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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.

Does Your Company Suffer From Quadrophobia? The SEC is Investigating the Fear of Four

A June 22, 2018 Wall Street Journal article, "SEC Probes Whether Companies Rounded Up Earnings Per Share," reports that the Securities and Exchange Commission is investigating the curious absence of quarterly earnings per share figures that end in .4 cents. The premise of the investigation is that, since EPS amounts that end in .5 cents can be rounded to the next highest whole cent, there is a strong incentive to make discretionary accounting adjustments that raise EPS calculations ending in .4 cents to .5. For example, if preliminary results indicate that EPS is 13.4 cents, which would be publicly reported as 13 cents per share, it may be relatively easy to adjust revenue or expense items so that the EPS rises to 13.5 cents, which, in turn, can be rounded to 14 cents per share. The Journal reports that the SEC Enforcement Division has sent inquiries to at least 10 companies asking them to provide information about accounting adjustments that could have increased their earnings per share in this manner. The SEC has not publicly commented.

According to the Journal, the SEC's staff became interested in this issue as a result of an academic paper, Quadrophobia: Strategic Rounding of EPS Data, released in 2014 by Nadya Malenko and Joseph Grundfest. (Professor Grundfest is a former SEC Commissioner and Stanford University Law School faculty member.) The Malenko/Grundfest study reviewed quarterly earnings reports for publicly traded companies during the period from 1980 to 2013. It found that the number four is "significantly underrepresented in the first post-decimal digit of EPS, particularly among firms that are covered by analysts and have high market-to-book ratios." The study also concluded that, once a company embarks on this type of rounding, it is not likely to discontinue the practice. "[T]he probability that a company that has not reported a four in the first post-decimal digit of its EPS for ten years will report a four in any of its next three quarters is only 6.3%." However, the Malenko and Grundfest finding that may be the most intriguing to the SEC Enforcement staff is that quadrophobia is also a predictor of more serious forms of financial reporting abuse:

> "[C]ompanies with high quadrophobia scores are significantly more likely to restate their financial statements, be named as defendants in SEC Accounting and Auditing Enforcement Releases (AAERs), and be involved in class action securities fraud litigation. * * * Thus, even if quadrophobia results from the exercise of legitimate

accounting discretion, it appears to be practiced by managements that are more likely to engage in other problematic practices that give rise to restatements and litigation."

Comment: Accounting involves a host of discretionary determinations, and the adjustments that would affect quarterly earning by a tenth of a cent would be quite small for most companies. Accordingly, the SEC might finding it challenging to prove that any given determination was made for the purpose of affecting reported EPS. On the other hand, the Commission might be successful in arguing that a pattern of discretionary decisions that altered EPS from a .4 figure to a .5 figure, repeated over a long period of time, indicated an intent to manipulate earnings, especially if the company's stock price is particularly sensitive to reported EPS.

For audit committees, the quadrophobia inquiry could serve as a basis to revisit the controls around the calculation of EPS, discretionary accounting adjustments, and quarterly earnings reporting. Given the publicity surrounding the topic, it would be prudent to ask whether there are controls in place that would prevent or detect these kinds of adjustments and, if not, to expect that such controls will be implemented.

CAQ Explains CAMs

As discussed in several prior Updates, last year the Public Company Accounting Oversight Board 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. This requirement will take effect for large accelerated filers for audits of fiscal years ending on or after June 30, 2019; for other public companies the requirement will apply to fiscal years ending on or after December 31, 2020.

On July 24, 2019, the Center for Audit Quality (CAQ) released a publication to help audit committees and investors understand the new auditor's reporting model. *Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements* focuses on the auditor's responsibility to determine and communicate CAMs and on how CAM reporting under the PCAOB requirement compares to similar non-U.S. reporting requirements.

The new CAQ publication addresses four topics:

- Understanding Critical Audit Matters. This section discusses the definition of a CAM and the factors that an auditor should consider in determining whether a matter involved especially challenging, subjective, or complex auditor judgment. A CAM is any matter arising from the financial statement audit that was communicated (or required to be communicated) to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements, and (2) involved especially challenging, subjective, or complex auditor judgment.

- CAM Reporting in the Auditor's Report. This section discusses the information that auditors will be required to include in their reports concerning CAMs. For each CAM communicated in the auditor's report the auditor must (1) identify the CAM; (2) describe

the principal considerations that led the auditor to determine that the matter is a CAM; (3) describe how the CAM was addressed in the audit; and (4) refer to the relevant financial statement accounts or disclosures that relate to the CAM.

