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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.

In This Update:

2019 PCAOB Large Firm Inspection Reports

On February 2, the PCAOB released the public portion of the 2019 inspection reports for the U.S. affiliates of the six largest global network audit firms. The overall percentage of inspected audits that the PCAOB found deficient fell slightly from 27 percent last year to 24 percent. Similar to prior years, the majority of deficient audits included one or more violations of the standard governing the audit of internal control over financial

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reporting (ICFR); of the 70 deficient audits described in these six inspection reports, 57 included an ICFR auditing deficiency.

Comparison of Firm Inspection Reports

The table below summarizes the results of the 2019 inspections of the six firms. A similar table, which appeared in 2018 PCAOB Large Firm Inspection Reports (and the PCAOB's Guide to its New Reporting Format), June 2020 Update, showing results of the 2018 inspections, follows the 2019 table.

2019 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(All reports are dated December 17, 2020 and were released on February 2, 2021)

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	26	11	42%
Deloitte & Touche	58	6	10%
Ernst & Young	60	11	18%
Grant Thornton	31	7	23%
KPMG	58	17	29%
PwC	60	18	30%
2019 Global Network Firm Totals	293	70	
2019 Global Network Firm Averages	49	12	24%

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

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

The tables above focus on the percentage of inspected engagements found to have at least one audit deficiency. Another way of comparing the six inspection reports is to look at the number of auditing standard (AS) violations cited in each report. That metric differs from the percentage-of-deficient engagements measure because an engagement may involve more than one auditing standard violation. The following table compares the 2019 inspection results of the six firms based on the number of auditing standards violations in each report.

AUDITING STANDARD VIOLATIONS IN SIX FIRM 2019 INSPECTION REPORTS

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Auditing Standard Violations in Part I.A	Average # of AS Violations Per Inspected Engagement	Average # of AS Violations Per Part I.A Engagement
BDO	26	11	36	1.38	3.3
Deloitte & Touche	58	6	18	0.31	3.0
Ernst & Young	60	11	39	0.65	3.5
Grant Thornton	31	7	60	1.94	8.6
KPMG	58	17	76	1.31	4.5
PwC	60	18	107	1.78	5.9
2019 Global Net Firm Totals	293	70	336		
2019 Global Net Firm Averages	49	12	56	1.15	4.8

Aggregate Deficiency Data

The ten auditing standards most frequently cited as the basis for audit deficiencies in the 2019 inspection reports of the six firms are listed in the table below. The table also shows the percentage of deficiencies in the six reports that were based on each auditing standard. The same auditing standard may have been cited more than once in the Board's description of a deficient engagement.

TOP TEN AUDITING STANDARDS REFERENCED IN SIX FIRM PART I DEFICIENCY FINDINGS

PCAOB Auditing Standard	Number of Times Standard Cited as Deficiency Basis	Percentage of Total Deficiencies Citing Standard
AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements	115	34.2%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	55	16.4%
AS 2101, Audit Planning	53	15.8%
AS 2315, Audit Sampling	24	7.1%
AS 2501, Auditing Accounting Estimates	19	5.7%
AS 1105, Audit Evidence	18	5.4%
AS 2502, Auditing Fair Value Measurements and Disclosures	17	5.1%
AS 2810, Evaluating Audit Results	17	5.1%
AS 2305, Substantive Analytical Procedures	6	1.8%
AS 2310, The Confirmation Process	4	1.2%

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

MOST FREQUENTLY IDENTIFIED AUDIT DEFICIENCIES IN 2019 SIX FIRM INPSECTION REPORTS

Deficiency Description	Number of Times Deficiency Was Identified	Audit Affected	Percentage of All Deficiencies
Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing.	41	ICFR	23.8%
Did not identify and test any controls related to a significant account or relevant assertion.	34	ICFR	19.8%
Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate.	22	FS	12.8%
Did not perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	22	FS	12.8%
Did not identify and/or sufficiently test controls over accuracy and completeness of data and reports issuer used in the operation of controls.	18	ICFR	10.5%
Did not perform substantive procedures to obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls).	16	FS	9.3%
Did not perform sufficient testing of the accuracy and completeness of data and reports used in the firm's substantive testing.	8	FS	4.7%
Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.	5	FS	2.9%
Did not perform sufficient testing of the sample transactions selected for testing.	2	FS	1.2%
Did not sufficiently evaluate the appropriateness of issuer's accounting method or disclosure for one or more transactions or accounts.	2	FS	1.2%
Did not appropriately evaluate control deficiencies.	2	ICFR	1.2%

