Corporate Law and Practice
Course Handbook Series

Audit Committees and Financial Reporting 2017:
Recent Developments and Current Issues

Co-Chairs
Catherine L. Bromilow
Linda L. Griggs
John F. Olson

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Number B-2334

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Prepared for distribution at the
AUDIT COMMITTEES AND FINANCIAL REPORTING 2017:
RECENT DEVELOPMENTS AND CURRENT ISSUES
Program
New York City, June 12, 2017

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Governance Insights Center PwC

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Governance Insights Center PwC

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Gibson, Dunn & Crutcher LLP

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Program Attorney: Willis Goodmoore

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Audit Committees and Financial Reporting 2017:
Recent Developments and Current Issues
June 12, 2017
New York City

AGENDA

Morning Session:

9:00
Opening Remarks and Introduction
Catherine L. Bromilow, Linda L. Griggs, John F. Olson

9:15
SEC Developments Audit Committee Members Need to Know About
- Impact of the change in Administration
- Status of Dodd-Frank based rulemaking
- What the SEC expects in today's MD&A and CD&A
- Current SEC financial reporting concerns – including internal controls
- Recurring issues identified in SEC reviews
- Disclosure Effectiveness project – will it proceed? What direction will it take?

Moderator: John F. Olson
Speakers: Wesley R. Bricker, Linda L. Griggs,
Michael J. Gallagher, Joseph B. Ucuzoglu

10:15
PCAOB Developments: What's Happening in the Auditing Arena?
- Concerns raised in audit firm inspections and what audit committees should do about them
- PCAOB outreach to audit committees and effectiveness of communications between auditors and audit committees
- Changes in the content and format of the audit opinion
- Auditor reporting on Form AP
- Going concern and other research topics
- Challenging audit issues

Moderator: Linda L. Griggs
Speakers: Michael J. Gallagher, Jeanette M. Franzel,
Joseph B. Ucuzoglu

11:15 Networking Break

11:30

Evolving Expectations for Audit Committees, Including Audit Committee and Company Communications

- SEC concerns about audit committee focus
- Audit Committee oversight of non-GAAP financial disclosures, internal control over financial reporting and new accounting standards
- Audit committee reporting
- Audit Committees as “gatekeepers”: SEC enforcement actions

Moderator: Linda L. Griggs

Speakers: Jeanette M. Franzel, Joseph B. Ucuzoglu

12:30 Lunch

Afternoon Session:

1:45

Financial Reporting Developments: What Audit Committees Need to Know

- Revenue recognition – what companies should be doing now
- Key FASB projects: Disclosure Framework and Materiality, Leasing, Financial Instruments
- Emerging Issues Task Force developments
- Private company accounting standard-setting

Moderator: Catherine L. Bromilow

Speakers: Wesley R. Bricker, Linda L. Griggs

2:45 Networking Break

3:00

Risk Management & Compliance: What Audit Committees Need to Know

- Audit committee involvement in overseeing risk management
- Addressing the unanticipated (cheap oil, etc) – impact on risk management processes
- Continuing focus on FCPA enforcement
- Crisis management
- Cybersecurity

Moderator: Catherine L. Bromilow

Speakers: Honorable Mary K. Bush (Invited), Karen R. Osar, Debra Wong Yang

4:00

Evolving Ethical and Liability Challenges for Audit Committee Advisors: 2017 Edition

- The SEC goes after lawyers and auditors as "gatekeepers": recent enforcement actions
- SEC reporting up rules and conflicting ethical obligations
- When should a lawyer or auditor resign and should it be "noisy"?
- Common pitfalls: How in-house and outside legal advisors get into trouble

Moderator: John F. Olson

Speakers: Peter J. Beshar, Debra Wong Yang, Michael R. Young

5:00 Adjourn

Faculty:

Co-Chairs:

Catherine L. Bromilow
Partner
Center for Board Governance
PwC
Florham Park, NJ

Linda L. Griggs
Consultant
Washington, D.C.

John F. Olson
Gibson, Dunn & Crutcher LLP
Washington, D.C.

Peter J. Beshar
Executive Vice President and General Counsel
Marsh & McLennan Companies, Inc.
New York City

Wesley R. Bricker
Deputy Chief Accountant
Office of Chief Accountant
United States Securities and Exchange Commission
Washington, D.C.

Jeanette M. Franzel
Board Member
Public Company Accounting Oversight Board (PCAOB)
Washington, D.C.

Michael J. Gallagher
Managing Partner, Assurance Quality & Transformation
PwC
New York City

Karen R. Osar
Corporate Director
Naples, FL

Joseph B. Ucuzoglu
Deloitte LLP
National Managing Partner, Government, Regulatory and
Professional Matters
Washington, D.C.

Debra Wong Yang
Gibson, Dunn & Crutcher LLP
Los Angeles

Michael R. Young
Willkie Farr & Gallagher LLP
New York City

Program Attorney: Willis Goodmoore

Faculty Bios

Catherine Bromilow
PwC's Governance Insights Center
400 Campus Drive
Florham Park, NJ 07932
Tel: 973.236.4120
catherine.bromilow@pwc.com

Catherine is a partner in PwC's Governance Insights Center. She helps boards and audit committees apply leading practices and understand the impact of emerging regulations on their activities. She has worked extensively with boards and directors from a number of countries, including the Bahamas, Barbados, Bermuda, Brazil, Canada, Chile, the Dominican Republic, India, Israel, Japan, Mexico, South Africa, the United States, and Venezuela.

Catherine developed many of the governance publications that PwC has issued: Audit Committee Effectiveness — What Works Best; Board Effectiveness — What Works Best; Governance for Companies Going Public — What Works Best; Going Public? Five Governance Factors to Focus On; Director Dialogue with Shareholders — What You Need to Consider; and PwC's Family Business Corporate Governance Series. She also contributed to PwC's Audit Committee Excellence Series, which focuses on leading practices on specific topics. NACD Directorship magazine in 2015 named her for the ninth consecutive year as one of the 100 most influential people in corporate governance in the United States. She also speaks frequently at director conferences.

Catherine is a Certified Public Accountant (licensed in New Jersey) and a Chartered Professional Accountant, CPA, CA (from Canada). She holds a Master of Accounting degree from the University of Waterloo in Canada.

Linda L. Griggs
Morgan Lewis & Bockius LLP
1111 Pennsylvania Avenue NW
Washington, D.C. 20004
202.739.5245
lgriggs@morganlewis.com

Linda L. Griggs is a partner in Morgan Lewis's Corporate Business Transactions practice. Ms. Griggs's practice focuses on securities regulatory matters, including financial reporting and accounting and other disclosure requirements under the securities laws and public and private securities offerings. Ms. Griggs also handles corporate law matters, including advising with respect to the fiduciary duties of directors and corporate governance matters.

In August 2013, Ms. Griggs was appointed to serve on the Financial Accounting Standards Advisory Council (FASAC) by the Board of Trustees of the Financial Accounting Foundation. FASAC is responsible for advising the Financial Accounting Standards Board on strategic issues, project priorities, and other matters that affect accounting standards. Ms. Griggs served on the SEC's Advisory Committee on Improvements to Financial Reporting, which submitted its final report and recommendations to the SEC in August 2008. Before joining Morgan Lewis, Ms. Griggs served as chief counsel to the chief accountant of the SEC for five years. Prior to that, she worked in the Division of Corporation Finance at the SEC as a special counsel, as an attorney in the Division's rule-writing office, and as a reviewer of registration statements, proxy statements and reports filed by companies covered by federal securities laws.

Ms. Griggs is admitted to practice in the District of Columbia.

John F. Olson
Gibson, Dunn & Crutcher LLP
1050 Connecticut Avenue, N.W.
Washington, DC 20036-5306
Tel: 202.955.8522
jolson@gibsondunn.com

John F. Olson is a founding partner of Gibson, Dunn & Crutcher's Washington, D.C. office. Mr. Olson represents business organizations in corporate governance, corporate securities, corporate finance and merger and acquisition matters. He has acted as special counsel for boards of directors and board committees on governance issues and in assessing shareholder litigation, responding to business combination proposals and conducting internal investigations. He has represented corporations, broker-dealer firms and individuals in Securities and Exchange Commission and other federal agency investigations and regulatory matters.

Mr. Olson has chaired the American Bar Association (ABA) Business Law Section Corporate Governance and Federal Regulation of Securities Committees, and has served for many years on the Corporate Laws Committee. He has also served, by appointment of the ABA President, on the Presidential Task Force on Corporate Responsibility and the ABA's Standing Committee on Government Affairs. He is a member of the Executive Council of the Securities Section of the Federal Bar Association and is Chair of the Board of Trustees of the American College of Governance Counsel.

Mr. Olson is frequently recognized as one of the nation's foremost authorities on securities, corporate governance and mergers and acquisitions law. He is ranked as one of the top securities regulation attorneys in the country by Chambers USA, has been named by the International Financial Law Review as a Leading Lawyer in U.S. Mergers & Acquisitions and by Who's Who Legal as one of the leading corporate governance practitioners in the world. Mr. Olson was named the Washington, DC Corporate Law Lawyer of the Year for 2013 and the Washington, DC Corporate Governance Law Lawyer of the Year for 2012 by The Best Lawyers in America®. Additionally, Best Lawyers has listed Mr. Olson for his corporate, securities, and governance work in every edition published since its inception more than 30 years ago. Annually, Mr. Olson has been selected by the National Association of Corporate Directors and Directorship magazine to its NACD Directorship 100: The Most Influential People in the Boardroom and Corporate Governance Community, in the U.S. and in 2013 was elected to the NACD Directorship Corporate Governance Hall of Fame.

The author and editor of many books and articles on legal issues, Mr. Olson is a Distinguished Visitor from Practice at Georgetown University Law Center.

Peter J. Beshar

Marsh & McLennan Companies, Inc.

1166 Avenue of the Americas
New York, NY 10036
Telephone: (212) 345-1071
peter.beshar@mmc.com
twitter:@pbeshar

Peter J. Beshar serves as the Executive Vice President and General Counsel of the Marsh & McLennan Companies. MMC, which has 60,000 employees worldwide and a market capitalization over $35 billion, operates through four leading brands: Marsh, Mercer, Guy Carpenter and Oliver Wyman. Mr. Beshar supervises the Company's Legal, Compliance, Government Relations and Risk Management Departments.

Prior to joining Marsh & McLennan in 2004, Mr. Beshar was a litigation partner at Gibson, Dunn & Crutcher LLP where he served as Co-Chair of the firm's Securities Litigation Group. Mr. Beshar joined Gibson Dunn in 1995 after serving as the Assistant Attorney General in charge of the New York State Attorney General's Task Force on Illegal Firearms. In 1992 and 1993, Mr. Beshar served as the Special Assistant to the Honorable Cyrus Vance in connection with the United Nations' peace negotiations in the former Yugoslavia.

Mr. Beshar is the recipient of the Business Leadership Award from the Citizens Union of New York, the Burton Award for Leadership in the Law, and the Law and Society Award from New York Lawyers for the Public Interest. In 2015, Mr. Beshar was appointed by President Obama as a trustee of the Woodrow Wilson Center for International Scholars in Washington and by Governor Cuomo as a director of the Empire State Development Corporation. Mr. Beshar serves as a Trustee and Chair of the Veterans' Committee of John Jay College for Criminal Justice and is a board member of the Jackson Institute for Global Affairs at Yale University. Mr. Beshar was selected as a David Rockefeller Fellow by the Partnership for the City of New York. Mr. Beshar has testified multiple times before Congress on topics ranging from cybersecurity to terrorism.

Mr. Beshar graduated from Yale University and Harvard Law School.

Wesley Bricker
U.S. Securities & Exchange

Mr. Bricker is the Chief Accountant for the U.S. Securities and Exchange Commission. In the role, he serves as the principal advisor to the SEC on accounting and auditing matters. He consults with registrants, auditors and other industry representatives, and is responsible for the oversight of the Financial Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB), among the other duties of the Chief Accountant.

Mr. Bricker joined the SEC from PricewaterhouseCoopers LLP, where he was a partner responsible for clients in the banking, capital markets, financial technology, and investment management sectors.

Earlier, he served as a professional accounting fellow in Office of the Chief Accountant and prior to that held various audit and professional practice positions at PwC, including in the firm's national office during the global financial crisis advising on complex financial accounting matters.

Mr. Bricker is trained as an accountant and lawyer with degrees from Elizabethtown College and the American University Washington College of Law. He is licensed to practice as a certified public accountant in Virginia, Maryland, the District of Columbia, Pennsylvania, and New Jersey and as an attorney in New York.

Jeanette Franzel

PCAOB Board Member
franzelj@pcaobus.org

Jeanette M. Franzel is a Board Member of the Public Company Accounting Oversight Board (PCAOB). PCAOB's mission is to oversee the audits of public companies and brokers and dealers to protect investors and further the public interest.

Board Member Franzel brings extensive audit experience to the PCAOB after a distinguished career at the U.S. Government Accountability Office (GAO). She ended her tenure as Managing Director, overseeing all aspects of GAO's financial audits of the U.S. federal government. From 2008 through 2011, Ms. Franzel's team provided oversight of the U.S. government's efforts to stabilize the financial markets and promote economic recovery.

Earlier in her career, Ms. Franzel audited the federal government's actions to resolve over one thousand failed banks and savings and loan institutions.

Ms. Franzel has testified before congressional committees more than a dozen times.

Ms. Franzel holds the following professional certifications: CPA, CIA, CMA and CGFM.

Michael J. Gallagher

PricewaterhouseCoopers LLP

300 Madison Avenue
New York, NY
Tel: 646-471-6331
michael.j.gallagher@pwc.com

As PwC's Managing Partner, Assurance Quality, Mike leads PwC's U.S. Assurance National Office (National Office). National Office functions include: Accounting Services; SEC Services; Risk Management; Strategic Thought Leadership; and Auditing Services Methods and Tools. He is also responsible for PwC's Learning & Development, Regulatory Relations, and Inspections groups.

Mike has more than 30 years of public accounting experience. His previous National Office roles and leadership positions include serving as: PwC's U.S. Chief Accountant; U.S. Risk Management Leader; and National Office Accounting Consulting Partner. Prior to joining the National Office, he served as a Global Engagement Partner on a number of multinational SEC registrants focused primarily in the chemical/industrial products sector.

Mike served on PwC's US Board of Partners and Principals, including the Finance, Governance, and Clients and Strategy committees.

Mike is a member of The Center for Audit Quality's (CAQ) Professional Practice Executive Committee (PPEC). He Chaired the PPEC from 2011 to 2016. Mike was a member of the Public Company Accounting Oversight Board's (PCAOB) Standing Advisory Group (SAG) from 2010 to 2016. He is also a frequent speaker at profession related events and a member of the AICPA and Pennsylvania Institute of CPAs.

Joseph B. Ucuzoglu
Chairman and CEO
Deloitte & Touche LLP
555 12th Street NW
Washington D.C. 20004
+1.202.879.3109
jucuzoglu@deloitte.com

Joe Ucuzoglu is the chairman and chief executive officer of Deloitte & Touche LLP. As the leader of the US audit practice, Joe is responsible for overseeing all aspects of the organization including execution of our quality, innovation, growth, and talent strategies. He maintains significant audit client responsibilities, serving as the advisory partner for selected client engagements, and is a frequent speaker on issues impacting the audit profession and regulatory landscape. Joe also serves on Deloitte's Global Board of Directors.

Recognized as a leader in the public accounting profession's drive to continuously improve audit quality, Deloitte has more than 2,700 US audit clients. Deloitte's public company audit clients total over $6.5 trillion in market capitalization and include 23 percent of Fortune 1000 companies.

Previously, Joe was Deloitte's national managing partner for government, regulatory, and professional matters. In this role, he was responsible for Deloitte's interactions with regulators and elected officials as well as overseeing the government affairs, public policy, independence, and ethics functions. Prior to rejoining Deloitte, Joe served as senior advisor to the chief accountant at the Securities and Exchange Commission (SEC), advising on complex accounting, auditing, and public policy matters, and interacting frequently with other governmental agencies and Congress.

Joe is a graduate of the University of Southern California (USC). He serves on the board of directors of the US Chamber of Commerce, the board of advisors of the SEC Historical Society, and the executive committee of USC's SEC Financial Reporting Institute. He is a member of the Committee on Capital Markets Regulation, an independent research organization dedicated to enhancing the competitiveness of US capital markets and ensuring stability of the US financial system, and is active in the Center for Audit Quality, an autonomous group devoted to fostering high-quality performance by public company auditors.

Debra Wong Yang
Gibson, Dunn & Crutcher LLP
dwongyang@gibsondunn.com
T: +1 213.229.7472
F: +1 213.229.6472
Los Angeles Office
333 South Grand Avenue
Los Angeles, CA 90071-3197, USA

Debra Wong Yang is a partner in Gibson, Dunn & Crutcher's Los Angeles office. She is Co-Chair of the firm's Crisis Management Practice Group, the White Collar Defense and Investigations Practice Group and the Privacy, Cybersecurity, and Consumer Protection Practice Group. She is a member of the Media and Entertainment and Intellectual Property Practice Groups. Ms. Yang was also a member of the firm's Executive Committee and Management Committee.

Ms. Yang's practice specializes in corporate crime and compliance. She served as a DOJ-appointed Monitor over an orthopedic manufacturing company with health care compliance and regulatory issues. She has also represented companies and boards in internal investigations, compliance matters, and criminal investigations. In addition, Ms. Yang has provided advice on matters relating to FCPA, trade secrets, and cyber/data intrusions. She has overseen teams of attorneys conducting internal investigations and has reviewed compliance programs in a variety of industries. She has also managed matters in the crisis arena relating to recalled products, health care and insurance.

Ms. Yang has led investigative and monitoring teams of attorneys in foreign countries. She has managed data transfers, negotiated interviews of witnesses in Asian languages, and overseen extensive reviews for management or Audit Committees. She has extensive experience conducting compliance reviews in Asia in the areas of industrial manufacturing, energy, health care, and entertainment.

Ms. Yang received her Juris Doctorate in 1985 from Boston College Law School and served as a law clerk to the Honorable Ronald S.W. Lew in the U.S. District Court for the Central District of California.

Michael R. Young

Willkie Farr & Gallagher LLP

787 Seventh Avenue
New York, NY 10019-6099
212-728-8280
myoung@willkie.com

Named by *Accounting Today* as one of the "top 100 most influential people in accounting," Michael R. Young is a litigation partner at New York's Willkie Farr & Gallagher LLP where he chairs the firm's securities litigation practice.

His practice concentrates on the representation of companies, audit committees, officers, directors, accounting firms, and investment banks in United States and international securities class actions, SEC proceedings, and special committee investigations. His trial work includes the landmark jury verdict for the defense in the first class action tried to a jury pursuant to the Private Securities Litigation Reform Act of 1995. He has served as a member of FASB's Financial Accounting Standards Advisory Council, as chair of the New York City Bar Association's Financial Reporting Committee, and as counsel to the American Institute of Certified Public Accountants and the Center for Audit Quality.

A prolific author on the subjects of financial reporting, audit committee effectiveness and the role and responsibilities of the independent auditor, Mr. Young's books include *The Financial Reporting Handbook* (Wolters Kluwer 2003), *Accounting Irregularities and Financial Fraud* (Harcourt 2000) and, most recently, *Financial Fraud Prevention and Detection: Governance and Effective Practices* (Wiley 2014). Mr. Young is a much sought speaker and commentator on financial reporting issues, and has been regularly quoted in such publications as *The Wall Street Journal*, *The New York Times*, *Fortune*, *Forbes*, *USA Today*, *The Washington Post*, and *The National Law Journal*. He has also appeared as an invited guest on Fox Business News, CNBC, MSNBC, CNN, and BNN (Canada).

Mr. Young is a graduate of Allegheny College and the Duke University School of Law, where he was Research and Managing Editor of the *Duke Law Journal*.

1

SEC Developments Audit Committee Members Need to Know About

Submitted by:
John F. Olson

Gibson, Dunn & Crutcher LLP

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If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

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5. Andrew Ceresney Speech: "The SEC Enforcement Division's Focus on Auditors and Auditing" (September 22, 2016)

6. Wesley Bricker Speech: "Working Together to Advance High Quality Information in the Capital Markets" (December 5, 2016)

7. Wesley Bricker Speech: "Advancing the Role and Effectiveness of Audit Committees" (March 24, 2017)

8. SEC Litigation Release No. 23639: SEC Charges RPM International Inc. and its General Counsel for Disclosure and Accounting Failures (September 9, 2016)

1. **Selected Recent Developments in U.S. Securities Laws and Corporate Finance (Accounting and Audit Issues)**

AUDIT COMMITTEES AND FINANCIAL REPORTING 2017: RECENT DEVELOPMENTS AND CURRENT ISSUES

June 12, 2017

SELECTED RECENT DEVELOPMENTS IN U.S. SECURITIES LAWS AND CORPORATE FINANCE

as of December 1, 2016

By:
John F. Olson
Jonathan C. Dickey
Stephen I. Glover
Brian J. Lane
Ronald O. Mueller
Amy L. Goodman
James J. Moloney
Paul J. Collins
Gillian McPhee
Peter W. Wardle
Ari B. Lanin
Elizabeth Ising
Michael Scanlon
Andrew Hirsch
Melissa Barshop

GIBSON, DUNN & CRUTCHER LLP

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Portions of this outline may be used for other programs.

The authors gratefully acknowledge the assistance of Thomas Alexander, Arthur Chan, Chloe Clifford, Jennifer Cohen, Matthew Haskell, Andrew Hazlett, Taylor Hathaway-Zepeda, Colleen Kenny, Mia Lee, Andria Montoya, Jean Park, Jennifer Park, Emily Speak, Victor Twu and Katherine Zuber in the preparation of this outline.

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SELECTED RECENT DEVELOPMENTS IN U.S. SECURITIES LAWS AND CORPORATE FINANCE

I. Introduction

This outline reviews recent cases, no-action letters, releases and other information promulgated by the Securities and Exchange Commission (the "**SEC**" or the "**Commission**"), including under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), Jumpstart Our Business Startups Act (the "**JOBS Act**"), and the Sarbanes-Oxley Act of 2002 (the "**Sarbanes-Oxley Act**"), and actions taken by the major securities exchanges and the Public Company Accounting Oversight Board (the "**PCAOB**"), and addresses many recent and proposed changes to the federal securities laws and rules and regulations thereunder, the Commission's practices and various rules that may be material to public companies in the context of audit and financial reporting practices.[1]

II. Internal Controls and Accounting Issues

A. PCAOB Again Issues Proposal to Change Audit Report

On May 11, 2016, the PCAOB re-proposed for public comment an audit standard to amend the form and content requirements for the independent auditor's report on financial statements.[2] The new proposal retains the pass/fail model present in the existing audit report but also requires the auditor to include new disclosures in the audit report about "critical audit matters" that are identified during the course of the audit. The re-proposal also requires new disclosures about the length of the auditor's tenure and the applicable auditor independence requirements.

The re-proposal is the latest chapter in a standard-setting project that dates back to 2011, when the PCAOB issued a concept release on potential changes to the audit report, and that evolved in 2013, when the PCAOB issued its original proposal on this topic. The PCAOB's re-proposal narrows in some respects the scope of the disclosure requirements for critical audit matters that appear in the audit report, and also drops the component of the original proposal that would have required the auditor to review and report on matters outside the financial statements. But the re-proposal still represents an important development for the financial reporting landscape that issuers and their audit committees should review and consider in detail, including as described uner Section II.A.3 below.

The deadline for commenting on the PCAOB's proposal was August 15, 2016.

1. What are CAMs? – Required Disclosures in the Audit Report about Critical Audit Matters

Under the re-proposal, a critical audit matter ("**CAM**") is defined as "any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment."

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[1] The United States Supreme Court ruled on the constitutionality of the PCAOB, upholding the PCAOB's regulatory authority, although the Court concluded that the provisions of the Sarbanes-Oxley Act requiring "good cause" for removal of members of the PCAOB violated the Constitution's separation of powers principles and severed those provisions from the the Sarbanes-Oxley Act. *Free Enterprise Fund v. PCAOB*, No. 08-861, 2010 U.S. LEXIS 5524 (June 28, 2010).

[2] *Available at*: https://pcaobus.org//Rulemaking/Docket034/Release-2016-003-ARM.pdf

The proposed definition thus has three component pieces. First, a CAM must be a matter that was voluntarily communicated to the audit committee or that was required to be communicated to the audit committee under Auditing Standard 1301 (formerly AS No. 16), Communications with Audit Committees. As issuers and audit committees are well aware, the scope of these required communications is not narrow, with AS 1301 containing more than fifteen topics and several dozen related paragraphs that specify what must be communicated to the audit committee. Second, a CAM must relate to an account or disclosure that is "material" to the financial statements. Notably, the proposed definition does not require the communication itself to involve a material issue, but rather that the communication must be about an account or disclosure that is material to the financial statements. And third, the proposed definition provides that a CAM must have involved an "especially challenging, subjective, or complex auditor judgment." The proposal seeks to inject some objective criteria to help guide this test by laying out several factors that an auditor should take into account in determining whether a matter involved such judgments, specifically:

- the auditor's assessment of the risks of material misstatement, including significant risks;
- the degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
- the nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;
- the degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
- the nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and
- the nature of audit evidence obtained regarding the matter.

The new proposal provides that if the auditor determines that a CAM exists, the auditor must include disclosure in the audit report that identifies the CAM, describes the principal considerations that led the auditor to determine that the matter is a CAM, describes how the CAM was addressed in the audit, and identifies the relevant financial statement accounts and/or disclosures that relate to the CAM.

The CAM definition offered in the original proposal was more expansive because it did not specifically relate back to disclosure of matters that were communicated to the audit committee. By incorporating the concept of matters required to be communicated to the audit committee, the re-proposal draws on existing AS 1301 to provide some guideposts for determining which matters may be treated as CAMs. However, given the lengthy list of required communications in AS 1301 and that the re-proposal includes both required communications and those that are voluntarily communicated to the audit committee, the range of matters that could be CAMs remains quite broad and could lead to significant new disclosures in the audit report, as discussed in more detail below under Section II.A.3 below.

The new proposal specifies that CAMs would not have to be disclosed in audit reports issued in connection with audits of brokers and dealers; investment companies other than business development companies; or employee stock purchase, savings, and similar plans.

2. Additional New Disclosures in the Audit Report

Auditor Tenure. The re-proposal requires the auditor to include in its report "[a] statement containing the year the auditor began serving consecutively as the company's auditor." Under the proposed requirement, the auditor tenure would include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting obligations. Although the Board unanimously approved the issuance of the proposal, several Board members indicated they were not certain this disclosure is needed. These sentiments were expressed in part because many issuers have voluntarily included enhanced audit committee-related disclosures in their proxy statements and such disclosures often include information about the length of service by the auditor.

Independence. The re-proposal also requires a statement in the audit report that the auditor "is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB."

Clarification of Auditor Responsibilities. Under the re-proposal, the auditor also has to include in its audit report the phrase "whether due to error or fraud," when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. This phrase is not included in the existing auditor's report and the release accompanying the re-proposal says that the phrase is added to clarify that the auditor is responsible for detecting material misstatements, whether such misstatements are due to error or fraud.

3. Steps to Consider

With this re-proposal, the PCAOB appears to be moving closer to requiring changes to the pass/fail model that has served as the basis for an unqualified audit report for many decades. As a result, issuers and their audit committees would be well served to review in depth the new disclosures contemplated by the proposal – particularly as they are disclosures for which the auditor will have the final say; consider the potential implications and costs associated with the new disclosures, including the questions and potential issues discussed below; and evaluate whether to comment on the proposal. In considering this topic, issuers and audit committees also may wish to engage with their auditors to understand what types of issues in prior audits may be considered CAMs under the proposal and what corresponding disclosures would have looked like if they had been disclosed in connection with those prior audit reports.

(a) Scope of the New CAM definition.

In its re-proposal, the PCAOB made efforts to rein in the breadth of its original concept for critical audit matters, but aspects of the proposed CAM definition still may present concern. The audit standard governing communications that the auditor is required to make to the audit committee is itself expansive, as noted above. The definition also includes any communication made to the audit committee outside of the required communications. It also appears that CAMs may not be limited to communication about material issues, but rather could include disclosure of an issue that may not itself be material but that may involve a material account or disclosure. And, the question of whether an issue was "especially challenging, subjective, or complex auditor judgment" by its terms still leaves the auditor with broad discretion to determine whether a matter is a CAM that should be disclosed in the audit report. Auditor discretion in making this determination of course could cut either way, but issuers and their audit committees may wish to consider whether the degree of uncertainty in how the proposed CAM definition will be applied in practice, given its potential breadth and subjectivity, merits comment.

(b) Auditor Disclosure of Original Information.

In reviewing the original proposal, a number of commenters expressed concern that the proposal would place the auditor in the position of being the source of disclosure of original information about a company – in other words, having to make disclosures before a company itself has made the disclosure or, in effect, forcing a company's hand to make disclosures. The PCAOB's re-proposal responded to this concern by noting that "[s]ince the auditor would be communicating information regarding the audit rather than information directly about the company and its financial statements, the communication of critical audit matters should not diminish the governance role of the audit committee and management's responsibility for the company's disclosure of financial information." Companies and audit committees may wish to consider if this response is sufficient to allay the noted concerns, particularly given the nature of the proposed disclosure topics that have to be addressed once a CAM has been identified – as reflected by the three pages of sample disclosures for a CAM that appear in the proposing release. The PCAOB's proposed standard also includes a note intended to address concerns about the auditor becoming the source of original (and potentially confidential) information about the company. This note says that the auditor will not be expected to provide information about the company that has not been made publicly available by the company "unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit." Companies and audit committees may wish to consider whether this exception in effect nearly swallows the rule, and if so, what disclosure considerations may be implicated, including whether it would put the auditor in a position of having to make disclosures in the first instance about any number of matters, such as loss contingency considerations or investigations.

(c) Uncertainty in Application.

A number of concerns expressed in relation to the original proposal also appear not to have been fully addressed by the re-proposal. Companies and their audit committees may wish to comment on these issues as well. For example, because the re-proposal may require disclosure of matters that have been voluntarily reported to the audit committee, some have expressed the view that the approach outlined could lead auditors to hesitate in raising matters to audit committees as it would then trigger potential CAM reporting. Conversely, some have expressed concern that there will be a tendency to over-disclose the existence of CAMs given the subjectivity in the proposed standard and the potential adverse consequences for the auditor associated with being second guessed in whether a CAM should have been disclosed. Still others have expressed concern that the range of CAM disclosure practice amongst firms and engagement teams will lead to unhelpful variability across audit reports. Concerns expressed about the original proposal with respect to the increased strain on audit committee resources and timing issues associated with completing the audit – for example, when financial reporting or audit-related issues that have CAM implications arise at the last moment – also seem relevant in relation to the re-proposal. Although varied in nature, the common theme underlying these concerns appears to be that uncertainty in application will result from requiring CAM disclosures in the audit report, particularly in light of the subjectivity inherent in the definition and the significance of the changes to the audit reporting model.

B. SEC Issues Concept Release Seeking Input on Enhanced Disclosures for Audit Committees

At an open meeting held on July 1, 2015, the Commission issued a concept release addressing the prospect of enhanced disclosures for audit committees.[3] The concept release requests comment on a number

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[3] SEC Release No. 33-9862, *available at* https://www.sec.gov/rules/concept.shtml; *see also* Gibson, Dunn & Crutcher client alert, *SEC Issues Concept Release Seeking Input on Enhanced Disclosures for Audit*

of possible changes to existing Commission disclosure requirements about the work of audit committees, focusing in particular on audit committees' selection and oversight of independent auditors. The Commission said that it has issued the release in response to views expressed by some that current disclosures may not provide investors with sufficient information about what audit committees do and how they perform their duties. The release seeks feedback on whether certain audit committee disclosures should be added, removed or modified to provide additional meaningful disclosures to investors.

As described in greater detail below, the scope of the issues addressed in the release raises the possibility that future rule changes could significantly expand the length of audit committee reports and other proxy disclosures about audit committees, require disclosure about matters that arguably are not material to investors, and lead to increased risk of exposure for companies and their audit committee members.

1. SEC Concept Release

The Commission's concept release focuses primarily on enhanced disclosures about the audit committee's selection and oversight of the independent auditor. Broadly, the release seeks comment on whether the current disclosure requirements are sufficient to help investors understand and evaluate audit committee roles and responsibilities. More specifically, the release sets forth three main areas for potential disclosure and requests comments on questions the Commission poses related to these areas. These three areas, which are discussed in greater detail below, focus on:

- the audit committee's oversight of the independent auditor;
- the audit committee's process for selecting the independent auditor; and
- the audit committee's consideration of the independent auditor's qualifications.

(a) Audit Committee's Oversight of the Independent Auditor

(i) Communications Between the Audit Committee and Independent Auditor

In the release, the Commission notes that standards of the PCAOB require the auditor to communicate with the audit committee prior to the issuance of the auditor's report about various topics, and that the audit committee report must disclose that these communications took place. The release inquires whether new Commission rules should require:

> "not just whether and when all of the required communications occurred, but also the audit committee's consideration of the matters discussed. Such communications and related disclosures could address, for instance, the nature of the audit committee's communications with the auditor related to items such as 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 in its oversight of the independent auditor."

Committees, dated July 7, 2015, *available at* http://www.gibsondunn.com/publications/Pages/SEC-Issues-Concept-Release-Seeking-Input-on-Enhanced-Disclosures-for-Audit-Committees.aspx.

The release then lays out 11 paragraphs with specific questions on potential disclosures in this area, including whether there should be disclosures about:

- the "nature or substance of the required communications between the auditor and the audit committee";
- *all* required communications from the auditor or some subset of the required communications, and how the audit committee considered the nature of such communications;
- for multi-location audits, how the audit committee considered 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; and
- the extent to which additional matters (beyond those required by PCAOB and Commission rules) were discussed with the auditor and what level of detail should be required. The release also asks about the effects of expanded disclosures on market participants, and whether expanded disclosure requirements could chill communications between the committee and independent auditor.

(ii) Meetings Between the Audit Committee and Independent Auditor

The concept release notes that the number of audit committee meetings is already required disclosure, but inquires whether additional disclosure about meetings with the independent auditor would be appropriate. For example, the release asks whether companies should have to disclose the frequency of the audit committee's private sessions with the auditor and the topics discussed in these sessions.

(iii) Internal Quality Review and PCAOB Inspection Reports

The concept release notes that NYSE rules require audit committees to obtain a report from the independent auditor that describes the firm's internal quality-control procedures and any material issues raised by the firm's most recent internal quality-control review or peer review. The release asks whether companies should be required to disclose information about whether there have been discussions between the audit committee and the auditor about this report – and PCAOB inspection results – and about the nature of any such discussions. With respect to PCAOB inspections, the release asks whether there should be disclosures about how the audit committee considered the results described in PCAOB inspection reports in overseeing the independent auditor. The release also inquires whether there is a risk that these disclosures could undermine the confidentiality of nonpublic PCAOB inspection results.

(iv) Auditor's Objectivity and Professional Skepticism

The concept release states that "[h]eightened oversight by the audit committee of the auditor's objectivity and professional skepticism should promote greater audit quality." To that end, the release seeks comment on:

- whether investors would find useful disclosure about "whether, and if so, how the audit committee assesses, promotes and reinforces the independent auditor's objectivity and professional skepticism"; and
- what types of disclosures audit committees could provide to satisfy such a disclosure requirement.

(b) Audit Committee's Process for Selecting the Independent Auditor

Noting that the audit committee's responsibility to appoint and retain the independent auditor can involve a wide range of activities, the concept release seeks comment on a range of potential disclosures about the criteria used to assess the independent auditor and the actions the audit committee took in reaching a decision to select the auditor for the coming year.

(i) How the Audit Committee Assessed the Auditor

The concept release seeks feedback on the types of disclosures that could be made about the audit committee's process for evaluating the performance and qualifications of the auditor. These include the audit committee's rationale for selecting or retaining the auditor, a description of the audit committee's involvement in approving the auditor's compensation, the nature and extent of non-audit services provided by the auditor and the committee's evaluation of how such services impacted its assessment of the auditor's independence and objectivity, and the committee's use of any audit quality indicators in evaluating the independent auditor.

(ii) RFPs for the Independent Audit

The concept release also asks whether disclosures about any requests for proposal relating to the audit would be useful to investors and the types of disclosures that companies could provide. Among other things, the release indicates disclosures could address whether the audit committee sought proposals for the independent audit (and if so, why), the committee's process in reviewing any such proposals, and the factors the audit committee considered in selecting the independent auditor.

(iii) Board Policy Regarding Shareholder Ratification Vote

The concept release asks whether there should be additional disclosures about the shareholder vote to ratify the selection of the independent auditor. The release asks whether it would be useful for companies to provide disclosure about whether the board of directors has a policy on shareholder ratification and about the audit committee's consideration of the voting results. The release also seeks comment on whether auditor ratification should continue to be considered a "routine matter" for which brokers may use discretionary voting if the Commission adopts additional disclosure requirements in this area.

(c) Qualifications of the Independent Auditor

Noting that the audit committee's oversight responsibility for the independent auditor positions the committee to gain an understanding of the key participants in the audit and their qualifications, the concept release seeks comment on potential disclosures about the qualifications of both the audit firm selected by the audit committee and members of the engagement team.

(i) Members of the Engagement Team

The concept release addresses whether to require disclosure of the names of the engagement partner and other key members of the engagement team, and if so, which members. The release also asks what other information about the engagement team or other audit participants should be disclosed, such as the length of time individuals have served in their roles, any relevant experience and licensing status.

(ii) Audit Committee Input in Selecting the Engagement Partner

The concept release asks whether there should be disclosure about the audit committee's involvement in the selection of the engagement partner, and if so, the nature and extent of that disclosure.

(iii) **Auditor Tenure**

The concept release asks whether the audit committee report should include information about the duration of the auditor's tenure with the company and if so, whether the disclosure should be limited to the number of years or address other matters. These matters could include whether and if so, how, the audit committee considered tenure in evaluating the auditor's independence or deciding to retain the auditor. The release also asks whether tenure information is more appropriately addressed elsewhere, such as in the auditor's opinion or a filing with the PCAOB.

2. **Additional Requests for Comment**

In addition to the three categories of disclosures discussed above, the concept release seeks feedback on a number of additional questions. Among other things, the Commission has asked for input on:

- whether any enhanced disclosures, if adopted, should be voluntary or mandatory;
- whether investors would benefit from having all audit committee-related disclosures in one place;
- where the disclosures should be made (*for example*, in the audit committee report within the proxy statement, elsewhere in the proxy statement, in the annual report, or on the company's website); and
- whether to require updates to the disclosures to reflect developments that occur between proxy statements and if so, how often (for example, quarterly or more frequently).

The release also seeks feedback on whether disclosure requirements should vary for smaller reporting companies and emerging growth companies. Although the release does not specifically invite comment on the effect of expanded disclosures on foreign private issuers, the manner in which any potentially required disclosures may impact audit committees (or similar governing bodies) of foreign private issuers also should be considered for comment.

Comments on the concept release were due 60 days following publication of the release in the Federal Register. The comment period closed in early September 2015.

C. **PCAOB Issues Concept Release on Audit Quality Indicators**

On June 30, 2015, the PCAOB issued a Concept Release (the "**AQI Concept Release**") seeking public comment on a proposed set of quantitative "audit quality indicators" ("**AQIs**") that the PCAOB board hopes will "provide new insights about how to evaluate the quality of audits and how high quality audits are achieved."[4] The AQI Concept Release is the result of more than two years of research and consultation with key stakeholders by the PCAOB, a project launched in part out of the concern that relatively "little is known" about an audit, even by a company's audit committee.[5] In his statement regarding the AQI Concept Release,

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[4] Concept Release on Audit Quality Indicators, PCAOB Release No. 2015-005, PCAOB Rulemaking Docket Matter No. 041 (July 1, 2015), *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf.

[5] James R. Doty, Chairman, PCAOB, Statement on Concept Release on Audit Quality Indicators (June 30, 2015), *available at* http://pcaobus.org/News/Speech/Pages/06302015_Doty_AQI.aspx; *see also* Concept Release on Audit Quality Indicators, PCAOB Release No. 2015-005, PCAOB Rulemaking Docket Matter

PCAOB board member Jay D. Hanson argued that "this project has the great potential to provide the marketplace better tools to evaluate the quality of audits, to increase understanding about how good audits are performed, and to allow firms to compete on quality rather than price."[6]

The AQI Concept Release proposes 28 indicators, which have been grouped into three categories: those relating to (1) audit professionals, (2) audit process, and (3) audit results.[7] The indicators in the first category seek to measure the "availability, competence, and focus" of audit professionals, which the AQI Concept Release proposes to quantify by measuring aspects such as "staffing leverage," "experience of audit personnel," and the "allocation of audit hours to phases of the audit," respectively.[8] The second group of indicators—those related to audit process—are further categorized into measurements addressing "tone at the top and leadership, incentives, independence, infrastructure, and monitoring and remediation."[9] Third, the indicators relating to audit results examine financial statements (*e.g.*, "frequency and impact of financial statement restatements and errors"), "timely reporting of internal control weaknesses," "timely reporting of going concern issues, communications between auditors and audit committees, and enforcement and litigation."[10] The AQI Concept Release notes that most of the proposed indicators (19 of 28) will require data that only audit firms can provide, eight indicators will use data that is publicly available, and one will request information from the company's audit committee. As articulated by Hanson, the goal of these indicators is not to compile a "credit score-like measure for each firm or engagement team," but instead to consider all of the factors collectively, as a "balanced picture" of the quality of each firm or team.[11]

The AQI Concept Release specifically calls for comments on the content of these indicators. In particular, the public is asked to consider whether any of the proposed indicators should be deleted, whether others should be added, and whether the indicators are "clearly defined."[12] The AQI Concept Release also requests comments on the likelihood that the proposed indicators will effectively quantify audit quality, and relatedly, whether they will facilitate the comparison of data across audit firms.

No. 041 (July 1, 2015), *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf ("The auditor is usually in the best position to determine the scope of the service required; the client has limited ability to make a similar judgment, and the outcome of the service—the quality of the audit—is either unobservable or can only be observed at significant cost to the audited company or others.").

[6] Jay D. Hanson, Board Member, PCAOB, Statement on Concept Release on Audit Quality Indicators (June 30, 2015), *available at* http://pcaobus.org/News/Speech/Pages/06302015_Hanson_AQI.aspx.

[7] Concept Release on Audit Quality Indicators, PCAOB Release No. 2015-005, PCAOB Rulemaking Docket Matter No. 041 (July 1, 2015), *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] Jay D. Hanson, Board Member, PCAOB, Statement on Concept Release on Audit Quality Indicators (June 30, 2015), *available at* http://pcaobus.org/News/Speech/Pages/06302015_Hanson_AQI.aspx.

[12] Concept Release on Audit Quality Indicators, PCAOB Release No. 2015-005, PCAOB Rulemaking Docket Matter No. 041 (July 1, 2015), *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf.

In addition to soliciting comments on the content of the indicators, the AQI Concept Release urges commenters to consider "how to shape the indicators to maximize their value to users."[13] The AQI Concept Release identifies four types of users that the PCAOB believes will benefit from the AQIs: audit committees, audit firms, investors ("if, when, and to the extent that information is made publicly available"), and regulators such as the PCAOB.[14] With these groups in mind, the AQI Concept Release asks commenters to consider issues such as how the data should be made available, what groups of users will find the data most useful, and how the PCAOB should implement the AQIs (*e.g.*, whether the PCAOB board should distinguish between audit firms of different sizes, or between companies in different industries).

The PCAOB held a meeting with its "Standing Advisory Group" to discuss the AQI Concept Release and audit quality indicators in November 2015. The deadline to submit comments in response to the AQI Concept Release ended November 30, 2015.[15]

D. PCAOB Issues Final Rules Requiring Audit Partner and Participant Disclosure

On December 15, 2015, the PCAOB adopted new rules requiring audit firms to disclose the names of each audit engagement partner as well as the names of other audit firms that participated in each audit.[16]

Under the final rules, auditors will be required to file a new PCAOB Form AP, Auditor Reporting of Certain Audit Participants, for each issuer audit, disclosing:

- The name of the engagement partner;
- The names, locations, and extent of participation of other accounting firms that took part in the audit, if their work constituted 5 percent or more of the total audit hours; and
- The number and aggregate extent of participation of all other accounting firms that took part in the audit whose individual participation was less than 5 percent of the total audit hours.[17]

In connection with the adoption of the new rules, James R. Doty, PCAOB Chairman recently stated: "Transparency about the partner and firms involved should further incentivize auditors to organize audit teams conscientiously to give investors comfort that it is reliable." Additionally, Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards, was quoted as saying: "Form AP will provide investors and other financial statement users with the information they have continued to request — the name of the engagement partner and information about other accounting firms participating in the audit — in a single searchable database, giving the market valuable information, while responding to concerns raised by

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[13] *Id.*

[14] *Id.*

[15] News Release, PCAOB Announces SAG Meeting Agenda Focused on Audit Quality Indicators and Emerging Issues for November 12-13 (Oct. 29, 2015), available at http://pcaobus.org/News/Releases/Pages/November-12-2015-SAG-Meeting-Agenda.aspx.

[16] News Release, PCAOB Adopts Rules Requiring Disclosure of the Engagement Partner and Other Accounting Firms Participating in an Audit (December 15, 2015), *available at* http://pcaobus.org/News/Releases/Pages/PCAOB-adopts-disclosure-rules-Form-AP-12-15-15.aspx.

[17] *Id.*

accounting firms and others about the unintended consequences of such a disclosure in the auditor's report."[18]

The standard filing deadline for Form AP will be 35 days after the date the auditor's report is first included in a document filed with the Commision, but in the case of initial public offerings, the Form AP filing deadline will be 10 days after the auditor's report is first included in a document filed with the Commission.[19]

However, the new rules are subject to approval by the SEC. If approved by the SEC, the disclosure requirement for the engagement partner will be effective for auditor's reports issued on or after January 31, 2017, or three months after SEC approval of the final rules, whichever is later, and for disclosure of other audit firms participating in the audit, the requirement will be effective for reports issued on or after June 30, 2017.[20]

E. Disclosure Requirements for Domestic Registrants

In 2014, Chair White directed the SEC staff, led by the Division of Corporation Finance, to complete a "comprehensive review of the disclosure requirements," and to make recommendations regarding how these requirements should be updated and improved.[21] Building on a report summarizing the SEC's review of Regulation S-K that was mandated by the JOBS Act and submitted to Congress in December 2013, the "Disclosure Effectiveness Project" seeks to "facilitate timely, material, and more meaningful disclosure by companies to their shareholders."[22]

In her keynote address at the 2015 AICPA National Conference, Chair White discussed some of the results of the Disclosure Effectiveness Project to date and the increased focus on disclosure effectiveness generally, noting that, among other things, the Commission issued a request for comment on certain Regulation S-X requirements in September 2015, Congress enacted a transportation bill in December 2015 that contained a number of SEC-related provisions, including a provision addressing the modernization and simplification of disclosures, and the SEC will continue to examine the use of non-GAAP financial measures in financial reporting.[23] Publicly, Chair White has recognized that progress has been made[24] but has also

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[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] Mary Jo White, Chair, SEC, Remarks at the Financial Accounting Foundation Trustees Dinner (May 20, 2014), *available at* http://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370541872065.

[22] Keith F. Higgins, Director, SEC Division of Corporation Finance, Testimony on "Oversight of the SEC's Division of Corporation Finance" (Jul. 24, 2014), *available at* http://www.sec.gov/servlet/Satellite/News/Testimony/Detail/Testimony/1370542357516.

[23] Mary Jo White, Chair, SEC, Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility" (Dec. 9, 2015), *available at* http://www.sec.gov/news/speech/keynote-2015-aicpa-white.html.

[24] *Id.* ("Momentum on disclosure effectiveness is also occurring at companies. We have seen concrete progress by companies working to make disclosures clearer and more understandable, in particular by removing redundancies or unnecessary information.").

noted the need to continue to make improvements to the current disclosure scheme.[25] Relatedly, James V. Schnurr, Chief Accountant, Office of the Chief Accountant, recently spoke about several recent developments relating to the Disclosure Effectiveness Project, including the Division of Corporation Finance's efforts to update the existing requirements in Regulations S-K and S-X, the coordination by the Office of the Chief Accountant and FASB "on ways to improve the effectiveness of financial statement disclosures and to minimize duplication with other existing disclosure requirements", and the FASB's recent proposal regarding the omission of immaterial information in financial statement disclosures.[26]

F. FASB Standard-Setting Developments

While the FASB has been active in pursuing its standard-setting agenda,[27] we have highlighted some of the most important ongoing developments below.

1. Disclosure Framework

On March 4, 2014, the FASB released an exposure draft on disclosure framework – *Conceptual Framework for Financial Reporting, Chapter 8: Notes to Financial Statements*.[28] This exposure draft discusses the FASB's process for identifying relevant information in the notes to financial statements and the limits that should be imposed regarding information that should be included in the notes to financial statements. Among other things, the proposal would require the FASB to: (1) identify information to disclose in the notes to the financial statements that is likely to help those who are deciding whether to provide resources to an organization; (2) eliminate disclosures of certain types of future-oriented information that may have negative effects on the cash flow prospects of the reporting organization; and (3) consider the costs and potential consequences of providing a disclosure in the notes.[29]

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[25] *Id.* ("[Y]ou will hear from our staff in Corporation Finance that there are other areas – foreign tax disclosure is one – where the staff believes that more disclosure would help investors."); *see also* Mary Jo White, Chair, SEC, Keynote Address at the 47th Annual Securities Regulation Institute: "Building a Dynamic Framework for Offering Reform" (Oct. 28, 2015), *available at* http://www.sec.gov/news/speech/building-dynamic-framework-for-offering-reform.html ("Our next step will be to address Regulation S-K and certain Industry Guides, including the guide for disclosures by bank holding companies and the guide for mining companies.")

[26] James V. Schnurr, Chief Accountant, Office of the Chief Accountant, Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 9, 2015), *available at* http://www.sec.gov/news/speech/schnurr-remarks-aicpa-2015-conference-sec-pcaob-developments.html.

[27] *See* Project Roster & Status, FASB, *available at* http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137074.

[28] Conceptual Framework for Financial Reporting: Chapter 8: Notes to Financial Statements, FASB Proposed Statement of Financial Accounting Concepts Exposure Draft (Mar. 4, 2014), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828468314&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=424282&blobheadervalue1=filename%3DProposed_Concepts_Statement_CF_for_Financial_Reporting%25E2%2580%2594Chapter8-Notes_to_Financial_Statements.pdf&blobcol=urldata&blobtable=MungoBlobs.

[29] *See* Ken Tysiac, *FASB Takes Step Forward in Streamlining of Disclosures*, Journal of Accountancy (Mar. 4, 2014), http://www.journalofaccountancy.com/News/20149726.htm; *FASB Proposes Decision Process for Determining Disclosures to Require in Notes to Financial Statements*, 21 DELOITTE HEADS UP 5 (Mar. 6, 2014), *available at* http://www.iasplus.com/en-us/publications/us/heads-up/2014/fasb-disclosure-ed.

If the exposure draft is approved, this framework will become a permanent part of the FASB's conceptual framework. This framework establishes a foundation for the FASB in making standard-setting decisions. Comments to the exposure draft were due July 14, 2014. The FASB held a non-decision-making meeting on September 10, 2014 to discuss the comments[30] followed by another board meeting on November 19, 2014 to discuss the definition of materiality in the framework.[31] On February 18, 2015, the FASB met to discuss the development of an Exposure Draft addressing flexible disclosure requirements and disclosures related to fair value measurement, but did not determine when they would release this Exposure Draft.[32]

On September 24, 2015, the FASB issued an exposure draft containing amendments to FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting intended to clarify the concept of materiality.[33]

First, the FASB has proposed an Accounting Standards Update, Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material (the "**Materiality ASU**"), intended to promote the appropriate use of discretion by organizations when deciding which disclosures should be considered material in their particular circumstances.[34] The amendments would apply to all types of organizations—public and private companies, not-for-profit organizations, and employee benefit plans. Specifically, the Materiality ASU would:

- state that materiality is applied to quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole; therefore, some, all, or none of the requirements in a disclosure Section may be material;
- Refer to materiality as a legal concept; and
- State specifically that an omission of immaterial information is not an accounting error.[35]

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[30] Minutes of the September 10, 2014 Board Meeting (Sept. 11, 2014), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176164433101.

[31] Minutes of the November 19, 2014 Board Meeting (Nov. 20, 2014), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176164583050.

[32] Minutes of the February 18, 2015, Disclosure Framework Board Meeting (Feb. 26, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176165054486.

[33] News Release, FASB Proposes Improvements to Materiality to Make Financial Statement Disclosures More Effective (September 24, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176166401832.

[34] *Id.*

[35] Exposure Draft, Accounting Standards Update, Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material (Issued September 24, 2015), *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true.

