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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.

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CAM Reporting Begins: Goodwill and Intangible Assets Top the List; Many Companies are Considering Disclosure Changes

Auditors have begun to issue audit reports that include critical audit matters (CAMs). A Deloitte analysis of auditors' reports for 52 large companies with June 30 fiscal years filed with the SEC through August 29 indicates that goodwill and intangible assets, revenue, and income taxes were the three areas that generated the most CAMs. There was an average of 1.8 CAMs per audit report, and none of these audits had zero CAMs. Further, according to a report issued by Intelligize, the dry runs that precede CAM reporting for most companies are resulting in numerous changes in company disclosure and controls.

Background

As described in earlier Updates (see, e.g., More PCAOB Advice for Audit Committees on CAMs, July, 2019 Update), a CAM is any matter arising from the audit of the financial statements that was (1) communicated or required to be communicated to the audit committee, (2) relates to accounts or disclosures that are

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material to the financial statements, and (3) involved especially challenging, subjective, or complex auditor judgment. The auditor's report must identify each CAM, describe the principal considerations that led the auditor to determine that the matter was a CAM, describe how the auditor addressed the CAM in the audit, and refer to the financial statement accounts or disclosures related to the CAM.

CAM reporting begins this year. For large accelerated filers with fiscal years ending on or after June 30, 2019, the auditor's report must include a discussion of CAMs identified during the audit. (A large accelerated filer is a company that has been subject to the SEC's reporting requirements for at least a year and that has a public float of $700 million or more.) CAM reporting will become effective for audits of most other public companies for fiscal years ending on or after December 15, 2020.

Initial Large Accelerated Filer CAMs

Deloitte's study, Critical audit matters make their debut!, finds that, for 52 large accelerated filers with June 30 fiscal years that had filed with the SEC as of August 29, the average number of CAMs per company was 1.8. The CAMs in the 52 audit reports related to the following accounting or disclosure areas:

Area	Percent
Goodwill and Intangible Assets	35 percent
Revenue	19 percent
Income Taxes	15 percent
Acquisitions and Related Liabilities	6 percent
Inventory	5 percent
Other Liabilities	5 percent
Contingencies	4 percent
Other	11 percent

Deloitte notes that, prior to the effective date, most accounting firms conducted "dry runs" of CAM reporting in which the audit firm evaluated matters that might be CAMs, considered how CAM disclosure would be drafted, and discussed potential CAMs with management and audit committees. Deloitte identifies several lessons learned during the dry runs, including:

- Practicing the identification and communication of CAMs allowed auditors to gain valuable experience, resulting in a smoother implementation process.

- Deciding whether an account or disclosure was a CAM required significant judgment and was specific to the circumstances of each audit. Therefore, what might be a CAM on one audit might not be a CAM on another audit.

- Communicating CAMs that are easily understood by a broad readership can be challenging. For example, it can be difficult to convey concisely why a matter is a CAM or to summarize the audit procedures performed in a manner that is informative but not overly technical.

- Sharing draft CAMs with management, audit committees, and legal counsel provided an opportunity to set expectations about CAMs and to reach a common understanding about applying the standard's requirements and how the implementation process and timing may work.

CAM Totals by Audit Firm

A study performed by accounting firm Kral Ussery provides another perspective on the initial CAM filings. In Critical Audit Matters Have Arrived: Insights into the early results, Kral examined 50 Form 10-Ks for large accelerated filers with fiscal years ending on or after June 30, 2019. Kral also looked at the accounting firms that prepared these reports. While Kral, like Deloitte, found 1.8 CAMs per audit, it also found considerable variation between firms:

	Deloitte	EY	KPMG	PwC	Other Firms*	Totals
Audit Reports	10	12	13	9	6	50
CAMs	16	32	22	11	8	89
CAMs per Report	1.6	2.7	1.7	1.2	1.3	1.8

* Other Firms included two audit reports issued by Crowe and Grant Thornton and one by BDO and Moss Adams.

Since these initial CAM filings are a small sample, it is difficult to reach conclusions about the reason for the variation between firms in the average number of CAMs reported. It may simply reflect underlying differences in the challenges presented by these specific audits. Alternatively, it could indicate differences in the firms' approaches to determining which matters rise to the level of CAM disclosure.

Dry Run Survey

On September 20, Intelligize, a web-based platform that supports research and the preparation of SEC filings, issued a paper that provides additional insight into the dry runs. Critical Audit Matters: Public company adaptation to enhanced auditor reporting reports the results of a survey of 171 compliance specialists at public companies (including 69 large accelerated filers) conducted by SourceMedia Research/Accounting. Findings reported in the Intelligize report include:

- Slightly over half of surveyed companies subject to CAM reporting (54 percent of large accelerated filers and 51 percent of other reporting companies) conducted, or plan to conduct, a dry run.