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

- Revenue and related accounts – 41 deficiencies
- Inventory – 9 deficiencies

- Allowance for loan losses – 7 deficiencies
- Business combinations – 7 deficiencies
- Income Taxes – 7 deficiencies
- Investment securities – 7 deficiencies
- Goodwill and intangibles – 3 deficiencies
- Long-lived assets – 3 deficiencies
- Derivatives – 2 deficiencies

Part I.B Deficiencies

The 2019 inspection reports include a section (Part I.B) that describes auditing standard or PCAOB rule violations discovered in the inspections that did not affect the auditor's opinion. The 54 violations in the six reports related to:

- Rule 3211, Auditor Reporting of Certain Audit Participants (requiring the auditor to file Form AP with the PCAOB identifying, among other things, other participating audit firms) – 18 violations
- AS 1301, Communications with Audit Committees (requiring the auditor to communicate certain matters to the audit committee) – 11 violations
- Rule 3524, Audit Committee Pre-approval of Certain Tax Services (requiring the auditor to document discussion with the audit committee of potential effects of permissible tax services) -- 8 violations
- AS 1215, Audit Documentation (requiring the auditor to assemble a final set of work papers) – 7 violations
- AS 1205, Part of the Audit Performed by Other Independent Auditors (requiring the principal auditor to, among other things, review and retain management representation letters that component auditors obtained) – 5 violations
- AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (requiring, among other things, the auditor's report on the ICFR audit to include certain disclosures) – 2 violations
- AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (requiring the audit opinion to describe and discuss critical audit matters) – 1 violation
- AS 2805, Management Representations (requiring the auditor to, among other things, provide management with a list of uncorrected misstatements to be included in the management representation letter) – 1 violation
- Rule 3526, Communication with Audit Committees Concerning Independence (requiring the auditor to document discussion with the audit committee of potential effects of relationships that might bear on independence) – 1 violation

Comment: In its inspection reports, the PCAOB cautions against drawing broad conclusions from its inspections because "our inspection results are not necessarily comparable over time or among firms." While that warning should certainly be kept in mind, below are some observations that seem to emerge from the 2019 reports.

1. Audit quality may have improved slightly. As measured by these PCAOB inspection findings, audit quality seems to have improved, compared to last year. For the six U.S. global network firm affiliates as a group, the overall deficient engagement rate fell from 27 percent of inspected engagements in 2018 to 24 percent in 2019. For the Big Four, the deficiency rate declined from 25 percent to 22 percent of all inspected engagements. D&T's deficiency rate dropped to 10 percent – a record low for these six firms.

   It is however possible that the improvement in aggregate deficiency rates is a result of a change in the engagements selected for review. In the 2019 inspection cycle, the PCAOB increased the percentage of inspected engagements selected at random from 18.7 percent to 23.7 percent and, correspondingly, decreased the percentage of those selected based on an assessment of the engagement's risk. Deficiencies are presumably less likely to be found in engagements selected at random than in those selected because they involve elevated risk.

2. There is a range of inspection results among the six firms. The gap between the firm with the lowest deficiency percentage in 2019 reports (D&T) and the firm with the highest (BDO) was 32 percent (10 percent for D&T versus 42 percent for BDO). There are also wide differences between the inspection results based on the number of auditing standards violations cited in each report. On average, the inspectors found 1.15 auditing standards violations in each engagement they inspected. (This is a small increase from 1.06 deficiencies per inspection last year.) However, in the D&T inspection, eighteen violations were found out of 52 engagements inspected – an average of 0.31 violations per engagement. At the other end of the spectrum, in 31 Grant engagements inspected, the staff found 60 violations – an average of 1.94 per engagement. PwC was not far behind (or ahead of) Grant with 107 auditing standard violations in 60 inspected engagements or 1.78 violations per inspected engagement.

3. ICFR audit deficiencies continue to dominate. The 2019 inspection results suggest that the PCAOB continues to focus on ICFR auditing – and that this focus continues to uncover deficiencies. The PCAOB found deficiencies in the ICFR audit in 23 percent of the integrated audits it inspected, and 81 percent of all audit engagements with deficiencies included an ICFR deficiency. By comparison, in 2018, the Board found ICFR deficiencies in 26 percent of the integrated audit engagements it inspected, and 89 percent of all deficient engagements included an ICFR audit deficiency. Moreover, over half (55.3 percent) of the most frequently cited deficiencies affected the ICFR audit, and the two most common audit deficiencies were control-related, with "Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing" at the top of the list.

