

## NEW SEC AND PCAOB PROPOSALS RELATED TO AUDIT COMMITTEE DISCLOSURE AND AUDIT QUALITY

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## OVERVIEW

On July 1, 2015, the US Securities and Exchange Commission (SEC) issued a concept release relating to its audit committee reporting requirements.<sup>1</sup> This release references two Public Company Accounting Oversight Board (PCAOB) releases, one dated June 30<sup>2</sup> and the other dated July 1.<sup>3</sup> These three releases evidence a coordinated approach to addressing investor requests for additional information about how audit committees oversee independent auditors and evaluate their performance and about the quality of audits. Taken together, the releases suggest an SEC and PCAOB effort to enhance audit committee performance and investor understanding of the performance of both audit committees and independent auditors. This may impact investor decision-making with respect to how to vote on directors who are audit committee members, whether to ratify the selection of the independent auditors, and whether to invest in a company.

The SEC concept release seeks comment on whether revisions to the SEC's audit committee reporting requirements, and particularly the committee's disclosure about how it oversees the independent auditors, would be useful to investors. Through 74 numbered sets of questions, the SEC seeks comments on, among other things, the following: (1) the adequacy of the existing audit committee reporting requirements; (2) additional possible disclosures related to the way audit committees oversee independent auditors, the process audit committees follow when they determine to appoint or retain auditors, and the qualifications of the independent auditors and certain members of the engagement team, including the consideration of audit quality indicators, such as those discussed in the PCAOB concept release on audit quality indicators; (3) the location of any additional disclosures, such as in one place in the proxy statement, in the Form 10-K, or in a prospectus; and (4) the applicability of any additional disclosures to smaller reporting companies and emerging growth companies. Several of the questions ask specifically whether the additional disclosure should be in the following: the audit committee's report; the independent auditors' report, as the PCAOB has considered with respect to the possible additional disclosures related to the identity of the engagement partner and certain participants in the audit; or somewhere else.

The PCAOB supplemental request seeks comments on whether it should require independent auditors to disclose in a new PCAOB form rather than in the auditors' report, as it had proposed in 2013, the name of the audit engagement partner and information about certain other participants in the audit. The PCAOB's 2013 proposal had generated substantial concerns that adopting the proposal would subject the persons named in the auditors' report to liability under section 11 of the Securities Act of 1933.<sup>4</sup> The PCAOB supplemental request notes that commenters suggested that the audit committee's report provide the disclosure about participants in the audit.

The PCAOB concept release seeks comment on the content and possible uses of audit quality indicators, which are quantitative measures that the PCAOB believes should "inform" discussions between the audit committee and the independent auditors about audit quality, strengthen audit quality, and enhance

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1. Securities Act Release No. 9862, "Possible Revisions to Audit Committee Disclosures" (July 1, 2015), *available at* <http://www.sec.gov/rules/concept/2015/33-9862.pdf> (hereinafter referred to as "SEC concept release").

2. PCAOB Release No. 2015-004, "Supplemental Request for Comment: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form" (June 30, 2015), *available at* [http://pcaobus.org/Rules/Rulemaking/Docket029/Release\\_2015\\_004.pdf](http://pcaobus.org/Rules/Rulemaking/Docket029/Release_2015_004.pdf) (hereinafter referred to as "PCAOB supplemental request").

3. PCAOB Release No. 2015-005, "Concept Release on Audit Quality Indicators" (July 1, 2015), *available at* [http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release\\_2015\\_005.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf) (hereinafter referred to as "PCAOB concept release").

4. *See, e.g.*, Comment Letter of the Society of Corporate Secretaries & Governance Professionals on PCAOB Release No. 2013-009, "Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit" (March 12, 2014), *available at* [http://pcaobus.org/Rules/Rulemaking/Docket029/047c\\_SCSGP.pdf](http://pcaobus.org/Rules/Rulemaking/Docket029/047c_SCSGP.pdf).

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investors' understanding of audit quality. The concept release identifies 28 potential audit quality indicators (identified in the release as "AQIs") in the areas of audit professionals, the audit process, and audit results. Noting that "[t]he goal of the AQI project is to improve the ability of persons to evaluate the quality of audits in which they are involved or on which they rely and to enhance discussions among interested parties,"<sup>5</sup> the concept release seeks comment on the content and potential value of audit quality indicators to audit committees, accounting firms, investors, and regulators.

Comments are due on the SEC concept release by September 8, 2015. Comments on the PCAOB supplemental request are due by August 31, 2015, and comments are due on the PCAOB concept release by September 29, 2015. The PCAOB plans to convene a roundtable to discuss the audit quality indicators during the fourth quarter of 2015.