The FASB believes the amendments in this the proposed Materiality ASU also would improve the effectiveness of the notes to financial statements by helping reporting entities omit immaterial information. The deadline for comments on the proposed Materiality ASU ended on December 8, 2015.[36]

The second exposure draft contains amendments to FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting, and is intended to clarify the concept of materiality by amending Chapter 3, Qualitative Characteristics of Useful Financial Information, of Concepts Statement No. 8.[37] According to the FASB, the main proposed amendment to Chapter 3 of Concepts Statement 8 is a modification of the current definition of materiality that adds a statement that materiality is a legal concept, and another noteworthy amendment to Concepts Statement 8 includes a brief summaryof the U.S. Supreme Court's definition of materiality because that is the definition that is currently observed by the Board.[38] The deadline for comments on the proposed Materiality ASU ended on December 8, 2015.[39]

(a) Fair Market Value Measurement

As part of the disclosure framework, on December 3, 2015, the FASB issued a proposed Accounting Standard Update fair value measurement disclosure requirements (the "**FV ASU**").[40] The following disclosure requirements would be removed from Topic 820, Fair Value Measurement ("**Topic 820**"):

- 1. The amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy
- 2. The policy for timing of transfers between levels
- 3. The valuation policies and procedures for Level 3 fair value measurements
- 4. For private companies, the change in unrealized gains and losses for the period included in earnings (or changes in net assets) on recurring Level 3 fair value measurements held at the end of the reporting period.[41]

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[36] *Id.*

[37] News Release, FASB Proposes Improvements to Materiality to Make Financial Statement Disclosures More Effective (September 24, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176166401832.

[38] Exposure Draft, Proposed Amendments to Statement of Financial Accounting Concepts (Issued September 24, 2015), *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402450&acceptedDisclaimer=true.

[39] *Id.*

[40] News Release, FASB Issues Proposed Improvements to Disclosure Requirements for Fair Value Measurement (Dec. 3, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176167663533.

[41] FASB Exposure Draft, Proposed Accounting Standards Update, Fair Value Measurement (Topic 820), Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement (Issued Dec. 3, 2015), *available at*

The disclosure requirements in Topic 820 would be modified as follows:

- For private companies, no longer require a reconciliation of the opening balances to the closing balances of recurring Level 3 fair value measurements. However, private companies would be required to disclose transfers into and out of Level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities.

- For investments in certain entities that calculate net asset value, require disclosure of the timing of liquidation of an investee's assets and the date when restrictions from redemption will lapse only if the investee has communicated the timing to the entity or announced the timing publicly.

- Clarify the measurement uncertainty disclosure to communicate information about the uncertainty in measurement as of the reporting date rather than information about sensitivity to changes in the future.[42]

The following disclosure requirements would be added to Topic 820; however, the disclosures would not be required for private companies:

- The changes in unrealized gains and losses for the period included in other comprehensive income and earnings (or changes in net assets) for recurring Level 1, Level 2, and Level 3 fair value measurements held at the end of the reporting period, disaggregated by level of the fair value hierarchy

- For Level 3 fair value measurements, the range, weighted average, and time period used to develop significant unobservable inputs.[43]

In addition, the proposed amendments include language designed to promote the use of discretion by entities that reinforces that an entity can assess disclosures on the basis of whether they are material, thereby improving the effectiveness of the notes to financial statements. Comments on the FV ASU were due by February 29, 2016.[44]

The FASB's aim to increase the usefulness of financial statement disclosures tracks a similar program being undertaken by the IASB. In March 2014, the IASB proposed changes to corporate disclosure rules that would focus on clarity, comparability, and allowing users of financial statements to more easily access and identify the most important disclosures.[45] Comments to the IASB's proposal were due July 23, 2014.

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http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167664088&acceptedDisclaimer=true
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[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] Disclosure Initiative: Proposed Amendments to IAS 1, International Accounting Standards Board (March 2014), *available at* http://www.ifrs.org/Current-Projects/IASB-Projects/Amendments-to-IAS-1/ED-March-2014/Documents/ED-Disclosure-Initiative-Amendments-IAS-1-March-2014.pdf.

2. Going Concern

In August 2014, the FASB issued an Amendment of the *FASB Accounting Standards Codification, Presentation of Financial Statements (Subtopic 205-40): Disclosures of Uncertainties about an Entity's Going Concern Presumption.*[46] The amendment requires the management (rather than just the auditors) of all entities to assess at each reporting period their ability to meet their obligations as they become due within a look-forward period of one year from the financial statement date. This assessment will inform whether companies should include financial statement disclosures about going concern uncertainties. Additionally, SEC filers are required to evaluate whether there is a "probability" that the entity will not be able to fulfill those obligations in the look-forward period. If "substantial doubt" exists as to the company's ability to continue as a going concern and management's plans will not mitigate this doubt, the company must express this conclusion in its financial statements. These amendments apply to all entities for the annual period ending after December 15, 2016 and for all subsequent annual periods and interim periods.

Following the FASB's adoption of these amendments, the PCAOB released Staff Audit Practice Alert No. 13 that served to reinforce that auditors must still follow PCAOB's standards regarding an entity's ability to continue as a going concern .[47]

3. Revenue Recognition

On May 28, 2014, the FASB and the IASB issued converged guidance on revenue recognition under both IFRS and U.S. GAAP.[48] The central principle is "for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration (that is, payment) to which the company expects to be entitled in exchange for those goods or services."[49] The ability to implement these new rules varies by industry and depends in part on the complexity of the customer contracts in those industries. Following concerns raised about the ability of companies to implement these standards, the FASB board voted on April 1, 2015 to delay the implementation of this standard for the reporting periods beginning after December 15, 2017 for public companies and December 15, 2018 for private companies, but allowed for early adoption (the original effective dates).[50] On August 31, 2015, the FASB issued a proposed Accounting Standards Update intended to clarify the implementation guidance on

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[46] Presentation of Financial Statements (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Going Concern Presumption, FASB Accounting Standards Update (August 27, 2014), *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176164329772&acceptedDisclaimer=true.

[47] Staff Audit Practice Alert No. 13: Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern (Sept. 22, 2014), *available at* http://pcaobus.org/Standards/QandA/09222014_SAPA_13.pdf.

[48] Press Release, FASB, IASB and FASB Issue Converged Standard on Revenue Recognition (May 28, 2014), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176164075286.

[49] *Id.*

[50] Michael Rapoport, *FASB Panel Proposed Delaying New Revenue-Recognition Rules by One Year*, THE WALL STREET JOURNAL (Apr. 1, 2015, 5:41 PM), http://www.wsj.com/articles/fasb-staff-recommend-2-year-delay-of-new-revenue-recognition-rules-1427896184.

principal versus agent considerations contained in the new revenue recognition standard.[51] The amendments in the proposed Accounting Standards Update would affect entities with transactions covered by Topic 606 (Revenue from Contracts with Customers), which relates to entities that enter into contracts with customers to transfer goods or services (that are an output of the entity's ordinary activities) in exchange for consideration.[52] Specifically, the amendments are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations by clarifying the following:

- An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer. If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

- An entity determines the nature of each specified good or service (for example, whether it is a good, a service, or a right to a good or service).

- When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of (a) a good or another asset from the other party that it then transfers to the customer; (b) a right to a service that will be performed by another party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf; or (c) a good or service from the other party that it combines with other goods or services to provide the specified good or service to the customer.

- The purpose of the indicators in paragraph 606-10-55-39 is to support or assist in the assessment of control. The proposed amendments in paragraph 606-10-55-39A clarify that the indicators may be more or less relevant to the control assessment and that one or more indicators may be more or less persuasive.[53]

The deadline for comments on the proposal occurred on October 15, 2015.

4. Leases

On May 16, 2013, the FASB and the IASB issued a revised Exposure Draft, *Leases (Topic 842)*.[54] On January 23, 2014, the FASB and IASB boards began their redeliberations of the proposals included in the

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[51] Media Advisory, FASB Proposes Clarification to Principal vs. Agent Guidance in Revenue Recognition Standard (August 31, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176166356525.

[52] Exposure Draft, Proposed Accounting Standards Update, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) (Issued August 31, 2015), *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402450&acceptedDisclaimer=true.

[53] *Id.*

[54] Leases (Topic 842): A Revision of the 2010 Proposed FASB Accounting Standards Update, *Leases (Topic 840)*, FASB Proposed Accounting Standards Update (Revised) Exposure Draft (May 16, 2013), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175827732013&blobhead

May 2013 Exposure Draft.[55] The FASB and IASB tentatively agreed that assets and liabilities from all leases would need to be recognized on the balance sheet.[56] In August 2014, however, the IASB released a project update that suggested that it was moving away from convergence by reverting to a single lessee model that does not differentiate between different types of leases.[57] In January 2016, the IASB published IFRS 16, Leases, which replaced its previous guidance. IFRS 16 requires lessees to recognize a lease liability reflecting future lease payments and a "right-of-use asset" for virtually all lease contracts.

On February 25, 2015, the FASB continued to move forward with a dual model that distinguishes between Type A capital (equipment) leases and Type B operating (real estate) leases on the balance sheet.[58]

In April 2015, the FASB board continued deliberations with respect to proposals in the May 2013 Exposure Draft, Leases, specifically discussing nonpublic business entity issues, and ultimately deciding, except for permitting the use of a risk-free rate to measure lease liabilities under certain circumstances, that there should not be any additional guidance provided for nonpublic business entities reporting under GAAP (except for certain practical circumstances to allow the use of a risk-free rate to measure lease liabilities).[59]

As of May 2015, FASB had reached a tentative agreement with respect to several additional issues regarding the treatment of leases, including:

- Certain issues regarding the incorporation of collectability into the lessor accounting model;
- Treatment of a Type A lease upon modification, when such modification is not accounted for as a separate, new lease;
- Requirement that a lessor assess its entire net investment in a lease (that is, both its lease receivable and any unguaranteed residual asset) for impairment in accordance with Topic 310, Receivables;
- Determination that leases that do not transfer control of the underlying asset to the lessee and for which collectability of the lease payments is less likely than not should be classified and accounted for as Type B leases; and

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[55] http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011123

[56] Project Update, *Leases* (Aug. 2014), *available at* http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/Project-Update-Leases-August-2014.pdf.

[57] *Id.*

[58] Minutes of the February 25, 2015 Board Meeting (Mar. 4, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176165846987.

[59] Minutes of the April 9, 2015 Board Meeting (Apr. 9, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176165929239

- Determination that if a lessee purchases a leased asset during the lease term, any difference between the purchase price and the carrying amount of the lease liability should be recorded as an adjustment of the carrying amount of the asset, with no gain or loss recognized.[60]

As of October 2015, FASB had reached a tentative agreement with respect to several additional issues regarding the treatment of leases, including:

- Requirement that initial direct costs arising from a sales-type lease be deferred and recognized over the lease term if the lease does not give rise to selling profit or selling loss.

- Determination that a lessor should present its net investment in sales-type and direct financing leases separately from other assets on its statement of financial position.

- Determination that a modification that extends a lease term changes the right of use the lessee already controls and does not grant the lessee and additional right of use.

- Determination that the requirements for recognition and presentation of lease assets and lease liabilities will apply to all entities.[61]

In a meeting held on November 11, 2015, the FASB board reached a tentative decision to classify a lease as a finance lease (for lessees) or a sales-type lease (for lessors) if the term of the lease is for the major part of the remaining economic life of the underlying asset (the lease term criterion).[62] The FASB board decided to provide an exception to the lease classification test whereby entities will not consider the lease term criterion when performing the lease classification test for leases that commence "at or near the end" of the underlying asset's economic life. The FASB board also decided that the final leases standard should include implementation guidance that one reasonable approach to determining the applicability of this exception would be to conclude that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.[63]

Additionally, the FASB board voted to proceed with a new accounting standard that would require companies and other organizations to include lease obligations on their balance sheets. The final Accounting Standards Update is expected to be published in early 2016.[64] The FASB board decided that for public companies, the upcoming standard will be effective for fiscal years (and interim periods within those fiscal

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[60] Minutes of the May 13, 2015 Board Meeting (May 15, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176166026335

[61] Minutes of the October 7, 2015 Board Meeting (Dated October 9, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176166900862.

[62] Minutes of the November 11, 2015 Board Meeting (Dated November 17, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176167608854.

[63] *Id.*

[64] News Release, FASB Votes to Proceed with Final Standard on Leases (Issued November 11, 2015), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176167530388.

years) beginning after December 15, 2018; for private companies, the standard will be effective for annual periods beginning after December 15, 2019.[65] Early adoption will be permitted for all companies and organizations upon issuance of the standard.

5. Recognition and Measurement of Financial Instrument

On January 5, 2016, the FASB issued an Accounting Standards Update (the "**Financial Instrument ASU**") intended to improve the recognition and measurement of financial instruments. The Financial Instrument ASU affects for-profit and non-profit companies and employee benefit plans that hold financial assets or have financial liabilities.[66] According to the FASB Chairman, Russel G. Golden, "[t]he new standard is intended to provide users of financial statements with more useful information on the recognition, measurement, presentation, and disclosure of financial instruments."[67]

The Financial Instrument ASU:

- requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) be measured at fair value with changes in fair value recognized in net income;
- requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes;
- requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements;
- eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities;
- eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and
- requires a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.[68]

The Financial Instrument ASU on recognition and measurement will take effect for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For private companies, not-for-profit organizations, and employee benefit plans, the Financial Instrument ASU

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[65] *Id.*

[66] News Release, FASB Issues New Guidance on the Recognition and Measurement of Financial Instrument (January 5, 2016), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176167762232.

[67] *Id.*

[68] *Id.*

becomes effective for fiscal years beginning after December 15, 2018, and for interim periods within fiscal years beginning after December 15, 2019. However, the Financial Instrument ASU permits early adoption of the own credit provision and the provision that exempts private companies and not-for-profit organizations from having to disclose fair value information about financial instruments measured at amortized cost.[69]

G. SEC Regulations and Interactions with China

1. Litigation Against Chinese Companies

The SEC has continued its ongoing initiative against foreign-based issuers trading in U.S. markets, particularly China-based companies. In June 2013, the SEC filed a case against China MediaExpress and its Chairman and CEO Zhen Cheng for materially overstating cash balances in its SEC filings and in press releases.[70] Among other things, the SEC alleged that the company had reported $57 million in cash at a time when it had less than $150,000 on hand. The SEC also alleged that defendants made material misrepresentations relating to the nature of the company's business relationships with two other multi-national corporations. The SEC's press release announced that the case originated out of the SEC's Cross-Border Working Group, which has to date been able to "file fraud cases against more than 65 foreign issuers or executives and deregister the securities of more than 50 companies."

On December 3, 2012, the SEC began administrative proceedings against the China affiliates of each of the Big Four accounting firms and another large U.S. accounting firm for refusing to produce audit work papers and other documents related to China-based companies under investigation by the SEC for potential accounting fraud against U.S. investors.[71]

The SEC charged BDO China Dahua Co. Ltd. (now Dahua CPA Co., Ltd.), Deloitte Touche Tohmatsu Certified Public Accountants Ltd, Ernst & Young Hua Ming LLP, KPMG Huazhen (Special General Partnership) and PricewaterhouseCoopers Zhong Tian CPAs Limited with violating the Exchange Act and the Sarbanes-Oxley Act, which requires foreign public accounting firms to provide the SEC upon request with audit work papers involving any company trading on U.S. markets.

According to the SEC's order instituting the proceedings, the audit materials are being sought as part of SEC investigations into potential wrongdoing by nine China-based companies whose securities are publicly traded in the U.S. The audit firms have refused to directly cooperate with the SEC in the investigations because of fears that doing so would violate Chinese law.

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[69] *Id.*

[70] Press Release, SEC, SEC Charges China-Based Company and CEO in Latest Cross-Border Working Group Case (June 20, 2013), *available at* www.sec.gov/news/press/2013/2013-115.htm.

[71] Order Instituting Administrative Proceedings Pursuant to Rule 102(3)(1)(iii) of the Commission's Rule of Practice and Notice of Hearing, Securities Exchange Act of 1934 Release No. 68335, Accounting and Auditing Enforcement Release No. 3426, Administrative Proceeding File No. 3-15116 (SEC Dec. 3, 2012), www.sec.gov/litigation/admin/2012/34-68335.pdf. See also Press Release, SEC, SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents (Dec. 3, 2012), *available at* http://www.sec.gov/news/press/2012/2012-249.htm.

On January 22, 2014, Administrative Law Judge Cameron Elliot issued an initial decision in the proceedings.[72] Judge Elliot rejected the accounting firms' arguments that turning over audit materials would violate Chinese law, and he found that the firms had willfully violated section 106 of the Sarbanes-Oxley Act. Section 106 requires registered public accounting firms to produce audit materials upon request by the PCAOB or SEC. Because of the willful violation, Judge Elliot censured the firms and barred the Chinese affiliates of the Big Four accounting firms from "appearing and practicing" before the SEC for six months. Though the initial decision is not final, as it is subject to appeal first to the SEC and then to the federal courts, its impacts could be significant.[73] Over 100 Chinese companies are traded publicly in the U.S., and this decision could effectively leave them without an auditor for six months. Additionally, the Chinese affiliates of the Big Four accounting firms often provide substantial assistance auditing the Chinese operations of large, multinational companies. Companies must have audited financial statements to sell securities in the U.S. and remain listed on U.S. securities exchanges. Companies have already begun to disclose this potential sanction as a risk factor in initial public offering documentation.[74]

Prior to Judge Elliot's initial decision, legal documents filed by Chinese affiliates of several accounting firms in late November and early December 2013 disclosed that Chinese authorities had turned over audit work papers for some of the companies under investigation by the SEC.[75] This document release stemmed from the Memorandum of Understanding entered into between the SEC, the China Securities Regulatory Commission, and the Chinese Ministry of Finance.

The current administrative proceeding stems from an SEC initiative to address concerns arising from reverse mergers and foreign issuers. The SEC has deregistered the securities of nearly 50 companies and filed fraud cases involving more than 40 foreign issuers and executives.

On February 6, 2015, these affiliates settled with the SEC and agreed to pay $500,000 each.[76] By settling, the firms were able to avoid having their ability to audit U.S.-trade firms temporarily suspended. Finally, the affiliates will now have to adhere to procedures that will facilitate the turnover of audit documents to the SEC moving forward.

In addition to this high-profile matter, audits of China-based companies continue to be a recurring enforcement theme. In July 2014, the Commission instituted litigation proceedings against Child Van

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[72] In the Matter of BDO China Dahua CPA Co., Ltd. et al., Initial Decision Release No. 553, Administrative Proceeding File No.s 3-14872, 3-15116 (Jan. 22, 2014), http://www.sec.gov/alj/aljdec/2014/id553ce.pdf.

[73] Michael Rapoport, *Judge Suspends Chinese Units of Big Four Auditors*, THE WALL STREET JOURNAL (Jan. 23, 2013, 1:42 AM), http://online.wsj.com/news/articles/SB10001424052702304477704579256282180428714?mod=WSJ_hp_LEFTWhatsNewsCollection.

[74] Emily Chasan, *A Tale of Two Chinese Auditor Risk Factors*, THE WALL STREET JOURNAL (Jan. 30, 2014, 4:57 PM), http://blogs.wsj.com/cfo/2014/01/30/a-tale-of-two-chinese-auditor-risk-factors/.

[75] Michael Rapoport, *China Turns Over Corporate Audit Documents to U.S. Regulators*, THE WALL STREET JOURNAL (Dec. 13, 2013, 1:06 PM), http://online.wsj.com/news/articles/SB10001424052702304477704579256282180428714?mod=WSJ_hp_LEFTWhatsNewsCollection.

[76] Michael Rapoport, *SEC, Big Four Accounting Firms in China Settle Dispute*, THE WALL STREET JOURNAL (Feb. 6, 2015, 7:03 PM), http://www.wsj.com/articles/sec-big-four-accounting-firms-in-china-settle-dispute-1423237083.

Wagoner & Bradshaw PLLC, a Salt Lake City accounting firm and two of its partners, who served as the independent auditors of a China-based chicken company, for improperly relying on prior auditor's work without sufficient review and failing to implement procedures that would identify known risks.[77] The firm and its partners settled in February 2014, agreeing to pay more than $130,000.[78] The two partners also agreed to a ban from auditing public companies for at least three years. In December 2014, the SEC announced a settlement with a Hong Kong accounting firm and two of its accountants in connection with their audit of a China-based oil company, alleging that they had failed to take appropriate steps in their review of the company's related party transactions.[79] The firm agreed to pay a $75,000 penalty, and the two individuals agreed to pay penalties of $10,000 and $20,000 and to be barred from practicing before the SEC as accountants for three years.

In May 2015, final judgements were made in a case wherein the Commission alleged that China Valves Technology, Inc. ("**China Valve**"), Siping Fang (its Chair and former CEO), Renrui Tang (its CFO), and Jianbao Wang (its former CEO) intentionally misled investors about (i) the nature of China Valves' acquisition of Watts Valve Changsha Co., Ltd. to mask the subsidiary's prior potential violations of the Foreign Corrupt Practices Act ("**FCPA**"), and (ii) payment of sales commissions to employees that potentially violated the FCPA.[80] The Commission further allaged that China Valves materially overstated income and understated liabilities incurred by a wholly-owned subsidiary. Final judgements included, among other things, (i) permanently enjoin the defendants from future violations of the anti-fraud, reporting, recordkeeping, and internal controls provisions of the federal securities laws; (ii) order China Valves, Mr. Fang, and Mr. Tang to pay civil penalties of $575,000, $75,000, and $40,000, respectively; and (iii) bar Fang and Tang from serving as an officer and director for five and three years, respectively.

In June 2015, the Commission announced that it obtained an emergency court order to freeze the assets of a Chinese trader who profited significantly after trading in a U.S. brokerage account prior to the public announcement that Qihoo 360 Technology Co. Ltd., a company based in China, had received a buyout offer at a substantial premium from its CEO and several affiliates.[81] The SEC dropped this case in January 2016.

In September 2015, the Commission announced a $55.6 million settlement with Focus Media Holding Limited ("**Focus Media**") and its CEO, Jason Jiang, to resolve charges of inaccurate disclosures about the China-based advertising company's partial sale of a subsidiary to insiders, including Mr. Jiang.[82]

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[77] *In the Matter of Child, Van Wagoner & Bradshaw*, Admin. Proceeding File No. 3-15965 (July 8, 2014), *available at* www.sec.gov/litigation/admin/2014/34-72557.pdf.

[78] Michael Rapoport, *Utah Firm Settles SEC Accounting Case Over Chinese Poultry Company*, THE WALL STREET JOURNAL (Feb. 12, 2015, 12:36 PM), http://www.wsj.com/articles/utah-firm-settles-sec-accounting-case-over-chinese-poultry-company-1423762613.

[79] SEC Press Release, SEC Imposes Sanctions Against Hong Kong-Based Firm and Two Accountants for Audit Failures (Dec. 17, 2014), *available at* www.sec.gov/news/pressrelease/2014-284.html.

[80] Litigation Release No. 23266, SEC Obtains Final Judgments Against China Valves Technology, Inc. and Two Senior Officers in Fraud Case (May 20, 2015), *available at* https://www.sec.gov/litigation/litreleases/2015/lr23266.htm.

[81] SEC Press Release, SEC Obtains Asset Freeze Against China-Based Trader for Suspicious Activity Last Week (June 23, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-128.html

[82] SEC Press Release, SEC Charges Executives for Defrauding Investors in Financial Fraud Scheme (Sept. 30, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-224.html.

The sale, which occurred before a third party purchased the subsidiary at a significantly higher price, yielded enormous profits to Mr. Jiang and other insiders.

As part of the settlement, Mr. Jiang agreed to disgorge $9.69 million of allegedly ill-gotten gains plus prejudgement interest of $1.6 million, and pay a $9.69 million penalty. Focus Media agreed to pay a $34.6 million penalty and the Commission has ordered the creation of a Fair Fund to return money to injured investors.

According to the SEC's order instituting a settled administrative proceeding, in March 2010, Focus Media disclosed an incentive initiative in which some of its managers and directors and certain employees, managers, and directors of its wholly-owned Internet advertising subsidiary, purchased a 38% stake in the subsidiary, Allyes Online Media Holdings Ltd. ("**Allyes**"). The purchase price, which Focus Media said was based on an independent third-party valuation, represented an implied value of $35 million for the entire subsidiary. However, unknown to shareholders, before the sale was finalized, a private equity firm had begun discussions with Allyes about acquiring the company for $150 million to $200 million. As described in the SEC's order, the potential acquirer's business records stated that Allyes asked it to "hold off the deal" until the insiders' purchase was finalized. In July 2010, Focus Media announced that Allyes had been sold to the private equity firm for an amount that valued it at $200 million, nearly six times what the insiders paid just months earlier.

As set forth in the SEC's order, the board of Focus Media did not receive accurate information and Focus Media's public disclosures were materially false and misleading as a result of Mr. Jiang's and Focus Media's failure to heed red flags about the transactions. The red flags included:

• the fact that the supposed management incentivization plan included non-manager consultants;

• that Mr. Jiang, the CEO of the parent company, was the largest beneficiary in a transaction designed to incentivize managers of the Allyes subsidiary;

• the vast difference in valuations for the two transactions approved months apart;

• evidence of negotiations between Allyes and the acquirer before the insider transaction was approved; and

• the lack of corporate formalities surrounding the approval and execution of both transactions.

Mr. Jiang and Focus Media consented to the SEC order without admitting or denying the findings that both violated an antifraud provision of federal securities laws and that Focus Media violated the books and recordkeeping provisions.

In October 2015, the SEC announced that Bristol-Myers Squibb agreed to settle charges that its joint venture in China made cash payments and provided other benefits to health care providers at state-owned and state-controlled hospitals in exchange for prescription sales.[83] Bristol-Myers Squibb agreed to pay more than $14 million to settle the SEC's finding that it violated the FCPA and reaped more than $11 million in profits from its misconduct.

According to the SEC's order instituting settled administrative proceedings, Bristol-Myers Squibb lacked effective internal controls over interactions with health care providers at BMS China, its majority-

[83] SEC Press Release, SEC Charges Bristol-Myers Squibb With FCPA Violations, *available at* https://www.sec.gov/news/pressrelease/2015-229.html.

owned joint venture. Between 2009 and 2014, BMS China sales representatives sought to secure and increase business by providing health care providers in China with cash, jewelry and other gifts, meals, travel, entertainment, and sponsorships for conferences and meetings. BMS China inaccurately recorded the spending as legitimate business expenses in its books and records, which were then consolidated into the books and records of Bristol-Myers Squibb.

Among the findings in the SEC's order:

- Bristol-Myers Squibb failed to respond effectively to red flags indicating that sales personnel provided bribes and other benefits to generate sales from health care providers in China;

- Bristol-Myers Squibb did not investigate claims by certain terminated employees of BMS China that faked invoices, receipts, and purchase orders were widely used to fund improper payments to health care providers; and

- Bristol-Myers Squibb was slow to remediate gaps in internal controls over interactions with health care providers and monitor potential inappropriate payments to them that were identified repeatedly in annual internal audits of BMS China between 2009 and 2013.

The SEC's order finds that Bristol-Myers Squibb violated the FCPA's internal controls and recordkeeping provisions. Without admitting or denying the findings, Bristol-Myers Squibb consented to the order and agreed to return $11.4 million of profits plus prejudgment interest of $500,000 and pay a civil penalty of $2.75 million. Bristol-Myers Squibb also agreed to report to the SEC for a two-year period on the status of its remediation and implementation of FCPA and anti-corruption compliance measures.

In December 2015, the SEC announced that two traders in China and Hong Kong agreed to pay more than $920,000 to settle an insider trading case against them. Zhichen Zhou and Yannan Liu, the two traders, must disgorge their entire ill-gotten profits of $306,929.59 plus pay penalties of $306,929.59 each.[84]

The SEC's complaint alleged that Zhou and Liu traded two health care company stocks (MedAssets Inc. and Chindex International) based on nonpublic information about their impending acquisitions by private equity firms.[85] Liu was a private equity associate at TPG Capital, which had ties to both of the deals, and maintains a personal relationship with at least one current TPG Capital employee.

Zhou and Liu, who reside in Beijing and Hong Kong, respectively, settled the charges without admitting or denying the allegations. They consented to the final judgment permanently enjoining them from violating Section 10(b) of the Exchange Act and Rule 10b-5.[86]

In February 2016, the Commission announced that a Massachusetts-based technology company and its Chinese subsidiaries agreed to pay more than $28 million to settle parallel civil and criminal actions involving violations of the FCPA.[87]

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[84] SEC Press Release, Traders in China and Hong Kong Paying $920,000 to Settle Insider Trading Case (December 28, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-290.html.

[85] *Id.*

[86] *Id.*

[87] SEC Press Release, SEC: Tech Company Bribed Chinese Officials (Feb. 16, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-29.html.

An SEC investigation found that two Chinese subsidiaries of PTC Inc. ("**PTC**") provided non-business related travel and other improper payments to various Chinese government officials in an effort to win business. PTC agreed to pay $11.858 million in disgorgement and $1.764 million in prejudgment interest to settle the SEC's charges and its two China subsidiaries agreed to pay a $14.54 million fine pursuant to a non-prosecution agreement.[88]

According to the SEC's order instituting a settled administrative proceeding against PTC:

- From at least 2006 to 2011, two PTC China-based subsidiaries provided improper travel, gifts, and entertainment totaling nearly $1.5 million to Chinese government officials who were employed by state-owned entities that were PTC customers;

- PTC gained approximately $11.8 million in profits from sales contracts with state-owned entities whose officials received the improper payments;

- Chinese officials were compensated directly and through third-party agents for sightseeing and tourist activities;

- Third-party agents typically arranged overseas sightseeing trips in conjunction with a visit to a PTC facility, typically the corporate headquarters in Massachusetts. After one day of business activities, the additional days of sightseeing visits lacked any business purpose;

- Typical PTC-paid travel destinations for Chinese officials included New York, Las Vegas, San Diego, Los Angeles, and Honolulu. Officials enjoyed guided tours, golfing, and other leisure activities;

- Employees of PTC's Chinese subsidiaries also provided improper gifts and entertainment to Chinese government officials, including small electronics such as cell phones, iPods, and GPS systems as well as gift cards, wine, and clothing; and

- The improper payments were disguised as legitimate commissions or business expenses in company books and records.[89]

The SEC's order fins that PTC violated the anti-bribery, internal controls, and books and records provisions of the Exchange Act. In the settlement, the SEC considered PTC's self-reporting of its misconduct as well as the significant remedial acts the company has since undertaken.[90]

2. Memorandum of Understanding Among SEC, China Securities Regulatory Commission, and Chinese Ministry of Finance

In May 2013, the PCAOB announced that it had entered into a Memorandum of Understanding on Enforcement Cooperation with the China Securities Regulatory Commission ("CSRC") and the Ministry of Finance (the "Memorandum of Understanding").[91] The Memorandum of Understanding "establishes a

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[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] PCAOB, PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators (May 24, 2013), *available at* pcaobus.org/News/Releases/Pages/05202013_ChinaMOU.aspx.

cooperative framework between the parties for the production and exchange of audit documents relevant to investigations in both countries respective jurisdictions" and, to that end, "provides a mechanism for the parties to request and receive from each other assistance in obtaining documents and information in furtherance of their investigative duties."

While commentators have acknowledged that this Memorandum of Understanding represents an important first step, commentators also see the deal as lacking in several important areas.[92] Notably, the Memorandum of Understanding gives China the right to reject requests that violate Chinese law or "essential national interest," language that appears to grant quite a bit of latitude to the Chinese government. Additionally, the Memorandum of Understanding only applies to enforcement actions. It does not apply to regular inspections of accounting firms, which is the key function of the PCAOB. According to the Wall Street Journal, "Still to be resolved is a parallel dispute over inspections of Chinese audit firms. The PCAOB inspects firms that audit U.S.-traded companies, but to date the Chinese government hasn't allowed the PCAOB inspectors into China to evaluate the firms, leaving the U.S. concerned that any problems at the Chinese firms could be going undetected."[93]

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[92] Floyd Norris, *An Agreement Opens Some Chinese Audit Papers to the U.S.*, DEALBOOK (May 24, 2013, 2:01 AM) http://dealbook.nytimes.com/2013/05/24/an-agreement-opens-some-chinese-audit-papers-to-the-u-s/?_r=0 .

[93] Michael Rapoport, *China Turns Over Corporate Audit Documents to U.S. Regulators*, THE WALL STREET JOURNAL (Dec. 13, 2013, 1:06 PM), http://online.wsj.com/news/articles/SB10001424052702304477704579256282180428714?mod=WSJ_hp_LEFTWhatsNewsCollection.

2. Audit Committee Checklist and Compliance Timeline

AUDIT COMMITTEE CHECKLIST AND COMPLIANCE TIMELINE

Audit committees continue to play an active role in monitoring the integrity of company financial statements, overseeing a company's relationship with and monitoring the independence of its outside auditor, and monitoring the company's internal controls and compliance with legal and regulatory requirements. Set forth below is a checklist outlining actions that companies and audit committees should consider to assist the audit committee in meeting its responsibilities under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and the implementing rules promulgated by the Securities and Exchange Commission (the "SEC"), and the listing standards of the New York Stock Exchange (the "NYSE") and The NASDAQ Stock Market LLC ("NASDAQ"). Under the SEC rules and applicable listing standards, companies also must make additional disclosures, which are discussed below.

Although the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") does not directly impact most public company audit committees, companies should consider the role that their audit committees play in the area of risk oversight, as discussed in more detail below. Finally, the Jumpstart Our Business Startups Act ("JOBS Act") makes it easier for companies to go public and creates a category of public company known as the "emerging growth company"—generally a company with less than $1.07 billion in annual gross revenues. The JOBS Act exempts emerging growth companies from certain provisions of the federal securities laws for up to five years after going public, and there are a handful of provisions in the JOBS Act that are relevant to the work of audit committees, as discussed below.

☑ ***Independence***.

- Consider whether audit committee members meet independence requirements and examine relationships of, and compensation paid to, audit committee members.

  - Audit committee members may not receive any fees (other than for service as a director and fixed amounts of compensation under a retirement plan, including deferred compensation, for prior service with the company), including consulting and advisory fees from the company or its subsidiaries, regardless of the amount. (Sarbanes-Oxley §301; Rule 10A-3(b)(1)(ii) under the Securities Exchange Act of 1934 (the "Exchange Act"); Section 303A.06 of the NYSE Listed Company Manual ("NYSE Manual"); NASDAQ Rule 5605(c)(2)(A)(ii)) The NYSE and NASDAQ listing standards incorporate the requirements of Exchange Act Rule 10A-3 by reference. (NYSE Manual Section 303A.06; NASDAQ Rule 5605(c)(2)(A)(ii)) The NYSE intends to apply Rule 10A-3 in a manner consistent with the guidance in the SEC's release adopting this rule. (Commentary to NYSE Manual Section 303A.06)

    - The SEC's rules under Section 301 of Sarbanes-Oxley prohibit audit committee members from receiving direct and indirect payments of consulting, advisory and other compensatory fees from the company or any of its subsidiaries. Indirect payments include payments to: (1) a

spouse, minor child or stepchild of, or a child or stepchild sharing a home with, an audit committee member; and (2) an entity in which the audit committee member is: (i) a partner or a member; (ii) an officer occupying a position comparable to a partner or member (such as a managing director); (iii) an executive officer; or (iv) in a position similar to any of the foregoing (excluding limited partners, non-managing members and others who have no active role in providing services to the entity) and that provides accounting, consulting, legal, investment banking, or financial advisory services to the company or any of its subsidiaries. (Exchange Act Rule 10A-3(e)(8)) The SEC indicated in the adopting release that other commercial relationships between a company and an entity with which an audit committee member has a relationship are not covered by the SEC's rule on indirect compensatory fees. The SEC also clarified in the adopting release that the rule only applies to current relationships with audit committee members.

- Audit committee members may not be an "affiliated person" of the company or any of its subsidiaries. (Sarbanes-Oxley §301; Exchange Act Rule 10A-3(b)(1)(ii)(B); NYSE Manual Section 303A.06; NASDAQ Rule 5605(c)(2)(A)(ii)) The NYSE and NASDAQ listing standards incorporate the requirements of Exchange Act Rule 10A-3 by reference. (NYSE Manual Section 303A.06; NASDAQ Rule 5605(c)(2)(A)(ii))

  - The definition of "affiliated person" in the SEC's rules under Section 301 is consistent with current SEC definitions, under which an "affiliate" of an issuer is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, [the issuer]." (Exchange Act Rule 10A-3(e)(1)(i) and (e)(4)) The definition of "affiliated person" includes a safe harbor under which a person who is not an executive officer and is not a greater than 10% stockholder is not deemed to control the issuer. The rules also provide that the safe harbor does not create a presumption that a person exceeding the 10% threshold controls or is otherwise an affiliate of another person. (Exchange Act Rule 10A-3(e)(1)(ii)) Notwithstanding the safe harbor, the following persons are deemed affiliates under the SEC rules: an executive officer of an affiliate, a director who is also an employee of an affiliate, a general partner of an affiliate, and a managing member of an affiliate. (Exchange Act Rule 10A-3(e)(1)(iii)) NASDAQ recommends that companies disclose in their proxy statements if a director is deemed independent but falls outside the safe harbor. (NASDAQ Interpretive Material ("IM")-5605-4)

- In addition to the requirements of Exchange Act Rule 10A-3, each audit committee member must be an independent director. (NYSE Manual Section 303A.07(a); NASDAQ Rule 5605(c)(2)(A)(i))
  - Under the NYSE listing standards, for a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the company (either directly or as a partner, stockholder or officer of an organization that has a relationship with the company). (NYSE Manual Section 303A.02(a)) In addition, a director is not independent if:
    - The director is, or has been within the last three years, an employee of the company, or an immediate family member of the director is, or has been within the last three years, an executive officer of the company. (NYSE Manual Section 303A.02(b)(i))
    - The director has received, or has an immediate family member who has received, during any 12-month period within the last three years, more than $120,000 in direct compensation from the company, other than director and committee fees, and pension or other forms of deferred compensation for prior service (provided the compensation is not contingent in any way on continued service) (NYSE Manual Section 303A.02(b)(ii)) Neither compensation received by a director for former service as an interim Chairman or CEO or other executive officer nor compensation received by an immediate family member for service as an employee of a company (other than an executive officer) need be considered in determining independence under this test. (Commentary to NYSE Manual Section 303A.02(b)(ii))
    - (1) The director is a current partner or employee of the company's internal or outside auditor; (2) an immediate family member of the director is a current partner of the company's internal or outside auditor; (3) an immediate family member of the director is a current employee of the company's internal or outside auditor and personally works on the company's audit; or (4) the director, or an immediate family member of the director, was within the last three years a partner or employee of the company's internal or outside auditor and personally worked on the company's audit within that time. (NYSE Manual Section 303A.02(b)(iii))
    - The director, or an immediate family member of the director, is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers serves or served at the same time on that company's compensation committee. (NYSE Manual Section 303A.02(b)(iv))
    - The director is a current executive officer or employee, or an immediate family member of the director is a current executive officer,

of another company that has made payments to, or received payments from, the listed company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of the other company's consolidated gross revenues. (NYSE Manual Section 303A.02(b)(v)) Under this standard, payments to the listed company from a director's company and payments from the listed company to a director's company must be separately compared against the consolidated gross revenues of the director's company for the same year. (NYSE Listed Company Manual - Section 303A Corporate Governance Standards - Frequently Asked Questions, Section 303A.02(b)(v), first published 1/29/04)

Although contributions to charitable organizations are not considered "payments" for purposes of this standard, commentary to the independence standards reminds boards of their obligation to consider the materiality of relationships between directors and non-profit organizations that receive corporate contributions. The standards also require companies to disclose either on their websites or in their proxy statements any contributions made to a non-profit organization where a director serves as an executive officer if, during the past three years, contributions in any one year exceeded $1 million or 2% of the organization's consolidated gross revenues. If this disclosure is made on the company's website, the company must disclose that fact in the proxy statement and provide the website address. (Commentary to NYSE Manual Section 303A.02(b)(v))

- Under the NASDAQ listing standards, an "independent director" means a person other than an executive officer or employee of the company or any other individual having a relationship that, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. (NASDAQ Rule 5605(a)(2)) The board has a responsibility to make an affirmative determination that no such relationships exist through the application of Rule 5605(a)(2). (NASDAQ IM-5605) In addition, the following directors will not be considered independent:

  - A director who is, or during the past three years was, employed by the company. (NASDAQ Rule 5605(a)(2)(A))

  - A director who accepted (or whose family member accepted) any compensation from the company in excess of $120,000, during any period of 12 consecutive months within the three years preceding the determination of the director's independence, other than: (1) compensation for board service; (2) compensation paid to a family member who is an employee (other than an executive officer) of the company; or (3) benefits under a tax qualified retirement plan or non-

discretionary compensation. Payments made by a company for the benefit of a director, such as political contributions to the campaign of a director or director's family member, would be considered indirect compensation for purposes of this standard. Non-preferential payments made in the ordinary course of providing business services (such as payments of interest or proceeds related to banking services or loans by a company that is a financial institution or payment of claims on a policy by a company that is an insurance company), payments arising solely from investments in the company's securities and loans permitted under Sarbanes-Oxley do not preclude a finding of independence as long as the payments are non-compensatory in nature. (NASDAQ Rule 5605(a)(2)(B) and IM-5605)

- A director who is (or whose family member is) a partner in, or a controlling stockholder or executive officer of, an organization, including a non-profit entity, if the company made payments to, or received payments from, the organization for property or services in the current fiscal year or any of the past three fiscal years, that exceeded the greater of $200,000 or five percent of the recipient's gross revenues for that year, other than payments arising solely from investments in the company's securities and payments under non-discretionary charitable contribution matching programs. The reference to partner is not intended to include limited partners. NASDAQ encourages boards to consider other situations where a director or a director's family member and the company each have a relationship with the same non-profit organization in assessing director independence. (NASDAQ Rule 5605(a)(2)(D) and IM-5605))
- A director who is (or whose family member is) an executive officer of another entity where, at any time during the past three years, any of the company's executive officers served on that entity's compensation committee. (NASDAQ Rule 5605(a)(2)(E))
- A director who has a family member that is, or has been within the past three years, an executive officer of the company. (NASDAQ Rule 5605(a)(2)(C))
- A director who is (or whose family member is) a current partner of the outside auditor, or who was a partner or employee of the outside auditor and worked on the company's audit engagement within the past three years. (NASDAQ Rule 5605(a)(2)(F))

➢ The NASDAQ listing standards also provide that an audit committee member must not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years. (NASDAQ Rule 5605(c)(2)(A)(iii))

☑ ***Financial expertise.***

- Disclose whether or not the audit committee has at least one "audit committee financial expert" (as defined by the SEC) and if not, why not. (Sarbanes-Oxley §407)

  - ➢ Under the SEC's rules implementing Section 407, an issuer must disclose in its Form 10-K whether or not (and if not, why not) it has at least one "audit committee financial expert" serving on the audit committee, and if so, the name of the expert and whether the expert is independent, as independence for audit committee members is defined in the listing standards applicable to the issuer. (Item 10 of Form 10-K; Item 407(d)(5) of Regulation S-K) The determination of whether an individual qualifies as an "audit committee financial expert" must be made by the full board of directors.

    The definition of "audit committee financial expert" in the SEC's rules is less restrictive than that initially proposed by the SEC and expands the pool of individuals who may qualify as an "audit committee financial expert." The SEC's final rules define an "audit committee financial expert" as a person who has:

    - o an understanding of GAAP and financial statements;
    - o the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves;
    - o experience: (1) preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to those that the issuer's financial statements can reasonably be expected to raise; or (2) actively supervising individuals engaged in these activities;
    - o an understanding of internal controls and procedures for financial reporting; and
    - o an understanding of audit committee functions. (Item 407(d)(5)(ii) of Regulation S-K)

  - ➢ The "audit committee financial expert" must have acquired these attributes through:

    - o education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in a position that involves the performance of similar functions;

- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions;

- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or

- other relevant experience (a brief listing of which must be included as part of the company's disclosure). (Item 407(d)(5)(iii) of Regulation S-K)

Because the SEC's rules permit an individual to acquire the mandatory attributes through experience "actively supervising" others, the rules make it possible for some CEOs to qualify as "audit committee financial experts." The SEC's adopting release emphasizes, however, that "active supervision" means that the supervisor participates in, and contributes to, the process of addressing the same types of financial and accounting issues addressed by the individuals being supervised.

- The SEC's rules include a safe harbor, clarifying that an "audit committee financial expert" will not be deemed an "expert" for any purpose. The safe harbor also clarifies that the designation of an individual as an "audit committee financial expert" does not: (1) impose any greater duties, obligations or liabilities than the individual would otherwise have as a member of the audit committee and board of directors; or (2) affect the duties, obligations or liabilities of other members of the audit committee or the board. (Item 407(d)(5)(iv) of Regulation S-K)

- NYSE listing standards require that at least one audit committee member have "accounting or related financial management expertise," and NASDAQ listing standards require that at least one committee member have "financial sophistication." (Commentary to NYSE Manual Section 303A.07(a); NASDAQ Rule 5605(c)(2)(A)(iv)) An "audit committee financial expert" may be presumed to satisfy these requirements. (Commentary to NYSE Manual Section 303A.07(a); NASDAQ IM 5605-4))

- Determine that each audit committee member is financially literate (NYSE) or able to read and understand financial statements (NASDAQ). NYSE listing standards permit an audit committee member to become financially literate "within a reasonable period of time" after appointment to the committee. (Commentary to NYSE Manual Section 303A.07(a); NASDAQ Rule 5605(c)(2)(A)(iv))

☑ ***Service on audit committees.***

- If an audit committee member simultaneously serves on the audit committees of more than three public companies, the board of each NYSE company must determine that the audit committee member's simultaneous service would not impair his or her ability to effectively serve on the listed company's audit committee. This determination must be disclosed either on the company's website or in the company's proxy statement. If this disclosure is made on the company's website, the company must disclose that fact in the proxy statement and provide the website address. (Commentary to NYSE Manual Section 303A.07(a))

- The NASDAQ listing standards do not contain an analogous requirement.

☑ ***Audit committee responsibilities; mandatory charter provisions for listed companies.***

- Review audit committee charter to assess whether it reflects relevant legal and regulatory developments, in addition to incorporating specific responsibilities mandated by Sarbanes-Oxley, the NYSE and NASDAQ. Most audit committees review their charters annually as a matter of good governance and in doing so also consider best practices.

- The audit committees of NYSE-listed companies must include in their charters the committee's purpose, which, at a minimum, must be to prepare the report included in the proxy statement (discussed separately below) and to assist in board oversight of:

  - the integrity of the company's financial statements;

  - the company's compliance with legal and regulatory requirements;

  - the outside auditor's qualifications and independence; and

  - the performance of the company's internal audit function and of the outside auditor. (NYSE Manual Section 303A.07(b)(i))

- Audit committees of NYSE-listed companies also must perform a number of responsibilities that must be set forth in the audit committee's charter, including those duties and responsibilities required by Exchange Act Rule 10A-3(b)(2), (3), (4) and (5). (NYSE Manual Section 303A.07(b)(ii) and (iii)) Specifically, the audit committee must:

  - be directly responsible, in its capacity as a committee of the board, for the appointment, retention, compensation, and oversight of the work of the outside auditor, as required by Exchange Act Rule 10A-3(b)(2) (discussed separately below);

- establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters, as required by Exchange Act Rule 10A-3(b)(3) (discussed separately below);

- obtain and review, at least annually, a report by the outside auditor describing: (1) the audit firm's internal quality control procedures; (2) any material issues raised by the most recent internal quality control review, or peer review, of the audit firm, or by any investigation by governmental or professional authorities, within the last five years, regarding any independent audit carried out by the audit firm, and any steps taken to address these issues; and (3) (to assess the audit firm's independence) all relationships between the auditor and the company;

    - The Public Company Accounting Oversight Board ("PCAOB") has adopted a rule that requires the outside auditor to communicate, in writing, to the audit committee any relationships between the auditor and related entities, and the company and individuals in a "financial reporting oversight role" at the company, that may reasonably be thought to bear on the auditor's independence and to discuss with the audit committee the potential effects of these relationships on independence. The report must be made both before accepting a new audit engagement, and then at least annually thereafter for continuing engagements. The rule superseded Independence Standards Board Standard No. 1 (*Independence Discussions with Audit Committees*). (PCAOB Rule 3526)

- meet to review and discuss the annual audited financial statements and quarterly financial statements with management and the outside auditor, including reviewing the listed company's specific MD&A disclosures;

- discuss earnings press releases, and financial information and earnings guidance provided to analysts and rating agencies (discussed separately below);

- have the authority, without seeking board approval, to obtain advice and assistance from outside legal, accounting or other advisors, and receive appropriate funding for the compensation of such advisors, as required by Exchange Act Rule 10A-3(b)(4) and (5) (discussed separately below);

- discuss policies with respect to risk assessment and risk management (discussed separately below);

- meet separately, periodically, with management, the internal auditor and the outside auditor (discussed separately below);

- review with the outside auditor any difficulties the auditor encountered in the course of its audit work (including any restrictions on the scope of the auditor's activities or on access to information, and any significant disagreements with management) and management's response;

- set clear hiring policies for employees or former employees of the outside auditor that are consistent with Sarbanes-Oxley, which prohibits an auditing firm from providing audit services to a company whose CEO, CFO or chief accounting officer (or any person serving in an equivalent position) was employed by the auditing firm and participated in the company's audit in any capacity within one year of audit initiation (Sarbanes-Oxley §206);

  - Under the SEC's rules implementing Section 206, an accounting firm is not independent with respect to an issuer if the lead partner, concurring partner, or any other member of the audit engagement team who provides more than 10 hours of audit, review or attest services for the issuer accepts a position with the issuer in a "financial reporting oversight role" within one year prior to the commencement of audit procedures for the year that included employment by the issuer of the former member of the audit engagement team. (Rule 2-01(c)(2)(iii)(B) of Regulation S-X) An individual has a "financial reporting oversight role" if the individual is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them. (Rule 2-01(f)(3)(ii) of Regulation S-X)

- report regularly to the board of directors; and

- undertake an annual evaluation of the audit committee's effectiveness. (NYSE Manual Section 303A.07(b)(ii) and (iii))

- Audit committee charters of companies listed on NASDAQ must include the committee's purpose of overseeing the accounting and financial reporting processes of the company and the audits of the company's financial statements. (NASDAQ Rule 5605(c)(1)(C)) The charter also must set forth specified responsibilities and authority of the audit committee, including:

  - the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements;

  - the audit committee's responsibility for: (1) ensuring its receipt from the outside auditor of a formal written statement delineating all relationships between the auditor and the company; and (2) actively engaging in a dialogue with the outside auditor about any disclosed relationships or services that may impact the objectivity and independence of the auditor and taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor; and

- the responsibilities and authority necessary to comply with Exchange Act Rule 10A-3(b)(2), (3), (4) and (5) regarding:
  - the authority to appoint and oversee the outside auditor (discussed separately below);
  - the establishment of procedures for complaints regarding accounting, internal accounting controls or auditing matters (discussed separately below);
  - the authority to engage outside advisors (discussed separately below); and funding, as determined by the audit committee. (NASDAQ Rule 5605(c)(1)(A), (B) & (D) and 5605(c)(3)).

- To enhance the effectiveness of communications between the audit committee and the outside auditor, the PCAOB has adopted Auditing Standard No. 1301 (formerly Auditing Standard No. 16) (*Communications with Audit Committees*). Among other things, Auditing Standard No. 1301 includes requirements relating to: (1) timing of communications between the outside auditor and the audit committee; (2) the audit committee's understanding and acknowledgement of the terms of the audit engagement letter; (3) communication of an overview of the audit strategy, including a discussion of timing of the audit, significant risks identified by the outside auditor during its risk assessment procedures, the use of the internal audit function, and the roles, responsibilities and location of firms participating in the audit; (4) communication about critical accounting policies, practices and estimates; (5) communication of significant unusual transactions and policies and practices used to account for these transactions; (6) communication about difficult or contentious matters for which the outside auditor consulted outside the engagement team and that it reasonably determined are relevant to the audit committee's oversight of the financial reporting process; (7) communication, where relevant, about the outside auditor's evaluation of a company's ability to continue as a going concern; (8) communication about uncorrected misstatements; (9) communication about other material written communications between the auditor and management; and (10) communication about certain matters related to departures from the auditor's standard report. Auditing Standard No. 1301 also requires the outside auditor to make inquiries of the audit committee to assess whether the committee is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations. At the time of its adoption, Auditing Standard No. 16 superseded PCAOB interim standard AU sec. 380 (*Communication With Audit Committees*) and AU sec. 310 (*Appointment of the Independent Auditor*). It was renumbered effective December 31, 2016 as part of a reorganization of the PCAOB's auditing standards. Auditing Standard No. 1301 applies to audits of emerging growth companies.

☑ ***Audit committee report in proxy statement.***

- The proxy statement must include an audit committee report that must state whether: (1) the audit committee has reviewed and discussed the audited financial statements with management; (2) the audit committee has discussed with the outside auditor the matters required to be discussed by applicable rules of the PCAOB (including matters covered by Auditing Standard No. 1301); (3) the audit committee has received the written disclosures and the letter from the outside auditor required by applicable PCAOB rules regarding the outside auditor's communications with the audit committee about auditor independence, and has discussed with the outside auditor its independence; and (4) based on the review and discussions referred to above, the audit committee recommended to the board of directors that the audited financial statements be included in the company's Form 10-K for the last fiscal year for filing with the SEC. (Item 407(d)(3)(i) of Regulation S-K)

- In the past several years, there has been a movement toward increased disclosure in audit committee reports, going beyond the minimum requirements.

  - In November 2013, a group of leading governance organizations, including the National Association of Corporate Directors, issued a report concluding that public company audit committee reporting could be strengthened in some ways. The report urged public company audit committees "to voluntarily and proactively improve their public disclosures" and emphasized the importance of providing more relevant—not just more—disclosure that is tailored for the company.