4. Estimates remain a financial statement audit challenge. The PCAOB found violations in the financial statement audit in 21 percent of the engagements it inspected, and 87 percent of all deficient audit engagements included a financial statement audit deficiency. In 2018, the Board also found financial statement audit deficiencies in 21 percent of the audits it inspected, and 79 percent of all deficient engagements included at least one financial statement audit deficiency. (Deficiencies in the financial statement audit do not, of course, necessarily mean that the financial statements were misstated.) The most frequent deficiencies affecting the financial statement audit were "Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate" and "Did not perform sufficient testing related to an account or significant portion of an account or to address an identified risk" – each of which accounted for 12.8 percent of all frequently-cited deficiencies. Deficiencies related to evaluating assumptions underlying estimates also topped the 2018 list of financial statement audit deficiencies.

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

The PCAOB Speaks – With Audit Committee Chairs

During its 2020 inspections, the Public Company Accounting Oversight Board offered the audit committee chairs of most of the U.S. public companies whose audits were reviewed the opportunity to speak with the inspection team. The PCAOB staff spoke with nearly 300 audit committee chairs, and, on February 1, the Board released 2020 Conversations with Audit Committee Chairs (Conversations Report), which summarizes these discussions. This is the second year the PCAOB has published the results of the inspection staff's interactions with audit committee chairs. See What the PCAOB Heard: Report on Conversations with Audit Committee Chairs, January 2020 Update.

COVID-19 was an overarching theme of many of the 2020 conversations, and the PCAOB has previously reported on this aspect of the discussions. See Audit Committee Chairs Discuss the Impact of C0VID-19 with the PCAOB, September 2020 Update. The Conversations Report focuses on three other topics: the auditor and communications with the audit committee, new auditing and accounting standards, and emerging technologies.

The Auditor and Communications with the Audit Committee

Most audit committee chairs were satisfied with their communications with their auditor. Several referred to the value of dashboards that highlight data on audit progress. Audit committee chairs also said that their auditors performed well in areas such as "assigning resources with expertise on complex accounting issues, consulting their national offices as appropriate, offering practical approaches to problem-solving (as opposed to being highly theoretical), and providing continuity on audit teams." In contrast, areas that were identified as needing improvement included:

- Managing global audit operations.
- Helping more junior audit team members learn the company's business.
- Independence communications.
- Guidance around auditing of certain controls for third-party vendors.
- Over-auditing and/or over-documentation.
- Increased visibility into and discussion around fee changes.

Views were mixed as to the quality of innovation and partner rotation, with some chairs satisfied and others seeing room for improvement.

The PCAOB asked audit committee chairs whether they reviewed the firm's PCAOB inspection report with their auditor. Practice and perceptions in this area varied. There were complaints about the delay between when the inspection is performed and when the PCAOB issues the inspection report. Those audit committees that did review inspection reports and discuss them with their auditor "generally found the exercise to be useful." Specific practices reported to work well included asking the auditor "to discuss any initiatives the firm has implemented to address deficiencies described in the inspection report" and "[r]eviewing year-over-year PCAOB inspection report trends within and between audit firms."

New Auditing and Accounting Standards

Audit committee chairs complained that the implementation of the new accounting standards for revenue recognition, lease accounting, and current expected credit losses were challenging and time consuming. On the other hand, implementation of the PCAOB's critical audit matter disclosure requirement "was generally viewed as smooth, with audit committee chairs noting that dry runs and other early preparation with their auditors led to few surprises." Practices described as working well with respect to implementation of new standards included:

- When reviewing the audit plan, asking the auditors if there will be any significant changes to their audit approach for the year in light of new or revised accounting or auditing standards.

- Asking the auditors to provide the audit committee early notice and frequent updates when new standards are being implemented.

- Setting aside time for educational sessions or deep dives where auditors can explain and answer questions about how new audit requirements may impact the audit.

Emerging Technology

Regarding the use of new technology in auditing, the chairs saw both opportunities and challenges. On the positive side, they thought that data analytics, workflow automation, cloud computing, and other new technology tools could "allow auditors to reduce manual work, obtain better evidence, and become more efficient." However, some chairs were concerned about the gap between the technology capabilities of the company and those of the auditor, while others cited cybersecurity risks stemming from emerging technology. Another concern was the potential for over-reliance on technology to result in "less attention to or emphasis on preparer and auditor judgment, experience, or professional skepticism." Other audit committee chairs referred to internal control implications – for both the company and the auditor – of increased reliance on technology.

Some of best practices regarding emerging technology that chairs discussed include:

- Asking the auditors if/how the use of technology will change the way the team's time and/or resources will be allocated.

- As new technologies are implemented, discussing with management if/how the underlying controls will change and discussing with the auditors how they will evaluate and test any changes to the new controls.