- Expanded Auditor Reporting Outside the United States. The International Auditing and Assurance Standards Board (IAASB), which establishes auditing standards outside the United States, requires similar reporting. See Study Finds that, Outside the U.S., KAM Reporting Has Improved Auditing, March 2018 Update. Under the IAASB's standards, the matters that must be disclosed by the auditor are referred to as "key audit matters" or KAMs. The new CAQ publication discusses KAM reporting and the similarities and differences between the PCAOB IAASB requirements. The CAQ publication also includes an Appendix which provides a detailed, tabular comparison.

- Frequently Asked Questions About CAMs. This section consists of responses to eight frequently asked questions regarding CAM reporting. For example, one FAQ addresses the impact of CAM reporting on auditor/audit committee communications:

  > "The source of CAMs are those matters communicated or required to be communicated to the audit committee. PCAOB auditing standards already require a wide range of topics to be discussed and communicated with the audit committee, which in most cases means most, and likely all, of the matters that will be CAMs are already being discussed with the audit committee. However, not every topic that is discussed with the audit committee will rise to the level of a CAM. The PCAOB Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing."

Comment: Presumably, most audit committee members are already familiar with the basics of the PCAOB's new auditor's reporting model, including CAM reporting. However, for those who are not, the CAQ's publication is a short, readable overview of the topic.

Audit Committee Disclosures Continue to Grow, Especially About Cybersecurity Oversight

The Deloitte Center for Board Effectiveness has released an analysis of 2018 S&P 100 proxy statement disclosures concerning the audit committee. The study finds that these large companies are "voluntarily increasing disclosures included in the proxy, albeit at a slower pace in some areas." The largest increase occurred in disclosures concerning the audit committee's role in the oversight of cybersecurity.

During the last several years, voluntary disclosure about audit committee responsibilities and how they are discharged has grown significantly. See Transparency Rolls On: Audit Committees Are Voluntarily Disclosing More About Their Work, November-December 2017 Update. In 2013, organizations with an interest in audit committee transparency issued a "Call to Action" urging audit committees to strengthen their disclosures. See Center For Audit Quality Calls for Greater Audit Committee Transparency, November-December 2013 Update. Since the Call to

Action, the Center for Audit Quality and research firm Audit Analytics (AA) have annually issued a report – the Transparency Barometer – on the state of audit committee disclosure. As discussed in the November-December 2017 Update item referenced above, those reports indicate that disclosure has increased steadily since 2013.

Key findings in Deloitte's new report include:

- Most frequent disclosures. The seven topics (as characterized by Deloitte) that are most frequently disclosed in S&P 100 proxy statements, and the percentage of companies that make the disclosure, are:

    - "Roles and responsibilities of the audit committee" (100 percent).

    - "The audit committee is responsible for oversight of risk" (99 percent).

    - "Discussion of the audit committee's oversight of the company's financial reporting processes" (96 percent).

    - "Topics of discussion by the audit committee" (96 percent).

    - "Discussion of the audit committee's role in overseeing the internal audit function" (93 percent).

    - "Audit committee has more than one financial expert" (84 percent).

    - "Audit committee compensates the independent auditor" (84 percent).

- Greatest increases in disclosure between 2017 and 2018. The four topics that showed the largest increases in the number of S&P 100 companies that made disclosure on the topic in 2018, as compared to 2017, (and the percentage increase over 2017) are:

    - "Discussion of the audit committee's role in the oversight of cybersecurity" (13 percent increase).

    - "Audit committee evaluates the independent auditor" (10 percent increase).

    - "Tenure of the independent auditor" (8 percent increase).

    - "Why the audit committee decided to reappoint the independent auditor" (7 percent increase).

Disclosure that the audit committee discusses financial reporting issues and challenges is reasonably common. For example, 57 percent of S&P 100 companies disclose "Audit committee review of significant accounting policies" (a 4 percent increase over 2017), and 40 percent disclose "Discussion of management judgments and/or accounting estimates" (a 6 percent increase over 2017). However, disclosures concerning discussion between the audit committee and the auditor regarding auditing challenges is rare. Only 8 percent of companies disclose

"Discussion of the issues encountered during the audit" (a 2 percent increase over 2017). Deloitte notes that, under the new PCAOB auditor reporting requirements, auditors of large accelerated filers will begin to disclose CAMs next year and that the "new requirement may drive an increase in company disclosures in related areas." Discussion of an audit issue with the audit committee is a prerequisite to treatment of the issue as a CAM. See CAQ Explains CAMs, in this Update.

Comment: As noted in prior Updates, audit committees should be aware of the types of voluntary disclosures concerning the committee's responsibilities and activities that their peers are making and consider expanding their own disclosures to match. Enhanced voluntary disclosure may head off shareholder demands for more audit committee information, and is, in any event, becoming a best practice.