  - Consistent with the recommendations in the report, many audit committees are now including additional disclosures in their audit committee reports, covering matters such as the scope of the audit committee's duties, the committee's role in selecting, overseeing and evaluating the outside auditor, the tenure of the outside auditor, and the committee's pre-approval of audit and non-audit services. Companies also have been looking at other audit committee-related disclosures, which often appear in a number of places throughout the proxy statement (such as in the audit committee report, auditor fee section, and the proposal on auditor ratification) and Form 10-K, to determine whether those disclosures can be enhanced in order to provide investors with a more comprehensive, easily accessible picture of the audit committee's work.

  - Surveys by Ernst & Young examining the proxy statements of Fortune 100 companies during the last five years have found that "voluntary audit-related disclosures continue to trend upward in a number of areas." Since 2012, Ernst & Young has observed a significant increase in the availability of information

regarding how surveyed companies appoint, compensate and oversee their outside auditors. In 2016, 73% of companies disclosed that the audit committee believed the choice of the outside auditor was in the best interests of the company and its stockholders, 73% disclosed that the audit committee was involved in the selection of the lead audit partner, and 31% provided information about the reasons for year-over-year changes in fees paid to the outside auditor. Moreover, Ernst & Young noted that in 2016, "amid heightened investor interest in director qualifications" there was an "emergence of enhanced disclosure around audit committee members."

- On July 1, 2015, the SEC issued a "concept release" on the auditor-audit committee relationship to solicit feedback on changes the SEC could make to its proxy disclosure requirements to provide greater transparency about the work of audit committees and to make the audit committee report more useful to investors. The SEC has not yet taken action on the concept release, but in a March 2017 speech, the SEC's Chief Accountant recommended that audit committees and their advisors consider the guidance contained in the release as they evaluate enhanced disclosures. The concept release requested comment on potential disclosure items in three major subject matter areas:

  - the audit committee's oversight of the outside auditor, including whether additional disclosure should be required regarding the nature, timing and frequency of communications between the audit committee and the outside auditor, and the committee's review and discussion of the outside auditor's internal quality-control review and PCAOB inspection report;

  - the audit committee's process for selecting the outside auditor, including whether additional disclosure should be required regarding the criteria used to assess the outside auditor, any requests for proposals for the independent audit, and any policy for an annual stockholder vote ratifying the selection of the outside auditor and the committee's consideration of the voting results; and

  - the audit committee's consideration of the qualifications of the outside auditor and certain members of the engagement team, including whether the audit committee should disclose the name and qualifications of the engagement partner and other key members of the engagement team, information about the audit committee's input in selecting the engagement partner, the tenure of the outside auditor, and information regarding other firms involved in the audit.

☑ ***Periodic private sessions with management and internal and outside auditors.***

- Conduct private sessions, periodically, with the internal and outside auditors and with management. Include a requirement for periodic private sessions in the audit committee charter. (NYSE Manual Section 303A.07(b)(iii)(E))

- The NASDAQ listing standards do not contain an analogous requirement.

☑ ***"Direct responsibility" for the outside auditor.***

- Make the audit committee "directly responsible" for the appointment, compensation, retention and oversight of the work of the outside auditor. (Sarbanes-Oxley §301; Exchange Act Rule 10A-3(b)(2); NYSE Manual Section 303A.07(b)(iii); NASDAQ Rule 5605(c)(3)(i))

    - The SEC's release adopting rules under Section 301 indicates that the audit committee's oversight responsibilities include the authority to retain and terminate the outside auditor, and ultimate authority to approve all audit engagement fees and terms.

- Include in the audit committee charter a provision that gives the audit committee authority to appoint and dismiss, oversee, and determine funding for the outside auditor. (NYSE Manual Section 303A.07(b)(iii); NASDAQ Rule 5605(c)(1) and 5605(c)(3))

☑ ***Services provided by the outside auditor.***

- Review non-audit services currently provided by the outside auditor to determine whether any of these services are prohibited under Sarbanes-Oxley and applicable rules. (See Sarbanes-Oxley §201) The SEC rules include a list of non-audit services that, if provided to an audit client, would impair an auditor's independence. Sarbanes-Oxley also prohibits any other services that the PCAOB determines, by regulation, are impermissible. Under SEC rules, services that impair an auditor's independence include:

    - bookkeeping and other services related to the company's accounting records or financial statements;

    - financial information systems design and implementation;

    - appraisal or valuation services, fairness opinions and contribution-in-kind reports;

    - actuarial services;

    - internal audit outsourcing services;

- management functions;
- human resources;
- broker-dealer, investment adviser or investment banking services;
- legal services; and
- expert services unrelated to the audit performed for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. (Rule 2-01(c)(4) of Regulation S-X)
  - The SEC rules contain limited exceptions within some of these restrictions on non-audit services. The SEC has clarified that auditors may continue to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval (discussed below). The SEC's adopting release states, however, that an auditor's independence would be impaired if it represented an issuer before a tax court, district court or federal court of claims. The SEC also stated that audit committees should scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant if the sole business purpose of the transaction may be tax avoidance and the tax treatment may be not supported in the Internal Revenue Code and related regulations.
  - The PCAOB has adopted auditor independence and ethics rules that treat an auditor as not independent of an audit client if the auditor: (1) provides any service or product to an audit client for a contingent fee; (2) plans, markets, or opines in favor of, certain types of confidential or aggressive tax position transactions; or (3) provides tax services to individuals who perform a "financial reporting oversight role" (as defined by SEC rules) at an audit client, other than directors, and to family members of individuals in a financial reporting oversight role. (PCAOB Rules 3521, 3522 & 3523)

- Adopt policies governing audit committee pre-approval of <u>all</u> <u>audit</u> <u>and</u> <u>permitted</u> <u>non</u>-<u>audit</u> services to be provided by the outside auditor. (Sarbanes-Oxley §202)
  - The SEC's rules implementing Section 202 provide that audit and non-audit services may be pre-approved either:
    - on an engagement-by-engagement basis; or
    - pursuant to pre-approval policies and procedures established by the audit committee, provided that: (1) the policies and procedures are detailed as to the particular service; (2) the audit committee is informed on a timely basis of each such service; and (3) the policies

and procedures do not include the delegation of audit committee responsibilities to management. (Rule 2-01(c)(7) of Regulation S-X)

- The audit committee also may delegate authority to grant pre-approvals to one or more of its members, provided that the pre-approvals are reported to the full committee at each of its scheduled meetings. (Sarbanes-Oxley §202)

- As part of its rules on tax services (discussed above), the PCAOB has adopted a rule designed to supplement the SEC's pre-approval requirements. The PCAOB rule requires that the outside auditor: (1) describe in writing to the audit committee the nature and scope of each proposed tax service, including the fee structure for the engagement; (2) discuss with the audit committee the potential effects of the proposed tax service on the auditor's independence; and (3) document the auditor's discussion with the audit committee. In addition, the auditor must disclose to the audit committee any side letters, agreements or amendments, written or unwritten, relating to the tax services engagements. (PCAOB Rule 3524)

- The PCAOB also has adopted a rule that requires the outside auditor to take steps similar to those required for tax services in connection with the process of obtaining audit committee pre-approval of internal control-related non-audit services. Specifically, the auditor must: (1) describe to the audit committee, in writing, the scope of the service; (2) discuss with the audit committee any potential impact of the service in the firm's independence; and (3) document the substance of the discussion with the audit committee. Unlike previous PCAOB requirements, which mandated audit committee pre-approval of each engagement to perform internal control-related services, the rule permits pre-approval either on an engagement-by-engagement basis or pursuant to policies and procedures. (PCAOB Rule 3525)

- Disclose pre-approval policies in 10-Ks and proxy statements. (Sarbanes-Oxley §202; Item 14(5) of Form 10-K; Item 9(e)(5) of Schedule 14A)

  - The SEC's rules contemplate that companies will incorporate the proxy disclosure by reference into their 10-Ks. Companies have the option of including a copy of their policies and procedures or providing "clear, concise and understandable descriptions."

  - The SEC's rules require proxy disclosure about fees paid by companies to their outside auditors. The rules require disclosure of fees in four categories: (1) Audit Fees; (2) Audit-Related Fees; (3) Tax Fees; and (4) All Other Fees. The required fee disclosures must cover the past two fiscal years. (Item 14(1)-(4) of Form 10-K; Items 9(e)(1)-(4) of Schedule 14A)

☑ ***Rotation of outside audit partners.***

- Assure regular rotation of the lead and concurring audit partners, and other significant audit partners, as required by Section 203 of Sarbanes-Oxley. Consider whether, in order to assure continuing independence, there should be regular rotation of the outside auditor. (Commentary to NYSE Manual Section 303A.07(b)(iii)(A))

    - ➢ The SEC's rules implementing Section 203 require the lead audit and concurring partners to rotate off the audit engagement after five years, with a five-year time-out period. Certain other significant audit partners are subject to a seven-year rotation requirement, followed by a two-year time-out period. (Rule 2-01(c)(6) of Regulation S-X)

    - ➢ In 2014, the PCAOB confirmed that it had no plans to pursue mandatory audit firm rotation in the foreseeable future, and that remains the case as of 2017. The PCAOB had previously issued a *Concept Release on Auditor Independence and Audit Firm Rotation* in 2011 soliciting public comment on the issue, but there was significant opposition to the possibility of mandatory audit firm rotation. In mid-2016, requirements took effect in the European Union for public companies to rotate their auditors every ten years, with possible extensions of up to ten years if the engagement is put out to bid and up to 14 years for companies that have "joint audits" by more than one audit firm.

    - ➢ On May 10, 2016 the SEC approved new PCAOB rules to provide investors with more information about who is participating in public company audits. Under the rules, auditors are required to file a new form with the PCAOB, Form AP, *Auditor Reporting of Certain Audit Participants,* for each issuer audit. The form discloses, among other things, the name of the engagement partner as well as the names of other audit firms that played a significant role in the audit. Audit firms must file Form AP for public company audit reports issued on or after January 31, 2017 (for engagement partner names) and June 30, 2017 (for other accounting firms that participated in the audit). Information filed on Form AP is available to the public through a searchable database on the PCAOB website.

☑ ***Complaints and concerns about accounting and auditing matters***.

- Develop procedures for the submission of complaints and concerns about accounting and auditing matters. These procedures must address: (1) the receipt, retention, and treatment of complaints received by the company about accounting, internal accounting controls and auditing matters; and (2) the confidential, anonymous submission of employee concerns about questionable auditing or accounting matters. (Sarbanes-Oxley §301; Exchange Act Rule 10A-3(b)(3); NYSE Manual Section 303A.07(b)(iii); NASDAQ Rule 5605(c)(3)(ii))

- Include in the audit committee charter a requirement that the committee establish such procedures and periodically receive reports regarding the status and treatment of complaints submitted through the procedures. (NYSE Manual Section 303A.07(b)(iii); NASDAQ Rule 5605(c)(1)(D) and 5605(c)(3)(ii))

☑ ***Outside advisors.***

- The audit committee must have authority to retain outside advisors and must receive appropriate funding from the company, as determined by the committee, to compensate outside advisors. (Sarbanes-Oxley §301; Exchange Act Rule 10A-3(b)(4) and (5); NYSE Manual Section 303A.07(b)(iii); NASDAQ Rule 5605(c)(3)(iii))

- Include in the audit committee charter a provision that gives the audit committee authority, without seeking board approval, to obtain advice from outside advisors, and to provide funding to compensate such advisors. (NYSE Manual Section 303A.07(b)(iii); NASDAQ Rule 5605(c)(1)(D) and 5605(c)(3)(iii))

☑ ***CEO and CFO certifications – disclosure controls and procedures.***

- Review with the CEO and CFO how they are meeting their obligations under the certification requirements of Sections 302 and 906 of Sarbanes-Oxley, and review the CEO's and CFO's evaluations of the company's disclosure controls and procedures.

    - In its rules implementing the Section 302 certification requirements, the SEC developed the concept of "disclosure controls and procedures," which are defined in Rule 13a-15(e) to include controls and other procedures designed to ensure that information required to be disclosed in a company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Section 302 certification also addresses "internal control over financial reporting" (discussed separately below).

    - As implemented by the SEC, the portion of the Section 302 certification addressing disclosure controls and procedures must state that the CEO and CFO:

        - are responsible for establishing and maintaining disclosure controls and procedures;

        - have designed the company's disclosure controls and procedures, or caused the disclosure controls and procedures to be designed under their supervision, to ensure that material information about the company, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the 10-Q or 10-K is being prepared; and

  - o have evaluated the effectiveness of the company's disclosure controls and presented in the 10-Q or 10-K their conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the 10-Q or 10-K, based on their evaluation. (Exchange Act Rule 13a-14(a); Item 601(b)(31) of Regulation S-K)

  The last prong of the certification is a change from the SEC's original rules implementing Section 302, which required that the evaluation of disclosure controls and procedures take place as of a date within 90 days prior to the filing date of the 10-Q or 10-K.

  - ➢ The SEC rules implementing Section 302 also require that companies maintain adequate disclosure controls and procedures, evaluate their effectiveness (with the participation of the CEO and CFO) as of the end of each fiscal quarter, and include in their 10-Ks and 10-Qs disclosures about the conclusions reached by the CEO and CFO following their evaluation of the company's disclosure controls and procedures. (Exchange Act Rules 13a-15(a) and (b); Item 9A of Form 10-K; Part I, Item 4 of Form 10-Q; Item 307 of Regulation S-K)

☑ ***CEO and CFO certifications – internal control over financial reporting.***

- Review with the CEO and CFO how they are meeting their obligations under the certification requirements of Sections 302 and 906 of Sarbanes-Oxley and provide for the CEO and CFO to disclose to the audit committee and the outside auditor: (1) all significant deficiencies and material weaknesses in the design or operation of "internal control over financial reporting" that are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial data; and (2) any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

  - ➢ Under Section 302 of Sarbanes-Oxley, as implemented by the SEC, the CEO and CFO certification must indicate that the CEO and CFO have made the disclosures in (1) and (2) above to the audit committee and outside auditor. (Exchange Act Rule 13a-14(a); Item 601(b)(31) of Regulation S-K; Item 9A of Form 10-K; Part I, Item 4 of Form 10-Q)

  - ➢ Under the SEC's rules, companies also must maintain "internal control over financial reporting" and the CEO and CFO certifications must include a statement that the CEO and CFO: (1) are responsible for establishing and maintaining internal control over financial reporting; and (2) have designed the company's internal control over financial reporting, or caused it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. (Exchange Act Rule 13a-15(a); Exchange Act Rule 13a-14(a); Item 601(b)(31) of Regulation S-K)

- The SEC has adopted a definition of "internal control over financial reporting," which is defined as a process designed by, or under the supervision of, the CEO and CFO and effected by the board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

    - pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;

    - provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of the company's management and directors; and

    - provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements. (Exchange Act Rule 13a-15(f))

- Review with the outside auditor and management steps that the company is taking to evaluate the effectiveness of internal control over financial reporting in connection with the "internal control report of management" required under Sarbanes-Oxley.

    - Section 404 of Sarbanes-Oxley requires that each annual report required to be filed with the SEC contain an "internal control report" of management setting forth management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year, and that the outside auditor attest to and report on management's assessment in accordance with standards issued by the PCAOB. (Exchange Act Rule 13a-15(c); Item 9A of Form 10-K; Item 308(a) of Regulation S-K) Under the SEC's rules implementing Section 404, management must evaluate, with the participation of the CEO and CFO, the effectiveness of the company's internal control over financial reporting as of the end of each fiscal year and companies must include in their annual reports a report of management on the company's internal control over financial reporting. (Exchange Act Rule 13a-15(c); Item 9A of Form 10-K; Item 308(a) of Regulation S-K) The report must include:

        - a statement that management is responsible for establishing and maintaining adequate internal control over financial reporting;

- a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting;

- management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including disclosure of any material weaknesses in the company's internal control over financial reporting identified by management; and

- a statement that the outside auditor has issued a report on management's assessment of the company's internal control over financial reporting, which must be filed as part of the annual report. (Items 308(a) & (b) of Regulation S-K)

Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses. (Item 308(a)(3) of Regulation S-K) Management's evaluation must be based on a suitable, recognized control framework established by a body that has followed due process procedures, including the distribution of the framework for public comment. (Exchange Act Rule 13a-15(c)) Although the SEC indicated in the release adopting its rules under Section 404 that the *Internal Control – Integrated Framework* developed by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission satisfies the SEC's criteria and may be used as an evaluation framework, the SEC has declined to mandate the use of a particular framework in its rules because other frameworks exist and may be developed in the future.

- In 2007, the SEC adopted interpretive guidance for management to use in conducting the annual evaluation of internal control over financial reporting required under the SEC's rules implementing Section 404 of Sarbanes-Oxley. This guidance is not specific to a particular framework for management's evaluation of internal control over financial reporting, although in several instances it refers to the COSO framework by way of example. (SEC Release No. 34-55929)

- The guidance sets forth an approach by which management can conduct a "top-down, risk-based" evaluation of internal control over financial reporting and is intended to make the Section 404 evaluation process more effective and cost-efficient.

- The SEC also adopted rule amendments clarifying that following this interpretive guidance in conducting an evaluation of the effectiveness of a company's internal control over financial reporting is one way—but not the only way—for management to satisfy its obligation to

conduct the annual Section 404 evaluation required by SEC rules. (SEC Release Nos. 34-55929, 34-55928)

- In May 2013, COSO released an updated version of its *Internal Control-Integrated Framework*. The updated framework preserved the core definition of internal control and the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring activities). It also preserved the requirement that each of the five components be present and functioning in order for a system of internal control to be considered effective. The 2013 framework included updates intended to formalize and provide additional guidance about the requirements for an effective system of internal control and to address changes in business and operating environments, including the globalization of markets, complexities in business and in laws and regulations, and the use of new technologies. COSO indicated that it would be appropriate for companies to continue using the prior framework during a transition period that ended December 15, 2014, and the SEC staff indicated that it expected companies to implement the 2013 framework no later than for the 2015 calendar year.

- The outside auditor's report (discussed in more detail below) must clearly state the auditor's opinion as to whether the company maintained, in all material respects, effective control over financial reporting. (Item 308(b) of Regulation S-K; Rules 1-02(a)(2) and 2-02(f) of Regulation S-X)

  - PCAOB Auditing Standard No. 2201 (*An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*) (formerly Auditing Standard No. 5) governs the outside auditor's audit of the effectiveness of internal control over financial reporting. This standard superseded Auditing Standard No. 2 (*An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*) and was renumbered effective December 31, 2016 as part of a reorganization of the PCAOB's auditing standards.

  - The standard is a principles-based standard designed to focus the auditor on the most important matters, eliminate unnecessary procedures, and simplify the existing standard. (SEC Release No. 34-56152)

  - Under Auditing Standard No. 2201, the outside auditor's report must express an opinion as to whether the company has maintained, in all material respects, effective internal control over financial reporting. Previously, under Auditing Standard No. 2, the auditor was required to express a separate opinion as to whether management's assessment of the effectiveness of internal control over financial reporting is fairly stated.

  - As part of the outside auditor's evaluation of a company's control environment and period-end financial reporting process, Auditing Standard No. 2201 requires that the auditor evaluate the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. (Auditing Standard No. 2201, paragraphs 25, 27)

  - Under Section 404(c) of the Sarbanes-Oxley Act, which was added by Section 989G of the Dodd-Frank Act, the SEC has adopted rules clarifying that the outside auditor of a non-accelerated filer need not include in its audit report an opinion on the company's internal control over financial reporting. (SEC Release Nos. 33-9142 and 34-62914; Sarbanes-Oxley §404(c); Item 308(a)(4) and (b) of Regulation S-K; Rule 2-02(f) of Regulation S-X) Under the JOBS Act, emerging growth companies are also exempt from this requirement. (JOBS Act §103; Sarbanes-Oxley §404(b)) Both non-accelerated filers and emerging growth companies remain subject to Section 404's requirement to provide management's assessment of the company's internal controls.

- Review and discuss any significant changes in internal control over financial reporting.

  - The SEC's rules under Section 302 also require CEOs and CFOs to certify that they have indicated in the 10-K or 10-Q whether or not any changes in internal control over financial reporting occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting. (Exchange Act Rule 13a-14(a); Item 601(b)(31) of Regulation S-K; Item 9A of Form 10-K; Part I, Item 4 of Form 10-Q; Item 308(c) of Regulation S-K) The rules also require management, with the participation of the CEO and CFO, to evaluate any changes in internal control over financial reporting that occurred during the quarter that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting. (Exchange Act Rule 13a-15(c))

    - In a March 2017 speech on internal controls, the SEC's Chief Accountant noted that over the next several years, updating and maintaining internal controls will be particularly important as companies work through the implementation of significant new accounting standards. These standards address revenue recognition (applicable starting for 2018) and leasing (applicable starting for 2019).

  - The commentary to the NYSE's rules states that the audit committee must review major issues as to the adequacy of the company's internal controls and

any special audit steps adopted in light of material control deficiencies. (General Commentary to NYSE Manual Section 303A.07(b))

☑ ***Outside auditor's report and changes under consideration by the PCAOB.***

- Over the last several years, the PCAOB has been considering changes to the model for the outside auditor's report on the financial statements included in the annual report on Form 10-K. On May 11, 2016, the PCAOB issued a revised proposal on the auditor's reporting model. The revised proposal was subject to a public comment period that closed on August 15, 2016, and if the PCAOB issues a final standard, it must receive SEC approval before it becomes effective.

- The revised proposal retains the "pass/fail" model used in the existing auditor's report, but would require additional information in the report and address the form of the report. The proposal would require disclosure about "critical audit matters" identified by the auditor during the course of the audit, which are matters communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective or complex auditor judgments. For each critical audit matter identified in the report, the auditor would have to describe in the audit report the principal considerations that led the auditor to determine that it is a critical audit matter, the manner in which the critical audit matter was addressed in the audit, and the relevant financial statement accounts and disclosures relating to the critical audit matter. The proposal also would require a statement about the requirement for the auditor to be independent and about the length of the auditor's tenure with the company. Finally, the proposal would introduce some standardization of auditors' reports by requiring the opinion in the first section and section titles to guide readers.

  - ➢ The revised proposal retains the core concept of "critical audit matters," which was part of the PCAOB's original proposal issued in 2013, but narrows the definition in response to concerns about the breadth of the definition as it was initially proposed. In particular, the revised proposal limits the source of critical audit matters to those matters communicated or required to be communicated to the audit committee, and it adds a materiality threshold.

  - ➢ The PCAOB declined to reissue a second proposal that was published for comment in 2013 in conjunction with the original proposal on the auditor's reporting model. That proposal would have required the auditor to report on information in the Form 10-K that appears outside the financial statements, such as Management's Discussion and Analysis.

  - ➢ Emerging growth companies are exempt from rules adopted by the PCAOB after April 5, 2012, the effective date of the JOBS Act, unless the SEC determines that the application of a particular rule to these companies is necessary or appropriate in the public interest. Emerging growth companies

also are exempt from any PCAOB rule mandating "a supplement to the auditor's report" requiring additional information about the audit and the financial statements (sometimes referred to as an "auditor discussion and analysis"). If the revised proposal on the auditor's reporting model is approved, it will be subject to an evaluation to determine whether it will apply to emerging growth companies. The PCAOB noted that even if the new requirements do not ultimately apply to emerging growth companies, this would not preclude an auditor from applying them voluntarily.

☑ ***Earnings releases, and financial information and earnings guidance provided to analysts and rating agencies.***

- Discuss earnings releases, and financial information and earnings guidance provided to analysts and ratings agencies. Include provision in the audit committee charter indicating that the audit committee is responsible for conducting discussions of earnings releases and guidance. (NYSE Manual Section 303A.07(b)(iii)(C))
    - ➢ The audit committee may have a general discussion of the types of information to be disclosed and the type of presentation to be made. It need not discuss each earnings release in advance or each circumstance in which the company provides earnings guidance. (Commentary to NYSE Manual Section 303A.07(b)(iii)(C))
- The NASDAQ listing standards do not contain an analogous requirement.
- In light of the SEC staff's renewed focus on non-GAAP financial measures (discussed separately below), audit committees at both NYSE and NASDAQ companies should discuss and understand management's approach to the use of non-GAAP financial measures in earnings releases.
- SEC rules implementing Section 409 of the Sarbanes-Oxley Act require issuers to furnish on Form 8-K all releases or announcements disclosing material non-public financial information about completed annual or quarterly fiscal periods within five business days after dissemination. (Item 2.02 of Form 8-K) This time period was shortened to four business days in 2004 as a result of amendments to the SEC's 8-K rules. (General Instruction B.1 to Form 8-K)

☑ ***Risk assessment and risk management policies.***

- Consider carefully the company's risk oversight process and structure, including how the board allocates responsibility for risk oversight among the full board, the audit committee and other committees. Include a provision in the audit committee charter reflecting the audit committee's role in risk oversight, and (at NYSE companies) indicating that the audit committee is responsible for discussing the company's risk assessment and risk management policies. (NYSE Manual Section 303A.07(b)(iii)(D))

- Many companies oversee risk through a combination of the full board and the audit committee, while some have delegated responsibility for risk oversight to committees other than the audit committee. The commentary to the NYSE listing standards indicates that companies may manage risk through mechanisms other than the audit committee, but that a company's processes for managing and assessing risk should be reviewed in a general manner by the audit committee. (Commentary to NYSE Manual Section 303A.07(b)(iii)(D))

  - The Dodd-Frank Act requires that certain publicly traded financial institutions establish a separate risk committee of the board of directors that is responsible for overseeing an institution's enterprise-wide risk management practices, in accordance with rules adopted by the Federal Reserve Board of Governors. Under the rules, the risk committee must: (1) perform specified risk oversight responsibilities; (2) have a chair who is an independent director and at least one member with experience identifying, assessing and managing risk exposure; (3) meet at least quarterly; and (4) have a written charter. All U.S. bank holding companies with assets of $50 billion or more were subject to a January 1, 2015 compliance date and publicly traded U.S. bank holding companies with assets of $10 billion or more but less than $50 billion were required to comply by July 1, 2015.

- The NASDAQ listing standards do not contain analogous requirements with respect to risk oversight.

- In recent years, cyber-security and cyber-risk have been elevated to the board level due to increasing recognition that these issues have enterprise-wide ramifications. This has led many boards to think about where to place ownership of cyber-risk oversight and what they should be doing to perform their oversight responsibilities in this area. Many boards assign primary responsibility for oversight of cyber-risk to the audit committee. According to a survey of public companies by the National Association of Corporate Directors ("NACD"), as of mid-2016, 51% of boards assigned the majority of tasks involving cyber-security oversight to the audit committee, while 41% of boards performed these tasks at the full board level. At 11% of companies, a risk committee took the lead on cyber-security, and a technology committee did so at 5% of companies (multiple survey responses were permitted). In its *Director's Handbook on Cyber-Risk Oversight*, the NACD recognizes that there is no one "right" approach for every board. However, the NACD recommends that the full board be briefed on cyber-security matters at least twice a year and "as specific incidents or situations warrant," and that committees with responsibility for risk oversight and cyber-risk in particular receive briefings at least quarterly.

- Item 407(h) of Regulation S-K requires companies to provide disclosure in their proxy statements about the board's role in risk oversight. The required disclosures address such matters as how the board administers its risk oversight function, whether through the board as a whole or through a committee such as the audit committee, and

whether the individuals overseeing risk management report directly to the board or to a committee and the effect this has on the board's leadership structure. (Item 7(b) of Schedule 14A; Item 407(h) of Regulation S-K)

☑ ***Related person transactions.***

- Review and approve related person transactions (if the board of directors has not designated another independent committee to do so).

  - ➢ SEC rules require disclosure in the proxy statement regarding company policies and procedures for the review, approval or ratification of "related person transactions" reportable under Item 404(a) of Regulation S-K. The required description of these policies and procedures must contain their material features, which could include: (1) the types of transactions covered by the policies and procedures; (2) the standards to be applied pursuant to these policies and procedures; (3) the persons on the board of directors or otherwise who are responsible for applying these policies and procedures; and (4) whether the policies and procedures are in writing. The rules also require companies to identify any related person transactions for which the policies and procedures did not apply or were not followed. (Item 7(b) of Schedule 14A; Item 404(b) of Regulation S-K)

  - ➢ NYSE listing standards state that related party transactions are to be reviewed and evaluated by "an appropriate group" within the listed company. The listing standards do not specify who should conduct this review, but the NYSE believes that it is appropriate for the audit committee or "another comparable body" to perform this task. Following this review, the listed company "should determine whether or not a particular relationship serves the best interest of the company and its shareholders and whether the relationship should be continued or eliminated." (NYSE Manual Section 314.00)

  - ➢ NASDAQ listing standards require the audit committee (or another independent body of the board of directors) to conduct an appropriate review, on an ongoing basis, of all related party transactions for potential conflict-of-interest situations. The term "related party transaction" refers to transactions required to be disclosed under Item 404 of Regulation S-K. (NASDAQ Rule 5630(a))

  - ➢ On October 21, 2014, the SEC approved the PCAOB's Auditing Standard No. 18 (*Related Parties*) (now Auditing Standard No. 2410), which superseded AU sec. 334 (*Related Parties*). The standard governs the procedures for auditors' assessment of transactions with related parties and significant unusual transactions (transactions outside the ordinary course of business). Auditing Standard No. 2410 is intended to strengthen audit performance requirements in these areas, out of a concern that related party transactions have been contributing factors in cases of financial reporting

fraud and other financial failures. Auditing Standard No. 2410 also requires auditors to assess risks relating to executive compensation because of concerns that an increased emphasis on pay-for-performance in executive compensation programs may increase the risk that financial results will be manipulated. Finally, the standard establishes a requirement for the auditor to communicate with the audit committee about its evaluation of related party transactions prior to the issuance of the auditor's report. The standard became effective for the audits/reviews of financial statements for fiscal years beginning on or after December 15, 2014 and was renumbered as part of a reorganization of the PCAOB's auditing standards that took effect December 31, 2016.

☑ ***Critical accounting policies, significant accounting judgments and estimates, and off-balance sheet transactions.***

- Receive report from the outside auditor on, among other things, critical accounting policies and alternative treatments of financial information that have been discussed with management. (Sarbanes-Oxley §204)

  - Although Section 204 of Sarbanes-Oxley applies to auditing firms rather than audit committees, members of the audit committee should make sure that they understand the company's critical accounting policies, internal controls, off-balance sheet financing and related party transactions.

  - The SEC rules implementing Section 204 require the outside auditor to report to the audit committee, prior to the filing of the audit report with the SEC, on:

    - all critical accounting policies and practices to be used;

    - all alternative accounting treatments of financial information within GAAP related to material items that have been discussed with management, including the ramifications of the use of alternative treatments and the treatment preferred by the outside auditor; and

    - other material written communications between the outside auditor and management. (Rule 2-07 of Regulation S-X)

  - Although the SEC's rules do not require that these communications be in writing, the SEC has indicated that it expects that the outside auditor and audit committee will document the communications. In addition, although the communications must, at a minimum, occur during the annual audit, the SEC expects that they could occur as frequently as quarterly or on a real-time basis.

  - Auditing Standard No. 1301 (*Communications with Audit Committees*) (discussed above), includes requirements relating to communications between the outside auditor and the audit committee about, among other things, critical accounting policies, practices and estimates. The requirements are consistent

with the SEC's rules and address additional matters relating to critical accounting policies and practices, and critical accounting estimates, that the auditor must communicate to the audit committee (discussed above).

- Review:
  - ➢ major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles; and
  - ➢ analyses prepared by management and/or the outside auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of financial statements, including analyses of the effects on the financial statements of alternative GAAP methods, regulatory and accounting initiatives and off-balance sheet structures. (General Commentary to NYSE Manual Section 303A.07(b))
- SEC rules implementing Section 401(a) of the Sarbanes-Oxley Act require disclosure about off-balance sheet arrangements that either have, or are "reasonably likely" to have, a material current or future effect on an issuer's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. Companies must provide the disclosure in a separately captioned subsection of the MD&A. (Item 303(a)(4) of Regulation S-K) The rules also require issuers to provide an overview in their 10-Ks, in tabular format, of specified known contractual obligations. (Item 303(a)(5) of Regulation S-K)

☑ ***Non-GAAP financial measures.***

- Review and discuss with management the company's approach to the use of non-GAAP financial measures in earnings releases and SEC filings. This discussion should include how 2016 guidance from the SEC staff has impacted the company's use and presentation of non-GAAP financial measures and relevant developments resulting from ongoing SEC focus on these measures.

o SEC rules implementing Section 401(b) of the Sarbanes-Oxley Act place conditions on the use of non-GAAP financial measures. Specifically:

  - ➢ Regulation G applies whenever an issuer, or a person acting on its behalf, publicly discloses or releases material information that includes a non-GAAP financial measure. Regulation G prohibits material misstatements or omissions that would make the presentation of the non-GAAP financial measure misleading, when viewed in context with the information accompanying that measure and any other accompanying discussion of the measure. In addition, Regulation G requires a quantitative reconciliation of the differences between the non-GAAP financial measure presented and the most directly comparable GAAP financial measure.

- Item 10(e) of Regulation S-K establishes parameters on the use of non-GAAP financial measures in SEC filings. Under Item 10(e), issuers using non-GAAP financial measures in SEC filings must provide: (1) a presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP; (2) a reconciliation (by schedule or other clearly understandable method), of the differences between the non-GAAP financial measure with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP; (3) a statement disclosing the reasons why the issuer's management believes that presentation of the non-GAAP financial measure provides useful information to investors about the issuer's financial condition and results of operations; and (4) to the extent material, a statement disclosing the additional purposes, if any, for which the issuer's management uses the non-GAAP financial measure that are not otherwise disclosed. Item 10 has a carve-out so that prohibitions on the use of certain non-GAAP financial measures do not prevent use of EBITDA.

- On May 17, 2016, the staff in the SEC's Division of Corporation Finance issued new interpretive guidance on the use of non-GAAP financial measures. The guidance reflected a new stance by the SEC on the use of non-GAAP financial measures. The guidance came on the heels of numerous speeches by SEC Commissioners and staff indicating that the SEC was increasing its scrutiny of non-GAAP financial measures in light of the increasing use of these measures by companies, as well as analysts and the press. In the months since the guidance was issued, the staff has also continued its intensified focus on non-GAAP financial measures in reviewing and commenting on companies' SEC filings.

  - The first of the two primary issues addressed in the guidance is the "equal or greater prominence" requirement. This requirement mandates that companies present the most directly comparable GAAP measure with "equal or greater prominence" when including a non-GAAP financial measure in any document filed with the SEC or in an earnings release furnished on Form 8-K. The SEC staff's guidance reads "equal" prominence to mean that the GAAP measure generally must precede any non-GAAP measure. It reads "prominence" to refer not simply to the location or ordering of GAAP and non-GAAP numbers, but also to apply to the manner in which GAAP and non-GAAP numbers are discussed and characterized.

  - The second issue addressed in the guidance is presentations of non-GAAP financial measures that the SEC staff views as improper. As noted above, Regulation G prohibits the use of a non-GAAP financial measure that is misleading when viewed in context with the information accompanying that measure and any other accompanying discussion of the measure. The guidance addresses four practices that,

in the staff's view, can result in a non-GAAP financial measure that is misleading: (1) presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a company's business; (2) varying non-GAAP financial measures from period to period by adjusting for a particular charge or gain in the current period when "other, similar charges or gains" were not also adjusted in prior periods, unless the change between periods is disclosed and the reasons for it explained; (3) adjusting only for non-recurring charges and not also non-recurring gains during the same period; and (4) presenting a performance measure that is adjusted to treat revenue recognized in a manner inconsistent with GAAP.

☑ ***Codes of conduct for directors, officers and employees.***

- Pursuant to the audit committee's responsibility for legal compliance, review codes of conduct applicable to directors, officers and employees and promptly disclose any waivers of the code for executive officers and directors. (NYSE Manual Section 303A.10)

  - NYSE-listed companies must adopt and disclose a code of business conduct and ethics for directors, officers, and employees. The code must require that any waivers for directors or executive officers can be made only by the board or a board committee. Waivers must be disclosed to stockholders within four business days through a press release, website disclosure or Form 8-K. In addition, the code must contain compliance standards and procedures reasonably designed to provide prompt and consistent action against violations. Each company's website must include its code and the company must state in its proxy statement that the code is available on its website. (NYSE Manual Section 303A.10 and commentary)

- Disclose whether or not the company has adopted a code of ethics for its senior financial officers – principal financial officer, comptroller or principal accounting officer – and if not, why not. (Sarbanes-Oxley §406)

  - Under the SEC rules implementing Section 406, companies must disclose whether or not they have adopted a code of ethics for their principal executive officer and their senior financial officers – principal financial officer, comptroller or principal accounting officer or persons performing similar functions – and if not, why not. (Item 10 of Form 10-K; Item 406 of Regulation S-K)

  - Under the SEC rules, a "code of ethics" must be reasonably designed to deter wrongdoing and to promote:

    - honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

- full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the Commission and in other public communications made by the company;
- compliance with applicable governmental laws, rules and regulations;
- the prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
- accountability for adherence to the code.

- The rules provide flexibility by permitting adoption of a separate code addressing the required elements or the inclusion of these elements in a code that has broader application. Companies that include the required elements in a broader document may satisfy the disclosure requirement by disclosing the portions of the document that meet the definition of "code of ethics" and that apply to the CEO and senior financial officers. However, under the NYSE listing standards, companies must post their codes of conduct in full on their websites. (Commentary to NYSE Manual Section 303A.10) NASDAQ listing standards (discussed below) also require that companies' codes of conduct be publicly available.

- Companies that have a code of ethics, as defined in the SEC's rules, must make that code (or the portions applicable to the CEO and senior financial officers) publicly available by: (1) filing the code (or relevant portions) as an exhibit to the Form 10-K; (2) posting the code (or relevant portions) on the company website; or (3) providing a copy of the code without charge upon request. Companies that post their codes on their websites or undertake to provide copies on request must indicate in their Form 10-K that they intend to provide disclosure in this manner.

- Companies must disclose any changes to, or waivers from, provisions of their code of ethics by filing a Form 8-K or posting the information on the company website within four business days of the amendment or waiver. Only amendments or waivers relating to the required elements of the code of ethics and the specified officers must be disclosed.

- Companies listed on NASDAQ must adopt a code of conduct applicable to all directors, officers, and employees that complies with the definition of "code of ethics" in Section 406 of Sarbanes-Oxley and any SEC implementing rules. Companies may adopt one or more codes, provided that all directors, officers and employees are subject to a code that meets the definition of "code of ethics." The code must be publicly available. In addition, the code must contain an enforcement mechanism that provides for prompt and consistent enforcement, protection for persons reporting questionable conduct, clear and objective compliance standards and a fair process by which to determine violations. Any waivers of the code for executive officers and directors may be made only by the board (or, according to

informal NASDAQ guidance, by an independent committee of the board) and must be promptly disclosed to stockholders, along with the reasons for the waiver. Disclosure must be made within four business days of the waiver on a Form 8-K or in a press release (unless a Form 8-K is required), or by posting the information on the company website. (Item 5.05 of Form 8-K; General Instruction B.1 to Form 8-K; NASDAQ Rule 5610 and IM-5610)

- In 2011, final SEC rules took effect implementing the whistleblower award program of Section 21F of the Exchange Act, which was added by Section 922 of the Dodd-Frank Act. Section 21F authorizes the SEC to pay rewards to individuals who provide the SEC with original information about securities law violations that leads to successful SEC enforcement actions, and includes anti-retaliation protections for whistleblowers. The SEC's whistleblower rules establish the standards and procedures the SEC will apply in awarding whistleblowers monetary compensation for providing tips. (Exchange Act Rules 21F-1 through 21F-17).

  - ➢ Notably, the SEC's whistleblower rules do not require employees to report internally before providing information to the SEC. During the SEC's 2016 fiscal year, approximately 80% of whistleblowers who were current or former employees raised their concerns internally (or understood that supervisory or compliance personnel knew of the conduct reported to the SEC), according to the agency's *2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program*.

  - ➢ During the SEC's 2016 fiscal year, it received 4,218 whistleblower tips, an increase of more than 40% since fiscal year 2012, the first full year for which data are available. (*2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program*)

☑ ***Annual evaluation of the audit committee's effectiveness and charter.***

- Undertake an annual self-evaluation to assess the effectiveness of the audit committee. Include a requirement for an annual self-evaluation in the audit committee charter. (NYSE Manual Section 303A.07(b)(ii))

  - ➢ The NYSE does not require the audit committee to conduct an annual evaluation of its charter, but most companies do so as a matter of good governance.

- The NASDAQ listing standards do not contain an analogous requirement to undertake an annual self-evaluation of the audit committee.

  - ➢ However, NASDAQ requires that the audit committee review and reassess the adequacy of the charter on an annual basis. (NASDAQ Rule 5605(c)(1))

3. SEC Updates Guidance on Non-GAAP Financial Measures

GIBSON DUNN

May 19, 2016

SEC UPDATES GUIDANCE ON NON-GAAP FINANCIAL MEASURES

To Our Clients and Friends:

On May 17, 2016, the Division of Corporation Finance of the Securities and Exchange Commission (the "Staff") issued new Compliance and Disclosure Interpretations (C&DIs) regarding the use of non-GAAP financial measures and revised existing C&DIs on the same topic. These interpretations come on the heels of numerous speeches by SEC Commissioners and the Staff indicating that the SEC is increasing its scrutiny of companies' use of non-GAAP financial measures in light of the increasing use of such measures by companies, analysts and the press. The Staff has also intensified its focus on non-GAAP financial measures in the review and comment process. The C&DIs related to non-GAAP financial measures are available here, and a redline comparing the Staff's non-GAAP C&DIs to its prior interpretations is available here.

The new and revised interpretations will significantly impact companies' use of non-GAAP financial measures and will require many companies to revise their current earnings release presentations. Whereas the Staff in recent years was viewed as encouraging companies to include in their SEC filings any non-GAAP financial measures contained in analyst presentations, the new interpretations represent a dramatic swing of the pendulum in the Staff's views on non-GAAP disclosures, and may lead companies to reconsider including such measures in earnings releases and filed documents.

The new guidance addresses two primary issues: the "equal or greater prominence" requirement for certain non-GAAP presentations and presentations of non-GAAP financial measures that the Staff views as improper. These interpretations carry out the recent statement by the Chief Accountant of the Division of Corporation Finance that the Staff intended to "crack down" on a variety of non-GAAP disclosure practices.

1. Equal or Greater Prominence Requirement. As stated in the C&DI, any document filed with the Commission and any earnings release furnished under Item 2.02 of Form 8-K that contains a non-GAAP financial measure must present the most directly comparable GAAP measure "with equal or greater prominence." The Staff's new interpretations read "equal" prominence to mean that the GAAP measure generally must *precede* any non-GAAP measure, and make clear that the Staff reads "prominence" to refer not simply to the location or ordering of GAAP and non-GAAP numbers, but also to apply to the manner in which GAAP and non-GAAP numbers are discussed and characterized.

Specifically, while acknowledging that "prominence" generally depends on the facts and circumstances under which a disclosure is made, C&DI 102.10 states that the Staff would consider the following situations to be examples of impermissibly presenting a non-GAAP measure as more prominent:

- Presenting a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption), or omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;

- Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;

- Presenting a non-GAAP measure using a style (*e.g.*, bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;

- Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure; and

- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

In the context of providing forward-looking statements (such as guidance or outlook) using non-GAAP measures, the same C&DI interprets the "equal or greater prominence" requirement to create a new disclosure obligation. Specifically, the non-GAAP disclosure rules require that any forward-looking non-GAAP financial measure be accompanied by a quantitative reconciliation to the most directly comparable GAAP measure, "to the extent available without unreasonable efforts." C&DI 102.10 states that when a company relies on the "unreasonable efforts" exception, the equal or greater prominence rule requires the company to disclose "in a location of equal or greater prominence" the fact that the company is relying on the exception and to identify the information that is unavailable and its probable significance.

Finally, the Staff reflected its long-standing disapproval of non-GAAP income statements through the equal or greater prominence rule, stating that a full income statement of non-GAAP measures presented alongside a GAAP income statement or presented when reconciling non-GAAP measures to the most directly comparable GAAP measures fails to satisfy the "equal or greater prominence" requirement.

2. Problematic Presentations of Non-GAAP Financial Measures. Rule 100(b) of Regulation G prohibits the use of a non-GAAP financial measure that is misleading when viewed in context with the information accompanying that measure and any other accompanying discussion of that measure. Four of the new interpretations address practices that, in the Staff's view, can result in a non-GAAP financial measure that is misleading. These are:

- Presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business could be misleading.

- Varying non-GAAP financial measures from period to period by adjusting for a particular charge or gain in the current period when "other, similar charges or gains" were not also

adjusted in prior periods, unless the change between periods is disclosed and the reasons for it explained. The Staff noted that, in addition, it may be necessary to recast prior measures to conform to the current presentation.

- For companies that present non-GAAP financial measures that are adjusted only for non-recurring charges, failing to adjust that non-GAAP financial measure for non-recurring gains that occurred during the same period.

- Presenting a non-GAAP performance measure that is adjusted to accelerate revenue recognized over time under GAAP as though the company earned revenue when customers were billed or using other individually tailored revenue recognition and measurement methods.

Notably, the Staff guidance does not address whether accompanying disclosures that highlight the nature of non-GAAP adjustments would, in the Staff's view, be sufficient to overcome the concern that a non-GAAP measure would be misleading. Instead, these interpretations reflect practices that may draw SEC scrutiny regardless of the context. For example, the Deputy Chief Accountant of the Division of Corporation Finance recently stated that, if a company presents an adjusted revenue measure, the company "will likely get a comment" from the Staff questioning the measure, and that companies should "expect the staff to look closely, and skeptically, at the explanation as to why the revenue adjustment is appropriate." *See* Remarks Wesley R. Bricker, Deputy Chief Accountant of the Division of Corporation Finance, before the 2016 Baruch College Financial Reporting Conference, available here.

As well, other interpretations reflect a more proactive stance by the Staff in reviewing and questioning certain non-GAAP disclosures:

- *Per Share Liquidity Measures*. The Staff's interpretations, for example, reflect a more prescriptive position under which "non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis." As stated in interpretation 102.05, the Staff will apply the prohibition on the use of per share data to any non-GAAP financial measure that can be used as a liquidity measure, even if management characterizes it solely as a performance measure. The Staff also revised existing C&DIs to make clear that free cash flow, EBIT and EBITDA may not be presented on a per share basis.

- *Adjustments for Tax*. The Staff also has focused on how income tax assumptions related to adjustments are calculated and presented when presenting a non-GAAP financial measure. The new interpretations touch upon this issue, stating that the nature of income tax effects reflected in non-GAAP financial measures depends on the nature of the measures. If a measure is a liquidity measure that includes income taxes, the Staff states that it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If, however, a measure is a performance measure, companies should include current and deferred income tax expense "commensurate with the non-GAAP measure of profitability." In addition, when setting forth reconciliations between GAAP and non-GAAP measures, adjustments to arrive at the non-GAAP measure

should not be presented "net of tax," but instead income taxes should be shown as a separate adjustment and clearly explained.

Based on speeches and comments by several SEC Commissioners and the Staff, these interpretations should be viewed as an early step, but not the last word, in the SEC's re-examination of non-GAAP presentations. Indeed, the Staff has indicated that they are more actively reviewing SEC filings, including earnings releases furnished under Item 2.02 of Form 8-K and investor materials presented on company websites, and commenting on non-GAAP financial measures. In addition to the topics addressed in the Staff's C&DIs, the Staff also has focused on the requirement that companies disclose the reasons why management believes that presentation of a non-GAAP financial measure provides useful information to investors, and has expressed concern that company disclosures in this area are often comprised of boilerplate explanations that do little to explain to investors the significance of non-GAAP financial measures.

The new and revised non-GAAP C&DIs reflect a new stance by the SEC on the use of non-GAAP financial measures. While many companies, analysts and investors find non-GAAP presentations helpful, the SEC is reacting to abuses it has seen in non-GAAP measures. Companies should, in advance of their next earnings release, review their non-GAAP presentations, including descriptions of and language accompanying the non-GAAP financial measures, in light of the C&DIs, and consider whether their non-GAAP presentations should be modified, further elaborated on, or dropped entirely.

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have about these developments. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work, any lawyer in the firm's Securities Regulation and Corporate Governance practice group, or any of the following practice leaders and members:

Brian J. Lane - Washington, D.C. (202-887-3646, blane@gibsondunn.com)
Ronald O. Mueller - Washington, D.C. (202-955-8671, rmueller@gibsondunn.com)
James J. Moloney - Orange County, CA (949-451-4343, jmoloney@gibsondunn.com)
Michael J. Scanlon - Washington, D.C. (202-887-3668, mscanlon@gibsondunn.com)
Elizabeth Ising - Washington, D.C. (202-955-8287, eising@gibsondunn.com)
Lori Zyskowski - New York (212-351-2309, lzyskowski@gibsondunn.com)
Gillian McPhee - Washington, D.C. (202-955-8201, gmcphee@gibsondunn.com)
Michael A. Titera - Orange County, CA (949-451-4365, mtitera@gibsondunn.com)

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4. SEC Press Release: SEC Proposes Amendments to Update and Simplify Disclosure Requirements As Part of Overall Disclosure Effectiveness Review (July 13, 2016)

Press Release

SEC Proposes Amendments to Update and Simplify Disclosure Requirements As Part of Overall Disclosure Effectiveness Review

Comments on Amendments Along With S-K Concept Release Input Will Further Inform Commission's Actions to Enhance Disclosure

FOR IMMEDIATE RELEASE
2016-141

Washington D.C., July 13, 2016— The Securities and Exchange Commission today voted to propose amendments to eliminate redundant, overlapping, outdated, or superseded provisions, in light of subsequent changes to Commission disclosure requirements, U.S. Generally Accepted Accounting Principles (U.S. GAAP), International Financial Reporting Standards (IFRS), and technology.

The Commission is also soliciting comment on certain disclosure requirements that overlap with U.S. GAAP to determine whether to retain, modify, eliminate or refer them to the Financial Accounting Standards Board (FASB) for potential incorporation into U.S. GAAP.

The amendments, along with the input received on the Regulation S-K concept release, are designed to further inform the Commission's actions to enhance disclosure.

"The proposed amendments address outdated and redundant disclosure requirements while continuing to require companies to provide investors with what they need to make informed decisions," said SEC Chair Mary Jo White. "We are keenly interested in investors' views on all aspects of the proposal and look forward to receiving their input as we continue to consider changes and enhancements to our disclosure requirements."

The proposing release is part of the disclosure effectiveness review, which is a broad-based staff review of the requirements, and the presentation and delivery of disclosures that companies make to investors. The proposal is also part of the Commission's work to implement the Fixing America's Surface Transportation (FAST) Act, which, among other things, requires the Commission to eliminate provisions of Regulation S-K that are duplicative, overlapping, outdated, or unnecessary.

The public comment period will remain open for 60 days following publication of the proposing release in the Federal Register.

* * *

FACT SHEET

Disclosure Update and Simplification

SEC Open Meeting

July 13, 2016

Action

The Commission will consider whether to propose amendments to update and simplify certain disclosure requirements by eliminating redundant, overlapping, outdated and superseded requirements due to changes in disclosure rules, accounting principles, and technology. The Commission also will consider issuing a related request for comment on whether other requirements should be modified, eliminated, or included in U.S. Generally Accepting Accounting Principles (U.S. GAAP).

The proposal under consideration arises out of the staff's work on the disclosure effectiveness review, which is intended to update and modernize the Commission's disclosure requirements for the benefit of investors and companies. The proposal also would implement certain provisions of the Fixing America's Surface Transportation (FAST) Act.

Highlights

The proposal would be primarily applicable to public companies (including foreign private issuers), but also would involve requirements applicable to other entities the Commission regulates, including Regulation A issuers, investment advisers, investment companies, broker-dealers, and nationally recognized statistical rating organizations.

The proposing release covers:

- Duplicative requirements, which require substantially the same disclosures as U.S. GAAP, International Financial Reporting Standards (IFRS), or other Commission disclosure requirements. The Commission will consider whether to propose to delete these requirements in light of the requirements elsewhere.
- Overlapping requirements, which are related to, but not the same as U.S. GAAP, IFRS, or other Commission disclosure requirements. For these requirements, the Commission will consider whether to:
  - Delete Commission disclosure requirements that: require disclosures that convey reasonably similar information to or are encompassed by the disclosures that result from compliance with the overlapping U.S. GAAP, IFRS, or Commission disclosure requirements, or require disclosure incremental to the overlapping U.S. GAAP, IFRS, or Commission disclosure requirements and may no longer be useful to investors;
  - Integrate Commission disclosure requirements that overlap with, but require information incremental to, other Commission disclosure requirements; or

  - Solicit comment on certain Commission disclosure requirements that overlap with, but require information incremental to, U.S. GAAP to determine whether to retain, modify, eliminate, or refer them to the Financial Accounting Standards Board (FASB) for potential incorporation into U.S. GAAP.

- Outdated requirements, which have become obsolete as a result of the passage of time or changes in the regulatory, business, or technological environment. The Commission will consider whether to propose to amend these outdated requirements. The Commission will consider whether to propose to require additional disclosure of information to reduce any loss of information or increased burdens for investors.

- Superseded requirements, which are inconsistent with recent legislation, more recently updated Commission disclosure requirements, or more recently updated U.S. GAAP. The Commission will consider whether to propose to amend these superseded disclosure requirements to reflect, as applicable, the more recently updated requirements.

