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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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Acting Chief Accountant Speaks Out on Auditor Independence

Acting SEC Chief Accountant Paul Munter has issued a significant statement on auditor independence. See The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession. The statement is a forceful reminder of the Commission's view that "auditor independence rule is integral to its mandate to protect investors and is fundamental for promoting investor confidence in the quality of financial disclosures." Mr. Munter focuses particular attention on the

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independence ramifications of non-audit services and business relationships between the auditor and affiliates of the company being audited.

While aimed primarily at accounting firms, the statement also underscores the SEC's view that audit committees have a key role in auditor independence. Mr. Munter asserts that the "Commission's auditor independence requirement is foundational to the credibility of the financial statements, and, as the Commission has consistently noted, it is a shared responsibility among audit committees, management, and their independent accountants."

The June 8 statement discusses four topics.

<u>The Auditor Independence Framework Under the SEC's Rules</u>

The general standard of auditor independence is that "[t]he Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment of all issues encompassed within the accountant's engagement." In determining whether an accountant is independent, the Commission takes into consideration "all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."

The auditor independence rule also contains a non-exclusive list of specific circumstances that are inconsistent with the general standard. "However, we caution that accountants, audit firms, registrants, and their audit committees should never make the mistake of assuming that just because a particular circumstance is not expressly prohibited in, or captured by, * * * [the non-exclusive list], their independence analysis is over. Instead, accountants, audit firms, registrants, and their audit committees must always assess and approach auditor independence for purposes of considering, beginning, or continuing an audit engagement" under the general independence standard.

<u>The Office of the Chief Accountant's Approach to Auditor Independence Consultations</u>

The SEC's Office of the Chief Accountant (OCA) will assist accountants, companies, and audit committees with interpretation of the independence rules. "Critical to the effectiveness of the auditor independence consultation process is that any party seeking guidance communicate all relevant circumstances of their specific question to OCA staff." Mr. Munter also points out that prior staff positions may not necessarily determine the staff's views on matters raised in the consultation process. "We caution that developments, including risk to investors, may affect the applicability of prior OCA staff positions and note that prior OCA staff positions may not apply to your particular set of facts and circumstances—even if you think they may appear similar."

<u>Certain Recurring Issues in Recent Auditor Independence Consultations</u>

In Mr. Munter's view, recent consultations reflect "loosening attitudes" toward the Commission's general standard of auditor independence. He lists three problem areas.

- In some cases, accounting firms, companies, and audit committees treat the auditor independence rule as a "mere checklist of prohibitions" and ignore the general independence standard. He states that this approach "is not conductive to compliance."

- A second area of concern is the provision of non-audit services. "While non-audit services are often not provided directly to the company being audited, OCA staff encounter circumstances in which the extent and magnitude of the non-audit services and business relationships between the accountant and affiliates and non-affiliates of the company being audited would make it difficult

for a reasonable investor to conclude that the accountant could exercise objective and impartial judgment in its audit."

- Accounting firms are engaging in "increasingly complex business arrangements and, in some cases, attempting to facilitate these arrangements through restructurings and the use of alternative practice structures. Such arrangements have the potential to undermine auditor independence."

The Paramount Importance that Accounting Firms Foster an Ethical Culture.

Mr. Munter states that accounting firms should foster a culture of ethical behavior with respect to their professional responsibilities, including auditor independence. He believes however that a "'checklist compliance' mentality" is becoming more common and that this has led to a deterioration in the ethical culture in some firms. He urges firms to "prioritize auditor independence and a culture of ethical behavior in all professional activities, and where independence on an audit engagement is a close-to-the-line call, the firms must be willing to forego audit and review fees or potentially lucrative restructuring proposals to comply with their independence responsibilities."

Comment: Mr. Munter's statement is a strong reminder that auditor independence issues must be approached broadly, from the perspective of a reasonable investor, not technically based on the specific prohibitions in the SEC's rule. It is important for audit committees to bear this message in mind when independence issues arise. In particular, Mr. Munter's statement seems to be something of a shot across the bow at accounting firms in response to the growing economic importance of their consulting practices and the tension between the desire to grow those practices and the limitations imposed by the independence rules. Audit committees should bear the SEC staff's attitude on this issue in mind when confronted with questions regarding whether particular non-audit services offered by their audit firm would impact independence.

The statement is also a powerful reminder that audit committees share responsibility with their audit firm and management for compliance with the independence requirements and that the SEC is prepared to examine the audit committee's role when independence violations come to light. In this regard, the statement builds on a theme that Mr. Munter has previously expressed. See Acting Chief Accountant Stresses Auditor Independence and Audit Committee Oversight, November -December 2021 Update.

