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In This Update:

CAQ Suggests Some Questions Directors Should Be Asking About Cyber Security Risks

New Leasing Standard Will Have a Material Impact – and the CAQ Has Some Suggested Audit Committee Questions About That As Well

SEC Chief Accountant Outlines Audit Committee's Non-GAAP Oversight Role (Again)

Accounting Class Actions Rise, But Settlements Fall

DOL Taps the Brakes on ESG Investing

Independent Audit Committee. What is it Good For? Absolutely Nothing!

PCAOB 2016 Inspections Status Report

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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.

CAQ Suggests Some Questions Directors Should Be Asking About Cyber Security Risks

Directors typically identify cybersecurity risk oversight as one of the top challenges facing the board. See Audit Committee Members are Challenged By Risk Management and Think They Would Benefit From a Better Understanding of the Business, January-February 2017 Update. To help in discharging board responsibilities in this area, the Center for Audit Quality has released Cybersecurity Risk Management Oversight: A Tool for Board Members. This publication contains a list of cyber risk questions that board members may want to ask management and the company's auditors. The CAQ focuses on board oversight of the auditor's cybersecurity responsibilities and of management's approach to cybersecurity and related disclosures. The CAQ tool comes on the heals of the SEC staff's new guidance on cybersecurity disclosure. See SEC Issues Guidance on Cyber Disclosure, Including the Board's Oversight Role, March 2018 Update.

The CAQ's suggested questions are aimed at improving board understanding in four categories of cybersecurity oversight:

- Understanding auditor consideration of cybersecurity risk. One set of questions focuses on discussion with the auditor regarding cybersecurity in the context of both the financial statement audit and the audit of internal control over financial reporting.

- Understanding the role of management and the auditor with respect to cybersecurity disclosures. The management questions in this area relate to compliance with SEC guidance on controls and procedures and on disclosures related to cybersecurity risks, including the relationship between insider trading policies and cyber incidents. The auditor questions address the auditor's responsibilities for cyber-related disclosures outside the financial statements, contingent liabilities, and cyber incidents discovered after the balance sheet date.

- Understanding management's approach to cybersecurity risk management. The tool includes a series of questions that that board members can use to better understand a company's cybersecurity risk management program.

- Understanding how CPA firms can assist boards of directors in their oversight of cybersecurity risk management. The tool also suggests questions aimed at encouraging dialogue regarding

non-audit cybersecurity-related services that accounting firms can provide.

In addition to these four categories, Appendix A to the CAQ's publication contains questions regarding cybersecurity recommended by the National Association of Corporate Directors in its 2017 Director's Handbook on Cyber-Risk Oversight. Appendix B lists other resources that may be useful to directors in discharging their cybersecurity oversight responsibilities.

Comment: As noted in the March 2018 Update, audit committees are often tasked with oversight of cybersecurity risks. The SEC's recent guidance, referenced above, emphasizes disclosure of how the board oversees cyber-security and how the board engages with management on that issue. As a result, many companies are likely to expand their discussion of these issues, and boards will want to review their role. The CAQ's suggested questions could serve as one component of enhanced board or audit committee oversight in this area.

New Leasing Standard Will Have a Material Impact – and the CAQ Has Some Suggested Audit Committee Questions About That As Well

As discussed in several prior Updates, a new standard governing accounting for leases will take effect for public companies at the beginning of 2019. See Despite Progress, Some Companies Are Still Behind Schedule on Lease Accounting, March 2018 Update. The use of leases is, of course, widespread. Accordingly, implementation of the new standard is proving to be a major challenge for many reporting companies. Two new publications may be helpful to audit committees as they seek to understand the impact of the new leasing rules and to oversee implementation.

With respect to the financial reporting impact of the new standard, lease accounting software provider LeaseAccelerator has released a study of the public disclosures that the 100 U.S. public companies with the greatest total leasing obligations have made pursuant to SEC Staff Accounting Bulletin No. 74. SAB 74 requires disclosure of the potential future financial statement impacts of new accounting standards. For these 100 companies, LeaseAccelerator finds that:

- Seventy-six percent reported that there will be a material balance sheet impact as a result of the new requirement to reflect "right-of-use" assets and associated liabilities on the balance sheet. Another 20 percent are still analyzing the potential impact. Two percent do not foresee a material impact, and two percent did not address the issue in their SAB 74 disclosure.

- Twenty-eight percent reported that there will not be a material impact on their income statement. Sixty-six percent are still analyzing the income statement impact.