- Asking the auditor to provide best practices or benchmarks for the use of technology and/or information security within the issuer's industry.

- Discussing whether the company uses third-party software or data processing for financial reporting processes and, if so, how risks and controls are considered and addressed.

Comment: The Conversations Report provides insight into what is on the minds of public company audit committee chairs, although in some respects it only hints at the substance of the PCAOB's discussions. It would, for example, be interesting to learn the details concerning the views expressed regarding such issues as over-auditing and over-documentation. For example, did audit committee chairs attribute these problems to their auditor or to the PCAOB's oversight?

The lack of detail aside, the various "what works well" comments reported by the PCAOB are a useful source of ideas. Audit committees may want to consider whether they are already following these practices or, if not, whether any are worth emulating.

In 2021, the PCAOB will undoubtedly continue its practice of engaging in dialogue with the audit committee chairs. An audit committee chair who is contacted by the PCAOB inspection staff as part of an inspection of the company's auditor may want to review the Conversations Report as a way of understanding what to expect during the interview.

How is Internal Audit Doing? The IIA Has a Tool to Help Audit Committees Answer That Question

The Institute of Internal Auditors (IIA) has released Internal Audit Assessment Tool for Audit Committees to assist boards and audit committees in evaluating the internal audit (IA) function. The IIA notes that boards and audit committees "depend on IA to provide accurate, timely, and objective information and observations about the broad spectrum of areas" and that a regular evaluation can give boards and audit committees confidence that internal audit is performing effectively. The IIA's assessment tool suggests issues that could usefully be addressed in such an evaluation.

The tool begins with a discussion of the assessment process, including possible legal requirements, and of the benefits of monitoring internal audit performance. It suggests that audit committees should consider three "big-picture questions":

- Is there an annual IA assessment process that is effective but not overly burdensome?
- Is there an assessment of how well IA is gathering and using information and helping the business to drive decisions?
- Is the assessment effective in helping leadership and IA activity leaders understand the role of IA in the organization and the need or opportunities for changes in its role?

The remainder of the assessment tool is divided into three sections, each of which provides guidance on assessing a different facet of internal audit's work. Each section includes sample questions to consider as part of that phase of the assessment.

1. Quality of services and sufficiency of resources provided by the internal audit activity.

The goals of an evaluation of the quality of internal audit's services and resources are to enable the audit committee (AC) to consider such matters as the committee's ability to evaluate internal audit's activities; whether internal audit is performing in line with the responsibilities in its charter; the quality of the insights and foresights that internal audit provides on governance, risk management, and control matters; and internal audit's use of technology and technical expertise. Sample questions include:

- Did the IA activity properly disclose, if necessary, if the activity was prohibited by law or regulation from conformance with certain parts of The IIA's Standards?
- Does the IA activity lend its expertise to key implementation initiatives, such as compliance with new laws and regulations, an unexpected event like the COVID-19 epidemic, or the organization's implementation of enabling technology?
- Is the AC informed about whether IA continually enhances its team through effective recruitment, retention, and promotion? Are team members rotated within the department to broaden their knowledge and perspectives?
- How does IA approach integrated/combined assurance to ensure it coordinates its activities with other internal and external assurance service providers?

2. Communication and interaction with the internal audit team.

The objective of the communications and interaction phase of the assessment is to enhance oversight by promoting "robust and constructive dialogue" between the audit committee and internal audit, including the chief audit executive (CAE). Sample questions in this area include:

- Does IA communicate its plan and seek feedback and approval? Does it follow up to ensure it is still applicable?
- Does the AC have executive sessions with the CAE without management? If yes, how often? If not, why not?
- Do IA activity communications to the AC provide a good understanding of the risks being covered, the process for monitoring emerging risks, and potential for fraud?

- Do the communications offer the information necessary for the AC to determine whether IA team processes are carried out in a professional manner and that its results are accurate?

3. Auditor independence, objectivity, and professional skepticism.

The IIA states that best practice calls for internal audit's charter to establish its independence through a dual reporting relationship under which the CAE reports administratively to senior management and to the audit committee for strategic direction and accountability. The third part of the evaluation focuses on whether and how internal audit "maintains a delicate balance between its role as an independent auditor and a key resource for the organization." Sample questions related to this issue include:

- Does the CAE promote a culture that actively encourages objectivity and skepticism?

- Is IA staff sufficiently trained in the importance of independence, objectivity, and skepticism? Does it receive refresher training as needed?

- Are the IA team and CAE able to develop a collaborative relationship with management, the board, and AC without allowing that relationship to interfere with their independence, objectivity, and skepticism?

