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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

Update No. 61
July-August 2020

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:

COVID-19 Disclosure and Financial Reporting Guidance: Part III

Guidance and advice concerning the impact of COVID-19 on financial reporting continues to proliferate. While the details may not be of critical importance for most audit committee members, the general tone and direction of these papers, especially those issued by regulators, are a useful guide to issues that are likely to arise as a result of the pandemic.

On June 23, the SEC's Division of Corporation Finance provided new guidance concerning the impact of COVID-19 on public company disclosure. On the same day, the SEC's Chief Accountant issued a statement describing his office's efforts to engage with financial reporting stakeholders and to promote high-quality financial reporting. The Chief Accountant's statement discusses several financial reporting issues related to COVID-19. These staff papers constitute the third round of disclosure guidance from the SEC. See SEC Leadership Offers More COVID-19 Disclosure and Financial Reporting Guidance, April-May 2020 Update,

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and SEC Provides Public Companies with COVID-19 Filing Deadline Relief and Guidance on the Financial Reporting Effects of the Virus, February-March 2020 Update.

In addition, on July 14, the Center for Audit Quality (CAQ) published an overview of the auditor reporting requirements and how COVID-19 could impact the types of audit reports issued. The CAQ previously issued CAQ Releases Key COVID-19 Auditor and Audit Committee Considerations, April-May 2020 Update.

SEC Division of Corporation Finance

On June 23, the staff of the SEC's Division of Corporation Finance (Division) issued CF Disclosure Guidance: Topic No. 9A, Coronavirus (COVID-19) – Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources. The Division is monitoring disclosure of the effects and risks of COVID-19 on companies' businesses, financial condition, and results of operations. The Division's staff continues "to encourage companies to provide disclosures that allow investors to evaluate the current and expected impact of COVID-19 through the eyes of management and to proactively revise and update disclosures as facts and circumstances change." Disclosures should permit investors to understand how management and the board are analyzing "the current and expected impact of COVID-19 on the company's operations and financial condition, including liquidity and capital resources."

Topic No. 9A expands on the guidance issued in March. Topic 9A highlights four issues:

- Operations, liquidity, and capital resources. Changes in operations, such as telework, supply chain adjustments, and suspending or modifying operations, may have effects that would be material to an investment or voting decision and should be considered for disclosure. Also, financing activities in response to the effects of COVID-19 may include novel terms and structures. Companies should provide "robust and transparent disclosures about how they are dealing with short- and long-term liquidity and funding risks in the current economic environment, particularly to the extent efforts present new risks or uncertainties to their businesses." Even if disclosed elsewhere, consideration should be given to whether information regarding financing should also be included in management's discussion and analysis of financial position and results of operations (MD&A).

- Disclosure considerations. In analyzing their disclosure obligations, companies should consider a broad range of questions. The Division suggests over three dozen such questions, organized under 11 bullets. For example:

    - What are the material operational challenges that management and the Board of Directors are monitoring and evaluating? How and to what extent have you altered your operations, such as implementing health and safety policies for employees, contractors, and customers, to deal with these challenges, including challenges related to employees returning to the workplace?

    - How is your overall liquidity position and outlook evolving?

    - Have COVID-19 related impacts affected your ability to access your traditional funding sources on the same or reasonably similar terms as were available to you in recent periods?

    - Are you at material risk of not meeting covenants in your credit and other agreements?

    - Have you reduced your capital expenditures and if so, how? What is the short- and long-term impact of these reductions on your ability to generate revenues and meet existing and future financial obligations?

    - Have you altered terms with your customers, such as extended payment terms or refund periods, and if so, how have those actions materially affected your financial condition or liquidity?

    - Are you relying on supplier finance programs, otherwise referred to as supply chain financing, structured trade payables, reverse factoring, or vendor financing, to manage your cash flow?

- Government assistance. Companies receiving federal assistance should consider the short- and long-term impact of that assistance on their financial condition, results of operations, liquidity, and capital resources, as well as related disclosures and critical accounting estimates and assumptions.

- Going concern. Management should consider whether conditions and events, taken as a whole, raise substantial doubt about the company's ability to meet its obligations as they become due within one year after the issuance of the financial statements. Where there is substantial doubt about a company's ability to continue as a going concern or the substantial doubt is alleviated by management's plans, management should provide the appropriate respective disclosures in the financial statements and consider the impact on MD&A disclosure. (The Chief Accountant's statement makes similar points – see below.)