- For large accelerated filers, management met with the auditors during 68 percent of the dry runs, the audit committee met with the auditors during 54 percent, corporate counsel met during 46 percent, and investor relations met during 16 percent.

- The CAM topics identified in the large accelerated filer dry runs were generally similar to those the Deloitte survey found were disclosed in the first round of reporting. Fifty-seven percent of the dry runs identified income tax as a CAM topic, followed by revenue recognition (49 percent), lease accounting (38 percent), intangible assets (32 percent), and goodwill impairment and business combinations (both at 30 percent).

Perhaps the most striking finding in the Intelligize report was how frequently dry runs caused companies to consider changing their disclosure or controls. A company might decide to enhance its disclosure in anticipation of a CAM to avoid the possibility that the auditor's report will provide new information and to make sure that the company is providing its own perspective on challenging matters related to its financial reporting. With respect to control changes, if a dry run CAM is the result of some weakness in the company's controls or accounting procedures, it may be possible to avoid the CAM altogether by remediating the problem before CAM reporting takes effect. Intelligize found that:

- Fifty-two percent of large accelerated filers and 61 percent of other CAM reporting companies are considering updates to their financial statement disclosure. Forty-nine percent of companies in each category are considering updating their MD&A, based on dry run results. Twenty-nine percent of large accelerated filers and 29 percent of other CAM reporting companies are considering updates to their proxy statement disclosures. Intelligize states that these findings suggest "that many issuers want investors to be able to see new CAM information through the eyes of management."

- For large accelerated filers in the survey, 43 percent of the audit committees identified additional controls requiring implementation during the dry run. Thirty-eight percent of audit committees did not identify additional controls, and 19 percent were undecided.

Intelligize concludes: "Our report reveals that digesting the CAM process requires a substantial time commitment, and a CAM dry run could ultimately lead to even more time-consuming implementation of new internal controls and financial reporting procedures. Despite experiencing fatigue from numerous new

accounting standards, public companies facing December 15, 2020 CAM implementation should not lose sight of this investor-facing disclosure."

Comment: For the large companies that have thus far reported, there do not appear to be surprises regarding the number and nature of CAMs. Both the early results and the Intelligize survey underscore the importance of dry runs. Both audit committees and managements need to devote time to understanding the likely CAMs and to considering how they affect the company's disclosures and controls.

The Intelligize report also emphasizes that CAM reporting is not just an auditing exercise. It opens new areas that are likely to result in press and investor inquiries. Audit committees should make sure that management is prepared to address questions about CAMs and may want to make sure that investor relations and the auditor are communicating with each other so that there will be a clear and consistent message.

2017 PCAOB Inspection Reports Summary

2017 Ernst & Young Inspection Report

On October 2, the PCAOB made publicly available the Report on 2017 Inspection of Ernst & Young LLP. During the 2017 inspection cycle, the PCAOB reviewed 55 EY issuer audits, 53 of which were integrated audits of both the financial statements and internal control over financial reporting (ICFR). In 17 of those audits (31 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 EY's 27 percent deficiency rate in 2016. Fifteen of the 17 engagements in Part I of the report included deficiencies related to both the audit of the financial statements and of ICFR. One of the 17 engagements included only an ICFR audit deficiency, and one included only a financial statement audit deficiency. (It is not clear from the report whether the engagement which included only a financial statement deficiency was an integrated audit or a financial statement only audit.)

2017 Global Network Firms Inspections Overview

The PCAOB has now released the public portion of the 2017 inspection reports with respect to the U.S. affiliate of all six global network accounting firms. The table below summarizes the results of the 2017 inspections of these firms. For comparison, a similar table showing results of the 2016 inspections follows.

2017 INSPECTIONS OF U.S. AFFILIATES OF GLOBAL NETWORKS (REPORTS PUBLICLY AVAILABLE IN 2019)

Firm	Report Date	Engagements Inspected	Part I Deficiencies	Percentage
Deloitte & Touche	December 20, 2018	55	11	20%
Ernst & Young	September 12, 2019	55	17	31%
KPMG	January 24, 2019	52	26	50%
PwC	February 28, 2019	55	13	24%
2017 Big Four Subtotals		217	67	
2017 Big Four Average		54	17	31%
BDO	June 20, 2019	23	9	39%
Grant Thornton	March 21, 2019	34	6	18%
2017 Global Network Firm Totals		274	82	
2017 Global Network Firm Average		46	14	30%

2016 INSPECTIONS OF U.S. AFFILIATES OF GLOBAL NETWORKS (REPORTS PUBLICLY AVAILABLE IN 2017/18)				
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%
KPMG	January 15, 2019	51	22	43%
PwC	December 19, 2017	56	11	20%
2016 Big Four Subtotals		217	61	
2016 Big Four Average		54	15	28%
BDO	July 12, 2018	24	16	75%
Grant Thornton	December 19, 2017	34	8	24%
2016 Global Network Firm Totals		275	85	
2016 Global Network Firm Average		46	14	30%

The auditing standards most frequently cited as the basis for audit deficiencies in Part I – the public portion – of the 2017 inspection reports of the Big Four firms are listed in the table below. The table also shows the percentage of inspected engagements that included a deficiency with respect to each standard and the percentage of deficient engagements in which the standard was cited. An auditing standard may have been cited as the basis for more than one deficiency in an engagement and deficiencies may have been based on more than one standard.