- If the CAE or other members of the team receive incentive-based compensation, do you feel it seems to affect their objectivity?

- Does the audit team have sufficient knowledge of the company, its industry, and the risks and challenges it faces to recognize questionable data or observations?

Comment: The IIA assessment tool concludes with this advice:

> "Boards and AC members should then ask themselves if assessment results were what was expected and if there are opportunities to improve. Assessments may develop benchmarks and will likely pave the way for additional considerations. They can also help boards and ACs consider whether the organization is getting its full value from the IA activity, or if there are consultative projects and roles that would allow the team to enhance their contribution. Once they've completed the assessment, the board and AC can use their conclusions to address any needed changes and take advantage of potential new opportunities to further engage IA in moving the organization to the next level."

The audit committee is key to ensuring that internal audit performs effectively and is respected within the company, and internal audit can be an important tool for the audit committee in discharging its responsibilities. See How Audit Committees Can Get the Most Value from Internal Audit, September 2020 Update. A periodic assessment of internal audit's performance, patterned on the IIA's recommendations, would be beneficial to both the audit committee and the internal audit function.

The CAQ Summarizes CAM Reporting

In Critical Audit Matters: A Year in Review, the Center for Audit Quality (CAQ) analyzes critical audit matters (CAMs) communicated in the auditor's reports of over 2,000 accelerated filers, including a detailed analysis of S&P 100 CAMs. The CAQ likes what it finds. Its conclusion is that: "The auditor's reports we reviewed provide straightforward descriptions about those matters that involved especially challenging, subjective, or complex auditor judgment. Within the audit procedures listed in the CAM communications, auditors provided insights into the auditing of the matter that was a CAM and a description of the audit procedures performed to get comfortable with the matter. The result is an increase in the total mix of information available to investors."

As described in earlier Updates (see, e.g., More PCAOB Advice for Audit Committees on CAMs, July, 2019 Update), the requirement that the auditor's report include a discussion of CAMs took effect for large accelerated filers (companies with public float of $700 million or more) for fiscal years ending on or after June 30, 2019. A CAM is defined as any matter arising from the audit of the financial statements that was (1) communicated or required to be communicated to the audit committee, (2) relates to accounts or disclosures that are material to the financial statements, and (3) involved especially challenging, subjective, or complex auditor judgment. The auditor's report must identify each CAM, describe the main considerations that led the auditor to determine that the matter was a CAM, describe how the auditor addressed the CAM in the audit, and refer to the financial statement accounts or disclosures related to the CAM. (For another analysis of large accelerated filer first year CAM disclosures, see Audit Analytics Provides an Update on CAM Disclosures, June 2020 Update.)

The CAQ's report finds that, for the S&P 100, every auditor's report contained at least one CAM. For all 2,000-plus companies it reviewed, only 16 auditor's reports did not include a CAM. For the S&P 100, there were an average of 1.98 CAMs per report. One of these reports communicated five CAMs, while 32 contained only one CAM. Slightly over half of the 198 CAMs in S&P 100 auditor's reports related to one of four financial statement areas:

- Taxes. The 32 tax CAMs identified various judgmental taxation areas, such as the impact of new federal tax laws (e.g., the Tax Cuts and Jobs Act of 2017), deferred tax assets, unrecognized tax benefits, and accounting for income taxes in general.

- Goodwill/intangibles. Of the 28 goodwill and/or intangible assets CAMs, eight related to intangibles, 13 related to impairment of goodwill, and seven related to both goodwill and intangibles. Two reports included one CAM for goodwill and one CAM for intangibles, and in seven reports there were CAMs that related to both goodwill and intangibles.

- Contingent liabilities. Eighteen of the 23 contingent liability CAMs related to legal and regulatory contingencies. Four CAMs addressed insurance-related liabilities, such as self-insurance programs, and one CAM related to interest and penalties arising from international tax positions.

- Revenue. The topics of the 18 revenue CAMs varied. The CAQ observes that "one theme across the majority of the revenue CAMs relates to timing. Software, consulting projects, and long-term contracts can require companies to recognize revenue over time regardless of when the company is paid. Understanding that timing requires management and, subsequently, their auditors, to use well-reasoned judgment in a complicated and material area."

Companies in the same industry tended to have similar CAMs. For example, in the S&P 100:

- All auditor's reports for financial institutions with banking operations included an allowance for loan or lease loss (ALLL) CAM.

- Insurance contract liabilities CAMs were common in the insurance industry.

- Petroleum refiners frequently had CAMs related to proven and unproven reserves and to asset retirement and environmental matters.

- Regulatory assets and liabilities CAMs were common for energy companies.