2022 PCAOB Inspections Preview

The PCAOB's inspection staff has released Spotlight: Staff Overview for Planned 2022 Inspections, its annual discussion of focus areas in the current inspection cycle. For audit committees, the Spotlight provides insight into the audit aspects that are likely to be addressed if the company's audit is inspected. It also highlights accounting and auditing challenges to which the committee may want to direct attention. (For last year's inspections outlook, see PCAOB Releases 2021 Inspections Outlook and Audit Committee/Auditor Dialogue Tool, March-April 2021 Update.)

Selected Areas of Inspections Focus

The staff discusses ten areas on which 2022 inspections will focus:

- Fraud and Other Risks. The inspection staff will emphasize audit procedures that address risks of material misstatement, including fraud. Some specific risk areas are IPOs or significant M&A activities, including SPAC transactions; the effects of supply chain disruption; and volatility due to fluctuations in interest rates and inflationary trends. Industries prone to supply chain disruption risks include electronic components and equipment, automobile, retail, and materials. Industries prone to COVID-19 related risks include airlines, hospitality, and entertainment. Inspectors will also review the auditor's assessment of fraud risk, including whether the company's controls sufficiently address identified risks, such as the risk of management override of controls.

The Spotlight lists five specific accounting and auditing risks:

- Unreasonable assumptions affecting revenue recognition due to the negative effects of the COVID-19 pandemic and supply chain disruptions.

- Unreasonable assumptions used in projections to account for business combinations or in testing goodwill or other intangibles for impairment.

- Earnings manipulation as a reaction to margin pressures driven by rising costs.

- Inventory existence and valuation (e.g., challenges in observing in-transit inventory and in valuation due to supply chain disruptions and rising costs).

- Financial, economic, and business uncertainties that impact the assessment of the company's ability to continue as a going concern.

- IPOs and M&A Activity. IPOs and M&A, including SPAC transactions, present reporting and audit risks due to transaction complexity and variations in company readiness to comply with public company financial reporting and internal control requirements. For SPAC and de-SPAC transactions, inspectors will focus on the auditor's work in the areas of financial instrument valuation; determination of whether a business combination should be accounted for as a reverse merger; internal controls; financial statement presentation and disclosures; and restatements.

- Audit Firms' Execution Challenges. Inspectors will review firm policies and procedures for assigning professionals with appropriate qualifications to audit engagements and whether firms are modifying their supervision and review procedures appropriately. The Board also plans to select engagements for review where the lead engagement partner is new to the engagement, including those resulting from partner turnover.

- Broker-Dealer-Specific Considerations. In inspections of securities broker-dealer audits, the staff will examine how auditors addressed the risk of misappropriation of customer assets at broker-dealers that hold customer funds.

- Independence. Independence will remain a focus area in 2022. In particular, inspectors may:

    - Analyze audit firm independence assessments, including relationships that present threats to objectivity and impartiality, and firm-identified violations of independence rules.

    - Evaluate compliance with the independence rules related to permissible non-audit services and their preapproval.

    - Review audit firm communications with audit committees concerning independence.

    - Review audit firm responses to independence-related quality control concerns identified in past inspections (e.g., high rates of exceptions in independence compliance testing).

- Use of Service Providers in the Confirmation Process. Inspectors will review procedures for maintaining control over confirmation requests and responses, particularly in cases where the auditor arranges for service providers to assist in the confirmation process by electronically sending and receiving confirmations.

- Critical Audit Matters (CAMs). Inspection procedures will include: (1) engaging in discussions about CAMs with engagement teams and certain audit committees; (2) reviewing CAMs in the auditor's report; (3) reviewing whether certain matters communicated to the audit committee were

included in the audit firm's procedures to determine CAMs; and (4) reviewing the engagement team's determination of whether a matter was a CAM.

- Audit Areas With Continued Deficiencies. Inspectors will focus on areas in which audit deficiencies commonly recur, including revenue recognition and related risk assessment; allowance for loan losses and other accounting estimates; and internal control over financial reporting, particularly controls with a review element.

- Firms' Quality Control Systems. Inspectors will assess audit firms' compliance with the PCAOB's quality control standards. Among other things, they will consider the impact of the COVID-19 pandemic and of the current economic environment in gaining an understanding of firm quality control systems.

- Technology. Inspectors will focus on three technology-related areas:

    - Auditing digital assets. Companies with material digital asset holdings and transactions will be selected for inspection, where appropriate, with an emphasis on assertions related to existence, valuation, rights and obligations, and financial statement disclosures.