AUDITING STANDARDS REFERENCED IN BIG FOUR 2017 PART I DEFICIENCY FINDINGS			
PCAOB Auditing Standard	# of Part I Engm'ts Citing this St'rd	% of All Inspected Engagements	% of All Part I Engagements
AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements*	56	26%	84%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	28	13%	42%
AS 2315, Audit Sampling	21	10%	31%
AS 2502, Auditing Fair Value Measurements and Disclosures	15	7%	22%
AS 2810, Evaluating Audit Results	11	5%	16%
AS 2501, Auditing Accounting Estimates	8	4%	12%
AS 1105, Audit Evidence	4	2%	6%
AS 2305, Substantive Analytical Procedures	4	2%	6%
AS 2510, Auditing Inventories	4	2%	6%
AS 2310, The Confirmation Process	3	1%	4%

* Eleven of the 217 Big Four engagements inspected in 2017 involved financial statement only audits in which AS 2201 was inapplicable. AS 2201 was cited as a basis for a deficiency in 27 percent of inspected engagements that included an ICFR audit.

In each inspection report, the PCAOB lists the three most frequently identified audit deficiencies. The table below aggregates these deficiencies lists for the Big Four firms. The table also indicates what percentage of the engagements in Part I of the four reports included these deficiencies.

MOST FREQUENTLY IDENTIFIED AUDIT DEFICIENCIES IN 2017 BIG FOUR INPSECTION REPORTS

Deficiency Description	Part I Engagements That Include this Deficiency
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing.	35 (52%)
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate.	23 (34%)
Failure to identify and test any controls that addressed the risks related to a particular account or assumption.	21 (31%)
Failure to sufficiently test controls over or sufficiently test the accuracy and completeness of data or reports.	8 (12%)
Failure to sufficiently test the design and/or operating effectiveness of controls that included a review element and that the Firm selected for testing.	7 (10%)
Failure to test that the relevant criteria for revenue recognition were met.	3 (4%)

In each inspection report, the PCAOB lists the financial statement accounts or auditing areas in which deficiencies included in Part I of that report most frequently occurred. For the Big Four firms, on an aggregate basis, these areas were:

- Revenue, including accounts receivable, allowance for loan losses, and/or deferred revenue -- 21 deficiencies.
- Business combinations – 13 deficiencies.
- Inventory – 8 deficiencies.
- Loans and allowance for loan losses – 8 deficiencies.
- Investments – 3 deficiencies.
- Impairment of goodwill and other intangibles – 2 deficiencies.

Comment: As measured by these PCAOB inspection findings, audit quality seems to be relatively constant, compared to last year. For the global network firms as a group, the overall deficiency rate was unchanged in 2017 from 2016, at 30 percent. For the Big Four, the deficiency rate rose slightly, from 28

percent to 31 percent of all inspected engagements. While Deloitte's deficiency rate dropped to 20 percent – a record low for the Big Four – each of the other three firms experienced an increase in the percentage of inspected engagements in which the PCAOB found deficiencies.

The gap between the Big Four firm with the lowest deficiency percentage in 2017 reports (Deloitte) and the firm with the highest (KPMG) was 30 percentage points. Looking at all six global network firms, Grant Thornton had the best inspection results (18 percent deficiency rate), while KPMG had the worst (50 percent). The most improved firm was BDO, which lowered its 75 percent deficiency rate in 2016 to a still-high 39 percent in 2017.

The 2017 inspection results also suggest that the PCAOB staff's focus on internal control over financial reporting is continuing. The PCAOB found ICFR deficiencies in 27 percent of the Big Four integrated audits it selected for inspection, and 84 percent of all audit engagements in Part I included an ICFR deficiency. By comparison, in 2016, for Deloitte, E&Y, and PwC only, the Board found ICFR deficiencies in 21 percent of the engagements it inspected, and 90 percent of all deficient engagements included at least one ICFR deficiency. In 2015, the Board found ICFR deficiencies in 25 percent of inspected Big Four engagements, and 89 percent of deficient engagements included an ICFR lapse. While ICFR findings remain high, the 2017 inspection results are an improvement over 2013 when the PCAOB found ICFR auditing breakdowns in 35 percent of inspected Big Four engagements. In response to the PCAOB's continuing emphasis on ICFR auditing, auditors are likely to remain focused on this aspect of their work. However, improvements in ICFR audit methodologies over the last several years seem to have had a measurable positive effect.

