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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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The SEC is Really Serious About Effective ICFR

On January 29, in the midst of the government shutdown, the SEC announced that it had filed and settled enforcement actions against four pubic companies for failing to maintain adequate internal control over financial reporting (ICFR). In each case, the companies involved had disclosed the existence of material control weaknesses, but failed to correct those weaknesses for periods ranging from seven to ten years. Two of the companies also failed to perform a management assessment of control effectiveness in certain years, and one repeatedly restated its financial statements while its controls were ineffective.

Since 1977, the Securities Exchange Act has required public companies to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that, among other things, transactions are recorded as necessary to permit the preparation of GAAP financial statements. In response to the Sarbanes-Oxley Act of 2002, the SEC also adopted rules requiring the maintenance of ICFR; an annual management assessment of ICFR effectiveness and disclosure of the results; and, for larger companies, an annual report by the company's independent auditor on ICFR effectiveness. Separate from these control requirements, the securities laws also require that companies publish accurate financial statements and other disclosures.

The Commission's orders (all of which were entered pursuant to settlements), find that each of the four companies violated the requirements related to the maintenance of controls for lengthy periods of time.

- Digital Turbine, Inc. Digital, a Texas-based global technology company, disclosed material weaknesses in ICFR for seven consecutive years, from 2011 to 2017. These material weaknesses related to its financial close and reporting process and to controls over IT systems. The company retained consultants to address the issues beginning in 2012 and started implementing a remediation plan in 2016. It finally reported that its ICFR was effective for the year ending

March 31, 2018. The SEC found that the company violated the statutory internal control requirement and the Commission's rule requiring ICFR. The company consented to a cease-and-desist order and a $100,000 civil penalty.

- Grupo Simec S.A.B. de C.V. Grupo Simec, a Mexican iron and steel alloy producer with some operations in the U.S., disclosed material weaknesses in ICFR for ten consecutive years, from 2008 to 2017. In 2015 and 2016, management also disclosed that it had failed to complete the required management evaluation of ICFR. The company's disclosures indicated that, among other things, it lacked an "appropriate consolidation system" and "did not have adequate accounting resources and/or adequate segregation of duties". The company hired an internal control consultant in 2016, but its controls continued to have material weaknesses at the time of the SEC order. The Commission found that the company violated the statutory internal control requirement and the Commission's rules requiring ICFR and an annual management assessment. The company consented to a cease-and-desist order, a $200,000 civil penalty, and extensive undertakings designed to bring its controls into compliance.

- Lifeway Foods, Inc. Lifeways, an Illinois-based dairy food producer, disclosed material weaknesses in ICFR for nine years, from 2007 to 2017, and significant control deficiencies that aggregated to a material weakness in 2016. Among other problems, in three of the years that it lacked effective controls, the company disclosed that it did not have a "requirement to post monthly activity to [its] general ledger". In 2013 and 2014, management failed to complete the required ICFR assessment. In addition, the company restated three times between 2012 and 2016, although none of the restatements had a material effect on financial results. (The order states that each of the restatements involved "failures to appropriately account for and assign costs related to manufacturing, cost of goods sold, or inventory.") The company began remediation efforts in 2013, but did not report that its ICFR was effective until December 31, 2017. The SEC's order finds that the company violated the statutory internal control requirement and the Commission's rules requiring ICFR and an annual management assessment. The company consented to a cease-and-desist order and a $100,000 civil penalty

- CytoDyn Inc. CytoDyn, a biotech company based in Washington state, reported material weaknesses in ICFR for nine years, from 2008 through 2016. According to the SEC order, the company's disclosures indicated that the material weaknesses related "primarily to segregation of duties and the review, recording and financial reporting of transactions." After being contacted by the SEC staff, the company retained a SOX consultant and announced that its ICFR was effective as of May 31, 2017. The SEC found that the company violated the statutory internal control requirement and the Commission's rule requiring ICFR. The company consented to a cease-and-desist order and a $35,000 civil penalty.

Comment: These cases – and the fact that the SEC released them simultaneously – underscore the importance that the Commission attaches to internal accounting controls and the seriousness with which it views conduct that seems to give low priority to control effectiveness. The cases against Digital Turbine and CytoDyn are clearest examples. In those two matters, the failure to maintain effective controls is the only violation alleged; there is no related failure to comply with the disclosure requirements. In contrast, Grupo Simec and Lifeways also failed to perform management assessments, and Lifeways restated its financials three times, apparently as a result of errors traceable to the material weaknesses.

