

Audit Committee *Brief*

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Update on regulatory issues affecting audit committees

Audit quality, transparency, auditor retention, and other financial reporting matters relevant to audit committees have been on regulators’ agendas in recent months. The SEC, PCAOB, and other regulatory bodies are actively soliciting audit committees’ views on various topics and initiatives, and have released a variety of publications, communications, and resources targeted to committee members.

This issue of the *Audit Committee Brief* discusses recent domestic and international regulatory developments that are likely to affect audit committees, and includes links to a variety of resources for further information.

SEC focus areas

Comments related to audit committees

SEC officials have emphasized in recent public comments the importance of the audit committee’s traditional responsibility to oversee the quality and accuracy of financial reporting, as well as the independent audit.

SEC Chief Accountant Paul Beswick has focused on the core duties of the audit committee in two major speeches he has given in recent months. In his December 2013 [speech](#) at the AICPA Conference on Current SEC and PCAOB Developments, Beswick highlighted the importance of considering audit quality in determining whether to hire or retain an auditor. He noted that focusing on audit quality is consistent with making sound business decisions and that the audit committee’s decision should focus on which auditor will best protect the interests of shareholders. Beswick cautioned registrants that “if the audit committee is solely fee hunting and if there was a subsequent audit failure, beyond the obvious problems for the auditor and the company, this may raise questions about the diligence of the members of the audit committee in fulfilling their responsibilities.”



In a February 2014 speech, Beswick centered his remarks on a presentation titled *Audit Committees: Back to Basics*, which emphasized the fundamental duties of the audit committee, and in particular the importance of overseeing the independent auditor. Among his suggestions were to develop metrics to assess the success of the audit, monitor auditor independence, and understand audit fees. For additional information on Beswick's comments and other highlights from the SEC Speaks in 2014 Conference, see Deloitte's March 20, 2014, [Heads Up](#).

SEC Chair Mary Jo White has also recently touched on the critical role that audit committees play in financial reporting oversight. In May 2014, she gave a [speech](#) in which she noted that investors have expressed significant interest in increased transparency into audit committee activities. White said she has asked the SEC staff to consider whether audit committee reporting requirements can be improved to make the reports more useful to investors. While she provided no details on the timing or extent of this review, her comments are notable given the increased focus on audit committee disclosure in recent proxy seasons. See Deloitte's February 2014 [Audit Committee Brief](#) for an overview of recent trends in this area.

SEC's renewed focus on financial reporting

As required by the Jumpstart Our Business Startups (JOBS) Act, the SEC staff issued a report to Congress in December 2013 that provides the staff's preliminary views on disclosure reform for U.S. public companies. Subsequent to the report's issuance, Mary Jo White asked the Division of Corporation Finance to explore ways to make public-company disclosure requirements more effective, with an initial focus on Forms 10-K, 10-Q, and 8-K. The SEC has emphasized that this project will focus not only on what information is disclosed, but also how it is disclosed. The SEC is seeking public comment on the [project](#), which is in its early stages.

The SEC has also emphasized that companies can improve their disclosure even absent a change in requirements. In a recent speech, Keith Higgins, director of the Division of Corporation Finance, suggested three approaches companies can consider to improve the clarity of disclosures: reducing repetition (e.g., verbatim repetition of the significant accounting policies footnote in Management's Discussion & Analysis (MD&A)), focusing and tailoring lengthy disclosures (e.g., risk factor disclosure), and eliminating outdated information.¹

While the SEC's disclosure effectiveness project is focused on the future of public-company reporting, the SEC has also renewed its focus on past and current disclosure practices. In 2013, the SEC formed the Financial Reporting and Audit Task Force to identify securities law violations related to financial reporting and audit failures. The task force also explores areas that may be susceptible to fraudulent financial reporting through reviewing restatements, analyzing performance trends by industry, and using technology-based tools. While financial statement fraud has always been a significant part of the SEC's enforcement agenda, the formation of the task force represents a renewed focus after a number of years of more public attention to cases coming from the financial crisis.

Among the tools at the task force's disposal is the Accounting Quality Model (AQM), which the SEC developed to analyze companies' filings through the identification of keywords or risk factors that could suggest accounting misstatements or insufficient disclosures. The SEC has provided examples of factors the AQM may be looking for, including two or more auditor changes in five years, a write-down in goodwill, or results that consistently do not differ by more than a certain

¹ Keith F. Higgins, "Disclosure Effectiveness: Remarks before the American Bar Association Business Law Section Spring Meeting" (April 2014), available at: <http://www.sec.gov/News/Speech/Detail/Speech/1370541479332>.



percentage from earnings estimates. While the SEC acknowledges that the tool may generate false positives, some companies will likely receive additional scrutiny from the SEC's Enforcement Division, or possibly the Division of Corporation Finance, as a result of the tool.