    - Responding to cyber threats. Inspection procedures will evaluate the auditor's response to identified cybersecurity breaches and known security vulnerabilities.

    - Use of data and technology in the audit. Inspectors may inquire about changes in the use of technology and seek to obtain an in-depth understanding of how auditors are using technology in identifying and responding to risks of material misstatement.

Target Teams

A relatively new facet of PCAOB inspections is the use of "target teams" which review specific issues across all inspected audit firms. The topics assigned to target teams vary from year to year. In 2022, target team will address four issues --- interim financial information (e.g., quarterly reviews); audits of public companies with financial reporting risks related to climate change; IPOs and de-SPAC transactions; and audit firm use of shared service centers.

Reminders for Auditors

The Spotlight also contains a series of key reminders for auditors. These include –

- The need for professional skepticism in evaluating management's representations, estimates and forecasts, due to the uncertainty and volatility of the economic environment.

- The possibility that remote or hybrid working environments may create new or increased risks of material misstatement.

- The possibility that changes in the audit client's circumstances could impair auditor independence.

- The implications of the economic environment for acceptance and continuance of clients.

- The need to consider each audit engagement team member's knowledge, skill, and ability, when assigning work and determining the extent of supervision.

- The potential economic impact of Russia's invasion of Ukraine on multi-national companies.

Comment: The Spotlight provides audit committees with insight into why a company's engagement may – or may not – be selected for review this year and why, if selected, the inspectors may concentrate on

some aspects of the audit and ignore others. In addition, the Spotlight may be helpful to the audit committee in understanding the auditor's work plan, since areas of PCAOB inspection emphasis may become areas of auditor focus in anticipation of possible PCAOB scrutiny in subsequent inspections. The Spotlight may also aid committees in their oversight of the company's financial reporting by providing a catalog of accounting and reporting issues that are challenging in the current environment.

Fueled by SPACs, Restatements Surge

Audit Analytics (AA) has released its annual report on public company restatements, 2021 Financial Restatements: A Twenty-One-Year Review. AA found that SEC filers disclosed 1,479 restatements in 2021 – quadrupole the 364 restatements in 2020. These restatements were filed by 1,039 companies, a 194 percent increase in restatement filers. But the restatement explosion was entirely the result of restatements by SPACs (special purpose acquisition companies) and SPAC merger companies; SPAC-related restatements accounted for 77 percent of the 1,470 filings. Excluding SPACs, restatements in 2021 fell 10 percent compared to 2020, and the number of companies disclosing a restatement declined by 15 percent. (For an analysis of AA's 2020 restatement report, see Restatements Decline for the Sixth Straight Year, Notching a New Twenty-Year Low, November-December 2021 Update.)

SPAC Restatements

The dramatic increase in SPAC restatements was primarily in response to a statement issued in April 2021 by the Acting Director of the Division of Corporation Finance and the Acting Chief Accountant. See Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"). This statement urged SPACs to reconsider the accounting treatment of redeemable shares and warrants. Most SPACs recorded shares that included a redeemable feature as permanent equity. The SEC objected and requested the shares be recorded as temporary equity. In addition, the SEC staff asked SPACs and companies that had gone public as a result of a SPAC merger to consider whether warrants recorded as equity should instead be treated as liabilities, subject to fair market value adjustments. The SEC staff statement resulted in over 1,100 restatements.

Big and Little R

As explained in Restatements Hit Another New Low, and SOX Could Be the Reason, July 2017 Update, restatements fall into two categories. When a company determines that users can no longer rely on previously issued financial statements due to a material error, it is required to disclose that determination by filing SEC Form 8-K within four business days. Restated financial statements would normally be filed sometime later, after the company has had the opportunity to analyze and correct the error or errors. This type of restatement is referred to as a "reissuance" or "Big R" restatement.

In contrast, if a company determines that previously issued financial statements contain immaterial errors, and that, despite the errors, users can continue to rely on the prior financial statements, it is not required to file Form 8-K. Corrected financial statements may simply be included in a subsequent SEC periodic filing with the restatement disclosed in the footnotes to the current financial statements. These less significant restatements are called "revision" or "little r" restatements. Revision restatements typically attract less public attention and market reaction than reissuance restatements.

Out-of-period adjustments (OPAs) are a third method of correcting immaterial errors in prior financial statements. OPAs are corrections of prior period errors in the current period. OPAs are not restatements because previous financial statements are not affected.

2022 Report Highlights

In addition to the spike in restatements noted above, highlights of the 2022 AA report include:

- Big R restatements tripled, but, ex-SPACs, little r restatements continued to predominate. Sixty-two percent of restatements were reissuance restatements, the highest proportion since 2005. However, excluding SPAC restatements, only 24 percent of 2021 restatements were reissuances, a 3 percent increase from the prior year.

