Dan Goelzer

AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

Update No. 67
May-June 2021

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

In This Update:

SEC Removes the Chair and Plans to Clean House at the PCAOB

CAQ Issues an Alert on SPACs

The IIA Urges that Internal Audit Play a Key Role in ESG Strategy

CAQ Provides an Overview of Amendments to the Auditor Independence Rules

On the Update Radar: Things in Brief

Survey Finds that Audit Fees are Expected to Rise in 2021

The Audit Blog

SEC Removes the Chair and Plans to Clean House at the PCAOB

On June 4, the SEC announced that it had removed William Duhnke from his position as Chair of the Public Company Accounting Oversight Board. One of the other Board members, Duane Desparte, was appointed as Acting Chair. The SEC simultaneously announced that it intended to seek candidates to fill all five PCAOB board positions, signaling that Mr. Desparte and the other two sitting board members could also eventually be removed, despite the fact that their terms do not expire until 2023, 2024, and 2025, respectively. Prior to Mr. Duhnke's ouster, the five-member board had one vacancy.

Under the Sarbanes-Oxley Act, the SEC appoints the PCAOB board, whose members serve for 5-year terms. The statute provides that PCAOB members can only be removed for cause – i.e., some type of misbehavior in office. However, in 2010, the Supreme Court held that the "for cause" limitation on board member removal was unconstitutional, in effect, striking it from the statute and permitting a majority of the SEC to remove a PCAOB member at any time, for any reason. In 2017, at the beginning of the Trump Administration, the SEC, under Chair Jay Clayton, replaced the entire PCAOB board. See SEC Appoints an All-New PCAOB,

---

Dan Goelzer is a retired partner of a major global law firm. He is a member of the Sustainability Accounting Standards Board and advises a Big Four accounting firm on audit quality issues. From 2002 to 2012, he was a member of the Public Company Accounting Oversight Board and served as Acting PCAOB Chair from August 2009 through January 2011. From 1983 to 1990, he was General Counsel of the Securities and Exchange Commission.

November-December 2017 Update. SEC Chair Gary Gensler, who took office in April, has now taken the same action. The two Republican SEC Commissioners issued a dissenting statement.

In the weeks leading up to the SEC's June 4 announcement, Chair Gensler had come under considerable pressure to replace the PCAOB board. Most notably, in a May 25 letter, Senators Elizabeth Warren and Bernie Sanders asked that "the SEC use its authority to immediately remove and replace the sitting members of the Public Company Accounting Oversight Board (PCAOB)." They described the PCAOB as a "troubled agency" that the Trump Administration had weakened by "taking deliberate steps to erode the PCAOB's independence and expertise while facilitating the agency's capture by partisan and corporate interests."

In a June 8 announcement, Chair Gensler formally commenced the appointment process. He invited interested persons to apply for a seat on the PCAOB by June 29.

Comment: The impact that a new PCAOB may have on audit committees is difficult to determine until a new Board is selected and seated. However, there may be major changes in the PCAOB's philosophy and priorities. In the statement announcing Mr. Duhnke's removal, SEC Chair Gensler said that the "PCAOB has an opportunity to live up to Congress's vision in the Sarbanes-Oxley Act" and that he looked forward to setting the PCAOB "on a path to better protect investors by ensuring that public company audits are informative, accurate, and independent." It is unclear specifically what those statements mean, but replacement of the entire PCAOB board could foreshadow significant changes in oversight of the auditing profession and of public company financial reporting.

At minimum, it seems likely that the PCAOB will revive its Standing Advisory Group and Investor Advisory Group and, in general, become more open than in recent years to input from investors and other users of audited financial information. It is also likely that, consistent with Chair Gensler's priorities at the SEC, the PCAOB will actively explore the potential role of auditors in considering ESG risks as part of financial statement and internal control audits and in reviewing company ESG disclosures. There have also been suggestions over the past few years that the PCAOB should more frequently pursue enforcement actions against auditors for deficiencies uncovered in PCAOB inspections and that enforcement actions and inspection reports should identify the reporting company involved, not just the accounting firm. Changes of this nature could have important ramifications for the work of audit committees.