The obvious lesson for audit committees is that, when material weaknesses are discovered, it is essential that management promptly implement remedial steps. Merely disclosing that controls are ineffective – while necessary – does not protect the company against SEC enforcement action, since ineffective controls are an independent violation of the securities laws. The periods during which material weaknesses were allowed to persist in these cases – ranging up to ten years – are rather stunning. The SEC would likely view shorter delays as violations as well.

It is also worth bearing in mind that the Commission has taken a broad view of the scope of required controls. As discussed in SEC Says That Cybersecurity is Part of ICFR, October-November Update, the

Commission has made clear that, in designing internal controls, companies need to consider cyber threats and that companies that fail to do so could be charged with having inadequate controls.

PCAOB Issues Two Large Firm 2017 Inspection Reports, along with KPMG's Delayed 2016 Report, and Takes KPMG to Task for Failing to Remediate Prior Deficiencies

The PCAOB has released the public portions of two 2017 inspection reports with respect to the largest U.S. accounting firms. The 2017 inspection reports that have become available are Report on 2017 Inspection of Deloitte & Touche LLP and Report on 2017 Inspection of KPMG LLP. The results of the 2017 inspections of D&T and KPMG are summarized at the end of this item in a table which will be expanded as additional 2017 reports become public. The 2017 PCAOB inspections generally reviewed audits of public company financial reporting for fiscal years ending in 2016.

In addition, the PCAOB released the 2016 inspection report for KPMG, which had been delayed because of a leak of inspections information to KPMG. The PCAOB also made public certain previously nonpublic parts of the quality control deficiencies sections of KPMG's 2014 and 2015 inspection reports.

Deloitte & Touche 2017 Inspection Report

D&T's 2017 inspection report, dated December 20, 2018, became publicly-available in early January. During the 2017 inspection cycle, the PCAOB reviewed 55 Deloitte audits and identified, in eleven of those audits (20 percent), deficiencies that, in the view of the PCAOB inspection staff, were of such significance that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to Deloitte's 24 percent deficiency rate in 2016. Eight of the eleven engagements described in Part I of the report included deficiencies related to the audit of internal control over financial reporting.

KPMG Inspection Reports

A. Background

According to the newly-released 2016 KPMG inspection report, in the Spring of 2017, the KPMG notified the PCAOB that firm leadership had obtained "improper advance notice" of engagements to be inspected during the 2016 and 2017 inspection cycles. Subsequently, in January 2018, the Department of Justice charged three senior KPMG officials and three former PCAOB inspections staff members with fraud and conspiracy. The indictment describes a scheme by which the former PCAOB employees, two of whom had joined KPMG, provided the senior KPMG officials with advance, secret information concerning the KPMG audit engagements the PCAOB planned to review.

Prior to learning of the leak, the PCAOB's inspection staff had conducted 52 reviews of issuer audits, including eleven financial institution audits, as part of the 2016 inspection. After KPMG informed the PCAOB that its inspections had been compromised, the inspection team expanded the 2016 inspection to include ten additional financial institution audits to replace its reviews of the eleven audits that had originally been part of the inspection plan.

The replacement reviews occurred between May and October of 2017. It appears that these new inspections, coupled with the controversy surrounding the leak, the indictments, and related SEC enforcement proceedings, delayed issuance of the 2016 KPMG inspection report until January 2019.

B. 2016 and 2017 Inspection Reports

The two recently-released KPMG inspection reports both reflect unusually high deficiency rates.

- 2016 Inspection Report. KPMG's 2016 inspection report, dated January 15, 2019, became publicly-available on January 25. During the 2016 inspection cycle, the PCAOB reviewed 51

KPMG audits and identified, in 22 of those audits (43 percent), deficiencies that, in the view of the PCAOB inspection staff, were of such significance that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to KPMG's 38 percent deficiency rate in 2015. Nineteen of the 22 engagements described in Part I of the report included deficiencies related to the audit of internal control over financial reporting.

The August-September 2018 Update contains a summary of the 2016 inspection results for D&T, E&Y, and PWC. This summary was prepared without KPMG's 2016 inspection results because of uncertainty over when its 2016 report would be issued. For the other three large firms as a group, the average 2016 deficiency rate was 24 percent.