- The average net income impact of restatements fell. In 2021, the average restatement net income impact was roughly negative $5 million, down from negative $17.6 million in 2020. Excluding SPAC-related restatements, the average appears to be about negative $10 million, also a drop from the prior year. Overall, 26 percent of restatements had a negative effect on net income, 6 percent had a positive impact, and 68 percent had no impact.

- The average number of accounting issues per restatement rose, but without SPACs it declined. In 2021, the average number of issues disclosed per restatement was 1.85, compared to 1.52 in 2020. However, excluding SPAC-related restatements, the average fell to 1.4. AA notes that accounting issues per restatement can provide insight into the quality of the company's controls.

- Ex-SPACs, annual report restatements rose slightly. Thirty-three percent of 2021 restatements were of an annual report, while the remaining 67 percent were of a quarterly filing. However, excluding SPAC-related restatements, 61 percent of restatements were of an annual report, reflecting a modest three percent increase in annual report restatements. AA states that the "restatement of an annual report can reflect the severity of a restatement because annual reports must be audited by an independent accounting firm. An error or misstatement in an annual report is not only missed by management but also by the firm conducting the audit."

- The average number of days restated dropped for the fifth consecutive year. Days restated is also a measure of restatement severity. In 2020, the average was 447 days. While AA does not provide exact numbers, a graph included in the report indicates that, including SPAC-related restatements, days restated in 2021 fell slightly; excluding SPACs, it appears to have dropped substantially into the mid-300s.

- Reissuance restatements were filed more quickly. AA tracked the period of time that elapsed between disclosure of an error and the filing of a restatement. This measure only applies to Big R restatements, since little r restatements are not pre-announced. The average number of days to file a restatement in 2020 was 39.9. While AA does not provide exact numbers, a graph included in its report indicates that, including SPAC-related restatements, the "disclosure window" in 2021 was less than 15 days; excluding SPACs, it appears to have dropped to about 30 days.

- Larger companies and foreign issuers were less likely to restate. Restatements by non-accelerated U.S. filers increased from 53.3 percent of all restatements in 2020 to 73.1 percent in 2021. (SPACs are generally non-accelerated U.S. filers.) Large accelerated U.S. filers accounted for 10.2 percent of restatements in 2021, and accelerated U.S. filers were 4.5 percent. Foreign company restatements were 12.3 percent of the total in 2021, down from 15.4 percent in 2020.

- Thanks to SPACs, revenue recognition fell out of first place as the accounting issue most frequently involved in restatements. Overall, 80.4 percent of restatements cited "Debt and equity securities" as an accounting issued involved in the restatement. This is, of course, the issue that drove SPAC-related restatements. Revenue recognition, the perennial top issue, came in second at 2.8 percent. The next three most-frequently cited issues were Liabilities and accruals, Expenses, and Taxes. Excluding SPAC-related restatements, Revenue recognition retained its top spot; it was cited in 19.1 percent of non-SPAC restatements, followed by Debt and equity issues at 12 percent.

Comment: SPACs clearly had a major impact on 2021 restatements. However, when this one-time event is excluded, AA's report reveals that the long-term trend toward improved reliability of financial reporting – at least as measured by restatement frequency and severity – continued in 2021. As the Update has

previously observed, the substantial investment companies have made in strengthening and monitoring the effectiveness of their controls seems to have paid off. The 2006 restatement peak occurred during the period when public companies and their auditors were devoting a new level of scrutiny to internal control over financial reporting (ICFR) in the wake of the implementation of the Sarbanes-Oxley Act requirement to assess and report on ICFR effectiveness. Since 2006, restatements (ex-SPACs) have declined substantially and continue to decline.

Audit committees should however also bear in mind that some of the decline in restatements may be the result of a change in restatement "culture" – and that that culture may be in the midst of a reset. In a recent statement, SEC Acting Chief Accountant Paul Munter discusses the concept of materiality and its application to financial statement errors. His remarks signal that the SEC staff believes companies and their advisors have been taking an unduly narrow view of materiality and that many errors treated as immaterial should have triggered a reissuance restatement. See SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions, March 2022 Update. It would not be surprising to see an upsurge in restatements – particularly Big R restatements --this year in response to Mr. Munter's comments and to increased SEC scrutiny of restatement practices.

