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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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2018 PCAOB Large Firm Inspection Reports (and the PCAOB's Guide to its New Reporting Format)

On June 1, the PCAOB made publicly available the 2018 inspection reports for the U.S. affiliates of the six largest global network audit firms. The overall percentage of inspected audits performed by the six firms that the PCAOB found deficient fell slightly from 30 percent last year to 27 percent. Similar to prior years, the majority of deficient audits included one or more violations of the standard governing the audit of internal control over financial reporting (ICFR); of the 72 deficient audits described in these six inspection reports, 64 included an ICFR auditing violation.

The reports are in a new format, and the Board also released Guide to Reading the PCAOB's New Inspection Report, which provides an overview of each section of an inspection report, highlights the information presented in reports, and explains changes from the previous reporting structure. The two most

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significant changes appear to be the addition of a new Part I.B and the presentation of new information in the "Overview of the Inspection and Historical Data by Inspection Year" section.

New Part I.B. Part I of an inspection report, "Inspection Observations", now consists of two subparts – I.A and I.B. Part I.A describes engagements in which the staff found audit deficiencies "of such significance that we believe the firm, at the time it issued its audit report(s), had not obtained sufficient appropriate audit evidence to support its opinion(s) on the issuer's financial statements and/or ICFR." These types of deficiencies have traditionally been included in Part I. New Part I.B describes deficiencies that "do not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion(s) but nevertheless relate to instances of non-compliance with PCAOB standards or rules." Examples of Part I.B deficiencies include violations of PCAOB requirements on such matters as required auditor communications with the audit committee, filing of Form AP (which identifies the engagement partner and other audit firms that participated in the audit), and assembly and retention of the final work papers.

Overview of the Inspection and Historical Data by Inspection Year. This section includes a range of data concerning the engagements selected for inspection and the deficiencies identified. Some of this information was not in the prior reporting format, and, unlike prior reporting, this data is presented for both the current inspection and the two prior inspection years. The categories of information provided are:

- Audits Reviewed
- Part I.A Deficiencies in Audits Reviewed
- Audits Affected by the Deficiencies Identified in Part I.A
- Most Frequently Identified Part I.A Deficiencies
- Audit Areas Most Frequently Reviewed
- Audit Areas with Frequent Part I.A Deficiencies
- Auditing Standards Associated with Identified Part I.A Deficiencies
- Inspection Results by Issuer Industry Sector
- Inspection Results by Issuer Revenue Range

In addition to these substantive changes, the new format streamlines the report's content -- that is, the reports are shorter and provide somewhat less technical detail concerning audit deficiencies, but also include new charts and graphs "to make the information more digestible and accessible for users."

2018 Inspection Cycle Report Synopses

Below is a summary of the 2018 inspection reports for the six U.S. affiliates of the global network firms:

- BDO USA, LLP. The PCAOB reviewed 23 issuer audits, 20 of which were integrated audits of both the financial statements and ICFR. In 11 of those audits (48 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to BDO's 39 percent deficiency rate in 2017. Seven of the 14 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; three included only an ICFR audit deficiency, and one included only a financial statement audit deficiency. The PCAOB cited 42 auditing standard violations in the 11 engagements in Part I.A. In Part I.B, the PCAOB identified four instances of noncompliance with PCAOB standards or rules that did not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion.

- Deloitte & Touche LLP. The PCAOB reviewed 52 issuer audits, 51 of which were integrated audits of both the financial statements and ICFR. In six of those audits (12 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to D&T's 20 percent deficiency rate in 2017. Two of the six engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; three included only an ICFR audit deficiency, and one included only a financial statement audit deficiency. The PCAOB cited eight auditing standard violations in the six engagements in Part I.A. In Part I.B, the PCAOB identified 21 instances of noncompliance with PCAOB standards or rules that did not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion.