Cybersecurity

The SEC renewed its focus on cybersecurity with a March 26, 2014, roundtable in Washington, D.C. Though no SEC rule explicitly addresses this topic, 2011 guidance stipulates that cyber risk may give rise to disclosure obligations with regard to investment risk factors, MD&A, descriptions of legal proceedings, financial statement disclosures, and disclosure controls and procedures. Mary Jo White said in May 2013 that the SEC, as part of its initial disclosures review, had issued comment letters to approximately 50 companies concerning compliance with the 2011 guidance,² which suggests that cybersecurity preparedness has been and will be subject to significant scrutiny.

Participants in the March roundtable discussed the sufficiency of disclosure requirements, board of director involvement, information sharing among companies and with the government, company preparations to prevent a cybersecurity breach, and the value of government guidelines. Following the roundtable, the SEC's Office of Compliance Inspections and Examinations released a [document](#) outlining its initiative to assess cybersecurity preparedness in the securities industry. A more detailed discussion of the SEC's cybersecurity roundtable can be found in Deloitte's April 8, 2014, [Heads Up](#). For an analysis of recent trends and developments in several areas of technology, including big data, social media, cloud computing, IT implementations, and cybersecurity, see Deloitte's May/June 2014 [Audit Committee Brief](#).

² Mary Jo White letter to Senator John D. Rockefeller IV, May 1, 2013, available at: http://www.commerce.senate.gov/public/?a=Files.Serve&File_id=7b54b6d0-e9a1-44e9-8545-ea3f90a40edf.

Updated COSO Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) released an updated version of its *Internal Control — Integrated Framework* on May 14, 2013, to provide enhanced guidance on internal controls to the boards and audit committees of publicly listed companies. COSO has set a deadline of December 15, 2014, for transitioning from the older 1992 framework. The SEC staff has indicated that "the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer's use of the 1992 framework satisfies the SEC's requirement to use a suitable, recognized framework (particularly after December 15, 2014)."³

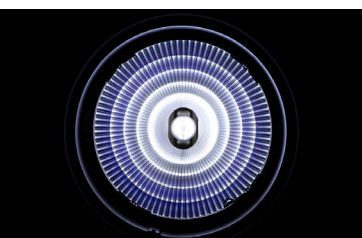
For a more detailed discussion of audit committees and the 2013 COSO Framework, see Deloitte's March 2014 [Audit Committee Brief](#).

Conflict minerals

For companies required to file SEC Form SD – *Specialized Disclosure Report* regarding conflict minerals, initial filings were due on June 2, 2014. The filings went forward despite an ongoing legal challenge of the SEC's final rule, which was initially upheld by the U.S. District Court for the District of Columbia in July 2013.

In April 2014, the U.S. Court of Appeals for the District of Columbia Circuit held that parts of the SEC rule and Section 1502 of the Dodd-Frank Act violate the First Amendment to the extent that they require issuers to disclose that their products have "not been found to be 'DRC [Democratic Republic of the Congo] conflict free.'" The Court of Appeals has remanded the case to the District Court for further consideration. Shortly after the April court ruling, the SEC's Division of Corporation

³ See minutes of the September 25, 2013, meeting of the Center for Audit Quality's SEC Regulations Committee with SEC staff, available at: <http://www.thecaq.org/docs/reports-and-publications/2013septembe25jointmeetinghls.pdf>.



Finance announced that companies submitting the June 2 filing would not be required to declare whether their products contain conflict minerals—that is, whether they are “conflict free,” “not been found to be conflict free,” or “conflict undeterminable.” The SEC has subsequently appealed the April court ruling, and that request is pending as of the time of this publication.

For more information on conflict minerals and the requirements of Form SD, see Deloitte’s March 27, 2014, [Heads Up](#).

PCAOB focus areas

Audit committee engagement

In recent months, the PCAOB has actively solicited input from audit committee members on its proposed standards and has provided resources to support audit committees in executing their Sarbanes-Oxley-imposed duties to be “directly responsible for the appointment, compensation, and oversight” of the independent auditor.

The PCAOB has dedicated a [section](#) of its website to resources to assist audit committee members in understanding its inspection process and standard-setting efforts. The PCAOB is also exploring the development of indicators of audit quality to assist audit committees and other stakeholders in assessing the audit.

Standard-setting agenda

The PCAOB has included in its published [standard-setting agenda](#) projects on which it has recently taken action or expects to take action by September 2014. Several of these projects are relevant to the work of the audit committee.

The auditor’s reporting model

The PCAOB released a [proposal](#) for comment in August 2013 to enhance the auditor’s reporting model and modify the auditor’s responsibility to provide additional information in annual reports

filed with the SEC. While the proposal preserves the pass/fail opinion, it would represent the most significant expansion of information required from auditors to date.

To gather further input on the proposal, the PCAOB held a [public meeting](#) on April 2–3, 2014. The PCAOB has not set a specific timeline for next steps, but several members have suggested that a re-proposal and an additional comment period may be forthcoming.

For more information on the PCAOB’s roundtable on the reporting model, as well as international developments related to the auditor’s report, see Deloitte’s April 30, 2014, [Heads Up](#).