Board inspectors continue to find deficiencies in judgment-dependent audit areas, such as auditing estimates, response to risk of misstatement, and auditing of fair value measurements and disclosures. This is also generally consistent with prior years. However, three of the four top audit deficiency areas were explicitly control related, with "Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing" at the top of the list. The most frequently identified deficiency areas that are not directly control-related were "Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate" and "Failure to test that the relevant criteria for revenue recognition were met." The later may be an indication of the PCAOB's focus on the auditing of the implementation of new accounting standards.

As noted in past years, the audit deficiency description and auditing standard deficiency tables could be used as a checklist for topics audit committees may want to discuss with their auditor to understand how the auditor addressed, or plans to address, the most challenging areas in the company's audit.

SEC Case Against PWC Charges Failure to Accurately Inform Audit Committees of Non-Audit Services

On September 23, the SEC announced that had charged PricewaterhouseCoopers and one of its partners with a violation of the auditor independence rules and with improper professional conduct in connection with 19 audit engagements. The SEC's allegations essentially involve failing to inform client audit committees of the nature of non-audit services that PwC was performing for their companies and of the potential impact of those services on PwC's independence.

Without admitting or denying the violations, PwC and its partner settled the SEC's charges. PwC agreed to pay a fine of $3.5 million, to disgorge audit fees of approximately $4.4 million, and to implement new procedures for compliance with the independence rules. The partner was fined $25,000 and barred from practicing before the Commission as an accountant, with the right to reapply after four years.

Independence Violation

The independence violation charged in the SEC's order resulted from PwC's performance of prohibited non-audit services during an audit. The SEC's independence rules contain a non-exclusive list of

circumstances that are inconsistent with auditor independence. Among other things, these prohibited activities include "engaging in the design or implementation of systems that are significant to the audit client's financial statements or other financial information systems taken as a whole." In addition, an auditor may not "perform any internal audit service related to the internal control over financial reporting, or to perform management functions for audit clients."

In the case of the client cited in the SEC order, PwC performed prohibited services concerning the design and implementation of Governance Risk and Compliance ("GRC") software, which was used to coordinate and to monitor controls over financial reporting, including employee access to critical financial functions. The PwC partner advised the client that PwC's work on the GRC software would not pose an independence problem. While it was apparently understood by both parties from the outset that the company required "design and implementation" assistance (contrary to the independence rule, quoted above), PwC's engagement letter for this work characterized the assignment as "performing assessments and high-level recommendations." The company's audit committee approved the work as a non-audit service on that basis.

Subsequently, PwC's internal Risk Assessment Independence group raised questions about the impact of the GRC project on PwC's independence. To avoid scrutiny, the partner changed the description of the services to be performed from consulting to "audit procedures," although, in fact, the services were not part of an audit. The audit committee was not advised of this change. The SEC's order states:

> "Issuer A's Audit Committee did not authorize the [GRC project] services as part of any audit. As a result of PwC's mischaracterizing the project as audit services and not informing the Audit Committee of this change, the Audit Committee was deprived of the opportunity to perform its responsibilities, including having an understanding of the services that were proposed and the purpose of that work, approving audit engagement fees and terms, reviewing the auditor's approach to and the scope of the audit, and overseeing the company's compliance with SEC requirements related to disclosure of the auditor's services and fees."

<u>Improper Professional Conduct</u>

In addition to the independence violation in the specific case of the company described above, the SEC charged PwC with repeated failures to advise client audit committees of the independence implications of proposed non-audit services.

The Sarbanes-Oxley Act and the SEC's rules require the audit committee to pre-approve any non-audit services that the company's auditor proposes to render. PCAOB Rule 3525 provides that, in seeking audit committee pre-approval to perform non-audit services related to internal control over financial reporting, an auditor must describe in writing to the audit committee the scope of the work, discuss with the audit committee the potential effects of the work on independence, and document the substance of the independence discussion. The SEC alleges that, between 2013 and 2016, PwC violated Rule 3525 on 19 audit engagements for 15 clients. According to the SEC's order:

> "On numerous engagements, PwC mischaracterized non-audit services as audit work. For example, the non-audit services involved PwC providing feedback and recommendations for management. PwC mischaracterized non-audit services as audit work involving 'pre-implementation' work involving financial software systems *before* the software was even implemented and providing recommendations to management on those systems. * * * By failing to comply with Rule 3525, PwC failed to discuss with the audit committees for fifteen issuers the scope of the services and the implications of performing the work on PwC's independence, thereby depriving the committees of their responsibilities to evaluate fully the provision of non-audit services, and to assess the potential effect of those services on auditor independence."

<u>Comment</u>: As noted, audit committee pre-approval of non-audit services and audit committee consideration of the ramifications for auditor independence of any such services are legally mandated. In fulfilling this responsibility, audit committees are dependent on their auditor to provide them with accurate information concerning the nature and scope of non-audit services and for guidance concerning the application of the

independence rules to those services. As the SEC's order emphasizes, if the auditor is not candid with the audit committee, the preapproval system cannot function.

