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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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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.

In This Update:

CAQ Updates its Auditor Assessment Tool

On April 2, the Center for Audit Quality released an updated version of its External Auditor Assessment Tool: A Reference for US Audit Committees. In conjunction with the 2019 update, the CAQ also released an 11-minute video discussing the Auditor Assessment Tool.

The assessment tool is designed to assist audit committees in evaluating the company's auditor in order to make an informed recommendation to the full board as to whether the auditor should be retained. The CAQ, in conjunction with the Audit Committee Collaboration (a group of organizations interested in corporate governance and auditing oversight), issued the U.S. assessment tool, along with a companion worldwide tool, in 2015. See The Audit Committee Collaboration Publishes External Auditor Assessment Tools, July 2015 Update. The U.S. tool was subsequently updated in 2017. See CAQ Updates its Auditor Assessment Tool, April 2017 Update.

The assessment tool begins with an overview of the auditor assessment process. According to the CAQ, that process should draw on the audit committee's experience with the auditor during the engagement, including presentations, reports, and dialogue during formal and informal meetings, and should be informed by prior evaluations. The committee should also obtain the views of management and internal audit. Other sources of assessment input include PCAOB inspection reports and peer review findings, along with the audit firm's own comments on its performance. The CAQ also recommends that the audit committee consider disclosing to shareholders that it performs an annual auditor evaluation and the process, scope, and factors considered in the evaluation.

The assessment tool contains 18 questions that an audit committee could consider asking as part of its evaluation. These questions are grouped under four topics:

- Quality of Services and Sufficiency of Resources Provided by the Auditor: Part I. These questions focus on the engagement team and on any other auditors involved in the company's audit, such as other firms in the principal auditor's global network.

- Quality of Services and Sufficiency of Resources Provided by the Auditor: Part II. Questions under this heading address the firm's resources and expertise. The results of, and firm responses to, the most recent PCAOB inspection fall into this category.

- Communication and Interaction with the Auditor. This set of questions deals with the frequency and quality of communication between the auditor and the audit committee and how effectively those communications provide the committee with information it needs to fulfill its responsibilities.

- Auditor Independence, Objectivity, and Professional Skepticism. Questions on this topic address compliance with independence requirements and the auditor's willingness to challenge management and maintain an attitude of professional skepticism.

The tool can be used as a template for memorializing the audit committee's assessment. It is formatted in a manner that permits responses to be added following each question and generates a record of the results of the information-gathering process.

The tool also has a section entitled "Obtaining Input from Company Personnel about the External Auditor." This part includes a questionnaire that could be distributed to company personnel to obtain their ratings of the auditor in 12 areas, along with responses to an open-ended question concerning areas in which the auditor could improve. Appendices to the assessment tool contain the text of requirements and standards relevant to auditor assessment and a bibliography of suggested reading.

The updated assessment tool is substantially the same as the prior version, although some questions have been revised, particularly those related to engagement team performance. In addition, discussion of audit quality indicators and of specific issues for discussion with the auditor (e.g., new GAAP requirements and new PCAOB standards), which were including in the 2017 edition, have been deleted.

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

Even After the Effective Date, Implementing the New Lease Accounting Standard is Still a Struggle for Many Companies

For public companies, the FASB's new standard governing financial reporting for leasing activities, ASU No. 2016-02, Leases (Topic 842), took effect December 15, 2018. See FASB Adopts New Lease Accounting Standard, February-March 2016 Update. Implementation of the new standard was a time- and resource-intensive process for many companies. See Companies Continue to Struggle With Lease Accounting as the Deadline Looms, but the FASB Throws a Lifeline, August-September 2018 Update. A survey from the Deloitte Center for Controllership indicates that many public companies still have not made it to the finish line.

On February 28, the Center hosted a webcast on lease accounting. The webcast included an online poll of 950 C-suite and other executives. Key poll findings, which are reported in Lease accounting: A Q&A with public company finance leaders, include:

- Only 45.7 percent of public company respondents described their organization's lease accounting implementation timeline as either "early adopt" or "adopt on time."

- Only 60.7 percent of public company respondents said their company was prepared to comply with the new accounting standard; 30.6 percent said their company was somewhat prepared, while 6.9 percent reported that their company was unprepared.

- Slightly over half (52.6 percent) of public company respondents reported that they were using lease accounting software to implement the new standard, while almost one-third (30.8 percent) reported using a combination of manual efforts and software that was not lease accounting specific. Almost 13 percent of respondents didn't know what approach their company was using, either because the company was still trying to determine its approach or because it was reassessing due to "initial lease accounting software effort did not work."