- Ernst & Young LLP. The PCAOB reviewed 54 issuer audits, 53 of which were integrated audits of both the financial statements and ICFR. In 14 of those audits (26 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to EY's 31 percent deficiency rate in 2017. Ten of the 14 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; three included only an ICFR audit deficiency, and one included only a financial statement audit deficiency. The PCAOB cited 64 auditing standard violations in the 14 engagements in Part I.A. In Part I.B, the PCAOB identified two instances of noncompliance with PCAOB standards or rules that did not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion.

- Grant Thornton LLP. The PCAOB reviewed 32 issuer audits, 27 of which were integrated audits of both the financial statements and ICFR. In eight of those audits (25 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to Grant's 18 percent deficiency rate in 2017. Six of the eight engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; one included only an ICFR audit deficiency, and one included only a financial statement audit deficiency. The PCAOB cited 32 auditing standard violations in the eight engagements in Part I.A. In Part I.B, the PCAOB identified one instance of noncompliance with PCAOB standards or rules that did not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion.

- KPMG LLP. The PCAOB reviewed 52 issuer audits, 51 of which were integrated audits of both the financial statements and ICFR. In 19 of those audits (37 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to KPMG's 50 percent deficiency rate in 2017. Fourteen of the 19 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; four included only an ICFR audit deficiency, and one included only a financial statement audit deficiency. The PCAOB cited 87 auditing standard violations in the 19 engagements in Part I.A. In Part I.B, the PCAOB identified 19 instances of noncompliance with PCAOB standards or rules that did not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion.

- PricewaterhouseCoopers LLP. The PCAOB reviewed 55 issuer audits, 45 of which were integrated audits of both the financial statements and ICFR. In 14 of those audits (25 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to PwC's 24 percent deficiency rate in 2017. Ten of the 14 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; one included only an ICFR audit deficiency, and three included only a financial statement audit deficiency. The PCAOB cited 51 auditing standard violations in the 14 engagements in Part I.A. In Part I.B, the PCAOB identified six instances of noncompliance with PCAOB standards or rules that did not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion.

Comparisons of Firm Performance

The table below summarizes the results of the 2018 inspections of the six firms. A similar table, which appeared in 2017 PCAOB Inspection Reports Summary, September-October 2019 Update, showing results of the 2017 inspections, follows the 2018 table.

2018 INSPECTIONS OF U.S. AFFILIATES OF GLOBAL NETWORKS (REPORTS PUBLICLY AVAILABLE IN 2020)
(All reports are dated April 28, 2020 and were released on June 1, 2020

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	23	11	48%
Deloitte & Touche	52	6	12%
Ernst & Young	54	14	26%
Grant Thornton	32	8	25%
KPMG	52	19	37%
PwC	55	14	25%
2018 Global Network Firm Totals	268	72	
2018 Global Network Firm Average	45	12	27%

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

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

The tables above focus on the percentage of inspected engagements found to have at least one audit deficiency. Another indicator of the relative performance of the six firms is the number individual audit deficiencies in each report, as measured by the number of auditing standards violations cited by the Board. That metric differs from the percentage-of-deficient engagements measure because an engagement included in Part I.A may involve more than one auditing standard violation. The following table compares the performance of the six firms based on the number of audit deficiencies (i.e., auditing standards violations) in each inspection report.

AUDITING STANDARD VIOLATIONS IN SIX FIRM 2018 INSPECTION REPORTS

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Auditing Standard Violations in Part I.A	Average # of AS Violations Per Inspected Engagement	Average # of AS Violations Per Part I.A Engagement
BDO	23	11	42	1.83	3.8
Deloitte & Touche	52	6	8	0.15	1.3
Ernst & Young	54	14	64	1.19	4.6
Grant Thornton	32	8	32	1.00	4.0
KPMG	52	19	87	1.67	4.6
PwC	55	14	51	0.93	3.6
2018 Global Net Firm Totals	268	72	284		
2018 Global Net Firm Average	45	12	47	1.06	3.9

Aggregate Inspection Data

The auditing standards most frequently cited as the basis for audit deficiencies in Part I.A of the 2018 inspection reports of the six firms are listed in the table below. The table also shows the percentage of all deficiencies in the six reports that were based on each auditing standard. The same auditing standard may have been cited more than once in an engagement described in Part I.A if the inspectors found more than one deficiency based on that standard in the audit.