SEC Chief Accountant

In Statement on the Continued Importance of High-Quality Financial Reporting for Investors in Light of COVID-19, the SEC's Chief Accountant, Segar Teotia, supplements his prior comments on pandemic-related accounting and auditing oversight activities. See SEC Leadership Offers More COVID-19 Disclosure and Financial Reporting Guidance, April-May 2020 Update. Mr. Teotia's statement discusses four broad topics – the work of the Office of the Chief Accountant's (OCA) related to high-quality financial reporting; engagement with the FASB and the PCAOB; engagement with international standard setters and other regulators; and the role of audit committees. From the perspective of audit committee financial reporting oversight, four points in the statement are of interest:

- Significant estimates and accounting judgements. The COVID-19 crisis has added to the challenges of making significant accounting judgments and developing estimates in a variety of areas. OCA "has consistently not objected to well-reasoned judgments." However, companies should ensure that their disclosure regarding judgments and estimates "is understandable and useful to investors and that their financial reporting is consistent with the facts and circumstances."

- Importance of disclosure controls and procedures and internal control over financial reporting. Companies need to consider the impact of the pandemic on the operation and testing of controls, including in the risks of operating effectively in a telework environment. In addition, new or enhanced controls may necessary to mitigate risks arising from business changes. Any material change in internal control over financial reporting must be disclosed in the quarter in which it occurred.

- Going concern disclosure. In each reporting period, management should consider whether there is substantial doubt about the entity's ability to meet its obligations as they become due during the next year. If there is substantial doubt about the company's ability to continue as a going concern, management should consider whether its plans alleviate such doubt and make appropriate disclosure to inform investors.

- Vital role of the audit committee. Mr. Teotia emphasizes the role of audit committee oversight during the current crisis: "In these times of rapid change and increased uncertainty, the need for the oversight role that audit committees play is as critical as ever. The most effective audit committees are engaged, executing their responsibilities with diligence, and this engagement significantly enhances the financial reporting output. We continue to emphasize the important role of the audit committee throughout our interactions with participants across the financial reporting system and we welcome continued feedback directly from this important stakeholder group."

Center for Audit Quality

On July 14, the Center for Audit Quality released Auditor Reporting: COVID-19 Considerations. This publication provides a high-level overview of the auditor reporting requirements and how COVID-19 could impact audit reports. As the CAQ notes, the "COVID-19 pandemic and the related market conditions create many new uncertainties for auditors, audit committees, investors and management of public companies" and has affected "public company financial statements in different ways and at differing levels of severity depending on an entity's capitalization, geographic location and the industry in which the entity operates, among other factors." The CAQ explains potential impacts on the auditor's report, including:

- Unqualified audit opinion with explanatory paragraph. In some circumstances, the auditor may be required to include an explanatory paragraph in the opinion. The most common such circumstance is where the auditor believes that there is substantial doubt about the entity's ability to continue as a going concern. "This is one example of a potential impact on audit reports stemming from COVID-19 and the resulting economic uncertainty as companies may face challenges that could impact their ability to continue operating as a going concern." Another example is the situation in which other information included in documents that contain financial statements is materially inconsistent with information in the financial statements.

- Unqualified audit opinion with an emphasis of a matter paragraph. An emphasis of matter paragraph may be included in an audit report at the auditor's discretion. Such paragraphs in public company audit reports are rare. The CAQ suggests that an emphasis of matter paragraph might be used where the company has adequately disclosed substantial doubt about its ability to continue as a going concern as a result of COVID-19, but the auditor determines that the going concern disclosures are "of such significance that an emphasis of matter paragraph in the audit report is necessary."

- Qualified audit opinion. In the COVID-19 environment, a qualified opinion could be required if the auditor concludes that the financial statement disclosures with respect to the entity's ability to continue as a going concern are inadequate. Another example would be a situation in which the pandemic has caused a scope limitation, such as an inability to observe material inventory balances in circumstances where alternative methods, such as video technology, were not available or practical. (It should be noted that the SEC generally will not accept a qualified opinion.)