Audit committees confronted with errors in prior financial reporting and questions concerning the need to restate should make sure they fully understand the reasons for management's proposed course of action. As stated in SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions, above, audit committees should take seriously Mr. Munter's view of their responsibilities with respect to restatements and make sure that they are informed of and involved in materiality determinations regarding errors. The SEC may inquire into the audit committee's role in cases where it disagrees with a company's determination regarding the handling of a financial statement error, and committees should be prepared to show that they provided active oversight.

Protiviti Reports that SOX Compliance Costs Continue to Rise

Consulting firm Protiviti has released the 2022 edition of its annual survey of Sarbanes-Oxley Act (SOX) compliance costs, SOX Compliance Amid Rising Costs, Labor Shortages and Other Post-Pandemic Challenges. Protiviti found that the number of hours devoted to SOX compliance increased in 2021 for 53 percent of respondent companies – similar to the percent that reported an increase in the prior survey. (The 2021 annual survey is summarized in Protiviti: Companies are Spending More Time and Money on SOX Compliance, July 2021 Update.) Protiviti attributes increasing compliance costs to, among other things, "[i]nflation, a rising interest rate environment, ongoing supply chain volatility, a bruising talent shortage, and other economic and external factors."

However, in Protiviti's view, escalating compliance costs have a silver lining. "They are driving more investments in automation and technology tools that generate greater efficiencies -- and potentially cost savings as well as effectiveness and coverage benefits -- into the SOX compliance process." Protiviti reports that, in 2021, companies used technology tools for 25 percent of overall SOX compliance activities. In Protiviti's view, that leaves "significant room for improvement."

Protiviti's findings are based on the results of an online survey conducted in March and April 2022 in collaboration with AuditBoard, a cloud-based compliance management platform. Protiviti and AuditBoard polled 562 audit, compliance, and finance leaders. The survey participants, half of whom were CFOs, represented a wide range of industries, with Financial Services--Banking (27 percent), Government/Education (12 percent), and Manufacturing and Distribution (9 percent) the top three.

As set forth in the executive summary, the "Key Findings" of the 2022 survey are:

- Costs continue to climb due to a range of factors: A combination of internal and external factors creating volatility – technology-driven transformation and innovation, talent shortages, strategic pivots and more – is contributing to rising SOX compliance costs. More companies spend $2 million or more on compliance while fewer spend $500,000 or less. A surge in the number of

smaller companies spending $2 million or more in SOX compliance costs likely reflects last year's significant increase in initial public offerings, driven by SPACs.

- Hours on the rise as well: A majority of organizations increased the number of hours logged for SOX compliance during their most recent fiscal year. This growth is driven by the same factors contributing to rising compliance costs. SOX compliance teams are also spending more time responding to higher volumes of more detailed information requests from external auditors, whose scrutiny is intensifying in response to actions of and guidance from the PCAOB.

- A growing number of companies are deploying automation to support SOX work; more should follow suit: Automation platforms and applications bring greater efficiency to SOX compliance activities. The deployment of process mining, advanced analytics, robotic process automation, continuous monitoring, and other advanced technological tools, can significantly reduce the volume of manual compliance tasks.

- A widespread desire for efficiency is kindling interest in centers of excellence and alternate sourcing strategies: In addition to investing in supporting automation, compliance and internal audit leaders are evaluating and adopting internal shared services models as well as partnerships with third parties that operate external centers of excellence for controls testing.

Some additional highlights of the 2022 survey are discussed below.

Internal SOX Compliance Costs

The average annual internal cost of SOX compliance for the largest public companies (large accelerated filers) rose 9 percent to $1.451 million, up from $1.328 million, in the prior survey. Internal compliance costs also rose for accelerated filers (up one percent) and for smaller reporting companies (up 27 percent) but fell three percent for emerging growth companies. The survey also found that, for companies that are beyond their second year of SOX compliance, average annual costs averaged $1.468 million, up 18 percent from 2021.

Outsourced and Offshored Costs

More organizations are investing in offshore and outsourced resources to assist with SOX compliance. On average across all respondents, 41 percent of SOX internal costs were for outsourced resources (both onshore and offshore), an increase from 37 percent last year. Thirty-five percent of internal SOX costs went to offshore resources, compared to 26 percent last year.

Hours Devoted to SOX Compliance

Fifty-three percent of companies reported that hours devoted to SOX compliance increased in fiscal 2021. In contrast, 21 percent reported a decrease in compliance hours, while 26 percent saw no change. These percentages are generally consistent with the findings of the 2021 survey. Protiviti states that a "key contributing factor to ongoing increases in SOX compliance hours includes the growing number of inquiries from external auditors for more detailed information form management teams to substantiate their audit conclusions."