We urge companies to carefully consider these releases and submit comments, at least to the SEC, to influence the SEC's next steps. Such action is important given the breadth of the possible new disclosures, which may also expand the responsibilities of audit committees and could result in a check-the-box approach to audit committee oversight of independent auditors and audit procedures.

## BACKGROUND

A former chair of the SEC described the audit committee's role as representing one leg of a three-legged stool, the other legs of which represent the roles played by management engaged in preparing financial statements and the independent auditors.<sup>6</sup> Since that analogy was made in 2001, the enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) required various rule and listing standard changes designed to strengthen the independence and expertise of audit committee members. These changes require that the audit committee have the responsibility to do the following: select, oversee, determine the compensation payable to, and evaluate the performance of the auditors; handle complaints and concerns regarding the company's accounting, auditing, and internal controls; and have the authority and appropriate funding to engage outside advisers.<sup>7</sup> In addition, in 2003, the New York Stock Exchange adopted listing standards that specifically identify a number of duties and responsibilities of audit committees that have become best practices for all audit committees, regardless of where they are listed.<sup>8</sup>

Despite these developments and the three-legged stool analogy, the SEC's disclosure rules relating to the role and responsibilities of audit committees are sparse in contrast with the extensive requirements applicable to the preparation and audits of financial statements. The SEC concept release points out that the audit committee reporting requirements have remained basically unchanged since 1999,<sup>9</sup> with the exception of the rules and listing standards implementing the Sarbanes-Oxley provisions related to audit

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5. PCAOB concept release, *supra* note 3, at 4.

6. Arthur Levitt, SEC Chairman (1993-2001), Letter to Audit Committee Chairmen (Jan. 5, 2001), *available at* [www.sec.gov/news/headlines/ltr2audc.htm](http://www.sec.gov/news/headlines/ltr2audc.htm).

7. Section 301 of Sarbanes-Oxley required the SEC to direct the exchanges to prohibit the listing of any company that did not comply with the requirements related to the audit committee's independence and duties and responsibilities.

8. NYSE Listed Company Manual section 303A.07(b), *available at* <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F1&CiRestriction=303A&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F>.

9. The existing requirements related to the audit committee's report and the existence of an audit committee charter were adopted in Securities Exchange Act Release No. 42266, "Audit Committee Disclosure" (Dec. 22, 1999), *available at* <http://www.sec.gov/rules/final/34-42266.htm>. Item 407(d) of Regulation S-K requires an audit committee's report to address whether the audit committee has reviewed and discussed the financial statements with management, whether the audit committee has discussed with auditors those matters in the auditing standard related to audit committee communications, whether the audit committee has received and discussed certain independence matters, and whether the audit committee recommended to the board that the financial statements be included in the Form 10-K.

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committee independence,<sup>10</sup> the audit committee financial expert,<sup>11</sup> the audit committee pre-approval of auditor services and required auditor communications to the audit committee.<sup>12</sup> In addition, citing the Audit Committee Collaboration, the SEC concept release observed that some have noted that the SEC's disclosure rules "do not provide investors with sufficient useful information regarding the role of and responsibilities carried out by the audit committee in public companies."<sup>13</sup>

Nevertheless, for the last several years, an increasing number of companies have voluntarily included in proxy statements prepared for shareholders' annual meetings expanded disclosure about the role and responsibilities of audit committees and the reasons why audit committees recommend that shareholders ratify the selection of independent auditors. Some of these changes in audit committee disclosures have resulted from investor requests for specific additional information about an audit committee's evaluation of auditors because of investors' concerns about the long-tenure of many public companies' auditors.<sup>14</sup> More recently, the increasing focus on information about audit committees may be related to comments made by officials at the SEC.

In February 2014, the then–chief accountant of the SEC suggested that audit committees consider expanding their reports included in proxy statements to assist investors in understanding how audit committees oversee auditors and determining whether to ratify an audit committee's selection of an auditor.<sup>15</sup> Shortly thereafter, in May 2014, SEC Chair Mary Jo White stated in a speech that she had asked the SEC staff to consider whether improvements to the audit committee reporting requirements should be made.<sup>16</sup> She noted that investors were expressing interest in increased transparency into audit committee activities, given audit committees' critical role in financial reporting oversight, but that audit committee reporting requirements had not changed significantly in a number of years.

A report analyzing proxy statements filed by 80 Fortune 100 companies between 2012 and August 16, 2014 reported a significant increase in the disclosures made about the role and responsibilities of audit committees since 2012.<sup>17</sup> The report identifies the following voluntary expansions in audit committee reporting:

- Greater consolidation of audit-related disclosures.

