

# Update

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## AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

This Update summarizes recent developments relating to public company audit committees and their oversight of financial reporting and of the company's relationship with its auditor.

### **CAQ Field Testing of PCAOB Auditor Report Proposals Highlights Potential Implementation Challenges**

On June 20, the Center for Audit Quality [released](#) the findings of its field testing of the Public Company Accounting Oversight Board's proposed expansion of the auditor's report. In a [letter to the PCAOB](#) discussing the findings, the CAQ suggested changes to the proposals. Separately, as noted in the next item, the PCAOB staff has announced that it plans to repropose the new auditor's reporting model, signaling that it intends to make revisions to the original proposal.

As discussed in the [September 2013 Update](#), the PCAOB has proposed far-reaching changes to the auditor's report. The most fundamental proposed change is a requirement that the auditor include in its report a discussion of "critical audit matters" (CAMs). CAMs are those matters addressed during the performance of the audit that, in the auditor's judgment, involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

In addition, the PCAOB has proposed to expand the auditor's responsibility for "other information" (OI) – that is, information, such as MD&A, that is outside of the financial statements, but included in the same SEC filing as the financial statements. The proposed standard would require auditors to "evaluate" such information and contains criteria for evaluation procedures. If the auditor identifies inconsistencies between the OI and evidence obtained in the audit, the auditor would be required to discuss the inconsistencies with management. If management failed to make changes, the auditor could be required to withdraw from the engagement or to disclose the inconsistencies in the audit report.

The CAQ's CAM field testing involved nine accounting firms and 51 public company audit engagements. The 51 companies had market capitalizations ranging from less than \$250 million to more than \$10 billion. Six firms participated in the OI field testing, which included 15

audit engagements. Essentially, the participating firms applied the PCAOB's proposals retrospectively to audit engagements that had previously been completed. Some of the CAQ's findings are –

- The criteria in the PCAOB's proposal for identifying CAMs resulted in a large universe of potential CAMs that auditors had to consider for disclosure. The number of potential CAMs per company ranged from one to 45. The number of actual, discloseable CAMs ranged from zero to eight, while the average number of actual CAMs per company was slightly under five.
- There were inconsistencies among the participating engagement teams in applying the proposed standard with respect to how CAMs would be communicated in the audit report. For example, the length of the CAM descriptions ranged from one sentence to several paragraphs.
- CAM reporting will require additional auditor (and audit committee) time and effort:

“Feedback from audit engagement teams, as well as management and audit committees, was that the additional time and effort was likely to be incurred during the completion phase of the audit by senior members of the audit engagement teams. \* \* \* Expanded discussions with management and the audit committee may also require additional time and effort in a ‘live’ audit environment versus the retrospective environment in which the field testing was conducted.”

- With respect to the OI proposal, the requirement that the auditor evaluate information outside of the financial statements “will likely give rise to additional work by auditors, compared to current practice, and \* \* \* there is uncertainty and diversity of views as to what is required.”

Based on the field testing, the CAQ recommended that the PCAOB consider various suggestions that “may mitigate some of the challenges identified.” For example --

- Including materiality relative to the financial statements as a factor to be considered in determining what constitutes a CAM. As proposed by the PCAOB, CAMs would not necessarily be material, as defined under the securities laws.
- Limiting potential CAMs to those matters communicated to the audit committee. The CAQ's letter states that 98% of the actual CAMs identified during the course of field testing were previously communicated to the audit committee.
- Clarifying how the auditor would communicate in the auditor's report the factors most important to determining whether a matter was a CAM.

Comment: The CAQ's field testing underscores the difficulties and inconsistencies that are likely to occur in the initial years of the implementation of the PCAOB's proposals to expand the audit report to require that audit reports be customized to each engagement. CAM

disclosure would also have ripple effects on the company's disclosures. As the CAQ states: "Most of the accounting firms indicated that management and the audit committee voiced concern about the potential need for management to revise disclosures to respond to CAM descriptions that include 'original' information about the issuer and to involve disclosure committees and outside counsel in the CAM process to evaluate these potential changes to the issuer's financial statements."