- Critical Audit Matters. A CAM is any matter arising from the audit of the financial statements 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. The auditor's opinion is required to include discussion of CAMs for large accelerated filer audits of fiscal years ending on or after June 30, 2019, and for other public company audits of fiscal years ending on or after December 15, 2020. The CAQ suggests that "the pandemic could increase the subjectivity and complexity of a specific audit area such that it meets the definition of a CAM, when it otherwise may not have prior to the pandemic." In addition, CAMs that were previously identified may need to be "expanded to include new assumptions that were especially challenging or complex due to the pandemic and/or result in changes to the auditor's response to a previously identified CAM."

Comment: Audit committees may want to focus particularly on the questions in Topic 9A that the Division staff suggests companies consider in analyzing the impact of COVID-19 on their disclosures. While these questions generally reflect issues that management needs to address in preparing its disclosure, they could also be used as a roadmap for dialogue between the audit committee and management concerning new disclosure challenges. The reminders concerning the disclosure implications of pandemic-related changes in business processes and controls and the need to consider MD&A disclosure of issues reflected elsewhere in SEC filings are particularly important. All three papers also underscore the fact that, in some cases, companies and their audit committees may need a refresher course on the disclosure ramifications of doubt concerning a company's ability to continue as a going concern.

IIA and IFAC Issue an Audit Committee Call to Action on COVID-19

On July 8, the Institute of Internal Auditors (IIA) and the International Federation of Accountants (IFAC) issued Six Recommendations for Audit Committees Operating in the "New Normal". The IIA and IFAC describe this paper as a "call to action" for audit committees to ensure objective oversight of organizational activities, including risk management, performance, controls, and key processes, as organizations confront the implications of COVID-19. In a press release, IFAC CEO Kevin Dancey said that the COVID-19 crisis "creates long-term risks and uncertainties that organizations need to confront head-on through strong governance and internal controls. We hope these recommendations will support governing bodies and audit committees as they navigate the continuously evolving operating environment of today and tomorrow."

The recommendations call on governing bodies and their audit committees to:

1. Stay informed: Maintain a timely and clear understanding of the continuously-evolving operating environment and how it may impact organizational objectives and performance.

2. Communicate and collaborate: Adopt a multi-disciplinary approach to exercising oversight of internal and external audit and reporting through dynamic communication and collaboration.

3. Leverage available expertise: Seek qualified and reliable assurance and advice on management evaluations of, and responses to, the organization's continuously evolving risks and risk profile.

4. Promote continuous improvement: Encourage innovation and change to address vulnerabilities and to build resilience, strengthening the pursuit of value creation.

5. Think holistically: Adopt a broad perspective of the organization and its environment across both financial and nonfinancial goals, considering interconnectivity with other organizations, internal and external interdependencies, and the central importance of people.

6. Embrace technology: Optimize the performance of the audit committee through the use of technology and flexible working practices.

The paper concludes with the observation: "Adoption of these recommendations may require a strengthening and refining of governance arrangements, including greater clarity of the respective roles of the governing body and its sub-committees, management, and internal and external audit. It may also lead to enhancements in the maturity of risk management and internal control activities."

Comment: The IIA/IFAC recommendations are quite general and, at least for U.S. audit committees, do not break new ground in terms of the scope of their responsibilities and of expectations regarding their performance. However, the recommendations do serve as a reminder of the attention to which audit committees may be subject in the wake of the pandemic. In this respect, the recommendations should be considered in the same context as the comments of SEC Chief Accountant Teotia regarding the role of audit committee oversight during the crisis. See COVID-19 Disclosure and Financial Reporting Guidance: Part III, above. In the aftermath of COVID-19, there is likely to be considerable scrutiny of how audit committees performed, particularly in cases in which, in hindsight, a company's financial reporting is called into question.

G&A Finds That Ninety Percent of the S&P 500 Publish a Sustainability Report

On July 16, the Governance & Accountability Institute (G&A) released Trends on the sustainability reporting practices of S&P 500 Index companies, its annual study of the non-financial disclosure and reporting activities of companies in the S&P 500 Index. G&A finds that 90 percent of these companies issued a sustainability report in 2019, up from 86 percent the prior year. See Large Company Sustainability Reporting Inches Up Still Further, May-June 2019 Update. Sustainability reporting has increased dramatically since G&A began its annual survey nine years ago. In 2011, only 20 percent of S&P companies released such reports; 53 percent did so in 2012. The tally rose to 72 percent in 2013, and 75 percent in 2014. The 90 percent level in 2019 is another new high.