At the same time, this case also illustrates the importance of management, internal audit, and audit committee sensitivity to independence issues and of internal company communication. The SEC order indicates that the company's internal audit staff was working with PwC on the GRC project and was aware of the change in the characterization of the work. In fact, the addendum to the audit engagement letter that re-characterized the work from consulting to auditing was furnished to the company's Head of Internal Audit, with the explanation that "PwC's 'risk management office has asked that we have this engagement letter as an extension of the audit engagement letter because of the assistance we are receiving from internal audit.'" The Head of Internal Audit signed the amendment to the audit engagement letter. It seems unusual for the Head of Internal Audit to approve a change to the audit engagement letter. In any event, internal audit should have brought the change to the audit committee's attention. Audit committees should consider whether their company has procedures in place to make sure that management or internal audit will inform the committee of any proposed modifications to non-audit services the committee has approved or to audit engagement letters.

SEC Enforcement Action Sheds Light on Material Loss Contingency Disclosure

On September 27, the SEC filed a complaint in federal court against Mylan N.V., a pharmaceutical company, alleging that the company failed to disclose a Department of Justice (DOJ) investigation into whether Mylan had over-charged Medicaid for the EpiPen, its largest revenue and profit-generating product. The complaint also charges that Mylan failed to make a timely accrual for the probable contingent loss arising from the investigation. Without admitting or denying the allegations, Mylan agreed to settle the SEC's case by paying a $30 million civil penalty. As noted in a prior Update (see Disclosing an SEC Financial Fraud Investigation Depresses Long Term Stock Prices and Shortens CEO Tenure, even if No Charges are Brought, July 2019 Update), decisions concerning when to disclose a pending governmental investigation, and when to accrue a contingent loss arising from an investigation, are among the challenging problems public companies face when under government scrutiny. The Mylan case provides guidance concerning how these issues should be addressed.

The SEC's complaint alleges that, in October 2014, the Centers for Medicare and Medicaid Services (CMS) informed Mylan that the EpiPen was misclassified as a generic drug. (Generic drug classification increases the level of government reimbursement for drugs sold through Medicaid.) Shortly thereafter, the DOJ began an investigation into whether Mylan had misclassified the EpiPen and overcharged the government for Medicaid sales. During the investigation, various events occurred which shed light on the likelihood that Mylan would eventually incur a significant loss. For example,

- In November 2014, Mylan received a subpoena from the DOJ seeking documents concerning its classification of the EpiPen.
- In August 2015, Mylan's counsel made a presentation to the DOJ arguing that there was no basis to bring any claims. DOJ rejected Mylan's request to close the investigation and requested instead that Mylan sign a tolling agreement to stop the statute of limitations from running.
- In October 2015, Mylan provided the DOJ with an analysis showing that, for one quarter in 2015, potential damages for misclassifying the EpiPen ranged from approximately $12 million to $42 million. Under the False Claims Act, these damages were subject to being trebled.
- In June 2016, Mylan provided additional data to the DOJ, including an estimate that non-trebled damages for the year 2015 would range from about $114 to $260 million.

- On July 29, 2016, Mylan offered to settle the DOJ's claims for $50 million. On August 3, DOJ rejected that offer and counter-offered at a significantly higher amount.

In October 2016, Mylan and the DOJ agreed in principle to a settlement in which Mylan would pay the government $465 million. On October 7, 2016, Mylan, for the first time, publicly disclosed the DOJ's investigation and Mylan's liability resulting from the misclassification of the EpiPen

Accounting Standard Codification 450 (ASC 450) contains the GAAP accounting requirements regarding "loss contingencies." Under ASC 450, a loss contingency is an existing condition, situation, or set of circumstances involving uncertainty as to a possible loss that will be resolved when one or more future events occurs or fails to occur. Loss contingencies include (i) actual or possible claims and (ii) pending or threatened litigation. Under ASC 450:

- A material loss contingency must be disclosed if a loss is at least reasonably possible. A loss is considered "reasonably possible" when the chance of the future event or events occurring is more than remote but less than likely. A loss is considered "remote" when the chance of the future event or events occurring is slight.

- An accrual for a material loss contingency must be recorded as a charge against income, if a loss is probable and reasonably estimable. "Probable" means the future event or events is likely to occur.

Based on the events outlined above, the complaint alleges that Mylan's SEC filings were false and misleading in three respects:

- By at least the time that it filed its Form 10-Q for the third quarter of 2015, Mylan knew or should have known that the likelihood of a material loss relating to the EpiPen classification and DOJ investigation was reasonably possible. Accordingly, the possibility of a loss resulting from the EpiPen investigation should have been disclosed, and the Q3 Form 10-Q, and subsequent SEC filings until October 2016, were false and misleading.