Auditor Reliance on Management Control Testing

Protiviti also identifies a trend of decreasing auditor reliance on management control testing, which it characterizes as an indicator of external auditors more frequently seeking to independently substantiate their findings based on guidance from the PCAOB. Survey respondents reported that, on average, auditors relied on 26 percent of management's testing, down from 29 percent last year.

Auditor requests may also be driving an increase in time spent by management in auditing suppliers directly. In 2022, 53 percent of respondents said that, for outsourced processes, they had to audit the supplier directly to gain sufficient comfort around the control environment. In 2021, only 39 percent reported the need to perform such supplier audits.

Technology and Automation

Protiviti's annual surveys have historically pointed to the benefits of automating controls. The 2022 survey finds progress among survey respondents in the use of technology for SOX compliance. Protiviti's emphasizes four points:

- "Our results indicate that, more than ever, organizations are embracing the use of technology to enable their SOX compliance programs. A majority [54 percent] are leveraging audit management and GRC platforms, two out of five organizations are using data analytics and visualization platforms, and one in three are using segregation of duties analysis tools and continuous monitoring.

- "Another positive development: In fiscal year 2021, a majority of organizations [53 percent] devoted 500 hours or more toward automating and modernizing various aspects of their SOX compliance program or otherwise enabling it with technology to drive improved efficiencies and effectiveness. Greater use of technology and automation are among the top opportunities organizations have to incorporate greater efficiencies into their SOX compliance activities. A commitment of resources is required to achieve significant progress in this area.

- "On average, 25% of an organization's SOX compliance program is enabled by technology. We expect this number to continue rising over time as audit management/GRC platforms further evolve, making it easier to automate control testing all while organizations continue to invest in modernizing their financial systems and enhancing data consistency and quality.

- "The most common challenges to automating controls testing are that many areas of the SOX control environment are not conducive to automation, and there is a perceived lack of time to explore automation opportunities due to other priorities."

Perceptions of the SOX Compliance Process and ICFR Reporting

In past years, Protiviti has asked respondents about their perceptions of the benefits of SOX. For example, last year 68 percent of respondents reported that, in their view, their organization's internal control over financial reporting (ICFR) structure has "significantly" or "moderately" improved since an ICFR external audit became required.

This year, Protiviti appears to have taken a different approach by focusing on the extension of SOX compliance processes to non-financial data. Forty-one percent of respondents stated that, during 2021, their organization applied ICFR-type processes to human capital reporting; an additional 34 percent indicated that they planned to do so in the future. Similarly, 42 percent of respondent indicated that their organization had disclosed ESG metrics in 2021 and applied ICFR-type processes to that information, while an additional 38 percent said that planned to do so in the future.

Protiviti also asked about the corporate functions involved in SOX compliance. Seventy-four percent of respondents said that internal audit engaged in SOX activities, down from 81 percent in 2021. Internal audit was also the organizational unit most frequently cited as supporting SOX testing. On average, internal audit was reported to have spent 58 percent of its time on SOX, up from 49 percent last year.

In terms of changes in SOX compliance programs during 2021, the three areas most frequently identified as having undergone either "extensive" or "substantial" changes were:

- Additional testing to justify using the work of others (38 percent).
- Challenging the credentials (objectivity and competency) of other performing testing (36 percent).
- Increase in scope to baseline test more IT reports (35 percent).

Comment: SOX compliance costs continue to rise for most categories of companies, and the extension of SOX processes to additional reporting areas, such as human capital and ESG, is likely to exacerbate these cost increases. This is especially likely if the SEC adopts its climate change reporting proposals. The proposed financial statements disclosures relating to climate would have a significant impact on ICFR for most companies. See SEC Unveils its Climate Disclosure Proposals, March 2022 Update. In light of the SEC's ambitious schedule for adoption and implementation of these rules (see SEC Rulemaking is in Hyperdrive: Spring 2022 Regulatory Agenda in this Update), managements and audit committees should already be considering how their controls would be affected.

Protiviti's annual surveys have also documented the increasing use of technology in SOX compliance and the opportunities that automation affords for reductions (or at least slower increases) in compliance costs. As noted last year in Protiviti: Companies are Spending More Time and Money on SOX Compliance, above, audit committees may want to explore with management whether it is taking advantage of opportunities to automate compliance and, if not, why not.