- 2017 Inspection Report. KPMG's 2017 inspection report, dated January 24, 2019, became publicly-available on January 25. During the 2017 inspection cycle, the PCAOB reviewed 52 KPMG audits and identified, in 26 of those audits (50 percent), deficiencies that, in the view of the PCAOB inspection staff, were of such significance that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to KPMG's 43 percent deficiency rate in 2016 (see above) and appears to be the highest deficiency percentage the PCAOB has ever reported for any Big Four firm. Twenty-four of the 26 engagements described in Part I of the report included deficiencies related to the audit of internal control over financial reporting.

C. 2014 and 2015 Quality Control Remediation Failures

Under the Sarbanes-Oxley Act, portions of an inspection report that contain criticisms of the firm's quality controls are not released to the public when the report is issued. If, during the one-year period following issuance of the report, the firm remediates those deficiencies, or makes progress satisfactory to the PCAOB, the quality control criticisms are permanently nonpublic. However, if the firm fails to remediate to the Board's satisfaction, the PCAOB may make the parts of the report that describe the un-remediated deficiencies public.

On January 25, 2019, the PCAOB issued a release making portions of KPMG's 2014 and 2015 inspection reports public. The release states that, "as of October 15, 2016 and November 9, 2017, respectively, the Firm had not addressed certain [quality control] criticisms in the Reports to the Board's satisfaction." The release notes that the PCAOB "takes very seriously the importance of firms making sufficient progress on quality control issues identified in an inspection report in the 12 months following the report."

The newly-public criticisms include the following PCAOB statements:

- Tone and messaging. "While multiple factors may have contributed to the negative trend in inspection results, it appears that the Firm's tone and messaging, in some respects, may present the risk of undercutting the Firm's specific efforts to remediate quality control concerns, in part because the tone and messaging may suggest a lack of complete commitment to an appropriately concentrated and objective approach to evaluating and responding to identified audit deficiencies and to addressing partners' audit quality." (2014 Inspection Report)

- Assignment of qualified personnel. "Under PCAOB quality control standards, a firm should have policies and procedures that provide it with reasonable assurance that work is assigned to personnel who have the necessary degree of technical proficiency * * * and that the work performed by those personnel meets applicable professional standards * * *. The inspection results indicate that the Firm's system of quality control does not provide such assurance with respect to testing and evaluating internal control in accordance with [PCAOB standards]." (2015 Inspection Report)

- Professional skepticism. "The inspection results indicate that the Firm's system of quality control appears not to provide reasonable assurance that the Firm's personnel will appropriately exercise professional skepticism in the performance of issuer audits." (2014 Inspection Report)

- Supervision. "The inspection results indicate that the Firm's system of quality control does not provide the reasonable assurance described in [PCAOB standards] that the supervisory, including review, activities performed by the Firm's partners will meet the requirements of AS No. 10 and that the review activities performed by the EQCR [engagement quality control review] partners will meet the requirements of AS No. 7." (2015 Inspection Report)

PCAOB 2017 Inspections Status Report

The results of the 2017 inspections of D&T and KPMG are summarized in the table below.

2017 Big Four Inspections (Reports Issued in 2018 or 2019)

Firm	Report Date	Engagements Inspected	Part I Deficiencies*	Percentage
Deloitte & Touche	December 20, 2018	55	11	20%
KPMG	January 24, 2019	52	26	50%

* The PCAOB describes deficiencies that are included in Part I of an inspection report as "of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion" on the financial statements or on internal control over financial reporting in all material respects.

After the PCAOB has made all 2017 Big Four firm inspection reports publicly available, the Update will present an overview of the PCAOB's inspection findings concerning these firms.

Comment: Audit committees should discuss the results of their audit firm's most recent PCAOB inspection with their engagement partner. If the company's audit is mentioned in either the public or nonpublic portion of the inspection report, the audit committee should understand the reasons for the reference to the audit and how it will affect the engagement in the future. If the company's audit is not cited in the report, the audit committee should explore with the auditor how deficiencies identified in other audits might have affected the company's audit and how changes in the firm's procedures might affect future audits. Audit committees should also understand how the firm intends to remediate quality control deficiencies described in the nonpublic portion of the report.

For companies with KPMG as their auditor, the audit committee may want to inquire specifically how the firm's efforts to improve audit quality and remediate the deficiencies discussed the nonpublic portions of its 2014 and 2015 inspection reports will affect the company's audit. In a statement attached to the PCAOB release announcing the disclosure of those inspection report sections, KPMG states:

> "We have made significant investments in new audit methodology and he related workflow technology that support the execution of our audits. These investments in particular are specifically focused on auditing internal controls over financial reporting and estimates. These investments, to fully implemented in 2020, will ensure a clear alignment of our audit methodology with the auditing standards and the facilitation of audit execution through a new technology platform. Certain elements of the methodology related to risk assessment have been accelerated into 2018 to expedite improvements in the auditing of internal controls over financial reporting and estimates."