Industry Sectors

The industry sectors with the highest percentage of S&P 500 companies that issued sustainability reports in 2019 were Utilities and Materials; all the companies in Utilities issued such reports, and all but one in Materials did so. Consumer Staples came in third with 94 percent reporting (31 out of 33 companies). At the other end of the spectrum, the industry sectors with the lowest percentages of companies issuing reports were Communication (5 non-reporters/24 percent of the sector), Information Technology (10 non-reporters/15 percent of the sector), Health Care (8 non-reporters/13 percent of the sector), and Real Estate (4 non-reporters/13 percent of the sector).

Use of Standards and Frameworks

The 2020 G&A report also looks at the use of four reporting approaches: The Global Reporting Initiative's (GRI) disclosure framework, the Sustainability Accounting Standards Board's (SASB) disclosure standards, the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), and disclosure of company alignment with the United Nation's Sustainable Development Goals (SDGs). G&A finds that, in 2019:

- 51 percent of the S&P 500 reporting companies made some use of GRI standards.
- 25 percent of S&P 500 reporters referenced or reported in alignment with SASB standards.
- 16 percent of the S&P 500 referenced the TCFD recommendations, while 5 percent reported in alignment with TCFD.
- 36 percent of S&P 500 reporters included discussion of company alignment with specific UN SDGs

Many companies use more than one reporting approach. As G&A notes, the two most popular approaches, GRI and SASB are "not in competition with one another" and have different objectives aimed at different audiences:

> "GRI is designed for disclosure on a wide range of ESG issues and topics relevant to stakeholders [as determined by each company] * * * . SASB is more refined focusing on a selected few disclosures relevant to a company's overall sector and is geared more toward an investor audience. * * * Many companies are reporting using hybridized approaches."

Assurance

Enhancing the credibility of sustainability reporting by obtaining third-party assurance of the company's disclosures is becoming more common. G&A also looked at the prevalence of assurance in its 2020 report. It found that:

- Twenty-nine percent of S&P 500 companies obtained some level of external assurance for at least some portion of their sustainability disclosures.
- Five percent of the S&P 500 obtained assurance of the company's entire sustainability report, while 55 percent sought assurance of specified sections of the report. For the remaining 40 percent, assurance only addressed disclosures regarding greenhouse gas emissions.
- The levels of assurance varied. "An overwhelming portion (78%) of external assurance statements are provided at a limited/moderate level, while 8% are seeking a high/reasonable level of assurance."

- The majority (52 percent) of external assurance providers were engineering firms, while most other assurance engagements were performed by accountants (24 percent) or "small consultancies" (24 percent). (Auditor assurance of sustainability reporting is discussed in Want to Improve the Reliability of Your ESG Reporting? The CAQ Suggests Asking Your Auditor for Help in this Update.)

Comment: Most companies face some level of investor, customer, and/or supplier demand for more transparency concerning ESG issues, particularly those related to its supply chain integrity and climate change response. In this regard, in the press release announcing the 2020 report, Hank Boerner, G&A's Chairman, Chief Strategist & Co-Founder, observes: "Over our years of research, we have seen a steady expansion of reporting in response to important drivers. These drivers include peer pressure, increasing demand from investors and other important stakeholders for greater disclosure of the corporate ESG strategies, actions, and achievements. This has led to a drive within the corporate sector to achieve industry leadership, gain a competitive advantage – and very important, to excel in the competition for capital."

For audit committees, these types of disclosures may give rise to oversight challenges involving the nature and content of the information and the controls and procedures to assure its accuracy and reliability. As investors rely more heavily on ESG disclosures as part of their decision-making, the reputational and liability risks associated with inaccurate disclosure increase. To address these risks, audit committees should explore with management the nature of the controls and procedures to which sustainability disclosures are subject. These controls should be as rigorous as those to which traditional financial reporting is subject. Obtaining third-party assurance over sustainability disclosures should also be considered.

Over time, there is likely to be substantial pressure to standardize disclosures on an industry-by-industry basis, so that investors will be able to compare company performance. Comparison is currently difficult because each company is free to present whatever information it thinks appropriate in whatever format it chooses. In this regard, SEC reporting companies and their audit committees should 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. SASB's standards provide a framework for disclosure of material information that is decision-useful to investors and that permits comparison between companies in the same industry.