Background

The proposal is the result of the staff's work on the disclosure effectiveness review, which is a comprehensive evaluation of the Commission's disclosure requirements with the objective of improving the disclosure regime for both investors and companies.

The work is focused on considering the type of information the rules require issuers to disclose, how the information is presented, where and how the information is disclosed, and how technology can be leveraged for improving disclosure to investors' access to the information.

The Commission has issued several releases in connection with the disclosure effectiveness review. The Commission is seeking public comment on modernizing certain business and financial disclosure requirements in Regulation S-K and on proposed amendments to its disclosure requirements for registrants involved in mining activities. The Commission also requested comment on financial disclosure requirements in Regulation S-X for certain entities other than the issuer.

What's Next?

The Commission will seek public comment on the proposed rules for 60 days.

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Related Materials

- Proposed Rule

5. **Andrew Ceresney Speech: “The SEC Enforcement Division’s Focus on Auditors and Auditing” (September 22, 2016)**

Speech

The SEC Enforcement Division's Focus on Auditors and Auditing

Andrew Ceresney, Director, Division of Enforcement

Keynote Address: American Law Institute Conference on Accountants' Liability 2016: Confronting Enforcement and Litigation Risks
Washington, D.C.

Sept. 22, 2016

Introduction

Good morning and thank you for that very kind introduction. It's a pleasure to speak with you all today. Before I start, I must give our standard disclaimer that the views I express today are my own and do not necessarily reflect the views of the Commission or its staff.[1]

This morning, I want to discuss our enforcement work in the area of auditing, a topic that is sure to be of interest to all of you. There is no doubt that the work of auditors, who function as critical gatekeepers in the area of issuer reporting and disclosure, is an important part of our renewed focus on financial reporting. As Chair White has emphasized, "[c]omprehensive, accurate, and reliable financial reporting is the bedrock upon which our markets are based, and is essential to ensuring public confidence in them,"[2] and preparers "are the lynchpin of high-quality, reliable financial reporting."[3] And, as the Supreme Court noted more than 30 years ago in *Arthur Young*, auditors play a crucial role in the financial reporting process by serving a "public watchdog function" that demands "total independence from the client at all times and requires complete fidelity to the public trust."[4]

I want to acknowledge the hard work and dedication that accountants and auditors demonstrate every day to ensure reliable financial reporting. At the SEC, we hold accountants and auditors in high regard and consider them to be key partners in our investor protection efforts. At the same time, however, we must also hold those who become auditors to the high standards of the profession. We have for a long time, and continue to, closely scrutinize the conduct of auditors during the course of our investigations and have not hesitated to pursue auditors where such charges are warranted or their conduct may indicate that they are a threat to the Commission's processes.

I thought I would start my remarks today with a discussion of certain key parts of the legal and regulatory framework governing the Commission's enforcement actions against auditors. I will also discuss the history and context of Rule 102(e) of the Commission's Rules of Practice, since a significant number of our accounting-related enforcement proceedings are instituted under that rule. After that, I plan to spend some time discussing the Commission's enforcement actions against

auditors. Finally, I will give you my perspective on what are the key takeaways from our actions in this area.

The Legal and Regulatory Landscape

The Commission's cases against auditors generally fall into two categories — audit failures and auditor independence violations. Generally, an audit failure occurs when an auditor deviates from the applicable professional standards in such a way that indicates the opinion contained in its audit report is false. As for independence, an auditor must be independent of its SEC audit clients pursuant to SEC and PCAOB rules, both in appearance and in fact.

One of the most important remedial tools we have to ensure accountability for audit quality and auditor independence is Rule 102(e) of the Commission's Rules of Practice. The Commission adopted Rule 2 (e), the predecessor to Rule 102(e), in 1935 under its general rulemaking powers as a "means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence."[5]

Under Rule 102(e), the Commission has authority to bring proceedings to censure, or temporarily or permanently deny, accountants, auditors and other professionals, the privilege of appearing or practicing before the Commission if that professional is found by the Commission to have engaged in improper professional conduct.[6] The Commission amended Rule 102(e) in 1998 to clarify that, for licensed accountants, "improper professional conduct" includes, along with intentional, knowing, or reckless conduct, two kinds of negligent conduct — a single act of "highly unreasonable conduct" in circumstances warranting "heightened scrutiny" or "repeated instances of unreasonable conduct . . . indicat[ing] a lack of competence to practice before the Commission."[7] Remedies under Rule 102(e) serve to protect the integrity of the Commission's processes,[8] and in evaluating potential suspensions of accountants and auditors under Rule 102(e), a key part of that evaluation is the threat posed to the Commission's processes.[9]

Rule 102(e) is not the only tool available to the Commission. For example, the Commission can charge auditors with direct violations of the securities laws, including charging them with primary violations of the anti-fraud provisions of the securities laws in those somewhat rare situations where auditors are engaged in fraud, or secondary violations where they aided and abetted or caused primary violations by others. In some instances, auditors will be charged based on misrepresentations in their audit report.[10] And, when an auditor of an issuer determines it is likely that an illegal act has occurred, the federal securities laws require the auditor to investigate and report upwards pursuant to Section 10A of the Exchange Act.[11] Failure to do so can also be the basis for Commission action.

Finally, I should note that we do not occupy this space alone. The PCAOB "enforce[s] compliance with [Sarbanes-Oxley], the rules of the [PCAOB], professional standards, and the securities laws relating to the preparation and issuance of audit reports . . . ."[12] Both the Commission and the PCAOB share regulatory enforcement authority over auditors, and we coordinate closely with the PCOAB to ensure that our collective resources are applied effectively and efficiently.

History and Context of the Commission's Actions Against Auditors

The Commission's focus on auditors is certainly not new and actions involving auditors have been a long-standing staple of our enforcement efforts. We have a rich tradition of actions that highlight the many problems that can occur when auditors fail to comply with professional standards.

In the early 1980s, the Commission charged Fox & Company with allegedly issuing false and misleading audit reports containing unqualified opinions that the financial statements of several issuers were presented fairly, in all material respects, in accordance with GAAP.[13] In the years that followed, the Commission brought a number of important audit-related cases that did not involve allegations of fraud.[14] For instance, in 1999, the Commission brought a settled independence case against PricewaterhouseCoopers LLP, finding that, as a result of the merger of Coopers & Lybrand and Price Waterhouse, numerous partners and other professionals at the firm — and even one of the firm's retirement plans — held investments in the securities of firm audit clients.[15]

Then, in the early 2000s, in the midst of several major accounting scandals, we saw an increase in focus on auditor cases, including cases against national audit firms and their partners. In 2001, the Commission charged Arthur Andersen LLP and four of its current and former partners, including a regional practice director, with fraud in connection with Andersen's audits of the annual financial statements of Waste Management, Inc. for the years 1992 through 1996. The Commission alleged that those financial statements, on which Arthur Andersen issued materially false and misleading audit reports, overstated Waste Management's pre-tax income by more than $1 billion. To settle these allegations, Andersen agreed to entry of the first antifraud injunction against a major accounting firm in more than 20 years, and to pay the then largest-ever civil penalty against a Big Five accounting firm — $7 million.[16]

In 2002, the Commission announced two significant independence matters — a settled case with KPMG LLP for independence violations arising from its provision of audit services to an audit client at the same time that it had made substantial financial investments in the client,[17] and a litigated action against Ernst & Young LLP, alleging that the firm violated the independence requirements by engaging in a series of business and marketing relationships from 1994 through 1999 with its audit client PeopleSoft Inc.[18] In 2004, the litigated proceeding against Ernst & Young resulted in a significant initial decision that suspended the firm from accepting audit engagements from new SEC registrant audit clients for a period of six months from the effective date of the decision and ordered the firm to retain an independent consultant to work with Ernst & Young LLP to assure the Commission that the firm's leadership was committed to, and had implemented policies and procedures that reasonably could be expected to, remedy the auditor independence violations described in the decision.[19]

Then, in 2003, the Commission filed a civil injunctive action against KPMG LLP and five of the firm's partners — including the head of the firm's department of professional practice — in connection with the 1997 through 2000 audits of Xerox Corp., alleging that they issued materially false and misleading audit reports on Xerox's financial statements, which had used manipulative accounting practices to close a $3 billion "gap" between actual operating results and results reported to the investing public.[20] The firm agreed to settle the allegations two years later by paying $22 million and, later that year and in the following year, the Commission announced settlements with the five partners that included penalties and suspensions from practice before the Commission of varying lengths for four of the partners.[21]

The same month that the settlement with KPMG was announced, the Commission announced that Deloitte & Touche LLP had agreed to pay $50 million — the largest monetary sanction the Commission has ever obtained from an audit firm — to settle charges stemming from its audit of Adelphia

Communications Corp.'s fiscal year 2000 financial statements.[22] Then, in 2009, the Commission charged Ernst & Young LLP and six of its current and former partners, including members of the firm's national office, for their roles relating to an accounting fraud at Bally Total Fitness Holding Corp. during the audit years 2001 to 2003.[23]

In the midst of all of this activity, Congress passed the Sarbanes-Oxley Act of 2002, which ushered in a new era for the auditing profession, including the creation of the PCAOB,[24] and the requirement for auditors of some issuers to attest to, or report on, management's report regarding internal controls over financial reporting.[25] There is no question that these changes resulted in a sea change at audit firms, increasing their focus on quality and controls.

The Current Landscape

Post Sarbanes-Oxley, the Commission's focus on auditor compliance with professional standards has continued. When Chair White arrived at the Commission in April 2013, she came with a plan to refocus the Enforcement staff on financial reporting issues and gatekeepers.[26] Given the importance of financial reporting and auditing to the integrity of our markets and the protection of investors, and the SEC's unique ability to do such complex cases, failures in that sphere must always be a high priority for the Division. I addressed this audience three years ago and talked about our renewed commitment in this area, including our creation of the Financial Reporting and Audit Task Force, which has now become a permanent group.[27] In late September 2013, the Division announced "Operation Broken Gate" — an initiative to identify auditors who neglected their duties and the required auditing standards,[28] and opened important issuer reporting and disclosure-related cases in every office, utilizing the Division's skilled accountants and talented attorneys to build the cases. And, our renewed focus on financial reporting issues has resulted in a significant increase in the quality and quantity of financial reporting cases, and in numerous cases against auditors and audit firms, including smaller, mid-size, and national audit firms.

While the numbers only tell part of the story, from fiscal year 2013 through the end of last fiscal year, excluding follow-on proceedings, the Commission has more than doubled its actions in the issuer reporting and disclosure area, which includes actions against auditors and audit firms — from 53 in fiscal year 2013 to 114 in fiscal year 2015.[29] We have made similar strides in the number of parties we have charged for such violations: in the past two fiscal years, excluding follow-ons, we have charged 128 and 191 parties, respectively, with issuer reporting and disclosure violations, a significant increase over the prior years.[30] The number of accountant proceedings under Rule 102(e) has also been increasing, from 37 respondents in fiscal year 2013 to 76 respondents in fiscal year 2015, which included actions against 57 individual accountants and 19 firms.[31] And, we continue to see similar trends in the number of proceedings against accountants under Rule 102(e) in the current fiscal year.

While there have been improvements in audit quality and processes, as you will see in a moment when I discuss some of our recent cases, the audit failures we have seen continue to highlight a variety of professional failures. At a high level, some of the indicators of good auditing include exercising due professional care and professional skepticism, obtaining sufficient appropriate audit evidence to support the audit opinion, and properly documenting audit work. Many of our recent audit failure cases demonstrate deficiencies in some or all of these areas. In addition, recent cases also highlight failures in areas including properly planning the audit, adequately training or supervising staff, over-reliance on management representations without sufficient corroborating evidence, failures in auditing valuation estimates by management, and in understanding and appropriately auditing related party transactions.

Capacity and Competence Issues

In policing the auditing space, one key systemic issue we encounter is firms taking on issuer clients well beyond their capacity. We have seen instances of a lack of understanding of the applicable rules, a lack of resources given the number and size of issuers, or undue reliance on generic audit checklists, particularly during the planning phase of the audit. For example:

- In 2014, Baker Tilly Hong Kong Ltd. and two of the firm's accountants agreed to pay more than $114,000 in monetary sanctions for failing to properly audit year-end financial statements of a company we charged with fraud. There, the audit team failed to adequately audit 176 related-party transactions that were called into question in an independent forensic accounting report. The audit failures were due, in part, to the audit team's lack of adequate professional training in U.S. GAAP.[32]
- Late last year, the Commission suspended five accountants and two audit firms from appearing or practicing before the SEC after they performed deficient audits of public companies, jeopardized the independence of other audits, and falsified and backdated audit documents, among other misconduct.[33] In fact, one of the firms had over 70 public company clients but had only one partner — the firm's sole owner — authorized to sign or issue audit reports, and also lacked the professional staff to properly perform the audits.[34]

Undue Reliance on Management

Another class of cases against auditors involves failure to exercise sufficient professional skepticism in evaluating management representations. Particularly where there are red flags, representations from management will not be sufficient evidential matter to support an audit finding and we have emphasized the need in our actions for more substantiation.

For example, we charged two KPMG auditors — the engagement partner and senior manager — for their alleged roles in a failed audit of TierOne Bank, a Nebraska-based bank that hid millions of dollars in loan losses from investors during the financial crisis and eventually was forced to file for bankruptcy.[35] We alleged that the two auditors failed to appropriately scrutinize management's estimates of TierOne's allowance for loan and lease losses which, due in part to the financial crisis and problems in the real estate market, was one of the highest risk areas of the audit. We further alleged that the auditors relied on stale information and management's representations and failed to heed numerous red flags when issuing unqualified opinions on the bank's 2008 financial statements and internal control over financial reporting. The Commission recently issued an opinion imposing suspensions on both the engagement partner and the senior manager on the TierOne Bank audit.[36]

Similarly, we recently suspended an engagement partner for conducting a faulty audit of the financial statements of a public company that was committing fraud, and EFP Rotenberg LLP, the firm where he was a partner at the time, agreed to an undertaking not to accept new public company clients for one year. The audit client, ContinuityX Solutions Inc., claimed to be a commission-based sales agent, selling enterprise Internet services provided by two providers.[37] Despite being aware of red flags suggesting that security deposits one of the customers paid were not assets of the audit client, as the audit client represented, the firm failed to perform sufficient procedures to resolve the inconsistencies in the audit evidence. As a result, the auditors did not detect that 99% of the company's revenues were false.[38]

Essentially No Audit At All

We also see examples of firms engaging in essentially no audit at all, often related to audits of microcap issuers.[39] In the microcap space, from April 2013 to the present, the Commission has brought proceedings against 23 audit firms and sole practitioners and 43 individual auditors for audit failures or — where warranted — for fraud. Last fiscal year alone, the Commission proceeded against 14 accountants for their roles in aiding perpetrators of microcap fraud.[40]

Insufficient Audit Documentation

Insufficient audit documentation is another area where we have seen firms fail to comply with professional standards. For example, earlier this year, we suspended Silberstein Ungar PLLC and four of the firm's partners for failing to comply with PCAOB audit standards in connection with the audits of nine microcap issuers. The documentation in that case included audit testing prepared and performed by a different accounting firm for a different audit of the client, or audits by the same firm of other clients.[41]

Evaluating Management Estimates

One area in particular where we have seen repeated audit failures is in the review of management valuation estimates. It is critical that auditors carefully scrutinize management's valuation estimates supporting the financial statements. This focus must go beyond a superficial understanding of the methodologies, assumptions and timing underlying the valuation. And, failure to do so cannot be remedied by the singular notion that valuations require professional judgment. We have seen these types of audit failures in both the investment advisory space and audits of corporate issuers.

For example, we charged Summit Asset Strategies Investment Management and its CEO with fraudulently inflating the values of investments in the portfolio of a private fund they advised so they could collect unearned management fees. The partner and manager on the audit recognized that the valuations posed a significant risk yet failed to obtain sufficient appropriate audit evidence with respect to the existence of certain fund assets. As a result of these failures, the Commission suspended the auditors with a right to apply for reinstatement after a period of three years.[42]

Similarly, the Commission charged the lead engagement partner on the audit of Miller Energy Resources, Inc. for audit failures associated with the issuer's valuation estimate of certain oil and gas assets of over $480 million that the company had purchased soon before for $4.25 million in cash and assumption of liabilities.[43] The basis for the value was a reserve report that explicitly cautioned that it should not be construed as an estimate of fair value. During the fiscal year 2010 audit of Miller Energy's financial statements, Miller Energy's external auditor failed to adequately test the valuation of the assets and inappropriately relied on the reserve report and a related cost study to justify the $480 million valuation. These failures resulted in a settlement that included a suspension of the external audit partner, with the right to apply for reinstatement after a period of three years.[44]

Cases Against Audit Firms

I want to spend a few minutes talking about our recent enforcement actions against major national audit firms. Last year, we announced audit-failure related cases against national audit firms BDO and Grant Thornton.[45] These actions were the first cases against national audit firms for audit failures since 2009[46] other than for independence violations and the first settled actions that included admissions of wrongdoing by an audit firm.

The charges against BDO and five of its partners arose from an audit client's purported certificate of deposit, representing approximately half of its assets, which went missing.[47] When the money was

returned to the client under suspicious circumstances from parties other than the bank where the funds were purportedly held, management made inconsistent statements to the auditors.[48] BDO demanded that the audit client conduct an independent investigation.[49] But then, about a week later, without receiving any real explanation or evidence explaining the prior inconsistencies or transactions, and with the concurrence of national office personnel, BDO withdrew its demand and issued an audit report containing an unqualified opinion on the client's financial statements.[50] The following year, BDO learned of a criminal complaint against the president and CEO of the bank alleging a wide ranging conspiracy that involved, among other things, the certificate of deposit at issue.[51] Despite the criminal complaint and a guilty plea by the bank's president and CEO, BDO failed to perform appropriate audit procedures to determine whether this new information had any impact on the client's financial statements or the firm's previously issued audit report.[52]

The Commission's charges against Grant Thornton and two of its partners arose from the failure to heed numerous warnings and red flags concerning alleged frauds occurring at two audit clients — Assisted Living Concepts and Broadwind Energy — both of which eventually became the subjects of enforcement action by the Commission for improper financial reporting.[53] The firm had assigned a particular audit partner to oversee both audits and allowed the partner to continue on those audits despite having received numerous warnings of quality issues with her work.[54] Aware of these concerns, the firm failed to adequately address the situation, providing insufficient technical resources and minimal oversight despite the increased risks.[55]

In our actions, we carefully consider the facts and circumstances of the audits to assess whether to charge the audit firm. In the case against BDO, personnel from the firm's national office were involved in the decision to withdraw the demand for an independent investigation. While national office involvement is good when appropriate, in this case, the decision to withdraw the demand for an independent investigation — without any real evidence explaining the inconsistencies — was relevant to our assessment. The competence and staffing issues in the multiple audits at issue, as well as red flags about the auditor's performance, were relevant in the case against Grant Thornton.

Independence Violations

I now want to spend some time discussing the Commission's enforcement actions against auditors for independence violations, as this is an area of significant importance to the Commission and to the audit profession. In order to be a "public watchdog,"[56] auditors need to be independent and our actions against auditors for independence violations reflect the breadth and depth of our commitment to this requirement. In recent years, we have brought independence-related cases involving, among others: the provision of bookkeeping and expert services to affiliates of audit clients[57]; audit personnel owning stock in audit clients or affiliates of audit clients[58]; lobbying on behalf of audit clients[59]; service by audit firm employees or affiliates on boards of audit clients[60]; preparation of financial statements of brokerage firms who also were audit clients[61]; circumvention of the lead audit partner rotation requirements[62]; and for indemnification provisions included in engagement letters.[63]

Just this week, the Commission announced two sets of charges against Ernst & Young and several of its partners arising from close personal relationships between senior management at audit clients and senior engagement personnel.[64] These settled actions are the Commission's first independence-related actions based on close personal relationships between auditors and audit clients.

In one case, the audit partner maintained a close personal and romantic relationship with the chief accounting officer of the issuer.[65] The coordinating partner on the engagement team was aware of facts suggesting a possible romantic relationship but failed to follow up on the red flags.[66]

The other case illustrates the independence issues which can occur in the context of friendships that arise in the course of repairing or maintaining client relations. In the other case, the audit partner, who had been tasked with repairing Ernst & Young's troubled relationship with the issuer, developed a close personal friendship with the issuer's CFO that entailed, among other things, spending extensive leisure time, including regular overnight, out-of-town trips and attendance at sporting events, with the CFO and the CFO's family.[67] Over three audit periods, the audit partner incurred more than $100,000 in entertainment expenses in connection with the issuer.[68] More senior personnel at Ernst & Young were placed on notice of the audit partner's excessive expenses, but Ernst & Young failed to take appropriate steps to determine whether these expenses were red flags signaling that the audit partner's independence was impaired.[69]

In short, these two matters revealed a systemic independence issue at the firm and caused Ernst & Young and its partners to pay a steep price — the firm was ordered to pay over $9.3 million in combined disgorgement, interest and penalties and the three firm partners collectively agreed to pay $95,000 in penalties and to be suspended from appearing or practicing before the SEC as accountants, with rights to apply for reinstatement after three years. These actions also are significant because the Commission charged the former senior accounting and finance personnel with violations arising from the issuers' failure to include financial statements audited by an independent auditor. Both individuals agreed to pay $25,000 each in penalties, while one of the individuals — the former chief accounting officer at one of the issuers — agreed to a suspension from appearing or practicing before the SEC as an accountant, with the right to apply for reinstatement after one year.[70]

Lessons Learned

I hope my speech has given you a sense of the rich history of the Commission's actions against auditors, which has continued through the present. I want to close my remarks today by distilling all of this into several key lessons and takeaways for the auditing profession.

First, before engaging with an audit client, auditors should ensure that the firm and its assigned personnel have sufficient capacity and competence to audit the client according to professional standards. Where there are red flags suggesting a lack of competence by audit team members, the firm must take action and remedy the situation.

Second, audits need to be properly planned and executed, with significant risks identified and addressed through adequate audit procedures. The planning process is key to the success of the audit and must be given adequate attention.

Third, auditors need to exercise appropriate professional skepticism, gather sufficient appropriate audit evidence, adequately document work, and, particularly when there are red flags, require more sufficient evidential matter than representations from management. Auditors perform a key role in providing a check on management's financial reporting and they must perform that role with a skeptical eye and appropriate objectivity.

Fourth, auditors should consult internally when particularly troublesome issues arise. Firms must have knowledgeable personnel ready to assist in sensitive areas and those personnel, as well as the audit

personnel, must be ready to hold the line against the client when their concerns are not addressed. Audit firms are one of the last lines of defense for investors, and they must act accordingly.

Finally, firms must have robust monitoring processes and training on independence issues so that firms comply with independence requirements and so that individual auditors are aware of, and well-versed on, areas of potential independence violations. Many independence-related issues can be avoided through strong firm processes and a tone at the top that emphasizes auditor independence. Firms that are not sufficiently proactive in guarding against independence lapses risk enforcement action.

Conclusion

I hope I have given you a sense of the history of our audit-related enforcement work, as well as our current areas of focus. We will continue to be focused on financial reporting and the critical roles auditors and audit firms play in ensuring accurate and reliable financial reporting, which our markets depend on in ensuring investor confidence.

We rely on auditors as essential partners in ensuring comprehensive, accurate, and reliable financial reporting, and they have our full support in this regard. That said, we will continue to scrutinize auditor work in all of our investigations. While good faith errors in judgment will not result in liability, those who fail to follow audit standards and perform unreasonable audits can expect scrutiny through our enforcement efforts.

Thank you for your time and attention.

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

[2] Chair Mary Jo White, U.S. Secs. & Exch. Comm'n, *Testimony on "Oversight of the U.S. Securities and Exchange Commission,"* (June 14, 2016), available at https://www.sec.gov/news/testimony/testimony-white-oversight-sec-06-14-2016.html.

[3] Chair Mary Jo White, U.S. Secs. & Exch. Comm'n, *Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility"* (Dec. 9, 2015), available at https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html ("White AICPA Speech").

[4] *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) ("*Arthur Young*").

[5] *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979).

[6] 17 C.F.R. § 201.102(e)(1)(ii).

[7] *Id.* § 201.102(e)(1)(iv).

[8] *See, e.g.*, *McCurdy v. SEC*, 396 F.3d 1258, 1264-65 (D.C. Cir. 2005).

[9] *See, e.g.*, *Robert W. Armstrong, III*, Exchange Act Release No. 51920, available at https://www.sec.gov/litigation/opinions/34-51920.pdf.

[10] *Cf. U.S. v Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

[11] 15 U.S.C. § 78j-1(b)(1)(B).

[12] Sarbanes-Oxley Act of 2002 § 101(c)(6), Pub L. No. 107-204, 116 Stat. 745, 751 (July 30, 2002) (codified at 15 U.S.C. § 7211) ("Sarbanes-Oxley").

[13] Litigation Release No. 10051, *Securities and Exchange Commission v. Fox & Company*, available at 1983 WL 1334.

[14] *See, e.g.*, Press Release 99-75, *W.R. Grace & Co. and Outside Auditors Settle SEC Proceedings* (June 30, 1999), available at https://www.sec.gov/news/press/pressarchive/1999/99-75.txt.

[15] Press Release 99-5, *SEC Censures PricewaterhouseCoopers for Violating Auditor Independence Rules and Improper Professional Conduct* (Jan. 14, 1999), available at https://www.sec.gov/news/press/pressarchive/1999/99-5.txt.

[16] Press Release 2001-62, *Arthur Andersen LLP Agrees to Settlement Resulting in First Antifraud Injunction in More Than 20 Years and Largest-Ever Civil Penalty ($7 Million) in SEC Enforcement Action Against a Big Five Accounting Firm* (June 19, 2001), available at https://www.sec.gov/news/headlines/andersenfraud.htm; Litigation Release No. 17039, *Arthur Andersen LLP and Three Partners Settle Civil Injunctive Action Charging Violations of Antifraud Provisions, and Settle Related Administrative Proceedings, Arising Out of Andersen's Audits of Waste Management, Inc.'s Financial Statements* (June 19, 2001), available at https://www.sec.gov/litigation/litreleases/lr17039.htm.

[17] Press Release 2002-4, *SEC Censures KPMG for Auditor Independence Violation* (Jan. 14, 2002), available at https://www.sec.gov/news/headlines/kpmgcensure.htm.

[18] U.S. Secs. & Exch. Comm'n, *SEC Institutes Proceedings Against Ernst & Young to Resolve Auditor Independence Allegations*, Exchange Act Release No. 46821 (Nov. 13, 2002).

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6. **Wesley Bricker Speech: "Working Together to Advance High Quality Information in the Capital Markets" (December 5, 2016)**

Speech

Working Together to Advance High Quality Information in the Capital Markets

Wesley R. Bricker, Chief Accountant

Keynote Address before the 2016 AICPA Conference on Current SEC and PCAOB Developments
Washington, D.C.

Dec. 5, 2016

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Introduction

Good morning and thank you Melanie [Dolan] for the kind introduction. It is a pleasure to be with you for the third time, and now in my role as Chief Accountant of the SEC.

Before I continue, let me remind you that for me and all of the SEC staff speaking at this conference, the views expressed are each speaker's own and not necessarily those of the Commission, the individual Commissioners, or other colleagues on the Commission staff.

We share a vital interest in maintaining the strength of the U.S. public capital markets, which function best when investors have confidence that their investment decisions can be made with the benefit of credible and reliable financial information. This is not new.

It was Joseph Kennedy, the first Chairman of the newly-formed Securities and Exchange Commission, who spoke to the importance of financial information in an address on November 15, 1934 at the Boston Chamber of Commerce, when he repeated the words of President Roosevelt on the passage of the Securities Act of 1933:

> "If the country is to flourish, capital must be invested in enterprise. But those who seek to draw upon other people's money must be wholly candid regarding the facts on which investors' judgment is asked."[1]

These are words that speak to the important public interest that preparers, auditors, audit committee members, regulators, and others serve in meeting investor needs for accurate, honest financial information. This high quality financial information is the lifeblood of our capital markets, enabling

domestic and foreign companies alike to obtain funding to support and grow their businesses, creating investment opportunities, jobs and other benefits for the U.S. economy.

Our markets are strong. In 2015 alone, businesses raised $2.27 trillion of funding in the U.S. capital markets and, by one estimate, the U.S. capital markets accounted for 42% of the global bond market and 40% of global equity market capitalization.[2]

Yet notwithstanding the strength, there is more to do, and so in my remaining time with you today, I would like to discuss several areas that both reinforce and advance our shared, weighty responsibility to maintain high quality financial reporting in our capital markets.[3] I will then close with some thoughts regarding the role of preparers, audit committees, auditors, and standard-setters in the current environment.

Update on OCA

Before going further I would like to also acknowledge some recent changes in the SEC's Office of the Chief Accountant (OCA). It was announced recently that Jim Schnurr is retiring from the agency. I want to thank him for his strong leadership and broad expertise in financial reporting and the capital markets.

I also want to welcome Marc Panucci as the new Deputy Chief Accountant leading the Professional Practice Group (PPG), and thank Marc's predecessor, Brian Croteau, for his many years of excellent leadership and accomplishments on behalf of investors.

In addition, I want to acknowledge that IOSCO recently announced[4] that it had selected Jenifer Minke-Girard of our staff to become the new vice chair of IOSCO's Committee on Issuer Accounting, Audit and Disclosure, which is known as Committee 1. I am pleased that with Jenifer's appointment the OCA staff will continue to play a leadership role for the committee, given that Julie Erhardt recently "timed out" of her role as chair of Committee 1 after almost 10 years of outstanding leadership.

Advancing high quality financial reporting

Preparers

Turning now to preparers, high-quality financial reporting starts with you. You are the ones who make the often difficult and nuanced decisions and judgments required to meet the objectives and principles of US GAAP or IFRS. Investors look to you to evaluate, challenge, and ultimately address transactions, judgments, and risk areas with accurate and informative disclosures. Effective internal control supports your work.

Internal Control over Financial Reporting (ICFR)

We are routinely reminded through our interactions with investors that they continue to believe that strong and effective internal controls and audits are an important component of the ability of companies to communicate credible financial reporting information in order to raise the capital needed to operate, grow and compete.

In 2011, OCA studied the impact of the reporting requirements for ICFR and recommended to maintain the existing investor protections of Section 404(b) of the Sarbanes-Oxley Act[5] for accelerated filers, while also encouraging activities that have the potential to further improve both the effectiveness and the efficiency of Section 404(b) implementation.[6] Among those activities are useful, ongoing

discussions, which the SEC staff has been observing, about how companies comply with SEC guidance and the PCAOB's auditing standards[7] on topics such as risk assessments, documentation, and testing of controls.

I am very pleased to see the continued attention that ICFR assessments will be given during this conference. While I will try not to get ahead of Marc Panucci or Kevin Stout's remarks later in the conference, it is hard to think of an area more important than ICFR to our mission of providing high-quality financial information that investors can rely on. If left unidentified or unaddressed, ICFR deficiencies can lead to lower-quality financial reporting and ultimately higher financial reporting restatement rates and higher cost of capital.

Over the next several years, updating and maintaining internal controls will be particularly important as companies work through the implementation of the significant new accounting standards. Companies' implementation activities will require careful planning and execution, as well as sound judgment from management, which leads me to new GAAP standards.

New GAAP Standards

I collectively refer to the implementation of the new revenue recognition, leases, financial instruments, and credit losses standards as "new GAAP standards." This is a financial reporting topic that deserves close attention, both to make sure that the implementation is done timely and with useful transition disclosures and to ensure the application of the standards, once implemented, is appropriate.

We need to be frank about any challenges and address them to the extent appropriate. But, when applied, the financial reporting under the new GAAP standards should achieve the objectives the standard setters identified so that investors see the benefits from the changes.

Revenue recognition

Revenue is one of the single most important measures used by investors in assessing a company's performance and prospects, regardless of a company's industry, the nature of its securities, or the capital markets it accesses. Revenue impacts key analytical ratios and bottom line earnings. Although often a complex area, companies cannot afford to get the accounting wrong.

The standards, including the disclosures, are an important step forward in financial reporting, both domestic and foreign, and when implemented, they are designed to enhance the comparability of companies' reported revenues.

Revenue implementation status

The changes in standards will impact all companies, and even if the extent of change for a particular industry or company is slight, the disclosures necessary to explain the changes—and when implemented, to describe revenue streams—may not be. Investors and OCA staff will be looking for increased disclosures in 2016 filings and during 2017 about the significance of the impact—whether quantitative or qualitative—of revenue recognition, among the other new standards, when those standards are adopted in the future. In addition, companies may find it helpful to investors to incorporate a discussion of the anticipated effects of the standard into their investor outreach activities to foster timely absorption of the information by market participants.[8]

Timely implementation of the new standard is important. Since my remarks at this conference last year when I said the overall state of readiness may be lagging, clear progress has been made by preparers,

but there is more to do. For example, in a recent survey of public companies released in October,[9] eight percent of respondents still had not started an initial assessment of the new revenue recognition standard, while the others were still assessing (75%) or implementing (17%).

Particularly for companies where implementation is lagging, preparers, their audit committees and auditors should discuss the reasons why and provide informative disclosures to investors about the status so that investors can assess the implications of the information. Successful implementation requires companies to allocate sufficient resources and develop or engage appropriate financial reporting competencies.

In addition, as the AICPA and other industry task forces continue their important work as part of the revenue standard's implementation, I urge task force members to complete their work expeditiously but without compromising quality. It is important to bring closure to the issues identified through this process.

OCA activities

OCA continues to be available and is consulting with companies as they finalize their technical accounting positions so that companies can advance in their implementation efforts. Jenifer Minke-Girard will provide an overview of our accounting consultations activities in her remarks, and other OCA staff will discuss specific consultation matters, including those involving new GAAP.

The staff in OCA, in forming our views, considers first the nature, design, and economic substance of the transaction, then the:

- language in the standard and the related basis for the standard setters' conclusions;
- implementation discussions, such as those at the TRG; and
- objectives expressed in the standard for consistency and comparability.

In doing so, we start with the terms of the arrangement — the *contract* with the *customer* and proceed from there. It is important for companies to fully understand their existing or planned transactions and arrangements and be able to clearly articulate their basis for their proposed accounting under the new standard. We engage in dialogue with companies so that we can understand all of this information — the facts and circumstances and the company's analysis as to how the new standard applies.

With new lease, financial instruments and credit losses standards awaiting required adoption in the years after revenue recognition, companies need to also begin to assess and implement those other new GAAP standards to meet the adoption dates.

Non-GAAP Reporting

Turning now to non-GAAP reporting, good practices in this area begin with preparers. Good reporting practices also place a premium on audit committee member understanding of the company's non-GAAP policies, procedures, and controls.

Last year at this conference Chair White spoke about non-GAAP reporting, highlighting that the area deserved close attention so that the measures convey relevant and useful information. Since then the staff in the Division of Corporation Finance and OCA developed and released new Compliance and Disclosure Interpretations (C&DIs)[10] to provide additional guidance on non-GAAP disclosures. The staff has also engaged with registrants and their advisors on non-GAAP measures, and substantial progress has been made in addressing the problematic practices. However, there is more progress for

companies to make, for example, in the evaluation of the appropriateness of the measure and its prominence, as well as the effectiveness of disclosure controls and procedures.

Audit committee members should seek to understand management's judgments in the design, preparation, and presentation of non-GAAP measures and how those measures might differ from approaches followed by other companies. These discussions will require an understanding of the company's business model and how it is managed.

For example, it is important to keep in mind that businesses operate in uncertain environments. If non-GAAP adjustments replace that business reality with smooth earnings over time, accelerate unearned revenues, or defer incurred expenses, those adjustments and disclosures should be evaluated closely under the C&DIs.

Valuation practices

I would like to also acknowledge and encourage timeliness and quality in the ongoing important work to continually enhance valuation performance standards, credentialing, quality assurance, governance, and related matters, which are designed to further buttress high quality valuation practices.

Audit Committees

Turning now to audit committees, you as committee members are a critical gatekeeper in the chain responsible for credible, reliable financial reporting.

Audit committees must stay current on emerging issues, whether financial, control, or disclosure related, through continuing education and other means. In addressing certain important issues, some audit committees may need expert advisors as they carry out fully their responsibilities.

Audit committees of listed companies have clear oversight authority and responsibility over the external auditor, which promotes auditor independence and greater alignment of the auditor's interests with those of investors.[11]

The audit committee helps set the tone for the company's relationship with the external auditor. Auditors are in a unique position to provide feedback to the audit committee about management, the company's processes, accounting policies, and internal control over financial reporting, among others. This oversight of management's activities is crucial for investor protection, and it is important for both auditors and audit committees to keep and maintain the direct relationship they share.

While I was an audit engagement partner, in addition to addressing the communications required by the auditing standards and audit committee charter, I found the following types of questions from audit committee members helpful in generating a dialogue:

- If you as the auditor were in management's shoes and solely responsible for preparation of the company's financial statements, would they have in any way been prepared differently?
- If you as the auditor were in an investor's shoes, would you believe that you have received the information essential to understanding the company's financial position and performance?
- Is the company following the same internal control over financial reporting and internal audit procedures that would be followed if you were in the CEO's shoes?
- Are there any recommendations that you as the auditor have made and management has not followed?

Audit committees should not underestimate the importance of their role overseeing the external auditor. Auditors are accountable to the board of directors through the audit committee, not to management.

The audit committee responsibilities include the authority and responsibility to directly oversee auditor engagement terms and compensation. In doing so, audit committees should work with other board committees as needed to monitor that important corporate objectives, such as cost reduction plans, are not unintentionally implemented in ways that would be at cross purposes with management meeting their financial reporting responsibilities or the external auditor's appropriate audit scope, engagement terms, and compensation. The design and operation of some of management's procurement policies and processes may be inappropriate if applied to the auditor selection, retention, and compensation decisions.

I encourage audit committees to be proactive in providing voluntary disclosures in the audit committee report, especially in describing how they execute their oversight responsibilities. I am encouraged by the trends in audit committee voluntary reporting.[12] For instance, in a recent survey 82% of audit committees of Fortune 100 companies disclosed in 2016 that the audit committee is responsible for appointment, compensation and oversight of the external auditor.[13] This has increased significantly from 42% just four years ago.[14]

Auditors

Of course, audit committees don't audit—auditors do. Auditors are the key gatekeepers for high quality financial reporting, protecting investors by providing reasonable assurance that issues are promptly identified and addressed. Maintaining the strength of financial reporting depends on thorough and objective audits performed by auditors who are independent, skeptical, and who apply the diligence needed to meet PCAOB standards. Investors expect and depend upon rigorous audits.

Independence

Auditors play a vital role in the capital markets, in part, because of their impartial and objective judgment about financial reporting—reinforced by their independence. An auditor would impair its independence any time it runs afoul of the "general standard" of independence or any one of a non-exclusive list of prohibited relationships and non-audit services.[15] Given the central role of independence in the auditor relationship, OCA monitors the application of SEC rules and guidance closely through consultations and cases.

Representatives from the Division of Enforcement will discuss later two recently-settled Commission enforcement actions brought under the general standard of independence that deserve review by auditors in considering the adequacy of their own policies, procedures, training, and other quality controls in relation to the circumstances, remedial steps taken and required undertakings.[16]

In light of these cases, audit committees also should consider whether any enhancements by management are needed to corporate governance, policies, and procedures to help deter costly independence issues from occurring.

Lastly on independence, as I noted earlier, we are in a period of significant accounting change, and auditors may be asked to provide input or feedback as management makes changes to accounting policies, processes, and controls. Investors benefit when auditors and management engage in dialogue regarding new accounting standards, as it may positively impact audit quality and the quality

of financial reporting. However, auditors should recognize that there are boundaries to their involvement as companies implement new accounting standards. Determining the extent to which an auditor can provide accounting advice to its audit client requires professional judgment and common sense. Auditors should never act as management or be involved in decision-making; otherwise, the auditor could later be put in the position of auditing what is essentially his or her own work. However, auditors can still provide their knowledge and point of view during the transition period, as long as they are mindful of the independence rules.

Public Company Accounting Oversight Board (PCAOB)
Let me now turn to the important work of the PCAOB with whom we work closely to achieve our shared goals on behalf of investors.

A cornerstone of investor protection is the independent audit of financial information. The mission of the PCAOB is an important one in protecting investors by establishing auditing and related professional practice standards. I commend the PCAOB for its ongoing, continuous improvements to its inspection program and believe that inspections, as well as the PCAOB's enforcement activities, have played a key role in maintaining and enhancing the quality of independent audits. In addition, to maintain and, where necessary, strengthen the quality of external audits, it is also essential to ensure that auditing standards are sufficiently strong, comprehensive, and responsive to new and emerging risks. In this regard, the PCAOB is designed to bring expertise and a variety of perspectives, including of its advisory groups, to the task of setting appropriate auditing standards and overseeing the practice of auditing public companies and SEC-registered broker-dealers.

I was pleased with the PCAOB's decision to implement a new research agenda.[17] An important objective of the new research agenda is to provide transparency and encourage input into the areas that the PCAOB is considering for future standard-setting or other regulatory action. You will hear more on this from Marc Panucci later today, but I believe that the topics included illustrate the importance of having a research agenda, and this has been a positive result of the PCAOB's review of its standard-setting process.

It also helps to ensure that those projects that warrant standard-setting are added to the standard-setting agenda. Careful consideration of the PCAOB's own regulatory experience, academic research, and stakeholder perspectives about the audit implications of these topics can help the PCAOB assess whether to pursue a standard-setting project and, if so, help to inform the project scope.

Under its revised standard-setting approach, the PCAOB has continued to update its auditing standards. For example, the PCAOB has made significant progress on its project to consider updating the standard auditor's report,[18] which is a project that has been of interest to many investors. Finally, the PCAOB should continue to work towards advancing and finalizing other important and challenging projects on its standard-setting agenda, including auditing accounting estimates.[19]

Lastly, this year the PCAOB has also launched a post-implementation review program for its standards, which is another important element of the PCAOB's efforts to draw upon past experiences to help continue to fulfill its statutory mission. I commend the PCAOB for its efforts and its commitment to high-quality auditing standards.

Standard-setters

Let me now turn to the importance of standard setters to high quality, reliable financial reporting.

In a fundamental sense, good financial reporting cannot occur without strong accounting standards designed by independent standard setters to produce transparent, neutral financial reporting.

While the Commission retains the ultimate standard-setting authority for financial reporting in the U.S. public capital markets, it has consistently looked to the private sector for leadership in establishing and enhancing high-quality accounting standards.

A private sector standard-setter is best positioned to promulgate accounting standards free from undue influence, whether commercial, political, national, or financial, so that investors' continue to rightly place a high degree of confidence in not only the accounting standards but also the process by which they are developed.

Setting a standard must be informed by all relevant viewpoints, but the standard must ultimately provide objective, representationally faithful, and neutral information about relevant economic activities useful for investor decisions, even if those decisions change the economic activities of market participants.

Investors benefit from the expertise and careful judgment of the FASB in its role as the designated accounting standard-setter for U.S. GAAP, [20] as they do from the International Accounting Standards Board (IASB), whose IFRSs may be used by foreign private issuers in filings with the SEC without reconciliation to U.S. GAAP.[21]

I commend the Boards for their significant progress over the past decade to enhance financial reporting in a number of priority areas such as business combinations, leases, revenue recognition, fair value measurement, and credit losses.

However, both Boards should continue to regularly identify the needs of users and respond in a timely manner, particularly since business models and transactions are not static and the pace of change will continue. The Boards' advisory groups and technical agenda consultations are vital to timely input regarding where current standards are missing, unclear, or produce financial reporting results that do not serve investors well.

Conducting objective, thorough, and reflective post-implementation reviews of major accounting standards serves an important role in ensuring that the objectives of standard-setting projects are achieved.[22]

International Financial Reporting Standards in the U.S.
I want to also touch on the topic of the use of IFRS in the United States.

IFRS is very significant for both U.S. investors and companies.

U.S. investors, in making their investment decisions, continue to rely on financial reporting by companies that operate globally, whether those companies are U.S. multinational companies with foreign subsidiaries or foreign private issuers that report here in the United States. Today, U.S. investors invest directly in securities of approximately 525 foreign private issuers with a market capitalization of approximately $7.3 trillion as of September 2016[23] that apply IFRS in filings with the Commission.

Many U.S. companies, particularly those with global operations, also continue to have an ongoing interest in the quality of IFRS. For example, U.S. companies frequently look abroad for potential targets and investees that use IFRS. In addition, U.S. multinational companies with foreign subsidiaries

may be permitted or required by other countries to apply IFRS for statutory financial reporting requirements for their non-U.S. subsidiaries. U.S. companies also enter into transactions with non-U.S. companies and other stakeholders who are required to use IFRS financial statements; still others prepare management information using IFRS. As a result, knowledge and understanding of IFRS, including similarities and differences between U.S. GAAP and IFRS, are highly relevant to stakeholders evaluating transactions and related financial reporting obligations.

Because IFRS is very significant to both U.S. investors and companies, the U.S. has a strong interest in monitoring the quality of IFRS standards, as well as the quality of their application. OCA staff monitors the development of IFRS standards and interprets their application through the OCA consultation process, making IFRS integrated into all aspects of our work.

On the question of possible further use of IFRS for domestic issuers, I believe that for at least the foreseeable future, the FASB's independent standard setting process and U.S. GAAP will continue to best serve the needs of investors and other users who rely on financial reporting by U.S. issuers.

That said, I strongly encourage the FASB and IASB to continue to work together to eliminate differences between their standards where such efforts will strengthen the standards and be in the best interests of investors in the U.S. public capital markets, as well as in other markets. I believe that both the FASB and the IASB will benefit from continued collaboration as both Boards continue to eliminate differences as a means of achieving progress towards the objective of high-quality accounting standards in the U.S. and globally.

I also believe it is worth continuing to consider the proposal that Jim Schnurr described at an earlier conference of allowing domestic issuers to provide IFRS-based information as a supplement to GAAP financial statements.[24]

Evolution of Technology

Next, I want to look ahead at how technology affects how investors and other users view and manage financial information.

Julie Erhardt will be speaking more about OCA's plans in this area later this morning, but I will start the conversation with an anecdote.

In the last year, the SEC's website received over 7 billion page views — which is more than some major media sites. The SEC delivered two petabytes of data through the site, which by today's standards is enormous. Over the past month, there have been more than 50,000 views of EDGAR filings per day from mobile devices. This suggests to me that market participants are seizing on opportunities to gather information from filings available on EDGAR. Anecdotally, I also sense that some of those participants then aggregate, normalize, and distribute the information as a service to investors and others.

With these opportunities and the benefits of those efforts also come risks, and complex ones. As financial information is collected from financial statements, then changed, and later distributed across a range of platforms, there are ongoing considerations for investors, companies, auditors, and information intermediaries. I believe there are a number of pieces in the changing landscape to consider together—and only in doing so can we discern how the nature and extent of involvement by each of those who are vital to a well-functioning financial information supply chain should evolve.

In addition, the evolution of technology and its effects on financial reporting have implications on the education and skills required of those entering the accounting profession.

Forward progress in the accounting profession

Finally, I want to acknowledge the broader environment in which we are all working and look ahead with the accounting profession. We are living in a time of significant change. I've already discussed some accounting and auditing changes, which is the typical focus of this conference, but now I am talking about change in a much broader context.

- We are living in a period of global economic change — for example, large central bank balance sheets, negative interest rates, and increasing public and private sector obligations.
- We are living in a period of demographic change — for example, baby boomers are retiring, millennials are assuming greater roles and influence, and our population is broadening.
- We are living in a period of technological change — for example, advances in artificial intelligence, big data, mobile devices, pervasive interconnectivity, cybersecurity risk, and virtual reality.
- And, of course, we are living in a period of institutional change, not just in the U.S. but in other countries that are home to significant capital markets.

New tools, new competitors, new challenges, and new opportunities have created a transition for all of us. Even as we advance the high quality information in the capital markets, it is critically important to understand and maintain focus on the core principles that will move us forward even further, and to continue to act in accordance with them.

Having fair, orderly, and efficient capital markets that facilitate capital formation while protecting investors, is a pillar of the U.S. economy, and the quality and performance of the U.S. economy supports and facilitates many of America's other strengths, as well as public policy initiatives.

But keeping true to fundamental principles is not just important for those of us as regulators, but for all of us who play important roles in maintaining our system of credible financial reporting that supports our capital markets and their participants. I will go even further in saying we all have important roles in upholding and contributing to the principles of accurate, honest information that are fundamental to the strength of our country and society.

I am a CPA. I am here at one of the largest conferences where we as licensed CPAs gather. As CPAs, we should challenge ourselves and each other to consistently keep ethical behaviors—objectivity, integrity, trust, and, most importantly, independence—that underpin the lasting value of our profession. Even as we work to ensure the public remains confident in the ethics, professionalism, and services of CPAs, we must also position ourselves and future generations of accountants and auditors to innovatively identify and solve the challenging and complex issues facing the evolving public interest. We do so best with a workplace that is reflective and inclusive of the global communities in which we serve—different people, different cultures, and different perspectives.

Indeed, Chair White has reinforced the value of diversity on company boards and in organizations generally,[25] and has also noted that diversity "brings with it a richness and variety of experiences and perspectives that benefit companies and shareholders."[26]

I hope that the profession will also continue to lead in the capital markets by promoting those values of ethics and diversity as we together foster the efficient functioning of our capital markets, which depend on continuous flow of reliable financial information.

Closing

It has been my pleasure to speak at this conference. In our time this morning, I have tried to give you an overview of the long-held support for high quality financial information that underpins our U.S. public capital markets, our shared responsibility for strong financial reporting and ways that we can all contribute, and to highlight some paths forward as the accounting profession maintains its relevance to all stakeholders.

Senior members of the Commission and OCA staff will talk more about these and other issues over the next three days. As you listen to the discussion of various financial reporting issues, it is important to keep in mind that we are trying to engage transparently and proactively with you on our shared responsibility for high quality, reliable financial reporting, which requires the very best efforts of all of us. Investors and our capital markets deserve and demand no less.

I look forward to joining the end of day Q&A panel to address questions or feedback you may have.

Thank you for your time.

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[1] *See* Chairman Joseph P. Kennedy, U.S. Securities and Exchange Commission, *Address at Meeting of the Boston Chamber of Commerce* (Nov. 15, 1934), *available at* https://www.sec.gov/news/speech/1934/111534kennedy-1.pdf.

[2] *See* SIFMA 2016 Fact Book, *available at* http://www.sifma.org/factbook .

[3] *See e.g.,* Chair Mary Jo White, U.S. Securities and Exchange Commission, *Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility"* (Dec. 9, 2015), *available at* https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html.

[4] *See* IOSCO Media Release, *IOSCO welcomes new leadership of IOSCO Board committees* (Nov. 21, 2016), *available at* https://www.iosco.org/news/pdf/IOSCONEWS444.pdf .

[5] *See* Section 404 of the Sarbanes-Oxley Act of 2002, Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934 ("Exchange Act"), and Item 308 of Regulation S-K.

[6] *See Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million, available at* https://www.sec.gov/news/studies/2011/404bfloat-study.pdf

[7] *See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* Release No. 33-8810 (June 20, 2007), *available at* https://www.sec.gov/rules/interp/2007/33-8810.pdf and *AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (originally adopted in June 2007 as Auditing Standard No. 5), *available at* http://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx.

[8] *See* SEC Staff Announcement at the September 22, 2016 EITF Meeting, *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168580761 .

[9] *See* PwC, *2016 Revenue Recognition Survey: Readiness update, impacts and remaining challenges* (2016), *available at* http://www.pwc.com/us/en/audit-assurance-services/accounting-advisory/revenue-recognition-survey.html .

[10] *See Compliance and Disclosures Interpretations, Non-GAAP Financial Measures section*, Division of Corporation Finance, *available at* https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[11] *See* Rule 10A-3 of the Exchange Act.

[12] *See* Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016), *available at* http://www.thecaq.org/2016-audit-committee-transparency-barometer .

[13] *See* Ernst & Young, *Audit Committee Reporting to Shareholders in 2016* (Sept. 2016), available at http://www.ey.com/Publication/vwLUAssets/ey-audit-committee-reporting-to-shareholders-in-2016/$FILE/ey-audit-committee-reporting-to-shareholders-in-2016.pdf .

[14] *See id.*

[15] Rule 2-01(b) and (c) of Regulation S-X.

[16] *See Ernst & Young, Former Partners Charged with Violating Auditor Independence Rules*, Press Release No. 2016-187 (Sept. 19, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-187.html; *In the Matter of Ernst & Young LLP and Gregory S. Bednar, CPA,* Release No. 34-78872 (Sept. 19, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-78872.pdf; and *In the Matter of Ernst & Young LLP, Robert J. Brehl, CPA, Pamela J. Hartford, CPA, and Michael T. Kamienski, CPA*, Release No. 34-78873 (Sept. 19, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-78873.pdf.

[17] The PCAOB's new research agenda was discussed at its Standing Advisory Group meeting on November 30, 2016. *See* https://pcaobus.org/News/Events/Pages/SAG-meeting-November-2016.aspx.

[18] *See Proposed Auditing Standards on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards,* PCAOB Release No. 2016-003 (May 11, 2016), *available at* https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf .

[19] *See PCAOB Standard-Setting Agenda* (Sept. 30, 2016), *available at* https://pcaobus.org/Standards/Documents/2016Q3-standard-setting-agenda.pdf .

[20] *See Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Release No. 33-8221 (April 25, 2003), *available at* https://www.sec.gov/rules/policy/33-8221.htm.