CAQ Issues an Alert on SPACs

The Center for Audit Quality (CAQ) has released Auditor and Audit Committee Considerations Relating to Special Purpose Acquisition Company (SPAC) Initial Public Offerings and Mergers. The May 4 Alert provides an overview of what a SPAC is and some key considerations for auditors and audit committees related to the risks and challenges a private company faces when entering the public markets through a merger with a SPAC. The Alert notes that SPACs "have been used for decades as a mechanism for private companies to access capital markets" but have recently "exploded in popularity." The merger of a SPAC and a private company can raise complex accounting, financial reporting, and governance issues that the company's audit committee needs to consider.

What is a SPAC?

The Alert defines a SPAC is a shell company formed for the purpose of raising funds to be used in connection with the acquisition of an existing operating company (the target company). The lifecycle of a SPAC has five phases:

- Formation.

- IPO. After formation, a SPAC raises capital through an initial public offering, the proceeds of which are held in trust while the SPAC identifies a target company.

- Target Search. The SPAC tries to acquire a target company in a specific industry or geographic location. Under its governing documents, the SPAC may have a limited time to identify a target. If a target is not acquired within that period, the SPAC is liquidated, and proceeds returned to shareholders.

- Shareholder Vote. Shareholder approval is typically required for consummation of the SPAC's merger with the target. Shareholders who oppose the merger may elect to redeem their shares.

- Merger or "De-SPAC" Transaction. Assuming shareholder approval, the SPAC and the target merge. This results in the target becoming a publicly traded company.

Considerations for Auditors

The CAQ highlights and discusses considerations for auditors related to SPAC merger transactions:

- Client Acceptance and Continuance. Issues auditors should consider relating to the acceptance as an audit client of a SPAC or a private company preparing to go public through a SPAC merger, include:

    - Capabilities of management (e.g., Does management have the skills to comply with the SEC's financial statement reporting requirements?).

    - Internal controls/books and records (e.g., Does the post-merger entity have a system of internal control over financial reporting that complies with public company requirements?).

    - Timing (e.g., Does the target company have a comprehensive plan in place to address the demands of becoming a public company on an accelerated timeline?).

    - Auditor independence (e.g., Has the permissibility of non-audit services and prior involvement in the preparation of the financial statements of the target company been considered?).

    - Capabilities of audit engagement team (e.g., Does the auditor have the capacity to complete the audit for the merger transaction and continue to perform audits and reviews of the surviving company?).

    - Corporate governance (e.g., Is the post-merger entity prepared to comply with exchange listing requirements, such as independent directors and an audit committee financial expert?).

- Auditor Registration with the PCAOB. Auditors of SPACs and their post-merger public target companies must be registered with the PCAOB.

- Auditor Reporting. Among other reporting issues, the auditor may be required to issue audit reports under both PCAOB public company auditing standards and AICPA private company standards.

- Disclosure Considerations. On December 22, 2020, the SEC's Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 11, which provides guidance on disclosure considerations for SPACs in connection with their initial public offerings and subsequent business combination transactions. The auditor should be familiar with this guidance and its application to the target.

- Classification of Warrant Provisions. On April 12, the SEC staff issued Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"). This statement required many SPACs to restate their financial statements to treat warrants issued as liabilities, rather than equity. The auditor should consider whether management has addressed the classification of warrants issued by the SPAC in accordance with this guidance.

- Elevated Risk of Fraud. The auditor should consider risk factors or conditions that could heighten fraud risk, such as overly optimistic forecasts or pressure to achieve earnings or stock price targets.

Considerations for Audit Committees

The CAQ also recommends that audit committees of private companies determining whether to go public via a SPAC transaction consider a range of issues, many of which are similar to the auditor considerations:

- Public Company Readiness. The company's readiness to go public includes such factors as financial reporting expertise, internal control effectiveness, investor relations capability, executive compensation plan, and tax implications.