- Nearly a fourth (23.9 percent) of public companies believe they will be spending more time and effort on lease accounting implementation in the coming year than they did up to the first quarter of 2019, while another 25 percent thought they would devote the same amount of time and effort in the year ahead. A little more than one-third (37.3 percent) predict their company will spend less time and effort in the coming year.

Like their public company brethren, many private companies, for which the standard takes effect next year, are behind schedule. Only 16.9 percent of private company respondents said their organization was prepared to comply with the new leasing standard. Just 36 percent characterized their organization's implementation timeline as either "early adopt" or "adopt on schedule."

In an April 1 press release announcing the survey results, Sean Torr, a Deloitte managing director, noted that, "Whether public companies need to better streamline lease accounting operations, fix temporary manual processes or refine technology solutions, there remains a lot of work ahead for many public companies. Private entities appear to have even more work ahead."

Comment: Audit committees need to be aware of the status of their company's implementation efforts and monitor when compliance will become a routine, repeatable and well-controlled process. In addition to reviewing the status, costs, and burdens of the implementation, audit committees may want to make sure that management is also focused on the benefits and opportunities. As Mr. Torr observed in a Journal of Accountancy article, "There is so much new data that companies haven't had in the past * * *. Some of the companies that we've spoken to are thinking about how you leverage that data moving forward for their economic decisions, as an example, lease versus buy."

Common Threads Across Boardrooms – Deloitte and the Society for Corporate Governance Issue 2018 Board Practices Report

The Society for Corporate Governance (Society) and the Deloitte Center for Board Effectiveness have released the 11th edition of their annual survey of boards of directors. The Board Practices Report: Common threads across boardrooms (BPR) provides a snapshot of how boards discharge their responsibilities. While audit committees are not the central focus of the BPR, several topics provide insight into audit committee practices.

The BPR is based on the results of a survey of public company members of the Society. The survey, which was conducted during the fourth quarter of 2018, asked respondents a series of questions regarding the activities and priorities of their board and its committees. There were 102 survey respondents, 43 percent of which were from large cap companies, 50 percent from mid-cap companies, and 7 percent from small caps. The breakdown by industry was energy, resources, and industrials -- 30 percent; consumer – 21 percent; financial services – 21 percent; technology, media, and telecommunications – 16 percent; and other industries – 12 percent.

Overall survey findings of interest are summarized below. (For some questions, response percentages exceed 100 percent because respondents could select more than one response.)

- Diversity. Ninety-four percent of respondents reported that their board is seeking to increase diversity. Sixty-one percent said the goal was to increase gender diversity, with significant percentages identifying other types of diversity (48 percent – race and ethnicity; and 43 percent -- professional skills or experience).

- Common discussion topics. The survey gathered a range of information concerning topics discussed at board meetings. The topics most frequently discussed at every board meeting were: Strategy (e.g., progress, alternatives, risks) (41 percent); regulatory matters (23 percent); capital allocation (20 percent); mergers and acquisitions (17 percent).

- Transparency and disclosure. Fifty-six percent of respondents anticipate that their company will increase disclosure related to corporate social responsibility, sustainability, and social impact in the next 12 to 18 months. The other topics most frequently cited as areas of increased future disclosure were board skills matrix (26 percent) and workforce diversity and inclusion (24 percent).

- Board level responsibility for CSR. Fifty-two percent of boards assign corporate social responsibility, sustainability, and social impact risks to the nominating and governance committee, while 50 percent allocate these risks to the full board. (As noted above, respondents could indicate that more than one body had responsibility.)

- Director use of social media. Nineteen percent of respondents said that company policy prohibits board members from using social media in relation to the company; 63 percent said that board members were neither expressly permitted nor prohibited from using social media to comment on the company or its industry. Only one percent of respondents (presumably one person) indicated that the board had received a report on director use of social media in the past year, although 17 percent didn't know whether their board had received such a report.

Regarding audit committees, survey findings include:

- Audit committee non-core responsibilities. Survey respondents were asked to identify the committee (or full board) to which various risk areas were assigned. With respect to audit committees, the responses indicated the following regarding the frequency with which various nonfinancial reporting areas are an audit committee responsibility:

    - Corporate culture. Seven percent of boards allocate corporate culture risk to the audit committee. At 75 percent of the surveyed companies, culture is a full board responsibility.

    - Corporate social responsibility, sustainability, and social impact. Three percent allocate CSR and related topics to the audit committee. As noted above, the full board and/or the nominating and governance committee is the usual home for these issues.

    - Cyber risk. Sixty-one percent of boards allocate cyber risk to the audit committee, while 52 percent allocate cyber to the full board. Ninety two percent of respondents reported that the company publicly discloses the role of the board or a committee in overseeing cyber risks.

    - Human capital and talent. One percent of boards assign human capital and talent risk to the audit committee, while 82 percent give this area to the compensation committee.