Since this statement seems to suggest a major, ongoing change in audit methodology, audit committees may want to understand the impact on their audit.

The CAQ Gives Audit Committees Some Help on Oversight of Emerging Technologies

The Center for Audit Quality has released Emerging Technologies: An Oversight Tool for Audit Committees to assist audit committees in understanding how emerging technologies impact the company's financial reporting. Emerging technologies include artificial intelligence (AI), robotic process automation (RPA), drones, and blockchain. The new CAQ publication explains how the COSO's Internal Control – Integrated Framework applies to oversight of these new technologies and provides questions that audit committees may want to ask management and the auditor regarding emerging technologies. In addition, the publication contains sidebar primers on the impact of AI and RPA on financial reporting.

The COSO internal control framework has five components. These are listed below, along with a brief summary of how the CAQ's new tool applies each framework element to emerging technology oversight.

Control Environment. The CAQ's tool treats management's emerging technology strategy, and the specific technologies that are part of that strategy, as an aspect of the control environment. Accordingly, "audit committees should be aware of the company's emerging technology strategy * * * [and] knowledgeable about the specific technology being contemplated, so that it can oversee its alignment with the company's strategy as well as its impact on the business and financial reporting."

Risk Assessment. In applying risk assessment to emerging technology changes, the CAQ recommends that audit committees consider whether management has assessed the risks associated with making changes to company processes to implement new technology and whether management has put controls in place to identify such risks as they emerge. A related risk assessment issue is whether management has access to adequate technology expertise.

Control Activities. Control activities are the actions taken to mitigate the risk that a control objective will not be met. The CAQ's tool states that the kinds of control activity issues related to emerging technologies that should concern the audit committee include, "if the technology is functioning as intended and the output is reliable; how emerging technologies will be tested and integrated with other systems; how information technology (IT) considerations regarding unauthorized access, user provisioning, and segregation of duties are controlled; and how important assets (including customer data and intellectual property assets) are safeguarded."

Information and Communication. The audit committee must have confidence that controls are in place to accurately capture, use, and retain all information necessary for financial reporting. Accordingly, the audit committee should ensure that management considered the impact on existing information-gathering processes and systems of new systems or processes that employ emerging technology.

Monitoring. Monitoring is the ongoing process of ensuring that controls are functioning effectively. "Audit committees may consider leveraging the internal audit function to probe whether emerging technology programs are operating with an appropriate level of rigor and control so that financial reporting objectives are met." Understanding of how the external auditor will approach financial reporting risks associated with emerging technologies is also an aspect of monitoring.

The discussion of each of the five COSO framework components includes questions that the audit committee may wish to ask management. For example, with respect to the control environment, the suggested questions (omitting sub-questions) are:

1. What are the objectives associated with the use of the emerging technology?

2. How does the emerging technology project integrate with management's existing digital and analytics plans?

3. Does use of the emerging technology raise tax, legal, regulatory, or financial reporting questions that require external advice?

4. What has the company done to train and maintain its internal resources and technological competencies related to emerging technologies?

In addition to the suggested questions for management with respect to each COSO element, the tool also includes five over-arching questions the audit committee may want to pose to their auditor:

1. Does the audit engagement team include individuals with the right expertise to assess and address risks related to the emerging technology? Is there a need to involve additional specialists? If so, will they be from within the audit firm or external resources?

2. What is the audit firm's experience with the emerging technology?

3. How has the impact of the emerging technology been considered during the auditor's risk assessment process?

4. Does the emerging technology have a significant impact on the planned audit scope?

5. Has the audit team identified any additional risks that management has not sufficiently explored?

Comment: Keeping abreast of the accelerating pace of change in technology and how new technologies will affect financial reporting, controls, and auditing (both internal and external) is one of the most difficult challenges audit committees face. By relating oversight of new technology to the COSO internal control framework, the CAQ's publication provides a useful way for audit committees to begin a conversation with management about how the company is addressing new technologies and related risks and opportunities.

Two Accounting Firms Share Their Audit Committee Agenda Ideas

Two major accounting firms have issued publications listing issues that audit committees should consider in preparing their 2019 agendas.