- SPAC Sponsor Experience. Does the SPAC leadership have a track record of completing SPAC transactions? Does the SPAC leadership have expertise in the target's industry or geography?

- Corporate Governance. Do board members, including those on the audit committee, have the right diversity of skillsets, level of experience, and independence? Does the company have an internal audit function? Does the company have a whistleblower complaint process as required by SOX?

- Accounting, Reporting, and Disclosure Issues. Does the audit committee understand management's plans to de-SPAC? Has management considered whether to seek pre-clearance from the SEC with respect to complex accounting issues? Have controls been established regarding the transition?

- External Auditor Selection and Oversight. Do the external auditors have the right experience? Are they registered with the PCAOB? Do they meet SEC and PCAOB independence requirements?

Comment: The CAQ's Alert provides a primer for audit committees on SPACs. Further, on March 31, the SEC's Acting Chief Accountant issued a public statement, Financial Reporting and Auditing Considerations of Companies Merging with SPACs. While the Chief Accountant's statement is somewhat more technical than the CAQ's Alert, that document also provides useful background for those learning about this area.

As the Alert suggests, becoming a public company outside of the traditional IPO process presents a variety of challenges and hurdles that the private company's board needs to address in a compressed timeframe. New SEC Chair Gensler has identified SPACs as an area on which he wants to focus. Boards considering involvement in a SPAC merger should make sure they are fully educated on the risks involved.

The IIA Urges that Internal Audit Play a Key Role in ESG Strategy

The Institute of Internal Auditors has released a White Paper entitled Internal Audit's Role in ESG Reporting. The paper discusses risks related to ESG reporting and outlines how internal audit can support ESG objectives and add value.

The White Paper notes that ESG risks, which it describes broadly as "risks associated with how organizations operate in respect to their impact on the world around them," include "areas that are dynamic and often driven by factors that can be difficult to measure objectively, such as inclusion, ethical behavior, corporate culture, and embracing sustainability across the organization." Risks associated with ESG "include reliance on third-party data, potential reputational damage from faulty reporting, and the real possibility that an organization's explicit commitments to meet specific sustainability goals could grow into a material weakness." Accordingly, ESG reporting "should be treated with the same care as financial reporting." In that context, the IIA sees two roles that internal audit should play – assurance and advisory.

Assurance

Directors need internal audit to provide reliable assurance on the effectiveness of ESG risk management and reporting. That assurance should include four components:

- Review reporting metrics for relevancy, accuracy, timeliness, and consistency. It is critical that all public sustainability reports provide information that accurately depicts an organization's ESG efforts. Internal audit can provide assurance on whether data (quantitative and qualitative) being reported is accurate, relevant, complete, and timely. This is particularly important as regulatory oversight increases.

- Review reporting for consistency with formal financial disclosure filings. While sustainability reporting provides nonfinancial data, any information that conflicts with formal financial disclosures will raise a red flag with regulators and investors.

- Conduct materiality or risk assessments on ESG reporting. Organizations sometimes struggle with understanding and reporting what is material in the ESG context. "However, organizations must have a clear understanding on how ongoing sustainability efforts or public commitments to reaching sustainability goals can rise to the level of materiality."

- Incorporate ESG into audit plans. ESG and sustainability-related engagements currently make up about one percent of the typical internal audit plan. IIA says that this "must change as ESG risks and risk management take on greater significance for organizations."

Advisory

Internal audit can also add value in an advisory capacity. The White Paper describes three components of internal audit's advisory role:

- Build an ESG control environment. Competent internal audit functions are familiar with the building blocks of effective control environments. They can also recommend control frameworks (e.g., COSO's Internal Control – Integrated Framework) to manage/mitigate ESG risks. Internal audit also can advise on developing specific internal controls over ESG reporting.

