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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

Update No. 62
September 2020

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:

Audit Committee Chairs Discuss the Impact of Covid-19 with the PCAOB

The PCAOB has published Conversations with Audit Committee Chairs: COVID-19 and the Audit (Conversations). As part of its 2020 audit firm inspections, the Board asked audit committee chairs for their thoughts on the effect of COVID-19 on financial reporting and auditing. In Conversations, the PCAOB summarizes two themes in these discussions – the impact of remote work and the impact on auditor communications with the audit committee.

Increased Risks Associated with Remote Work

The PCAOB reports that risks related to remote work were the most prevalent topic in its discussions with audit committee chairs. In particular, many audit committee chairs identified "cyber-related risks—such as increased phishing attempts and email security" as a top concern resulting from the move to remote work. Conversations includes examples of questions that it may be helpful for audit committees to discuss with their auditor in understanding these types of risks:

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- Will additional time be needed to get the audit work done remotely? What complexity does working remotely add to the audit?

- Will working remotely affect productivity of audit engagement team members? If so, does the audit plan need to be updated, and do fees need to be revisited?

- Has remote work affected the company's ICFR? If so:

  - Is the auditor including new controls in their assessment, or evaluating changes to existing ones?

  - Has the auditor identified any concerns with respect to segregation of duties?

- If a review of the issuer's interim financial information has been completed already, are there any lessons learned that can be applied to the year-end audit?

- Are there any technology enhancements or collaborative tools that should be considered to support longer-term remote work?

- Has the auditor assessed potential risks of material misstatement related to cybersecurity, and how does the auditor plan to respond to those risks?

Increased Communications with the Auditor

Most audit committee chairs reported more frequent communication with their auditor as a result of the pandemic. They highlighted three forms of communication as helpful:

- Discussions about trends auditors are seeing across their client base, particularly those pertaining to industry peers.

- Presentations on areas of the audit that may or will warrant increased attention due to the effects of COVID-19, as well as how the auditor plans to approach those areas.

- Audit firm resources and webinars with industry-specific content.

Audit committee chairs also noted that they expect to stay engaged with both management and auditors to understand how they are addressing emerging issues. Conversations identifies four considerations for these ongoing audit committee communications:

- Engage with the auditor and management to discuss potential challenges to a timely completion of the audit. Review and discuss the timeline for the phases of audit work.

- Determine a good cadence for communications that include both the auditor and management so that the audit committee receives the information it needs in a timely manner, while also considering the additional demands on auditors and management during the pandemic.

- Discuss any changes to the audit plan with the auditor, including changes to areas of focus and how the auditor plans to address areas of new or modified risk. Discuss if there are changes to how the auditor will identify and test internal controls.

- Discuss which disclosures may need to change as a result of COVID-19.

Comment: During the past several months, there has been a deluge of guidance and advice concerning the impact of COVID-19 on financial reporting and oversight. See, e.g., COVID-19 Disclosure and Financial Reporting Guidance: Part III, July-August 2020 Update. The PCAOB's report addresses the challenges audit

committees are facing because of the pandemic from a somewhat different angle – the experience of a group of audit committee chairs. The suggested questions and considerations in Conversations should be helpful as audit committees adjust their practices to the COVID-19 environment.

Voluntary Audit Committee Disclosures Continue to Increase – But Only Slightly

The EY Center for Board Matters (EY Center) has released its ninth annual review of Fortune 100 audit committee-related proxy disclosures. In Audit committee reporting to shareholders in 2020, the EY Center finds that, compared to last year, the number of companies providing such voluntary disclosures has changed "only slightly." However, during the past nine years, there has been a "dramatic increase" in audit committee disclosures. The EY Center began its annual reviews of Fortune 100 audit committee disclosures in 2012. See, e.g., CAQ and EY Center Audit Committee Transparency Reports: Disclosure Continues to Grow Apace. October-November 2018 Update.