AUDITING STANDARDS REFERENCED IN SIX FIRM PART I DEFICIENCY FINDINGS

PCAOB Auditing Standard	Number of Times Standard Cited as Deficiency Basis	Percentage of Total Deficiencies Citing Standard
AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements	147	51.8%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	42	14.8%
AS 2315, Audit Sampling	27	9.5%
AS 2502, Auditing Fair Value Measurements and Disclosures	20	7.0%
AS 2501, Auditing Accounting Estimates	19	6.7%
AS 2810, Evaluating Audit Results	10	3.5%
AS 1105, Audit Evidence	10	3.5%
AS 2310, The Confirmation Process	5	1.8%
AS 2305, Substantive Analytical Procedures	2	0.7%
AS 2510, Auditing Inventories	1	0.4%
AS 2101, Audit Planning	1	0.4%

In each inspection report, the PCAOB lists the most frequently identified audit deficiencies, divided between the most frequent deficiencies in financial statement (FS) audits and the most frequent deficiencies in ICFR audits. The table below aggregates these deficiencies lists for the six firms. The table also indicates what percentage of the engagements in Part I of the six reports included these deficiencies.

MOST FREQUENTLY IDENTIFIED AUDIT DEFICIENCIES IN 2018 SIX FIRM INPSECTION REPORTS

Deficiency Description	Number of Times Deficiency Was Identified	Audit Affected	Percentage of All Deficiencies
Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing.	39	ICFR	23.6%
Did not identify and/or sufficiently test controls over the accuracy and completeness of data or reports.	27	ICFR	16.4%
Did not identify and test any controls related to a significant account or relevant assertion.	27	ICFR	16.4%
Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate.	27	FS	16.4%
Did not perform substantive procedures to obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls).	25	FS	15.2%
Did not perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	15	FS	9.1%
Did not perform sufficient testing of the sample transactions selected for testing.	3	FS	1.8%
Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.	2	FS	1.2%

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

- Revenue and related accounts – 29 deficiencies
- Business combinations – 16 deficiencies
- Inventory – 14 deficiencies
- Allowance for loan losses – 7 deficiencies
- Loans and related accounts – 4
- Investment securities – 3 deficiencies

- Long-lived assets – 3 deficiencies
- Deposit liabilities – 3 deficiencies
- Insurance-related assets and liabilities, including insurance reserves – 3 deficiencies
- Income Taxes – 2 deficiencies

Part I.B Deficiencies

As noted above, the 2018 inspection reports include a new section (Part I.B) which describes auditing standard or PCAOB rule violations discovered in the inspections that did not affect the auditor's opinion. The 53 violations in the six reports related to:

- AS 1215, Audit Documentation (requiring the auditor to assemble a final set of work papers) – 18 violations
- Rule 3211, Auditor Reporting of Certain Audit Participants (requiring the auditor to file Form AP with the PCAOB identifying, among other things, other participating audit firms) – 15 violations
- AS 1301, Communications with Audit Committees (requiring the auditor to communicate certain matters to the audit committee) – 14 violations
- Rule 3524, Audit Committee Pre-approval of Certain Tax Services (requiring the auditor to document discussion with the audit committee of potential effects of permissible tax services) -- 5 violations
- Rule 3526, Communication with Audit Committees Concerning Independence (requiring the auditor to document discussion with the audit committee of potential effects of relationships that might bear on independence) – 1 violation

Comment: As measured by these PCAOB inspection findings, audit quality seems to have improved somewhat, compared to last year. For the six global network firm affiliates as a group, the overall deficient engagement rate fell from 30 percent in 2017 to 27 percent in 2018. For the Big Four, the deficiency rate declined from 31 percent to 25 percent of all inspected engagements. Deloitte's deficiency rate dropped to 12 percent – a record low for these six firms. The gap between the global network firm with the lowest deficiency percentage in 2018 reports (D&T) and the firm with the highest (BDO) was 36 percentage points.