SEC Chief Accountant Addresses the "Purpose and Promise" of Financial Reporting

In Advancing the Purpose and Promise of Those Involved in Financial Reporting, a June 19 address to the Institute of Management Accountant's 2018 Annual Conference, SEC Chief Accountant Wes Bricker discussed the "vital role of management accountants within our financial reporting process and the relationship among management, the audit committee, and the auditor." While his speech touches on many aspects of financial reporting, several points are particularly relevant to audit committees.

Echoing remarks SEC Chairman Clayton made at another conference, Mr. Bricker emphasized the importance of ethics and culture in financial reporting and the responsibility of board members to foster an ethical environment. He noted that directors, along with managers and employees, "can play a vital role in supporting management to run the companies you serve in a manner that will promote long-term shareholder value without compromising the integrity of the company's reputation for high-quality financial reporting. This gives management the courage to make right decisions." Further, an ethical corporate culture "is foundational to an effective control environment." For example, "The board and corporate leaders must consistently demonstrate ethical behavior in words and actions. Employees must be able to trust the board's and management's commitment to systems that both prevent and detect bad behavior, including in the financial reporting and preparation processes."

As to the audit committee specifically, Mr. Bricker made five points:

- "Companies and directors should carefully choose who serves on their audit committee, selecting those who have the time, commitment, and experience to do the job well. Just meeting the technical requirements of financial literacy may not be enough to understand the financial reporting requirements fully or to challenge senior management on major, complex decisions."

- "Audit committees of every company must be committed to their oversight of financial reporting. They must, for example, be able to adequately review how management is designing and implementing internal controls. * * * [T]he responsibility to maintain internal controls is incumbent upon management, with

oversight of the audit committee, regardless of the size of the company."

- "As part of their oversight of the external audit, audit committees can make a positive impact on financial reporting by asking probing questions of external auditors about the auditor's risk assessment and strategy undertaken for the audit. For example,

    - In an audit of the financial statements, was the external auditor able to rely on a company's internal control over financial reporting?

    - If not, which of the business processes included the internal controls on which the auditor did not (or could not) place reliance? What were the factors that prevented reliance?

    - Were any significant deficiencies or material weaknesses identified (and communicated in writing)?

    - How did management consider that feedback in preparing the financial statements, including in its period end closing processes?"

- "Audit committees can take insights from the conversation with auditors about whether, where, and why they were unable to rely on internal controls. The audit committee's expectations for clear and candid communications from the auditor and management in this area should not be taken lightly, particularly when it is time to evaluate the relationship with the auditor. Just the same, the auditor should expect appropriate support and tone from audit committees when internal control or other matters arise."

- "A board and audit committee should also understand the external auditor's compliance with the auditor independence rules and the impact on the board and company of noncompliance."

Comment: Mr. Bricker's has emphasized the role and responsibilities of audit committees in a series of speeches during the past 18 months. See e.g., SEC Chief Accountant Outlines Audit Committee's Non-GAAP Oversight Role (Again), April-May 2018 Update); SEC Chief Accountant Speaks on Audit Committees, July 2017 Update; SEC Chief Accountant on Advancing the Role and Effectiveness of Audit Committees, March 2017 Update; and SEC Chief Accountant Has Some Suggestions for Audit Committee "Critical Gatekeepers," 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.

Public Company Restatements At a 17-Year Low

Audit Analytics (AA) has released its annual report on public company restatements, 2017 Financial Restatements: A Seventeen Year Comparison (available here for purchase on the Audit Analytics website). The report concludes that the aggregate number of restatements in 2017 fell to 553 – a 17-year low. Total restatements in 2017 were about 18

percent (118 restatements) lower than the 671 reported in 2016. See Restatements Hit Another New Low, and SOX Could Be the Reason, July 2017 Update. The 553 2017 restatements were filed by 505 unique companies.

As explained in the July 2017 Update item referenced above, 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. This type of restatement is referred to 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. These less significant restatements are called as "Revision Restatements" or "little r restatements".

AA's June 7 public blog post on the 2017 report highlights these conclusions:

- Reissuance Restatements declined for the eleventh year in a row.

- Around 77% of restatements disclosed by 10-K filers were Revision Restatements.

- Total restatements dropped for three consecutive years to a 17-year low.

- There were 184 restatements filed by accelerated filers, and 236 restatements disclosed by non-accelerated filers. (The blog post does not reconcile these figures to the 533 total restatements.)