## **PCAOB Standard-Setting Agenda Indicates More to Come During 2014 on Changes to the Auditor's Report**

On June 30, the Public Company Accounting Oversight Board released an updated version of its [standard-setting agenda](#). That agenda indicates that the Board plans further public action before the end of this year on its two proposals to re-write the auditor's report.

With regard to the proposal (discussed in the prior item) to expand the auditor's reporting model by requiring CAM disclosure and auditor evaluation of "other information," the agenda states that the Board's staff is in the process of drafting a reproposal for public comment. While the agenda provides no substantive details, reproposal would normally indicate that there will be significant changes to the original proposal and that the Board wants to have the benefit of further public comment on its new approach. In light of the critical comments received on the original proposal (see [January 2014](#) and [May 2014](#) Updates), and the implementation challenges identified in the CAQ's field testing (see above), reproposal is not a surprise.

The other pending PCAOB proposal to change the auditor's report would require that the audit opinion include the name of the engagement partner and the names, locations, and extent of participation of accounting firms other than the signing firm that participated in the audit. This proposal, which was discussed in the [November-December 2013 Update](#), has also been controversial, in part because of the possible impact on engagement partner and participating firm liability, and in part because naming the engagement partner and participating firms would require that consents be obtained from them in order for the audit opinion to be included in a registration statement for a securities offering. Obtaining such consents could be a logistical problem in some cases. The standard-setting agenda states that the staff intends to recommend adoption of these proposals, but that the adopting release will "tak[e] into account comments received on the reproposal including comments related to liability and alternative locations for the disclosure." One alternative that has been suggested is requiring that the name of the engagement partner and the participating firms be included in a PCAOB filing, rather than in the auditor's opinion, in order to avoid the consent requirement.

Comment: Audit committees should follow the progress of both of these projects because of their potential impact on the auditor/public company relationship. Reproposal will open another opportunity to comment on the reporting model changes. Many companies and audit committee members submitted comments on the original proposal and, because of the importance of the changes, consideration should be given to commenting on the reproposal.

## PCAOB Standing Advisory Group Panel Sparks Debate Over Audit Committee Cybersecurity Role

As described in the [June 2014 Update](#), SEC Commissioner Luis Aguilar raised questions in a recent speech as to whether the audit committee should be assigned responsibility for cybersecurity. He asserted that the audit committee “may not have the expertise, support, or skills necessary to add oversight of a company’s cyber-risk management to their already full agenda.”

Similar issues arose during a panel discussion of cybersecurity issues and their implications for financial reporting and auditing at the PCAOB’s June 24-25 public meeting with its Standing Advisory Committee. Panelist Charles M. Elson, Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, observed that cybersecurity risk was likely to end up in the purview of the audit committee and predicted that auditors would eventually assume responsibility for cyber risk disclosure --

I suppose that we will probably ultimately in this area end up sending this to the audit committee in many companies. And, in the audit committee itself, it will occupy a disclosure point that I think ultimately will be -- you will have to get assurance from the auditor. There will be auditor participation in cybersecurity and auditor participation in disclosure of cybersecurity risk. So my gut is that it comes out of the audit committee itself.

And you could set up a separate committee, but that’s an awful small -- I don’t want to say small --it’s an important area, but it’s a rather narrow area to set up a separate committee. I don’t think it fits in compliance really. It’s not compliance. \* \* \* It’s really an operational threat. But the operations committee is the full board itself, and I am sure the full board is interested, but you are going to need some focus and specialization. That’s why my guess is ultimately that it ends up with the audit committee. It ends up as a reporting factor from the auditor and ultimately we are going to have to design some assurance procedures around it such that the audit committee and the full board gets comfort to the company that it is responding effectively to it.

In contrast, Standing Advisory Group member Mike Cook, a former head of Deloitte & Touche and a public company audit committee chair, argued that the full board should be responsible for cybersecurity risk and urged that audit committees and auditors not play a major role --

This notion that this is an issue for auditors and audit committees \* \*  
\* I think is misguided. And, as an audit committee chairman, if someone at a board level sent this to me and said that the audit committee has this responsibility for cybersecurity risk, I would stamp it “return to sender” and send it back.