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10. Securities Act Release No. 8220, "Standards Relating to Listed Company Audit Committees" (Apr. 9, 2003), *available at* <https://www.sec.gov/rules/final/33-8220.htm>.

11. Securities Act Release No. 8177, "Disclosure required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" (Jan. 23, 2003), *available at* <http://www.sec.gov/rules/final/33-8177.htm>.

12. Securities Act Release No. 8183, "Strengthening the Commission's Requirements Regarding Auditor Independence" (Jan. 28, 2003), *available at* <http://www.sec.gov/rules/final/33-8183.htm>.

13. SEC concept release, *supra* note 1, at 5. See Audit Committee Collaboration, "Enhancing the Audit Committee Report - A Call to Action" (Nov. 20, 2013). The report recommends that audit committees of public companies of all sizes and industries proactively strengthen their reporting because of the authors' view "that greater transparency about the audit committee's roles and responsibilities is one way of increasing investor confidence, and an opportunity to communicate more clearly to shareholders about audit committee-related activities." *Id.* at 2. The members of the collaboration are the following organizations: the National Association of Corporate Directors; Corporate Board Member/NYSE Euronext; Tapestry Networks; the Directors Council; the Association of Audit Committee Members, Inc.; and the Center for Audit Quality. The report is *available at* <http://thecaq.org/docs/audit-committees/enhancing-the-audit-committee-report-a-call-to-action.pdf?sfvrsn=2>.

14. In this regard, the SEC concept release notes that academic research is somewhat mixed as to the impact of auditor tenure on audit quality. SEC concept release, *supra* note 1, at 46.

15. Slide Presentation (PDF): Regarding Audit Committees at SEC Speaks 2014 (Feb. 22, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370540846980>.

16. Remarks at the Financial Accounting Foundation Trustees Dinner (May 20, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370541872065>.

17. E&Y Center for Board Matters, "Let's talk: governance – Audit committee reporting to shareholders 2014 proxy season update" (Aug. 2014), *available at* [http://www.ey.com/Publication/vwLUAssets/ey-lets-talk-governance-august-2014/\\$FILE/ey-lets-talk-governance-august-2014.pdf](http://www.ey.com/Publication/vwLUAssets/ey-lets-talk-governance-august-2014/$FILE/ey-lets-talk-governance-august-2014.pdf).

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- An increase in the provision of a link to the audit committee charter: 15% of companies provided such a link, more than twice the 6% level in 2012.
- Disclosures related to the audit committee's review and evaluation of auditors:
  - 65% of companies specified that the audit committee is responsible for the appointment, compensation, and oversight of the auditors, compared to 40% in 2012.
  - 46% of companies explicitly stated the audit committee's belief that their selection of the auditors is in the best interests of the company and/or shareholders, up from 4% in 2012.
  - 44% of companies disclosed that the audit committee was involved in the selection of the audit firm's lead engagement partner. In comparison, only 1% of companies did this in 2012.
  - 31% of companies explained the audit committee's rationale for appointing their auditors, including the factors used in assessing the auditors' quality and qualifications. Only 16% percent of companies did this in 2012.
  - 8% of companies disclosed the topics that the audit committee discussed with the auditors—beyond matters required to be discussed under regulatory rules.
- Disclosures related to the audit committee's authority to approve all audit engagement fees and terms:
  - 80% of companies noted that the audit committee considers nonaudit services and fees when assessing the independence of the auditors.
  - 19% of companies disclosed that the audit committee was involved in the auditors' fee negotiations, up significantly from just 1% in 2012.
  - 8% of companies' audit committees acknowledged a change in fees to the auditors and explained the circumstance for the change, doubling the percentage of companies that did so in 2012.
- Disclosures related to the tenure of their auditors:
  - Auditor tenure was disclosed by half of the audit committees of reviewed companies, an increase from 26% in 2012.
  - 28% of companies disclosed that the audit committee considers what would be the impact of rotating their auditors, up from 3% in 2012.

Consistent expanded disclosure is not being made, however, according to the SEC concept release.<sup>18</sup> In addition, the SEC's chief accountant noted in December 2014 that commenters on the PCAOB's projects related to disclosure of the names of the individual auditors involved in audits and the expansion of the auditors' report had suggested that audit committee reporting could be improved.<sup>19</sup>

## SEC CONCEPT RELEASE—"POSSIBLE REVISIONS TO AUDIT COMMITTEE DISCLOSURES"

Noting audit committees' "vital role in oversight of auditors," the SEC concept release suggests as follows:

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18. SEC concept release, *supra* note 1, at 18.

19. Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 8, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370543609306>.

The reporting of additional information by the audit committee with respect to its oversight of the auditor may provide useful information to investors as they evaluate the audit committee's performance in connection with, among other things, their vote for or against directors who are members of the audit committee, the ratification of the auditor, or their investment decisions.<sup>20</sup>

In addition, the SEC concept release points out that the additional information "may also enable investors to differentiate between companies based on the quality of audit committee oversight, and determine whether such differences in quality may contribute to differences in performance or quality of financial reporting among companies."<sup>21</sup>

As noted above, the SEC has asked questions in four primary areas: (1) the adequacy of the existing audit committee reporting requirements; (2) additional possible disclosures, including disclosures that would convey "how the audit committee executes its oversight" and not simply disclosures that such oversight was executed; (3) the location of any additional disclosures; and (4) the applicability of any additional disclosures to smaller reporting companies and emerging growth companies. In addition, the SEC asks 20 general questions about audit committee disclosures. There follows a summary of the SEC's principal questions.

## 1. Adequacy of Existing Audit Committee Reporting Requirements

The SEC's questions about the existing requirements relate primarily to whether the current audit committee reporting requirements provide useful information to investors and whether there should be any changes to these requirements to better inform investors about the role and responsibilities of audit committees, including removals of existing requirements or new required disclosures about different responsibilities of audit committees, such as their oversight of the financial reporting process or the internal audit function.

## 2. Additional Possible Disclosures

The SEC concept release explains that the additional possible disclosures would be intended to better inform investors about how an audit committee executes its responsibilities with respect to the appointment, compensation, retention, and oversight of the independent auditors' work and not just disclosures that such oversight was performed.

- Possible disclosures about an audit committee's oversight of an auditor include:
  - Additional information about communications between the audit committee and the auditors—
    - The SEC's questions in this area include whether its disclosure rules should require disclosure about the nature and substance of all of the communications between the audit committee and the auditor, and not just those required by PCAOB Auditing Standard No. 16.<sup>22</sup>
    - In addition, the SEC asked whether it should require additional qualitative disclosures about the actions that the audit committee took during the year to oversee the auditor and the audit or whether expanded disclosures could chill communications between the audit committee and the auditors. For example, the SEC notes the following:

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20. SEC concept release, *supra* note 1, at 5.

21. *Id.* at 19.

22. PCAOB Auditing Standard No. 16, "Communications with Audit Committees," available at [http://pcaobus.org/Standards/Auditing/Pages/Auditing\\_Standard\\_16.aspx](http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_16.aspx).

- the “disclosures could address, for instance, the nature of the audit committee’s communications with the auditor related to the auditor’s overall audit strategy, timing, significant risks identified, nature and extent of specialized skill used in the audit, planned use of other independent public accounting firms or other persons, planned use of internal audit, basis for determining that the auditor can serve as principal auditor, and results of the audit, among others, and how the audit committee considered these items in its oversight of the independent auditor”;<sup>23</sup>
  - the disclosures could include how the audit committee dealt with disagreements between management and the auditor; and
  - for audits with multiple locations, the disclosures could include how the audit committee considered in its oversight of the independent auditor “the scope of the audit, locations visited by the auditor, and the relative amount of account balances related to such locations compared to the consolidated financial statements.”<sup>24</sup>
- Disclosure about the frequency with which the audit committee met with the auditors—
    - The SEC asks whether additional disclosures should be required about the meetings between the audit committee and the auditors, including the frequency of private meetings with the auditors and the topics discussed.
  - Disclosure about the review of and discussion about the auditors’ internal quality review and most recent PCAOB inspection report—
    - Discussing some of the suggested questions in the PCAOB’s 2012 guidance related to its inspections,<sup>25</sup> the SEC asks whether disclosure should be required as to whether the audit committee had the type of discussion contemplated by the PCAOB’s guidance and whether such disclosure would be useful to investors.
    - The SEC asks whether it should require disclosure about how the audit committee considered any deficiencies in the PCAOB inspection report and how it considered the results of the inspection report in its oversight of the auditors.
    - Given that a portion of the PCAOB inspection report is not public, the SEC asks whether the confidentiality of the report could be undermined if the SEC disclosure rules required discussions about those reports.
  - Disclosure about whether and how the audit committee assesses, promotes, and reinforces the auditors’ objectivity and professional skepticism—
    - The SEC asks whether this type of disclosure would be useful.
- Possible disclosures about an audit committee’s process for appointing or retaining auditors:
    - Disclosure about how the audit committee assessed the auditors, including the auditors’ independence, objectivity, and audit quality and the audit committee’s rationale for selecting or retaining the auditors—

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23. SEC concept release, *supra* note 1. at 32.