    - Legal and regulatory. Sixty-one percent allocate legal and regulatory risk to the audit committee. Sixty-seven percent assign this issue with the full board. (Since these percentages exceed 100 percent, the area is often a shared responsibility between the full board and the audit committee.)

    - Technology strategy (e.g., IT infrastructure, innovative and disruptive technology, social media). Forty-five percent of respondent companies allocate technology strategy to the audit committee. Sixty-one percent said it was a full board responsibility.

- Executive attendance at audit committee meetings. The following percentages of respondents indicated that specific members of management "regularly" attend audit committee meetings: Chief Financial Officer (94 percent); Chief Accounting Officer/Controller (93 percent); General Counsel (84 percent); Chief Audit Executive (80 percent); Chief Executive Officer (76 percent); Chief Compliance Officer/Ethics Officer (63 percent).

- Frequency and length of audit committee meetings. Fifty-seven percent of respondents said that their audit committee meets in person four times a year, while 23 percent had five annual meetings. Almost all respondents reported that their audit committee also met telephonically. Forty-four percent indicated that the committee met telephonically four times a year. Forty-eight percent of respondents said that the average length of an in-person meeting was two hours, and 31 percent said three hours was the average. Fifty-six percent reported that telephone meetings averaged one hour, while approximately one-sixth said these meetings were 30 minutes or less.

Comment: The introduction to the BPR describes it as "a leading benchmarking resource for governance professionals." For audit committees that want to compare their practices to corporate norms, the BPR is a useful reference.

Changes in Accounting Estimates Are an Indicator of Poor Financial Reporting

Financial reporting is heavily dependent on estimates. Estimates, by their nature, are imprecise, involve subjective assumptions and measurement uncertainty, and are subject to change as more information becomes available. For these reasons, changes in accounting estimates (CAEs) – which, if material, must be disclosed -- are not unusual.

Research and data provider Audit Analytics (AA) reviewed three academic papers to determine what CAEs indicate about the quality of financial reporting. In Academic Literature Review – Changes in Accounting Estimates**,** AA reports that "although the working papers look at different metrics to measure financial quality, the conclusions were uniform: changes in estimates are used to provide short-term benefits and do not improve quality of the financial reporting."

The three papers address the following aspects of CAEs:

- Timing of CAE disclosures. Companies "are more likely to announce a positive CAE when the earnings are likely to miss consensus analyst forecasts. On the other hand, firms are more likely to announce a negative CAE when the earnings already exceed forecasts and the change is unlikely to lead to negative earnings." In addition, companies that disclose CAEs are more likely to file restatements and to receive SEC comment letters. Further, according to the study abstract, their financial reporting is more difficult to read and understand. A. Albrecht, K. Kim, K. Lee, Changes in Accounting Estimates: Are the Current Disclosure Requirements Sufficient to Deter Managerial Opportunism?

- Opinion shopping. Companies are more likely to report an income-increasing discretionary CAE following an auditor change than in the three prior years. The authors of this study hypothesize that managers are "able to achieve opportunistic reporting objectives through the switch to a more compliant successor auditor that possesses less information about the firm's underlying economics relative to the incumbent." They also find that companies that report a discretionary, income-increasing CAEs are more likely to subsequently restate, less likely to receive a going concern opinion qualification, and experience lower annual stock returns.

M. DeFond, J. Zhang, Y. Zhao, Do Managers Successfully Shop for Compliant Auditors? Evidence from Accounting Estimates.

- CAEs and restatements. Like the other two papers, this study finds that companies that report CAEs are more likely to later restate their financials. AA states that, "since restatements reflect low earnings and audit quality, this description may also be attached to changes in accounting estimates." P. Beaulieu, B.L. Hayes, L. Timoshenko, The Association between Changes in Accounting Estimates and Accounting Restatements.

AA concludes:

> "All three working papers found evidence that CAEs can lead to lower quality of financial reporting. Whether it may be from opinion shopping, managerial opportunism or an unintentional misstatement, these CAEs have been positively associated to subsequent restatements. This can lead to poorer financial quality which, in turn, can impede the assessment of earnings quality making it harder to accurately assess a company's performance."

Comment: There is nothing improper about changing an accounting estimate to reflect new information. However, this research indicates reasons why audit committees may want to probe the reasons behind material estimate changes and satisfy themselves that the change is not motivated by bias or a desire to manage earnings. As these research papers suggest, CAEs that follow a change in auditors or that make the difference between profit and loss or meeting or missing earnings expectations deserve particular scrutiny. Also, CAEs that subsequently result in a restatement should also trigger attention. Audit committees should not be surprised if CAEs are greeted by the auditor with increased audit effort.