This year, the EY Center analyzed the disclosures of the 72 companies on the 2020 Fortune 100 list that filed proxy statements each year since 2012. It found that:

- Nearly 80 percent of these companies disclosed that the audit committee is involved in selecting the lead audit partner. None made that disclosure in 2012.
- Nearly 90 percent of the 72 companies disclosed that the audit committee considers non-audit fees and services when assessing auditor independence, compared to 19 percent in 2012.
- About 40 percent include a statement that the audit committee is responsible for fee negotiations with the auditor, and about 38 percent provide an explanation for fee changes, up from less than 20 percent making such disclosures in 2012.
- Seventy-six percent of these companies disclosed the tenure of the current auditor. In 2012, 25 percent disclosed tenure.
- Sixty-four percent of companies disclosed factors used in the audit committee's assessment of the external auditor's qualifications and work quality. Just 15 percent did so in 2012.
- Ninety-one percent disclosed that the audit committee included two or more financial experts, compared to 70 percent in 2012. The EY Center suggests that this increase in the number of financial experts on audit committees "could be indicative of the increasing complexity of risks that audit committees are dealing with, requiring more financial expertise."
- Fifteen companies (21 percent) provided disclosures relating to the critical audit matters (CAMs) discussed in the auditor's report. These disclosures "generally noted that the audit committee reviewed and discussed with the external auditor CAMs that arose during the current period audit."

The EY Center's 2020 review focused on disclosures related to audit committee responsibilities in areas outside of financial reporting, compliance, and legal. The EY Center reports that 64 percent of companies in the study disclosed that the audit committee oversees additional risks, including cybersecurity, data privacy, enterprise risk management, and ESG/health and safety-related matters.

As the EY Center's annual reports document, voluntary disclosures regarding the work of the audit committee have become routine for many large companies. In that context, the EY Center suggests that audit committees consider the following questions in evaluating their company's disclosure:

- Does the company's proxy statement effectively communicate how the audit committee is overseeing and engaging with the external auditor? Does it address areas of investor interest, such as the independence and performance of the auditor and the audit committee's key areas of focus?

- How has the role of the audit committee evolved in recent years (e.g., oversight of enterprise risk management, cybersecurity risk) and to what extent are these changes being communicated to stakeholders?

- In light of the changing environment, what additional voluntary disclosures might be useful to shareholders related to the audit committee's time spent on certain activities, such as cybersecurity, data privacy, business continuity, corporate culture and financial statement reporting developments?

- Has the audit committee considered how changes in the auditor reporting requirements may impact audit committee disclosures?

- How do director qualifications and board composition-related disclosures highlight the diversity considerations, expertise, experiences and backgrounds of audit committee members?

Comment: As recommended in several prior Updates, audit committees should be aware of the types of voluntary disclosures concerning committee responsibilities and activities that their peers are making and compare those disclosures to their own. The kinds of disclosures that the EY Center's report identifies as common among Fortune 100 companies are generally not controversial and would rarely involve disclosing sensitive information or exposing the audit committee to increased litigation risk. Voluntary disclosure in these areas is becoming a best practice. The EY Center's suggested questions provide a framework for audit committee consideration of whether their company's disclosures should be enhanced.

How Audit Committees Can Get More Value from Internal Audit

The audit committee typically has oversight responsibility for the internal audit function and, conversely, relies on internal audit to aid the committee in fulfilling its responsibilities. In Getting the most out of internal audit: How can the audit committee help maximize the value of internal audit?, PwC's Governance Insights Center (PGI Center) outlines how audit committees can help ensure that internal audit is effective and provides maximum benefit to the committee. The PGI Center's theme is that the audit committee and the internal audit function both benefit from a mutually supportive relationship.

To foster that type of relationship, the PGI Center recommends that the audit committee focus on five issues:

- Empowering the Chief Audit Executive and the internal audit team. Communications between the chief audit executive (CAE) and the audit committee are important in building audit committee support for internal audit's priorities and findings. The report cites these leading practices:

    - Ensure that the CAE is a regular attendee at all audit committee meetings.

    - Hold a private session with the CAE as part of the regular audit committee meeting schedule.

    - Have regular one-on-one meetings between the audit committee chair and the CAE between audit committee meetings.

    - Ensure that reporting lines for internal audit, the audit committee, and senior management promote objectivity and the success of the function.

