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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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PCAOB Announces an Ambitious Standard-Setting Agenda

On May 4, the Public Company Accounting Oversight Board released an updated standard-setting and research project agenda. The agenda provides insight into the priorities of the new Board, appointed by the SEC last Fall. See SEC Unveils its PCAOB Make-Over, November-December 2021 Update. Among other things, the Board plans to address, in the short or medium term, such challenging and controversial issues as the auditor's responsibility to detect client noncompliance with laws and regulations (NOCLAR) and financial statement fraud. The PCAOB is also considering updates to the auditing standards

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governing the use of confirmations and the auditor's assessment of whether the audit report requires a going concern qualification.

The standard-setting agenda lists six projects on which the PCAOB's staff anticipates Board action (i.e., a proposal or adoption of a standard) within the next 12 months:

- Other Auditors. In 2021, the Board published proposed amendments to its standards regarding the lead auditor's planning and supervision of audits involving other audit firms.

- Quality Control. This project involves the standards for audit firm quality controls (QC) to provide reasonable assurance that the firm's personnel comply with applicable professional standards. In 2019, the Board issued a concept release discussing possible revisions to its QC standards.

- Noncompliance with Laws and Regulations. The Board is considering changes to the standards governing an auditor's response to information obtained during an audit suggesting client non-compliance with laws and regulations. The Board's objective is "a scalable, risk-based approach that takes into account recent developments in corporate governance and internal control practices."

- Attestation Standards Update. The agenda does not describe the substance of this project. It does, however, cross-reference the Board's interim standards project (see mid-term projects below). The interim standards project includes review of "Attestation standards, including those related to general attest engagements, agreed-upon procedures, and compliance attestation."

- Going Concern. This project focuses on revisions to the standards related to the auditor's evaluation and reporting of a company's ability to continue as a going concern.

- Confirmations. In 2010, the Board published proposed changes to the standards on the confirmation process. This project would revive that long-dormant proposal with the objective of reflecting changes in technology and aligning the confirmation process more closely with the risk assessment standards.

Mid-term standard-setting projects (i.e., those on which Board action is not anticipated in the next 12 months) are:

- Substantive Analytical Procedures. This project considers changes to the PCAOB standard on substantive analytical procedures "to better align with the auditor's risk assessment and to address the increasing use of technology tools in performing these procedures." (Analytical procedures involve determining and evaluating ratios or other relationships between particular types of financial or nonfinancial information, such as the ratio between accounts receivable and sales. When the results of such procedures are used as evidence to support of audit findings, their use is substantive.)

- Fraud. This project considers revisions to the standard on the auditor's consideration of financial statement fraud to "better align an auditor's responsibilities for addressing intentional acts that result in material misstatements in financial statements with the auditor's risk assessment, including addressing matters that may arise from developments in the use of technology."

- Interim Ethics And Independence Standards. As part of its review of the interim standards (see next item below), the PCAOB staff will consider whether the ethics and independence requirements should be "enhanced and updated to better promote compliance through improved ethical behavior and independence."

- Interim Standards. When the PCAOB commenced operations in 2003, it adopted as interim standards certain then-existing audit standards of the American Institute of Certified Public

Accountants. Many of these standards have subsequently been revised. The interim standards project will evaluate whether the remaining interim standards should be amended, replaced, or eliminated. "The Board will evaluate which standards are necessary to retain, * * * which should be retained with minimal updates, and which require more significant changes."

The PCAOB's research agenda includes two projects aimed at determining whether there is a need for standard-setting or other action. The research areas are:

- Data and Technology. This project involves research to assess whether there is a need for guidance, changes to PCAOB standards, or other regulatory actions in light of the increased use of technology-based tools by auditors and preparers.

- Audit Evidence. This project will research whether there is a need for guidance or changes to the standard on audit evidence due to the use of technology-based audit tools and the increasing availability and use of information from sources external to the company.

The PCAOB notes that its standard-setting and research agendas are informed by a range of activities, including engagement with its advisory groups – the Standards and Emerging Issues Advisory Group (SEIAG) and the Investor Advisory Group (IAG). While the PCAOB's original advisory groups were disbanded several years ago, on May 9 the Board announced the appointment of new members to reconstituted groups and scheduled inaugural meetings of the IAG and SEIAG for June 8 and 15, respectively. See PCAOB Announces Members of New Advisory Groups, Sets Dates for First Meetings.