Want to Improve the Reliability of Your ESG Reporting? The CAQ Suggests Asking Your Auditor for Help

As noted in the G&A report discussed above, a significant number of large-cap companies obtain some level of third-party assurance for their sustainability reporting. The Center for Audit Quality (CAQ) addresses that aspect of sustainability or ESG (environmental, social, and governance) disclosure in The Role of Auditors in Company-Prepared ESG Information: Present and Future. In the CAQ's view, independent assurance provided by the auditor "can enhance the reliability of information that companies disclose."

Consistent with the G&A report and many other studies (see Sustainability Reporting Continues to Grow – Both Inside and Outside SEC Filings, November-December 2019 Update), the CAQ states that ESG information is "gaining prominence in the capital markets," and "how a company tells its ESG story is becoming more important to both companies and investors." The CAQ report provides an overview of ESG reporting, how investors use ESG information, and how public company auditors can enhance the reliability of ESG disclosures. The CAQ report consist of four sections, summarized below.

The Basics on Today's ESG Reporting.

This section describes ESG reporting, discusses ESG disclosure standards and frameworks, and provides information about how investors use ESG information in their decision-making.

- What is ESG Reporting? "ESG reporting encompasses both qualitative discussions of topics as well as quantitative metrics used to measure a company's performance against ESG risks, opportunities, and related strategies." According to the CAQ:

- The E, or environmental, component of ESG information encompasses how a company is exposed to and manages risks and opportunities related to climate, natural resource scarcity, pollution, waste, and other environmental factors.

- The S, or social, component of ESG includes information about the company's values and business relationships. For example, social topics include labor and supply-chain standards, employee health and safety, product quality and safety, privacy and data security, and diversity and inclusion policies and efforts.

- The G, or governance, component of ESG incorporates information about a company's corporate governance. This could include information on the structure and diversity of the board of directors; executive compensation; critical event responsiveness; corporate resiliency; and policies on lobbying, political contributions, and bribery and corruption.

- <u>How is ESG Information Presented</u>? The report discusses where and how companies make ESG disclosure. "Disclosure mechanisms include sustainability reports, CSR reports, a dedicated sustainability company website, integrated reports, or SEC filings (e.g., 10-K, 8-K, Proxy, annual report)." It also describes and compares sustainability disclosure frameworks (such as the recommendations of the Task Force on Climate-related Financial) and standards (such as those promulgated by the Sustainability Accounting Standards Board and by the Global Reporting Initiative). As the CAQ notes, "It is important for users of ESG information to understand whether the information has been presented in accordance with a framework or standard and whether there have been adjustments to make a metric bespoke to the company."

- <u>What are Management's Responsibilities for ESG Disclosures</u>? ESG information that is disclosed on a company website or in a sustainability report is subject to SEC Rule 10b-5, which prohibits, among other things, making any untrue statements of material fact that is necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. ESG information that appears in an SEC filing is required to comply with SEC disclosure controls and procedures and any other applicable SEC rules for that filing and is also subject to Rule 10b-5.

- <u>How Do Investors Use This Information</u>? "Investors are increasingly focused on ESG information because they find such information helpful in understanding a company's long-term value creation story, and the information enables them to manage their investments based on ESG risks." Credit-rating agencies also frequently incorporate ESG factors into their ratings determinations.

<u>The Auditor's Role in ESG: Present and Future</u>.

The financial statement auditor is required to read and consider information, such as ESG disclosure, that is included in the same document as the audited financial statements. (Essentially, the auditor's responsibility is to inform management if such same-document disclosures are inconsistent with the financial statements.) Absent a separate engagement, the auditor has no responsibility for ESG information that is disclosed outside of the document that contains the financial statements, such as in a sustainability report.

In the CAQ's view, auditors are well-positioned to provide assurance on ESG disclosures. By obtaining third-party assurance, a public company can enhance the reliability of ESG information presented to investors and other stakeholders. The CAQ lays out reasons why a company's financial statement auditor is the logical choice to provide such assurance, including independence, experience in understanding business processes and risk, and access to subject matter experts.

Management has flexibility in selecting the level of auditor assurance over ESG disclosures. Conceptually, there are two choices -- companies can engage the auditor to provide reasonable assurance (e.g., an affirmative opinion) based on examination procedures or limited assurance (e.g., negative assurance) based on review procedures. The report discusses three recent examples (Vornado, Esty, and GUESS?).

ESG Considerations and Questions for Boards.