KPMG Board Leadership Center

The KPMG Board Leadership Center has released On the 2019 audit committee agenda. KPMG's top audit committee challenges include "long-term economic uncertainty (with concerns about mounting trade tensions, resurging debt, and market valuations), technology advances and business model disruption, cyber risk, regulatory scrutiny and investor demands for transparency, and political swings and policy changes in the U.S., UK, and elsewhere." Against this background, KPMG recommends that audit committees take seven steps as they formulate their 2019 agendas:

- Take a fresh look at the audit committee's agenda and workload. Audit committees are finding it increasingly difficult to oversee risks in their core areas of responsibility – financial reporting, internal control, and external auditor oversight. The committee should reassess whether it has the time and expertise to also take responsibility for such issues as cybersecurity and IT risk, supply chain and other operational risks, and legal and regulatory compliance. If not, these matters should be assigned to other committees or the full board.

- Sharpen the company's focus on culture, ethics, and compliance. Among other things, KPMG recommends monitoring tone at the top and culture, with a "focus on behaviors, not just results." The committee should also monitor the effectiveness of the company's whistleblower program.

- Understand how the finance organization will reinvent itself and add greater value in this technology and data-driven environment. During the next two years, KPMG expects finance

functions to undergo the greatest technological transformation since the 1990s. It is essential that the audit committee understand finance's transformation strategy.

- Monitor management's progress on implementing new FASB standards as well as SAB 118 adjustments related to U.S. tax reform. The impact of new accounting standards for revenue recognition, leases, and credit impairment on business systems, controls, disclosures, and resource requirements should be an area of audit committee focus. The committee should also monitor implementation of Staff Accounting Bulletin No. 118, which permitted companies to recognize provisional amounts reflecting the effects of the 2017 Tax Cuts and Jobs Act. SAB 118 required that these provisional amounts be finalized by the end of 2018. See SEC Staff Issues Guidance on Financial Reporting Implications of Tax Reform, January-February 2018 Update.

- Discuss the new reporting requirements for critical audit matters (CAMs) with the external auditor and reinforce audit quality by setting clear expectations for the auditor. Depending on company size, the new PCAOB requirement for auditors to include discussion of CAMs in their report will take effect in 2019 or 2020. Early auditor/audit committee dialogue is key to implementation. See The CAQ Has Ten Audit Committee Questions About CAMs (and the Answers), December 2018 Update. KPMG also recommends that audit committees monitor auditor performance "through frequent, quality communications and a rigorous performance assessment."

- Give non-GAAP financial measures, other key operating metrics, and cybersecurity disclosures a prominent place on the audit committee agenda. KPMG describes the importance that SEC Chief Accountant Wes Bricker has placed on audit committee involvement in the review and presentation of non-GAAP measures. See SEC Chief Accountant Focuses Again on Audit Committees, December 2018 Update. KPMG also recommends that audit committee focus on cybersecurity disclosures.

- Focus internal audit on the company's key risks beyond financial reporting and compliance. "The audit committee should work with the chief audit executive to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and help ensure that internal audit is focused on those risks and related controls."

EY Center for Board Matters

Along the same lines, the EY Center for Board Matters has issued 2018 year-end issues for audit committees to consider. Despite the title, many of the matters discussed potentially affect the work of the audit committee throughout 2019.

The EY report is divided into four topic areas, with issues for "further discussion" under each topic. In addition, each topic area includes a list of questions for the audit committee to consider and raise with management. The four topics, and the related "further discussion" issues with respect to financial reporting and regulatory developments, are described below:

1. Financial reporting. EY suggests six issues for discussion under the topic of financial reporting.

    - Gearing up for the leases standard. "As lessees prepare to adopt the new standard, audit committees should discuss with management the status of their implementation plans, key accounting policies the company elects, the impact on their processes and controls, and how management intends to communicate these to its stakeholders * * *."

    - Credit losses. EY notes that the new credit impairment accounting standard will affect companies in all industries since the standard makes significant changes to the accounting and disclosures for credit losses on a wide variety of financial instruments, including trade receivables.

- Accounting transition disclosures under SAB Topic 11.M. "SEC officials have continued to emphasize the importance of providing robust accounting transition disclosures as required under Staff Accounting Bulletin (SAB) Topic 11.M about the anticipated effects of the new accounting standards on a registrant's financial statements."