The distinctions between the inspection results for these six firms are even more stark based on the number of auditing standards violations cited in Part I.A of each inspection report. On average, the inspectors found 1.06 auditing standards violations in each engagement they inspected. However, in the D&T inspection, only eight violations were found out of 52 engagements inspected – and average of 0.15 violations per engagement. At the other end of the spectrum, in 23 BDO engagements inspected, the staff found 42 violations – and average of 1.83 per engagement.

The 2018 inspection results suggest that the PCAOB continues to focus on ICFR auditing. The PCAOB found ICFR deficiencies in 26 percent of the integrated audits it inspected, and 89 percent of all audit engagements in Part I.A included an ICFR deficiency. By comparison, in 2017, the Board found ICFR deficiencies in 27 percent of the integrated audit engagements it inspected, and 84 percent of all deficient engagements included at least one ICFR deficiency. Moreover, over half (56.4 percent) of all deficiencies affected the ICFR audit, and three of the four most frequently identified audit deficiencies were control-related, with "Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing" at the top of the list. In response to the PCAOB's continuing emphasis on ICFR auditing, auditors are likely to remain focused on this aspect of their work.

Board inspectors also continued to find deficiencies in judgment-dependent audit areas, such as auditing of fair value measurements and disclosures and auditing of estimates. This is also generally consistent with prior years. In this regard, the most frequently identified deficiency area that was not control-related was "Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate."

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

Audit Analytics Provides Two Updates on CAM Disclosures

In An Update on CAMs, Audit Analytics (AA) reviewed the critical audit matter (CAM) disclosures in the audit reports of over 2,000 large accelerated filers. AA's findings are generally consistent with prior analyses (see CAM Reporting Begins: Goodwill and Intangible Assets Top the List; Many Companies are Considering Disclosure Changes, September-October 2019 Update). The study provides useful benchmarks against which audit committees can compare the CAMs disclosed by their auditor. In a separate analysis, AA also reported on the frequency of disclosure of the role of the audit committee in CAM reporting. While such disclosures are not common, they may increase as the CAM requirement becomes fully implemented.

Background

As described in earlier Updates (see, e.g., More PCAOB Advice for Audit Committees on CAMs, July, 2019 Update), the requirement that the auditor's report include a discussion of CAMs took effect for large accelerated filers (companies with public float of $700 million or more) for fiscal years ending on or after June 30, 2019. A CAM is defined as any matter arising from the audit of the financial statements that was (1) communicated or required to be communicated to the audit committee, (2) relates to accounts or disclosures that are material to the financial statements, and (3) involved especially challenging, subjective, or complex auditor judgment. The auditor's report must identify each CAM, describe the main considerations that led the auditor to determine that the matter was a CAM, describe how the auditor addressed the CAM in the audit, and refer to the financial statement accounts or disclosures related to the CAM.

CAM Disclosures

AA reviewed 1,820 audit opinions on the financial statements of U.S. domestic companies, 89 Canadian company audits, and 307 audit reports of companies outside of the U.S. and Canada. AA found that four financial reporting areas -- intangible assets (including goodwill), revenue, structure events (e.g., acquisitions), and income taxes – accounted for more than half of all CAMs. The "top ten" CAM topics were:

Intangible Assets	16.6%
Revenue	15.1%
Structure Event	14.6%
Income Taxes	9.4%
Other Assets	9.0%
Contingent Liabilities	6.7%
Fixed Assets	6.2%
Long-Term Liabilities	5.1%

Investments	4.7%
Current Assets	4.4%

In explaining the frequency of CAMs in the first three categories, AA notes that all three involve significant management and auditor judgment. For example, assessing whether goodwill or other intangible are impaired requires estimates of such items as future cash flow, revenue growth rates, and discount rates.