Comment: The PCAOB's standard-setting agenda is ambitious. Following a period of several years during which standard-setting was limited, the current Board clearly intends to take a more activist approach. However, one omission from the agenda is surprising. There is no mention of guidance or standard-setting arising from the auditor's potential new responsibilities under the SEC's climate change proposals. See SEC Unveils its Climate Disclosure Proposals, March 2022 Update. It seems likely that, if the Commission's proposals are adopted in their current form, the PCAOB will be pressed to issue guidance on auditing the expanded financial statement disclosures relating to climate impact and the attestation requirements related to greenhouse gas emissions.

From the limited description of some of the projects, it is difficult to assess their potential impact. For example, depending on the parameters of specific proposals, broadening the auditor's obligation to discover fraud or to uncover and report illegal company conduct, regardless of financial statement impact, could have far-reaching implications. Similarly, major changes in the ethics and independence rules – such as requiring audit firm rotation – could be controversial. (Audit firm rotation was explored, but not adopted, by a prior Board. See Mandatory Audit Firm Rotation is Dead in the U.S. (For Now), March 2014 Update). However, there is no indication in the agenda of what specifically the Board is considering in these areas.

Audit committees should follow the PCAOB's standard-setting activities and ask their auditor to keep them informed of the potential impact of new standards on the company's audit and on the committee's relationship with the auditor.

SEC Notches Another EPS Enforcement Case

On April 18, the SEC brought an administrative action against Rollins Inc. alleging that the pest control company reduced certain accounting reserves, including the "termite reserve," in order to raise quarterly earnings per share and meet analysts' earnings expectations. This is the fourth Commission case resulting from the Division of Enforcement's initiative, announced in 2018, to identify and prosecute EPS manipulations. See The SEC Turns Up the Heat on EPS and Other Accounting Abuses, September-October 2021 Update. The Rollins case, like the earlier EPS cases, signals an aggressive SEC approach to financial reporting matters.

The SEC's order finds that, in the first quarter of 2016 and the second quarter of 2017, Rollins, made unsupported reductions to accounting reserves in amounts sufficient to allow the company to round up reported EPS to the next penny. The company's then-CFO, who was also charged in the SEC action, allegedly directed the accounting adjustments without conducting an analysis of the appropriate GAAP accounting criteria and without adequately memorializing the basis for the adjustments. If these reserves not been reduced, Rollins would have missed consensus EPS estimates in the two quarters by one penny. The order also finds that Rollins made other accounting entries that were not supported by adequate documentation in additional quarters from 2016 through 2018.

Rollins' quarterly close process allegedly included explicit consideration of the impact of reserves on EPS. In quarters where the company's preliminary EPS calculation fell short of analysts' consensus estimates, the CFO and other finance personnel discussed whether any corporate-level reserves could be reduced in order to increase reported EPS. Indeed, another Rollins executive had advised the CFO that, with respect to the reserve accounts, "[s]ome quarters you need flexibility, and it is good to know a place where you might have it. It's part of the art of the close" and that Rollins "need[ed] to keep something in that cookie jar for quarters like this." The reserves that served this purpose included the termite reserve (an estimate of repairs, settlements, and other costs relative to termite control services), the casualty and medical reserve (amounts accrued to pay for workers compensation and employee medical claims), the customer bad debt reserve, and the outside services reserve (accrued amounts payable to third-party service providers).

In connection with the improper reserve reductions, the Commission also alleged that Rollins failed to maintain accurate books and records and sufficient internal accounting controls:

> "Although Rollins had policies and procedures requiring accounting entries to have adequate supporting documentation, its finance staff recorded manual journal entries with no or inadequate supporting documentation. Rollins also lacked procedures to ensure that the accounting personnel received necessary information to properly record and document quarter-end reserve adjustments. Finally, Rollins did not maintain a sufficient complement of personnel with the requisite level of accounting knowledge, experience, and training.
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> "As a result, Rollins' internal accounting controls were not designed or maintained to provide reasonable assurance that Rollins' financial statements would be presented in conformity with GAAP, and it further failed to maintain internal control over financial reporting. Rollins's books, records, and accounts also did not accurately and fairly reflect, in reasonable detail, Rollins' transactions and disposition of assets."