    - Support having the CAE be part of the appropriate management leadership committees.

    - Hold management accountable for implementing internal audit recommendations according to the agreed-upon timetable.

    - Periodically have the audit committee chair attend an internal audit team meeting to reinforce the importance of the team.

- Having a team with the right structure and skills. The audit committee should understand the staffing levels and skills mix of the internal audit function. To meet the need for IT sophistication, companies should consider training existing staff, new hiring profiles, and outsourcing. The audit committees should ask the following questions:

    - Are resources competent, qualified, objective, and are they able to perform the work effectively?
    - How are skills in the group assessed and gaps identified and resolved?
    - How is internal audit using technology to make the audit more efficient and to capture and share broader insights on the company's risks and activities?
    - What percentage of the group is credentialed (e.g., Certified Internal Auditor, Certified Information Systems Auditor, Certified Public Accountant)?

  In addition, audit committees should understand internal audit's budget and to be alert for situations in which "spending pressures may prevent the group from meeting its key objectives."

- Defining and monitoring internal audit's mission. The audit committee should promote agreement across the enterprise about internal audit's priorities and scope of responsibility. "[I]t is important for the audit committee to help the team define its mission, considering what it can and should be able to accomplish given staffing and budgetary concerns, and maintain its objectivity."

  The PGI Center also points out that, in many cases, internal audit's role is evolving beyond the traditional focus of controls and financial reporting to encompass more forward-looking issues. Examples of these non-traditional areas include:

    - Assessing culture.
    - Assessing non-GAAP, environmental, social and governance (ESG) matters, or other metric disclosure controls.
    - Review of specified cyber areas (e.g., benchmarking processes, cyber crisis plan).
    - Review of controls involved in system implementations.
    - Review of data governance programs and procedures against recognized frameworks and regulations.
    - Review of the company's third-party risk management processes and procedures.
    - Review of employee health and safety programs.

- Holding management accountable for responding to findings and implementing recommendations. The CAE should provide the audit committee with summaries of its reports, including the scope of the audit, the findings by risk level, and whether the findings have been resolved. Unresolved findings should be of concern to the committee. "An effective way for audit committees to support the resolution of internal audit findings is to request that members of management with significant findings or findings that have not been resolved in a reasonable period of time to personally attend audit committee meetings and explain any root causes of the findings and commit to a plan of resolution." The audit committee should also ask internal audit to report any trends or themes it sees as a result of its work.

- Assessing performance. The audit committee should periodically assess the performance of the internal audit function and of the CAE. As part of its assessment process, the committee may want to consult with the external auditors, management, and third parties that interact with internal audit. The

report includes a series of questions that the audit committee could ask in assessing both the internal audit function as a whole and the CAE.

Appendices to the PGI Center report include examples of an executive summary of an internal audit reporting package and of internal audit quarterly dashboards.

Comment: As the PGI Center report emphasizes, the relationship between the audit committee and internal audit is a two-way street. The audit committee is key to ensuring that internal audit performs effectively and is respected within the company. At the same time, internal audit can be an important tool for the audit committee in discharging its responsibilities, particularly in the area of risk oversight. As the report states, "Internal audit (IA) can be viewed by committee members as an objective insider—one that can serve as their eyes and ears. Maximizing the value proposition of the internal audit group is an effective way to help audit committees address their risk oversight responsibilities." The PGI Center's suggestions are a useful blueprint for strengthening the audit committee/internal audit relationship.

More Public Companies Are Disclosing the Board's Cybersecurity Risk Oversight Role

The EY Center for Board Matters (EY Center) has released its third annual analysis of cybersecurity-related disclosures by Fortune 100 companies. The report, What companies are sharing about cybersecurity risk and oversight in 2020, states that the most significant disclosure changes in 2020 were in the area of board oversight. Board-level oversight responsibility is usually assigned to the audit committee. While there is a trend to more disclosure concerning cybersecurity oversight, the EY Center notes the "continued scarcity of disclosures related to cyber-readiness simulations and the use of independent third-party advisors."