For audit firms based in the U.S., the number of CAMs identified does not vary significantly between firms. AA reports the following average number of CAMs per U.S. firm audit report:

Deloitte	1.5
EY	1.7
KPMG	1.7
PwC	1.8
All Other U.S.-based Firms	1.6

There is somewhat more variation when U.S. firms are compared to non-U.S. firms. U.S. firms reported on average 1.6 CAMs in their opinions on the financial statements of accelerated filers. Canadian firms averaged 1.8 CAMs per opinion, and other non-U.S. firms averaged 2.1 CAMs per opinion. It seems likely that most of the Canadian and other non-U.S. firms in AA's data base were affiliates of one of the Big Four global networks. The higher CAM averages for non-U.S. firms could be influenced by the fact that the reporting companies audited by non-U.S. firms would also have been based outside the U.S.

Disclosure of the Audit Committee's Role

An earlier AA blog post looks at CAM reporting from a different perspective. In Critical Audit Matters in Audit Committee Disclosures (April 22, 2020), AA examined whether company filings discussed the audit committee's role in CAM disclosure. AA found that slightly over 6 percent of S&P 1500 company proxy statements filed between July 1, 2019 and March 31, 2020, included disclosure regarding the audit committee's role with respect to CAMs. These disclosures usually, but not always, appear in the audit committee's report. Larger companies were more likely to make such a disclosure – for the S&P 500, the audit committee's role in CAMs was disclosed in 10.5 percent of proxy statements. The determination of what matters rise to the level of CAMs is solely within the province of the auditor. Therefore, when there is proxy statement disclosure of the audit committee's role, it usually states that the audit committee reviewed the CAMs and discussed them with the auditor.

Comment: As noted, the financial reporting areas most likely to generate CAMs tend to be those that are dependent on management estimates and forecasts and therefore require a significant amount of auditor judgment. Audit committees of companies that have CAMs arising in other areas – or that have substantially more than the 1.6 CAM average (i.e., 1 or 2 CAMs) – may want to understand the reasons why they differ from these norms. The PCAOB has provided guidance concerning the types of questions audit committees should raise with their auditor concerning CAMs. See More PCAOB Advice for Audit Committees on CAMs, July 2019 Update.

CAMs – especially those that differ in nature or number from other companies in the same industry – may generate investor interest and questions. Accordingly, audit committees may want to consider whether to add disclosure concerning the committee's role in, and reaction to, CAMs in the audit committee report. As AA notes in its analysis, "We expect to see more companies disclose the audit committee's role in critical audit matters in the second year of the new disclosure requirement."

Audit Analytics on Cybersecurity Breach Disclosures

In May, Audit Analytics (AA) released Trends in Cybersecurity Breach Disclosures. This report analyzes public company disclosures concerning cybersecurity breaches between 2011 and 2019. AA finds that the number of disclosed cybersecurity incidents has increased substantially during the past decade, although the nature, content, and timing of the disclosure companies make concerning such events varies. Cybersecurity oversight is sometimes assigned to the audit committee, and, even when it is not, breaches can raise both disclosure and internal control issues that are within the audit committee's purview. See, e.g., SEC Says That Cybersecurity is Part of ICFR, October-November 2018 Update.

AA found that there were 140 public company cyber breach disclosures in 2019, compared to 126 in 2018 and 28 in 2011. Except for a small dip in 2015, in each year since 2011 more breaches were reported than in the prior year. The greatest number of breaches occurred in the Services and Manufacturing industries. AA speculates that certain industries may be targeted because of "the large amount of financial information stored, such as credit card numbers."