Without admitting or denying the SEC's findings, Rollins and its former CFO agreed to cease and desist from future violations and to pay civil penalties of $8 million and $100,000, respectively.

Comment: Rollins could serve as a trigger for the audit committee to revisit its understanding of the controls around discretionary accounting adjustments and quarterly earnings reporting. Audit committees should be especially vigilant in circumstances where management seems particularly focused on analysts' quarterly EPS expectations and the company has a long history of meeting expectations. Quarters in which market expectations are met as a result of rounding up EPS to the next penny should draw special scrutiny. See Does Your Company Suffer From Quadrophobia? The SEC is Investigating the Fear of Four, June-July 2018 Update. It would be prudent to ask what controls in place to prevent or detect small adjustments intended to bring quarterly results in line with analyst estimates. The audit committee might also want to be sure that there are controls that require, and confirm the existence of, documentation to support discretionary accounting adjustments.

Cornerstone: Accounting Class Actions Fell Sharply Last Year

Cornerstone Research has issued its annual report on accounting class action litigation, Accounting Class Action Filings and Settlements—2021 Review and Analysis. Cornerstone finds that, reversing the

trend of recent years, class action litigation filings against public companies for alleged accounting violations declined precipitously last year to the lowest level in 10 years. The total dollar value of accounting case settlements also fell to the lowest level in the last decade. (For a summary of Cornerstone's report on 2020 accounting class actions, see Accounting Class Actions Increase and Settlements are More Expensive, March-April 2021 Update.) Cornerstone has also recently reported that, in 2021, SEC enforcement cases involving accounting and auditing decreased and that monetary settlements in such cases fell sharply. See Accounting and Auditing Enforcement was Down in 2021, But May Now be on the Upswing, March 2022 Update.

Cornerstone found that, in 2021, 46 class actions were filed against public companies alleging accounting violations, a 34 percent decrease from the 70 filings in 2020, and the lowest number of new accounting cases since 45 cases were brought in 2012. Only 24 percent of 2021 federal securities law class actions included accounting allegations. Approximately 20 percent of accounting cases filed in 2021 involved special purpose acquisition companies. There were 33 accounting case settlements in 2021, compared to an average of 43 during 2012-2020.

Other interesting points regarding the nature, number, and magnitude of 2021 accounting class actions in Cornerstone's report include:

- Approximately 37 percent of accounting case filings in 2021 referenced reports published by short sellers. Forty-one percent involved allegations of improper revenue recognition, compared to 37 percent and 19 percent in 2020 and 2019, respectively.

- In the 46 accounting cases filed in 2021, average market capitalization losses, as measured by the change in the defendant company's market capitalization during the class period, was $29.4 billion – down from $70.9 billion in 2020, and about two-thirds of the 2012-2020 average. Only one 2021 case alleged market capitalization losses greater than $5 billion, compared to four "mega" cases in 2020.

- Thirty-three accounting class actions were settled in 2021, compared to 38 settlements in 2020. The size of the companies settling accounting class actions continued to increase. The median pre-disclosure market capitalization of settling companies in 2021 was slightly over $1 billion, 35 percent higher than the average annual 2012-2020 median.

- The total value of accounting case settlements in 2021 -- $755 million – was only about a fifth of the $3.7 billion in 2020. The steep decrease in settlement value in part reflects a decline the number of large settlements; there was only one settlement involving $100 million or more in 2021, compared to six in 2020. Cornerstone also notes that the decline in accounting case settlement amounts was part of a decline for all types of securities law class action settlements.

In 2021, restatements and internal control weaknesses became less popular grounds for accounting class action litigation. Only five accounting cases involving financial statement restatements were filed in 2021, a decrease of 55 from the eleven cases in 2020, and 72 percent lower than the 2012-2020 average of 18. Four of the five restatement cases brought in 2021 included an allegation of internal control weaknesses, roughly consistent with prior years. Overall, however, the number of accounting case filings containing allegations of internal control weaknesses fell to its lowest level in the last ten years; only 18 cases were filed alleging internal control violations, compared to 41 such cases in 2020. In eight of the 2021 control cases, the company had publicly disclosed an ICFR weakness (down from 16 such cases in 2020).