Every critical accounting policy disclosed in management's discussion and analysis (MD&A) did not result in a CAM, and every CAM did not relate to a critical accounting policy. Many S&P 100 companies had "two to three times the number of critical accounting policies in the MD&A section of their Form 10-K than CAMs communicated in the auditor's report." Conversely, "12 CAMs in auditor's reports for S&P 100 companies related to a business combination, and only one company also had a critical accounting policy related to business combinations."

Contrary to fears expressed prior to CAM reporting implementation, CAMs were not a vehicle for the disclosure of non-public deficiencies in internal control over financial reporting (ICFR). Companies are not required to disclose significant deficiencies in ICFR, and no CAM for the S&P 100 referred to a significant deficiency. Two auditor's reports for S&P 100 companies included a CAM that mentioned a material weakness in ICFR as a principal consideration for the CAM, and these companies were also the only S&P 100 companies that disclosed a material weakness.

Comment: As noted in prior Updates, the financial reporting areas most likely to generate CAMs tend to be those that are dependent on management estimates and forecasts and therefore require a significant amount of auditor judgment. Audit committees of companies that have CAMs arising in other areas – or that have CAMs that differ significantly in number or nature from those disclosed by other companies in the same industry – should explore the reasons why their company differs from these norms. The PCAOB has provided guidance concerning the types of questions audit committees should raise with their auditor concerning CAMs. See More PCAOB Advice for Audit Committees on CAMs, July 2019 Update.

Lessons from SEC Enforcement on Mitigating the Risk of Financial Reporting Fraud

The Anti-Fraud Collaboration (AFC), a group consisting of the Center for Audit Quality, the Institute of Internal Auditors, Financial Executives International, and the National Association of Corporate Directors, has released Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions. The report, prepared with the assistance of law firm Latham & Watkins and consulting firm AlixPartners, is based on an analysis of SEC enforcement actions between January 1, 2014 and June 30, 2019. It identifies 204 financial statement fraud schemes involving accounting or auditing issues. The objective of the study is "to provide observations on higher risk areas that are susceptible to fraud and insights into what companies can do to identify and mitigate these types of fraud risks more effectively." The AFC believes that its analysis will be "valuable to members of the financial reporting supply chain (board of directors, audit committees, financial management, internal auditors, and external auditors) as well as regulators, anti-fraud professionals, investors, customers, extended enterprises, service organizations, and other stakeholders."

Common Fraud Schemes and Where They Occur

The AFC found the four most common types of fraud were improper revenue recognition, reserves manipulation, inventory misstatement, and loan or other impairment issues.

- The greatest number of fraud schemes identified in the AFC's analysis related to improper revenue recognition attributable to timing, valuation, fictitious revenues, or percentage of completion. There were 60 such cases in 81 enforcement actions, or 40 percent of the 204 fraudulent financial reporting SEC enforcement actions.

- Cases involving reserves accounted for 28 of the actions or about 14 percent. Reserves-related violations included manipulation or improper reduction of reserves, timing of reserves and recording of expense, manipulation or misclassification of expenses, improperly calculated rebate/expense accruals, and failure to recognize liabilities.

- Misstatement and manipulation of inventory (including misstating cost of sales and misstating or overstating inventory) constituted 12 percent of the cases.

- Impairment and allowances cases (timing of impairment, including loan impairment deferral, failure to record asset impairment, faulty valuations, and improper reserves manipulation) were 8 percent.

Frauds identified in the study also sometimes involved misleading or inaccurate disclosures (78 instances), material weaknesses in internal control (44 instances), and unsupported journal entries (11 instances). The report discusses specific examples of each type of fraud.

The report also provides some data concerning the types of companies and defendants in SEC financial reporting fraud cases during the study period. The five industries in which companies were most frequently charged with financial fraud were Technology Services, Finance, Energy, Manufacturing, and Healthcare. Thirtynine percent of the enforcement actions involved companies with less than $250 million in market capitalization, while 22 percent involved companies with between $250 million and $ 2 billion in market capitalization. Not surprisingly, in financial reporting cases the company itself is typically charged. However, individuals are also often named. Company CFOs are the most charged employees, followed by CEOs, and other employees, such as chief accounting officers, other accounting department employees, and sales personnel.

Causes of Financial Reporting Fraud

Based on the SEC's descriptions of the facts and circumstances that potentially contributed to the fraud schemes, the report describes three principal causes of financial reporting fraud.

- Tone from above. "Through their actions and communications, leaders articulate and exemplify a certain set of ethical and behavioral standards and expectations. They also--intentionally or not--foster a culture that permeates the organization. Leaders who set and follow ethical standards will have a positive influence on the standards their employees follow."