- Recommend reporting metrics. Internal audit can provide insights into the kind of data (quantitative and qualitative) that accurately reflect relevant sustainability efforts within the organization.

- Advise on ESG governance. Internal audit can provide guidance on ESG governance and can help identify roles and responsibilities, as well as provide training on internal controls.

The IIA White Paper also discusses the growth in corporate ESG reporting and the growing regulatory focus on climate change and other ESG disclosures. The paper briefly describes the various ESG reporting standards and frameworks, including the work of the Sustainability Accounting Standards Board, the Global Reporting Initiative, the Task Force on Climate-Related Financial Disclosure, and the CDP Climate Change Questionnaire. It also provides an overview of investor pressure for expanded ESG disclosure, such as the efforts of BlackRock, the world's largest asset manager, in promoting portfolio company ESG disclosure and strategy. See BlackRock Calls for Disclosure and Board Oversight of Company Plans for the Net-Zero Economy, January-February 2021 Update.

The White Paper concludes with the observation that the ability of organizations to integrate ESG considerations into their business strategy and risk management practices depends on the design and effectiveness of internal control around accounting, reporting, and communication of information. "Applying the same systematic rigor to measuring, validating, managing, and reporting material sustainability information that is typically applied to financial reporting should lead to greater corporate and investor/stakeholder confidence, organizational value, and capital markets' effectiveness."

Comment: As the White Paper emphasizes, ESG disclosure has become ubiquitous. However, many companies lack the kinds of controls and procedures with respect to ESG that are in place to assure the accuracy of traditional financial disclosures. The Update has urged in the past that audit committees direct their attention to the control environment in which ESG disclosures are created and the controls and procedures that support their accuracy, particularly as investors rely more heavily on ESG metrics in decision-making. See, e.g., What is the Audit Committee's Role in ESG Oversight, December 2020 Update. As the IIA points out, internal audit can play an important role in promoting the accuracy of these disclosures, and it would be prudent for audit committees to consider how best to leverage the work of internal audit in ESG disclosure.

CAQ Provides an Overview of Amendments to the Auditor Independence Rules

In Amendments to SEC Independence Rules, an Alert issued on June 10, the Center for Audit Quality (CAQ) summarizes recent amendments to the SEC's auditor independence requirements. These changes to SEC Rule 2-01 of Regulation S-X were proposed in December 2019 (see SEC Proposes Changes to the Auditor Independence Rules, January 2020 Update), approved on October 16, 2020, and took effect on June 9, 2021. The Alert provides an overview of the amendments "to assist auditors and other stakeholders with understanding and applying the independence rules and the key changes included in the amendments."

The Alert consist of two sections and an appendix. Section 1 ("Auditor Independence Is Fundamental to Audit Quality – What Hasn't Changed") provides a high-level summary of the basic principles of the SEC's independence requirements. The recent amendments do not change these basic aspects of independence. Instead, according to the CAQ, the amendments "serve to focus the independence requirements on those relationships and services that are more likely to threaten an auditor's objectivity and impartiality in light of current market conditions and industry practice."

Section 2 ("Overview of the Amendments – Key Changes") discusses five changes resulting from the 2020 amendments:

- Definition of an Affiliate. The auditor and its affiliates must be independent of the audit client and its affiliates. The SEC amended the definition of "affiliate of the audit client," so that the auditor need not necessarily to be independent of sister affiliates of the audit client that are not material to the controlling entity. A similar change was made with respect to entities in an investment company complex.

- "Look-back" Period. The amendments changed the definition of "audit and professional engagement period" to shorten the "look-back" period during which a domestic IPO company's auditor must have been in compliance with the SEC's independence requirements. This change addresses the fact that the independence rules applicable to private company audits differ somewhat from the SEC's independence rules.

- Student and Consumer Loans. The SEC added certain student loans and de minimis consumer loans to the exclusions from independence-impairing lending relationships between audit personnel and the audit client.