- Nineteen percent reported there would be no impact on their statement of cash flow, while 64 percent are still analyzing the impact. No companies reported that they were expecting a material impact on the cash flow statement.

The magnitude of the potential financial reporting impact, coupled with the implementation challenges, underscore the importance of audit committee oversight in this area. In [Preparing for the New Leases Accounting Standard: A Tool for Audit Committees], released on April 4, the Center for Audit Quality suggests audit committee discussion topics on the new lease accounting standard. Below is a synopsis of the areas in which the CAQ's leasing oversight tool provides audit committee questions:

- Understanding the new standard. The publication contains a short overview of the standard and how it will change lessee and lessor accounting. It suggests that the audit committee probe key judgments and challenges management must make in implementing the standard, such as identifying all contracts that are, or that contain, leases, and determining how to measure the new right-of-use asset and lease liability.

- Evaluating the company's impact assessment. CAQ questions in this area include –

  - How has management assessed the impact of the new standard on the company?

  - Were all relevant internal parties involved in the assessment (e.g., accounting, tax, financial reporting, financial planning and analysis, investor relations, treasury, operations, procurement, legal, information technology, and real estate)?

  - What factors did management consider in assessing the impact (e.g., the company's industry, extent of activities that could be defined as leasing, approach to authorizing leases, steps to verify that the population of leases is complete)?

  - What other considerations may affect the company as a result of the new standard (e.g., debt covenants, income tax effects, financial planning and analysis, investor relations, regulatory compliance, controls).

  - When will management provide pro-forma financial statements, including disclosures, to the audit committee to demonstrate the expected reporting impact of the new standard?

  - How does the company's external auditor view the company's impact assessment?

- Evaluating the company's implementation plan. This is the area in which the CAQ suggests the most extensive questioning. The 30 specific proposed questions fall into six categories – the implementation project plan, culture and resources, involvement of stakeholders (both internal and external), accounting policy and significant accounting judgments, impact on financial reporting systems, and impact on internal controls.

- Other implementation considerations. The CAQ suggests questions relating to the company's transition method -- that is, recognition and measurement of leases in effect at the time the new standard takes effect and in prior period financial statements. The standard requires the use of a "modified retrospective

approach", subject to certain "practical expedients". In addition, the CAQ suggests that the audit committee should inquire concerning financial statement disclosures, impact on the auditor's risk assessment, and issues that will arise if the company (or an affiliate) reports under both U.S. GAAP and International Financial Reporting Standards.

Comment: Implementation of the new leasing standard is one of the major accounting oversight challenges audit committees currently face. As noted in the March 2018 Update, audit committees should be monitoring the company's progress on leasing standard implementation in order to avoid last-minute surprises. Companies that engage in any significant amount of leasing should already be nearly done with their implementation effort.

SEC Chief Accountant Outlines Audit Committee's Non-GAAP Oversight Role (Again)

Continuing a theme articulated in prior speeches (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), SEC Chief Accountant Wes Bricker called on audit committees to be active in overseeing company disclosure of non-GAAP financial measures. In May 3 remarks entitled "Working Together to Advance Financial Reporting" delivered at the 2018 Baruch College Financial reporting Conference, Mr. Bricker made three points regarding the audit committee's non-GAAP oversight.

- Use of non-GAAP measures. "A company's audit committee can play an important role in understanding whether—and how and why—management uses any supplemental scorecards in understanding and tracking results and how that supplemental information may be used in addition to GAAP financial statements in the company's public reporting."

- Culture of financial reporting. "Audit committees that clearly understand non-GAAP measures presented to the public—and who take the time and effort in their financial reporting oversight role to review with management the preparation, presentation, and integrity of those metrics—are an indicator of a strong compliance and reporting culture."

- Understanding non-GAAP measures. "Audit committees can review the metrics to understand how management evaluates performance, whether the metrics are consistently prepared and presented from period to period, and the related disclosure policies."

In summary, he observed: "Audit committees that are not engaging in these processes should consider doing so. A demonstration of strong interest in these issues can have a positive effect on the quality of disclosure."

Mr. Bricker also touched on audit committee responsibilities in another area. He urged audit committees to become more involved in disclosure of market risk information:

"[S]ome businesses' balance sheets, results of operations, and cash flows are particularly sensitive to changes in economic and market conditions such as changes in the liquidity in the markets, the level and volatility of market prices and rates, including for debt and equity investments, market indices, or business and other sentiments that affect the markets. I encourage those involved in the disclosure preparation and oversight process to be attentive to disclosures regarding changes in market risks."