This section of the report includes broad questions that board members may want to consider in seeking to understand key ESG risks and opportunities, governance and oversight of those topics, and metrics to measure progress. These questions fall under two headings:

- Consider Where the Company is Today Regarding ESG Reporting. For example, "Does the company have the appropriate internal controls, policies, and personnel in place to accurately track and disclose ESG information?" and "Who in management is preparing and providing the ESG information, and what is the finance function's role in the preparation of this information?"

- Consider Where the Company Wants to Go with ESG Reporting. For example, "What are the expectations of investors, stakeholders, and the landscape around the ESG raters and analysts?" and "Is the company ready for an attestation of this information?

ESG Considerations and Questions for Investors.

The final section suggests a series of questions that investors may want to consider in using ESG disclosures in investment decision-making. The questions fall into three categories: how the ESG information was developed, whether the information is standardized, and the reliability of the data.

Comment: As noted above, the CAQ report includes broad, overview questions that board members can use to explore ESG reporting with management and auditors. Oversight of the auditor is of course an audit committee responsibility, and in most cases, oversight of ESG disclosures is also likely to be assigned to the audit committee. Accordingly, audit committees may want to consider using these questions as a starting point for dialogue on these issues. More generally, as discussed above in the comments on the G&A report, ESG disclosure is becoming an important topic for most public companies, and audit committees will need to devote their attention to the reliability of this information. Auditor (or other third-party) assurance with respect to ESG disclosure is an important tool in promoting reliability and is likely to become more common.

Protiviti's Annual Survey Finds Rising SOX Compliance Costs

Consulting firm Protiviti has released the 2020 edition of its annual survey of Sarbanes-Oxley Act (SOX) compliance costs, SOX Compliance Amid a New Business Equilibrium. (The 2019 survey is summarized in Protiviti Finds that SOX Compliance Costs are Down, Hours are Up, and Technology is Slowly Taking Over, July 2019 Update.) As described in the executive summary, key findings of the 2020 survey are:

- Costs continue to rise. "This has been a long-term trend in our study, reflected in both internal SOX compliance costs and related external auditor fees. SOX compliance requirements are unlikely to change significantly – to drive down costs over the long term, greater use of data, automation and technology tools is key."

- Hours are increasing. "Commensurate with costs, SOX compliance-related hours are on the rise, as well. And similar to cost trends, organizations have an opportunity to reduce hours through increased use of data and technology, including automation as well as collaboration and workflow tools."

- It's time to embrace automation. "Automated processes and controls, along with utilization of technology tools to test controls, can create long-term efficiency, increased accuracy, and measurable time and cost savings. Of note, this also is advantageous during times such as the COVID-19 pandemic, when offices are shuttered and staff are working remotely."

With AuditBoard, a cloud-based platform offering audit management and compliance solutions, Protiviti conducted an online survey of 735 public company audit, compliance, and finance professionals during the first quarter of 2020 (before the scope of the COVID-19 pandemic was clear). Twenty-three percent of respondents were in the financial services industry, with the remainder from a range of industries. The most common positions held by respondents were audit manager, audit staff, audit director, and finance director. Thirty-eight percent of the surveyed non-financial services organizations had $5 billion or more in annual revenue, and about half of the financial services companies had $25 billion or more in assets under management.

Internal Compliance Costs

As noted above, SOX compliance costs rose in 2019 for most companies, reversing a small decline Protiviti reported in last year's survey. Changes in compliance costs varied with company size:

- The average annual internal cost of SOX compliance for the largest public companies (large accelerated filers) increased 5 percent from $1.309 million to $1.371 million in the prior survey. For the next tier of public companies (accelerated filers), average annual internal costs averaged 15 percent higher, up from $989,300 last year to $1.133 million.

- For smaller companies (non-accelerated filers), SOX compliance costs rose more sharply – by 21 percent to $889,300 from $734,200 last year. However, average compliance costs for emerging growth companies (EGCs – certain recently-public companies with revenues of less than $1 billion) fell one percent. Nevertheless, at an average of $1.3286 million per company, EGC SOX costs rivaled those of large accelerated filers.

On an industry sector basis, companies in Technology, Media and Telecommunications and those in Manufacturing and Distribution had the highest internal SOX compliance costs ($1.244 and $1.208 million, respectively). In the 2019 survey, Technology and Consumer Products/Retail lead the list.