This is a responsibility in almost every company of the full board. Every company is different. The kind of risks they might have are very different. If you are a manufacturing company, maybe it’s the safety risk that can be threatened by a cybersecurity attack. Maybe it’s intellectual property. \* \* \* There is all kinds of different things that can be the risk of a cybersecurity attack. We have always had

technology risk in the financial reporting area. \* \* \* But to engender this discussion where this becomes a responsibility of auditors and we are going to have that responsibility at the audit committee level is, in my mind, again just not the right place to be. \* \* \*

These are enterprise-wide risks that need to be dealt with by the full board, and I would suggest that we are not doing ourselves any favors – I can tell you that the accounting firms are not doing themselves any favor – by ginning up these – and I read the literature that comes from each of the major firms – “20 Questions the Audit Committee Should Ask About Cybersecurity Risk.” And about 15 of them are appropriate questions for a board to ask and have nothing to do with the audit committee. \* \* \*

Now if a company has no cybersecurity risks that they need to deal with at the board level, God bless them. \* \* \* But all companies have significant operating and enterprise-wide risks that they need to be addressing at the board level, and, to throw this over your shoulder and carry it to the audit committee and the auditing firms, is to misplace that responsibility. \* \* \*

(The foregoing quotations are based on the archived audio webcast available on the PCAOB’s website.)

Comment: As noted in the [June, 2014 Update](#), the appropriate committee structure for addressing cybersecurity depends on the expertise of the board members. While many audit committees have general responsibility for risk assessment and evaluation, there is a growing trend to assign responsibility for particular risk areas, such as cybersecurity, to a separate committee. Audit committees need to make sure that additional areas of responsibility, such as cyber risk, don’t detract from their ability to perform their primary task of overseeing the company’s financial reporting.

## **PCAOB Issues 2013 PWC Inspection Report**

On June 30, the Public Company Accounting Oversight Board released the public portion of its [Report on 2013 Inspection of PricewaterhouseCoopers LLP](#). PWC’s report is the second 2013 Big Four inspection report the PCAOB has published.

The 2013 inspection of PWC (which took place between December 2012 and November 2013) included reviews of 57 public company audits (and two additional engagements in which PWC USA played a substantial role, but was not the principal auditor). In 19 of the 59 engagements reviewed, (32 percent), the inspection team identified deficiencies that, in its view, were of such significance that the firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion. The 32 percent deficiency rate is lower than the 39 percent rate in PWC’s 2012 inspection report; for the four largest firms as a group, the 2012 deficiency percentage was 37 percent. As the Board notes, audit work is selected for inspection based on factors that “heighten the possibility that auditing deficiencies are present, rather than through a process intended to identify a representative sample.” In addition, audit deficiencies included in the public portion of a report do not necessarily indicate that the audited financial statements were

misstated or that there were undisclosed material weaknesses in the company's internal control over financial reporting.

Of the 19 PWC engagements in which the Board identified audit deficiencies, two related only to the audit of the financial statements, while five related only to the ICFR audit. In the remaining 12 engagements, the Board's inspectors found deficiencies in both the ICFR audit and the financial statement audit.

The 2013 PWC report notes that four of the 19 deficiencies "relate to auditing aspects of an issuer's financial statements that the issuer restated after the primary inspection procedures." In addition, in five of the 19 deficient audits, PWC "revised its opinion on the effectiveness of the issuer's internal control over financial reporting (ICFR) to express an adverse opinion or the issuer subsequently disclosed that there was a previously undisclosed material weakness as of the date of the Firm's opinion on ICFR."