Comment: Non-GAAP disclosures have been an SEC priority for several years, and the importance of audit committee oversight in this area has been a point of emphasis. Audit committees should be aware of the non-GAAP measures their company is disclosing and of the rationale for those measures. Attention should also be paid to the controls around the accuracy of the inputs and calculations involved.

Accounting Class Actions Rise, But Settlements Fall

As discussed in Securities Law Class Actions are Mushrooming, But More Cases are Being Dismissed and the Survivors are Settling for Less, March 2018 Update, Cornerstone Research has found that class action litigation filings under the securities laws are increasing. At the same time, more cases are being dismissed and settlement amounts are declining. Cornerstone has now issued additional research focused specifically on accounting class actions filed in 2017. Accounting Class Action Filings and Settlements: 2017 Review and Analysis finds that, in absolute numbers, accounting class actions reached an all-time high in 2017. At the same time, the value of settlements in accounting cases "declined dramatically."

Among the findings the new accounting class actions study are –

- 165 accounting class actions were filed during 2017. This compares to 88 during 2016.

- However, 107 of the 2017 accounting class action cases were "non-traditional." These non-traditional cases involved litigation objecting to M&A transactions on the ground that the merger-related disclosures did not include a reconciliation of projected non-GAAP measures to the most directly comparable GAAP measure. Cornerstone notes that only 20 percent of these cases were pending at the end of 2017, which seems to be consistent with the practice of quickly settling or voluntarily dismissing merger-objection cases on a disclosure-only basis. (Many observers would regard this type of cases as filed primarily to generate a court award of attorneys fees for the plaintiff class's lawyers.)

- The number of accounting class action settlements increased slightly in 2017, but the value of these settlements fell to its lowest level in over 15 years. The value of cases settled in 2017 was 58 percent of the value of cases settled in 2016.

- For the first time since 1995, no auditors were named as defendants in any traditional accounting case filed in 2017.

- Class actions based on internal control weaknesses are common, but seem to be declining. Fifty percent of traditional accounting cases filed in 2017 included allegations of internal control weaknesses. This was the first year since 2009 that an ICFR allegation was not included in more than half of new cases.

Comment: As noted in the March 2018 Update, 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. However, the risk that a non-M&A class action suit will raise accounting issues seems to be declining, although accounting remains a significant line of attack for the plaintiff's bar. The best protection against litigation is diligence and care in overseeing the company's financial reporting.

DOL Taps the Brakes on ESG Investing

One of the strongest recent trends in corporate disclosure is the increased emphasis on information relating to the company's performance relating on environmental, social, and governance (ESG) issues. See, e,g., Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture, March 2018 Update. The demand for ESG disclosure has, in turn, been driven in large part by the increase in ESG-based investing. Large percentages of institutional investors assert that they take ESG factors into account in their investment decision-making. See, e.g., Institutional Investors Say They Use ESG Disclosure, But Aren't Satisfied with What They are Getting, April 2017 Update. However, on April 23, the Department of Labor (DOL) issued a statement that may cause one type of institution – ERISA plan fiduciaries – to exercise more caution in making investments that are driven by ESG considerations.

DOL Field Assistance Bulletin No. 2018-01 clarifies previously-issued guidance on the role of ESG factors in the decisions of asset managers and other fiduciaries with responsibility of ERISA plan assets. FAB 2018-01 states that it is the Department's "longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals." In addition, fiduciaries should not conclude lightly that ESG factors are economically relevant to their investments; a focused financial analysis is necessary. "It does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors." The fiduciary's duty is to "put first the economic interests of the plan in providing retirement benefits." Accordingly, "evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment."

FAB 2018-01 also addresses ERISA plan proxy voting and other types of shareholder engagement with portfolio companies. The DOL notes that these activities usually do not involve significant plan expenses because they are generally undertaken by institutional investment managers, not by the plan itself. Indeed, FAB 2018-01 suggests that the expenditure of plan assets on ESG engagement activities may be problematic. The new guidance indicates that prior DOL statements were "not meant to imply that plan fiduciaries, including appointed investment managers, should routinely incur significant plan expenses to, for example, fund advocacy, press, or mailing campaigns on shareholder resolutions, call special

shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues" relating companies in the investment portfolio they manage.

Comment: Whether the DOL or the plaintiff's bar will use FAB 2018-01 as a vehicle for challenging ERISA fiduciary decisions to make ESG-based investments remains to be seen. Companies faced with ESG-driven shareholder proposals or other types of activism by ERISA fiduciaries may also seek to use FAB 2018-01 as a defensive measure.