Audit transparency

The comment period recently closed for the re-proposed standard issued in December 2013 that would amend PCAOB auditing standards to require disclosure in the auditor’s report of the name of the engagement partner who led the audit for the most recent period. Other required information would include the names, locations, and extent of participation of other public accounting firms that took part in the audit, and the locations and extent of participation of others not employed by the auditor who performed more than 5 percent of procedures, based on total audit hours. Deloitte’s January 6, 2014, [Heads Up](#) has more information on the transparency proposal.

Related parties

The PCAOB issued and approved [Auditing Standard 18](#) (AS 18), a new standard on related parties, on June 10, 2014. The associated release also amended auditing standards pertaining to significant unusual transactions, executive compensation, and other matters. If approved by the SEC, these standards will be effective for audits of fiscal years beginning on or after December 15, 2014, including reviews of interim financial information in those fiscal years.



The standards add and expand requirements intended to help auditors achieve the objective of obtaining “sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.” For more information on AS 18, see Deloitte’s June 23, 2014, [Heads Up](#).

A discussion of how audit committees can become involved in regulatory discussions with the PCAOB, SEC, and other regulators can be found in Deloitte’s June/July 2013 [Audit Committee Brief](#).

Global regulatory developments related to audit committees

The role of the audit committee in financial reporting has also been the topic of considerable discussion and legislation in other jurisdictions, particularly in Europe.

EU audit legislation

The European Union formally approved a significant audit legislation package in spring 2014 that will affect statutory audits for many EU companies. The provisions that have received the most attention include mandatory audit firm rotation for EU public-interest entities (PIEs) and new prohibitions on non-audit services. These provisions will affect only a limited number of U.S. companies, because they apply only to EU statutory audits of PIEs, which are defined to include:

- EU-based (incorporated) companies listed on an EU-regulated exchange, but not non-EU companies that are dually listed in the EU
- Certain credit institutions and insurance undertakings in the EU.⁴

Certain parts of the legislation have received less attention in the United States, including provisions designed to strengthen the audit committees of EU companies and to provide more transparency into the activities of the audit committee and the statutory auditor. Some of these will result in closer alignment with audit committee requirements in the United States. For example, each PIE, subject to certain exceptions, will be required to have an audit committee composed of non-executive members that is responsible, among other things, for auditor selection. Auditors of PIEs will be required to prepare a more comprehensive report for the audit committee.

The legislation will be effective by the summer of 2016, with additional transition periods for firm rotation. For more information on the EU legislation, see [Overview of European Union Audit Legislation](#).

U.K. audit committee reports

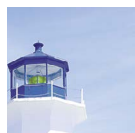
The U.K. Corporate Governance Code was amended to include additional requirements for the annual reports of most listed U.K. companies, including the audit committee report and the external auditor’s report, in September 2013. Audit committee reports must now discuss significant issues considered in relation to the financial statements and how those issues were addressed. In addition, the external auditor’s report must discuss the risks that had the greatest effect on the audit, and the corresponding audit response. The first round of reports filed under the new provisions may inform the discussion about reporting in the United States, and was discussed at the PCAOB’s April 2014 public meeting on the auditor’s reporting model.

⁴ Individual EU member states also can designate other entities as PIEs.

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Conclusion

Regulators have recently renewed their focus on the audit committee's role and fundamental importance in the financial reporting process. The SEC's Mary Jo White and Paul Beswick have repeatedly highlighted the audit committee's responsibilities in their comments over the past several months, focusing on topics such as the selection and oversight of the independent auditor and the need for transparency regarding audit committee activities. In addition, the PCAOB continues to explore changes to the auditor's reporting model, and is increasingly reaching out to audit committees to solicit their views on various proposals. These developments, coupled with the recent EU audit legislation, suggest that the domestic and global regulators' focus on the audit committee will continue in the coming years.

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Additional Deloitte resources

[June/July 2013 Audit Committee Brief: A Voice at the Table: Becoming More Involved in the Financial Reporting Regulatory Process](#)

[January 6, 2014, Heads Up: PCAOB Reproposes Requiring Disclosure of Engagement Partner and Certain Audit Participants](#)

[February 2014 Audit Committee Brief: A New Era in Audit Committee Reporting](#)

[March 2014 Audit Committee Brief: The 2013 COSO Framework and the Audit Committee](#)

[March 20, 2014, Heads Up: Highlights of the "SEC Speaks in 2014" Conference](#)

[March 27, 2014, Heads Up: Navigating Reporting Requirements for Form SD and Conflict Minerals Reports](#)

[April 8, 2014, Heads Up: Highlights of the SEC's Cybersecurity Roundtable](#)

[April 30, 2014, Heads Up: PCAOB Gathers More Input on Proposed Changes to the Auditor's Report](#)

[May/June 2014 Audit Committee Brief: Technology at the Forefront](#)

[June 23, 2014, Heads Up: PCAOB Adopts New Requirements for Auditing Related Parties, Significant Unusual Transactions, and Other Matters](#)

[Overview of European Union Audit Legislation](#)

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