- SEC comment letter trends. EY lists several topics the SEC staff is likely to focus on, including accounting under the new revenue recognition standard, disclosures about the impact of the new accounting standards on leases and credit impairment, disclosures about cybersecurity, and tax reform act accounting effects.

- SEC staff focuses on ASC 606 (Revenue from contracts with customers disclosure). "Audit committees should continue to evaluate the adequacy of the company's disclosures required by the new revenue standard. We believe this evaluation should include the consideration of disclosures by peer companies, industry practice and other best practices as they evolve over time."

- SEC amends rules to eliminate redundant and outdated disclosures. Companies "should carefully review the changes made by the rule and address them as necessary."

2. Tax. EY states that audit committees will need to address tax policy changes as businesses continue to implement the 2017 Tax Cuts and Jobs Act and come to grips with the Supreme Court's Wayfair decision on the ability of states to impose sales tax liability on nonresident sellers. In addition, audit committees should stay focused on U.S. trade policy, including tariffs.

3. Regulatory developments. EY cites five regulatory issues for audit committee discussion.

    - SEC outlook. EY discusses several SEC regulatory trends and Chairman Clayton's priorities and recommends that audit committees "keep abreast of the evolving SEC agenda and the impact that such changes have on the organization."

    - SEC's continued focus on cybersecurity disclosures. The SEC has emphasized cyber-security related disclosures. A recent EY analysis finds that the audit committee oversees cybersecurity matters at 70 percent of the Fortune 100.

    - PCAOB outlook and developments. The PCAOB has announced that it intends to make changes in its inspections, standard setting, and enforcement programs. The PCAOB Chair has also stated that the Board plans to communicate more closely with audit committees. See A Re-Vamped PCAOB Inspections Program Will Feature More Communication With Audit Committees, October-November 2018 Update.

    - Auditor's reporting model. Audit committees should be working with their auditor to understand the new PCAOB requirement for disclosure of critical audit matters and should be taking steps to prepare for implementation.

    - Enhancing audit committee reporting. "Enhancing audit committee transparency can increase investors' confidence in financial reporting and their confidence in the role of the audit committee in overseeing the audit process and promoting audit quality." See Transparency Rolls On: Audit Committees are Voluntarily Disclosing More About Their Work, November-December 2017 Update.

4. Risk management. EY notes that disruption in the business environment comes in many forms and suggests four topics for audit committee discussion: next generation Enterprise Risk Management; driving digital trust and overseeing data privacy; third-party risk management; and the future of compliance and board oversight of culture.

Comment: As noted in prior Updates, many accounting and consulting firms publish lists of issues that should be on the audit committee's radar. See Protiviti Has Suggestions for the Audit Committee's 2019 Agenda, December 2018 Update. Each company's circumstances and challenges vary, but these lists can serve as a useful check as audit committees develop their plan for the coming year.

FERF: The Median Public Company Audit Fee Rose in 2017, But Some Companies Have Found Ways to Avoid Paying More

The Financial Executives Research Foundation (FERF), the research affiliate of Financial Executives International (FEI), has released the results of its annual survey of audit fees. The 2018 Audit Fee Survey Report, which was sponsored by Workiva, a provider of cloud-based reporting, compliance, and data-management solutions, indicates that the median public company audit fee rose 2.5 percent in 2017. The private company median audit fee rose 3.2 percent, while nonprofit organization audit fees were unchanged. (The 2017 FERF audit fee survey is discussed in Audit Fees Continue to Rise, But More Slowly, For Most SEC Filers, March 2018 Update.)

The FERF/Workiva report is based on survey responses from financial executives at a mix of public companies, private companies, and non-profit organizations. The report also examines publicly-reported audit fees for 6,340 SEC filers. According to financial analysis firm idaciti, those filings indicated that, for the entire SEC reporting company universe, the median 2017 audit fee increase was 5.7 percent. Broken down by filer size, the SEC data indicates that smaller companies experienced greater fee increases than their larger counterparts. For example, while the large accelerated filer median audit fee decreased slightly between 2016 and 2017 (from $2,495,970 to $2,477,500 or .7 percent), for smaller reporting companies the media fee increased from $78,516 to $81,000 (3.2 percent). On an industry basis, business services experienced the largest percentage increase in average fees (8.31 percent), while communications saw the largest decrease in average fees (2.84 percent).