Similar to its approach to audit committee disclosure (see Voluntary Audit Committee Disclosures Continue to Increase – But Only Slightly, above) the EY Center reviewed the disclosures of the 76 Fortune 100 companies that filed annual Form 10-Ks with the SEC between 2018 and May 31, 2020. Highlights of its findings include:

- Board-level committee oversight. Eighty-seven percent of the companies have a one board-level committee with responsibility for cybersecurity oversight (up from 82 percent in 2019 and 74 percent in 2018). Sixty-seven percent of boards assign cybersecurity oversight to the audit committee (up from 62 percent in 2019 and 59 percent in 2018). Twenty-six percent of companies assigned cybersecurity oversight to a committee other than audit (e.g., risk or technology committees), down from 28 percent in 2019. Seven percent of boards assigned cybersecurity to both the audit committee and another committee.

- Identification of director skills and expertise. In 2020, 58 percent of these companies disclosed that they included cybersecurity as an area of expertise sought on the board or cited such expertise in at least one director biography (up from 51 percent last year and 39 percent in 2018).

- Management reporting. Sixty-one percent of the 76 Fortune 100 companies "provided insights" into management reporting to the board and/or committees overseeing cybersecurity. Thirty-three percent identified a management cybersecurity point person (e.g., the Chief Information Security Officer). Forty-seven percent include disclosure concerning the frequency of management reporting to the board or committees, although the EY Center found that "most of this language was vague."

- Risk factor disclosure. As in the past two years, all companies included cybersecurity as a risk factor, and data privacy was a risk factor for 99 percent. The report states that "a quarter (24 percent) focused on data privacy as a stand-alone risk factor, often noting increasingly complex and changing data privacy regulations that create high financial and legal exposure in addition to the reputational and operational risks involved."

- Compensation incentives. Only 5 percent of these companies disclosed that they included cyber-security in executive pay considerations, generally as a qualitative factor considered in connection with annual incentive pay.

- Response readiness simulations and tabletop exercises. As noted above, only 7 percent of the companies disclosed that they performed cyber-incident simulations (up from 3 percent in 2019). The report states: "Simulations are a critical risk-preparedness practice that EY leaders and others believe companies should prioritize. * * * Management should conduct these exercises to test the company's significant vulnerabilities and where the greatest financial impact is at stake. Boards should consider participating in at least one of these simulations annually."

- Use of external independent advisor. Twelve companies disclosed management use of an external independent cybersecurity consultant, the same number as last year. Four of these companies disclosed that the board met directly with the independent third party.

Based on dialogue with directors and cybersecurity experts, the report lists "leading board practices" with respect to cybersecurity and concludes with a series of questions for board consideration:

- Is the board allocating sufficient time on its agenda, and is the committee structure appropriate, to provide effective oversight of cybersecurity?

- Do the company's disclosures effectively communicate the rigor of its cybersecurity risk management program and related board oversight?

- What information has management provided to help the board assess which critical business assets and critical partners, including third parties and suppliers, are most vulnerable to cyber attacks?

- Have appropriate and meaningful cyber metrics been identified and provided to the board on a regular basis and given a dollar value?

- How does management evaluate and categorize identified cyber and data privacy incidents and determine which to escalate to the board?

- Has the board leveraged a third-party assessment, as described in the NACD's Cyber-Risk Oversight 2020 handbook, to validate the cybersecurity risk management program is meeting its objectives? If so, is the board having direct dialogue with the third party related to the scope of work and findings?

- Has the board participated with management in one of its cyber breach simulations in the last year?

- Has the board considered the value of obtaining a cybersecurity attestation opinion to build confidence among key stakeholders?

Comment: Audit committees should focus on both the disclosure their company is making concerning cybersecurity risk oversight and the substance of the company's cyber risk mitigation program. As to disclosure, committees should consider whether the company's disclosures effectively communicate the risk management program and the related board oversight. The EY Center recommends that the objective of this disclosure be to build "stakeholder trust around how cybersecurity is prioritized, managed and overseen." The EY Center's suggestions as to the substance of the cyber risk effort also deserve consideration, particularly those relating to the use of outside advisors, periodic cyber-incident simulations, and board participation in such exercises.