[21] *See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP*, Release No. 33-8818 (July 2, 2007), *available at* http://www.sec.gov/rules/proposed/2007/33-8818.pdf.

[22] The last post-implementation review completed by the Financial Accounting Foundation was for FASB Statement No. 128, *Earnings per Share* (Feb. 2016).

[23] These numbers are approximates, and are based on the SEC staff's analysis of filings and market information.

[24] *See* James Schnurr, Chief Accountant, U.S. Securities and Exchange Commission, *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.

[25] *See* Chair Mary Jo White, U.S. Securities and Exchange Commission, *Keynote Address at the International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, non-GAAP, and Sustainability* (June 27, 2016), *available at* https://www.sec.gov/news/speech/chair-white-icgn-speech.html.

[26] *See* Chair Mary Jo White, U.S. Securities and Exchange Commission, *Completing the Journey: Women as Directors of Public Companies* (Sept. 16, 2014), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370542961053.

Modified: Dec. 6, 2016

7. Wesley Bricker Speech: "Advancing the Role and Effectiveness of Audit Committees" (March 24, 2017)

Speech

Remarks before the University of Tennessee's C. Warren Neel Corporate Governance Center: "Advancing the Role and Effectiveness of Audit Committees"

Wesley R. Bricker, Chief Accountant, Office of the Chief Accountant

Knoxville, TN

March 24, 2017

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Good afternoon and thank you Dr. Terry Neel for the kind introduction. I want to also acknowledge and thank Dr. Joseph V. Carcello, as the Accounting and Information Management Department Head and the cofounder and Executive Director of the Corporate Governance Center for his invitation to speak here today.

Before I begin, let me remind you that the views expressed today are my own and not necessarily those of the Commission, the individual Commissioners, or other colleagues on the Commission staff. Let me also express a word of gratitude to the entire OCA team for their work in providing advice to the Commission regarding accounting and auditing matters arising in the administration of the federal securities laws. I want to also acknowledge their valuable assistance in preparing me to make today's remarks, including Emily Fitts, Karen Plunkett, Ying Compton and Duc Dang. Also, Jenifer Minke-Girard has recently taken on the role of Interim Deputy Chief Accountant – International as she continues to serve as the Vice Chair of IOSCO's Committee on Issuer Accounting, Audit and Disclosure, which is known as Committee 1. In her role, Jenifer will oversee the activities of the Office of the Chief Accountant's International Group, which include collaborating with securities regulators from other countries on proposals and requests from international accounting, audit, and ethics standard setters, interpretative committees and oversight bodies. Having recently "timed out" of her role as Chair of Committee 1 after almost 10 years of outstanding leadership,
Julie Erhardt continues to serve as a Deputy Chief Accountant, taking on roles that include leading our

work to identify and assess the impact of emerging trends and events on accounting and auditing matters.

The livelihood of every American depends in a meaningful way on how well accountants do their jobs. Economic decisions are no better than the information on which they are based -- if the numbers are wrong, the decisions are wrong, and our economic future is placed at risk. Investors depend on accurate financial reporting.

Financial reporting can and should provide investors with a clear picture of a company's financial condition – information that investors need to make informed investment decisions as they place their investment capital with the businesses that need it to operate, grow, and compete. The credibility of financial statements most likely has a direct effect on the price that investors are willing to pay for a company's securities.

Audit committees also play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company's culture and internal control over financial reporting ("ICFR"), the quality of financial reporting, and the quality of audits performed on behalf of investors. The importance of the audit committees' work cannot be overstated.

Broadly, a corporate board is in place to ensure that management is working in the best interests of the corporation and its shareholders -- by working to enhance corporate value.

A key element of board oversight is working with management to achieve high quality financial reporting, including implementing quality accounting policies and ICFR and appointing independent external auditors to promote accurate and timely disclosure of financial information to the board, to investors and the public markets more broadly.

This oversight function is typically delegated by the full board to the audit committee. While the listing standards of the primary U.S. securities exchanges mandate that companies have an audit committee, these listing standards leave room for judgement on certain matters as to how an audit committee should be comprised and, moreover, how it should function.

So, today, I would like to talk about ways to reinforce audit committee effectiveness for high quality financial reporting.

The role of the audit committee

The Commission has a long tradition of recognizing the importance of governance and thus promoting effective audit committee oversight. The need to provide markets and investors with more reliable information laid the foundation for the creation of the Commission in 1934 and its mission which continues to this day.

Since as early as the 1940s, the Commission, along with the auditing and corporate communities, has had a continued interest in the ability of audit committees to promote reliability in financial reporting. Over the following decades, there has been an evolution in the role and responsibilities of audit committees. The process was driven by the need to find the appropriate balance between the roles of management, independent auditors and audit committees to achieve the ultimate objective of providing investors with high-quality decision useful information regarding public companies.

In the late 1990s, the NYSE and the NASD, among others, revised their listing standards relating to audit committees, addressing recommendations of a Blue Ribbon Committee formed in response to

corporate and governance failures. The Blue Ribbon Committee's report stated that the "audit committee must be first among equals in this [financial reporting] process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process."[1]

Many of the Blue Ribbon Committee's recommendations for strengthening the role of audit committees were subsequently incorporated into listing standards, rules and regulations of the SEC, and the Sarbanes-Oxley Act of 2002, which provided for:

- Enhancements to the role of the audit committee;
- Increased visibility of the audit committee and its responsibilities to investors and other stakeholders;
- Strengthening the relationship between the audit committee (as a representative of investors) and the independent auditors; and
- Enhancements to audit committee independence.

The academic literature has long documented the importance of the independence and expertise of audit committees. For example, studies using data prior to the Sarbanes-Oxley Act of 2002 found better internal control, financial reporting quality, and audit quality for companies with more independent audit committees. [2] More recently, academic studies further emphasized the vital role audit committees have in the oversight of the independent auditor, audits,[3] and financial reporting.

Fulfilling its oversight responsibilities places the audit committee at the center of the relationship between management of a public company and its independent auditor. Investors look to audit committees with high expectations to establish and maintain the appropriate tone, capacity, and competence to oversee the quality of the financial reporting system.

Understanding the business operating environment

Audit committees should understand the businesses they serve and the impact of the operating environment – the economic, technological, and societal changes – on corporate strategies. Obtaining such an understanding of the entity and its environment is an essential aspect of serving in an audit committee role to oversee and counsel those having responsibility for preparing the financial statements, as well as overseeing the external audit of the financial statements.

This understanding establishes a frame of reference in which the audit committee considers the scope of its charter, its agendas, education needs, advisory needs, and ultimately the exercise of its business judgment in assessing the information about the accounting and financial reporting.

As a continuous, dynamic process of gathering, updating, and analyzing information throughout any given year, this understanding also enables the audit committee to consider areas where special consideration may be necessary, for example, related-party transactions, use of the going concern assumption in preparing the financial statements, complex or unusual transactions, evaluating the business purpose of transactions or understanding changes in accounting standards.

The current business operating environment highlights a number of considerations for those involved in financial reporting, including audit committees. For example,

- Operating environment. Changes in the operating environment can result in changes in competitive pressures and different financial reporting risks.

- Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- New business models, products, or activities. Entering into industries, business areas or transactions with which an entity has little experience may introduce new risks associated with financial reporting, including ICFR. For example, within many industries, some companies will need to understand the impact on financial reporting of the pace and scope of business and competitive changes as they expand from product companies to data and technology services businesses.
- New accounting pronouncements. The implementation of new GAAP standards may affect risks in preparing financial statements, particularly if implementation planning or execution is lacking.

Effectiveness of Audit Committees

Continuing on the topic of audit committee effectiveness, the board (including the audit committee), management (including the internal audit function), and the external auditor all have a distinct role in financial reporting.

Yet, all three together effectuate a system that supports credible financial reporting. In the system, management is responsible for the preparation of the financial statements and for establishing and maintaining adequate ICFR as well as evaluating the effectiveness of ICFR. The external auditor is responsible for opining on the fair presentation of the financial statements and, when applicable, evaluating the effectiveness of ICFR. Last, the audit committee, as the delegate of the full board, is responsible for overseeing the entire process.

One size doesn't fit all when it comes to audit committees. Within broad parameters, each audit committee develops its charter and agenda. The committee's job is one of oversight and monitoring, and in carrying out this job, it acts in reliance on senior management, the external auditor, and any advisors that the committee might engage.

Composition

Recently, there has been an appropriately strong interest and focus of investors on diversity of thoughts within the board of directors. Investors have expressed that board composition, including diversity, and assessment should be a board priority in the coming year.[4]

Diversity of thoughts diminishes the extent of group thinking, and diversity of relevant skills (for example, industry or financial reporting expertise) enhances the audit committee's ability to monitor financial reporting.[5] Academic research tells us that boards with diverse members allocate more effort to monitoring, have better financial reporting quality, and are more likely to hold management accountable after poor performance.[6] Given the importance of diversity to audit committee effectiveness, there is an opportunity to increase the level of diversity on U.S. boards and audit committees.[7]

Workload

Let me now turn to audit committee capacity and assessment of the workload. Balancing audit committee workload is especially critical given the need for audit committees to stay current on emerging issues, whether financial, ICFR, or disclosure related through continuing education and other means.

Periodic examination of the audit committee's capacity, which supports any committee's ability to perform its responsibilities effectively, is necessary.

Recent surveys indicate that some audit committees are finding it difficult to perform its core responsibilities while covering other major risks on its agenda.[8] For example, a recent Corporate Directors survey by an audit firm suggests that while 75% of Board directors say their workload is manageable, only 57% of audit committee members say their workload is manageable.

Among audit committee members, the survey results are more pronounced in certain industries. For example, in the banking and capital markets sector, only 34% of audit committee members surveyed indicated they believe their workload is manageable.

This emphasizes the importance of the role of the board in driving the audit committee's focus and responsibilities. Board directors should ask themselves if they are identifying the risk of audit committee overload, and if so, are they appropriately managing this risk to enable the audit committee to operate effectively.

While audit committees may be equipped to play a role in overseeing risks that extend beyond financial reporting, such as cybersecurity and portions of enterprise risk management, I believe it is important for audit committees to not lose focus on their core roles and responsibilities.

Still, workload can be managed at least in part through consideration of the scope of the audit committee charter, agendas, education, and advisors. It is worth noting that listing standards required as a result of the Sarbanes-Oxley Act provide an audit committee with explicit authority to obtain advice and assistance from outside legal, accounting or other advisors as the audit committee deems necessary or appropriate to carry out its duties.

Audit Committee members must help each other test their judgement and instincts in landing on the important issues. Factors that lead to greater audit committee effectiveness include group dynamics, training, information reporting, and focus on substantive issues.

Tone (at the top)

Let me now turn to the effect of an audit committee on the control environment, including tone at the top. The control environment influences the control consciousness of its people. It is the foundation for effective ICFR, providing discipline and structure. A company's control consciousness is significantly influenced by those on the board and audit committee.

A strong control environment is especially critical for company management and personnel as accounting judgments are increasingly required to be formed by many levels of individuals in the organization and disclosed in the financial statements to meet the objectives of the new GAAP standards. A strong control environment also supports the audit committee's work.

The COSO Internal Control – Integrated Framework (2013), which companies commonly use in evaluating the effectiveness of ICFR, includes guidance for assessing the effectiveness of control environment, including tone at the top.

The importance of the audit committee's involvement in tone and culture is further emphasized by the fact that tone and culture are one of the top challenges that audit committees believe impact the company it oversees. A significant number of audit committee members – roughly one in four in a

recent audit firm survey – ranked tone and culture as a top challenge in its oversight role.[9] The counsel of management guru Peter Drucker seems apt, "What gets measured gets improved."

It is important for both audit committees and management to perform assessments on the adequacy of the control environment, including tone at the top. One way audit committees can focus on tone and culture is by working with management to obtain a clear and common understanding of what tone means, why tone is important, and what mechanisms are in place to assess the adequacy of control environment, including across any relevant divisions and geographies.

I believe open and candid discussions between the external auditor and the audit committee is a critical component in determining whether the organization's tone and culture is appropriate.

Staying Current on Accounting and Financial Reporting Developments

The audit committee should also consider training and education programs to ensure that its membership has the proper background and stays current as to relevant developments in accounting and financial reporting.

New GAAP standards

In OCA, we continue to direct significant attention to monitoring companies' implementation activities for recently-issued accounting standards, including revenue recognition, leasing, financial instruments and credit losses.

The standards advance the dual goals of improving financial reporting within the United States and reducing country-by-country disparity in financial reporting for enhanced allocation of capital.

As for the new GAAP standards:

- The revenue recognition standard is intended to improve the financial reporting of revenue and enhance comparability of this critical metric. It is permitted to be applied for most public companies in 2017 and is required to be applied in 2018.
- The leases standard is the result of more than a decade of standard-setting due process and outreach, and will increase transparency and comparability among organizations that lease buildings, equipment, and other assets by recognizing on balance sheets the assets and liabilities that arise from lease transactions. Public companies are permitted to begin applying the standards immediately, but must do so by 2019.
- The financial instruments standards include a change from the "incurred loss model" to an "expected credit loss approach" and improve the reporting for equity investments which may allow investors to have a more timely and representative depiction of a company's arrangements.

Investors need time to absorb the effect of new GAAP standards. Accordingly, OCA has encouraged investor outreach, emphasized investor expectations for disclosure, and updated our transition disclosure guidance.

OCA also has encouraged companies, their audit committees, and their auditors to assess the quality and status of implementation to ensure that the new standards meet their objectives to better inform

investors. As part of the assessment, we encourage audit committees to anticipate, and require, dialogue with the auditor about the auditor's views of implementation progress.

ICFR

Maintaining adequate internal accounting controls, representing annually to investors whether ICFR is effective, and, when required, having an independent accountant attest to the effectiveness of ICFR, promotes reliable financial reporting, strengthens public confidence, and encourages investment in our capital markets.

Over the next several years, updating and maintaining ICFR will be particularly important as companies work through the implementation of the significant new accounting standards.

OCA is committed to appropriately and timely addressing any emerging questions related to ICFR assessments and the application of the related guidance, including in coordination with the PCAOB as necessary.

Non-GAAP and Key Operational Metrics

Let me turn to another important topic, non-GAAP and key operational measures. Audit committees are well positioned to exercise healthy oversight by understanding management's process and controls to calculate the non-GAAP and other key operational measures. For example, what procedures are in place over the accuracy of the calculations and consistency of the measures with those of prior periods?

As part of considering management's disclosure controls and procedures it is important for audit committees to understand corporate policies in this area and if such a policy does not exist to understand the reasons why. It can also be useful to understand who is responsible for administering the policy – how many times have they approved changes in reporting, why, and should the change be communicated to investors through disclosure.

Oversight of External Auditors

Audit committees of listed companies have clear oversight authority and responsibility over the external auditor, which promotes auditor independence and greater alignment of the auditor's interests with those of investors. The audit committee helps set the tone for the company's relationship with the external auditor. This reporting relationship between the auditor and audit committee positions the auditor to be able to raise any contentious issues to the audit committee, in a candid, frank, and professional relationship.

Audit committees should not underestimate the importance of their role overseeing the external auditor. Auditors are accountable to the company's shareholders, through the board of directors and its audit committee, not to management.

The audit committee responsibilities under the listing standards include the authority and responsibility to directly oversee auditor engagement terms (including proposed scope) and compensation.

In doing so, audit committees should work with other board committees as needed to monitor that important corporate objectives, such as cost reduction plans, are not unintentionally implemented in ways that would be at cross purposes with management meeting its financial reporting responsibilities or the external auditor's appropriate audit scope, engagement terms, and compensation. Some of

management's standard procurement policies and processes may not be appropriately designed if used in the audit committee's selection, retention, and compensation decisions for the external auditor.

Audit Committee's Own Reporting

As it relates to the transparency of activities performed by audit committees, I am encouraged by the momentum that appears to exist for increased voluntary reporting by the audit committee over the past several years, particularly about the audit committee's work in overseeing the independent auditor.

For example, in a recent survey, 82% of audit committees of Fortune 100 companies disclosed in 2016 that the audit committee is responsible for appointment, compensation and oversight of the external auditor.[10] This has increased significantly from 42% just four years ago.[11]

While strides are being made by audit committees to help investors better understand and evaluate audit committee performance, I encourage audit committee members of listed companies to continue to consider reviewing their audit committee disclosures and consider whether providing additional insight into how the audit committee executes its responsibilities would make the disclosures more effective in communicating with investors.

In considering enhanced disclosure, I recommend to audit committees and their advisors the 2015 Commission concept release[12] which highlighted that disclosures could include a description of the nature of the audit committee's involvement in evaluating and approving the auditor's compensation, including how compensation is determined and evaluated.

Audit committees can help increase investor understanding of the reliability and quality of financial reporting when they provide additional insights into how the audit committee has fulfilled its responsibilities, particularly about the audit committee's work in overseeing the independent auditor and the financial reporting process.

Conclusion

It has been my pleasure to speak with you today. In our time together, I have provided thoughts on how we can continue to provide investors quality financial information for their use in making investment decisions.

Before I conclude my remarks and open it up for a few questions, I would like to thank the University for the invitation. I would also like to acknowledge and thank audit committee members for the hard work in carrying out your critical roles in maintaining the strength of our capital markets.

Our capital markets are among our nation's most spectacular achievements -- they're the envy of the world. Those markets are a rich legacy we have inherited, but do not own. We are guardians of that legacy -- that the markets of our nation; that the integrity of the process; that the confidence of investors will not be compromised.

And, if we ensure the continued focus on the credibility of financial reporting that underpins our nation's capital markets and foster investment activity in them through effective audit committees, I have no doubt that they will remain the envy of the world. Thank you.

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[1] Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, page 7 (1999).

[2] See Klein, A., *Audit Committee, Board of Director Characteristics, and Earnings Management*, 33 Journal of Accounting and Economics-375 (2002); Krishnan, J., *Audit Committee Quality and Internal Control: an Empirical Analysis*, 80 The Accounting Review-649 (2005); and Carcello, J and T. Neal, *Audit Committee Composition and Auditor Reporting*-75 The Accounting Review-453 (2000).

[3] Goh, B. W., *Audit Committees, Boards of Directors, and Remediation of Material Weaknesses in Internal Control*-26 Contemporary Accounting Research-549 (2009); and Hoitash, R., and U. Hoitash, *The Role of Audit Committees in Managing Relationships with External Auditors After SOX: Evidence from the USA*, 24 Managerial Auditing Journal-368 (2009).

[4] See, EY Center for Board Matters, *2017 Proxy Season Preview, What We're Hearing from Investors*, (2017), available at http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-preview/$FILE/ey-2017-proxy-season-preview.pdf .

[5] See Krishnan, J., Y. Wen, and W. Zhao, *Legal Expertise on Corporate Audit Committees and Financial Reporting Quality,*86 The Accounting Review 2011, 2099 (2011); and Cohen, J., U. Hoitash, G. Krishnamoorthy, and A. Wright, *The Effect of Audit Committee Industry Expertise on Monitoring the Financial Reporting Process,* 89 The Accounting Review-243 (2014).

[6] See Adams, R. B. & Ferreira, *Women in the Boardroom and their Impact on Governance and Performance*, 94 Journal of Financial Economics-291 (2009) and Abbott, L. J., S. Parker, and T. J. Presley, *Female board presence and the likelihood of financial restatement*, Accounting Horizons-607 (2012).

[7] See KPMG Audit Committee Institute, *Is Everything Under Control? Audit Committee Challenges and Priorities*, page 12 (2017), available at https://boardleadership.kpmg.us/relevant-topics/articles/2017/01/2017-global-audit-committee-pulse-survey.html and KPMG Board Leadership Center, *Building a Great Board, Global Boardroom Insights*, page 6 (2016), available at https://boardleadership.kpmg.us/content/dam/blc/pdfs/2016/building-a-great-board-global-boardroom-insights.pdf .

[8] See, PwC Governance Insight Center, *The Swinging Pendulum: Board Goverance in the Age of Shareholder Empowerment*, page 19 (2016), available at http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/assets/pwc-2016-annual-corporate--directors--survey.pdf .

[9] See KPMG Audit Committee Institute, *Is Everything Under Control? Audit Committee Challenges and Priorities*, page 19 (2017).

[10] See EY Center for Board Matters , *Sample Audit Committee Disclosures*, 2016, available at http://www.ey.com/Publication/vwLUAssets/ey-sample-audit-committee-disclosures-in-2016/$FILE/ey-sample-audit-committee-disclosures-in-2016.pdf

[11] Id.

[12] *Possible Revisions to Audit Committee Disclosures*, Release No. 33-9862 (July 1, 2015) [80 FR 38995 (July 8, 2015)].

8. SEC Litigation Release No. 23639: SEC Charges RPM International Inc. and its General Counsel for Disclosure and Accounting Failures (September 9, 2016)

U.S. Securities and Exchange Commission

U.S. SECURITIES AND EXCHANGE COMMISSION

Litigation Release No. 23639 / September 9, 2016

Securities and Exchange Commission v. RPM International Inc., et al., Case No. 16-cv-01803 (D.D.C. filed Sept. 9, 2016)

SEC Charges RPM International Inc. and its General Counsel for Disclosure and Accounting Failures

The Securities and Exchange Commission today charged Ohio-based chemical company RPM International Inc. and its General Counsel, Edward W. Moore, with failing to disclose a material loss contingency, or record an accrual for, a government investigation when required to do so under governing accounting principles and securities laws.

The SEC alleges that, from 2011 through 2013, RPM and one of its subsidiaries were under investigation by the U.S. Department of Justice (DOJ) for overcharging the government on certain contracts. Moore, RPM's General Counsel and Chief Compliance Officer, oversaw RPM's response to the DOJ investigation. According to the SEC's complaint, however, Moore did not inform RPM's CEO, CFO, Audit Committee, and independent auditors, of material facts about the investigation. For example, Moore knew but failed to inform them that: RPM sent DOJ estimates showing RPM's subsidiary overcharged the government on the contracts under investigation by a material amount; RPM agreed to submit a settlement offer by a specific date to resolve the DOJ investigation; and, prior to submitting the settlement offer to DOJ, RPM's overcharge estimates increased substantially to at least $28 million.

As a result of Moore's conduct, the SEC alleges that RPM filed multiple false and misleading documents with the SEC. For example, among other things, RPM failed to disclose in its filings with the SEC any loss contingency related to the DOJ investigation, or to record an accrual on its books, when required to do so by governing accounting principles and the securities laws. RPM also failed to disclose in its SEC filings a material weakness in its internal control over financial reporting and its disclosure controls when in fact such weakness existed. Consequently, RPM did not provide investors with accurate information about RPM's financial condition. In August 2014, RPM restated its financial results for three quarters that occurred during the DOJ investigation and filed amended SEC filings for those quarters, disclosing the DOJ investigation and related accruals. In the restated filings, RPM also disclosed errors relating to the timing of its disclosure and accrual for the DOJ investigation.

The SEC's complaint charges RPM with violating antifraud provisions of the federal securities laws, Sections 17(a)(2) and (a)(3) of the Securities Act of 1933; the reporting provisions of the federal securities laws, Section 13(a) of the Securities Exchange Act of 1934 and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder; and the books and records and internal controls

provisions of the federal securities laws, Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. The complaint also charges Moore with violating Sections 17(a)(2) and (a)(3) of the Securities Act and Rules 13b2-1 and 13b2-2 under the Exchange Act. The complaint seeks permanent injunctions, disgorgement of ill-gotten gains plus interest, and penalties.

The SEC's investigation was conducted by Timothy K. Halloran and Michael J. Hoess. The SEC's litigation will be conducted by H. Michael Semler, Gregory R. Bockin, Mr. Halloran, and Mr. Hoess.

- SEC Complaint

http://www.sec.gov/litigation/litreleases/2016/lr23639.htm

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Effective Communications Between Auditors and Audit Committees (December 1, 2016)

Submitted by:
Jeanette M. Franzel
Public Company Accounting Oversight Board

If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

https://pcaobus.org/News/Events/Documents/11302016_SAGMeeting/Audit-Committee-Communications-11-30-16.pdf

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

STANDING ADVISORY GROUP MEETING

Effective Communications Between Auditors and Audit Committees

DECEMBER 1, 2016

As part of its mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports, the PCAOB is committed to constructive engagement and information sharing with audit committees in areas of common interest.

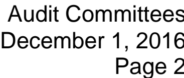
Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports. Communications between the auditor and the audit committee allow the audit committee to be well-informed about accounting and disclosure matters, including the auditor's evaluation of matters that are significant to the financial statements, and to be better able to carry out its oversight role. Communications with the audit committee provide auditors with a forum that is different from management's to discuss matters about the audit and the company's financial reporting process.

At the December 1, 2016 SAG meeting, a panel of SAG members will discuss effective communications between auditors and audit committees. The discussion is intended to further the dialogue on how auditors and audit committees communicate effectively. A panel consisting of audit committee chairs, audit partners, and a chief financial officer will discuss a broad range of topics, which may include, among others:

- How audit committees stay informed about current and emerging issues;
- Whether and how auditors are providing audit quality indicators to audit committees, and how audit committees are using them;
- Audit committee use of PCAOB inspection reports; and
- Frequency and depth of auditor communications with audit committees (e.g., use of executive sessions, nature of discussions between audit committee meetings).

After the panel presentations, SAG members will have the opportunity to discuss their views regarding the topic, including current communication practices between

This paper was developed by the staff of the Office of the Chief Auditor as of November 18, 2016 to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.



auditors and audit committees and the PCAOB's role in promoting effective communications.

Background

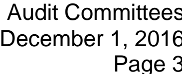
Audit committees play a vital role in the capital markets' investor protection framework through their oversight of the audit engagement and their company's financial reporting process. The PCAOB has engaged audit committees in a variety of ways, including through:

- Issuance of AS No. 16, *Communications with Audit Committees;*
- Issuance of Board Release, *Information for Audit Committees about the PCAOB Inspection Process*
- Board member outreach to audit committees;
- SAG meetings;
- PCAOB's Audit Committee Dialogue;
- Board Reports and Staff Briefs on PCAOB Inspections;
- Concept Release on Audit Quality Indicators; and
- Information for Audit Committees webpage.

AS No. 16, which was adopted in August 2012, improves the audit by enhancing communications between auditors and audit committees. The standard establishes requirements that enhance the relevance, timeliness, and quality of the communications between the auditor and the audit committee. The enhanced relevance, timeliness, and quality of communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, thereby benefitting investors.

In August 2012, the Board issued a release titled *Information for Audit Committees about the PCAOB Inspection Process*. The document was issued to assist audit committees in (1) understanding the PCAOB's inspections of their audit firms and (2) gathering useful information from their audit firms about those inspections.

PCAOB Board members conduct outreach with audit committees through participation in conferences for and meetings with audit committee members. Board members provide information about the work of the PCAOB, including inspections, standard setting, and international activities.



The SAG discussed auditor/audit committee communications at its May 2013 meeting. Among the topics discussed were the objectives of the Board's outreach efforts, the effectiveness of the Board's past outreach efforts, and potential approaches to future outreach efforts. Since then, the PCAOB has developed a number of publications of interest to audit committees and other stakeholders:

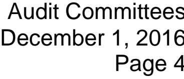
- *Publication of PCAOB's Audit Committee Dialogue.* In May 2015, the PCAOB published *Audit Committee Dialogue*, a digital outreach communication to audit committees. This *Dialogue* highlighted insights from PCAOB inspections and discussed recurring areas of concern and emerging risks related to increases in mergers and acquisitions, falling oil prices, undistributed foreign earnings, and maintaining audit quality while growing other business. The Dialogue also offered potential questions for audit committee members to ask their auditors.

- *Publication of the concept release on Audit Quality Indicators.* In July 2015, the Board issued a concept release titled *Audit Quality Indicators.* Audit quality indicators are a potential portfolio of quantitative measures that may provide new insights about how high quality audits are achieved. Taken together with qualitative context, the indicators may inform discussions among those concerned with the financial reporting and auditing process, for example between audit committees and audit firms. Enhanced discussions between audit committees and auditors, in turn, may strengthen audit planning, execution, and communication. The staff discussed comments on the concept release at the November 2015 SAG meeting. Many SAG members expressed that it is important for audit committees and auditors to discuss relevant audit quality indicators.

The PCAOB has issued several reports and staff briefs regarding inspections in 2016:

- *Staff Inspection Brief Detailing Scope and Objectives of 2016 Inspections of Auditors of Public Companies* (July 2016). This staff inspection brief notes, among other things, that the PCAOB continues to focus on public company audit areas where inspectors have found frequent and recurring deficiencies, such as auditing internal control over financial reporting, assessing and responding to risks of material misstatement, and auditing accounting estimates, including fair value measurements.

- *Report Describing Inspection Observations Related to Audit Firms' Communications with Audit Committees* (April 2016) – This general report notes that in most of the audits inspected during 2014 where the PCAOB auditing standard on *Communications with Audit Committees* was applicable,



Inspections staff identified no failures to comply with the requirements of the standard.

- *Staff Inspection Brief Previewing 2015 Inspection Findings* (April 2016) --In preliminary 2015 inspection results outlined in this staff inspection brief, the most frequent audit deficiencies continued to be in three key areas: auditing internal control over financial reporting; assessing and responding to risks of material misstatement; and auditing accounting estimates, including fair value measurements.

These documents and reports are available on the PCAOB's Information for Audit Committees web page. That web page also includes information regarding the Board's approved rules soon to become effective and recent standard-setting projects.[1]

* * *

The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

[1] See the PCAOB's *Information for Audit Committees* webpage at https://pcaobus.org/Information/Pages/AuditCommitteeMembers.aspx.

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Audit Expectations Gap: A Framework for Regulatory Analysis (December 13, 2016)

Submitted by:
Jeanette M. Franzel
Public Company Accounting Oversight Board

If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

https://pcaobus.org/News/Speech/Pages/Franzel-speech-Institute-12-13-16.aspx

Board Member Jeanette M. Franzel
PCAOB International Institute on Audit Regulation
December 13, 2016

Audit Expectations Gap: A Framework for Regulatory Analysis

I welcome our international guests, who represent independent audit regulators from 37 non-U.S. jurisdictions and staff of four international organizations, to the PCAOB's 10th annual International Institute on Audit Regulation.

And I congratulate the PCAOB staff for hosting this collaborative event that promotes dialogue among regulators across jurisdictions on initiatives to advance audit quality for the benefit of investors.

The focus of the Institute this year is on "advancing a quality audit environment" through innovative regulatory approaches and consideration of new and emerging developments, such as the impact of technology and the significance of culture on auditing.

As regulators study and deliberate over these issues, it is imperative that regulatory analyses take account of the perspectives of investors on the role, responsibilities, and performance of, and information communicated by, auditors.

Investor access to timely, relevant, and reliable information serves as the foundation of investment activity and, in turn, influences capital formation and allocation.

The integrity of capital markets depends on transparent, relevant and reliable financial information. Auditors serve the public trust by assuring the integrity of this information, and increasingly have been asked to assure the integrity of other types of information.

Most acknowledge, however, that there remains a "gap" between what investors expect from auditors and what auditors deliver. In my view, it is necessary and helpful to break-down this "gap" into various components when analyzing potential regulatory initiatives in order to find effective, appropriate, and targeted solutions.

Expectations Gap

The expectations gap has been acknowledged since the 1970's and studied extensively by academics and the profession, which until relatively recently regulated itself.

https://pcaobus.org/News/Speech/Pages/Franzel-speech-Institute-12-13-16.aspx

But the scope, dimensions, and significance of this gap could receive more explicit attention in public policy debates and analyses.

At a high level, it is necessary to distinguish between two factors that contribute to this gap: (1) the information being provided to investors and market participants; and (2) the auditor's role in providing assurance over that information.

- First, there is the difference between the information investors want or need and the information required to be disclosed (or disclosed voluntarily) by participants in the capital markets. Some refer to this as an "information gap." Although this gap cannot necessarily be addressed by auditing standards or auditors, it is an important issue to be addressed. For example, good auditor assurance over required information that is irrelevant or inadequate may not meet investor needs and could even be diverting resources from material areas.

- Second, the opaque nature of the audit process and the audit results can cause a number of "gaps" between what investors and other market participants to expect or need and what an audit is designed to provide.

Each facet or dimension of the audit expectations gap may inform regulatory oversight of auditors, as is it helpful to understand which gaps exist and which gaps are being addressed when trying to solve a problem through regulation or rulemaking.

Gaps Related to the Audit Process and Results

Gaps related to the audit process and results can be further broken down into a number of categories. There is a **Normative Gap** that encompasses both the role of the auditor (meaning the scope of the assurance or other services being engaged) and the responsibilities of the auditor to provide certain levels of assurance over information within that scope.

Some surveys and academic research demonstrate that there remains a gap between what market participants think an audit SHOULD be versus what an audit actually is required to be (by applicable standards and applicable laws and regulations). Part of this gap may exist because of a difference between the level of confidence that investors want or need in information versus what is required for the particular assurance service.

Another element of the audit expectations gap concerns the interpretation of what the existing auditing standards actually require auditors to do or to communicate to the user about the audit process or results. Stakeholders and market participants might have different interpretations about existing requirements and the assurance that is conveyed by the auditor's report (**Interpretative Gap)**.

https://pcaobus.org/News/Speech/Pages/Franzel-speech-Institute-12-13-16.aspx

Another audit expectations gap relates to information about the audit (**Information Gap**). Stakeholders and market participants may need or want more information about the audit and the results of the audit, the nature and extent of the audit procedures performed, and the quality of the audit.

Economists refer to the audit as a "credence good," which is a good or service for which consumers find it difficult or impossible to ascertain its utility or quality, even after its use.[1] Currently, the quality of an individual audit that investors are relying on is unknown to those investors. And although progress has been made among regulators and audit firms in exploring "Audit Quality Indicators," mechanisms for defining and measuring audit quality, and providing a level transparency around audit quality remain elusive.

Finally, gaps can exist between actual auditor performance and what is required by the standards and related laws and regulations (**Performance Gap**). Regulatory inspection programs and enforcement actions are targeted toward this gap.

A Common Frame of Reference

A common frame of reference in thinking about the various types of gaps that exist can help regulators analyze current issues when considering potential solutions.

So, as we work together across international boundaries to share ideas on the emerging issues in auditing, I hope we can enhance our mutual understanding of the persistent audit expectations gap and its components to help make our analyses targeted and focused.

Devoting particular attention to this condition will make us more effective in carrying out our missions of serving the public interest and protecting the interests of investors.

[1] See Monika Causholli and W. Robert Knechel (*2012*) *An Examination of the Credence Attributes of an Audit.* Accounting Horizons: December 2012, Vol. 26, No. 4, pp. 631-656; *see also* PCAOB Release No. 2015-005, *Concept Release on Audit Quality Indicators*, pg. 6, July 1, 2015.

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Standard-Setting Update, Office of the Chief Auditor (March 31, 2017)

Submitted by:
Jeanette M. Franzel

Public Company Accounting Oversight Board

If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

https://pcaobus.org/Standards/Documents/Q22017-standard-setting-update.pdf

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
http://www.pcaobus.org

STANDARD-SETTING UPDATE

OFFICE OF THE CHIEF AUDITOR

MARCH 31, 2017

The Public Company Accounting Oversight Board ("PCAOB" or "Board") seeks to establish and maintain high-quality auditing and related professional practice standards for audits of issuers and brokers and dealers in support of the PCAOB's overall mission of protecting investors and furthering the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB's Office of the Chief Auditor—working with other PCAOB offices and divisions—assists the Board in establishing and maintaining PCAOB standards.

The PCAOB takes a priority-based approach to standards-related projects. The process begins with a PCAOB interdivisional team that performs an annual environmental scan to identify current or emerging audit issues and informs the Board regarding matters that potentially warrant changes to PCAOB standards or additional staff guidance. The interdivisional team also continues to monitor current or emerging issues throughout the year, including observations from oversight activities, that may merit further consideration. The evaluation of potential issues may result in a project being added to the PCAOB research agenda.

For each project on the PCAOB research agenda, a PCAOB interdivisional research team is formed to perform research, outreach, and economic analysis to assess whether there is a need for changes to PCAOB standards; consider alternative regulatory responses; and, if standard setting is needed, evaluate potential standard-setting scope and approaches. If standard setting is pursued, the project would be added to the standard-setting agenda. If standard setting is not pursued, consideration will be given to whether or not any other action is needed. In addition to the projects on the research agenda, the PCAOB also conducts monitoring activities in other areas that could impact audits or PCAOB standards (e.g., financial reporting fraud, auditor independence, and new accounting standards).

The Board solicits public comment on potential changes to the PCAOB standards before adopting changes. Consideration of changes to PCAOB standards also involves conducting an economic analysis and analyzing potential impacts of changes on audits of emerging growth companies.

The standard-setting update, which includes the standard-setting and research agendas, was prepared by the staff of the Office of the Chief Auditor. Standard-setting and research agendas, staff consultation papers, and staff audit practice alerts are not statements of the Board, nor do they necessarily reflect the views of the Board, individual Board members, or other staff.

Additionally, the PCAOB staff may prepare guidance regarding the application of existing PCAOB standards. For example, PCAOB staff audit practice alerts highlight new, emerging, or noteworthy circumstances that may affect how auditors conduct audits under, or otherwise comply with, the existing requirements of the standards and rules of the PCAOB and relevant laws.

The PCAOB's standard-setting related processes, including identifying current or emerging audit issues, developing the research agenda, and working on standard-setting projects, are informed by a range of activities. These activities include the PCAOB's oversight activities, consultation with the Board's Standing Advisory Group ("SAG"), input from the Board's Investor Advisory Group ("IAG"), discussion with the U.S. Securities and Exchange Commission staff, work of other standard setters (for example, the International Auditing and Assurance Standards Board ("IAASB"), Financial Accounting Standards Board ("FASB"), and International Accounting Standards Board), and other relevant inputs and developments.

Part I below covers the projects on the standard-setting agenda. Part II, beginning on page 5, covers the projects on the research agenda. Timing of the projects on the standard-setting agenda is subject to change.

Part I Standard–Setting Agenda

Project	Current Stage	Timing
Auditor's Reporting Model	Drafting final standard and adopting release	Q2 2017
Auditing Accounting Estimates, Including Fair Value Measurements	Drafting proposal	Q2 2017
The Auditor's Use of the Work of Specialists	Drafting proposal	Q2 2017
Supervision of Audits Involving Other Auditors	Determining next action	
Going Concern	Outreach, monitoring, and research	

Standard–Setting Project Overviews

1. ***Auditor's Reporting Model.*** On May 11, 2016, the Board issued for public comment a reproposed auditor reporting standard. The reproposal revises the Board's initial proposal issued in August 2013 (the "2013 proposal"). The reproposal would retain the pass/fail model in the existing auditor's report, but would update the form and content of the report to make it more relevant and informative to investors and other financial statement users. In particular, the auditor's report would include a description of "critical audit matters," which would provide audit-specific information about especially challenging, subjective, or complex aspects of the audit. In addition, the reproposal includes other improvements, primarily intended to clarify the auditor's role and responsibilities in the audit of financial statements and to make the auditor's report easier to read. The comment period on the reproposed standard and related amendments to PCAOB standards ended on August 15, 2016. The staff has evaluated the comments on the reproposal, considered the discussion at the May 2016 SAG and October 2016 IAG meetings, and is drafting a final standard and adopting release for Board action in the second quarter of 2017. For further information, see Rulemaking Docket No. 034.

2. ***Auditing Accounting Estimates, Including Fair Value Measurements.*** On August 19, 2014, the PCAOB issued a staff consultation paper to seek public comment on certain issues related to auditing accounting estimates, including fair value measurements. As discussed in the paper, auditing accounting estimates and fair value measurements has proven challenging to auditors. Additionally, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosure requirements. The paper described the staff's preliminary views concerning the potential need for change and presented potential revisions to PCAOB standards. The staff is evaluating the responses from commenters in addition to considering the discussions at the October 2014 and June 2015 SAG meetings and the September 2015 IAG meeting. In addition, the staff is monitoring developments related to the IAASB's project on Accounting Estimates (ISA 540) and Special Audit Considerations Relevant to Financial Institutions. The staff is drafting a proposal for Board action in the second quarter of 2017. The project is also being closely coordinated with the project on specialists. For further information, see Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements.

3. ***The Auditor's Use of the Work of Specialists.*** On May 28, 2015, the PCAOB issued a staff consultation paper to seek public comment on certain matters related to the auditor's use of the work of specialists. As discussed in the paper, the use and importance of specialists has increased in recent years, in part due to the increasing complexity of business transactions and the resulting complexity of information needed to account for those transactions. Specialists covered by the project include specialists employed or engaged by the auditor and specialists employed or retained

by the company whose work is used by the auditor. The paper described the staff's preliminary views concerning the potential need for change and presented potential revisions to PCAOB standards. The staff is evaluating the responses from commenters in addition to considering the discussions at the June and November 2015 SAG meetings and the September 2015 IAG meeting. The staff is drafting a proposal for Board action in the second quarter of 2017. The project is also being closely coordinated with the project on auditing accounting estimates, including fair value measurements. For further information, see Staff Consultation Paper No. 2015-01: The Auditor's Use of the Work of Specialists.

4. ***Supervision of Audits Involving Other Auditors.*** On April 12, 2016, the Board issued for public comment amendments to improve the auditing standards that govern the supervision of audits involving other auditors, and a new auditing standard for situations in which the auditor divides responsibility for the audit with another accounting firm. The roles of other accounting firms and individual accountants in audits (collectively, "other auditors") have taken on greater significance with the increasingly global operations of companies. The lead auditor often involves other auditors at various locations of the company, including in areas of the audit where there is a high risk of material misstatement in the financial statements. The comment period on the proposal ended on July 29, 2016. Having analyzed comments on the proposal and considered the discussion at the May and November 2016 SAG meetings, the staff is preparing a recommendation for the next Board action. For further information, see Rulemaking Docket No. 042.

5. ***Going Concern.*** The auditor's evaluation of a company's ability to continue as a going concern is an important part of an audit under PCAOB standards and federal securities law. The purpose of this project is to evaluate whether there is a need for regulatory action—e.g., changes to the existing PCAOB standard on the auditor's going concern evaluation, staff guidance, or other actions—in light of changes in the relevant accounting requirements[1] and concerns from investors about the effectiveness of auditor going concern reporting. This project is considering, among other things, input from the SAG and IAG, observations from the Board's oversight activities, and relevant research. The staff plans to continue its research and outreach activities, including monitoring the effect on audits of the changes to the relevant accounting standards. In the meantime, AS 2415, *Consideration of an*

[1] On August 27, 2014, FASB issued Accounting Standards Update No. 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. On September 22, 2014, the PCAOB issued Staff Audit Practice Alert No. 13, to remind auditors to continue to follow existing PCAOB standards when considering a company's ability to continue as a going concern.

Entity's Ability to Continue as a Going Concern, and Staff Audit Practice Alert No. 13 continue to provide the applicable requirements and guidance, respectively, for audits under PCAOB standards.

Part II Research Agenda

Project
Quality Control Standards, Including Assignment and Documentation of Firm Supervisory Responsibilities
Changes in the Use of Data and Technology in the Conduct of Audits
The Auditor's Role Regarding Other Information and Company Performance Measures, Including Non-GAAP Measures
Auditor's Consideration of Noncompliance with Laws and Regulations

Research Project Overviews

1. ***Quality Control Standards, Including Assignment and Documentation of Firm Supervisory Responsibilities.*** Deficiencies identified in PCAOB inspections suggest that improvements may be needed in firms' systems of quality control. The staff is exploring whether there is a need for changes to PCAOB quality control standards—including improvements related to assignment and documentation of firm supervisory responsibilities—that would prompt firms to improve their quality control systems and more proactively identify and address emerging risks and deficiencies, thereby enhancing audit quality. This project is considering, among other things, observations from the Board's oversight activities, relevant research, input from the SAG and other outreach, and activities of international audit regulators, as well as related PCAOB activities, specifically the root cause analysis and audit quality indicator initiatives. The staff is also monitoring developments related to the IAASB's project on quality control. Outreach activities may include a staff consultation paper or public roundtable. The project will also consider impacts of potential standard-setting approaches on large and small domestic and international firms.

2. ***Changes in the Use of Data and Technology in the Conduct of Audits.*** There have been significant advances in technology, including data analysis, in recent years. An increased use of these new technologies in audits could have a fundamental impact on the audit process, including the amount of information available to auditors, significant judgments made by auditors in critical areas of the audit, and staffing of audit engagements. The staff is exploring whether there is a need for guidance or changes to PCAOB standards in light of the potential increased

use of new technologies in the conduct of audits. This project is considering, among other things, the new technology-based tools being used in audits and related changes to firms' audit methodologies, academic research, outreach, and activities of others, including auditing standard setters (e.g., the IAASB's Data Analytics Working Group).

3. ***The Auditor's Role Regarding Other Information and Company Performance Measures, Including Non-GAAP Measures.*** In recent years, there has been much press attention and regulatory scrutiny about the use of company performance measures, including non-GAAP financial measures and operating measures. These measures could be included in a company's annual reports, registration statements, earnings releases, or in other communications, such as calls with analysts and information on the company's website. Company performance measures that are included in an annual report, for example in management's discussion and analysis of financial condition and results of operations, are considered "other information" and are subject to the requirements of AS 2710, *Other Information in Documents Containing Audited Financial Statements*. Under AS 2710, the auditor has a responsibility to "read and consider" other information in documents containing audited financial statements.[2] However, under current PCAOB standards, auditors do not have responsibilities to perform procedures related to information presented in corporate earnings releases, investor presentations, or other communications, such as calls with analysts and information on the company's website.

   In August 2013, the Board proposed a new standard that would enhance the auditor's responsibility under AS 2710. For further information, see Rulemaking Docket No. 034. In light of comments received on this proposal, the Board is reevaluating whether there is a need to revise the standards in this area and, if so, how to change the auditor's existing performance and reporting responsibilities related to other information accompanying audited financial statements. At the same time, the Board is considering input it has received regarding the significance to the capital markets of company performance measures that are often reported in documents outside of the scope of AS 2710.

   This research project will consider, among other things, comments received on the proposed other information standard, input from the SAG and IAG, activities of other regulators and standard setters related to this topic, reports and data on current practices in this area, and relevant academic research. The staff also plans to perform additional outreach to seek input on current practice and the potential need to improve the auditor's responsibilities.

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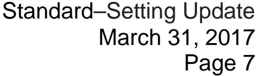
[2] In addition, AS 4105, *Reviews of Interim Financial Information*, includes a similar responsibility for the auditor with respect to other information that accompanies the interim financial information.



4. ***Auditor's Consideration of Noncompliance with Laws and Regulations.*** AS 2405, *Illegal Acts by Clients*, establishes requirements regarding the auditor's consideration of possible illegal acts by a client in an audit of financial statements. AS 2405 has remained largely unchanged since its issuance in 1988. Since then, regulatory and investor attention to company violations of laws and regulations has increased. The staff is exploring whether there is a need for improvements to AS 2405 to provide better direction to auditors regarding their responsibilities with respect to illegal acts. This project is considering, among other things, observations from the Board's oversight activities, relevant research, activities of other regulators and standard setters (e.g., the IAASB recently revised its analogous standard), and input from the SAG and IAG. The staff also plans to perform outreach to seek input on this matter.

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Eighteen Safeguards to an Audit Committee's Investigation of Financial Reporting (October–December 2015)

Michael R. Young

Willkie Farr & Gallagher LLP

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REPRINT

EIGHTEEN SAFEGUARDS TO AN AUDIT COMMITTEE'S INVESTIGATION OF FINANCIAL REPORTING

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PERSPECTIVES

EIGHTEEN SAFEGUARDS TO AN AUDIT COMMITTEE'S INVESTIGATION OF FINANCIAL REPORTING

BY **MICHAEL R. YOUNG**
> WILLKIE FARR & GALLAGHER LLP

As the financial crisis recedes into history, the SEC has renewed its focus on fraudulent financial reporting. It has created a new Financial Reporting and Audit Task Force with enhanced capabilities to seek out and uncover improper accounting, and it has made clear its determination to bring enhanced resources to accounting investigations.

Any audit committee that has been through one knows that an internal investigation of a company's accounting can be a source of great frustration. Often, accounting investigations seem to take too long, cost too much and leave the company in legal limbo – or, worse, legal freefall – for way too long. Sometimes, those in charge seem to have lost sight of the fact that the objective of the investigation is to fulfil a practical business need.

Nonetheless, attempts at shortcuts have rarely seemed to work out. And both the SEC and independent auditors of financial statements have proved to be exacting audiences for audit committee investigative reports.

For its part, the SEC has made clear its frustration with audit committee investigations lacking in thoroughness and objectivity. Alarming to many audit committees, the SEC has pursued enforcement actions against audit committee members who, faced with potential evidence of fraud, in the SEC staff's view did not sufficiently fulfil their 'gatekeeper' responsibility.

As to the independent auditor, in addition to the requirements of professional standards, an amendment to the US Securities Exchange Act of 1934 calls upon the auditor to evaluate whether a company encountering illegal acts materially affecting the company's financial statements is taking "timely and appropriate remedial actions". If the auditor determines the company is not, the auditor may have to provide a report to that effect to the company's board of directors, which then has 24 hours to inform the SEC. Failure of the board to do so may require the auditor, within 24 hours thereafter, to notify the SEC itself.

So, it is a good time to take a fresh look at audit committee investigations of financial reporting. While the needs of any investigation will necessarily depend upon the circumstances, certain procedures, established at the outset, can act as a safeguard against undue compromise of an investigation's adequacy and objectivity. It may be that, in some investigations, not every safeguard is warranted. Still, it is probably useful that they at least be considered.

Eighteen Safeguards

1. An internal investigation of potential fraudulent financial reporting at a public company should normally be overseen by the audit committee.

2. This investigation should be undertaken by a law firm of recognised reputation and capability that has little or no prior history of reporting to management. For potentially serious financial reporting issues, regular outside counsel, or defence counsel in parallel litigation, will rarely suffice.

3. The law firm, under normal circumstances, should engage forensic assistance.

4. The investigation may initially focus on particular issues but is not to be unduly constrained in scope. In assessing scope, the audit committee should be attentive to the materiality guidance of SEC Staff Accounting Bulletin No. 99.

5. It is useful for the investigators to consult with the independent auditor at the outset to ensure that the proposed scope of the investigation will be sufficient for audit purposes. To avoid diverging expectations, the auditor's views as to continuing scope adequacy should be periodically sought.

6. The audit committee, as a matter of substance and tone, should express a willingness to actively oversee the investigation and assume responsibility for its results. It is the audit committee that should select and engage the law firm responsible for conducting the investigation. It is similarly the audit committee to whom the investigators should report.

7. The audit committee should do its best to see that company personnel cooperate with the investigation in both substance and spirit. Personnel should be expected to make themselves available on request, make available requested documents and be candid with the investigators.

8. The audit committee should consider the need to put in place procedures to ensure that executives potentially involved in misconduct are not informed or updated as to substantive progress or tentative findings. Executives should not have prior substantive contact with individuals being interviewed on the subjects into which inquiry is being made.

9. The audit committee, in conjunction with its counsel, should consider the extent to which initial disclosure regarding the investigation may be needed with due cognisance being given to the expectations of regulators who may evaluate such a decision with the benefit of hindsight. To avoid miscommunication, draft press releases are best made available to the auditor for review.

10. The investigation should proceed with utmost efficiency but should not be compromised by upcoming deadlines for the filing of a Form 10-K or other such constraint. An auditor or regulator will normally be sensitive to whether the scope, quality or depth of an investigation is being compromised by deadlines.

11. The auditor will often seek 'complete transparency' between the conduct of the investigation and the information available to the auditor. Assertions of attorney-client privilege will not normally be accepted where such assertions impede access to investigative processes or findings.

12. The audit committee should consult its counsel as to cooperation with the staff of the SEC. The auditor's responsibility to evaluate the company's "timely and appropriate remedial actions" will often include auditor cognisance of the audit committee's approach to SEC cooperation.

13. On particular issues, investigators may find evidence going both ways – both incriminating and exculpatory. The auditor should be expected to seriously consider incriminating evidence in assessing appropriate remedial actions and the auditor's acceptance of management representations.

14. Upon the investigation's completion, the investigators should provide a report setting forth, among other things: (i) the circumstances giving rise to the investigation; (ii) the investigation's scope; (iii) the persons interviewed; (iv) sources of documents reviewed; (v) the underlying facts; (vi) determinations as to wrongful intent; and (vii) proposed remedial action. The auditor and the audit committee should discuss, optimally at the outset, whether the report should be in writing with appropriate cognisance being taken of the needs of relevant regulators. Regardless of whether a written report is prepared, the auditor should be expected to document important aspects of the report in its work papers.

"It may be that, in some investigations, not every safeguard is warranted. Still, it is probably useful that they at least be considered."

15. Upon the investigation's completion, the auditor will assess the reasonableness of the scope, objectivity and findings of the investigation and the extent to which the investigation can be relied upon for the purpose of issuing an audit report.

16. The auditor will separately assess the extent to which the company has taken "timely and appropriate remedial actions" pursuant to US Securities Exchange Act Section 10A. An important aspect of that assessment will often involve the extent to which remedial action regarding particular employees is consistent with the investigative findings.

17. The audit committee and management will often be called upon to provide representations regarding the investigation and any financial statements affected by its findings.

18. Throughout the investigation, and upon its completion, the audit committee and its counsel should assess the extent to which additional public disclosure is appropriate. Such disclosure is best made available for auditor review prior to issuance.