24. *Id.*

25. See PCAOB Release No. 2012-003, Information for Audit Committees about the PCAOB Inspection Process (Aug. 1, 2012), available at [http://pcaobus.org/Inspections/Documents/Inspection\\_Information\\_for\\_Audit\\_Committees.pdf](http://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf).

- The SEC suggests that the disclosure could include the steps involved in the process to assess the auditor, including the specific elements or criteria the audit committee considered and the way in which the auditors' compensation was determined and evaluated.
- Referencing the PCAOB July 1 concept release on audit quality indicators and other publications,<sup>26</sup> the SEC asks whether disclosure about the ways in which the audit committee assessed audit quality, such as by using metrics and other indicators, should be required because it could provide useful information about the audit committee's process for assessing the auditors and determining whether to select or retain the auditors.
- Disclosure about the process the audit committee undertook, if any, to seek proposals for the independent audit, including factors considered in selecting the accounting firm—
  - The SEC suggests that the additional disclosure could include the number of auditors that were asked to make proposals, information about how those auditors were selected, and the information that the audit committee used in its decision.
  - The SEC asks for suggestions as to appropriate disclosures in this area and asks whether disclosure should be required as to whether the audit committee has a policy to seek proposals.
- Disclosure of any board of directors' policy to seek annual shareholder approval of the selection of the independent auditors and the audit committee's evaluation of the results of such a vote, particularly given that companies voluntarily seek shareholder ratification of the appointment of the auditors—
  - The SEC asks whether it should require disclosure of the factors that the board considered in establishing any such policy.
  - The SEC asks whether the audit committee should explain why it determined to retain the auditors if a significant number of votes opposed the auditor ratification proposal.
  - The SEC asks whether the vote on the ratification of the selection of the auditors should continue to be a "routine matter" with respect to which brokers have discretionary voting authority under New York Stock Exchange Rule 452.<sup>27</sup>
- Possible disclosures related to the qualifications of the independent auditors and certain members of the engagement team:
  - Disclosures of certain individuals on the engagement team—
    - Referencing the PCAOB's proposal to require naming the engagement partner in the auditors' report,<sup>28</sup> the SEC suggests that disclosure could be required of the name of the engagement partner, and possible other key members of the engagement team, such as the engagement quality

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26. SEC concept release, *supra* note 1 at footnote 96.

27. See New York Stock Exchange General Rules, Rule 452, available at [http://nyserules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp\\_1\\_2&manual=/nyse/rules/nyse-rules/](http://nyserules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_2&manual=/nyse/rules/nyse-rules/).

28. PCAOB Release No. 2013-009, "Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit" (Dec. 4, 2013) (hereinafter referred to as "PCAOB transparency project"), available at <http://pcaobus.org/Rules/Rulemaking/Docket029/PCAOB%20Release%20No%20%202013-009%20-%20Transparency.pdf>.



reviewer, the length of time such individual(s) have served in that role, and the relevant experience of the participants in the audit.

- The SEC asks whether such disclosure should be in the auditors' report, despite the fact that the PCAOB received comments pointing out the challenges with that location, and asks why or why not.<sup>29</sup> In addition, the SEC asks whether the disclosure should be in the audit committee's report even if it is also in the auditors' report or in a supplemental filing with the PCAOB.
- The SEC asks whether there should be disclosure about any known change in the participants in the audit for the upcoming year's audit and asks whether disclosure about that change should be made sooner than in the next proxy statement.
- Disclosure about the audit committee's involvement in the selection of the audit engagement partner—
  - The SEC suggests that disclosure about the involvement of the audit committee in the selection of the engagement partner may provide transparency and insight into the way the audit committee oversees the auditors.
  - The SEC asks whether the audit committee should be required to disclose what it considered in providing input to the selection of the engagement partner and any details about the audit committee's input.
- Disclosure of the number of years the auditors have audited the company—
  - The SEC suggests that disclosure about the audit committee's assessment of the auditors' tenure with the company might provide insight into the audit committee's overall decision to engage or retain the auditors.
  - The SEC asks whether the audit committee's report should address the auditors' tenure and how the audit committee considered tenure in deciding to retain the auditors or whether auditor tenure would more appropriately be disclosed in the auditors' report or in a form filed with the PCAOB.
- Disclosure about other firms involved in the audit—
  - Noting that PCAOB Auditing Standard No. 16 requires auditors to discuss with the audit committee the involvement in the audit of other accounting firms and other persons involved in the audit, the SEC asks whether it should require disclosure of the names of such other persons involved in the audit and the extent of such involvement and whether that disclosure should be in the auditors' report or in the audit committee's report or somewhere else.<sup>30</sup>