While the SEC has issued cybersecurity disclosure guidance (see SEC Issues Staff Guidance on Cyber Disclosure, Including the Board's Oversight Role, March 2018 Update), and some states have disclosure requirements, the nature and timing of breach disclosure varies greatly. For example, only 53 percent of firms that reported a cyber breach between 2011 and 2019 disclosed the type of attack to which the company was subject. For those companies that made such a disclosure, 91 percent said that the attack was carried out by one of four methods:

- Malware (34 percent). Malicious software intentionally designed to cause damage.
- Phishing (25 percent). Fraudulent attempt to obtain sensitive information under guise of trustworthy electronic communication.
- Unauthorized access (20 percent). Unauthorized party gains access to protected systems and data.
- Misconfiguration (12 percent). Exploitation of incorrectly assembled safeguards for web applications.

In 2019, the most frequently stolen type of data was personal information, i.e., names (compromised in 48 percent of attacks) and addresses (29 percent of attacks). In prior years, names and credit card information were most often compromised. AA states that investors "are more likely to punish firms that lost financial information in a cyberattack, as these firms are more likely to receive significant fines and/or face legal action." In 2019, 22 percent of breaches involved social security numbers, and the share of attacks in which social security numbers were comprised has increased each year since 2016.

AA also looked at the time required for a company to detect a cybersecurity breach and the time after discovery before public disclosure was made. On average, 108 days elapsed between a breach and its discovery. The maximum period until discovery was 1,625 days – roughly four and half years; while the median discovery period was 30 days. As AA notes, "Data breaches that are not discovered quickly raise red flags about a company's internal controls, suggesting that controls may not have been sufficient enough to detect the issues in a timely manner." Companies in the Transportation, Communications, Electric, Gas & Sanitary Services industry took longer (161 days) to discover a breach than other industries.

Companies disclosed breaches an average of 49 days after discovery. AA cites three factors that seem to influence the average length of the delay between discovery and disclosure:

- Industry. Companies in the Manufacturing and Finance, Insurance, and Real Estate industries took longer (58 days) to disclose a breach than other industries.
- Type of attack. Phishing attacks took longer (72 days) to disclose than other types of attacks.

- Type of information compromised. Attacks in which personal information was compromised took longer to disclose (60 days) than breaches involving other types of information.

With respect to the costs of cybersecurity breaches, AA notes that the type of data stolen is a major factor. Breaches involving payment cards and social security numbers are especially costly because of the credit monitoring services that are typically provided to affected consumers. These types of breaches are also likely to result in litigation against the company. Of public company breaches costing more than $50 billion to remediate since 2011, seven involved personal financial information and three involved social security numbers. The Equifax breach, which involved payment cards, bank accounts, and social security numbers appears to have been the costliest cybersecurity incident.

Comment: Striking aspects of AA's study are the findings regarding the time between the breach of a company's systems and discovery of the breach and the time between discovery and disclosure. As AA notes, companies should ensure that their control systems are designed to alert management to cyber breaches. Audit committees may want to discuss with management its controls in this regard and consider the need for outside expertise. This may also be a good topic for the audit committee to suggest that internal audit review.

As to the timing of disclosure, these incidents often require some level of investigation prior to disclosure, including the retention of outside experts. Disclosures made before the company has at least a preliminary understanding of the scope of the breach and the extent of the information compromised can prove to be incorrect and cause additional reputational harm. At the same time, lengthy delays in public disclosure can attract the attention of the SEC and erode the confidence of investors and customers. Further, since these events are typically material and can have significant share price implications, it is important to keep the risk of insider trading in mind if disclosure is delayed. Those with knowledge of a breach should not engage in trading in the company's stock prior to disclosure nor should they inform others of the breach.

FASB Delays Revenue Recognition and Leasing Standards for Private Companies

On June 3, the Financial Accounting Standards Board issued ASU 2020-05 which postpones for one year the effective dates of the Board's new standards on revenue recognition and lease accounting for private companies and certain not-for-profit (NFP) entities. These deferrals implement decisions made at a public Board meeting on May 20 and are based on the economic and business impacts of the COVID-19 pandemic.