Fee change causal factors

FERF's survey of financial executives asked respondents to indicate the primary factors that contributed to an increase or decrease in their audit fees. For all public companies represented in the survey, the top reasons cited were new FASB standards (47 percent); focus on revenue recognition (42 percent); acquisition (33 percent); and negotiation with primary auditor (26 percent). Since many companies were focused on implementation of the FASB's new revenue recognition standard in 2017, it seems likely that the "new FASB standards" response and the "focus on revenue recognition" response are overlapping. In that regard, 69 percent of respondents said they were devoting "substantial" effort to implementing new accounting standards. FERF characterizes this aspect of the survey as indicating that "respondents say the major new standards adopted by the Financial Accounting Standards Board (FASB) in recent years produced a modest increase in their audit fees, primarily for technical advice and documenting their preparation efforts."

Survey respondents have in the past pointed the finger at the PCAOB as a driver of increased audit fees (see March 2018 Update, cited above). In the 2018 survey, two PCAOB-related factors together were cited by 20 percent of respondents: review of manual controls resulting from PCAOB inspections (14 percent) and review of prior year workpapers resulting from PCAOB inspections (6 percent). The report quotes some of the interview responses it received on the issue of PCAOB impact. For example, one Chief Accounting Officer said:

> "I think the simple concept of reasonableness has lost its way where the auditors have to document like crazy to say that they've looked at everything. Obviously, their opinion is not saying that they have looked at everything, but as an accountant, you can't make a human error without having it blown up into something huge and a significant deficiency."

Another respondent observed (somewhat cynically):

> "I think the PCAOB has audit partners scared, and the path of least resistance is to layer more work on your client until your client says no. That does two things. You drive revenue, which is a metric you get incentivized for, and you reduce your downside risk. So if you're a partner, why would you not?"

Fee increase mitigation strategies

The FERF survey also looks at "mitigation strategies" – steps companies reporting audit fee decreases took to reduce audit. The top public company responses were:

- Reviewed our audit hours and fees and negotiated with our auditors (70 percent).
- Increased our audit preparedness (25 percent).
- Improved our internal controls (15 percent).
- Reviewed our current audit focus areas to identify areas for improvement (15 percent).
- Centralized our audit footprint (15 percent).
- Increased automation (15 percent)

Only 20 public company financial executives provided response to this aspect of the survey, so the sample size is small. Nonetheless, it is interesting that the percentage of executives reporting that a decrease resulted from negotiations with the auditor rose from 47 percent last year to 70 percent. Improving controls, increasing audit preparedness, and improving audit focus all declined from the mid-40s to between 15 and 25 percent as an explanation for fee decreases. The report contains discussion of mitigation strategies, including respondents' comments on increasing audit preparedness, increasing work done internally on which auditors can rely, improving communications with the external auditors, expanding automation, monitoring audit progress, and "finding the right audit firm".

Comment: While the 2017 increases in audit fees were relatively modest, at least for large companies, it appears that the FASB has overtaken the PCAOB as the main driver of rising audit fees. Nonetheless, many survey respondents still blame the PCAOB and its focus on ICFR auditing for fee increases. As the Update observed last year, one would expect the system-wide fee impacts of PCAOB inspections and ICFR auditing to level off, as audit firms and their clients adjust to these requirements.

The FERF survey may also be of interest to audit committees because it collects strategies for reducing audit fees. As noted above, in 2017 old-fashioned negotiation with the auditor seems to be have been the most popular approach, surpassing structural measures like improving controls or increasing automation. In the long run, increasing company and audit firm use of artificial intelligence may reduce audit costs, although this does not yet appear to be a major factor.

Issuing the Earnings Report Before the Audit is Finished Puts the Auditor in a Tough Spot, But the Audit Committee Can Help

Most public companies today issue their annual earnings press release prior to the completion of the audit for the year in question. This practice raises obvious questions about the impact on the company's credibility (and stock price) if the auditor ultimately refuses to sign off on the previously-announced earnings figures. Viewed from a different perspective, announcing earnings before the end of the audit seems to put considerable pressure on the auditor to refrain from requiring any adjustments that would change the already-public results.

Three academics at the University of Indiana's Kelley School of Business, Lori Shefchik Bhaskar, Patrick Hopkins, and Joseph Schroeder, conducted a "controlled experiment" with audit partners and senior managers to determine the effect of earnings announcements on auditors. Their findings, which appear in

a paper entitled, An Investigation of Auditors' Judgments when Companies Release Earnings before Audit Completion, are that "in the presence of today's typical level of audit committee engagement, auditors are significantly more likely to accept aggressive financial reporting when earnings have been released (versus drafted)." They further find, however, that "this effect is mitigated with strong audit committee effectiveness (i.e., including ideal, but achievable, characteristics typically currently lacking in today's average committees)." The authors conclude: "Our study provides evidence on the importance of investing in high-quality audit committees in promoting high-quality financial reporting."