External Audit Fees

Like internal compliance costs, external audit fees rose for most companies. Protiviti observes that "external auditors have been spending more time on internal controls reviews and attestations" and that this "is likely to continue in the wake of the COVID-19 pandemic as internal control environments undergo significant changes." Forty-nine percent of large accelerated filers, and 50 percent of accelerated filers, reported that their external audit fee increased in fiscal 2019, while only about 10 percent of each of these filer groups reported a decrease. For non-accelerated filers, 36 percent reported an increase, and 24 percent reported a decrease. For emerging growth companies, 53 percent reported an audit fee increase, while 8 percent said their audit fee decreased.

Hours Devoted to SOX Compliance

Significant percentages of companies reported that hours devoted to SOX compliance increased. For all companies in the survey, 51 percent said that their total hours increased in FY 2019. Only 13 percent of respondents said their SOX compliance hours fell, and 36 percent said they were constant. Non-accelerated filers were the least likely to report an increase in compliance hours – 35 percent of these companies said that their compliance hours were higher in fiscal 2019 than in the prior year. Almost two-thirds (64 percent) of emerging growth companies reported higher SOX compliance hours in 2019.

External Auditor Reliance on Company Testing

Protiviti asked respondents what percentage of their control testing the external auditor relied on. For all accelerated filers, the overall percentage of controls on which the auditor relied was 44 percent. In contrast, for non-accelerated filers and EGCs the overall reliance percentages were 43 percent and 39 percent, respectively. For the smaller filing company categories, these percentages have been increasing, apparently indicating increasing auditor confidence in company control testing.

Technology Tools

Surprisingly, Protiviti finds that "the overall use of technology tools for testing controls appears to be trending down" and that "RPA [robotic process automation] and other forms of automation do not appear to be advancing significantly in the SOX compliance environment." Protiviti offers several explanations for this decline:

- Uncertainty about whether external auditors are ready to deal with automated control testing.

- Concern about how much an external auditor may inquire about the testing "bot". "Some auditors still question whether bots might actually cause more, rather than less, work when it comes to meeting control requirements and answering external auditor questions."

- Access to data at companies that were not "born digital". "For those firms that are digitalizing now, data is not always available electronically, or it is not in the right format (i.e., it is unstructured). Additional tools are needed to structure the data properly, and that obviously causes complexity, along with extra costs, raising the barrier to automation."

Respondents were asked which technology tools their organization used in SOX Section 404 compliance. The five most frequently reported tools were:

- Data analytics -- 47 percent, up from 41 percent last year.

- Automated process approval workflow tools (e.g., expense report approval process -- 35 percent, down from 38 percent last year.

- Automated reconciliation tools -- 26 percent, down from 28 percent last year.

- Continuous controls monitoring -- 25 percent, down from 28 percent last year.

- Access controls/user provision/segregation of duties review tools -- 25 percent, down from 36 percent last year.

Across all categories of companies, respondents' estimates of the percentage of their key controls that were automated declined in the 2020 survey, as compared to last year. For example, large accelerated filers estimated that 24 percent of their key controls were automated, compared to 26 percent in the prior year.

<u>Perceptions of SOX Compliance and Internal Control Over Financial Reporting</u>

Respondents continue to be generally positive on the benefits of SOX. Sixty percent of respondents believe that their organization's internal control over financial reporting (ICFR) structure has "significantly" or "moderately" improved since an ICFR external audit became required. Only 1 percent thought their ICFR structure had been "minimally weakened" while 8 percent reported that they did not know how it had changed.

The primary benefits of SOX compliance cited by respondents were:

- Improved ICFR structure – 61 percent, up from 57 percent last year.

- Continuous improvement of business processes -- 55 percent, up from 47 percent last year.

- Enhanced understanding of control design and control operating effectiveness -- 54 percent, up from 51 percent last year.

- Compliance with SEC rules -- 44 percent, down from 46 percent last year.

- Ability to better identify duplicate of superfluous controls -- 41 percent, down from 43 percent last year.

- Improvement in company culture related to risks and controls -- 39 percent, up from 36 percent last year.

Comment: SOX compliance has imposed significant costs on companies of all sizes, and the impact on non-accelerated filers and EGCs has been substantial, given their more limited resources. Protiviti survey respondents have, however, consistently also reported that SOX compliance has created value in the form of stronger and more reliable controls. While costs rose somewhat last year, they seem generally to have plateaued for most companies. Protiviti foresees the possibility of SOX compliance cost reductions based on the adoption of advanced technology as part of SOX compliance, although, as noted, this year's survey seems to suggest that trend has stalled. Audit committees may want to explore with management whether it is taking advantage of these opportunities.