As to the industries that attract accounting class actions:

- The greatest number of 2021 cases were filed against companies in the Technology sector (twelve cases), Consumer Non-Cyclical sector (eight cases), and the Financial Sector (seven cases). Consumer Non-Cyclical (which includes biotechnology, healthcare, and pharmaceuticals) was the most-sued sector in 2020.

- The number of new accounting cases against companies in the Energy sector increased by 50 percent in 2021, from four cases in 2020 to six in 2021. On the other hand, new Financial sector cases decreased by more than 50 percent, compared to 2020 (from 15 cases to seven).

- Companies in the Consumer Non-Cyclical sector settled the most accounting cases in 2021 – eleven cases out of a total of 33 settlements. By dollar amount, the Technology sector had the highest median settlement amount ($13.6 million median value of four settlements), followed by the Industrial sector ($9.4 million median value of two settlements).

Comment: The decline in accounting class actions is somewhat surprising. Two factors may help to explain it. First, as noted above, Cornerstone has also found that SEC enforcement cases involving accounting and auditing matters decreased in 2021. See Accounting and Auditing Enforcement was Down in 2021, But May Now be on the Upswing, above. Although far from universal, some securities class action suits mirror SEC enforcement cases. Therefore, to the extent that SEC enforcement is less active, the plaintiff's class action bar may be less active as well.

Second, restatements have traditionally been fertile ground for accounting class action litigation. The number of public company restatements has declined for the past six years and fell to the lowest number since at least 2001 in 2020. The drop in restatements is, in turn, at least partly a result of company decisions (motivated perhaps by compensation claw back policies) to correct financial statement errors via lower profile revisions, rather than formal restatements. See Restatements Decline for the Sixth Straight Year, Notching a New Twenty-Year Low, November-December 2021 Update. It is also possible of course that fewer restatements are the result of improvements in financial reporting and fewer errors requiring correction.

Both of these factors may be in the process of reversing. As noted in Accounting and Auditing Enforcement was Down in 2021, But May Now be on the Upswing, above, the SEC's Director of Enforcement has asserted that accounting cases will increase, and there is some evidence that this is already occurring. Further, the SEC's Acting Chief Accountant recently warned that companies are treating too many errors as immaterial when they should be filing restatements and reissuing the affected financial statements. See SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions, March 2022 Update. This warning may increase the frequency of restatements.

Whatever the causes of the 2021 decline in accounting class actions, litigation based on financial reporting errors has not disappeared and remains a real possibility for many public companies. As stated in several prior Updates, accounting issues are a significant line of attack for the plaintiff's bar, and restatements and disclosure of internal control weaknesses are likely to attract litigation, if they coincide with a significant drop in stock price. The best protection against accounting class action litigation is diligence and care in overseeing the company's financial reporting.

Compared to Canada and Europe, in the U.S. the Cost of an Audit is High and Going Up

On April 25, the International Federation of Accountants (IFAC) published Audit Fees Survey 2022: Understanding Audit and Non-Audit Service Fees, 2013-2020. The study provides data on the audit and non-audit fees paid by U.S., Canadian, and European exchange-listed companies of all sizes in nine industries. IFAC finds that, as a percentage of company revenue, audit fees in the U.S. are substantially higher, and rising more rapidly, than in Canada or Europe. However, across the markets IFAC studied, fees paid for non-audit services are stable or declining.

Audit Fees

Audit fees, as a percent of revenue, were almost three times higher in the U.S. than in Europe. U.S. fees were 33 percent higher than in Canada.

- For U.S. companies in the Russell 3000 index with average revenues over $10 million, the average audit fee as a percentage of revenue rose from 0.39 percent in 2018 and 2019 to 0.44 percent in 2020. In 2013, the first year studied, the average audit fee was 0.35 percent of revenue.

- In contrast, for Canadian companies on the Toronto Stock Exchange with revenue over $10 million in Canadian dollars, average audit fees rose from 0.30 percent in 2017, 2018 and 2019 to 0.33 percent of revenue in 2020.

- For European companies listed on the major European exchanges with revenue in excess of €10 million, average audit fees in 2020 were 0.15 percent of revenue, up from 0.11 percent in 2013 and 0.13 percent in 2015-2019.