Conclusion

The objective of an audit committee investigation is to help the company put the problem behind it – not to make it worse. Inadequate investigations can anger regulators and make the procurement of an audit report on a company's financial statements exceedingly difficult. A thorough investigation, overseen by the audit committee and undertaken by sophisticated professionals in a way that safeguards the objectivity of the determinations, best serves the interests of a public company and its shareholders. RC

Michael R. Young
Partner
Willkie Farr & Gallagher LLP
T: +1 (212) 728 8280
E: myoung@willkie.com

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Getting the Most out of Internal Audit (August 2016)

Submitted by:
Catherine L. Bromilow

Governance Insights Center PwC

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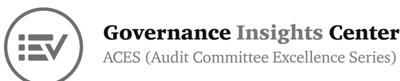

August 2016

Getting the most out of internal audit

How can the audit committee help maximize the value of internal audit?

The audit committee is a key player in ensuring the internal audit function is high-performing, effective, and viewed as an important part of the organization. Doing so helps the audit committee address its risk oversight responsibilities.

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Why is internal audit oversight important?

As audit committees face a wider range of business risks and increased expectations from stakeholders, many audit committees are turning to a particular resource—the internal audit function. Internal audit (IA) can be viewed by committee members as an objective insider—one that can serve as their eyes and ears.

Maximizing the value proposition of the internal audit group is an effective way to help audit committees address their risk oversight responsibilities. However, getting full value from the function isn't easy: 62% of stakeholders expect more value from internal audit, according to PwC's *2016 State of the Internal Audit Profession Study*. Here, we outline how audit committees can get the most out of internal audit.

The key things to focus on for internal audit oversight:

- Empowering the role,
- Having a team with the right structure and skills,
- Making sure the mission is clear and is adhered to,
- Supporting findings to drive organizational improvements, and
- Assessing performance of the team to enhance talent development.

NYSE-listed companies are required to have an internal audit function with oversight by the audit committee. Nasdaq-listed companies do not have this requirement, although many choose to have an internal audit function.

Empowering the Chief Audit Executive and the internal audit team

The audit committee can empower internal audit by providing visible support. This support starts with the Chief Audit Executive (CAE) as the leader of the group. Empowering him or her and the team shows the entire organization how important internal audit is.

Here are some leading practices:

- Hold a private session with the CAE as part of the regular schedule of audit committee meetings.
- Have regular one-on-one meetings between the audit committee chair and the CAE between audit committee meetings.
- Support having the CAE be part of the appropriate management leadership teams.
- Reinforce timely resolution of internal audit recommendations by holding management accountable to implementing changes according to the agreed-upon timetable.

Effective internal audit leaders have a strong vision, excel at developing and mentoring people, hold a strong position in the company, communicate effectively, and establish trust-based relationships throughout the business.

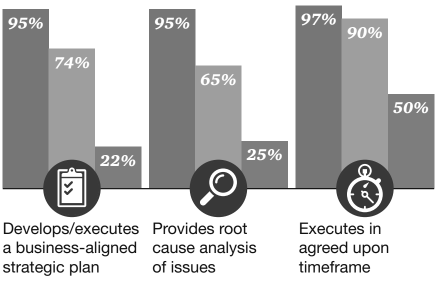
PwC, *2016 State of the Internal Audit Profession Study*, March 2016.

- Periodically have the audit committee chair attend an internal audit team meeting to reinforce the importance of the team and help them feel empowered.

PwC's *2016 State of the Internal Audit Profession Study* unequivocally shows a close correlation between strong leadership by the CAE and internal audit's ability to add value and deliver strong performance. Strong CAEs build functions that excel in delivering value today while evolving to stay current with emerging business needs and risks. An open and trusting relationship between the audit committee and the CAE is critical to help develop the CAE into a leader who can deliver value to the organization.

Very effectively-led internal audit functions deliver better outcomes

Percentage of internal audit leaders who do this well



Very effectively led internal audit functions
Effectively led internal audit functions
Less effectively led internal audit functions

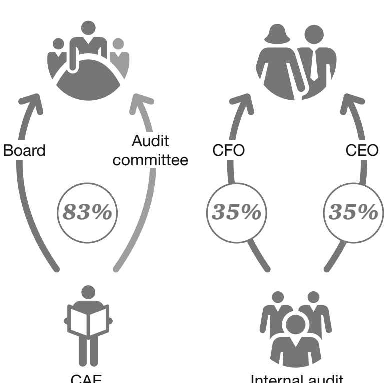
Source: PwC, *2016 State of the Internal Audit Profession Study*, March 2016.

A team with the right structure and skills

Internal audit often reports to both the audit committee and management. Regardless of the organizational structure, reporting lines that promote objectivity and effectiveness are critical to a high-performing internal audit function.

Further, the interaction between the CAE and the audit committee is one of the foundations of good governance. Both formal and informal communications with the CAE can help the internal audit function protect its objectivity by getting audit committee support on its priorities and findings, thus helping them to deliver more value.

Common reporting lines



About 83% of CAEs report functionally to the audit committee or board of directors.

Within the company, internal audit administratively reports most often to either the CFO (35%) or the CEO (35%).

Source: The Institute of Internal Auditors, *2016 North American Pulse of Internal Audit*, February 2016.

As part of its oversight, audit committees should understand the staffing levels and mix of the internal audit function. It can be particularly difficult for some companies to attract and retain sufficient internal audit resources with the appropriate skills to address certain risks. For example, information technology risks, including cybersecurity, require specialized skills that may be difficult to maintain in-house. Also, foreign language skills and local knowledge necessary to effectively perform work at international locations may need to be sourced from third parties.

Many internal audit groups look beyond in-house resources and co-source or sometimes even fully outsource the roles of the internal audit function. Either way, the same oversight questions apply: Are the resources competent, qualified, objective, and are they able to perform the work effectively? The CAE's annual audit plan should communicate to the audit committee the sufficiency and qualifications of resources, regardless of source, to meet its objectives.

Lastly, pressure to manage and possibly reduce expenses is an everyday reality for many businesses. Internal audit departments are not immune to cost pressures. As part of their oversight of the internal audit function, it is important for audit committees to understand the cost and staffing budget for the internal audit team and watch for situations when spending pressures may prevent the group from meeting its key objectives.

Finding the way: defining and monitoring internal audit's mission

Ensuring there is agreement across the enterprise about internal audit's priorities and scope is another way to maximize its value.

Internal audit's dual reporting lines could result in a lack of clarity of focus or an unclear mission. Accordingly, it is important for the audit committee to help the team define its mission, considering what it can and should be able to accomplish given staffing and budgetary concerns, and maintain its objectivity. One question the audit committee could advise on is where internal audit should focus its resources. Internal control over financial reporting? High-risk areas? Regulatory and compliance? Process improvement and operational efficiencies?

The answer might be "all of the above," and perhaps could even include other areas. For example, some internal audit groups have expanded their mission beyond the traditional assurance role to also provide proactive strategic advice.

The audit committee should work with ***internal audit leaders and management*** *to shape the mission of internal audit and oversee the allocation of resources to the various priority areas.*

When evaluating the internal audit team's overall mission and the annual audit plan, it's important to be comfortable that the areas of focus are aligned with the company's strategy and the risks identified through enterprise risk management efforts. The expertise and value of internal audit could be underutilized if its focus is not aligned to the company's strategic objectives.

The audit committee should work with the CAE and management to shape the mission of internal audit and oversee the allocation of resources to the various priority areas. These priorities should then be reflected in the IA's charter.

Internal audit charter

The charter should define IA's mission, purpose, authority, reporting structure, and responsibilities.

Many audit committees will review the IA charter annually and approve any changes.

Driving organizational improvement through internal audit findings

Once internal audit has completed its work in an area, it issues a report to management and sometimes to the audit committee as well. Some audit committees rely on the CAE to report to them only on significant areas or significant findings. In addition to providing the full reports to the audit committee, it is helpful for the CAE to provide a summary of all reports issued that includes the objective of the audits and whether or not the findings have been resolved, particularly noting reports with findings that have not been resolved timely.

Audit committees should watch for those findings from past audit reports that have not been resolved in a reasonable time. Taking too long to resolve areas of concern could create undue risk and may signal that internal audit is not getting adequate support from management.

Significant findings by internal audit, such as those that could impact revenue recognition or that may increase the risk of fraud, may be of concern to the committee. Management should be held accountable to implement recommended changes. An effective way for audit committees to support the resolution of internal audit findings is to request that members of management with significant findings or findings that have not been resolved in a reasonable period of time personally attend audit committee meetings and explain any root causes of the findings and commit to a plan of resolution.

Striving for talent development: assessing performance

The audit committee should periodically assess the performance of the internal audit function as a whole and the CAE in particular. In doing so, the committee may consult with the independent auditors, management, and individuals from third parties (e.g., firms that provide internal audit services) who regularly interact with internal audit.

In making its assessment of the internal audit department, the audit committee should ask:

- Is internal audit viewed as a value-adding function in the company?
- Does it focus on the right areas, i.e., the areas that align with the company's overall strategy?
- Are its findings and recommendations accurate, meaningful, and of high quality?
- Are its reports clear, succinct, and timely?
- Does it approach its audits with professional skepticism, as well as a client service and collaborative mentality?
- Does internal audit have appropriate resources to do its job in a thorough and high-quality manner?
- Does the team use the latest technology, such as data analytics, to improve the effectiveness and efficiency of its audits?

Assessment of the CAE may go deeper, given the critical need for a true leader in that role. The audit committee might consider these questions:

- Do the CAE's business acumen and professional experience align with the emerging risks the company faces?
- Does the CAE maintain good working relationships with peer executives, including auditees?
- Does the CAE model professional behavior for the team?
- Does the CAE hold the internal audit team accountable for high-quality audits and recommendations?
- Does the CAE provide development opportunities for the internal audit team members?
- Do exit interviews of team members reveal any matters of concern with the CAE?
- Do the external auditors have any concerns about the performance of the CAE?

78% *of stakeholders rate their CAEs as* **effective** *or* **very effective** *leaders.*

Source: PwC, *2016 State of the Internal Audit Profession Study*, March 2016.

Looking forward: what audit committees should think about

The audit committee's role in overseeing internal audit is a cornerstone of its governance responsibilities. Helping maximize the value of the internal audit function is a critical factor in the audit committee's effective oversight. High on the list should be the audit committee's focus to empower and develop the CAE. Internal audit functions with effective leadership perform better and add greater value to their businesses. As the geopolitical landscape and global economy change, a high-performing internal audit function aligned to the organization's strategy will be a trusted advisor to help the audit committee meet its objectives.

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center or Internal Audit Solutions.

Paula Loop
Leader, Governance Insights Center
(646) 471 1881
paula.loop@pwc.com

Catherine Bromilow
Partner, Governance Insights Center
(973) 236 4120
catherine.bromilow@pwc.com

Terry Ward
Partner, Governance Insights Center
(651) 261 3763
terrence.j.ward@pwc.com

Jason Pett
Leader, US Internal Audit Solutions
(410) 659 3380
jason.pett@pwc.com

pwc.com

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To GAAP or Non-GAAP? The SEC is Watching (June 2016)

Submitted by:
Catherine L. Bromilow

Governance Insights Center PwC

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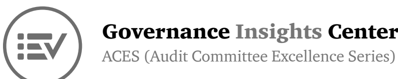

June 2016

To GAAP or non-GAAP? The SEC is watching

The use of non-GAAP financial measures is surging, and the SEC is noticing.

The SEC is scrutinizing the use of non-GAAP financial measures. What audit committees should know about the SEC's renewed focus.

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Nearly 20 years after the dot-com boom sparked a proliferation of non-GAAP financial measures, they're back in style again. Audit Analytics reports that 88% of S&P 500 companies used at least one non-GAAP metric in third-quarter 2015 earnings releases.[1] Almost one in 10 major securities filings used the term "adjusted earnings before interest, taxes, depreciation, and amortization" (EBITDA) in 2015, up from one in 40 a decade ago, according to The Wall Street Journal.[2] And the discrepancy between generally accepted accounting principles (GAAP) and non-GAAP measures is growing.

What's the big deal about using non-GAAP measures? For one thing, the SEC is noticing. And the Commission has indicated that it will be sending more comment letters to companies questioning their use of non-GAAP metrics.[3] So what should companies and their audit committees know about this issue? That's what we want to share with you.

1 Audit Analytics, "Trends in Non-GAAP Disclosures," December 1, 2015; http://www.auditanalytics.com/blog/trends-in-non-gaap-disclosures/.

2 Theo Francis and Kate Linebaugh, "U.S. Corporations Increasingly Adjust to Mind the GAAP," *The Wall Street Journal*, December 14, 2015; http://www.wsj.com/articles/u-s-corporations-increasingly-adjust-to-mind-the-gaap-1450142921.

3 Michael Rapoport and Dave Michaels, "SEC Tightens Crackdown on 'Adjusted' Accounting Measures," *The Wall Street Journal*, May 18, 2016; http://www.wsj.com/articles/sec-tightens-crackdown-on-adjusted-accounting-measures-1463608923.

A brief history

The debate over the use of adjusted financial measures is not new. Non-GAAP measures (referred to then as "pro forma" measures) were popular in the 1990s, and many companies used them in earnings press releases. But the accounting scandals of the early 2000s caused concern that those measures were misleading investors, resulting in the SEC issuing "Cautionary Advice" and leading to the Commission's first enforcement action based on non-GAAP financial measures.

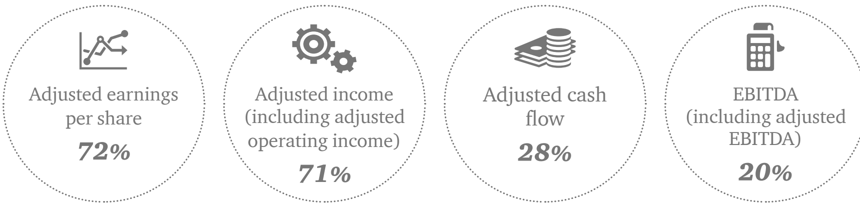
What are non-GAAP measures?
Non-GAAP measures adjust a company's historical or future performance, financial position, or cash flows by excluding or including amounts from the most directly comparable GAAP measure.

In 2003, as directed by the Sarbanes-Oxley Act, the SEC adopted Regulation G and Item 10(e) of Regulation S-K, which addressed the disclosure of non-GAAP financial measures. The disclosure requirements of these two rules differ, but both require, at a minimum, that public companies disclose a reconciliation of the non-GAAP metric to the closest GAAP metric and require that the measure not be misleading.

Then in 2010, the SEC revised its guidance, allowing companies to include non-GAAP measures in SEC filings that adjusted for non-recurring items, as long as recurring items were not labeled as non-recurring. Also, the SEC encouraged companies using non-GAAP measures outside of their SEC filings to include those measures in SEC filings so that communications with investors were consistent.

Commonly used non-GAAP measures

Percentage of S&P 500 companies using a particular type of non-GAAP metric



Source: Audit Analytics, "Trends in Non-GAAP Disclosures," December 1, 2015; http://www.auditanalytics.com/blog/trends-in-non-gaap-disclosures/. Based on Form 8-K Item 2.02 filings by S&P 500 companies between July and September 2015.

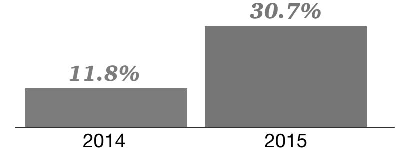
Why is this topic hot again?

Fast-forward to today, and non-GAAP measures are back in the spotlight. More companies now use non-GAAP measures, and often, their non-GAAP results are better than those reported under GAAP. The spread between non-GAAP results and their GAAP counterparts has also been growing. And that has sparked renewed concern by the SEC staff.

*Only 12% of S&P 500 companies did **not** use non-GAAP measures in Q3 2015 earnings releases*
Source: Audit Analytics, December 2015

The non-GAAP to GAAP spread is widening

The average difference between non-GAAP and GAAP EPS in Dow Jones Industrial Average companies



Source: John Butters, "Did DJIA Companies Report Higher Non-GAAP EPS in FY2015?" FactSet, March 11, 2016.
In 2015, 20 of 30 DJIA companies reported non-GAAP EPS; 18 of those 20 reported higher non-GAAP EPS than GAAP EPS. Percentages exclude companies not providing non-GAAP EPS.

In recent speeches, commissioners and top SEC staff have expressed concerns about the frequency of using accounting measures that don't comply with GAAP. "This area deserves close attention," SEC Chair Mary Jo White said at a conference in December 2015.[4]

SEC Chief Accountant James Schnurr also noted "a significant and, in some respects, troubling increase over the past few years in the use of, and nature of adjustments within, non-GAAP measures by companies as well [as the] prominence that the analysts and media have accorded such measures when reporting on the results of the companies they cover."[5]

4 SEC Chair Mary Jo White, Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility" (speech, Washington DC, December 9, 2015) Securities and Exchange Commission, https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html.

5 James V. Schnurr, Remarks Before the 12th Annual Life Sciences Accounting and Reporting Congress (speech, Philadelphia, PA, March 22, 2016) Securities and Exchange Commission, https://www.sec.gov/news/speech/schnurr-remarks-12th-life-sciences-accounting-congress.html.

The mounting concerns resulted in the SEC staff updating its interpretive guidance by releasing additional Compliance & Disclosure Interpretations (C&DIs) on May 17, 2016. The updated C&DIs—coming more than six years after the latest update regarding non-GAAP measures—underscore the extent of the SEC staff's recent concerns. The guidance also offers insights into how the SEC staff will likely review and issue comments on SEC filings going forward.

The updated C&DIs address a range of issues, many of which were mentioned in recent speeches by SEC staff. The most significant themes of the updated C&DIs are:

- The kinds of non-GAAP measures that are potentially misleading
- The presentation of GAAP measures with "equal or greater prominence"
- The prohibition of certain per-share presentations
- The calculation and presentation of the income tax effects of non-GAAP adjustments

Certain of the C&DIs denote a shift by SEC staff to a more prescriptive approach to non-GAAP financial measures. For example, the C&DIs provide examples of disclosures that give undue prominence to non-GAAP measures, such as including only a non-GAAP measure in an earnings release headline. A number of the disclosure practices are common in public company earnings releases. As a result, companies should re-evaluate their disclosures for compliance with the updated guidance.

"[The use of non-GAAP measures is] something that we are really looking at—whether we need to rein that in a bit even by regulation. We have a lot of concern in that space."

SEC Chair Mary Jo White, 10th Annual Capital Markets Summit: The Foundation of Economic Growth, US Chamber of Commerce, March 16, 2016

What are the rules around non-GAAP information?

Unless you are steeped in the SEC rules covering non-GAAP information, they can be confusing. Part of this is caused by rules that are dependent on where or how the non-GAAP information is communicated. We summarize elements of the various rules but cannot address all aspects of the regulations and interpretive guidance. For more information, see the SEC's website at www.sec.gov.

Which non-GAAP rules govern the presentation of non-GAAP measures depends on where the disclosure will appear.

Determining the applicable non-GAAP rules

Where does the non-GAAP disclosure appear?	Which regulation governs?
• Earnings calls • Media interviews • Investor and industry presentations • Certain press releases (including earnings guidance)	Regulation G
• Annual and quarterly earnings press releases	Item 2.02 of Form 8-K
• Filings with the SEC - Form 10-K - Form 10-Q - Registration statements - Proxy statements	Regulation S-K Item 10(e)

The disclosure requirements vary based on the applicable regulation. Regardless of the source, all of the governing regulations share an overarching principle that non-GAAP information cannot be misleading.

Non-GAAP disclosure requirements

Disclosure requirements	Regulation G	Item 2.02 of Form 8-K	Regulation S-K Item 10(e)
Most directly comparable GAAP measure	x	x	x
Reconciliation to GAAP measure	x	x	x
Equal or greater prominence of GAAP measure		x	x
Why management believes investors would find the non-GAAP measure useful		x	x
Management purpose, if any, of the non-GAAP measure		x	x

Companies may also be subject to express prohibitions depending on which regulation governs a particular non-GAAP disclosure. For example, adjusting a non-GAAP performance measure to eliminate or smooth items described in a filing with the SEC as being non-recurring, infrequent, or unusual when such items are likely to recur or have occurred over a two-year period is prohibited under Item 10(e). In addition, non-GAAP disclosures are prohibited from being included in financial statements or the accompanying notes.

Remember: Non-GAAP financial measures are not audited and are often not subject to a company's internal control over financial reporting.

Can the non-GAAP adjustments be trusted?

The use of GAAP provides uniformity in how companies report their financial performance. But most S&P 500 companies choose to report non-GAAP metrics in addition to GAAP measures. If done appropriately, non-GAAP measures can provide insights into a company's business, past performance, and its potential prospects.

However, with the proliferation of the use of non-GAAP measures and the increased spread between non-GAAP and GAAP results—the majority of which show non-GAAP results exceeding GAAP results—critics have questioned whether, in some instances, the alternative metrics are painting too rosy a financial picture. In addition, non-GAAP

measures are not audited, and the preparation of non-GAAP information is not typically covered by a company's internal control over financial reporting. These factors have led to an overall lack of trust in non-GAAP measures.

Non-GAAP measures have also caught the eye of the Public Company Accounting Oversight Board (PCAOB). Because non-GAAP measures are not included in financial statements and are often only included in press releases, the non-GAAP information is not covered by the external auditor's professional auditing literature. Although auditors do not report on non-GAAP measures, some management and audit committees may use the external auditors as an informal sounding board on whether the company has complied with the non-GAAP regulations. The PCAOB's Standing Advisory Group recently discussed the possibility of expanding auditor responsibilities to provide assurance over non-GAAP measures to help build trust. Stay tuned for further developments on potential auditor responsibilities with regard to non-GAAP measures.

"Investors not only rely on the information contained in the financial statements but also what is presented outside of the financial statements, such as non-GAAP measures…Some investors wonder if the auditor should examine and provide some level of assurance on non-GAAP measures…"

Steven B. Harris, PCAOB Board Member, Issues for the Academic Community to Consider, PCAOB/AAA Annual Meeting, April 15, 2016

"Non-GAAP measures are intended to supplement the information in the financial statements and not supplant the information in the financial statements."

SEC Chief Accountant James Schnurr, Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress, March 22, 2016

Where does the audit committee fit in?

Audit committees may also be concerned about the increased growth of non-GAAP measures. How do audit committees know if adjustments are justified, supported, fairly disclosed, or even calculated correctly?

Audit committees can play a key role in building trust in non-GAAP measures. Acting as a bridge between management and stakeholders, the audit committee is well positioned to exercise healthy oversight by asking the right questions.

Here are some questions audit committees can ask of management:

Why has management chosen to present non-GAAP measures?

- What is the purpose (regardless of how long the measures have been used)?
- Are measures consistent with those used by competitors and peer companies? If not, why not?
- Has management received questions or feedback from investors or analysts?

What is management's process to calculate the non-GAAP measures?

- What procedures are in place to ensure the calculations are accurate and consistent with those of prior periods?
- Is the process covered by management's internal control over financial reporting or other disclosure controls?

What are the incentives for possible "earnings management?"

- Does the company have a written policy on what will give rise to a non-GAAP adjustment? How is materiality considered in this policy?
- What are areas of judgment?
- Is management "cherry picking" by adjusting for losses but not removing similar gains or are they not being consistent with the comparable-period adjustment?
- How do non-GAAP measures impact management compensation?

Is the presentation and disclosure fair, balanced, and transparent?

- Are GAAP measures presented with equal or greater prominence?
- Is the disclosure descriptive and transparent or "boilerplate?"

Do the measures comply with the SEC regulations and the SEC staff's recently issued interpretive guidance?

- Can the measures potentially be considered misleading?
- Are prohibited measures excluded?

The audit committee has a significant role in overseeing the presentation of non-GAAP measures. And non-GAAP measures will likely continue to be an area of focus for the SEC.

For more information about the steps companies can take to build confidence in their non-GAAP measures and other key performance indicators, read our Point of view, *Building confidence in non-GAAP measures and other KPIs*. For information on the SEC's updated interpretive guidance on non-GAAP measures, read our In brief, *SEC updates interpretive guidance on non-GAAP financial measures.*

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

Paula Loop
Leader, Governance Insights Center
(646) 471 1881
paula.loop@pwc.com

Terry Ward
Partner, Governance Insights Center
(651) 261 3763
terrence.j.ward@pwc.com

pwc.com

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Approaching the 2016 Year-End Financial Reporting Season (December 2016)

Submitted by:
Catherine L. Bromilow

Governance Insights Center PwC

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Governance Insights Center

December 2016

Approaching the 2016 year-end financial reporting season

Five things for audit committees to think about

The 2016 calendar year-end financial reporting season is approaching and audit committees are preparing for their year-end meetings. Here, we highlight some of the financial reporting issues, SEC trends and other developments that audit committees should be thinking about.

pwc.com/us/governanceinsightscenter

1. Are we on course to adopt the new revenue recognition standard?

In May 2014, the FASB issued its new standard on revenue recognition. The standard, which largely removed industry-specific guidance, is meant to allow investors to better compare financial statements across companies and industries. It is also intended to simplify today's revenue recognition guidance by making it principles-based. But, depending on the company or industry, the new standard could greatly change the timing of, recognition of, and, in some cases, the amount of, revenue compared to the current rules. These changes could have ripple effects on key performance measures and debt covenant ratios, and could ultimately affect contract negotiations, budgets, and even business models.

What should the audit committee be thinking about?

The 2018 effective date may seem far away, but audit committees need to be thinking about the new standard now. Many companies have experienced or anticipate difficulties implementing the new standard—with a potentially time-consuming review of customer contracts topping the list of implementation challenges. Yet our research finds that three-fourths of public companies are still assessing the impact, and only 17% say they have taken the next step toward implementation.[1] The SEC has been closely watching and has expressed some concern over company readiness.[2]

When is it effective?

For calendar year companies, the new FASB standards will take effect in the first quarter of 2018. Non-calendar year companies must comply during the first interim period within annual reporting periods beginning after December 15, 2017. Nonpublic entities have an additional year. A company can apply the new revenue standard retrospectively, including using certain practical expedients. Or, the cumulative effect of applying the new standard to existing contracts can be reflected in the opening balance of retained earnings on the effective date—with proper disclosures.

1 PwC/FERF, *2016 Revenue recognition survey*, 2016.

2 SEC Chief Accountant Wesley R. Bricker, Remarks before the 2016 AICPA Conference on Current SEC and PCAOB Developments, December 5, 2016.

In light of this, audit committees should review their companies' proposed implementation timeline. Does it align with the effective date? Is it realistic given the complexity of the company's operations, business model and attendant revenue streams as well as the policy, system, process and control updates required?

Audit committees will want to understand:

- How management has interpreted the new standard and its assessment of the impact on the company's revenue model
- Management's project plan for implementation, including when key milestones will be met
- How new decision points and required disclosure will affect IT systems, processes, and internal controls, and how management is evaluating existing contracts, revenue models, and business practices
- Whether current filings properly disclose the potential impact of the new standard, if known
- The expected impact on pay programs and any related changes to company policies and practices
- The impact on current business activities, contract negotiations, budgeting, and key metrics

Where to go for more information:

CFOdirect resources on revenue recognition

Accounting advisory resources on revenue recognition

2. Are we comfortable with the company's use of non-GAAP measures?

Use of non-GAAP measures in company filings has grown over the past several years, as companies seek to give investors what they see as a fuller picture of company performance. SEC regulations allow the use of these measures, but there are strings attached (such as needing to present the most comparable GAAP figure first and including a reconciliation of the non-GAAP amount to the GAAP figure). In recent years the SEC has targeted the use of non-GAAP measures that it believes could be potentially misleading to investors. And in May 2016, the SEC staff issued clarifying guidance on the use of these measures. The update calls out potentially problematic practices, including:

- Performance measures that exclude normal, recurring cash operating expenses necessary to operate a company's business
- Use of non-GAAP measures inconsistently between periods without disclosing the change and the reasons for change
- Non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains
- Individually-tailored accounting principles used to calculate non-GAAP earnings—for example, a non-GAAP revenue metric that accelerates revenue recognition
- Disclosures that cause a non-GAAP measure to be more prominent than the closest comparable GAAP measure

Recent SEC comment letters on the topic have focused on a few key areas. The most common issue identified is the failure to include the most directly comparable GAAP financial measure with equal or greater prominence. The SEC is also frequently asking companies to explain how the non-GAAP measures help investors understand the company's operations and financial results. Additionally, the SEC has targeted improper labeling of non-GAAP measures that sound too similar to a GAAP measure.

What should the audit committee be thinking about?

Audit committees will want to understand what non-GAAP measures are being used in filings, and why. They should ask management how they will ensure that when the measures are used, it is done in line with the new SEC guidance. Audit committees will also want to:

- Read the disclosure that includes non-GAAP measures (and other key metrics communicated to analysts) and decide whether it is fair, balanced, and transparent
- Understand how management ensures that the calculation of the non-GAAP measures and other key metrics are accurate and consistent with those of prior periods considering that the information is not typically covered by a company's internal control over financial reporting and is not audited
- Look to peers to evaluate whether use of non-GAAP measures is commonly accepted and measures used are similar
- Understand how non-GAAP measures could affect executive compensation
- Evaluate whether the use of these measures complies with SEC regulations and updated guidance

Where to go for more information:

Audit Committee Excellence Series: To GAAP or non-GAAP? The SEC is watching

3. How will we be impacted by the new lease accounting standard ?

In February 2016, the FASB issued a new standard on lease accounting. The new standard could impact almost all companies to some extent, but lessees will likely see the biggest changes. Lessees will now need to recognize virtually all of their leases on the balance sheet (i.e., a liability for the future lease payments and a corresponding right-of-use asset), even if the lease is embedded in another arrangement, such as a long-term contract. Each lease also needs to be classified as an operating or finance lease. Operating leases will have straight line rent expense. Finance leases will follow a traditional interest-amortization model.

When is it effective?

For most calendar year entities, the new FASB standards will take effect in the first quarter of 2019. Private companies have an additional year to comply. Companies are required to adopt the standard using a modified retrospective transition approach, which requires application of the new guidance at the beginning of the earliest comparative period presented in the year of adoption. Early adoption is permitted. Lessors may want to consider interactions with the revenue standard and adopt at the same time.

Although this is an accounting change, systems and data issues will likely present challenges for companies. In preparation, management will need to identify and review all existing leases and other contracts that may contain embedded leases. Once the leases are identified, all lease terms will need to be analyzed to measure the amounts that will go on the balance sheet. This could be a time-consuming and difficult effort, depending on the number of leases, their variety and complexity, the availability of records, and the sophistication of current systems.

What should the audit committee be thinking about?

Management will need to discuss with the audit committee how it is analyzing the impact of this new standard on the company. Audit committees will also want to understand:

- The effort required to get the information necessary, and the planned timeline to ensure adoption by the required date
- Management's process for creating a complete and accurate inventory of leases
- How management has evaluated the impacts beyond financial reporting (e.g., debt covenants, apportionment of income for state taxes, and determining whether to lease or buy in the future)

Where to go for more information:

Accounting advisory resources on lease accounting standards

10Minutes on the new US lease standard

4. Should we enhance our audit committee proxy disclosures?

Over the last several years, there has been a growing interest by investors, regulators, and other stakeholders in better understanding the audit committee's role in oversight of the external auditor. In response, a growing number of audit committees have chosen to voluntarily provide more relevant and useful information to investors and other stakeholders about how they perform their role. And recent research affirms the continued rise in such voluntary proxy disclosures by S&P 500 companies.[3] In particular:

- *Audit partner selection*—43% now state that the audit committee is involved in audit partner selection, compared to 13% in 2014
- *Audit firm evaluation/supervision*—34% now discuss criteria considered when evaluating the audit firm, up from 8% in 2014
- *Audit firm selection/ratification*—31% now disclose the audit committee's considerations in recommending the audit firm's appointment, up from 13% in 2014
- *Audit firm compensation*—17% now explicitly state the role the audit committee plays in negotiating audit fees, up from 8% in 2014

What should the audit committee be thinking about?

Audit committees considering changes should re-read their previous disclosure with an eye to how they can better explain the work that they do to investors and other stakeholders. Audit committees will also want to consider:

- Asking management to propose sample disclosure covering the categories to the left, and others tracked in the Center for Audit Quality's *2016 Audit Committee Transparency Barometer*
- Benchmarking proxy disclosures of peers and competitors
- Reviewing the proxies of companies that have already embraced enhanced disclosure

3 Center for Audit Quality/Audit Analytics, *2016 Audit Committee Transparency Barometer,* November 2016.

5. Do we have our arms around recent developments in the income tax space?

As audit committees think about where to spend more time, the income tax area may be moving up the list. A number of issues are converging in this area, including a continued emphasis by the SEC staff on income tax disclosures as noted in comment letters, and a new FASB standard related to tax accounting for intercompany transactions.

In addition, there are developments in the way governments—including the US—are looking at changing tax laws or furthering enforcement. For example, governments around the world facing budget shortfalls are questioning whether multinational companies are paying their "fair share" of taxes. The OECD's[4] base erosion and profit shifting (BEPS) project is likely to spur significant changes in the taxation of international businesses in the future, and may trigger the need for changes to companies' tax structures.

There have been several recent developments in the tax area that audit committees should be aware of:

- **FASB standard update on intra-entity transfers.** In October 2016, the FASB issued new guidance that will require the immediate recognition of the current and deferred tax consequences from an intra-entity asset transfer of an asset other than inventory. One such example would be the sale of intellectual property. This guidance is effective in 2018 but can be adopted in 2017, but only during the first quarter. When adopted, this new guidance could have a significant impact on the company's effective tax rate.
- **Internal Revenue Code (IRC) Section 385 regulations.** Also in October 2016, the US Treasury Department and Internal Revenue Service finalized new regulations under Section 385, which relates to intercompany borrowings. The new rules are intended to minimize the ability of US entities to deduct interest on certain borrowings from foreign related parties by treating them as equity instead of debt for US federal tax purposes. Depending on a company's global structure, this change in tax law could have an impact going forward. Generally, there is no impact until 2017 but the rules may apply to arrangements already in place. The new regulations also impose significant new documentation requirements.

4 The Organization for Economic Co-operation and Development (OECD) is an intergovernmental economic organization with 35 member countries.

Looking forward, tax reform is certainly top of mind in Washington and around the world. President-elect Trump's call for action on comprehensive tax reform, including significantly lowering business income tax rates, is expected to receive strong support from Republicans in Congress. House Republicans have been drafting language for the tax reform "blueprint" that they released earlier this year, which differs in some respects from Trump's tax proposals. House Speaker Paul Ryan (R-WI) has said a Republican-controlled Congress could quickly adopt tax reform in 2017 by using "budget reconciliation" procedures that allow legislation to be approved in the Senate with a simple 51-vote majority, instead of the 60 votes generally needed to advance legislation.

What should the audit committee be thinking about?

Audit committees will want to understand the impact of recent developments in tax policy on a global basis and stay updated on the potential impact of US tax reform efforts under the new administration. Audit committees will also want to:

- Understand the potential impact of the OECD's BEPS project on the global tax picture
- Discuss with management their assessment of the impact of the new FASB guidance on intra-entity asset transfers and IRC Section 385 regulations
- Stay updated on recent trends in SEC comment letters related to income taxes to assess the adequacy of current disclosures and other areas of focus

Where to go for more information:

10Minutes on the OECD's BEPS project

In brief: FASB simplifies tax accounting for intra-entity asset transfers

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

Paula Loop
Leader, Governance Insights Center
(646) 471 1881
paula.loop@pwc.com

Catherine Bromilow
Partner, Governance Insights Center
(973) 236 4120
catherine.bromilow@pwc.com

Terry Ward
Partner, Governance Insights Center
(612) 326 2066
terrence.j.ward@pwc.com

Paul DeNicola
Managing Director, Governance Insights Center
(646) 471 8897
paul.denicola@pwc.com

pwc.com

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The Quarter Close: A Look at This Quarter's Financial Reporting Issues, Directors Edition (March 15, 2017)

Submitted by:
Catherine L. Bromilow

Governance Insights Center PwC

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The quarter close

A look at this quarter's financial reporting issues

Directors edition

March 15, 2017

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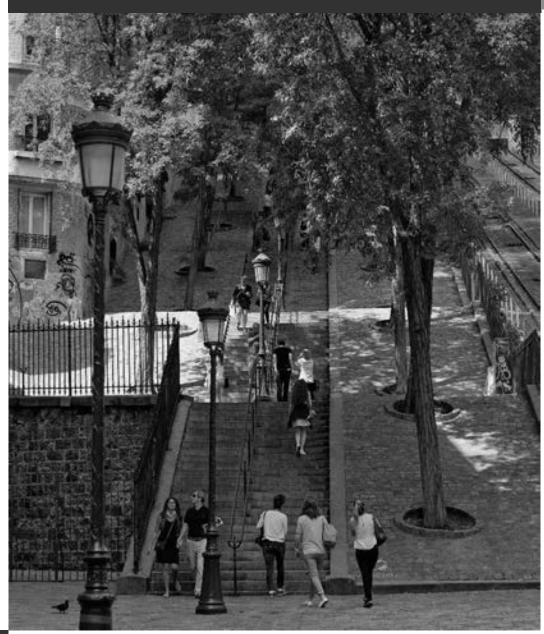

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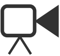
Accounting hot topics



Watch this quarter's videos:

- Basics of the fair value hierarchy
- Classification: debt vs. equity
- Credit loss standard
- Deferred taxes classification
- New definition of a business
- Partial disposition of a business
- Top 5 comment letter trends
- Uncertain tax positions

New revenue standard: the first ones out of the gate

We have seen expanded disclosures on the expected impact of the new revenue standard in the largest public company filings in 2017. In particular, these disclosures provide insight into the progress and status of the implementation of the new revenue standard. This follows recent SEC reminders for companies to include robust disclosures describing the impacts of adopting new accounting standards in accordance with SAB 74.

Early adopters

There are a small number of companies within the aerospace and defense, industrial products, and technology industries that have disclosed that they will early adopt or have early adopted the new revenue standard. Companies that will early adopt include robust disclosures in their financial statements, including the impact on the timing of revenue recognition.

Method of adoption

The number of companies that have disclosed their expected adoption method has increased from 40 in Q4 2016 to over 200 in Q1 2017. Of those companies, most disclose that they will apply the modified retrospective method, rather than the full retrospective method.

Impact

Most companies disclose that they have not yet determined the impact of the new revenue standard, or have concluded that the impact will be immaterial. Many companies that have not quantified the expected impact still included expanded qualitative disclosures regarding the types of contracts or product lines expected to be impacted.

Watch our video

A few minutes on new effective guidance

The FASB's guidance intended to simplify the classification of deferred taxes on the balance sheet is effective this quarter for public companies with a calendar year end. Check out our video on deferred tax classification and quickly catch up on the key changes.

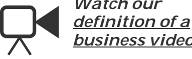
Watch our deferred taxes video

The FASB's new stock compensation simplification guidance is also effective beginning January 1, 2017 for public companies. Under the new guidance, the differences between actual and expected stock compensation tax deductions (windfalls or shortfalls), will now be reflected entirely in the income statement. The new guidance is intended to eliminate the off-balance sheet tracking that was required previously, but is expected to increase income statement volatility. It also provides new policy elections and other new guidance.

For more information

For more information on deferred taxes balance sheet classification, read In depth US2015-37, *FASB simplifies balance sheet classification of deferred taxes*. For more information on the simplified accounting for stock compensation, read In depth US2016-03, *Stock-based compensation guidance to increase income statement volatility*.

Hot off the press



Watch our ***definition of a business video***

New definition of a business

The recent update to the definition of a business is more than just an update to the glossary. For more information on the new definition, check out our video or read In depth US2017-01 *The FASB's new definition of a business.*

Clarifying the guidance for derecognizing certain assets

The FASB recently released guidance that provides a consistent approach to the derecognition of nonfinancial assets and in substance nonfinancial assets, unless other specific guidance applies. An in substance nonfinancial asset is an asset within a contract or subsidiary in which substantially all of the fair value of the asset is concentrated in a nonfinancial asset.

As a result of the new guidance, the specific accounting for real estate sales in current GAAP will be eliminated. Sales and partial sales of real estate assets will now be accounted for similar to all other sales of nonfinancial and in substance nonfinancial assets. For example, if a company sells 60% of its interest in a rental property and retains a 40% noncontrolling interest, the company will need to measure the retained interest at fair value. This will result in full gain/loss recognition upon the sale of the controlling interest in the rental property. This is similar to the guidance on the sale of controlling interests in a business. Previous guidance generally prohibited gain recognition on the retained interest.

When is it effective?

The transition guidance is consistent with the new revenue guidance. For public companies with calendar year ends, the standard is effective in 2018. All other entities have one additional year. Early adoption is permitted in 2017 for calendar year-end companies. Either the full retrospective or modified retrospective approach can be used for transition.

For more information

For more information on the new derecognition guidance, read In brief US2017-06, *FASB changes how to derecognize nonfinancial assets.*

Simplifying the goodwill impairment test

The FASB recently finalized guidance to simplify the goodwill impairment test with the intent of reducing its cost and complexity.

Once adopted, companies will calculate the impairment as the excess of the carrying value of a reporting unit over its fair value, up to the carrying value of the goodwill. The same one-step impairment test will be applied to goodwill at all reporting units, even those with zero or negative carrying amounts. While some companies may not recognize an impairment today when the carrying value of a reporting unit exceeds its fair value, under the revised guidance, this will always result in some goodwill impairment.

A qualitative test to avoid quantitative testing (i.e., step zero) is still optional. All other goodwill guidance will remain relatively unchanged.

When is it effective?

The new guidance is required for goodwill impairment testing of calendar year-end public companies that are SEC filers in 2020, with early adoption permitted for goodwill impairment testing after January 1, 2017.

For more information

For more information on the simplified goodwill impairment test, read In depth US2017-03, *Measuring goodwill impairment to get easier*.

New standards and certification for the valuation profession

In January 2017, the International Valuation Standards Council issued the International Valuation Standards (IVS 2017), global valuation standards for use by valuation professionals. The issuance of these voluntary standards is expected to increase consistency and transparency in the valuation profession.

Additionally in January 2017, a task force of valuation professional organizations established performance requirements related to how valuation professionals should support and document their work. The task force also established a new credential: Certified in Entity and Intangible Valuation (CEIV). The availability of the credential is intended to increase consistency in the valuation profession.

New pension cost presentation impacts operating margin

The FASB recently amended its guidance on the presentation of net periodic pension and postretirement benefit cost (i.e., net benefit cost). Companies that provide defined benefit pension and postretirement benefits to their employees will be impacted by this amendment.

The new guidance requires the service cost component to be presented separate from the other components of net benefit cost. Service cost will be presented with other employee compensation costs within operations or capitalized in inventory or other assets according to the company's accounting policies. The other components of net benefit cost, such as interest cost, amortization of prior service cost, and gains or losses, are required to be separately presented outside of operations, if income or loss from operations is presented. Additionally, the amount of net benefit cost eligible for capitalization into inventory and other assets is limited to only the service cost component. All other components of net benefit cost, including interest costs, are not eligible for capitalization.

Companies that have elected to immediately recognizing actuarial gains and losses will likely view this change favorably. Presenting only the service cost component within operations and limiting the amount eligible for capitalization will likely reduce volatility within the operating section of the income statement. The FASB did not provide exceptions for not-for-profit entities or entities within specific industries (e.g., rate-regulated entities).

When is it effective?

The amendment is effective for calendar year-end public companies in 2018, and interim periods within that reporting period. All other entities will have an additional year to adopt. Early adoption will be permitted as of the beginning of an annual reporting period. If a company issues interim financial statements, early adoption is only allowed in the first quarter. This means that calendar year-end public companies are only permitted to early adopt in the first quarter of 2017. The presentation of service cost should be applied retrospectively while the capitalization of service cost is to be applied prospectively.

On the horizon

Long-term debt, short-term classification

The FASB recently proposed new guidance for the balance sheet classification of debt. As proposed, debt would be classified as current or noncurrent based on the contractual rights of the lender and the borrower on the balance sheet date. Debt would only be classified as noncurrent if it is contractually due more than one year from the balance sheet date or the borrower has a contractual right to defer settlement for at least one year. With the exception of a waiver for a debt covenant violation, the proposed guidance would prohibit the consideration of events occurring after the balance sheet date when determining the classification of debt.

Current guidance permits short-term debt to be classified as noncurrent if the debt is refinanced on a long-term basis after the balance sheet date, provided certain conditions are met. This will no longer be permitted under the proposed guidance.

The proposed guidance could have a significant impact on practice and future borrowing decisions. For example, management may choose to accelerate the timing of debt refinancing negotiations because classification as current as of the balance sheet date could result in violation of debt covenant ratios or working capital requirements.

Current guidance also requires that the likelihood of acceleration of debt due to a subjective acceleration clause be considered in determining debt classification. Under the proposed guidance, a subjective acceleration clause would only impact classification when it is triggered.

What's next?

Stakeholders are encouraged to provide comments on the proposal. Comments are due by May 5, 2017. The effective date will be determined after the Board considers stakeholder feedback. The guidance is expected to be applied on a prospective basis.

For more information

For more information, see In brief US2017-02, *Debt Classification: changes exposed for comment.*

Corporate governance

Why your board should take a fresh look at risk oversight

In a world of evolving risks and constant regulatory change, boards need a thoughtfully-defined approach for overseeing risk. Companies that can depend on their boards to offer guidance and oversight on a variety of risk-related topics are at an advantage. The challenges boards often face when overseeing risk include:

- How can a board reassure investors that it is overseeing risk effectively?
- Do directors' backgrounds support effective risk oversight?
- Are any key risks falling through the cracks and not being overseen anywhere at the board level?
- Is too much of the board-level effort on risk focusing on compliance and regulatory matters?

To address these challenges, boards can:

- Enhance proxy disclosures to describe risk oversight so shareholders can better understand what the board does and how
- Rethink board composition. Ensure directors bring diverse perspectives to risk discussions
- Clearly allocate risk oversight among the board and its committees. Ensure that the chairs share their committees' insights about those risks with the full board
- Preserve agenda time to focus on key risks, including big picture strategic risks

At a well-run company, boards play a crucial role in risk oversight. Interestingly, almost half of the directors in PwC's 2016 Annual Corporate Directors Survey indicated that they would like to see their boards devote at least some additional time and focus to risk assessments and risk management. Boards that invest the time to examine and refine their approach to risk oversight can deliver enhanced value to the company and its shareholders.

For more information

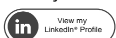
Refer to PwC's first module in its Risk Oversight Series, *Why your board should take a fresh look at risk oversight: a practical guide for getting started* for more insights. The report is the first in a series that will focus on various risk matters. The series offers practical advice on how directors can add value when it comes to risk matters and provides a series of board actions that help directors avoid or overcome common challenges.

Edited by:

Terry Ward
Partner
Phone: 1-612-326-2066
Email: terrence.j.ward@pwc.com

Beth Paul
Partner
Phone: 1-973-236-7270
Email: elizabeth.paul@pwc.com

John Formica
Partner
Phone: 1-973-236-4152
Email: john.r.formica@pwc.com



Becky Bisesar
Senior Manager
Phone: 1-973-236-5794
Email: becky.bisesar@pwc.com

Christopher Chung
Director
Phone: 1-973-236-7755
Email: christopher.chung@pwc.com

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Risk Management Oversight: A Debate Continues and Committees Get Busier (July–September 2014)

Michael R. Young

Willkie Farr & Gallagher LLP

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RISK MANAGEMENT OVERSIGHT: A DEBATE CONTINUES AND AUDIT COMMITTEES GET BUSIER

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WILLKIE FARR & GALLAGHER LLP

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riskandcompliance@financierworldwide.com
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PERSPECTIVES

RISK MANAGEMENT OVERSIGHT: A DEBATE CONTINUES AND AUDIT COMMITTEES GET BUSIER

BY **MICHAEL R. YOUNG**
> WILLKIE FARR & GALLAGHER LLP

The debate over board oversight of risk management continues. And the central issue is the same. How is risk most effectively overseen by the board of directors? Should there be a board-level 'risk committee'? Should risk oversight be spread among a number of committees? Should risk management oversight reside with the full board?

Some board members are dead set against a separate risk committee. They point out that risk oversight is a full board responsibility. And they observe that risk is inseparable from strategy and that a board-level risk committee might operate to unduly constrain those able to participate in key discussions.

Others argue that a board-level risk committee is critical. They point to perceived risk management failures during the financial crisis and the particular expertise needed to interact with the risk management professionals. They also contend that some sort of board-level risk committee needs to exist, if for no other reason so that there is some place for enterprise risk management to go.

Audit committees have a lot of skin in this game. In the absence of a board-level risk committee, audit committees can find themselves with responsibility

for oversight of all sorts of risks. They may include credit risk, liquidity risk, operational risk, cyber security, environmental risk and 'overall legal compliance'. That is a lot to ask of a committee whose expertise resides in financial statement presentation and disclosure.

But the problem is not just one of expertise. Another problem is time. As audit committees get drawn further and further into collateral areas of risk management, they stand to be increasingly distracted from their core responsibility: financial reporting. Sarbanes-Oxley places squarely within a US audit committee responsibility for the oversight of financial reporting. And the statute contains no exception for audit committees that are too busy with other things.

Nor does the US SEC appear to be in a particularly forgiving mood. The SEC recently brought charges against an audit committee chair who, as the SEC perceived it, was not properly fulfilling his financial reporting 'gatekeeper' function. At the same time, the SEC's chief accountant has been encouraging audit committees to get 'back to basics'. A particular peeve of the SEC is audit committees too busy or distracted to pay enough attention to the audit fee and delegating that task to management.

How did audit committees get into this fix? Recent history helps explain. In the wake of a number of high-profile financial reporting failures, audit committees were often perceived to be the most independent and active of the board's committees. As the need for additional board oversight increased, the logical place to put the responsibility seemed to be the audit committee. That is certainly how the New York Stock Exchange (NYSE) seemed to approach it. The NYSE wrote rules taking the audit committees of listed companies well beyond the boundaries of financial reporting into, essentially, all risks a company may face.

"Some board members are dead set against a separate risk committee. They point out that risk oversight is a full board responsibility."

But now, some audit committee advocates are pushing back. One audit committee adviser has cautioned that audit committees in substance have become the 'default committee' – the committee that gets responsibilities that don't seem to fit

anywhere else. A committee of the New York City Bar Association recently wrote to the NYSE urging revision of the NYSE rule mandating broad audit committee risk oversight. An international group, the Society of Corporate Secretaries & Governance Professionals, has been agitating with increasing vigour for change.

What's an audit committee to do? The first thing is to recognise there simply may not be a one-size-fits-all solution. For some boards, a separate risk committee may make sense; for others, not. But the key thing is for an audit committee to ensure that it has the time and resources to fulfill its legally mandated financial reporting responsibility. If it does not, that is not just a problem for the audit committee. The entire board has an interest in seeing that the audit committee gets it right.

And if the audit committee is too busy? One possibility would be to look at the risks given to an overly burdened audit committee and divide them into two groups. One group, quite obviously, would be those risks associated with financial reporting. The second group might be thought of as 'other'.

As to the first group, those risks should obviously stay with the audit committee. As to the second, if they are to be placed within a committee, another committee or committees need be found. In the absence of anything better, perhaps the second committee should be called the 'risk committee'. RC

Michael R. Young
Partner
Willkie Farr & Gallagher LLP
T: +1 (212) 728 8280
E: myoung@willkie.com

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How Your Board Can Influence Culture and Risk Appetite (February 2017)

Submitted by:
Catherine L. Bromilow

Governance Insights Center PwC

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February 2017

How your board can influence culture and risk appetite

Boards understand that corporate culture is vital. It drives behavior, expectations and norms—but it can also lead employees to take too much or too little risk.

Understanding culture is difficult. It's especially tricky for directors to know whether the culture supports the right kind of risk-taking. Aggressive compensation targets or growing numbers of whistleblower complaints may be signs that a company's culture is out of control. Does your board have a handle on company culture?

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Recognizing the importance of culture and risk appetite

We've all read headlines about companies that took bets involving levels of risk they didn't fully understand, or that overstepped ethical boundaries. There's also concern about taking on too little risk and missing opportunities for performance and growth. In light of what they see happening, it's not unusual for directors to wonder: How much risk does our company need to take to succeed? What roles should the board and the CEO play in setting culture? And how do we know our culture is promoting the right behaviors and encouraging employees to take appropriate risks?

Before we go any further, we need to recognize that the culture problems that may seem obvious in hindsight are less easy to see when a company is going about its day-to-day business. But shareholders, regulators, the media and even customers don't care if it's difficult—they'll want to know why a board didn't take action on items they believe it should have known about. The tricky issue is how to spot evidence of culture problems before a crisis erupts and those problems become all too evident to stakeholders.

Addressing the key challenges for directors

How can directors understand an intangible subject like culture and figure out whether the culture is appropriate for the company?

Board action: Get the information you need to understand the company's real culture and insist management work to improve it, if required. Re-think which metrics can help the board assess the culture.

What's the board's appropriate role in setting risk appetite, so directors can better understand the amount and type of risk the company is taking?

Board action: Weigh in on risk appetite until you're satisfied it reflects the appropriate amount of risk-taking.

How well do directors understand how management handles conflicting goals and mixed messages that can muddy decisions and create unintended consequences?

Board action: Challenge executives on how they prioritize conflicting objectives.

Challenge: How can directors understand an intangible subject like culture and figure out whether the culture is appropriate for the company?

Board agendas are full, and culture is often "squishy"—difficult to describe and understand. But ignoring culture prevents directors from understanding how it drives what people are doing.

> ***What is culture?***
>
> It's the set of common assumptions or beliefs in a company that allow you to predict how people will behave and what they will achieve.