- The average number of days restated decreased, and was much lower than the 737 days during 2005. (A chart in the blog post indicates that the average restatement period in 2017 was 509 days.)

- 168 of the restatements disclosed by publicly traded companies had no impact on earnings.

Comment: Restatements peaked at 1,842 in 2006, more than triple the number last year. See Although Restatement Frequency is Steady and Severity is Low, Accounting Class Actions Alleging Accounting Violations Are Increasing, June 2015 Update. The 2006 peak occurred during the period when public companies and their auditors were devoting a new level of scrutiny to internal control over financial reporting in the wake of the implementation of the Sarbanes-Oxley Act requirement to assess and report on control effectiveness. Since the 2006 high water mark, restatements have declined steadily. This seems consistent with other research indicating that the quality of financial reporting (as measured by the frequency and severity of restatements) has increased since the Sarbanes-Oxley Act. This is likely the result of the substantial investment companies have made in strengthening the effectiveness of their controls. And, while class action litigation based on accounting and financial

reporting issues has also increased, the settlement value of such litigation (presumably a measure of the severity of the alleged violation) has also fallen. See Accounting Class Actions Rise, But Settlements Fall, April-May 2018 Update.

New Delaware Law Provides for Voluntary Sustainability Transparency Certification

Delaware has adopted a new statute that will provide a framework for companies to commit voluntarily to sustainability disclosure and performance standards. The "Certification of Adoption of Transparency and Sustainability Standards Act" was signed on June 28 and will take effect October 1, 2018. The legislation is another step toward bringing sustainability reporting into the mainstream of corporate disclosure responsibilities.

The Act states that its purpose is "to support Delaware business entities in their global sustainability efforts" by permitting "a Delaware entity to signal its commitment to global sustainability." Compliance with the Act is not mandatory, and, entities that do elect to comply are not required to follow any particular sustainability performance or disclosure regime: "[A] Delaware entity is free to choose standards promulgated or developed by any entity."

Under the Act, if an entity's internal affairs are subject to Delaware law (such as a company incorporated in Delaware), it may elect to seek a "Certificate of Adoption of Transparency and Sustainability Standards" from the Delaware Secretary of State. A company that receives such a certificate becomes a reporting entity under the Act. In order to become certified, the governing body – such as the board of directors in the case of a corporation – must adopt resolutions setting forth the entity's sustainability "Standards" and "Assessment Measures."

- Standards are defined as "the principles, guidelines or standards adopted by the Entity to assess and report the impacts of its activities on society and the environment, which principles, guidelines or standards shall be based on or derived from Third Party Criteria."

- Assessment Measures are "the policies, procedures or practices adopted by such Entity to adduce objective factual information to assess the Entity's performance in meeting its Standards, including any procedures for internal or external verification of such information."

The governing body may select Standards and Assessment Measures, based on the circumstances of the company, and may rely on input from relevant parties, including experts and investors. Delaware will not evaluate the company's Standards or Assessment Measures.

Once certified, in order to continue as a reporting entity, the company must annually file for renewal. The renewal statement must acknowledge that the reporting company has made a "Report" publicly available on its website for the most recent annual reporting period. Among other things, Reports are required to include:

- A summary of the Standards and Assessment Measures in effect during the reporting period.

- A summary of the actions or activities by which the entity has sought to meet the Standards during the reporting period, including any engagement with and disclosure to stakeholders.
- The most recent available "objective and factual information" developed pursuant to the Assessment Measures with respect to the entity's performance in meeting its Standards during the reporting period, and an assessment by the governing body of whether the entity has been successful in meeting the Standards.

- If the entity failed to meet the Standards, a summary of any additional efforts the governing body has determined the entity will undertake to improve its performance.

- The identity of any consultants or service providers that assisted in measuring, managing or reporting the impact of the entity's business and operations in light of its Standards.

- A summary of any changes to the Standards or Assessment Measures.

- A summary of any planned material changes to the entity's actions or activities to measure, manage, and report with respect to the Standards.

Comment: As noted in prior Updates (see, e.g., Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture, March 2018 Update), 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. 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 new Delaware law is an effort to create a legal framework within which these disclosure demands can be met without directly imposing a disclosure requirement or mandating that companies follow any particular set of disclosure standards. It will be interesting to see whether investors demand that companies opt in to the Delaware scheme – or whether companies perceive that there are benefits in doing so without waiting for investor pressure. Although most companies today publish a sustainability report, fewer do so in compliance with any specific set of third party standards. Since compliance with the new Delaware law requires disclosure pursuant to such standards, widespread acceptance of the Certification of Adoption of Transparency and Sustainability Standards Act could be a major step toward consistency and comparability of sustainability

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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