During the period 2013-2020, IFAC found significant differences in audit fees for companies based on location of headquarters, industry, and company size:

- On a state-by-state basis, California was the most expensive jurisdiction for a Russell 3000 company audit (on average, audit fees were 0.68 percent of revenue). North Dakota was the cheapest (0.10 percent of revenue).

- U.S. Manufacturing sector companies paid the highest fees in the western world as a percentage of revenue – slightly in excess of 0.50 percent. Among U.S. companies, firms in the Retail Trade, Wholesale Trade, and Construction sectors paid the lowest fees; approximately 0.10 percent of revenue. Worldwide, European retailers had the lowest percentage-of-revenue fees.

- Smaller companies paid higher fees (as a percentage of revenue) than large- and mid-cap companies. This was true in the U.S., Canada, and Europe. In the U.S., micro-cap companies (companies with market capitalizations of less than $300 million) paid about 0.70 percent of revenue in audit fees. At the other end of the spectrum, mega-cap companies (companies in the top five percent by market capitalization) paid roughly 0.06 percent of revenue for their audit.

Non-Audit Fees

IFAC also studied fees paid to the financial statement auditor for tax-related and other non-audit professional services. In contrast to audit fees, the study found a flat or declining trend in total non-audit service fees across all markets. (Total non-audit service fees include audit related services, tax related services, and other non-audit services.)

- For U.S. companies in the Russell 3000 index with revenues over $10 million, average total non-audit service fees as a percentage of revenue rose slightly from 0.057 percent in 2019 to 0.062 percent in 2020. The average between 2013 and 2020 was 0.061 percent. In 2013, the first year studied, the average total non-audit service fee was 0.069 percent of revenue.

- For Canadian companies on the Toronto Stock Exchange with revenue over $10 million Canadian dollars, average total non-audit service fees rose from 0.100 percent in 2019 to 0.110 percent of revenue in 2020. Both years were however below the 2013-2020 average of 0.121 percent.

- For European companies listed on the major European exchanges with revenue in excess of €10 million, average total non-audit service fees in 2020 were 0.032 percent of revenue, down from 0.037 percent in 2019 and from 0.053 percent in 2013-2020.

Comment: For U.S. companies, IFAC's headline finding seems to differ somewhat from that of Audit Analytics. While IFAC reports a 2020 fee increase, AA found that, in 2020, audit fees paid by U.S. public

companies declined for the first time since 2010. See Audit Fees Declined, But Don't Get Used to It, January-February 2022 Update. The difference appears to stem from the fact that AA focuses on the dollar amount of aggregate and average audit fees for all U.S. public companies, while IFAC concentrates on audit fees as a percentage of revenue for the Russell 3000. As noted in Audit Fees Declined, But Don't Get Used to It, AA also found that, for reporting companies of all types, audit fees per million dollars of revenue increased seven percent between 2019 and 2020. AA attributes that increase to revenue declines, rather than audit fee increases.

Audit committees that want to benchmark trends in their audit and non-audit fees against industry peers may find both the AA and IFAC studies useful data points. Of course, audit fees will also be influenced by factors unique to the company, such as the sophistication of controls and systems and the presence or absence of unusual or non-recurring events and transactions. The level of non-audit fees, on the other hand, is driven primarily by discretionary decisions regarding whether to retain the auditor for permissible non-audit services.

On the Update Radar: Things in Brief

PCAOB Wants to Hear How its Estimates and Specialists Standards are Working. The Public Company Accounting Oversight Board has issued a Request for Comment on the impact of its new standards for auditing accounting estimates and using the work of specialists. This request is part of the PCAOB's interim analysis of these requirements and consideration of whether additional guidance or other steps may be appropriate. The PCAOB expects to report its findings and to provide insights into the initial impact of the requirements in the fourth quarter of 2022. PCAOB Chair Erica Y. Williams stated: "We welcome input from investors, audit committees, preparers, academics, audit firms, and others who use financial statements."

In 2018, the Board adopted amendments to its standards for auditing accounting estimates and fair value measurements. The revised standard reflected a risk-based approach to auditing accounting estimates, emphasized the application of professional skepticism (including addressing potential management bias), and provided more direction on issues unique to auditing fair values of financial instruments, including the use of pricing information from third parties. At the same time, the Board adopted amendments to its auditing standards for using the work of a specialist (i.e., a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing). The specialist amendments apply a "risk-based supervisory approach" to both auditor-employed and outside or auditor-engaged specialists. Both sets of amended requirements became effective for audits of fiscal years ending on or after December 15, 2020.