The effects of ASU 2020-5 are summarized below.

- Revenue Recognition. Private companies and private NFPs that have not yet applied the new revenue recognition standard may delay implementation until annual reporting periods beginning after December. 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020.

- Leasing. The effective date of the new lease accounting standard is deferred for private companies and private NFPs until fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. This is the second time that FASB has extended the lease accounting compliance dated for private entities. See FASB Delays New Accounting Standards for Smaller Public Companies and Private Entities, August 2019 Update.

  Public NFPs that have not yet issued financial statements reflecting the new lease accounting rules now have until fiscal years beginning after December 15, 2019 (including interim periods within those fiscal years) to begin implementation. FASB defines a public NFP as a not-for-profit entity that has issued, or is a conduit obligor for, securities that are traded, listed, or quoted on an exchange or on the over-the-counter market.

FASB's action has no impact on public companies, except for public NFPs, and applies only to entities that have not issued financial statements implementing the new standards as of June 3, 2020. Early adoption of both standards is permitted.

Comment: For many companies, the new revenue recognition and leasing standards require fundamental changes in accounting systems and controls. Considering the challenges many private companies face because of the pandemic, those that have not yet implemented these changes will likely welcome the delay.

Audit committees should, however, bear in mind that delaying the use of new accounting standards that have already been implemented by public companies may have hidden costs. As noted in FASB Delays New Accounting Standards for Smaller Public Companies and Private Entities, August 2019 Update, private companies that report based on different accounting standards than public companies may be at a disadvantage with respect to third-party financial analysis and may face delays in the timing of mergers, initial public offerings, and other transactions in which companies move between public and private status. Accordingly, private company audit committees may wish to encourage financial reporting management to implement new accounting standards as rapidly as possible.

More Tips for Audit Committees in the COVID-19 World

The Association of International Certified Professional Accountants (Association) has added to the growing body of literature designed to assist audit committees in fulfilling their responsibilities in the COVID-19 environment. (The Association is a joint venture of the American Institute of Certified Public Accountants and the U.K.'s Chartered Institute of Management Accountants.) In The Audit Committee Checklist for COVID-19, the Association provides questions and considerations for audit committees of public, private, government, or not-for-profit entities regarding oversight, risk management and governance processes. The Association's questions are not intended to be all-inclusive, but to suggest areas for discussion "in an open forum through the committee's interaction with senior management, independent auditors, external and internal auditors, and other key members of the financial management team."

The 24 questions are organized under five headings:

- Risk management
- Entity operations, including culture
- Impacts of new legislation
- Financial reporting and disclosures
- Technology and cybersecurity

Responses to the questions on the Association's list are designed to highlight areas under the audit committee's purview in which there could be weaknesses that management should address.

Comment: Checklists of this nature can be helpful in determining how the audit committee should direct its attention as challenges the business faces evolve because of the pandemic. Audit committees may want to review the Association's questions, along with guidance from other sources, in formulating an agenda of issues to explore with management that fits the company's specific circumstances. See also CAQ Releases Key COVID-19 Auditor and Audit Committee Considerations and PwC Has COVID-19 Guidance for Audit Committees, April-May 2020 Update and What's on the Audit Committee's Agenda in 2020? Part II: COVID-19, February-March 2020 Update.

When Can Audit Committee Members Be Liable for Not Doing Their Job?

It isn't easy to successfully sue directors – such as the members of an audit committee – for failing to exercise proper oversight of a company's affairs. The courts have set a high bar for such claims, and mere carelessness is not sufficient. In essence, a showing of bad faith is necessary.

While such cases are difficult to bring, they are not impossible. In Hughes v. Hu, the Delaware Chancery Court reviewed a complaint alleging that the members of the audit committee of a public company failed to establish a board-level system of oversight for the company's financial statements and related-party transactions. The court held that the action against the audit committee members could proceed. At this stage in the litigation, the allegations have not been proven. They are, however, an illustration of how inaction by an audit committee that is on notice of serious reporting and control deficiencies can result in potential liability.