- Business Relationship Rule. The amendments limit the scope of the "substantial stockholders" of the company under audit as to which the auditor must be independent. Independence is now required only as to beneficial owners of the company's shares that have significant influence over the company.

- Transition Framework for Mergers & Acquisitions (M&A) Activity. Independence violations sometimes result from mergers and acquisitions, such as where an audit client acquires a company for which the acquiror's auditor is performing non-audit services that are inconsistent with independence. Under the amended rules, there is a transition framework to address independence violations that arise inadvertently as a result of M&A transactions.

The Appendix to the Alert contains the full text of Rule 2-01, with changes resulting from the recent amendments highlighted in red.

Comment: The Alert notes that compliance with the independence requirements "is a shared responsibility among management, auditors, and audit committees." While audit committee members need not master the technical intricacies of the independence rules, a general understanding of their requirements is useful. The Alert is a good aid to that understanding.

On the Update Radar: Things in Brief

Survey Finds that Audit Fees are Expected to Rise in 2021. According to the results of a survey conducted by research and advisory firm Gartner, Inc., respondents expect external audit fees to increase this year. Gartner also found that organizations that automate at least 25 percent of their internal controls paid 27 percent lower audit fees on average in 2020 and that fee negotiation is an effective tactic in mitigating fee increases. Gartner's survey results are described in a June 8 press release; the full survey results are available only to Gartner clients.

Gartner surveyed 166 publicly traded and privately held audit firm clients in a variety of industries during March and April of 2021. Survey respondents ranged from organizations with revenue over $10 billion to those with revenue under $500 million. Eighty-one percent of respondents employed a "big four" audit firm.

In addition to the fee survey, Gartner analyzed a subset of 124 of the respondents to determine the impact of internal control automation on audit fees. According to the June 8 press release, that analysis found:

- The 80 companies in the analysis subset that had less than 25 percent of their controls automated paid on average $1,233,143 in audit fees. The 44 companies that had more than 25 percent of their controls automated paid $900,513 in fees – 27 percent less.

- Companies with fewer controls were the greatest beneficiaries of automation. Respondents with less than 50 controls, and more than 25 percent of those controls automated, reported 52 percent lower audit fees, compared to companies with less than 25 percent of automated controls.

The Gartner survey also looked at 2020 audit fee increases. Findings include:

- Companies in the banking and insurance sectors had the highest percentage of fee increases – 69 percent of those respondents reported increases. The technology/telecom sector had the lowest percentage of fee increases – 41 percent of respondents in that sector reported increases in 2020.

- Of the companies in all industries that reported fee increases, 22 percent reported increases of 6 percent or more, compared to 2019.

- Companies that sought to negotiate fees with their auditor were frequently rewarded. Gartner reports that, of the respondents that undertook negotiation, 45 percent said their fees decreased by more than 6 percent, while half were able to decrease their fees by 3 to 6 percent.

The Financial Executives Research Foundation's annual survey of audit fee increases has generally found that fees have increased on average by low- to mid-single digit percentages in recent years. See FERF Finds that Audit Fees Continue Their Upward March, May-June 2021 Update. Against that background, it would not be surprising if Covid-19 and general inflationary pressures lead to higher fees in 2021. Audit committees may want to consider Gartner's findings regarding the efficacy of both control automation and fee negotiation as tools to control fee increases.

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. Recent posts include --

- Climate Change is Rapidly Becoming an SEC Priority (Dan Goelzer, May 14, 2021)

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

For further information, please contact:

Daniel L. Goelzer
301.288.3788
dangoelzer@gmail.com

Email distribution of the Update is provided free of charge. If you would like to be added to the distribution, please email me at the address above. Readers are also free to recirculate the Update.

The Update seeks to provide general information of interest to audit committees, auditors, and their professional advisors, but it is not a comprehensive analysis of the matters discussed. The Update is not intended as, and should not be relied on as, legal or accounting advice.

Prior Updates issued between January 1, 2019, and May 31, 2020, are available here. Updates issued after June 1, 2020, are available here.