From an audit committee perspective, the significance of the new DOL guidance may lie in the possibility that it will increase investor pressure for company disclosure of material information related to ESG performance that can be used as a basis for economic investment decision-making. If ERISA fiduciaries are going to be in the position of having to defend their use of ESG factors on economic grounds, they will likely demand that companies make disclosures that can provide the basis for that type of defense. (In this regard, companies should consider the work of the Sustainability Accounting Standards Board. SASB disclosure standards seek to identify, on an industry-by-industry basis, the specific, quantifiable sustainability information that is material under the federal securities laws and is useful in investment decision-making.) For audit committees, new ESG disclosures will pose oversight challenges, particularly as to controls and procedures to assure the accuracy and reliability of non-traditional disclosures.

Independent Audit Committee. What is it Good For? Absolutely Nothing!

The results of a research study summarized in a recent article in The CPA Journal (a publication of the New York State Society of CPAs) finds that the independence of audit committee members (as defined in pre-Sarbanes-Oxley stock exchange listing requirements) had no impact on either share prices or the quality of public company financial reporting. In Questioning the Effectiveness of Independent Audit Committees: Does the Current Regulatory Regime Improve Reporting Quality, April Klein, a professor of accounting at New York University's Stern School of Business, concludes that "there was no tangible change in earnings management and restatements (egregious or not) between the time periods before and after the implementation of the audit committee independence * * * standards." Moreover, she states, "[t]he empirical results of this research strongly suggest that the current regulatory regime surrounding the composition of audit committees is not adequate in providing investors with high-quality financial reports."

In reaching these conclusions, Professor Klein and a colleague examined the impact of the adoption, in December, 1999, of New York Stock Exchange and Nasdaq audit committee listing standards. These standards required all listed companies to have an audit committee comprised of at least three directors having "no relationship to the company that may interfere with the exercise of their independence from management and the company." (The Sarbanes-Oxley Act subsequently codified those requirements and added other audit committee provisions.) The 1999 listing standard changes were set in motion in September, 1998, when SEC Chairman Arthur Levitt gave a speech calling for strengthening the role of audit committees. At the time of the speech,

only 40.8 percent of listed companies had at least three members, all of whom were independent.

Professor Klein's research has two key findings:

- The market did not value independent audit committees. Companies that were not in compliance with the independence and size requirements in September, 1998 did not experience abnormal positive (or negative) stock market returns during the 15-month period ending with the SEC's approval of the new listing standards. The same was true when the analysis looked only at companies with "poor financial reporting quality" (as measured by the announcement of a fraud-based restatement between 1996 and 1998). This lack of market reaction, Professor Klein states, is "consistent with the market perceiving that audit committees with full independence or a minimum of three directors provide no net benefit to existing shareholders."

- Independent audit committees did not improve the quality of financial reporting. The study also compared financial reporting quality prior to and after the implementation of the 1999 listing standards. For this part of the analysis, the study looked at earnings management, "egregious" restatements, and all restatements during the one-year period prior to Chairman Levitt's speech and during the post-listing standard one-year period beginning June 30, 2001. Professor Klein concludes that "there was no tangible change" in earnings management and restatements before and after the implementation of the audit committee independence and size standards. "Most pointedly, companies with audit committees out of compliance [with the audit committee requirements] prior to 1998 showed no improvement in financial reporting quality" after the listing standards took effect.

While not discussed in detail in The CPA Journal article, Professor Klein also analyzed the impact of certain other audit committee characteristics. Among other things, she found that, "somewhat surprisingly", the presence on the audit committee of a financial expert had "no tangible effects".

Comment: Professor Klein recognizes that her findings do not stand broadly for the proposition that audit committees provide no value. "These results should not, however, be interpreted as a negation of using an audit committee as a conduit between the auditor and the auditee in order to produce high-quality financial reporting. These findings merely confirm the view that independence, as defined by stock exchanges and the SEC, as well as the minimum size requirement, are not *by themselves* adequate to ensure financial statements free from fraud or error." It also seems possible that the results of this research only reflect the value of audit committees, independent or otherwise, in the pre-Sarbanes Oxley period. During the 15-plus years since the enactment of SOX, audit committees' understanding of the scope and nature of their responsibilities has changed radically, along with the time commitment associated with committee service. If the SOX independent audit committee requirement were to be abolished today, it seems unlikely that the market would be as sanguine about that change as it apparently was when the requirement was imposed by the stock exchanges in 1999.

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.

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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