Protiviti suggests a series of questions that management should ask the external auditor as part of managing costs, particularly in light of COVID-19. Given the audit committee's oversight responsibilities, it may also want to consider a dialogue with the auditors around these topics, which are listed below:

- Obtain external auditor agreement with the risk assessment conclusion and practical guidance for updates in fiscal year 2020.

- Query their external auditor regarding the relationship between their increasing internal control attestation costs versus a potential reduction of substantive audit costs, with the expected driver being greater control reliance in aggregate audit approaches.

- Understand if/how the external auditors will be applying technology/tools to the audit process to increase efficiency, while also ensuring a clear understanding of how external audit will evaluate management's use of similar tools (e.g., RPA).

- Discuss how the timing and extent of audit procedures will be impacted and coordinate on the effects of any filing extension. Organizations also should keep their auditors apprised of critical changes to business operations and how those might affect the control environment.

Thinking of Replacing Your Auditor's Tax Services? Get Ready for a Higher Tax Bill – At Least Temporarily

One of the concerns that lead to the Sarbanes-Oxley Act (SOX) was that the auditor's provision of non-audit services to audit clients impairs independence. Nonetheless, SOX does not preclude auditors from providing tax planning and compliance services to audit clients. However, disclosure in a company's proxy statement of the payment of significant non-audit fees to the auditor can be a red flag. Accordingly, audit committees sometimes retain a firm other than the financial statement auditor for tax services to minimize non-audit fees and promote the appearance of auditor independence.

A recent academic research paper looks at the tax liability impact of replacing the financial statement auditor with another tax services provider. In The Cost of Independence: Evidence from Companies' Decisions to Dismiss Audit Firms as Tax-Service Providers in the June/August issue of Accounting Horizons (available here for purchase), Kirsten A. Cook (Texas Tech University), Kevin Kim (University of Memphis), and Thomas C. Omer (University of Nebraska-Lincoln) find that companies' effective tax rates "increased by an economically significant 1.36 percentage points in the year after terminating or substantially decreasing purchases of tax services from their audit firms." Cash tax payments increased by 1.63 percent, and the average additional first-year tax payment for the 419 companies in the study that changed tax service providers was $7.6 million. The authors conclude: "These tax-avoidance results suggest that companies dismissing or substantially reducing reliance on their audit firms as tax-service providers during our sample period incurred substantial costs to avoid the perception of impaired auditor independence."

This finding is, as the authors point out, subject to some important qualifications.

- The increase in taxes resulting from replacing the auditor as tax advisor is not permanent. "[O]ur results also suggest that these costs are relatively short-lived, as the decrease in tax avoidance lasted only for one year." The authors note that the "temporary worsening of tax-avoidance outcomes likely reflects new providers' lack of experience with clients' current tax planning."

- The tax expertise of the firms involved affects the impact of switching from the auditor to another advisor:

  > "If a company uses its audit firm as its tax service provider and that audit firm is a tax expert, the decision by this company to dismiss or substantially decrease reliance on this tax expert due to SOX-related independence concerns is all the more costly for that company in terms of the foregone tax avoidance. In contrast, if a company uses its audit firm as its tax-service provider and the audit firm is not a tax expert, the decision by this company to dismiss or substantially decrease reliance on this non-expert appears to be without cost because the new tax-service provider is a tax expert or at least equally skilled as the outgoing tax-service provider."

- Switching to another tax services provider only appears to increase tax expense when the switch is motivated by the audit committee's desire to improve the perception of auditor independence. Changes that have other motivations – e.g., to obtain higher quality tax services – do not result in increased tax costs. The study reaches this conclusion by comparing changes in tax providers during the years immediately following passage of SOX (when the alleged independence impact of non-audit services was widely discussed) with changes made in later years by companies that initially stayed with their auditor as tax services provider in the wake of SOX.

Comment: One might ask whether the additional tax costs found by Cook, Kim, and Omer are justified by improvements in either the fact or appearance of auditor independence. That question is outside the scope of the study, although the authors note that the literature on the impact of non-audit services on auditor independence "presents mixed results" and that "[r]esearch concerning the associations between the joint provision of audit and tax services and financial- and tax-reporting outcomes is sparse." In any event, the study suggests that audit committees should be slow to replace their auditor as tax advisor merely for appearance reasons.

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

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