Inspection of Ernst & Young LLP, and Report on 2016 Inspection of PricewaterhouseCoopers LLP. No 2016 report has yet been issued with respect to KPMG. The results of the 2016 inspections of D&T, PwC, and E&Y are summarized in the table below.

2016 Big Four Inspections (Reports Issued in 2017)				
Firm	Report Date	Engagements Inspected	Part I Deficiencies*	Percentage
Deloitte & Touche	November 28, 2017	55	13	24%
Ernst & Young	December 19, 2017	55	15	27%
PwC	December 19, 2017	56	11	20%

* The PCAOB describes deficiencies that are included in Part I of an inspection report as "of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion" on the financial statements or on internal control over financial reporting in all material respects.

After the PCAOB has made all of the 2016 Big Four firm inspection reports publicly available, the Update will present an overview of the PCAOB's inspection findings concerning these firms.

The PCAOB has also released its Report on 2016 Inspection of Grant Thornton LLP, another large accounting firm subject to annual PCAOB inspection. In its 2016 inspection of Grant Thornton, the PCAOB reviewed portions of 34 public company audits. The report describes Part I deficiencies in eight (24 percent) of those engagements.

Comment: Audit committees should discuss the results of the firm's most recent PCAOB inspection with their engagement partner. If the company's audit is mentioned in either the public or nonpublic portion of the inspection report, the audit committee should understand the reasons for the reference to the audit and how it will affect the engagement in the future. If the company's audit is not cited in the report, the audit committee should explore with the auditor how deficiencies identified in other audits might have affected the company's audit and how changes in the firm's procedures might affect future audits. Audit committees should also have an understanding of how the firm intends to remediate quality control deficiencies described in the nonpublic portion of the report.

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

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