- High-pressure environment. "A high-pressure environment may demand that employees meet unrealistic goals, for example, or may cause employees to feel their jobs are threatened if they do not circumvent certain standards or procedures."

- Lack of personnel with sufficient accounting experience or training. "As the landscape of accounting rules and the ways in which companies operate are everchanging, there may be a continual need to refresh and update your employees' skill sets. Companies should strive to keep employees informed and up to date on best practices, new guidance, and potential emerging risks."

Fraud Risk Mitigation Oversight

To mitigate fraud risks, the board and audit committee, management, internal auditors, and external auditors need "to be attuned to quantitative and qualitative metrics, including the company's culture and tone at the top (and middle)." The report discusses steps that can aid in that process.

- Culture and skepticism. "Culture can serve a 'gap filling' function when individuals on the front lines encounter circumstances not contemplated by their policies and procedures and need to make decisions. The actions companies take in such scenarios reflect a great deal about the company's culture." The report suggests questions companies should consider asking when employees "diverge from cultural expectations, compliance mandates, or legal requirements".

- Executive and board oversight. The report lists four ways in which the board and senior management can enhance their oversight: (1) Ask the right questions (ensure that the board is engaged, especially in challenging economic times); (2) Assess the identified risks (scrutinize whether control activities are properly carried out and whether risk assessment concerns are addressed); (3) Consider corporate culture (a proactive approach to corporate culture can deter misconduct and promote enhance morale and productivity); and (4) Pay attention to red flags. (for example, whistleblower or employee hotline complaints or compensation practices that reward behavior that can lead to fraudulent activities).

- Risk assessment and analytics. Data analytics can be a useful tool in identifying financial statement fraud risks. Some sources to consider include "sales journal entries, accounts receivable, customer and vendor master lists, and sub-ledgers that can include inventory, capital expenses, and outstanding loans." Geographic location is also a consideration in fraud risk assessment, since a significant number of frauds occur outside the U.S., and some locations are recognized as higher risk.

Financial Reporting Fraud Risk in the Current Environment

The AFC report discusses the likelihood of financial reporting fraud due to COVID-19 disruptions. The authors' present a laundry-list of financial reporting fraud schemes that may be more prevalent in the COVID-19 environment, such as fabrication of revenue to offset losses, understatement of accounts receivable reserves as customers delay payments, manipulation of compliance with debt covenants, overstated business interruption insurance claims that sweep in costs unrelated to the pandemic, and cookie jar reserves by companies that may be outperforming expectations during the pandemic. The report notes that pandemic-induced remote work may impact "operating procedures, segregation of duties, and associated internal controls, which can leave companies vulnerable to emerging fraud risks" and may create new types of cybersecurity risks. The AFC also discusses the importance of assessing the impact of COVID-19 on disclosure obligations, particularly in areas that are susceptible to judgment and manipulation.

Comment: The AFC concludes: "The key to protecting companies against fraud is vigilance, a continued resolve to exercise skepticism, and attention to the potential risks. Companies should remain focused on the fundamentals— controls, processes, and environments that impact financial recordkeeping and decision-making—and company-specific risks by conducting regular risk assessments." The report is a good reminder for audit committees of how financial reporting frauds occur and a checklist of some of the oversight measures that can be taken to help prevent or detect fraud.

On the Update Radar: Things in Brief

What Should be on the Audit Committee's 2021 Agenda? At the beginning of each year, accounting and consulting firms present their views on the issues that audit committees should focus on at year-end and during the coming 12 months. Below is a list (with hyperlinks to the documents) of some of these 2020 year-end and 2021 agenda papers.

- BDO, 2020 Year End Audit Committee Agenda
- Deloitte Center for Board Effectiveness, The strategic audit committee: Navigating 2021
- Deloitte Center for Board Effectiveness, Year-end accounting and financial reporting considerations: Questions for audit committees to consider
- EY Center for Board Matters, What audit committees should consider at the end of 2020 and beyond
- KPMG Board Leadership Center, On the 2021 audit committee agenda
- Protiviti, Setting the 2021 Audit Committee Agenda
- PwC Governance Insights Center, Approaching the 2020 year-end financial reporting season

While each firm has its own perspective on where audit committees should direct their time and attention, there are many common themes. Some frequently mentioned 2021 agenda topics include the impact of COVID-19 on operations, financial reporting, disclosure, and internal control; changes in cyber security risk; increasing demands for environmental, social, and governance (ESG) disclosure; impact of COVID-19 on the work of the external auditor and changes in audit risk assessment; the priorities of internal audit; and management's processes for identifying and managing risk. A high-level review of these papers could be helpful to audit committees as a check that they are not overlooking topics that should be considered.