### 3. Location of Audit Committee Disclosures in SEC Filings

The SEC requests comment on where audit committee disclosures should be set forth, whether they should be in one location, and whether they should also be included in registration statements filed for initial public offerings and other securities offerings. In addition, the SEC asks whether, if adopted, the additional possible disclosures discussed in the concept release should be included in the audit committee

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29. Commenters on the PCAOB transparency project noted concerns about liability under section 11 of the Securities Act, as discussed below in the text accompanying footnote 33, and whether such risk of liability would differ depending on where the disclosure is made. SEC concept release, *supra* note 1, at 45.

30. We note that disclosure of the identities of other participants in an audit is also addressed in the PCAOB supplemental request.

report, a separate section of the proxy statement, the annual report, a company's website, or somewhere else.

## 4. Smaller Reporting Companies and Emerging Growth Companies

The SEC asks whether the current audit committee disclosure requirements should be changed for smaller reporting companies or emerging growth companies and whether any additional disclosures should be required for smaller reporting companies or emerging growth companies.

## 5. Additional Questions

A fundamental question the SEC asks is whether it should amend its disclosure rules to require expanded disclosures by audit committees or whether such expanded disclosures should continue to be voluntary. Among the 19 additional general questions that the SEC asks in the concept release are the following: whether any of the disclosures would “prompt the audit committee to change how it oversees the auditor”; whether they would “promote audit quality”; whether any of the additional disclosures should be updated between proxy statements; whether any new disclosures should be in interactive data format; whether adoption of expanded disclosure rules might have unintended consequences, such as to chill or overly formalize audit committee communications with auditors or raise liability implications; and how the SEC should “address potential changes in the auditors’ report with respect to audit committee oversight of the auditor.”<sup>31</sup>

## PCAOB SUPPLEMENTAL REQUEST RELATED TO DISCLOSURE ABOUT AUDIT PARTICIPANTS

The PCAOB supplemental request supplements its 2013 release in which it repropose amendments to require disclosure in the auditors’ report of the name of the engagement partner and the names, locations, and extent of participation in the audit of other accounting firms and other persons not employed by the auditors that took part in the audit.<sup>32</sup> As generally noted above, the 2013 proposal generated adverse comment from commenters, who argued that, if adopted, the identification in the auditors’ report of participants in the audit “could create both legal and practical issues under the federal securities laws by increasing the named parties’ potential liability and by requiring their consent if the auditors’ reports naming them were included in, or incorporated by reference into, registration statements under the Securities Act of 1933” and by increasing the likelihood that the identified persons would be subject to litigation.<sup>33</sup>

The PCAOB supplemental request addresses these comments by proposing that the disclosure be included in a new PCAOB form (Form AP—“Auditor Reporting of Certain Audit Participants”) that would be filed by an accounting firm within 30 days after the date on which the auditors’ report<sup>34</sup> is first included in a document filed with the SEC except that, for an initial public offering, the form would be required to be filed within 10 days after the registration statement is first filed so that the information is available before any road show for the initial public offering. The Form AP would need to be amended to correct any error in the report, but a new Form AP would be required whenever an auditors’ report is filed, even if the auditors’ report is reissued and dual-dated.<sup>35</sup> The new form would be publicly accessible on the PCAOB’s

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31. SEC concept release, *supra* note 1, at 51-54 (see Questions 57, 59, 64, 65, 69, and 71).

32. PCAOB transparency project, *supra* note 28. The 2013 reproposal followed an initial proposal in 2011 that would have required disclosure in the auditors’ report of the name of the engagement partner. That proposal was made in response to the concerns related to liability made with respect to the PCAOB’s 2009 concept release in which the PCAOB sought comment on whether the engagement partner should be required to sign the auditors’ report.

33. PCAOB supplemental request, *supra* note 2, at 4.

34. The proposal would not apply to auditors’ reports on interim reviews. *Id.* at 8.

35. *Id.* at 9.

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website and searchable by the name of the engagement partner and by the name of the company. The PCAOB supplemental request includes proposed amendments that would enable auditors to also include the disclosure in their auditors' reports.