On the Update Radar: Things in Brief

EY Fined $100 Million for Ethics Exam Cheating. The SEC has charged Ernst & Young with violations of SEC and PCAOB rules requiring auditors that practice before the Commission to "maintain integrity," adhere to professional ethics standards, and monitor the effectiveness of professional development activities. The Commission's order is based on allegations that EY personnel shared answer keys to the ethics component of the CPA exam and other examinations required to maintain their CPA licenses. The Commission also charged that EY withheld information concerning this misconduct from the SEC staff during an investigation of potential cheating. Without admitting or denying the SEC's allegations, EY consented to a penalty of $100 million and to remedial measures to address the underlying ethics issues. In announcing the settlement, SEC Director of Enforcement Gurbir Grewal stated, "This action involves breaches of trust by gatekeepers within the gatekeeper entrusted to audit many of our Nation's public companies. It's simply outrageous that the very professionals responsible for catching cheating by clients cheated on ethics exams of all things."

This is the fourth case that U.S. regulators have brought alleging audit firm personnel wrongdoing in connection with training examinations. In 2019, KPMG consented to an SEC order and $50 million penalty based on (among other things) allegations that its audit professionals had shared answers and manipulated results in connection with internal training examinations. The PCAOB has brought similar cases against PwC Canada and KPMG Australia. While actions of this nature do not relate directly to the performance of audits, as part of the annual evaluation of its audit firm, the audit committee should review any SEC, PCAOB, or other disciplinary actions against its auditor and discuss with the engagement partner how the firm is addressing the violations and whether the issues raised by the regulatory authorities could have affected the company's audit.

PCAOB Strengthens the Standards for Audits Involving Multiple Auditors. The PCAOB has adopted amendments to its auditing standards to strengthen the requirements for planning and supervising audits involving accounting firms and individual accountants in addition to the accounting firm that issues the auditor's report. The Board also adopted a new auditing standard that will apply when the lead auditor divides responsibility for an audit with another accounting firm. Because companies frequently have operations in more than one country, the use of other firms in audits has increased significantly.

The amendments are intended to increase and improve the lead auditor's involvement in and evaluation of the other auditors' work. Among other things, the changes will:

- Require that the engagement partner determine whether his or her firm's participation in the audit is sufficient to fulfill the responsibilities of a lead auditor and issue the audit report.

- Require that the lead auditor, when determining the engagement's compliance with independence and ethics requirements, understand the other auditors' knowledge of those requirements and experience in applying them. The lead auditor must also obtain and review written affirmations regarding the other auditors' policies, procedures, and client relationships.

- Require that the lead auditor understand the knowledge, skill, and ability of other auditors' engagement team members and obtain a written affirmation from other auditors that their team members possess the knowledge, skill, and ability to perform assigned tasks.

- Require that the lead auditor supervise other auditors in accordance with PCAOB standards; inform other auditors about the scope of their work and risks of material misstatement; communicate about audit procedures to be performed; and obtain and review written affirmations from other auditors about their performance.

While these amendments primarily affect the relationship between the lead auditor and other auditors, the PCAOB believes they may also indirectly benefit audit committees (and investors):

> "Because of the lead auditor's enhanced involvement in the work of other auditors, the quality of communications with audit committees could also be enhanced, specifically as it relates to risks of material misstatements in the financial statements related to the component(s) of the company audited by the other auditor(s). Such enhanced discussions with the audit committee could improve the audit committee's oversight of the audit by highlighting areas where audit committees and companies should increase attention to ensure the quality of their financial statements, including related disclosures. This increased attention by audit committees and companies could result in higher quality financial reporting, which benefits investors."

Assuming approval by the SEC, the amendments will take effect for audits of financial statements for fiscal years ending on or after December 15, 2024.

SEC Rulemaking is in Hyperdrive: Spring 2022 Regulatory Agenda. On June 22, the Biden Administration released the Spring 2022 Unified Agenda of Regulatory and Deregulatory Actions – essentially a collection of the regulatory actions that the various federal administrative agencies plan to take in the near and long term. The SEC's contribution to the Agenda indicates that the Commission plans to adopt or propose over 50 rules in the coming months, many of which would have far-reaching impacts on public companies, financial institutions, or the securities markets. Items and their target action dates that may be of particular interest to audit committees include:

- Climate Change Disclosure – Final rule to be adopted in October 2022. The SEC staff is considering recommending that the Commission adopt rule amendments to enhance disclosures regarding issuers' climate-related risks and opportunities. The amendments were proposed in March 2022. See SEC Unveils its Climate Disclosure Proposals, March 2022 Update.

- Listing Standards for Recovery of Erroneously Awarded Compensation (Claw Backs) – Final rule to be adopted in October 2022. The SEC staff is considering recommending that the Commission adopt rules to direct securities exchanges to prohibit the listing of companies that have not implemented a policy mandating the recovery of incentive-based compensation following the restatement of financial statements on which the compensation was based. The claw back rule was originally proposed in 2015. The comment period was re-opened October

2021. See SEC Revives a Proposal to Require Compensation Claw Backs After Restatements, September-October 2021 Update). The SEC recently announced a third comment period on this proposal.