BlackRock Calls for Disclosure and Board Oversight of Company Plans for the Net-Zero Economy. Each year, Laurence Fink, Chairman and CEO of BlackRock, the world's largest asset manager, sends an open letter to corporate CEOs. Last year, in his 2020 letter to CEOs, Mr. Fink asserted that "[c]limate change has become a defining factor in companies' long-term prospects" and that "sustainable investing is the strongest foundation for client portfolios going forward." He called on the companies that Blackrock invests in on behalf of clients to make disclosures in accordance the Sustainability Accounting Standards Board (SASB) standards for their industry and to disclose climate-related risks in line with the recommendations of the Task Force on Climate-Related Disclosures (TCFD). See BlackRock's CEO Calls for Portfolio Companies to Make SASB and TCFD Disclosures January 2020 Update.

This year, Mr. Fink has a step gone further. In his 2021 letter to CEOs, he asks that companies "disclose a plan for how their business model will be compatible with a net-zero economy" by 2050. (A net-zero economy is an economy that emits no more carbon dioxide than it removes from the atmosphere.) "We expect you to disclose how this plan is incorporated into your long-term strategy and reviewed by your board of directors." He also reiterates the importance to investors of disclosure concerning company ESG performance: "Because better sustainability disclosures are in companies' as well as investors' own interests, I urge companies to move quickly to issue them rather than waiting for regulators to impose them. (While the world moves towards a single standard, BlackRock continues to endorse TCFD- and SASB-aligned reporting.)"

Blackrock has signaled that it is prepared to use its leverage as an investor to back up Mr. Fink's requests. Blackrock's 2021 letter to clients (released simultaneously with Mr. Fink's letter to CEOs) states: "Where we do not see progress in this area [i.e., the 2050 net-zero economy plan], and in particular where we see a lack of alignment combined with a lack of engagement, we will not only use our vote against management for our index portfolio-held shares, we will also flag these holdings for potential exit in our discretionary active portfolios because we believe they would present a risk to our clients' returns."

Because of BlackRock's importance as an institutional investor, public company boards need to seriously consider Mr. Fink's requests. Transition to a net-zero economy, even over a 30-year period, will have major ramifications for the business models of most companies. For audit committees specifically, BlackRock's insistence on SASB and TCFD disclosures may significantly affect their work. Demands for more ESG disclosure are increasing, and some form of regulatory mandate is likely. Audit committees should review their company's ESG disclosures and discuss with management bringing the company's reporting into conformity with SASB and TCFD. They should also consider management's plans to implement procedures and controls to ensure the accuracy of these new types of disclosures.

A Study Finds That Most Boards Lack Climate Expertise. While BlackRock CEO Laurence Fink emphasized the importance of board oversight of company climate-change strategy (see BlackRock Calls for Disclosure and Board Oversight of Company Plans for the Net-Zero Economy above), a recent study raises questions about the level of director expertise in climate and other environmental, social, or governance (ESG) areas. Tensie Whelan of the NYU Stern Center for Sustainable Business analyzed the credentials of the 1,188 Fortune 100 directors, based on their publicly available biographies. In U.S. Corporate Boards Suffer from Inadequate Expertise in Financially Material ESG Matters, Professor Whelan reports that 29 percent of these directors had relevant ESG credentials, although their experience was heavily weighted toward social issues – 21 percent of board members had relevant experience with issues that comprise the social, or S, element of ESG, while only 6 percent had E (environmental) or G (governance) expertise. (Some directors had credentials in more than one area.) In the specific environmental area of climate, only three of the 1,188 board members had relevant experience. The industries with the greatest number of directors with ESG expertise were Health Care: Pharmaceuticals, Biotechnology & Life Sciences; Utilities; Consumer Staples: Household & Personal Products; and Telecommunication Services. Those with the lowest ESG relevant representation were Consumer Discretionary: Media; Consumer Discretionary: Retailing; and Industrials: Transportation.

It is far from clear that an educational credential or professional experience in some facet of ESG is necessary for a board member to effectively oversee a company's policies, practices, and disclosures with respect to such matters as climate change, human capital management, supply chain integrity, relations with the communities in which it operates, or other aspects of ESG. Nonetheless, given the current interest in the risks and opportunities ESG issues present for companies, it is quite possible that ESG expertise may join the list of desirable attributes that boards consider in recruiting new directors. Particularly if ESG disclosure becomes mandatory, experience with these issues may also become a plus factor for audit committee members.

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 @BlogAuditor on twitter or @the-audit-blog on medium.com.

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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.