- By at least the filing of its Form 10-Q for the second quarter of 2016, Mylan knew, or should have known, that a material loss resulting from the DOJ investigation and claims that Mylan incorrectly classified the EpiPen was probable and that the amount of the loss was reasonably estimable. Therefore, Mylan should have accrued its best estimate of the loss (or the minimum amount of the loss within the estimated range of losses). As a result of Mylan's failure to accrue such a loss, its reported earnings were materially overstated in the second quarter 2016.

- Mylan's 2014 and 2015 risk factor disclosures included a statement that, in connection with calculating and reporting payments to Medicaid, "a governmental authority may take a position contrary to a position we have taken." Since CMS had informed Mylan in October 2014 that the EpiPen was misclassified, this statement was materially misleading. As the SEC observes in its press announcement of the case, "Instead of disclosing that CMS disagreed with Mylan's classification of EpiPen, Mylan misleadingly presented a potential risk that CMS could disagree."

Comment: As noted above, decisions about when to disclose a governmental investigation and when to accrue a loss arising from such an investigation are inherently judgmental. There are no clear-cut guidelines. Because of the high stakes involved, these questions are likely to be discussed with the audit committee.

While each situation must be decided on its own facts, the Mylan case provides an illustration of how the SEC believes these issues should have been resolved in a concrete situation. In the context of the Mylan investigation, the SEC seems to take the position that the DOJ's definitive rejection of arguments that the investigation should be closed, coupled with the tolling agreement, indicated that a loss was "reasonably possible" for purposes of ASC 450. Further, the company's submission of a settlement offer seems to be viewed by the SEC as indicating that a loss was both "probable" and "reasonably estimable" and should

have been accrued. Of course, disclosure also depends on a determination of the materiality of the contingency, which can, in some cases, also be a difficult call.

Fifteen Years of SOX 404 Reporting: Adverse ICFR Audit Opinions Rose Last Year, But Remain Below 2005 High

Research firm Audit Analytics (AA) has published its annual report on auditor opinions and management assessments of the effectiveness of internal control over financial reporting (ICFR). In both absolute numbers and as a percentage, adverse auditor opinions on ICFR increased in 2018, reversing a drop in 2017. At smaller companies, where only a management assessment is required, the number of adverse assessments declined, continuing a nine-year trend that began in 2010. As to the reasons for ineffective controls, the most frequent cause cited by auditors was the materiality and/or number of audit adjustments. In management assessments, on the other hand, the number one cause of an adverse determination was deficiencies in accounting personnel resources, including competency or training.

AA prepares an annual analysis of trends in ICFR management assessments and audit opinions. See, e.g., Adverse ICFR Opinions are Beginning to Decline, October-November 2018 Update, and ICFR Auditing is Improving, But Material Weaknesses are Going Up, September 2016 Update. On September 30, AA released its 2019 report, SOX 404 Disclosures: A Fifteen Year Review. The report is available for purchase from AA. The comments in this Update are based on AA's public blog summary of the 2019 report.

Section 404 of the Sarbanes-Oxley Act requires public company managements to perform an annual assessment of the effectiveness of the company's ICFR. Section 404 also requires companies to obtain a report from the company's external auditor expressing the auditor's opinion on the effectiveness of the company's ICFR. Smaller public companies – non-accelerated filers, defined generally as companies with less than $75 million in publicly-traded securities – are, however, exempt from the external audit requirement. Therefore, these smaller companies are only required to disclose management's assessment of control effectiveness. For either a management assessment or an auditor's report, the existence of one or more ICFR material weaknesses means that controls are ineffective and requires the issuance of an adverse assessment or opinion.

According to AA's analysis, in 2018, auditors issued 217 adverse ICFR opinions. This represents a 14.8 percent increase from the 189 adverse opinions in 2017. The increase is a reversal of the prior year comparison: Between 2016 to 2017, the number of adverse opinions dropped from 247 in 2016 to 189 in 2017. However, from 2012 to 2016, the number of adverse opinions increased every year. Prior to 2010, adverse opinions were much more frequent, with an all-time high of 492 ineffective control opinions in 2005, the second year of Section 404 reporting. Since the number of accelerated filers is not constant, it is useful to look at these numbers as a percentage of all ICFR opinions. In 2018, the percentage of adverse auditor opinions was 6 percent. This compares to 5.2 percent in 2017. The all-time high was 15.9 percent in 2004, and the all-time low was 3.5 percent in 2010.

For the smaller companies that are required only to perform a management assessment, the frequency of ineffective controls disclosure is far higher than at larger companies. Non-accelerated filers disclosed 1,141 adverse assessments in 2018, reflecting ineffective ICFR at 39.6 percent of these companies. On a percentage basis, adverse assessments in 2018 were down slightly from 40 percent in 2017 and from the peak of 40.9 percent in 2014. The variation over time in the number and percentage of adverse assessments at non-accelerated filers is lower than at large companies. In 2011, 2012, and 2013, the number of adverse assessments was virtually constant at 1,620, 1,619, and 1,618, respectively, but has declined modestly each year since 2013.