- Pay Versus Performance – Final rule to be adopted in October 2022. The SEC staff is considering recommending that the Commission adopt rules to require issuers to disclose information that shows the relationship between executive compensation actually paid and the financial performance of the issuer. This rule was originally proposed in 2015. The comment period was reopened in February 2022. See SEC Wants to Hear More About Pay-For-Performance Metrics, January-February 2022 Update.

- Human Capital Management Disclosure – Proposed rule to be published in October 2022. The SEC staff is considering recommending that the Commission propose rule amendments to enhance disclosures regarding human capital management. The current human capital disclosure rules were adopted in August 2020. See SASB Can Help Companies Comply with the SEC's Human Capital Disclosure Requirement, December 2020 Update.

- Cybersecurity Risk Governance – Final rule to be adopted in April 2023. The SEC staff is considering recommending that the Commission adopt rules to inform investors about cyber-security risk management, strategy, and governance, and to provide timely notification of material cybersecurity incidents. The Commission proposed such rules in March 2022. See SEC Proposes Cyber Risk Management and Attack Reporting Requirements, March 2022 Update.

- Corporate Board Diversity – Proposed rule to be published in April 2023. The SEC staff is considering recommending that the Commission propose rule amendments to enhance disclosures about the diversity of board members and nominees. The current board diversity disclosure rules were adopted in 2009.

- Disclosure of Payments by Resource Extraction Issuers – Proposed rule to be published in April 2023. The SEC staff is considering recommending that the Commission amend the existing rules that require disclosure of payments made by issuers to the U.S. government or to foreign governments for the commercial development of oil, natural gas, or minerals. The current resource extraction disclosure rules were adopted in December 2020. See If at First You Don't Succeed: SEC Adopts Revised Resource Extraction Disclosure Rule, December 2020 Update.

Inclusion of a project on the Agenda does not commit an agency to act on it, and many of the SEC's ambitious target action dates are likely to slip. SEC Commissioner Peirce issued a statement criticizing the Agenda, which she characterized as a "rush of radical rulemakings * * * despite pleas from almost every type of market participant and other interested party that the Commission slow down so that the public can catch up and provide meaningful input on our outstanding proposals."

Directors and Senior Managers See Both ESG Reporting Challenges and Benefits. Reporting solutions provider Workiva has released the results of a survey of the "challenges, potential opportunities, and the positives" of ESG reporting. ESG Reporting Global Insights 2022 is based on an online survey of 1,300 senior managers, executives, and directors at companies in 13 countries representing eleven industry sectors. Among other things, Workiva concludes that, "w]hile challenges around communicating ESG corporate value to stakeholders still exist, the findings show clear positive outcomes for businesses who prioritize this reporting."

Some of the key Workiva findings include:

- Most organizations (75 percent) report ESG, climate and sustainability, or corporate social responsibility data. A third of organizations (34 percent) align with the Sustainability Accounting

Standards Board framework, 30 percent with CDP, and 29 percent with the Task Force on Climate-Related Financial Disclosures. (As to the use of frameworks among U.S. companies, see The S&P 500 Are (Almost) All in on ESG Disclosure, August 2021 Update.)

- More than two thirds (68 percent) of organizations have specific roles assigned to oversee ESG reporting and initiatives. In 38 percent of organizations, ESG reporting is driven by sustainability/ESG and operations/facilities.

- About two-thirds of survey respondents (63 percent worldwide, 68 percent in the U.S.) feel unprepared to meet their ESG goals and government and regulatory reporting mandates. The top challenges are "Calculating greenhouse gas protocols to measure scope 1, 2 and 3 emissions," "Having carbon accounting level data," and "Communicating corporate value to address investor/stakeholder needs." (For another perspective on company readiness to report, see Companies are Preparing for Required ESG Disclosure, But Many Have a Lot Left to Do, March 2022 Update.)

- While 76 percent of decision makers believe technology is important to compiling and collaborating on ESG data, only 35 percent believe they can use technology and data "very well" to make decisions on advancing ESG strategy.

- ESG reporting has a positive business impact. Respondents reported increased customer retention and recruitment (72 percent), better insurance/credit engagement (72 percent), reduction in long-term risk (71 percent), positive media attention and brand awareness (71 percent), and cost savings (71 percent).

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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Updates issued after June 1, 2020, are available here. Updates issued between January 1, 2019, and May 31, 2020, are available here. An index to titles and topics in the Update beginning with No. 39 (July 2017) is available here.