How Low Can They Go? Restatements Hit Another New Low in 2019

Audit Analytics (AA) has released its annual report on public company restatements, 2019 Financial Restatements: An Nineteen Year Comparison (available here for download). AA found that the number of

restatements in 2019 fell to 484 – the fewest since AA began tracking restatements in 2001 and 32 fewer than in 2018. See Restatements Continue to Decline, Despite an Uptick in Changes Driven by Revenue Recognition, August 2019 Update. After relatively constant restatement totals from 2009 to 2014, the number of restatement disclosures has now declined for five consecutive years. The 484 restatements in 2019 were filed by 444 companies. Overall, 6.34 percent of the SEC public company filer population (excluding funds and trusts) restated their financial statements in 2019 – the lowest percentage since AA began tracking this parameter in 2006.

As explained in Restatements Hit Another New Low, and SOX Could Be the Reason, July 2017 Update, restatements fall into two categories. When a company determines that users can no longer rely on previously issued financial statements, it is required to disclose that determination by filing SEC Form 8-K within four business days. Restated financial statements would normally be filed sometime later, after the company has had the opportunity to analyze and correct the errors. This type of restatement is referred to as a "reissuance" or "Big R" restatement. In contrast, if a company determines that previously issued financial statements contain errors, but that, despite the errors, users can continue to rely on the financial statements, it is not required to file Form 8-K. Corrected financial statements would simply be included in a subsequent periodic SEC filing. These less significant restatements are called "revision" or "Little R" restatements. Revision restatements typically attract less public attention and market reaction than reissuance restatements.

In addition to the record low restatement numbers noted above, highlights of the 2019 AA report include:

- The severity of restatements continued to decline. For example—
    - Revision, or Little R, restatements were 79.7 percent of all restatements in 2019. In 2018, Little R restatements were 74.3 percent of the total.
    - In 2019, 56.8 percent of restatements had no impact on the income statement. In 2018, 53.6 percent did not affect earnings. AA observes that the 2019 percentage "to some degree, is due to cash flow statement errors, which have no impact on the income statements."
    - The average number of days restated dropped for the third consecutive year, averaging 451 days in 2019.
    - The average number of accounting issues per restatement dropped for the second year in a row, averaging 1.51 issues per restatement in 2019.
- Restatements are being filed more quickly after disclosure of the misstatement. AA reviewed the average number of days between initial disclosure of the need to restate and the filing of the restatement. For companies traded on the three major stock exchanges, the average period between disclosure and restatement in 2019 was 6.5 days. By comparison, in 2007 this period was about 30 days. AA's explanation of this acceleration is two-fold. First, since the time needed to restate is less for less complicated errors, a "high percentage of revision restatements would cause a decrease in the average time period needed to restate." In addition, "improved internal control over financial reporting (ICFR) would allow a company to recalculate and restate financials more quickly after an error is discovered. Improved ICFR could cut response time, notwithstanding the complexity of the restatement at hand."
- Revenue recognition was the accounting issue most frequently involved in 2019 restatements. After revenue recognition, the most common restatement accounting issues were:
    - Cash flow statement.
    - Debt, quasi-debt, warrants and equity security issues.
    - Tax expense, tax benefit and tax deferral, and other tax accounting issues.
    - Liabilities, payables, reserves, and accrual estimates.

- Accounts/loans receivable, investments, and cash issues.
- Expense (payroll, SGA, other) issues.

Comment: The decline in the number and severity of restatements during the past 19 years seems to confirm that the Sarbanes-Oxley Act has strengthened the quality and reliability of public company financial reporting. Restatements peaked in 2006 at 1,842. The 2006 peak occurred during the period when public companies and their auditors were devoting a new level of scrutiny to internal control over financial reporting in the wake of the implementation of the Sarbanes-Oxley Act requirement to assess and report on ICFR effectiveness. Since 2006, restatements have declined substantially. At least as measured by restatement frequency and severity, the substantial investment companies have made in strengthening and monitoring the effectiveness of their controls seems to have paid off.