Adverse auditor's reports and management assessments are required to describe the reasons why controls were found to be ineffective. In 2018 auditor's reports, the five most commonly disclosed control weaknesses were:

- Material and/or numerous auditor/year-end adjustments.

- Accounting personnel resources, competency/training.
- Information technology, software, security and access issues.
- Segregation of duties/design of controls (personnel).
- Inadequacy disclosure controls (timely, accurate, complete).

This list is the same as in 2017, although "IT, software, security and access" rose from fifth place last year to third in 2018.

In the case of management-only assessments, the top five 2018 control weaknesses were:

- Accounting personnel resources, competency/training.
- Segregation of duties/design of controls (personnel).
- Ineffective, non-existent or understaffed audit committee.
- Inadequacy disclosure controls (timely, accurate, complete).
- Material and/or numerous auditor/year-end adjustments.

The list of causes cited by management is identical to the 2017 list. Interestingly, unlike the auditor list, "IT, software, security and access" was not among the top causes of ineffective controls for these companies.

Comment: As noted last year, the increase in adverse ICFR audit opinions beginning in 2012 is likely a consequence of the PCAOB's increased inspections focus on ICFR auditing beginning at about the same time. Last year, we also observed that, for companies subject to auditor ICFR attestation, it seemed possible that the decline in adverse opinions in 2017 indicated that auditors (and managements) had adjusted to the PCAOB's tougher scrutiny and that the control deficiencies which came to light in prior years had been remedied. The uptick in adverse opinions in 2018 may undermine that theory.

The relatively higher, and more constant, level of adverse management assessments at smaller companies may reflect the fact that, without the discipline of an ICFR audit, there is less incentive for these companies to correct their control deficiencies. Of course, higher deficiency levels at smaller companies are probably also a structural phenomenon, since smaller companies have fewer resources to devote to controls.

Little Evidence that Investors Care About Engagement Partner Identity–Except After a Restatement

A paper prepared by four researchers at the University of Alabama's Culverhouse School of Accountancy examines trading market reactions to the implementation of one of the Public Company Accounting Oversight Board's signature initiatives. In Do Investors Care Who Did the Audit? Early Evidence on the Informativeness of Form AP, Marcus Doxey, James Lawson, Thomas Lopez, and Quinn Swanquist find "no significant investor response" to disclosure of the identity of engagement partners or of the participation of other audit firms in public company audits. There is, however, an exception: If the engagement partner has previously been associated with a restatement, there is a measurable market response to the disclosure of his or her identity. The authors conclude:

> "Taken together, we provide evidence that specifically disclosing partners associated with audit failures appears informative to investors, consistent with the assertions of the PCAOB, though the

preponderance of evidence suggests other partner and audit participant disclosures have not significantly impacted capital markets."

Background

On December 15, 2015, the PCAOB adopted Rule 3211 requiring accounting firms to make a filing (on Form AP) with the PCAOB for each of the firm's public company audits disclosing the name of the engagement partner and the names and certain additional information regarding other accounting firms that participated in the audit. See PCAOB Takes Final Action to Require Disclosure of Engagement Partner and Participating Accounting Firm Names, December 2015 Update. As discussed in the release adopting the new rule, the rationale for requiring disclosure of engagement partner identity was transparency:

> "Investors will be able to take into account not just the firm issuing the auditor's report but also the specific partner in charge of the audit and his or her history as an engagement partner on issuer audits. This will allow interested parties to compile information about the engagement partner, such as whether the partner is associated with restatements of financial statements or has been the subject of public disciplinary proceedings, as well as whether he or she has experience as an engagement partner auditing issuers of a particular size or in a particular industry. While this information may not be useful in every instance or meaningful to every investor, the Board believes that, overall, it will contribute to the mix of information available to investors."

As to disclosure regarding other accounting firms that participated in the audit, the Board stated that the new disclosures would help investors understand how much of the audit was performed by the accounting firm signing the auditor's report and how much was performed by other firms. "Investors will also be able to research publicly available information about the firms identified in the form, such as whether a participating firm is registered with the PCAOB, whether it has been inspected and, if so, what the results were and whether it has any publicly available disciplinary history."

Research Findings

The study authors reviewed Form AP disclosures dated through September 6, 2018, and trading market data through December 10, 2018. They note that, since partner name disclosure and other participant disclosures were phased in separately, they were able to study investor reactions to each disclosure independently. In addition, the fact that Form AP is filed by the auditor with the PCAOB at a different time than the company's Form 10-K filing with the SEC, permitted them to better "isolate Form AP's effects from confounding events and disclosures."

Engagement partner name disclosure. The study finds "a significant increase in trading only around the disclosure of partners associated with past restatements. As expected, our initial evidence suggests that on average engagement partners' identities do not elicit significant investor response."