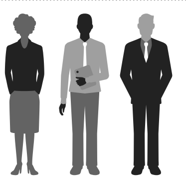
An effective culture promotes appropriate risk-taking and transparency with a clear, consistent, ethical tone at the top, which filters through to all employees. Financial services regulators and others are looking more carefully at culture, especially in the aftermath of the 2008 financial crisis. As former SEC Chair Mary Jo White noted, "Deficient corporate cultures are often the cause of the most egregious securities law violations." For instance, the wrong compensation structure can derail a culture—we've seen too many companies incentivize the wrong behaviors.

What happens when the culture is poor? There may be out of pocket costs in the form of fines. Indeed, in 2016, several companies were fined by regulators or government agencies for wrongdoing, in some cases prompting governments and institutions to question doing further business with these companies. Such situations point to the real cost of a poor culture: damage to a company's reputation that can be long-lasting. Whether or not the issue is significant in regulators' eyes, the response from customers, employees and the public can be devastating.

The issue of culture is important for another reason. Companies that operate in the United States are subject to the Federal Sentencing Guidelines. Those Guidelines establish penalties if a company is found guilty of wrongdoing. But more importantly, they allow the courts to reduce the fines if a company has an effective compliance and ethics program. To be considered "effective," a program has to promote a "culture that encourages ethical conduct and a commitment to compliance with the law."

Compliance and ethics executives see inconsistent support from leadership

98%
say their company's senior leadership is committed to compliance and ethics



yet

55%
say senior leadership's involvement in the compliance and ethics program is either ad hoc or delegated.

Source: PwC, *State of Compliance Study*, 2016.

There are many reasons why boards may find it challenging to distinguish what's just noise in the system from what's a more significant culture problem.

- The C-suite may say all the right things in the boardroom but middle managers might send a different message to employees. That "mood in the middle" is trickier to figure out.
- Board presentations are carefully vetted and edited, and may not include all of the relevant issues.
- Trends or patterns in whistleblower complaints may be explained away as being from disgruntled employees or caused by one manager who's been fired. Even reports that tell you about the number of hotline calls don't necessarily reveal that some managers may be pressuring employees to take outsized risks. Plus, there's evidence that many issues are reported directly to middle management, so boards don't necessarily hear about them unless they're escalated.
- Employees aren't necessarily driven by incentive compensation—they may just be focused on trying to please their supervisor.
- Having all the right rules, policies and checklists don't by themselves impact how employees behave. So much hinges on *how* people meet performance goals.

"Culture eats strategy for breakfast."
– Attributed to Peter Drucker

- Many companies get numerous whistleblower complaints or experience significant employee departures. But it's not clear when these go beyond "normal" and signal a deeper problem.
- Different parts of the company may have different cultures. That's especially true after acquisitions. If directors don't have access to employees throughout the company, they can't see these differences.

Finally, it's difficult for directors to recognize the culture might be bad because to do so they have to overcome their innate belief that the CEO is behaving properly. After all, they hired the CEO and wouldn't serve on the board if they didn't trust management. But since the risk of wrongdoing is never zero, directors have to be open to the possibility that things are going wrong. In the company. Right now.

***Board action:** Get the information you need to understand the company's real culture and insist management work to improve it, if required. Re-think which metrics can help the board assess the culture.*

Culture is difficult to assess, but past crises have shown one clear red flag. If the company's results are way better than any of its competitors, directors need to be skeptical. Time and again it has turned out that companies that looked like superstars weren't. They were driving bad behavior to meet unrealistic goals in an unsustainable manner, or were outright manipulating their results. So directors in outperforming companies should probe how management has been able to achieve superior results. And keep probing. That may lead you to discover that the company is simply taking too much risk, or worse, doing things it shouldn't be.

Culture isn't aspirational—it's how people are acting today. To better understand current culture, boards can:

- Ensure the topic is on the board's agenda so directors spend the time needed to focus on it.
- Ask how performance targets are set and how related incentives are determined to explicitly connect compensation plans to risk-taking.
- Review a standard "dashboard" regularly that tracks elements of culture and probe why measures have—or haven't—changed. Measures might include the results of employee culture surveys or employee engagement scores.
- Challenge management on risks they are taking during strategy and performance reviews.
- Ask for examples of how disciplinary actions were applied and ensure they are consistent regardless of whether or not someone is a top performer.
- Review reports and trends from whistleblower hotlines, regulators and exit interviews. These can give you a heads-up on problems that may be brewing.
- Get feedback on culture in private sessions with the chief audit executive and the chief compliance officer to see if they have noticed any anomalies.
- Consider requesting a culture assessment periodically—either by internal audit or an outside party.
- Discuss how a significant change—a new strategy or a major acquisition—impacts culture.
- Discuss tone at the top with the CEO and other top executives. Look for whether the CEO reinforces it consistently. Check that managers continually demonstrate ethical behavior and that employees feel able to speak up without fear of reprisal.
- Discuss results of the CEO's 360 degree evaluation, being on the lookout for any evidence that he or she is creating a toxic environment. For example, a high rate of senior executive departures could be a sign that the CEO is placing unreasonable pressure on the management team.
- Meet with employees outside of the boardroom. Take advantage of board meetings held at different company locations to do so.

How can directors use whistleblower complaints?

Whistleblower hotlines are important starting points to let directors know when there may be problems brewing. If there are obvious patterns—the same types of complaints or caller location, for example—dig deeper into what may be going on. If most of the calls are classified as HR-related, have a conversation with the chief human resources officer to find out the causes of the complaints. And let management know when you think certain complaints deserve investigation. Boards may want to start their own investigations if they think something meaningful isn't being disclosed or properly managed.

Room to improve board engagement with culture

Directors report:

68% ***discussed tone at the top***

57% ***had directors interact more with members of management below the executive level***

42% ***increased the time discussing risks embedded in compensation plans***

25% ***evaluated executives' upward/peer feedback***

15% ***discussed information from exit interviews***

Source: PwC, *2015 Annual Corporate Directors Survey*, October 2015.
Question: Which of the following has your board done in the last 12 months to reduce fraud risk?

These are not "one and done" discussions. Without attention, a good culture can drift over time, so this needs ongoing board—and executive—attention.

Ideally, probing into the culture will reassure the board that it's satisfactory. But the reality is that some boards will get results that cause concern. When allegations of wrongdoing are widespread, it's hard to write them off as being caused by just a few bad actors. And it's unclear that simply dismissing or punishing individuals fixes the problem. How do you drive a needed change in culture?

- Agree on exactly what it is about the current culture that needs to change.
- Ask the CEO about his or her plans to improve the culture. Get specifics, including timeline commitments. Actions might include:
  - Examining the operating model to flag processes or handoffs along the value chain that may lead to riskier behavior.
  - Rethinking performance targets and incentives structures and their impact on behaviors.
  - Outlining plans to engage with the broader workforce and gain employee buy-in.
  - Defining the performance metrics that will track the degree of culture change achieved—possibly through regular surveys or focus groups.
  - Hiring a consultant to assess the culture and advise on improving it.

Finally, there's always the nuclear option: replacing senior leaders. If the culture is toxic. If the board suspects senior leadership knew about the problems yet did nothing. Or if the board doesn't believe the current leaders can right the ship. But recognize that new executives alone may not be enough to change the culture.

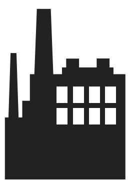
Follow the money

Tying performance targets to incentives should help drive the right behaviors, but sometimes that simply isn't the case. Be sure to have management re-examine the many ways in which targets that are solely focused on revenue growth or the bottom line can drive the wrong behaviors. There are too many instances when even senior management can be blinded by superior returns that may come from engineering shortcuts or selling to phantom customers. If it seems too good to be true, follow the money. It may be your compensation plans that are at the root of the problem.

Challenge: What's the board's appropriate role in setting risk appetite, so directors can better understand the amount and type of risk the company is taking?

Instinct drives risk-taking at many companies. Most people have a sense of how they should behave and what risks are acceptable. But how can senior management and the board know everyone is on the same page when it comes to taking risks? It comes down to risk appetite. Management can let people know how much risk is okay in trying to achieve objectives by articulating its risk appetite. That said, some chief risk officers are reluctant to develop one because they see it as an academic exercise that ends up on a shelf. But despite possible reluctance, a risk appetite statement can provide insight into the types and amount of risk that are seen as suitable.

Few companies have a formal risk appetite statement



23%
of companies excluding the financial sector

35%
of all companies

Source: NACD, *2015-2016 Public Company Governance Survey*, 2015.

Risk appetite statements differ for financial services companies

Formal risk appetite statements are slightly more common in financial services companies, largely driven by regulatory requirements. Along with some qualitative factors, they often quantify the acceptable ranges of specific risks in areas such as credit, market and liquidity. These kinds of statements make it easier for regulators to gauge whether a particular institution is taking too much risk.

Board action: *Weigh in on risk appetite until you're satisfied it reflects the appropriate amount of risk-taking.*

If there isn't one already, decide whether management should craft a formal risk appetite statement—to provide a framework for risk-taking. Ensure it fits the strategy and informs business decisions. Regular risk appetite reviews should be part of board risk oversight. Make sure risk appetite and culture are aligned.

Encourage management to create a risk appetite structure that reflects the interaction of multiple risks. Directors can plan regular discussions about risk interactions and how they impact the stated risk appetites.

Recognize that management may need to revisit, refine and revise risk appetite as the company's strategy changes and as enterprise risk management (ERM) evolves within the company.

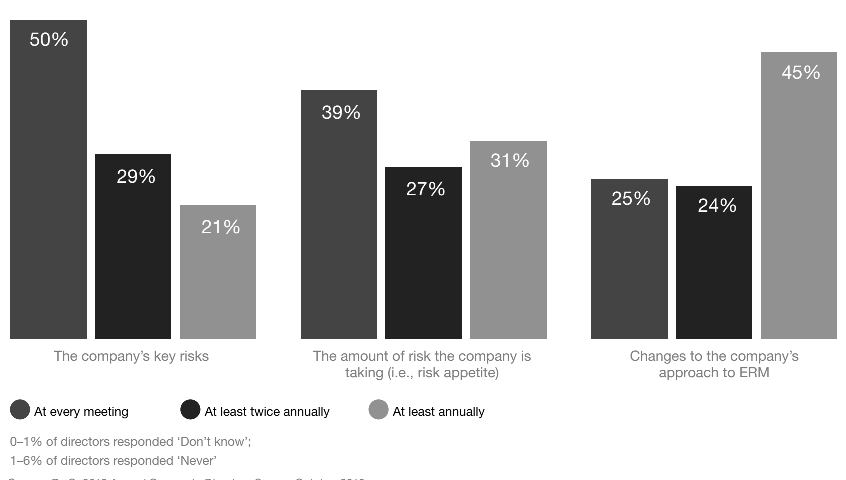
Ask management to notify the board when risk moves outside acceptable levels so directors can discuss the impact on strategy and performance. Accountability for risk-taking can be tricky. Sometimes taking even reasonable risk has a negative outcome. But boards should hold managers accountable when people take risks that are well outside the bounds of the established risk appetite. And that even includes when those risks pay off.

What makes a good risk appetite statement?

A good risk appetite statement will promote a healthy culture and aid in decision-making. It becomes a company playbook for how much uncertainty is acceptable. It sets the boundaries of how much risk to take to meet strategic and operating objectives. (Those boundaries will be different for different kinds of risks.) Indeed, it may take several sentences to express how much risk is needed (floor) and how much is acceptable (ceiling) to achieve objectives. In summary, it makes risk-taking more transparent.

For examples, see the Defining Risk Appetite section of COSO's 2017 *Enterprise Risk Management—Aligning Risk with Strategy and Performance*.

Boards get regular updates on the amount of risk the company is taking



0–1% of directors responded 'Don't know';
1–6% of directors responded 'Never'

Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Challenge: How well do directors understand how management handles conflicting goals and mixed messages that can muddy decisions and create unintended consequences?

The reality is that even getting the culture and risk appetite "right" doesn't solve everything. Business complexity and conflicting objectives mean management has to make decisions that involve trade-offs. What kind of trade-offs? For example, employee safety may be a core value, but pressure to make quarterly numbers could discourage investments in improving safety.

Some argue that having conflicting goals is the right way to go—as it inherently helps manage risk. To take the earlier example, if the company doesn't have safety targets that counterbalance earnings targets, workplace or product safety could decline substantially. That could not only hurt people, it could damage the company's brand. And even with the "right" conflicting targets, if compensation programs are poorly designed, they won't support appropriate behavior.

How can boards know that management is making appropriate trade-offs between different objectives? The right culture and aligned risk appetite can help, but directors can't stop at those high level indicators of risk-taking.

***Board action:** Challenge executives on how they prioritize conflicting objectives.*

Directors need to understand how management resolves the tension of conflicting objectives and monitors decision-making in the absence of clear guidelines. One technique management can use is to design code of conduct training using stories to help teach how to make the best decision when a situation is ambivalent. Conversations with employees outside the C-suite can let you know if the culture feels right.

In conclusion...

The right culture gives the board and management confidence that employees will do the right thing in tough situations. And communicating the risk appetite helps management throughout the company understand how much risk is acceptable in pursuing the company's objectives. Both are vital components to a board's effective oversight of risk.

Contacts

For more information about the topics in this publication, please contact any of the following individuals.

Paula Loop
Leader, Governance Insights Center
(646) 471 1881
paula.loop@pwc.com

Catherine Bromilow
Partner, Governance Insights Center
(973) 236 4120
catherine.bromilow@pwc.com

Dennis Chesley
Global Risk and
Regulatory Consulting Leader
(202) 730 8036
dennis.l.chesley@pwc.com

Jason Pett
Risk Assurance US Internal Audit, Compliance and Risk Management Solutions Leader
(410) 659 3380
jason.pett@pwc.com

Stephen Zawoyski
Partner, Risk Assurance Solutions - ERM
(612) 596 4931
stephen.v.zawoyski@pwc.com

Project team

Karen Bissell
Marketing Manager
Governance Insights Center

Nick Bochna
Project Team Specialist
Governance Insights Center

Other "Risk Oversight Series" topics include:

- ***Why your board should take a fresh look at risk oversight: a practical guide for getting started***
- ***How your board can ensure enterprise risk management connects with strategy***
- ***Why your board should refocus on key risks***
- ***How your board can decide if it needs a risk committee***
- ***How your board can be ready for crisis***

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Why Your Board Should Take a Fresh Look at Risk Oversight: A Practical Guide for Getting Started (January 2017)

Submitted by:
Catherine L. Bromilow

Governance Insights Center PwC

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Governance Insights Center
Risk Oversight Series

January 2017

Why your board should take a fresh look at risk oversight: a practical guide for getting started

Boards play a critical role in overseeing company risk. Ongoing and evolving challenges call for a fresh approach to the task.

A thoughtful approach to risk oversight can bring real value to a company and its shareholders. The right approach delivers transparency on the board's activities to investors; engages a diverse set of directors with the right skill sets; allocates risk effectively at the board level; and provides time for strategic risk discussions. So how can your board refresh its risk approach to be more effective?

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A renewed focus on effective risk oversight

Boards have a critical role in overseeing a company's key risks—whether those risks fall into strategic, financial or operational buckets, or relate to regulatory compliance or other corporate obligations. Directors who thoughtfully define and agree on their board's approach to overseeing risk can bring real value to a company and its shareholders. The board's role in overseeing risk also continues to attract the attention of investors, regulators and other stakeholders, prompting calls for greater transparency.

To respond to the following challenges in overseeing risk, boards should consider ways to refresh their current approach.

Addressing the key challenges for directors

How can a board reassure investors that it is overseeing risk effectively?

Board action: *Enhance proxy disclosures to better describe risk oversight, so shareholders can better understand what your board does and how.*

Do directors' backgrounds support effective risk oversight?

Board action: *Rethink board composition. Ensure directors bring diverse perspectives to risk discussions.*

Are any key risks falling through the cracks and not being overseen anywhere at the board level?

Board action: *Clearly allocate risk oversight among the board and its committees. Ensure that the chairs share their committees' insights about those risks with the full board.*

Is too much of the board-level effort on risk focusing on compliance and regulatory matters?

Board action: *Preserve agenda time to focus on key risks, including big picture strategic risks.*

Challenge: How can a board reassure investors that it is overseeing risk effectively?

Shareholders have pushed for more meaningful and transparent disclosures on boards' activities and performance in recent years. Investors' focus on the oversight of risks is no exception, particularly as more companies have experienced cyberattacks, supply chain disruptions, allegations of wrongdoing, and other challenges that damage both reputations and bottom lines. When investors witness such damaging incidents, they may even consider voting against re-electing directors.

Starting in 2010, public companies were required to include in their proxy statements disclosures about the board's role in risk oversight. Initially, many companies disclosed little beyond the fact that the board had overall responsibility for overseeing risk, the audit committee oversaw financial-related risks, the governance committee oversaw governance-related risks and the compensation committee oversaw compensation-related risks.

Such basic disclosures didn't give shareholders much confidence that the board was actively overseeing the risks that matter.

Today, some companies have significantly expanded their disclosure on how their board oversees risk. According to our 2016 survey, 30% of directors indicated that their board has taken action to enhance proxy disclosures related to risk oversight.[1]

[1] PwC, *2016 Annual Corporate Directors Survey*, October 2016.

How robust are your risk oversight disclosures?

We reviewed the proxy statements of over 50 companies from the S&P 500, representing multiple industries. Some of the more robust disclosures we reviewed:

- Made it clear the **full board is engaged** in discussing all risks, even if specific committees are described as overseeing the risk assessment process or overseeing specific risks. Some of the advantages noted of full board involvement included allowing directors to collectively provide input on key risks, assessing the interplay among risks, making informed cost-benefit decisions and providing views on the adequacy of risk mitigation.
- Described **how the board oversees key risks.** In addition to describing which committees oversee which risks, many explain the full board's role. Some boards dedicated a portion of several board meetings a year to discussing specific risks in greater detail while others covered each risk on a rotating basis at regular board meetings. Additionally, some disclosures identified which board meetings were focused on risk discussions; listed which risks are regularly reported on to the board; or specified which risks the board focused on during the prior year.
- Described the board's **approach to allocating risk oversight.** Sometimes they indicated whether the full board or a specific committee (e.g., the audit or risk committee) does the allocation. We also saw proxies that described the board's awareness of the need to coordinate the oversight allocation, particularly for risks that impact multiple committees, and the governance committee's role in ensuring all significant risk categories are addressed by at least one committee.
- Described the **nature and frequency of reporting** to the board, including which specific executives lead the discussion; which committees receive reports; and whether the entire board receives regular reports. Some disclose how risk discussions are woven into other management presentations about strategy, business unit performance or proposed significant transactions.

Many of the proxy statements also discussed management's role, describing how management supports the board and how the enterprise risk management (ERM) process works.

Proxy disclosures are detailing management's role in risk

Some of the more robust disclosures included:

- Which executives (from the C-Suite, business and functional units or regional operations) make up the management-level risk committee, and how any subcommittee structure works
- What role the chief risk officer plays
- How risk management is coordinated across the company and how management remains alert to emerging risks
- The ERM process, including the use of common frameworks; agreed-upon risk definitions; the categories of risk being assessed; techniques used to capture risks across the organization (e.g., surveys); and whether third parties helped with the assessment. Some also noted that they identify risk owners as part of the process and that there is a centralized assessment of the adequacy of risk mitigation.

***Board action:** Enhance proxy disclosures to better describe risk oversight, so shareholders can better understand what your board does and how.*

To improve descriptions of the board's risk oversight, directors can:

- Have management benchmark the company's disclosure about the board's oversight of risk with those of peers and competitors
- Ask those who prepare the proxy statement to draft a sample disclosure that includes additional information on the board's practices; considers insights drawn from management's review of other companies' disclosures; and incorporates the elements of robust disclosures described earlier

With this information, your board can critically evaluate whether you should enhance your disclosures so investors can better understand the board's activities. This exercise may also identify changes that could improve the board's underlying practices. For example, it may point to the need to devote more board time to risk management. It may also point to gaps in management's processes.

Challenge: Do directors' backgrounds support effective risk oversight?

Boards may not be as effective at overseeing risk if directors don't have industry expertise or sufficiently diverse backgrounds that allow them to bring different perspectives to the discussion. Many of the key risks a company faces are linked to its strategy and industry. Yet antitrust regulations make it a challenge to have many directors with deep industry knowledge on a company's board. This can make it harder for boards to have in-depth understanding of the key risks or spot risks that management hasn't already identified. The challenge may be more evident in highly specialized or regulated industries. For example, a director who has services or general manufacturing experience may not be familiar with the more unique risks at insurance or pharmaceutical/ biotech companies.

Having diverse skills, backgrounds and experiences on a board is vital to understanding the broad range of risks a company can face. Directors who have risk management expertise can also bring real value.

While consensus is that it's an important skill, the definition of what qualifies as "risk management expertise" is broad. The Dodd-Frank rules require large financial institutions to have at least one risk management expert on their risk committees. The definition says that person is to have experience identifying, assessing and managing risk exposures of large, complex firms.

Based on our review of a sample of 2016 proxy statements, over half of the companies (52%), including many companies that are not in financial services, specifically disclose that certain board members have skills or experience in risk management.[2] Those individuals had varying backgrounds, serving as chief executive officer (CEO), chief financial officer (CFO), or general counsel; being directors of other public companies; or having operational experience. A few companies even specified that "risk management" was a director skill they need on their board in their skill matrices, and then identified which directors possess this attribute.

Risk management expertise is important to board composition

63%

of directors *rate risk management expertise as very important to have on their boards—placing it fourth in a long list of attributes.*

79%

of investors *said it's a very important attribute to be represented on boards—rating it as the second most important attribute.*

Sources: PwC, *2016 Annual Corporate Directors Survey,* October 2016; PwC, *What matters in the boardroom? Director and investor views on trends shaping governance and the board of the future*, 2014.

[2] Based on PwC analysis of 2016 proxy statements of 100 S&P 500 companies, judgmentally selected to represent multiple sectors, April 2016.

***Board action:** Rethink board composition. Ensure directors bring diverse perspectives to risk discussions.*

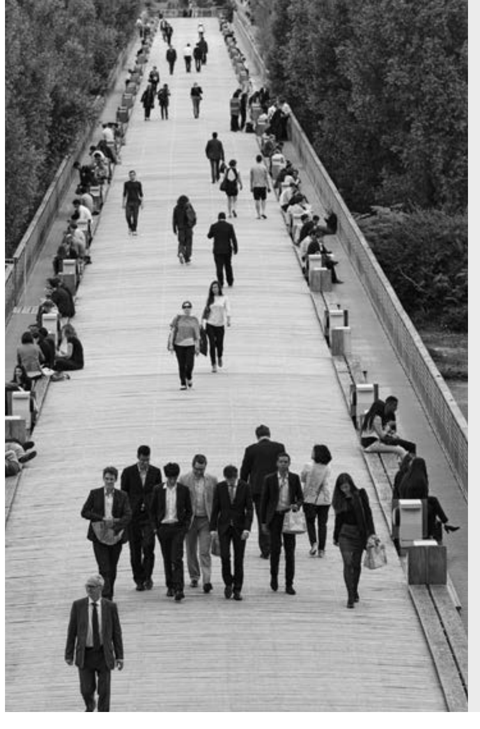
Boards need the right composition to oversee risk effectively:

A sophisticated understanding of the company's industry to help with assessing risks and their implications. This may involve having or adding directors from non-competitors in the industry or adjacent industries or even a retired industry executive.

A broad diversity of backgrounds among directors to help better understand the different risks that could impact the company. A company's changing strategy may drive the need to add a director with specific expertise; some boards have added directors with digital or IT expertise for this reason.

Perhaps even **one or more directors with risk management expertise** who understand the company's processes and results.

The right board composition allows you to drive more effective discussions and helps ensure management has identified all relevant risks.



Additionally, boards can:

- Highlight in the proxy statement which directors bring risk management experience, given investors' interest in this director attribute
- Ensure new directors receive robust orientation and all directors get continuing education that focuses on changes in the industry and its implications on risk

Challenge: Are any key risks falling through the cracks and not being overseen anywhere at the board level?

With the various key risks that a company faces, there can be confusion over who is ultimately responsible for which risks and where they are overseen at the board level. In particular, directors might believe another board committee is covering a risk when it's not.

The good news is that most directors (83%) believe their board's performance is good or excellent when it comes to mapping specific risks to the board and its committees.[3]

***Board action:** Clearly allocate risk oversight among the board and its committees. Ensure that the chairs share their committees' insights about those risks with the full board.*

It's helpful for the board and committee chairs to work together to ensure all key risks are subject to board-level oversight. Some boards find it helpful to use a risk allocation matrix, which extends the key risk summary that many boards currently receive. Some companies even show overall risk allocation graphically in their proxy statements.[4]

When individual committees take the lead in overseeing key risks, the committee chairs need to provide robust reporting back to the full board so other directors get a sense of how well the company is managing critical risks. Regardless of which board committees may have responsibilities for specific risks, the entire board should discuss the cross-enterprise risks.

Things get more complicated, though, when a key risk overlaps multiple committees. For example, the risk of incentive compensation promoting risky behavior impacts both the audit and compensation committees. Different boards take different approaches to such situations. The committee chairs could simply discuss the risks, attend the other committee's meetings or even periodically hold joint committee meetings. Some boards embrace cross-committee memberships to promote knowledge sharing.

A risk allocation matrix can be useful

Key risks (illustrative only)	Executive responsible	Board oversight	Frequency	Source of assurance
Breaches in IT security	Chief information officer	Audit committee	Biannually	Internal audit IT security consultant
Unreliable supply chain	Chief procurement officer or chief operating officer	Board	Annually	Internal audit
Integrating new acquisitions	Chief executive officer	Board	Annually	Internal audit

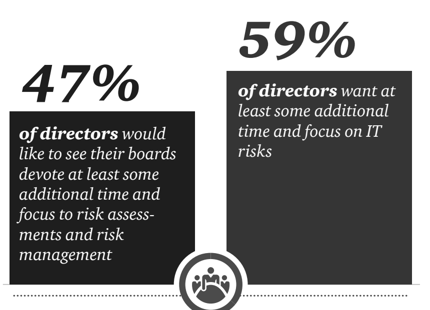
[3] PwC, *2015 Annual Corporate Directors Survey*, October 2015.
[4] For examples of overall risk allocation graphics, see Walmart's (page 31) and GE's 2016 proxy statements.

Challenge: Is too much of the board-level effort on risk focusing on compliance and regulatory matters?

It may be easy for directors—whether as part of the full board, an audit committee, a risk committee or another committee—to get bogged down in risk discussions that overly focus on regulatory and compliance risks. This isn't surprising given today's heightened enforcement environment and the proliferation of regulations facing companies.

Another factor is that many boards assign risk oversight responsibilities disproportionately to audit committees. Audit committee members typically have some form of financial reporting experience. Such background may have given them little opportunity to think creatively about risks other than financial and compliance risks. And so an audit committee may not be the best venue to discuss whether management is appropriately identifying emerging risks, disruptors or broader strategic risks.

Boards want to focus more on risk



Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Plus, with already full meeting agendas—for both boards and committees—it's challenging to make time for robust discussions that range beyond compliance to strategic and operational risks.

***Board action:** Preserve agenda time to focus on key risks, including big picture strategic risks.*

Boards should evaluate their current approach to overseeing risk and assess whether too much time is focused on compliance risks versus strategic risks. Do your discussions about company strategy or proposed transactions consider the related risks? Is there a focus on predicting the impact of emerging disruptive forces? If not, consider adding risk as a required topic to the reports from management supporting such discussions. You can also use a facilitator or third party to drive the discussion or add insights about how broader economic, business or industry trends impact risk. Finally, an unstructured, free-flowing session to brainstorm about risks with management is another way to move beyond compliance risks and encourage out-of-the-box thinking. It may also help directors understand how risks are interconnected.

An evaluation may also determine that the full board needs to spend more time discussing risk. Dedicating time during strategy retreats or regular board meetings can help. Plus, if management highlights key issues in the pre-reading materials, boards can focus their discussion appropriately. They may also be able to free up agenda time by handling routine requirements differently.

Audit committees and risk committees already tend to have packed agendas. So you may need to update your committee structure and/or responsibility allocations.

In conclusion...

At a well-run company, boards play a crucial role in risk oversight. Boards thinking proactively about their risk oversight should consider enhancing proxy disclosure, bringing more diverse viewpoints into the boardroom, rethinking the allocation of risk oversight duties, and ensuring the topic has necessary agenda time at meetings of both committees and the full board. By examining and refining its approach to risk oversight, a board can deliver enhanced value to the company and its shareholders.

Contacts

For more information about the topics in this publication, please contact any of the following individuals.

Paula Loop
Leader, Governance Insights Center
(646) 471 1881
paula.loop@pwc.com

Catherine Bromilow
Partner, Governance Insights Center
(973) 236 4120
catherine.bromilow@pwc.com

Barbara Berlin
Director, Governance Insights Center
(973) 236 5349
barbara.berlin@pwc.com

Project team

Karen Bissell
Marketing Manager
Governance Insights Center

Nick Bochna
Project Team Specialist
Governance Insights Center

Other "Risk Oversight Series" topics include:

- ***How your board can influence culture and risk appetite***
- ***How your board can ensure enterprise risk management connects with strategy***
- ***Why your board should refocus on key risks***
- ***How your board can decide if it needs a risk committee***
- ***How your board can be ready for crisis***

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Evolving Ethical and Liability Challenges for Audit Committee Advisors: 2017 Edition

Submitted by:
John. F. Olson

Gibson, Dunn & Crutcher LLP

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1. NYCLA Committee on Professional Ethics Formal Opinion 746 (October 7, 2013)

NYCLA COMMITTEE ON PROFESSIONAL ETHICS
FORMAL OPINION 746
October 7, 2013

TOPIC: Ethical Conflicts Caused by Lawyers as Whistleblowers under the Dodd-Frank Wall Street Reform Act of 2010

DIGEST: New York lawyers who are acting as attorneys on behalf of clients presumptively may not ethically collect whistleblower bounties in exchange for disclosing confidential information about their clients under the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act because doing so generally gives rise to a conflict between the lawyers' interests and those of their clients. New York lawyers, in matters governed by the New York Rules of Professional Conduct, may not disclose confidential information, relating to current or past clients, under the Dodd-Frank whistleblower regulations, except to the extent permissible under the New York Rules of Professional Conduct. This Opinion is limited to New York lawyers who are acting as attorneys on behalf of clients.

RPC: 1.6, 1.7, 1.9

QUESTION: May a New York lawyer ethically participate in the whistleblower bounty program under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 by revealing confidential information about the lawyer's client and then seeking a bounty?

OPINION:

I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) authorizes the payment of bounties to whistleblowers who report corporate wrongdoing to the U.S. Securities and Exchange Commission (SEC), Department of Justice, or the Commodity Futures Trading Commission (CFTC). The question arises as to the ethical implications under the New York Rules of Professional Conduct (RPC) if a New York lawyer were to accept a whistleblower bounty in exchange for furnishing information to the SEC or other government agency. This opinion analyzes the duties of New York lawyers under the New York RPC.

In 2002, the Sarbanes-Oxley Act (Sarbanes-Oxley), overwhelmingly passed by both houses, became law. It was a response to major corporate and accounting scandals, such as those involving Enron, Tyco International, Adelphia and WorldCom, that cost investors billions of dollars when the share prices of affected companies collapsed. The SEC adopted Rule 205 as an attorney conduct regulation to implement portions of Sarbanes-Oxley. Rule 205 requires lawyers and others who deal with the SEC to report corporate misdeeds up the corporate ladder and permits, but does not require, reporting outside the corporation if the internal reporting does not solve the problem.[1]

In an attempt to regulate the financial markets in order to prevent a recurrence of the financial crisis of 2008-2009, Dodd-Frank was signed into law on July 21, 2010. Building onto Sarbanes-Oxley, section 922 of Dodd-Frank creates a whistleblower bounty program under which individuals, who voluntarily provide original information leading to successful SEC enforcement actions, may receive bounty payments based on penalties assessed against respondents.[2] Whistleblowers whose "original information"[3] results in successful prosecutions netting monetary penalties in excess of $1 million are entitled, with some exceptions, to bounties

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[1] As relevant to attorneys, SEC Rule 205 provides:

> An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:
> (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
> (ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or
> (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

17 C.F.R. § 205.3(d)(2).

[2] Bounties are also available to whistleblowers who provide original information to the CFTC and the Department of Justice.

[3] "Original information" is defined at 17 C.F.R. § 240.21F-4(b) as deriving from the whistleblower's "independent knowledge or independent analysis," and not available from a court or administrative record or the news media, or otherwise known to the Commission.

of 10% to 30% of the amount recovered in the government enforcement actions. Thus, the minimum whistleblower bounty is $100,000. While, as explained below, lawyers subject to SEC jurisdiction are required to report serious corporate wrongdoing up the corporate ladder, reporting out – and collecting a bounty – is permissible under SEC rules. There are two sets of relevant SEC rules: attorney conduct regulations under Rule 205 (17 C.F.R. § 205); and Rules 240 and 249 (17 C.F.R. §§ 240, 249), promulgated under Dodd-Frank, concerning whistleblowing provisions.

II. Attorneys as Whistleblowers and Bounty Seekers under SEC Rules

SEC whistleblower rules exclude from the definition of "original information" most material that lawyers, in-house or retained, are likely to gain in the course of their professional representation of clients, and thus generally preclude attorneys, in most instances, from receiving a bounty for revealing such information.[4] SEC Rule 21F-4(b) acknowledges the importance of the attorney-client privilege, as well as state ethics rules, and presumptively excludes the use of privileged or confidential information from the definition of eligible original information under the whistleblower rule.[5] Indeed, the SEC warns lawyers that there will be no financial benefit to lawyers who disclose such information in violation of the attorney-client privilege or their ethical requirements.[6]

However, the SEC permits attorneys to reveal information obtained as a result of legal

[4] The categories excluded from whistleblower bounty include: (a) confidential communications subject to the attorney-client privilege; (b) information that came from the legal representation of a client, whatever its source; (c) information that came from persons in a compliance, legal, audit, supervisory or governance role for the entity; and (d) information from the entity's legal, compliance, audit, or related functions for dealing with violations, unless the entity did not disclose the information to the SEC or CFTC within a reasonable time or acted in bad faith. 17 C.F.R. § 240.21F-4(b)(4), *available at* http://www.law.cornell.edu/cfr/text/17/240.21F-4.

[5] *See* Implementation of the Whistleblower Provisions of Section 21F, Exchange Act Release No. 34-64545, at 50-52, 60-66, 249-50 (Aug. 12, 2011) [hereinafter SEC Release No. 34-64545], *available at* http://www.sec.gov/rules/final/2011/34-64545.pdf.

[6] *Id.* at 60-61, 249-50.

representation of a client when such disclosure is permitted by either state ethics rules or SEC Rule 205.3(d)(2), which Rule, as noted above, was promulgated under Sarbanes-Oxley.[7] Rule 205 allows attorneys practicing before the SEC in the representation of an issuer to reveal confidential information related to the representation when the attorney reasonably believes disclosure is necessary: (a) to prevent the issuer from committing a material violation of securities laws that is likely to cause substantial financial injury to the interests or property of the issuer or investors, (b) to rectify the consequences of a material violation of securities laws in which the attorney's services have been used, or (c) to prevent the issuer from committing or suborning perjury in an SEC proceeding.

Under SEC Rule 205, the disclosure of client confidences outside the organization is a last resort, not a first step. The rule requires lawyers practicing before the Commission to report evidence of material violations of the securities laws to the company's chief legal officer (CLO), who is required to investigate the claim and report back to the lawyer who originally made the report.[8] In the event that the CLO finds credible evidence of a material violation, she must report the wrongdoing up the corporate ladder, including, if necessary, to the audit committee, qualified legal compliance committee or full board of directors. If all else fails, and if necessary to prevent further harm to the corporation or to investors, the CLO is authorized to disclose client confidences outside the company.[9] A junior reporting lawyer may report disclosures outside the organization if the CLO fails to act. Thus, under SEC Rule 205, reporting up the corporate ladder is mandatory; reporting out is permissible. However, to the extent that there is an independent violation of the securities laws, a lawyer may be subject to an enforcement action by the SEC for failing to correct or prevent the wrongdoing of a client in which the lawyer was

[7] 17 C.F.R. § 240.21F-4(b)(4)(i), *available at* http://www.law.cornell.edu/cfr/text/17/240.21F-4.
[8] *Id.* at § 205.3(b), *available at* http://www.law.cornell.edu/cfr/text/17/205.3.
[9] *Id.* at § 205.3(d), *available at* http://www.law.cornell.edu/cfr/text/17/205.3.

complicit.[10]

The prospect of government-rewarded lawyer whistleblowers poses two ethical questions for New York lawyers: (1) In those limited circumstances in which the New York Rules and SEC Rule 205 diverge, would a New York attorney violate the RPC if she makes a disclosure not authorized by the confidentiality provisions of RPC 1.6 in order to seek a bounty? (2) Would a New York attorney who is representing a client violate the conflict of interest provisions of NY RPC 1.7 by seeking a bounty as a whistleblower with respect to that client by using that client's confidential information?

III. Disclosure of Confidential Information

In addressing the foregoing questions, the Committee begins from the obvious premise that its jurisdiction is limited to interpreting the New York Rules of Professional Conduct, and does not extend to the rules of other states or questions of substantive law. Nor can the Committee anticipate the myriad choice-of-law issues that may arise in different contexts under RPC 8.5, particularly in matters involving nationwide practices and administrative procedure. In addition, there are some circumstances in which state regulations may be preempted by inconsistent federal law.[11] Preemption is a question of substantive law, to be applied by the courts to the specific facts of each case, and is beyond this committee's jurisdiction.[12] However,

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[10] *See* In re Don Hershman, Securities Act Release No. 33-9180 (Feb. 2, 2011), *available at* http://www.sec.gov/litigation/admin/2011/33-9180.pdf.

[11] *See, e.g.*, Giovanni P. Prezioso, *Public Statement by SEC Official: Letter Regarding Washington State Bar Association's Proposed Opinion on the Effect of the SEC's Attorney Conduct Rules* (July 23, 2013), *available at* http://www.sec.gov/news/speech/spch072303gpp.htm.

[12] *Compare*, Grievance Comm. v. Simels, 48 F.3d 640, 646 (2d Cir. 1995) (reversing imposition of discipline against attorney who violated state "no-contact" rule in federal criminal proceeding; finding that "[i]f a particular interpretation of a state ethics rule is inconsistent with or antithetical to federal interests, a federal court interpreting that rule must do so in a way that balances the varying *federal* interests at stake"), *with* Gadda v. Ashcroft, 377 F.3d 934, 945 (9th Cir. 2004) (state bar has authority to discipline attorney for neglect of federal immigration matters) ("We apply a presumption against federal preemption unless the state attempts to regulate an area in which there is a history of significant federal regulation."), *and* Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th

SEC whistleblower rules explicitly reference "attorney-client privilege" and "applicable state attorney conduct rules," and thereby implicitly assume a side-by-side coexistence of the RPC and Rule 205.[13] Moreover, the SEC itself has acknowledged the applicability of state ethics rules in its own proceedings.[14]

The New York RPC prevent a lawyer generally from disclosing confidential information, but present six categories of exceptions to the general rule in RPC 1.6(b) if the circumstances are such that "the lawyer reasonably believes [disclosure is] necessary." Of these six exceptions, three are relevant to this discussion: RPC 1.6(b)(2), RPC 1.6(b)(3), and RPC 1.6(b)(6).

RPC 1.6(b)(2) permits an attorney to disclose confidential information to prevent a client from "committing a crime." This exception has some overlap with the "material violation" of the securities laws described in SEC Rule 205; however, not all securities violations rise to the level of a crime. Lawyers have been civilly or administratively sued for registration and record-keeping violations that do not amount to fraud or a crime. For example, in *In re Isselmann*, a general counsel improperly failed to correct his client's misperception of foreign law.[15] In *In re Drummond*, the SEC civilly prosecuted the general counsel of Google for failing to report that a grant of stock options would cause the company to cross a reporting threshold.[16] In both *Isselmann* and *Drummond*, general counsels were prosecuted for securities law violations. However, it is at least arguable that the lawyers' conduct in those cases, even if

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Cir. 2005) (California arbitrator ethics rules preempted in FINRA proceedings by FINRA rules approved by SEC), *and* Sperry v. State of Florida, 373 U.S. 379 (1963) (IRS regulations for practice before federal agency preempt inconsistent state rules).

[13] *See* 17 C.F.R. § 240.21F-4(b)(4); SEC Release No. 34-64545, *supra* note 5, at 50-52, 250-51.

[14] *See, e.g.*, SEC v. Steven Altman, Securities Act Release No. 34-63306 (Nov. 10, 2010); Steven Altman v. SEC, 666 F.3d 1322 (D.C. Cir. 2011) (disciplining lawyer for violations of NY RPC based on extortionate conduct which impeded SEC investigation). *See also*, 28 U.S.C. § 530B (2006) (The "McDade Amendment") (binding federal prosecutors to follow state ethics rules to the same extent as state lawyers); Lisa G. Lerman & Philip G. Schrag, Ethical Problems in the Practice of Law 716-17 (Aspen 2008).

[15] Securities Act Release No. 34-50428 (Sept. 23, 2004), *available at* http://www.sec.gov/litigation/admin/34-50428.htm.

[16] Securities Act Release No. 33-8523 (Jan. 13, 2005), *available at* http://www.sec.gov/litigation/admin/33-8523.htm.

violations of securities law, did not rise to the level of crime or fraud for the purpose of state ethics rules.

To the extent that SEC Rule 205 permits (but does not require) reporting out of client confidences that amount to a material violation of the securities laws, regardless of whether the client's conduct amounts to a crime or whether the lawyer's services were used, it is broader than, and inconsistent with, the New York RPC exceptions to the confidentiality requirement.

Additionally, New York RPC 1.6(b)(3) permits a lawyer to reveal client confidential information where reasonably necessary

> to withdraw a written or oral opinion or representation previously given by the lawyer and reasonably believed by the lawyer still to be relied upon by a third person, where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud.

This exception permits reporting out of client confidences, but only in circumstances in which the lawyer's services have been used, in essence, to perpetrate a crime or fraud. For example, where the lawyer participated in drafting an offering statement that the lawyer later learns to be materially misleading, the New York Rules and SEC Rule 205 are in essential agreement that disclosure is permissible.

The third relevant exception is New York RPC 1.6(b)(6), which permits disclosure of client information "when permitted or required under these Rules or to comply with other law or court order." We do not need to decide here whether or not an administrative regulation, such as SEC Rule 205, is a law or court order within the meaning of the exception of RPC 1.6(b)(6). This is because RPC 1.6(b) explicitly provides that disclosure of client confidential information under its six exceptions – including RPC 1.6(b)(6) – may be made only "to the extent the lawyer reasonably believes necessary." The SEC regulations, as mentioned, only require reporting up the ladder. Reporting out is permissive, not mandatory. Thus, as a general rule, SEC Rule 205,

standing by itself, does not require a lawyer to report out corporate wrongdoing and, therefore, such reporting is not reasonably necessary within the meaning of RPC 1.6(b).[17] The whistleblower rule is permissive as well, and does not mandate reporting out.

Other ethics rules also inform the conduct of corporate lawyers. New York RPC 1.13, "Organization as Client," which covers the responsibilities of a corporate attorney, requires an attorney aware of corporate misconduct that constitutes a violation of law or of a legal duty to the corporation to take reasonable measures within the organization to prevent harm to the organization, but does not contain independent support for reporting outside the organization if such reporting might result in disclosure of confidential information in violation of Rule 1.6:

> If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly in violation of law and is likely to result in a substantial injury to the organization, the lawyer may reveal confidential information <u>only if permitted by Rule 1.6</u>, and may resign in accordance with Rule 1.16.[18]

Thus, reporting out is circumscribed under New York law to those instances permitted in RPC 1.6(b).

In addition, in the case of known false evidence, a lawyer is required under RPC 3.3(a) to take reasonable remedial measures, "including, if necessary, disclosure to the tribunal." Disclosing client confidences to a tribunal may also be required when the lawyer knows of criminal or fraudulent conduct related to a proceeding in a tribunal.[19]

In sum, the New York exceptions permitting disclosure of confidential information are

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[17] For the same reason, the state and federal regulatory schemes are not mutually antagonistic. SEC whistleblower regulations do not require reporting out; they permit it, within the exceptions set forth in Rule 205. If federal regulations required reporting out, we might be in a different situation.

[18] NY RPC 1.13(c) (emphasis added). By contrast, American Bar Association Model Rule 1.13 permits outside disclosure if the corporation's board fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law and if the lawyer reasonably believes that the violation is "reasonably certain to result in substantial injury to the organization." But disclosure is permitted only to the extent necessary to prevent substantial injury to the organization.

[19] NY RPC 3.3(b).

different from the SEC exceptions. Under the SEC rules discussed above, an attorney may collect a bounty in exchange for disclosure of confidential information in situations not permitted under the New York Rules. Even when disclosure is permitted under the New York Rules, for example, when clear corporate wrongdoing rising to the level of crime or fraud has been perpetrated through the use of the lawyer's services, preventing wrongdoing is not the same as collecting a bounty. Even in cases of clear criminal conduct or fraud, the lawyer's disclosure must be limited to reasonably necessary information.[20]

As a general principle, there are few circumstances, if any, in which, in the Committee's view, it would be reasonably necessary within the meaning of RPC 1.6(b) for a lawyer to pursue the steps necessary to collect a bounty as a reward for revealing confidential material. This point was acknowledged in a recent federal opinion in a *qui tam* whistleblower case decided under the False Claims Act.[21]

Thus, in those circumstances in which the New York Rules apply, this Committee opines that disclosure of confidential information in order to collect a whistleblower bounty is unlikely, in most instances, to be ethically justifiable. This is because, under most circumstances, such disclosure is not reasonably necessary, and does not fit within the enumerated exceptions of RPC 1.6(b).[22] RPC 1.6, by its terms, is limited to "information gained during or relating to the representation of a client . . . ." Accordingly, this opinion applies only when a lawyer is acting as a legal representative of a client. Thus, a lawyer functioning in a non-legal capacity would not be within the scope of this opinion.

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[20] *See, e.g.*, NYSBA Comm. on Prof'l Ethics, Op. 837 (lawyer must take reasonable remedial measures under RPC 3.3 to correct client perjury, but may only reveal client confidences to the extent reasonably necessary; "[t]herefore, if there are any reasonable remedial measures short of disclosure, that course must be taken").

[21] *See* United States Ex Rel. Fair Lab. Practices Assocs. v. Quest Diagnostics Inc., No. 05-C5393, 2011 WL 1330542, 2011 U.S. Dist. LEXIS 37014 (S.D.N.Y. Mar. 24, 2011) (disclosure of client confidences by former general counsel of corporation was not "reasonably necessary" under former Code of Professional Responsibility to rectify client fraud).

[22] *See id.*

Accordingly, New York RPC 1.6 does not permit disclosure of confidential information in order to collect a Dodd-Frank whistleblower bounty, even in compliance with the SEC rules, if that disclosure does not fit within an exception under New York RPC 1.6 or is not necessary to correct a fraud, crime or false evidence within the meaning of RPC 3.3.

IV. Conflicts of Interest Under RPC 1.7

An additional and even more significant ethical issue is presented by the bounty provisions of Dodd-Frank: Is a conflict of interest under RPC 1.7 presented when a corporate lawyer, functioning as a lawyer, seeks to collect a whistleblower bounty? Our answer is presumptively yes. A lawyer confronted with potential corporate wrongdoing must evaluate and consider varying requirements under SEC and state ethics rules and then make some difficult decisions: Is the potential violation material? Is the potential violation criminal? Should the lawyer report the wrongdoing up the corporate ladder? Should the lawyer report the wrongdoing to an outside body, and if so, when?

These complex and potentially inconsistent considerations call for the exercise of objective, dispassionate professional judgment. A lawyer who blows the whistle prematurely could harm the client and be professionally responsible for the precipitous disclosure of client confidences. A lawyer who fails to report credible evidence of corporate wrongdoing up the ladder, if it amounts to an independent violation of the securities laws, could potentially be prosecuted by securities regulators, subject to professional discipline by the SEC, and subject to reciprocal discipline by state bar counsel.[23]

Especially under these delicate circumstances, a financial incentive might tend to cloud a

[23] *See, e.g.*, New York City Bar, Report of the Task Force on the Lawyer's Role in Corporate Governance 46 (Nov. 2006) (collecting seventy-four SEC enforcement actions against lawyers), *available at* http://online.wsj.com/public/resources/documents/WSJ-CORP-GOV-FINAL_REPORT.pdf.

lawyer's professional judgment. Yet Dodd-Frank permits the SEC to pay lawyers potential bounties of 10%-30% of collected fines in excess of $1 million. The potential bounties range from $100,000 to literally millions of dollars in larger cases. The prospect of financial benefit could place the attorney's personal interests in potential conflict with those of the client.

RPC 1.7(a)(2) precludes representation of a client, absent waiver, where a reasonable lawyer would conclude that "there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests." The prospect of a government payment to a whistleblower poses such a risk. While we cannot anticipate all potential circumstances and situations, and do not wish to paint a bright line rule applicable to all cases, it is the opinion of the Committee that the potential payment of an anticipated whistleblower bounty in excess of $100,000 presumptively gives rise to a conflict of interest between the lawyer's personal interest and that of the client.

We cannot anticipate all potential circumstances and, therefore, our opinion anticipates the overwhelming majority of cases in which the lawyer's professional judgment may be affected by the prospect of a monetary bounty. This opinion is narrowly tailored to an interpretation of permissive whistleblowing, and does not purport to address the rare and exceptional situation in which the lawyer is affirmatively required by law or the rules of professional conduct to report out the client's misconduct, *i.e.,* when reporting out is mandatory.[24] Under those rare circumstances (in which reporting out is mandatory), the financial incentive could be less of a factor in determining the existence of a conflict with the lawyer's personal interest.

Further, although Rule 1.7(b) provides for a waiver by a client of the conflict even if there is a "significant risk" that the lawyer's professional judgment or representation will be

[24] *See, e.g.*, NY RPC 3.3(b).

adversely affected by the lawyer's personal interest, in some circumstances the whistleblower-bounty conflict may be unwaivable.[25]

Indeed, where an attorney can hope to claim close to a $10 million bounty by reporting a securities fraud of $30 million or more – the same amount that gave rise to an unwaivable conflict in *Schwarz* – the conflict may be unwaivable. Such large sums of money would tend to cloud lawyers' professional judgment, influencing lawyers to report out a violation regardless of their clients' interests.[26]

V. Former Clients

In our view, some ethical concerns with regard to whistleblower bounties apply to former clients as well. New York RPC 1.9(c) prohibits a lawyer from using client confidential information to the detriment of a former client, unless permitted by Rule 1.6(b). According to RPC 1.9(c):

> A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:
>
> (1) use confidential information of the former client protected by Rule 1.6 to the disadvantage of the former client, except as these Rules would permit or require with respect to a current client or when the information has become generally known; or
>
> (2) reveal confidential information of the former client protected by Rule 1.6 except as these Rules would permit or require with respect to a current client.

Thus, Rule 1.9 protects the confidences of former clients, which may not be disclosed to the client's detriment unless pursuant to an exception under RPC 1.6(b). And, as mentioned, the

[25] *See, e.g.*, United States v. Schwarz, 283 F.3d 76, 95 (2d Cir. 2002) (unwaivable conflict of interest raised by criminal defense lawyer's $10 million contract with police union where lawyer failed to point finger at union delegates in defense of criminal defendant accused of participating in torture of Abner Louima).

[26] This opinion does not deal with circumstances where the attorney's financial interest is less than $100,000, and is not meant to suggest that no ethical concerns are present in such situations.

exceptions in Rule 1.6(b) permit disclosure of client confidences only "to the extent the lawyer reasonably believes necessary . . . ." The lawyer's duty to maintain client confidences has been held to survive the termination of the client-lawyer relationship.[27] It is the Committee's view that lawyers of former clients, even those wrongfully discharged in violation of the law, may not seek bounties, although it has been held that they may, under some circumstances, reveal some client confidences in the context of a claim for wrongful termination.[28] This is because the confidentiality provisions of RPC 1.9, which apply to former clients, incorporate those of RPC 1.6. Accordingly, a former lawyer for a client may not reveal information that could not have been revealed in the course of the representation.

Moreover, case law has recognized, more generally, the lawyer's duty not to harm a former client. In *Oasis West Realty, LLC v. Goldman*, the California Supreme Court sustained a breach of fiduciary duty claim against a lawyer who was disloyal to a former client when he publicly protested a development permit that he himself had formerly obtained on behalf of the client, at considerable expense.[29] The lawyer's interest in free speech did not permit his act of disloyalty to his former client regarding the same matter for which he had been retained.

We believe that a similar analysis applies in the case of a lawyer standing to profit from blowing the whistle on a former client in exchange for a monetary bounty. While in some circumstances a lawyer may be required to take remedial action to prevent or correct client fraud or perjury, such actions should be taken because they are required by the law or the RPC – not because the lawyer seeks personal gain at the former client's expense. Additionally, we believe that attorneys owe a fiduciary duty to former clients to maintain confidentiality, and may not

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[27] *See Quest Diagnostics*, 2011 U.S. Dist. LEXIS 37014; Swidler & Berlin v. United States, 524 U.S. 399 (1998) (notes of Vincent Foster's lawyer are confidential even after his death).
[28] *See, e.g.*, Van Asdale v. Int'l Game Tech., 577 F.3d 989 (9th Cir. 2009).
[29] 51 Cal.4th 811 (2011).

violate that fiduciary duty in order to promote a personal interest.[30] Furthermore, there are circumstances in which an attorney may be *permitted* under Rule 1.9 to reveal otherwise confidential information about a former client – for example, when the disclosure is reasonably necessary to prevent the client from committing a crime under Rule 1.6. However, we believe that undertaking this otherwise permissible disclosure in a manner that results in a bounty for the attorney raises a significant risk that the attorney's judgment in determining whether disclosure is "reasonably necessary" will be adversely affected and presents a conflict of interest that is beyond what Rule 1.9 was intended to allow.