The Request for Comment includes separate sets of questions addressed to (1) investors, and (2) auditors, audit committee members, and financial statement preparers. Examples of questions in the latter category that may be particularly relevant to audit committees include:

- To what extent did the new requirements have implications for communication and dialog between auditors, audit committees, and preparers? Please describe any changes and associated implications for audit and financial reporting quality.

- Did audit fees change because of the new requirements? To what extent were any additional fees due to the new requirements versus other contemporaneous environmental factors (e.g., new accounting requirements or the COVID-19 pandemic) that may have influenced audit effort? What other costs, if any, did companies experience directly related to the new requirements?

Comments will be publicly available on the PCAOB's website and are due by June 10.

SEC is Serious About ESG Disclosure Enforcement. In 2021, the SEC announced the formation of a task force in the Division of Enforcement "to proactively identify ESG-related misconduct." See Climate Change is Rapidly Becoming an SEC Priority, March-April 2021 Update. On April 28, the Commission brought the first action against a reporting company resulting from the work of the Climate and ESG Task Force.

In SEC v. Vale S.A., the Commission alleges that Vale S.A., a large Brazilian iron ore producer, made false and misleading statements about the safety of dams it had built to hold waste from its mining operations. In January 2019, the Brumadinho dam in Brazil collapsed. The Brumadinho collapse was among the worst mining disasters in history. According to the SEC's complaint, the collapse released nearly 12 million cubic tons of mining waste, or "tailings", and killed 270 people. Following the tragedy, Vale lost more than $4 billion in market capitalization and became the subject of numerous lawsuits and investigations.

The Commission's press release announcing its enforcement action states:

> "[B]eginning in 2016, Vale manipulated multiple dam safety audits; obtained numerous fraudulent stability certificates; and regularly misled local governments, communities, and investors about the safety of the Brumadinho dam through its environmental, social, and governance (ESG) disclosures. * * * [F]or years, Vale knew that the Brumadinho dam, which was built to contain potentially toxic byproducts from mining operations, did not meet internationally-recognized standards for dam safety. However, Vale's public Sustainability Reports and other public filings fraudulently assured investors that the company adhered to the 'strictest international practices' in evaluating dam safety and that 100 percent of its dams were certified to be in stable condition."

The Vale case illustrates that the SEC is serious about focusing on ESG and is likely to be aggressive in pursuing cases where misleading ESG disclosures were material to investors. Vale has the added dimensions of involving deception of non-investor stakeholders, such as Brazilian dam safety regulators, and of massive loss of human life.

The case is a reminder that materially false statements outside of SEC filings, such as in sustain-ability reports or at ESG webinars, can have the same securities law consequences as those in filed documents. In announcing the Vale action, Gurbir S. Grewal, Director of the SEC's Division of Enforcement, said: "Many investors rely on ESG disclosures like those contained in Vale's annual Sustainability Reports and other public filings to make informed investment decisions. * * * By allegedly manipulating those disclosures, Vale compounded the social and environmental harm caused by the Brumadinho dam's tragic collapse and undermined investors' ability to evaluate the risks posed by Vale's securities." Sustainability reports should be prepared and reviewed with the same rigor as SEC filings.

SEC and PCAOB Provide Guidance on the Ukraine War's Disclosure and Auditing Impact. The staff of the SEC's Division of Corporation Finance has issued Sample Letter to Companies Regarding Disclosures Pertaining to Russia's Invasion of Ukraine and Related Supply Chain Issues. The letter illustrates the types of questions the staff may ask regarding the impact of Russia's invasion of Ukraine in reviewing a company's filings. In releasing the sample letter, the Corp. Fin. staff stated that it believes companies should "provide detailed disclosure, to the extent material or otherwise required," regarding (1) direct or indirect exposure to Russia, Belarus, or Ukraine, (2) direct or indirect reliance on goods or services sourced in Russia, Belarus, or Ukraine, (3) actual or potential disruptions in the company's supply chain, and (4) business relationships, connections to, or assets in, Russia, Belarus, or Ukraine. The staff also notes that the conflict may impact financial statements in such areas as impairment of assets, changes in inventory valuation or deferred tax asset valuation allowances, disposal a business, or changes in customer contracts or the collectability of contractual obligations.