The study looked at reaction to three specific types of Form AP disclosures that might be expected to have a market impact: (1) partner switches in the second year of Form AP, (2) partner switches where the incoming partner has industry experience, and (3) partners associated with restatements on other clients. As to these situations, the authors state: "While we find no evidence that Form AP informs market participants in the first two cases, for partners associated with restatements at other clients (restatement partners), we find significant abnormal trading volume around the Form AP release. * * * [We] find no evidence that other disclosures are more likely to confound restatement partner disclosures, lending credence to the inference that the reaction is attributable to Form AP."

Participating firm disclosure. As to disclosure of firms in addition to the primary auditor that participated in the audit, the study finds "no significant abnormal trading in the period around the Form AP date after outside participant disclosures begin." This phase of the study also focused on Form AP disclosures related to three specific situations: (1) the amount of outside auditor participation, (2) outside participation associated with PCAOB inspection deficiencies, and (3) participation from non-PCAOB inspected jurisdictions. The authors conclude: "We find no evidence that these disclosures inform

> investors. We also note that, in many analyses, the precision of our estimates allows us to reasonably conclude that even if investors do respond to Form AP, their response is not economically significant."

The authors conclude with these caveats:

> "First, as we note earlier, our study provides initial evidence on the informativeness of Form AP disclosures. However, these disclosures may become more useful to investors over time as more data about partner identity becomes available. Second, the findings related to the disclosure of partners associated with restatements are based on a relatively small sample, which affects the precision and generalizability of the analyses. Third, while usefulness to investors is a stated purpose of the Form AP, the Form AP disclosures may have other effects on audits and capital markets. We believe these are interesting avenues for future research."

Audit Quality Impact?

The third caveat seems to be a reference to the possibility that public disclosure of the name of the engagement partner might create an incentive for better performance and thereby improve audit quality. The PCAOB did not rely on that argument in adopting the disclosure requirement, although, in a statement issued at the time of the vote on the rule, one Board member stated that "increased transparency and sense of accountability on the part of the engagement partner will benefit investors, audit committees, and the market at large * * * [and] this enhanced sense of accountability will result in improved audit quality." Steven Harris, Statement on the Reproposal on Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits.

Another recent study examines that issue. See Lauren M. Cunningham, Chan Li, Sarah E. Stein, and Nicole S. Wright, What's in a Name? Initial Evidence of U.S. Partner Identification Using Difference-in Differences Analysis. (This research appears in 94 The Accounting Review 139-163 (September 2019), available here for purchase.) The paper finds only limited evidence of an audit quality impact:

> "Overall, we are unable to detect a significant change in audit quality attributable to Rule 3211 when evaluated along the dimensions of discretionary accruals (ABSDA), the propensity to misstate (FSCORE), and the likelihood of issuing an incorrect material weakness opinion (INCORRECT_MW). These results are consistent across additional proxies for audit quality, as well as several alternative specifications, control groups, and company characteristics. However, it should be noted that we do observe an increase in timely loss recognition following Rule 3211, and while audit quality proxied for by ABSDA did not improve, on average, it did improve for specific types of engagements with weak internal controls and higher risk of litigation."

Comment: Rule 3211 has only been in effect for three years, and the research on its impact is still therefore preliminary. Nonetheless, the work that has been done to date underscores the need for audit committees to be aware of the new information available as a result of the PCAOB's engagement partner disclosure requirement.

Obviously, not all restatements reflect negatively on the restating company's auditor or the engagement partner in charge of the audit. In many cases, it is necessary to have a sophisticated understanding of the circumstances of the restatement to assess whether it represents an audit failure. It would be unfortunate if, as the Culverhouse School research seems to suggest, the market for a company's stock reacts to disclosure that a company's engagement partner has been associated with a restatement without the benefit of that type of understanding. However, audit committees need to be aware of litigation, restatements or similar events arising in other audits for which their engagement partner was responsible, since the committee might face press or shareholder scrutiny regarding whether to change engagement partners when such events seem to reflect poorly on the partner. This could add a new dimension to the task of selecting or retaining an auditor and to the choice of the engagement partner.

The Audit Blog

I am a co-founder of The Audit Blog and blog on developments in auditing and financial reporting, on auditor oversight and regulation, and on sustainability disclosure. Occasionally, items that appear in the Audit Committee and Auditor Oversight Update also appear on the blog. Recent posts include –

- Do Audit Committees Avoid Accounting Firms That Uncover Material Weaknesses? (Dan Goelzer, August 30, 2019)
- Would Auditing Improve if the PCAOB Brought More Enforcement Actions? (Dan Goelzer and Tom Riesenberg, September 16, 2019)
- Global Quality Control Initiative Moves Forward (Tom Riesenberg, August 9, 2019)

The blog is available here. You can follow @BlogAuditor on twitter or @the-audit-blog on medium.com.

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