Questions About ESG Disclosure? WBCSD's Handbook Has Answers

Institutional investors are demanding that public companies disclose increasing amounts of information concerning their performance and strategy regarding a wide range of environmental, social, and governance (ESG) issues, and companies are responding. See Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture, March 2018 Update. However, U.S. public companies are not generally subject to mandatory ESG disclosure, and there is no clear consensus on the objectives, scope, and content of voluntary disclosure. As a result, managements and boards face challenging issues in deciding what ESG information to disclose and how to disclose it.

To aid companies in making the choices inherent in ESG reporting, the World Business Council for Sustainable Development (WBCSD) has released the ESG Disclosure Handbook. The Handbook is "designed for use by companies when considering what to report, where, why, to whom and how in response to non-prescriptive mandatory ESG reporting requirements * * *, voluntary ESG reporting requirements and corporate ESG reporting objectives." WBCSD is "a global, CEO-led organization of over 200 leading businesses working together to accelerate the transition to a sustainable world."

The WBCSD states that companies may use the Handbook to accomplish eight objectives:

- Explore the various options associated with external ESG disclosure.
- Inform the development of a reporting strategy and external disclosure processes.
- Apply the structured process described in the Handbook for developing ESG reporting.
- Identify the most appropriate reporting provisions and indicators. (The WBCSD has created the Reporting Exchange and Indicator Library to aid in this determination).
- Control the company's ESG narrative to limit or balance opinions and conclusions reached by investors and others based on external information sources.

- Support collaboration, knowledge sharing and cross-functional, interdisciplinary discussion between the various business units with an interest in the company's disclosure (e.g., finance, risk management, investor relations, legal, sustainability and communications).

- Understand more about user information needs.

- Provide a reference in external reporting to explain the approach used in preparing disclosures.

The Handbook begins by providing guidance for answering six key questions:

1. Why report ESG information?

2. For whom should ESG information be reported?

3. Where should ESG information be reported?

4. What ESG information should be reported?

5. How should ESG information be prepared and presented?

6. How much ESG information should be reported?

Once these foundational questions have been addressed, the Handbook recommends a structured process for "optimizing confidence" in externally reported ESG information. The process steps, which are discussed in detail, are:

A. Evaluate options in a neutral, objective manner and according to a list of criteria designed to identify information that supports the objectives and purpose of reporting; has business value; meets the needs of the primary intended audience(s); is supportable; and can be clearly communicated.

B. Decide what ESG information to disclose. Inputs to decision-making could include the results of the evaluation process, assumptions about disclosure users and materiality, opinions of internal and external experts, and management's judgement, as informed by the six key questions.

C. Document the judgment process and decision, along with any uncertainties, limitations, or sensitivities that affected the process and conclusions.

Comment: Investor demand for ESG disclosures is likely to make this an area to which audit committees will be required to devote more attention. For companies that are grappling with what information to disclose and how to justify those decisions, the Handbook lays out a process that may be useful and that could be cited as the basis for the company's approach. In this regard, SEC reporting companies and their audit committees should also consider becoming familiar with the Sustainability Accounting Standards Board's ESG disclosure standards that apply to the industry or industries in which they operate. See SASB Releases its Codified Standards, December 2018 Update.

PCAOB 2017 Inspections Status Report

On March 28, the PCAOB made publicly available the Report on 2017 Inspection of PricewaterhouseCoopers LLP. During the 2017 inspection cycle, the PCAOB reviewed 55 PwC audits. In 13 of those audits (24 percent), the PCAOB staff identified deficiencies of such significance that it appeared to the inspection team that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to PwC's 20 percent deficiency rate in 2016. Eleven of the 13 engagements described in Part I of the report included deficiencies related to the audit of internal control over financial reporting.

The PCAOB has now released the public portion of the 2017 inspections reports with respect to the U.S. affiliate of four of the six global network accounting firms. (The Global Networks are described on the PCAOB's website.) No 2017 report has yet been issued for the U.S. affiliate of BDO International or Ernst & Young Global. The table below summarizes the results of the 2017 inspection of the firms for which inspection reports are available.

2017 Inspections of U.S. Affiliates of Global Networks (Reports Made Publicly Available in 2019)

Firm	Report Date	Engagements Inspected	Part I Deficiencies*	Percentage
Deloitte & Touche	December 20, 2018	55	11	20%
Grant Thornton	March 21, 2019	34	6	18%
KPMG	January 24, 2019	52	26	50%
PwC	February 28, 2019	55	13	24%

* 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."

After the PCAOB has made the 2017 inspection reports for the U.S. affiliate of all six global networks 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 understand how the firm intends to remediate quality control deficiencies described in the nonpublic portion of the report.

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Prior Updates issued after January 1, 2019 are available here.