The SEC staff's sample letter contains eleven potential disclosure questions under six headings. The "General" heading includes, among other things, a request for a description of the extent and nature of the role of the board of directors in overseeing risks related to the invasion. The other topic headings in the sample letter are Risks Related to Cybersecurity, Management's Discussion and Analysis of Financial Condition and Results of Operations, Non-GAAP Measures, Disclosure Controls and Procedures, and Internal Control Over Financial Reporting (ICFR). (For additional perspective concerning disclosure issues arising from the Ukraine war, see The War in Ukraine Raises Accounting and Disclosure Challenges, March 2022 Update.)

The PCAOB has also released Ukraine war guidance. In Spotlight: Auditing Considerations Related to the Invasion of Ukraine, the PCAOB staff highlights important considerations for auditors as they plan and conduct audits. The Spotlight addresses a range of audit-related matters, including Identifying and assessing risks (including fraud risks and cybersecurity risks); planning and performing audit procedures (including materiality, ICFR, specific audit areas, use of other auditors, and communications with audit committees); possible illegal acts; reviews of interim financial information; and acceptance and continuance of clients and engagements. With respect to audit committee communications, the Spotlight observes:

> "The rapidly changing environment may necessitate more frequent communications between auditors and audit committees. For example, management may make changes to certain accounting policies, practices, or estimates as a result of the current environment. These changes in turn may affect the planned audit strategy. In addition to the required communications to the audit committee, auditors are also reminded of their responsibilities of obtaining information relevant to the audit from the audit committee. For example, auditors should inquire of the audit committee's knowledge of risks of material misstatement, including fraud risks."

The Spotlight also discusses issues that may arise as a result of the Ukraine conflict in audits nearing completion and reminds auditors of their responsibilities with respect to (1) events that occur subsequent to the balance sheet date, (2) other information in documents containing the financial statements, and (3) auditor reporting, including critical audit matters and scope limitations.

Cybersecurity Breach Disclosure is Surging. On April 12, Audit Analytics (AA) released Trends in Cybersecurity Breaches (available here for download), AA's annual report on public company cyber breach disclosures. The analysis covers the years 2011 through 2021. AA finds that, in 2021, 169 public companies disclosed 188 cybersecurity breaches, a new yearly high and a significant increase from the 131 breach disclosures in 2020. AA's blog post discussing the report states: "This increase is expected, given the current nature of conducting business and inherent digital risk. During the COVID-19 pandemic, businesses shifted their operations to be as 'online' as possible. As businesses increase reliance on digital solutions, such as remote working and e-commerce, the virtual door to cyber-security risks opens."

Some highlights of the report include:

- Forty-one percent of 2021 cyberbreach disclosures involved unauthorized access (i.e., an unauthorized party gaining access to protected systems and disclosures). Twenty-four percent of 2021 disclosures reported ransomware (malware designed to hold systems hostage in exchange for demands being met).

- Less than half -- 43 percent – of public company cybersecurity breaches reported in 2021 were discussed in an SEC filing. Within SEC filings, the most popular disclosure location was the risk factors section of a periodic report. Eighteen percent of breaches were reported in a current report on Form 8-K or 6-K.

- The gap between the occurrence of a breach and its disclosure is increasing. In 2021, breaches were disclosed, on average, 79.8 days after they occurred. In 2020, the average was 60.6 days.

Currently, public companies must disclose breaches in their SEC filings if the breach is material, but the content and timing of these disclosures varies widely. See EY Reports on the State of Cybersecurity Risk Disclosure, September-October 2021 Update). In March, the SEC proposed rules that would standardize public company disclosures regarding cybersecurity risk management, strategy, governance, and incident reporting. See SEC Proposes Cyber Risk Management and Attack Disclosure Requirements, March 2022 Update. Among other things, the proposed rules, which would apply to all SEC reporting companies, would require disclosure of specific information about material cybersecurity incidents within four business days after a company determines that it has experienced an incident. Updated disclosure relating to previously disclosed cybersecurity incidents would be required in subsequent quarterly and annual filings.

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