The authors conducted their experiment using 114 "highly experienced" auditors (about two-thirds of whom were audit partners). Participants received a brief description of a hypothetical company, its annual earnings announcement with selected financial information, a description of its audit committee, and details about a year-end accounting issue related to the valuation of the allowance for deferred taxes. The paper states that the case was designed such that the deferred tax valuation allowance and related assumptions were "aggressive, resulting in a potential material misstatement."

The "strong" and "moderate" audit committee conditions were presented to participants as follows:

- "*Strong* conditions: The audit committee is composed of three individuals, who are all independent. Two of the members are CPAs with extensive experience in public accounting and qualify as financial experts as defined by the SEC, and the third member is financially literate. You have been very impressed with the audit committee's high level of diligence in representing shareholders' interest. They meet frequently and are actively involved in the resolution of key accounting and disclosure issues. The audit committee members are proactive, ask probing questions, and debate the appropriate accounting treatment regarding key transactions and issues."

- "*Moderate* conditions: The audit committee is composed of three individuals, who are all independent. Only one of the members qualifies as a financial expert as defined by the SEC as he is viewed as a supervisory financial expert. The other two members are financially literate. None of the members have direct accounting or financial reporting experience. Your experience with the audit committee is that they meet infrequently and are somewhat involved in the resolution of key accounting and disclosure issues. The audit committee members are reactive; they follow discussions of the issues during meetings, but they do not ask too many questions regarding the issues."

The results of the experiment were that, with a moderately effective audit committee, "the likelihood the auditor would require a year-end audit adjustment were reduced significantly if earnings had already been released." In contrast, in the case of a strong audit committee, auditors were equally likely to require or not require an audit adjustment, regardless of whether earnings had been released. Similarly, with the moderately effective audit committee, the auditor was more likely to view the deferred tax allowance as reasonable if earnings had been released; in the strong audit committee case, auditors' reasonableness assessments were not affected by whether earnings results had been released or merely drafted. The study states:

> "The findings support [the authors' hypothesis] that strong [audit committee] effectiveness mitigates the negative effect of released earnings on auditors' propensity to accept client's aggressive accounting. Moreover, we find when earnings have been released, auditors are significantly more likely to require year-end audit adjustments if there is a strong versus moderate [audit committee] effectiveness * * * and they assess the account balance as significantly less reasonable * * *. This finding is important given this is the setting most auditors face during the completion of year-end audits. Together, our findings highlight the importance of having a strong [audit committee] to help auditors stand against aggressive financial reporting."

Interestingly, the authors also note that issuance of earnings releases prior to audit completion became "the new normal" after the PCAOB adopted its standard on the auditing of internal control over financial reporting in response to the requirements of Section 404 of the Sarbanes-Oxley Act. Apparently, although

the ICFR audit work tended to increase the time needed to complete the financial statement audit, companies continued to make their earnings announcements on the same schedule as they had traditionally followed. The result is that announcements are now frequently issued without waiting for the auditors to finish their work. The paper states that prior research suggests financial reporting quality is lower when firms announce earnings before the audit report date.

Comment: This research is not just theoretical. In 2008, the PCAOB brought and settled an enforcement action, cited in the research paper, against an auditor who was alleged to have violated PCAOB standards and authorized an unqualified audit opinion notwithstanding material errors because of "management's interest in avoiding a retraction of that [previously issued earnings] announcement and in meeting the companies' internal target date for filing their Forms 10-K." In the Matter of Christopher E. Anderson, CPA, PCAOB Release No. 105-2008-003, October 31, 2008.

The research might give some audit committees pause in agreeing to pre-audit completion earnings announcements. But, if changing that practice is not feasible, the research also makes clear that the auditor's perception that the audit committee is actively involved in accounting issues, and proactively communicating with the auditor, can make a substantial difference in the auditor's willingness to stand up to management pressure in the face of aggressive accounting choices. The researchers' experiment and its results suggest that, if the auditor believes, based on experience with the audit committee, the committee is engaged and interested in accounting issues, that perception alone can be sufficient to empower the auditor to resist pressure to go along with accounting judgments that he or she believes are improper.

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