The PWC inspection report includes a chart summarizing the auditing standards as to which deficiencies were found. The five standards most frequently cited as the basis for audit deficiencies were –

<u>PCAOB Auditing Standard</u>	<u>Number of Engagements in Which Standard Was Deficiency Basis</u>
AS No. 5, <u>An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements</u>	17
AU Section 328, <u>Auditing Fair Value Measurements and Disclosures</u>	7
AU Section 342, <u>Auditing Accounting Estimates</u>	7
AS No. 14, <u>Evaluating Audit Results</u>	6
AS No. 13, <u>The Auditor's Responses to the Risks of Material Misstatement</u>	5

In a response appended to the 2013 inspection report, PWC US Chairman and Senior Partner Bob Moritz, and US Assurance Leader Vincent Colman, said: "The top priority of the Firm and our partners continues to be consistently performing high-quality audits in order to serve the investing community and bring value to the capital markets. To deliver on this responsibility, we must listen to and respond to the evolving needs of our stakeholders while meeting the expectations of our regulators, including the PCAOB. In this regard, we recognize the value of the inspection process and have taken all of the Board's observations into account in formulating our plan to continuously improve audit quality."

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

other audits might have affected the company's audit and how changes in the firm's procedures might affect future audits. Audit committees should also have an understanding of how the firm intends to remediate quality control deficiencies described in the nonpublic portion of the report. An agenda for an audit committee discussion of the firm's PCAOB inspection report is available from the undersigned.

## SEC Chair Has Advice For Directors

In a June 23 [speech](#) at the Stanford University Directors' College, SEC Chair Mary Jo White discussed the role of directors as gatekeepers and the benefits of self-reporting of wrongdoing and cooperation in SEC investigations. She also commented on the SEC's recent enforcement actions against audit committee chairs. (Those actions are described in the [April 2014 Update](#)).

Some of the points Chair White emphasized that are particularly relevant to audit committees included --

- The SEC uses the term "gatekeeper" to refer to auditors, lawyers, and others who have professional obligations to spot and prevent potential misconduct. "A company's directors serve as its most important gatekeepers. For by law, it is ultimately the fiduciary responsibility of the board of directors to oversee the business and affairs of a company."
- "To state the obvious, you must ask the difficult questions, particularly if you see something suspicious or problematic, or, simply, when you do not understand. You should never hesitate to ask more questions, and, always, insist on answers when questions arise. It also goes without saying that you should never ignore red flags. It is your job to be knowledgeable about issues, to be vigilant in protecting against wrongdoing, and to tackle difficult issues head on."
- While the SEC does bring law enforcement cases against directors, "these cases should not strike fear in the heart of a conscientious, diligent director." In the two recent SEC actions against audit committee chairs, "these were clear lines crossed by directors not doing their jobs, and then some." She also stated, "Service as a director is not for the faint of heart, but nor should it be a role where you fear a game of 'gotcha' is being played by the SEC."
- Audit committees have "an extraordinarily important role in creating a culture of compliance through their oversight of financial reporting." In this regard, Ms. White referred to audit committee procedures for handling complaints regarding accounting, internal controls, and auditing matters, and whistleblower tips concerning accounting or auditing practices. She also noted that audit committees play a critical role in the selection and oversight of the company's auditors. "These responsibilities are critical ones and we want to support you."
- If serious wrongdoing comes to the board's attention, a decision has to be made as to whether to report the matter to the SEC and whether and to what extent to cooperate in any resulting



SEC investigation. “We are looking for companies to be forthcoming and candid partners with the SEC investigative team – and the board has a responsibility to ensure that management and the legal team are providing this kind of cooperation.”

- Companies that decide to self-report and cooperate with the SEC should do so “decisively.” “Make it clear from the outset that the board’s expectation is that any internal investigation will search for misconduct wherever and however high up it occurred; that the company will act promptly and report real-time to the Enforcement staff on any misconduct uncovered; and that the company will hold its responsible employees to account.”

Comment: As has been noted in several recent Updates, both the SEC and the PCAOB are currently highly focused on audit committees. It is likely that there will be further SEC enforcement cases fleshing out the SEC’s views of the audit committee’s role as a gatekeeper and on where the SEC draws the “clear line” to which Ms. White referred between the “conscientious, diligent director” and “directors not doing their job.”

Prior editions of the [Audit Committee and Auditor Oversight Update](#) are [available here](#).

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