An accounting firm would identify itself, the issuer, and the date of its report in the Form AP, as well as identifying the following:

- The name of the engagement partner;
- The name(s) of any other public accounting firm that performed 5% or more of the total number of hours involved in the audit and the percentage of total audit hours performed by such other public accounting firm, either as a single number or the percentage range of the total audit hours (such as between 5% and less than 10%, 10% to less than 20%, and additional ranges in 10% increments, up to 100%); and
- The number of other public accounting firms that individually performed less than 5% of the total audit hours and the aggregate percentage of the audit work performed by such group of public accounting firms, as either a single number or the percentage range of total audit hours, beginning with less than 5% of total audit hours, then 5% to less than 10% of total audit hours, and additional ranges in 10% increments.

In addition, Form AP would require certain information about another accounting firm that has divided responsibility with the independent auditors for the audit, including the magnitude of the portion of the financial statements audited by the other auditor.

Unlike the 2013 proposal, the PCAOB supplemental request does not propose to require disclosure about nonaccounting firm participants in the audit. Instead, the PCAOB notes that it is "reexamining the proposed requirements to disclose information about nonaccounting firm participants and engaged specialists."<sup>36</sup> The PCAOB notes that it is considering whether disclosure about nonaccounting firm participants should be required when the auditors are required to supervise persons who are not in accounting firms or entities controlled by the auditors.

The PCAOB supplemental request notes, among other things, that the disclosure of the name of the engagement partner and information about other participants in the audit could assist investors and other financial statement users in evaluating audit quality and "influence" and enhance their investment and voting decision-making. In addition, the PCAOB suggests that the disclosure may enhance audit quality,<sup>37</sup> "should reduce the level of information asymmetry about audit quality between company management and investors,"<sup>38</sup> and may affect the way audit committees select the independent auditors.<sup>39</sup>

Disclosure to investors and shareholders about audit quality and the performance of audit committees may not be within the jurisdiction of the PCAOB, however. It is the SEC that has the responsibility for appropriate disclosure requirements. In addition, as noted earlier, the 2013 proposal generated some comments that the disclosure of the name of the engagement partner and other participants in the audit should be included in the report of a company's audit committee rather than in the auditors' report or in a PCAOB form. Accordingly, it seems to us that commenters may want to comment on whether the SEC rather than the PCAOB should be the entity that considers the need for disclosure of the name of the engagement partner and information about certain other participants in the audit in response to the

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36. *Id.* at 10.

37. *Id.* at A2-3 and A2-13.

38. *Id.* at A2-6.

39. *Id.*

PCAOB's question whether "disclosure on Form AP [would] achieve the same potential benefits of transparency and an increased sense of accountability as mandatory disclosure in an auditor's report."<sup>40</sup>

## PCAOB CONCEPT RELEASE

The PCAOB concept release on audit quality indicators reflects more than two years of work by the PCAOB's Office of Research and Analysis and others, three discussions of the PCAOB and its staff with the PCAOB's Standing Advisory Committee, and numerous other meetings with a range of persons, including audit committee members, accounting firms, academics, and SEC staff. The project is consistent with the PCAOB's responsibilities under Sarbanes-Oxley directed at improving audit quality and addresses the 2008 recommendation of the US Department of the Treasury's Advisory Committee on the Auditing Profession that the PCAOB consider developing key indicators of audit quality.<sup>41</sup> The concept release notes the following goal of the project to develop AQIs:

The goal of the AQI project is to improve the ability of persons to evaluate the quality of audits in which they are involved or on which they rely and to enhance discussions among interested parties; use of the indicators may also stimulate competition by audit firms based on quality.<sup>42</sup>

In addition, the concept release observes the following:

The indicators can also have two broader effects. First, comparative information about audit firms may over time help to drive a more vibrant "market in quality" for audit services and stimulate competition among audit firms on that basis and may counter pressures on audit firms to reduce audit effort or resources inappropriately; both consequences may enhance audit quality across the profession. Second, as the project evolves, the potential availability of AQI information may help investors become better able to evaluate the audit quality associated with particular financial statements, with a consequent effect on investment decisions.<sup>43</sup>

In developing AQIs, the PCAOB focused on trying to identify measures that meet the following three principles: (1) they are quantitative, to the extent possible, to "add consistency of approach and objectivity" to what otherwise is a very subjective analysis; (2) they generate data that enable users to ask critical questions; and (3) they "function together as a 'balanced portfolio' of audit quality."<sup>44</sup> The concept release identifies 28 potential audit quality indicators that include some measures based on tools that the PCAOB believes audit committee members now use as well as measures that the PCAOB has used in its oversight of the accounting profession. The AQIs are grouped into three categories: (1) AQIs related to the audit professionals, (2) AQIs related to the audit process, and (3) AQIs related to the audit results.

There follows a summary of the AQIs, which are intended to generate, in most cases, information on both a firm level as well as on the audit engagement level.

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40. *Id.* at 16.