Listen to Your Auditor or Pay the Price Later

An academic paper sheds light on audit adjustments and the impact of declining to implement them. In The Costs of Waiving Audit Adjustments, Preeti Choudhary, Kenneth Merkley, and Katherine Schipper find that most audits result in the auditor proposing financial statement adjustments, but that many companies decline to record some or all of these adjustments. However, management decisions to waive an audit adjustment may be costly in the long run. Waivers are associated with a higher risk of future restatements and with increased audit costs.

Audits often uncover financial reporting mistakes. When a misstatement is detected, the auditor proposes an adjustment to correct the error. However, in the case of adjustments that are below the materiality threshold, management has discretion whether to record the adjustments or whether to ignore, or waive, them. Any material adjustment must, of course, be made, since the auditor cannot issue a clean opinion on financial statements that are materially inaccurate.

The auditor must communicate all misstatements discovered – both those that are corrected and those that are waived – to the audit committee. Under the PCAOB's auditing standards, the auditor (or management) should discuss with the audit committee the basis for the determination that any uncorrected misstatements were immaterial, The auditor should also communicate that uncorrected misstatements "could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit." The auditor is also required to discuss with the committee the implications that corrected misstatements might have on the company's financial reporting process.

Choudhary, Merkley, and Schipper had access to PCAOB inspections data and analyzed audit adjustment decisions in 3,144 audits involving 1,681 companies from audit engagements inspected by the Board between 2005 and 2014. They found that:

- Approximately 81 percent of these engagements involved at least one proposed audit adjustment. (As the authors recognize, the PCAOB does not select engagements for inspection solely on a random basis; higher risk audits are more likely to be inspected. Accordingly, this and other study finding are not necessarily representative of all public company audits.)

- In audits with proposed adjustments, management waived all adjustments in 50.5 percent of the engagements. In 11.6 percent of the audits, management recorded all proposed adjustments. In the remaining 37.9 percent of engagements, management recorded some of the auditor's proposed adjustments and waived others, which the authors refer to as "selective recording".

- Decisions on how to deal with a proposed adjustment ("dispositions"), seem in some cases to be tied to the potential impact of the adjustment on whether the company's reported earnings would meet analysts' expectations. The authors observe, "This analysis provides some confirmation of suspicions * * * that disposition decisions can be an earnings-management tool."

But waiver of audit adjustments comes at price for the company, both in terms of the reliability of its financial reporting and in terms of audit costs. As to financial reporting reliability, recording audit adjustments "improves financial statement reliability as measured by the propensity to restate financial reports, while waiving detracts from it." Companies that waive adjustments with magnitudes above the median, were 1.4 to 2.1 percent more likely subsequently restate. In addition, there were "substantial overlaps" between the subjects of proposed audit adjustments and the aspects of the financial statements that were eventually restated.

As to audit costs, the study finds that waived adjustments above the sample median are associated with an increase in current-period audit hours of between 8.6 percent to 10.7 percent and a 6 percent to 7.3 percent increase in audit fees. The study also found that waived adjustments in the current reporting period were associated with greater proposed audit adjustments and increased hours and fees in the subsequent year.

The authors conclude that "errors below quantitative materiality are consequential, even if they do not lead to a modified audit opinion" and that:

> "Viewed as a whole, the results of our analyses document costly financial reporting and auditing consequences to waiving auditor-proposed adjustments and provide evidence on an earnings-management motivation for this behavior." * * * [W]e believe we provide important new evidence on the costs of waiving misstatements that should be of interest to academics, investors, regulators, practitioners and audit committees."

Comment: Review of the schedule of unadjusted audit differences, or "passed adjustments", is a routine part of the post-audit discussion between the audit committee and the auditor. The Choudhary, Merkley, and Schipper paper underscores that this topic should not be treated as routine. Management decisions to waive adjustments, particularly those that begin to approach the frontier of materiality, may have unfortunate consequences and could be indicators of more serious problems. Audit committees should make sure they understand how earnings would be affected if all audit adjustments were accepted and consider the possibility that analyst earnings expectations might be an unarticulated factor in management's decision-making on whether to waive particular audit adjustments.

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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