Kandi Technologies Group, Inc., a publicly traded Delaware company based in China, sells auto parts for electric vehicles. It went public in the U.S. in 2007 through reverse merger with a listed shell company. In 2013, Kandi entered into a joint venture with another company to produce electric vehicles and sell them to a third company in which both Kandi and Kandi's CEO were substantial shareholders. The arrangement was allegedly structured to take advantage of Chinese government electric vehicle manufacturing subsidies.

According to the complaint, beginning in 2010 Kandi engaged in a variety of undisclosed related party transactions and improper accounting practices. Kandi's auditor, AWC (CPA) Limited, allegedly discovered some of these issues, including, for example, that significant amounts of company cash were held in the personal bank accounts of company executives. AWC did not sufficiently follow up on these issues, and in some cases, did not inform the audit committee.

In March 2014, Kandi publicly disclosed in its 2013 Form 10-K material weaknesses in its financial reporting and oversight system, including a lack of oversight by the audit committee and a lack of internal controls for related-party transactions. The company pledged to remediate these problems. Three years later, in March 2017, Kandi's 2016 Form 10-K disclosed that its 2014-2016 financial statements could not be relied on and needed to be restated. In connection with the restatement, the company also disclosed that it lacked sufficient expertise relating to US GAAP and SEC disclosure regulations, lacked sufficient expertise to ensure the completeness of its financial statements, and did not have effective controls in various respects, including as to accounts receivable, accounts payable, and notes payable.

Regarding the audit committee, the complaint alleges a series of failings, including:

- The committee met only once each year and for only less than an hour. These allegations led the court to observe that "there was no possible way that the Audit Committee could have fulfilled all of the responsibilities it was given."

- The committee took several important actions by written consent, retroactively making decisions that should have been addressed at prior committee meetings.

- The committee replaced AWC with BDO China, based on management's recommendation. (This occurred in 2016, shortly before the PCAOB brought disciplinary proceedings against AWC based on auditing standards violations in the 2010-2012 Kandi audits.)

- The committee was aware of, but failed to ensure that action was taken on, the material weaknesses disclosed in 2013 Form 10-K, described above.

In holding that the allegations in the complaint, if proven at trial, are a basis for liability, the court stated:

> "The complaint alleges facts that support an inference that the Company's Audit Committee met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously

> turned a blind eye to their continuation. As detailed in the [complaint], the Company suffered from pervasive problems with its internal controls, which the Company acknowledged in March 2014 and pledged to correct. Yet after making that commitment, the Audit Committee continued to meet only when prompted by the requirements of the federal securities laws. When it did meet, its meetings were short and regularly overlooked important issues."
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> * * *
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> "These chronic deficiencies support a reasonable inference that the Company's board of directors, acting through its Audit Committee, failed to provide meaningful oversight over the Company's financial statements and system of financial controls."

Comment: The Hu case is a reminder that, while courts are reluctant to second-guess directors' decisions, inaction in the face of known deficiencies can serve as a basis for liability. The facts in Hu are rather extreme but underscore the importance of ensuring that known reporting and internal control deficiencies are addressed. The decision also illustrates the skepticism with which courts are likely to view the diligence of an audit committee that meets only infrequently, particularly in the face of serious, publicly reported, problems.

Hu can also be read as a cautionary lesson for directors of companies based in emerging markets, especially China. SEC Chairman Clayton and PCAOB Chairman Duhnke have recently issued a warning to investors about the financial reporting practices of emerging market companies. See Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited. President Trump has also weighed in on the risks U.S. investors in Chinese companies face, particularly in light of the fact the Chinese government does not permit the PCAOB to inspect accounting firms in China that issue reports on the financial statements of U.S. listed companies. See Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies. Audit committee members of companies with operations in China should view these developments as a warning that their diligence in discharging their oversight responsibilities may be subjected to special scrutiny.

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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