41. US Department of the Treasury, Final Report of the Advisory Committee on the Auditing Profession (Final Report), Chapter VIII, Recommendation 3, at VIII:14-15 (2008), available at <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>.

42. PCAOB concept release, *supra* note 3, at 4.

43. *Id.* at 8.

44. *Id.* at 7.

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## Audit Professionals

- Availability, which encompasses the following:
  - Staffing leverage
  - Partner workload
  - Manager and staff workload
  - Technical accounting and auditing resources
  - Persons with specialized skill and knowledge
- Competence, which encompasses the following:
  - Experience of audit personnel
  - Industry expertise of audit personnel
  - Turnover of audit personnel
  - Amount of audit work centralized at service centers
  - Training hours per audit professional
- Focus, which encompasses the following:
  - Audit hours and risk areas
  - Allocation of audit hours to phases of the audit

## Audit Process

- Tone at the top and leadership, which encompass the following:
  - Results of independent survey of firm personnel
- Incentives, which encompass the following:
  - Quality ratings and compensation
  - Audit fees, effort, and client risk
- Independence, which encompasses the following:
  - Measurement of elements of a firm's training and monitoring programs related to compliance with the independence requirements
- Infrastructure, which encompasses the following:
  - Investment in infrastructure supporting quality auditing
- Monitoring and remediation, which encompass the following:
  - Audit firms' internal quality review results
  - PCAOB inspection results
  - Technical competency testing

## Audit Results

- Financial statements, which encompass the following:
  - Frequency and impact of restatements of financial statements for errors

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- Fraud and other financial reporting misconduct
- Determine whether and, if so, which measures of financial reporting quality used by investment analysts, academics and regulators can be used as measures of audit quality
- Internal control, which encompasses the following:
  - Timely reporting of internal control weaknesses
- Going concern, which encompasses the following:
  - Timely reporting of going concern issues
- Communications between auditors and audit committees, which encompass the following:
  - Results of independent surveys of audit committee members
- Enforcement and litigation, which encompass the following:
  - Trends in PCAOB and SEC enforcement proceedings
  - Trends in private litigation

The PCAOB concept release states that four categories of persons are potential users of AQIs: audit committees, audit firms, investors, and the PCAOB and other regulators. The PCAOB suggests the following ways in which such persons can use AQIs:<sup>45</sup>

Potential AQI User	Potential Use (Decisions AQIs Can Influence)
Audit Committees	<ul style="list-style-type: none"> <li>● Assess reporting risk and audit quality</li> <li>● Retain and compensate auditors</li> <li>● Oversee auditors</li> </ul>
Audit Firms	<ul style="list-style-type: none"> <li>● Assess and manage risk</li> <li>● Improve quality control efforts and, ultimately, audit quality</li> <li>● Identify root causes of audit deficiencies and remediate weaknesses</li> </ul>
Investors	<ul style="list-style-type: none"> <li>● Assess reporting risk</li> <li>● Vote shares</li> </ul>

45. *Id.* at 18.

PCAOB (and other regulators)	<ul style="list-style-type: none"><li>• Inform policymaking</li><li>• Assist root cause and quality control projects</li><li>• Stimulate public discussion of, and market demand for, quality</li></ul>
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The PCAOB notes that investors could only use AQI information “if, when, and to the extent that information is made publicly available” and adds that “of course use of AQI data by audit committees to produce higher quality audits can benefit investors in the companies involved.”<sup>46</sup>

Several of the PCAOB’s questions in the concept release relate to who the potential users of AQIs might be and whether AQI data should be available to the public as well as how and by whom the AQI data should be made available to such users. Whether investors could really evaluate the quality of audits based on the AQIs is a significant issue that commenters are likely to address. One question that the SEC and PCAOB have so far not asked but certainly could once the PCAOB’s AQI project is completed is whether the audit committee report should address AQIs when discussing the committee’s evaluation of the auditors’ performance or compensation or when explaining why the committee determined to retain or engage auditors.

## CONCLUSION

Many of the potential additional disclosures discussed by the SEC in the SEC concept release, including those contemplated by the PCAOB in the supplemental request, relate to considerations that audit committees take into account in overseeing auditors. The PCAOB’s project to develop AQIs also relates to audit committees’ oversight activities.

We believe that comment from all participants involved in public company audit and related disclosure processes will be crucial to the regulators’ effective resolution of the issues raised by the releases. An open-minded, fulsome and constructive comment process will be necessary to properly balance the need for audit committees to have complete and candid discussions and to exercise judgment about complex issues with investor calls for more useful information about audit committees and auditors and the work they do.

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46. *Id.* at footnote 22.

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