VI. The Attorney's Status

While the RPC apply with equal force to lawyers in private practice and in-house counsel, we note that the conflict provisions of RPC 1.7 (and, as mentioned above, RPC 1.6) do not apply to all lawyers at all times, but only to lawyers who are engaging or have engaged in the representation of a client. RPC 1.7(a) specifically says that "a lawyer shall not represent a client" if the lawyer's professional judgment "on behalf of a client" would be affected by a personal interest of the lawyer. Thus, our opinion would not affect or apply to lawyers who are not representing, or did not represent clients. For example, a corporate officer or compliance officer who happens to be a lawyer may not necessarily be representing a client in the performance of his duties, depending on the facts of the individual case. To the extent that the lawyer is not representing a client, our opinion would not apply to that conduct simply because the lawyer happens to be a licensed attorney.

[30] *See generally* Birnbaum v. Birnbaum, 73 N.Y.2d 461 (1989) (general duty of fidelity requires avoidance of situations in which personal interests conflict with the interests of those owed a fiduciary duty).

VII. Conclusion

It is the Committee's opinion that New York lawyers who are acting as attorneys on behalf of clients presumptively may not ethically serve as whistleblowers for a bounty against their clients under the Dodd-Frank Wall Street Reform and Consumer Protection Act, because doing so generally gives rise to a conflict between the lawyers' interests and those of their clients. New York lawyers, in matters governed by the New York RPC, may not disclose confidential information under the Dodd-Frank whistleblower regulations, except to the extent permissible under the Rules of Professional Conduct. This conclusion is the same for current and former lawyers, whether in-house or outside counsel. However, this Opinion is limited to New York lawyers who are acting as attorneys on behalf of clients.

2. **SEC Press Release: SEC Charges Gatekeepers in Microcap Frauds (December 16, 2016)**

Press Release

SEC Charges Gatekeepers in Microcap Frauds

Agency Releases White Paper on Risks of Penny Stock Investing

FOR IMMEDIATE RELEASE
2016-265

Washington D.C., Dec. 16, 2016— The Securities and Exchange Commission today barred several market participants from the penny stock industry for their roles in various sham initial public offerings (IPOs) of microcap stocks that defrauded investors.

In one case, Newport Beach, Calif.-based securities lawyer Michael J. Muellerleile authored false and misleading registration statements used in sham IPOs for five microcap issuers in order to transfer unrestricted shares of penny stocks to offshore market participants. Muellerleile's law firm M2 Law Professional Corp. also is charged along with Lan Phuong Nguyen, an attorney who assisted Muellerleile by signing false and misleading attorney opinion letters, and Joel Felix, the CFO of one of the issuers, for making false and misleading statements. The SEC today suspended trading in that issuer, American Energy Development Corp.

In another case, Nevada-based stock transfer agent Empire Stock Transfer and its supervisor of operations Matthew J. Blevins transferred large blocks of several penny stock securities without restrictions to offshore nominees despite red flags indicating the shares were likely part of an illegal operation. The SEC previously charged several offshore entities behind the illegal sales of unregistered penny stocks made possible by Empire Stock Transfer and Blevins.

"These enforcement actions bar any further penny stock activity by these market participants, including attorneys and a transfer agent supervisor who betrayed the trust that investors place in gatekeepers to protect them in this highly risky market," said Stephanie Avakian, Deputy Director of the SEC's Enforcement Division. "The SEC is committed to combating microcap fraud through the investigative work of its Microcap Fraud Task Force, the initiatives of its Microcap Fraud Working Group, and repeated warnings to investors about the red flags of penny stock investing."

All of the market participants named in today's cases have agreed to settle the charges without admitting or denying the SEC's findings.

Muellerleile agreed to pay $154,267 and Nguyen agreed to pay $13,039 while accepting penny stock bars and permanent suspensions from appearing and practicing before the SEC as attorneys, which includes representing clients in SEC matters including investigations, litigation, or examinations and

advising clients about SEC filing obligations or content. Felix agreed to a penny stock bar, officer-and-director bar, and payment of $63,695.

Empire Stock Transfer agreed to pay more than $154,000, and Blevins agreed to pay $20,000 and be permanently barred from the securities industry.

The SEC's investigations were conducted by Tracy Sivitz, Ernie A. Amparo, Douglas Smith, David Stoelting, Christopher Dunnigan, and Sandeep Satwalekar. The cases were supervised by Lara Shalov Mehraban and Anita B. Bandy. The SEC appreciates the assistance of the Financial Industry Regulatory Authority, Swiss Financial Market Supervisory Authority, Québec Autorité des Marchés Financiers, British Columbia Securities Commission, Hong Kong Securities and Futures Commission, Liechtenstein Financial Market Authority, Turks and Caicos Islands Financial Services Commission, and Guernsey Financial Services Commission.

The SEC also has released a white paper produced by its Division of Economic and Risk Analysis outlining some consequences of investing in stocks quoted in the microcap markets versus those listed on a national securities exchange. The white paper analyzed 1.8 million trades by more than 200,000 individual investors and determined that individual investor returns in the microcap markets tend to be negative, with returns worsening for penny stocks of less transparent companies and those that have experienced an alleged promotional campaign. Demographic analysis revealed that older, retired, low-income, and less-educated investors experience significantly poorer outcomes in microcap stock markets. The white paper also reports recent trends in the microcap markets and synthesizes academic research on the documented risks of investing in these stocks.

The SEC's Office of Investor Education and Advocacy recently issued a series of three bulletins to educate investors about microcap stocks and their marketplaces. The bulletins discuss the unique characteristics of microcap stocks and where they're traded, outline resources for investors to get information about microcap companies, and note the risks and red flags for investors to keep in mind.

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Related Materials

- SEC Order - Muellerleile and M2 Law Professional Corp.
- SEC Order - Nguyen
- SEC Order - Felix
- SEC Order - Blevins and Empire Stock Transfer

3. SEC Press Release: Ernst & Young, Former Partners Charged with Violating Auditor Independence Rules (September 19, 2016)

Press Release

Ernst & Young, Former Partners Charged With Violating Auditor Independence Rules

First SEC Enforcement Actions for Auditor Independence Failures Due to Close Personal Relationships

FOR IMMEDIATE RELEASE
2016-187

Washington D.C., Sept. 19, 2016— The Securities and Exchange Commission today announced that public accounting firm Ernst & Young has agreed to pay $9.3 million to settle charges that two of the firm's audit partners got too close to their clients on a personal level and violated rules that ensure firms maintain their objectivity and impartiality during audits.

SEC investigations found that the senior partner on an engagement team for the audit of a New York-based public company maintained an improperly close friendship with its chief financial officer, and a different partner serving on an engagement team for the audit of another public company was romantically involved with its chief accounting officer. Ernst & Young misrepresented in audit reports issued with the companies' financial statements that it maintained its independence throughout these audits.

"These are the first SEC enforcement actions for auditor independence failures due to close personal relationships between auditors and client personnel," said Andrew J. Ceresney, Director of the SEC's Division of Enforcement. "Ernst & Young did not do enough to detect or prevent these partners from getting too close to their clients and compromising their roles as independent auditors."

According to the SEC's order finding that Gregory S. Bednar caused auditor independence rule violations at Ernst & Young from January 2012 to March 2015, he was specifically tasked by the firm to improve its relationship with the New York-based audit client because it was a "troubled account." Bednar and the company's CFO stayed overnight at each other's homes on multiple occasions and traveled together with family members on overnight trips with no valid business purpose, and they exchanged hundreds of personal text messages, emails, and voicemails during the auditing periods. Bednar also became friends with the CFO's son and often treated them to sporting events and other gifts. Certain Ernst & Young partners became aware of Bednar's excessive entertainment spending but took no action to confirm that Bednar was complying with his independence obligations.

Bednar and Ernst & Young consented to the SEC's order without admitting or denying the findings. The firm agreed to pay $4.975 million in monetary sanctions for these violations. Bednar must pay a $45,000 penalty and is suspended from appearing and practicing before the SEC as an accountant, which includes not participating in the financial reporting or audits of public companies. The SEC's order permits Bednar to apply for reinstatement after three years. Bednar no longer works at Ernst & Young.

According to the SEC's order finding that Pamela Hartford caused auditor independence rule violations at Ernst & Young from March 2012 to June 2014, she maintained a romantic relationship with financial executive Robert Brehl while she served on the engagement team auditing his company. Meanwhile another Ernst & Young partner named Michael Kamienski, who supervised Hartford on the audit, became aware of facts suggesting the improper relationship yet failed to perform a reasonable inquiry or raise concerns internally to Ernst & Young's U.S. independence group.

According to the SEC's order, Ernst & Young required audit engagement teams to follow certain procedures to assess their independence, and employees were asked whether they had familial, employment, or financial relationships with audit clients that could raise independence concerns. But these procedures did not specifically inquire about non-familial close personal relationships that could impair the firm's independence.

Ernst & Young, Hartford, Kamienski, and Brehl consented to the SEC's order without admitting or denying the findings. The firm agreed to pay $4.366 million in monetary sanctions for these violations, and Hartford and Brehl agreed to pay penalties of $25,000 each. Hartford, Kamienski, and Brehl are suspended from appearing and practicing before the SEC as accountants, which includes not participating in the financial reporting or audits of public companies. The SEC's order permits Brehl to apply for reinstatement after one year, and Hartford and Kamienski can apply after three years. Hartford and Kamienski no longer work at Ernst & Young.

The SEC's investigation involving the audit of the New York-based issuer was conducted by Vanessa De Simone, John O. Enright, Lisa Knoop, and Thomas P. Smith Jr., and was supervised by Sanjay Wadhwa. The investigation involving the audit of the other issuer was conducted by Deborah R. Maisel and Amanda deRoo, and was supervised by Jennifer S. Leete. The SEC appreciates the assistance of the Public Company Accounting Oversight Board.

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Related Materials

- SEC order - E&Y, Bednar
- SEC order - E&Y, Hartford et al

4. **Andrew Ceresney Speech: "The SEC's Whistleblower Program- The Successful Early Years" (September 14, 2016)**

Speech

The SEC's Whistleblower Program: The Successful Early Years

Andrew Ceresney, Director, Division of Enforcement

Sixteenth Annual Taxpayers Against Fraud Conference
Washington, D.C.

Sept. 14, 2016

Introduction

Good morning and thank you Molly [Knobler] for that very kind introduction. It's a pleasure to speak with you all today. Before I start, I must give our standard disclaimer that the views I express today are my own and do not necessarily reflect the views of the Commission or its staff.[1]

I am pleased to have the opportunity this morning to speak about the Commission's whistleblower program to an audience so integral to that program, whistleblowers and their counsel. Whistleblowers provide an invaluable public service, often at great personal and professional sacrifice and peril. I cannot overstate the appreciation we have for the willingness of whistleblowers to come forward with evidence of potential securities law violations. I often speak of the transformative impact that the program has had on the Agency, both in terms of the detection of illegal conduct and in moving our investigations forward quicker and through the use of fewer resources. The success of the program can be seen, in part, in the over $107 million we have paid to 33 whistleblowers for their valuable assistance, in cases with more than $500 million ordered in sanctions.[2] But it can also be seen in my daily interactions with enforcement teams who when I ask the question of how an investigation began, often respond by pointing to a whistleblower.

The Commission also has taken significant actions to ensure that employees feel secure in reporting wrongdoing. As Chair White remarked in a speech last year, "[w]e want whistleblowers — and their employers — to know that employees are free to come forward without fear of reprisals."[3] The Commission has brought its first settled action under the anti-retaliation provisions of the Dodd-Frank Act,[4] and four settled actions against companies for violating Rule 21F-17, which prohibits anyone from taking any action to impede communications with the SEC about possible securities law violations.[5] The Commission has also actively supported the anti-retaliation protections for whistleblowers through its filing of *amicus* briefs. Notably, the Commission has filed six briefs in courts of appeals, and nearly a dozen briefs in district courts, in support of its rule clarifying that individuals who make internal reports of possible securities law violations are protected under the Commission's whistleblower rules.[6]

The bottom line is that in its short history, our whistleblower program has had tremendous impact. And, as imitation is the sincerest form of flattery, other domestic and foreign regulators have sought to replicate the successes of our program.[7]

I want to spend my time with you today focusing on a few areas that I hope will be of interest to you. First, I will discuss the history of our Whistleblower Office and how the Office has grown since its inception. Second, I want to give you a sense of the types of cases where a whistleblower's assistance is particularly valuable, which line up with some of our overall enforcement priorities. Third, I want to discuss the different types of whistleblowers we have seen and the timing of their provision of information. Finally, I will close with some observations on how whistleblowers — and their counsel — can be most helpful to our enforcement efforts.

A Brief History of the SEC's Office of the Whistleblower

The SEC's Office of the Whistleblower opened its doors in the wake of the most serious financial crisis to hit our economy since the Great Depression. The Office started with a staff consisting of our first chief, deputy chief, and five detailees. The leanly-staffed Office had a tremendous task in starting off the program.

Following the adoption of the final rules, the Office's work kicked into high gear. Among other things, the Office's staff provided the Enforcement Division with extensive training on the final whistleblower rules, established a publicly-available Whistleblower hotline for members of the public to call with questions about the program, and designed and launched an Office of the Whistleblower website.

Today, there are 18 dedicated staff attorneys, paralegals and support staff responsible for the initial review and intake of whistleblower tips received by the Commission, for tracking whistleblower tips as they work their way through our investigative pipeline, for evaluating whistleblower award claims, and for making recommendations to the Commission's Claims Review Staff, which makes recommendations to the Commission on award claims. Our dedicated staff has made significant strides in executing the program's mission, which is to incentivize individuals to provide the Commission with specific, credible and timely information about possible federal securities law violations, and thereby enhance the Commission's ability to act swiftly to protect investors from harm and bring violators to justice.

Since the inception of the program, the Office has received more than 14,000 tips from whistleblowers in every state in the United States and from over 95 foreign countries.[8] What's more, tips from whistleblowers increased from 3,001 in fiscal year 2012 — the first full fiscal year that the Commission's Whistleblower Office was in operation — to nearly 4,000 last year, an approximately 30% increase.[9] And we are on target to exceed that level this year. During fiscal year 2015, the Office returned over 2,800 phone calls from members of the public.[10] By the end of fiscal year 2015, the Commission and Claims Review Staff had issued Final Orders and Preliminary Determinations with respect to over 390 claims for whistleblower awards.[11]

Types of SEC Cases where Whistleblower Assistance Is Valued

I now want to turn my attention to discussing particular categories of cases. Let me be clear — as long as a whistleblower believes that he or she has information that may suggest a violation of the federal

securities laws, we are interested in hearing from them. That said, there are certain categories of cases where we have found whistleblower assistance particularly invaluable.

Issuer Reporting and Disclosure

Issuer reporting and disclosure cases are one category of cases where whistleblower assistance is extremely helpful. Last fiscal year, excluding follow-on proceedings, the Commission brought 114 actions against 191 parties involving financial fraud.[12] These investigations typically involve misconduct that is hard to spot and are typically very document-intensive, involving sophisticated defense counsel. Whistleblowers — particularly company insiders — are able to provide us with a roadmap of the potential misconduct that can save us months of sifting through documents and complex accounting records. They can also give us a description of the types of documents to request and the types of analyses to conduct. For example, among other actions, we brought a complicated accounting case last year that was built in large part through a whistleblower tip.

Last fiscal year, about 18% of all whistleblower complaints we received involved issuer reporting and disclosures and, since the first full fiscal year of the whistleblower program's operation, we have seen tips in this area increase approximately 25%.[13] This continues to be the most common type of tip.[14] We are hopeful that this trend will continue in future years.

Offering Frauds and Ponzi Schemes

Offering frauds and Ponzi schemes are another class of cases where whistleblowers have greatly aided us. Retail investors are frequently the largest class of victimized investors in these schemes and they also can be difficult to detect until it is too late. Whistleblowers have provided us with timely and valuable tips enabling the Commission to quickly halt these fraudulent schemes and protect investors from further harm. Whistleblowers also have helped focus us on false and misleading statements in offering memoranda or marketing materials, enabling us to act quickly and stop these investment frauds from attracting more investors. Like issuer reporting and disclosures, this is an area where we commonly receive tips — last fiscal year, approximately 16% of our tips related to offering frauds[15] — and we hope this will continue in future years as well.

Foreign Corrupt Practices Act

Another class of cases where whistleblower tips can be helpful is in our enforcement of the Foreign Corrupt Practices Act. Pursuing violations of the FCPA remains an important part of the SEC's enforcement efforts. Most of the activity in these cases is usually overseas, where we have less access to evidence. And parties to these arrangements have great incentives to conceal their conduct. Tips related to FCPA violations have increased from 115 in fiscal year 2012 to 186 in fiscal year 2015 — an approximate 62% increase.[16] Because of the difficulties in investigating overseas conduct, we are hopeful this trend will continue. Here, though, I want to highlight a subsidiary benefit of the whistleblower program. We are often alerted to FCPA violations by companies self-reporting violations. The program has vastly increased the incentives for companies to self-report misconduct to us, as companies are aware that we may receive information from other sources if they are not forthcoming with us, and as I have emphasized before, if we learn the company made the decision not to self-report after learning of misconduct, there will be consequences. So even before the tips are sent, the impact of the program manifests in other ways as well.

I should note here that international whistleblowers can add great value to our investigations. Recognizing the value of international whistleblowers, we have made eight awards to whistleblowers

living in foreign countries. In fact, our largest whistleblower award to date — $30 million — went to a foreign whistleblower who provided us with key original information about an ongoing fraud that would have been very difficult to detect.[17] In making this award, the Commission staked out a clear position that the fact that a whistleblower is a foreign resident does not prevent an award when the whistleblower's information led to a successful Commission enforcement action brought in the United States concerning violations of the U.S. securities laws.[18]

Who Qualifies as a Dodd-Frank Whistleblower

One issue we have faced as we addressed the first series of awards is who qualifies as a whistleblower under the Dodd-Frank Act. Based on Section 922 of the Dodd-Frank Act, the Commission's Rule 21F-2 defines a whistleblower as any individual who, alone or jointly with others, provides the Commission with information relating to a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur. Importantly, to be considered for a whistleblower award, an individual must also follow the procedures described in our rules for submitting his or her information.

Obviously, company insiders are important whistleblowers. Current or former employees are often best positioned to witness wrongdoing and may hold the key to helping our investigators unlock intricate fraudulent schemes and investigate the full extent of violations. And, the Commission's rules provide incentives to company insiders to report misconduct internally before or simultaneous to SEC reporting. For example, a whistleblower who internally reports, and at the same time or within 120 days reports to the Commission, will receive credit for any information the company subsequently provides to the SEC.[19] A whistleblower's participation in internal compliance systems also is a factor that will generally increase an award.[20]

Through 2015, almost half of the award recipients were current or former employees of the companies for which they reported wrongdoing,[21] and insiders continue to be an important source of tips. For example, last month, the Commission announced an award of more than $22 million to a whistleblower whose detailed tip and extensive assistance helped us halt well-hidden wrongdoing at the company where the whistleblower worked.[22] The Commission also recently announced an award of between $5 million and $6 million to a former company insider whose detailed tip led us to uncover securities violations which would have been nearly impossible for us to uncover otherwise.[23] And, last year, the Commission announced a whistleblower award of more than $3 million to a company insider whose specific and detailed information comprehensively laid out a complex fraudulent scheme.[24]

Compliance and internal audit personnel also can be whistleblowers (1) if the information is reported to the Commission at least 120 days after providing it to the employer's audit committee, chief legal officer, chief compliance officer, or a supervisor; (2) if they have a reasonable basis to believe that disclosure to the Commission was necessary to prevent imminent misconduct from causing substantial financial harm to the company or investors; or (3) if they have a reasonable basis to believe that the company is engaging in conduct that will impede an investigation. Awards have been made under the first two exceptions. In August 2014, the Commission announced its first award to a whistleblower with an audit or compliance function at a company who reported wrongdoing to us after the company failed to take action when the employee reported it internally.[25] And, in April 2015, we made an award of more than $1 million to a compliance professional who had a reasonable basis to believe that disclosure to the Commission was necessary to prevent imminent misconduct from causing substantial financial harm to the company or investors.[26]

Importantly, company outsiders also can be whistleblowers and their assistance can be very valuable. Data analysis is one area where outsiders can be useful. The voluntary submission of high-quality analysis by industry experts can be just as valuable as first-hand knowledge of wrongdoing by company insiders. We welcome analytical information from those with in-depth market knowledge and experience that may provide the springboard for an investigation or may supplement an ongoing investigation. For example, earlier this year, the Commission announced an award of more than $700,000 to an individual who was a company outsider and who provided us this type of data analysis, leading to a successful enforcement action.[27]

Finally, I want to say a word about participants in wrongdoing and their ability to be whistleblowers. It is important for participants in misconduct to understand that, in many circumstances, they are eligible for awards and we would like to hear from them. Obviously, culpable insiders with first-hand knowledge of misconduct can provide valuable information and assistance in identifying participants in, transactions relating to, and proceeds of, fraudulent schemes. And, while there are safeguards built into the program to ensure that whistleblowers do not profit from their own misconduct, including where they substantially directed, planned or initiated the misconduct of an entity, or conduct for which they are criminally convicted, culpable whistleblowers can still get paid for eligible information they report that falls outside of these limitations. In these other cases, while culpability is a factor that is considered when determining the award percentage, any whistleblower who qualifies for an award under our rules, including a culpable one, will receive at least 10% (collectively if there are other whistleblowers or alone if not) of the monetary sanctions collected in the enforcement action. There are also other potential benefits for culpable whistleblowers — in appropriate circumstances, we will take their cooperation under the whistleblower program and in our investigation into consideration in deciding what remedies, if any, are appropriate in any action we determine should be brought against the whistleblowers for their role in the scheme.

Timing of Whistleblower Assistance

Another question our program has faced is at what point in time whistleblower assistance can help the Commission's enforcement efforts such that the assistance will be eligible for an award. Whistleblowers can be helpful at any point during our investigation. While "the primary focus of the program is to encourage the submission regarding conduct not already known to us,"[28] there is no requirement under the Dodd-Frank Act or our rules that a whistleblower originate a case in order to qualify for an award. In fact, our rules provide that information that leads to the success of an enforcement action — thus triggering potential eligibility for an award — is information that causes the Commission to commence an examination, open or reopen an investigation, or to inquire into different courses of conduct where the resulting enforcement action is based on the whistleblower's tip, or that otherwise significantly contributes to the success of an enforcement action.[29] If an investigation is underway, a whistleblower will be eligible for an award if his or her information "significantly contributes" to our success by, for example, allowing us to bring a successful action in significantly less time or with significantly fewer resources, bring additional successful claims, or bring successful claims against additional parties.[30]

The Commission has made significant awards to whistleblowers recognizing that they provide critical information at all phases of our investigatory processes. For example, in May 2016, the Commission announced an award of more than $3.5 million to a company employee whose tip bolstered an ongoing investigation with additional evidence of wrongdoing that substantially strengthened our ongoing case and increased our leverage during settlement negotiations with the entity.[31] In June,

the Commission announced a whistleblower award of more than $17 million to a former company employee whose detailed tip enabled our enforcement staff to conserve time and resources and gather strong evidence supporting our already ongoing case.[32] So the bottom line is that whistleblowers should not shy away from providing us information, even if we have an investigation ongoing.

A related issue we have grappled with is how to evaluate the timing of whistleblower tips when determining award size. My general message to whistleblowers is to report as soon as you learn of misconduct, as you never know whether someone else will report, whether the information will become stale, or whether the statute of limitations will run. Coming forward without delay also helps prevent misconduct from continuing unabated while investors suffer more harm.

Unreasonable delay in the reporting of information to us is a significant factor the Commission considers in determining the amount of a whistleblower award. For example, approximately 20% of the awards made through 2015 were reduced because of an unreasonable reporting delay.[33] And late last year, the SEC announced a whistleblower award totaling more than $325,000 to a former investment firm employee who tipped the agency with specific information that enabled enforcement staff to open an investigation and uncover the extent of the fraudulent activity.[34] The whistleblower in that case waited until after leaving the firm to come forward to us.[35] The award could have been higher had this whistleblower not hesitated.[36] We know that making the decision to report is not an easy one, and we take the specific facts and circumstances surrounding the reporting into consideration as we evaluate each claim. That said, we are particularly mindful that whistleblowers should not benefit from the delay in reporting to the extent that delay results in a significant increase in the monetary remedies we recover, and hence the potential whistleblower award. We will continue to evaluate the impact of delay as we make future award determinations.

Closing Thoughts For Whistleblowers and Whistleblower Attorneys

I want to close my remarks today with some thoughts on what whistleblowers and, for whistleblowers who engage attorneys to assist them, their counsel can do to help us in our enforcement efforts.

One thing I get asked about a lot is how we view whistleblower counsel. It will come as no surprise to this audience that we welcome the involvement of counsel in whistleblower tips. While whistleblowers can engage with us without the assistance of counsel, counsel experienced in whistleblower representations can help with up-front triage of tips to identify those that have a nexus with the federal securities laws and that may have merit. And they can work with whistleblowers going forward to identify information that will be important to us and that will allow us to advance our investigations.

Counsel for whistleblowers can also help manage client expectations regarding the length of our investigations and the length of the awards process. We do not conclude our investigations overnight, and how long an investigation takes depends very much on the facts and circumstances of the investigation. For instance, it is not uncommon for financial fraud investigations, which typically involve numerous documents and witnesses, to take a significant period of time. FCPA investigations frequently involve overseas evidence and coordination with foreign regulators and our criminal counterparts at the Department of Justice. Whistleblower counsel can help by emphasizing to clients that the passage of time without contact does not mean we are not taking the allegations seriously. In this regard, it is also helpful to remind clients that, because our investigations are nonpublic, we are very limited in what we can disclose about ongoing investigations.

And, similar to our investigations, the award process takes time. There are sometimes multiple claimants applying for an award in a matter — we have had up to 16 in one matter. Our Whistleblower Office gives each one the attention and due diligence that it deserves. The award applications also often present unique, first impression issues that require careful review and thought.

Next, it is important for whistleblowers to consider whether they can provide corroborating information for their tips. There obviously are several types of corroboration, including documents,[37] names of other individuals who can provide additional information, or independent analysis that might reinforce the validity of their tip. Any supporting evidence may help us investigate more quickly.

At the same time, in an effort to be helpful, whistleblowers are often tempted to provide us with information that may protected by the attorney-client privilege or the work product doctrine. This is not helpful and in fact can substantially delay our investigation. If whistleblowers or their attorneys are unsure whether something is privileged, it is best to segregate the material and engage in a dialogue with us to determine how to proceed.

Another important aspect of our whistleblower program is confidentiality. We have built the program to ensure that the identity of whistleblowers will remain confidential, with certain limited exceptions. Individuals can report anonymously under our program with the assistance of an attorney; we make requests of companies for documents and testimony in ways that seek to protect the whistleblower's identity; and we disclose nothing that may identify the whistleblower in any of our award announcements. We are committed to ensuring that, consistent with legal requirements, whistleblowers' identities are protected and whistleblowers should be assured that we will do all we can to protect them. One way attorneys and whistleblowers can help us to maintain their confidentiality is to identify any facts they are disclosing, or documents that they are providing, that may tend to identify the whistleblower. This will help us to craft document requests and conduct testimony in the most protective manner.

A final way that whistleblowers and their counsel can be helpful is through assisting us with our outreach efforts. One of our Whistleblower Office's primary goals is to increase public awareness of the Commission's whistleblower program. As part of that outreach effort, the Office has actively participated in numerous webinars, media interviews, presentations, press releases, and other public communications since the program's inception. Just last fiscal year, our Whistleblower Office's staff participated in over 20 public engagements aimed at promoting and educating the public concerning the Commission's whistleblower program.[38] By raising awareness of the program, we hope to receive an even greater number of high-quality tips that can assist the Commission in discovering and stopping fraudulent schemes early. As more individuals have become aware of the program, we have received, in turn, more award claims. So we ask you to help us publicize the program and increase public awareness of it.

Conclusion

Thank you all for the opportunity to speak today about our whistleblower program. I am proud of the program's accomplishments during its brief existence and anticipate that the whistleblower program will continue to be a game changer in future years. In fact, my prediction is that it will take us significantly less time to announce that we have passed the $200 million milestone than it did to pass the $100 million mark. All signs are that the whistleblower program is performing exceedingly well and I am grateful for all you have done to help make that happen.

I'm happy to take your questions.

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

[2] Press Release 2016-173, *SEC Whistleblower Program Surpasses $100 Million in Awards* (Aug. 30, 2016), available at https://www.sec.gov/news/pressrelease/2016-173.html.

[3] Chair Mary Jo White, U.S. Secs. & Exch. Comm'n, *The SEC as the Whistleblower's Advocate* (Apr. 30, 2015), available at https://www.sec.gov/news/speech/chair-white-remarks-at-garrett-institute.html.

[4] Press Release 2014-118, *SEC Charges Hedge Fund Adviser With Conducting Conflicted Transactions and Retaliating Against Whistleblower* (June 16, 2014), available at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307.

[5] Press Release 2016-164, *Company Punished for Severance Agreements that Removed Financial Incentives for Whistleblowing* (Aug. 16, 2016), available at http://www.sec.gov/news/pressrelease/2016-164.html; Press Release 2016-157, *Company Paying Penalty for Violating Key Whistleblower Protection Rule* (Aug. 10, 2016), available at https://www.sec.gov/news/pressrelease/2016-157.html; Press Release 2016-128, *Merrill Lynch to Pay $415 Million for Misusing Customer Cash and Putting Customer Securities at Risk* (June 23, 2016), available at https://www.sec.gov/news/pressrelease/2016-128.html; Press Release 2015-54, *SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements* (Apr. 1, 2015), available at https://www.sec.gov/news/pressrelease/2015-54.html.

[6] 17 C.F.R. § 240-21F-2(b)(1).

[7] In February 2015, the New York State Attorney General called for legislation to establish a state program modeled on the Commission's. *See* Press Release, *A.G. Schneiderman Proposes Bill To Reward And Protect Whistleblowers Who Report Financial Crimes* (Feb. 26, 2015), available at http://www.ag.ny.gov/press-release/ag-schneiderman-proposes-bill-reward-and-protect-whistleblowers-who-report-financial. And, in July of this year, the Ontario Securities Commission adopted a whistleblower program that tracks ours in certain key ways, as did the Autorité des marchés financiers (AMF) in Quebec, although the AMF's program does not offer rewards for tips. Ontario Secs. Comm'n, *OSC Notice of Policy Adopted under Securities Act, OSC Policy 15-601, Whistleblower Program* (July 14, 2016), available at http://www.osc.gov.on.ca/documents/en/Securities-Category1/20160714_15-601_osc-notice-policy-adopted.pdf; Press Release, *AMF launches whistleblower Program* (June 20, 2016), available at http://www.lautorite.qc.ca/en/press-releases-2016-conso.html_2016_amf-launches-whistleblower-program20-06-2016-00-0.html . The Australian Securities and Investment Commission also has established a whistleblower's office but, like the AMF, they too do not pay awards. *See* Australian Secs & Investments Comm'n, *Guidance for whistleblowers*, available at http://asic.gov.au/about-asic/asic-investigations-and-enforcement/whistleblowing/guidance-for-whistleblowers/. And, both the states of Indiana and Utah have followed in our wake to create bounty programs. *See* Gretchen Morgenson, *To Crack Down on Securities Fraud, States Reward Whistle-blowers*, N.Y. Times (Aug. 21, 2016), available at

http://www.nytimes.com/2016/08/22/business/to-crack-down-on-securities-fraud-states-reward-whistle-blowers.html?_r=0 .

[8] *See* Sean McKessy, Chief, Office of the Whistleblower, U.S. Secs. & Exch. Comm'n, *Testimony on Continued Oversight of the SEC's Offices and Divisions: Office of the Whistleblower* (Apr. 21, 2016), available at https://www.sec.gov/news/testimony/testimony-04-21-16.html; U.S. Secs. & Exch. Comm'n, *2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program* at 24 (Nov. 16, 2015) ("2015 Annual Report"), available at https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2015.pdf.

[9] *Compare* Press Release 2012-229, *SEC Receives More than 3000 Whistleblower Tips in FY2012* (Nov. 15, 2012), available at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171485882 *with* 2015 Annual Report, *supra* note 8, at 1.

[10] 2015 Annual Report, *supra* note 8, at 8.

[11] *Id.* at 1.

[12] Andrew Ceresney, Director, Div. of Enforcement, U.S. Secs. & Exch. Comm'n, *Directors Forum 2016 Keynote Address* (Jan. 25, 2016), available at https://www.sec.gov/news/speech/directors-forum-keynote-ceresney.html.

[13] 2015 Annual Report, *supra* note 8, at 22, 28.

[14] *Id.*

[15] *Id.* at 22.

[16] *Id.* at 28.

[17] Press Release 2014-206, *SEC Announces Largest-Ever Whistleblower Award* (Sept. 22, 2014), available at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543011290.

[18] *Claim for Award in connection with [Redacted]*, Exchange Act Release No. 73174 (Sept. 22, 2014) (Order Determining Whistleblower Award Claim), available at https://www.sec.gov/rules/other/2014/34-73174.pdf.

[19] 17 C.F.R. § 240.21F-4(b)(7).

[20] *Id.* § 240.21F-6(a)(4).

[21] 2015 Annual Report, *supra* note 8, at 16.

[22] Press Release 2016-172, *$22 Million Whistleblower Award for Company Insider Who Helped Uncover Fraud* (Aug. 30, 2016), available at http://www.sec.gov/news/pressrelease/2016-172.html.

[23] Press Release 2016-91, *SEC Awards More Than $5 Million to Whistleblower* (May 17, 2016), available at https://www.sec.gov/news/pressrelease/2016-91.html.

[24] Press Release 2015-150, *SEC Pays More than $3 Million to Whistleblower* (July 17, 2015), available at https://www.sec.gov/news/pressrelease/2015-150.html.

[25] Press Release 2014-180, *SEC Announces $300,000 Whistleblower Award to Audit and Compliance Professional Who Reported Company's Wrongdoing* (Aug. 29, 2014), available at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812.

[26] Press Release 2015-73, *SEC Announces Million-Dollar Whistleblower Award to Compliance Officer* (Apr. 22, 2015), available at https://www.sec.gov/news/pressrelease/2015-73.html.

[27] Press Release 2016-10, *SEC Awards Whistleblower More Than $700,000 for Detailed Analysis* (Jan. 15, 2016), available at https://www.sec.gov/news/pressrelease/2016-10.html.

[28] *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, Exchange Act Release No. 64545 at 100 (May 25, 2011) (codified at 17 C.F.R. Parts 240 and 249), available at https://www.sec.gov/rules/final/2011/34-64545.pdf. ("Adopting Release").

[29] 17 C.F.R. § 21F-4(c)(1), (2).

[30] Adopting Release, *supra* note 28, at 100.

[31] Press Release 2016-88, *Whistleblower Earns $3.5 Million Award for Bolstering Ongoing Investigation* (May 13, 2016), available at http://www.sec.gov/news/pressrelease/2016-88.html.

[32] Press Release 2016-114, *SEC Issues $17 Million Whistleblower Award* (June 9, 2016), available at http://www.sec.gov/news/pressrelease/2016-114.html.

[33] 2015 Annual Report, *supra* note 8, at 18.

[34] Press Release 2015-252, *SEC Announces Whistleblower Award of More Than $325,000* (Nov. 4, 2015), available at https://www.sec.gov/news/pressrelease/2015-252.html.

[35] *Id.*

[36] *Id.*

[37] Press Release 2012-162, *SEC Issues First Whistleblower Program Award* (Aug. 21, 2012), available at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483972; Press Release 2013-209, *SEC Awards More than $14 Million to Whistleblower* (Oct. 1, 2013), available at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258.

[38] 2015 Annual Report, *supra* note 8 at 8.

Modified: Sept. 14, 2016

5. SEC Press Release: $22 Million Whistleblower Award for Company Insider Who Helped Uncover Fraud (August 30, 2016)

Press Release

$22 Million Whistleblower Award for Company Insider Who Helped Uncover Fraud

FOR IMMEDIATE RELEASE
2016-172

Washington D.C., Aug. 30, 2016— The Securities and Exchange Commission today announced the award of more than $22 million to a whistleblower whose detailed tip and extensive assistance helped the agency halt a well-hidden fraud at the company where the whistleblower worked.

The $22 million-plus award is the second-largest total the SEC has awarded a whistleblower. The largest, $30 million, was awarded in 2014.

"Company employees are in unique positions behind-the-scenes to unravel complex or deeply buried wrongdoing. Without this whistleblower's courage, information, and assistance, it would have been extremely difficult for law enforcement to discover this securities fraud on its own," said Jane Norberg, Acting Chief of the SEC's Office of the Whistleblower.

The SEC's whistleblower program, which has been rewarding valuable information from tipsters since its inception in 2011, has now surpassed $100 million in total money awarded. More than $107 million has been awarded to 33 whistleblowers who became eligible for an award by voluntarily providing the SEC with original and useful information that led to a successful enforcement action. Whistleblower awards can range from 10 percent to 30 percent of the money collected when the monetary sanctions exceed $1 million. All payments are made out of an investor protection fund established by Congress that is financed through monetary sanctions paid to the SEC by securities law violators. No money has been taken or withheld from harmed investors to pay whistleblower awards.

By law, the SEC protects the confidentiality of whistleblowers and does not disclose information that might directly or indirectly reveal a whistleblower's identity.

For more information about the whistleblower program and how to report a tip: www.sec.gov/whistleblower.

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Related Materials

- SEC order

6. **SEC Press Release: Company Settles Charges in Whistleblower Retaliation Case (December 20, 2016)**

Press Release

Company Settles Charges in Whistleblower Retaliation Case

FOR IMMEDIATE RELEASE
2016-270

Washington D.C., Dec. 20, 2016— The Securities and Exchange Commission today announced that an oil-and-gas company has agreed to settle charges that it used illegal separation agreements and retaliated against a whistleblower who expressed concerns internally about how its reserves were being calculated.

The SEC's order finds that Oklahoma City-based SandRidge Energy Inc. conducted multiple reviews of its separation agreements after a new whistleblower protection rule became effective in August 2011, yet continued to regularly use restrictive language that prohibited outgoing employees from participating in any government investigation or disclosing information potentially harmful or embarrassing to the company.

The SEC's order further finds that SandRidge fired an internal whistleblower who kept raising concerns about the process used by SandRidge to calculate its publicly reported oil-and-gas reserves. The employee had been offered a promotion, which was turned down. Just months later, senior management concluded the employee was disruptive and could be replaced with someone "who could do the work without creating all the internal strife." The company had conducted no substantial investigation of the whistleblower's concerns and only initiated an internal audit that was never completed. The employee's separation agreement also contained the company's prohibitive language that violated the whistleblower protection rule.

"Ignoring a rule that protects communications between outgoing employees and the SEC, SandRidge flatly prohibited such contact in their separation agreements and at the same time retaliated against an employee who raised concerns about the company to its management," said Shamoil T. Shipchandler, Director of the SEC's Fort Worth Regional Office.

Jane Norberg, Chief of the SEC's Office of the Whistleblower, added, "Whistleblowers who step forward and raise concerns internally to their companies about potential securities law violations should be protected from retaliation regardless of whether they have filed a complaint with the SEC. This is the first time a company is being charged for retaliating against an internal whistleblower, and the second enforcement action this week against a company for impeding employees from communicating with the SEC."

Without admitting or denying the SEC's findings, SandRidge agreed to pay a penalty of $1.4 million, subject to the company's bankruptcy plan.

The SEC's investigation was conducted by Tamara F. McCreary, Timothy L. Evans, and David R. King and supervised by Jonathan P. Scott and David L. Peavler of the Fort Worth office.

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Related Materials

- SEC order

Modified: Dec. 20, 2016

7. SEC Press Release: Casino-Gaming Company Retaliated Against Whistleblower (September 29, 2016)

Press Release

SEC: Casino-Gaming Company Retaliated Against Whistleblower

FOR IMMEDIATE RELEASE
2016-204

Washington D.C., Sept. 29, 2016— The Securities and Exchange Commission today announced that casino-gaming company International Game Technology (IGT) has agreed to pay a half-million dollar penalty for firing an employee with several years of positive performance reviews because he reported to senior management and the SEC that the company's financial statements might be distorted.

In its second whistleblower retaliation case since the Dodd-Frank Act authorized the agency to bring such charges, the SEC found that the employee was removed from significant work assignments within weeks of raising concerns about the company's cost accounting model. He was terminated approximately three months later.

"Strong enforcement of the anti-retaliation protections is critical to the success of the SEC's whistleblower program. This whistleblower noticed something that he felt might lead to inaccurate financial reporting and law violations, and he was wrongfully targeted for doing the right thing and reporting it," said Andrew J. Ceresney, Director of the SEC's Division of Enforcement.

"Bringing retaliation cases, including this first stand-alone retaliation case, illustrates the high priority we place on ensuring a safe environment for whistleblowers," said Jane A. Norberg, Chief of the SEC's Office of the Whistleblower. "We will continue to exercise our anti-retaliation authority when companies take reprisals for whistleblowing efforts."

According to the SEC's order, IGT conducted an internal investigation into the allegations made by the whistleblower, who did not oversee the company's accounting functions, and determined its reported financial statements contained no misstatements.

Without admitting or denying the SEC's findings, IGT agreed to pay the $500,000 penalty and cease and desist from committing or causing any further violations of Section 21F(h) of the Securities Exchange Act of 1934.

The SEC's investigation was conducted by Brent W. Wilner, Rhoda H. Chang, and Gary Y. Leung, and the case was supervised by Diana K. Tani, John W. Berry, C. Dabney O'Riordan, and Michele W. Layne of the Los Angeles Regional Office. The SEC appreciates the assistance of the U.S. Labor Department's Occupational Safety and Health Administration.

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8. SEC *Amicus Curiae* Brief in *Wadler v. Bio-Rad Laboratories, Inc.* (December 13, 2016)

THOMAS J. KARR (D.C. Bar No. 426340)
KarrT@sec.gov
KAREN J. SHIMP (D.C. Bar No. 456265)
ShimpK@sec.gov
ERIC A. REICHER (D.C. Bar No. 490866)
ReicherE@sec.gov

SECURITIES AND EXCHANGE COMMISSION
Office of the General Counsel
100 F Street NE
Washington, DC 20549-9612
Telephone: (202) 551-5163 (Karr)
Facsimile: (202) 772-9263

Attorneys for *Amicus Curiae SEC*

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

SANFORD S. WADLER, Plaintiff, vs. BIO-RAD LABORATORIES, INC., a Delaware Corporation; NORMAN SCHWARTZ; LOUIS DRAPEAU; ALICE N. SCHWARTZ; ALBERT J. HILLMAN; DEBORAH J. NEFF, Defendants.	No. 3:15-cv-2356 JCS ***AMICUS CURIAE* BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN SUPPORT OF PLAINTIFF** --- Hearing Date: December 15, 2016 Time: 10:30 A.M. Place: Courtroom G, 15th Floor Judge: Hon. Joseph C. Spero TRIAL: January 17, 2017

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Interest of the Securities and Exchange Commission

The Commission is the agency primarily responsible for administering and enforcing the federal securities laws, including anti-bribery, books and records, and internal controls provisions of the Foreign Corrupt Practices Act ("FCPA").[1] Attorneys employed by public companies play a significant role in assisting those companies in complying with these important obligations, which are designed to protect investors and the capital markets. As the Commission has observed, "[a]ttorneys [] play an important and expanding role in the internal processes and governance of issuers, ensuring compliance with applicable reporting and disclosure requirements, including requirements mandated by the federal securities laws."[2]

Under Commission rules, attorneys employed by public companies are obligated to report evidence of material violations of law by their companies to company management. Thus, the Commission has a strong interest in ensuring that public companies do not retaliate against attorney-whistleblowers who, upon becoming aware of potential material violations, report them to management. If attorney–whistleblowers cannot use their reports to management of potential violations as evidence in anti-retaliation litigation against their employers, then the Congressional scheme of requiring lawyers for public companies to report potential

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[1] *See* 15 U.S.C. 78dd-1; 78m(b)(2)(A), (B).

[2] *See* Securities and Exchange Commission, Implementation of Standards of Professional Conduct for Attorneys, 68 FR 6295, 6325 (Feb. 6, 2003); *see also* Cong. Rec. S6551 (Jul. 10, 2002) (remarks of Sen. Edwards) ("wherever you see corporate executives and accountants working, lawyers are virtually always there looking over their shoulder"); Cong. Rec. S6555 (Jul. 10, 2002) (remarks of Sen. Enzi) ("attorneys are hired to aid the corporation and its accountants in adhering to Federal securities law"); Cong. Rec. S6556 (Jul. 10, 2002) (remarks of Sen. Corzine) ("The bottom line is this. Lawyers can and should play an important role in preventing and addressing corporate fraud."); "The Preliminary Report of the ABA Task Force on Corporate Responsibility," (Jul. 16, 2002) ("our system of corporate governance has long relied upon the active oversight and advice of independent participants in the corporate governance process, such as . . . outside counsel.").

violations, while protecting them from reprisals through the anti-retaliation provisions of the securities laws, would be seriously undermined.[3] Bio-Rad's motion to exclude Wadler's evidence regarding his report to Bio-Rad's management about possible violations of law challenges the supremacy of the Commission's regulations over California state ethics rules that would interfere with the effectiveness of the federal scheme to protect attorney-whistleblowers.[4]

Legal Background and Issue Presented

In 2002, the Sarbanes-Oxley Act ("SOX") mandated a number of reforms to enhance corporate responsibility and combat corporate and accounting fraud. One of those reforms, SOX Section 307, required the Commission to "issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule **requiring** an **attorney** to **report** evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company * * *" to increasingly higher levels of the company, including if necessary the company's audit committee or the board of directors.[5] An attorney's report of possible violations to company

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[3] In addition to creating a private right of action for whistleblowers, Congress gave the Commission authority to enforce the anti-retaliation laws. *See* Section 21(d) of the Exchange Act, 15 U.S.C. 78u(d): "Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this title [or] the rules or regulations thereunder … it may in its discretion bring an action in the proper district court of the United States * * *."

[4] For example, a decision that California law takes precedence over the Commission's regulations could interfere with California-licensed attorneys' ability to reveal confidential information to the Commission in circumstances where the Commission has determined that the attorneys should be allowed to disclose that information without the client's consent. 17 C.F.R. 205.3(d)(2).

[5] 15 U.S.C. 7245 (emphasis added).

1 management is commonly referred to as reporting "up the ladder." The Commission
2 rule implementing Section 307 is referred to as "Part 205." 17 C.F.R. 205.1 *et seq*.
3 In SOX, Congress also enacted protections for employees of public companies[6]
4 against reprisal for reporting potential violations of certain laws, including the
5 federal securities laws and "any rule or regulation of the Securities and Exchange
6 Commission." SOX Section 806, *codified at* 18 U.S.C. 1514A. Section 806 protects
7 attorney-whistleblowers who make an "up the ladder" report against reprisal for
8 that reporting, and provides the right to file a complaint with the Secretary of Labor
9 and, if not decided within 180 days, in federal district court.[7] In 2010, Congress
10 expanded the anti-retaliation remedy by providing the right to file an action directly
11 in district court. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act
12 Section 922, *codified at* Section 21F(h) of the Exchange Act, 15 U.S.C. 78u-6(h).
13 Wadler alleges that the defendants (collectively, "Bio-Rad") fired him for
14 "engaging in mandatory 'up the ladder' reporting" of potential bribery, books and
15 records, or other violations of the FCPA in the company's Chinese operations." He
16 alleges that he made his Part 205 report to key Bio-Rad officers and directors and
17 ultimately to the audit committee of Bio-Rad's board of directors. *See* Complaint
18 (DE 1) at ¶¶ 1, 22, 29, 72. Bio-Rad has moved the Court to preclude Wadler from
19 introducing any of the following as evidence at trial:
20
21 - All testimony by Wadler that may be based on information he learned in the course of his service as Bio-Rad's general counsel.
22 - All testimony of other lawyers regarding Bio-Rad's confidential information.
23 - Any reference to or introduction into evidence of Bio-Rad's attorney-client privileged information.
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25 [6] SOX 806 also protects agents and contractors (such as outside counsel) of public companies. *See Lawson v. FMR LLC*, __ U.S. __, 134 S.Ct. 1158, 1168 (2014).
26
27 [7] 18 U.S.C. 1514A(b)(1).

- All questions and responses likely to elicit attorney-client privileged information from any witness and/or confidential information from any lawyer-witness.

DE 94 at ECF p. 2.

The evidentiary limitations Bio-Rad seeks would cover Wadler's Part 205 report as well as any responses thereto. The Commission recognized in promulgating Part 205 that "up the ladder" reports by an attorney-whistleblower would likely include client confidences[8] and that entering those reports into evidence in anti-retaliation litigation would be essential to proving that the attorney was retaliated against for reporting potential wrongdoing. To ensure that attorney-whistleblowers could use those reports as evidence in such litigation,[9] the Commission adopted Section 205.3(d)(1), which provides that "[a]ny report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) **may be used** by an attorney in connection with any investigation, proceeding, or **litigation** in which the attorney's compliance with this part is in issue."[10] The Commission also specified that if "the standards of a state*** where an attorney is admitted or practices conflict with this part, **this part shall govern**."[11]

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[8] While "client confidences" include attorney-client privileged communications, it also encompasses nearly any nonpublic information the attorney becomes aware of as a result of the attorney-client relationship. *See, e.g.*, Model Rule of Professional Conduct ("Model Rule") 1.6, comment 3 ("The confidentiality rule, for example, applies not only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source.").

[9] According to Bio-Rad, Wadler's claims and the company's own defenses "are inextricably intertwined with Bio-Rad's privileged and confidential information," to the point that Wadler may not be able to proceed to trial. DE 94 at ECF p. 8. As we discuss later, Bio-Rad's suggestion that its privilege concerns warrant dismissing Wadler's claims is not well-founded.

[10] 17 C.F.R. 205.3(d)(1) (emphasis added).

[11] 17 C.F.R. 205.1 (emphasis added).

Bio-Rad grounds its motion on California Business & Professions Code Section 6068(e) and California Rule of Professional Conduct 3-100, each of which generally prohibits an attorney from revealing a client's privileged or confidential information. Bio-Rad has asserted that these state laws are not preempted by federal law because "[n]othing in the Sarbanes-Oxley or Dodd-Frank Acts evidences a clear legislative intent to preempt California's ethical and statutory rules." DE 94 at ECF pp. 12-13.[12] More recently, Bio-Rad has asserted that SOX and Part 205 are permissive—that is, an attorney "may" file suit and "may" use a Part 205 report—and thus there is no actual conflict between those provisions and California law. DE 105 at ECF pp. 11-12. Both assertions are wrong.

The Commission respectfully submits that the principal issue the Court must resolve in deciding Bio-Rad's motion is whether the Commission's Part 205 regulations preempt the California state laws that generally prohibit attorneys from disclosing client confidences.[13] The Commission's view is that Section 205.3(d)(1)—without which attorneys complying with their legal obligation to report possible violations would have limited anti-retaliation protection—preempts the California laws on which Bio-Rad relies because those laws would interfere with the effectiveness of Part 205. Accordingly, the Court should deny Bio-Rad's motion.

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[12] Bio-Rad also cites to Federal Rule of Evidence 501 (which provides that federal common law governs privilege claims in certain circumstances), and continues to rely heavily on authority concerning traditional privilege issues in contexts that are significantly different than the one presented here. As shown below, Bio-Rad's reliance on Rule 501 is misplaced.

[13] The Commission does not have any information about the potential evidence beyond what the parties have stated in redacted public filings. In addition, the parties dispute whether and to what extent privilege has been waived by Bio-Rad's disclosures to various government agencies (including the Commission). The Commission does not express any views on those (or any other) factual or legal questions.

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ARGUMENT

I. Section 205.3(d)(1) Applies to This Case.

Bio-Rad contends that Section 205.3(d)(1) does not apply here. DE 105 at ECF pp. 11-12. To the contrary, Bio-Rad's reliance on state laws to exclude evidence of Wadler's Part 205 "up the ladder" reporting presents the precise situation Section 205.3(d)(1) was adopted to address.

The Commission's Part 205 rules explicitly permit attorney-whistleblowers at public companies to use as evidence their "up the ladder" reports of potential wrongdoing in circumstances where the attorney's compliance with Part 205 is "in issue":

> **Any report** under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) **may be used by an attorney in connection with any** investigation, proceeding, or **litigation in which the attorney's compliance with [Part 205] is in issue**.

17 CFR 205.3(d)(1) (emphasis added). In construing Section 205.3(d)(1), courts "must begin with the words in the regulation and their plain language."[14] This regulation plainly authorizes an attorney-whistleblower to use his or her Part 205 report[15] as evidence in litigation so long as the attorney-whistleblower's compliance with Part 205 is "in issue"—*i.e.*, is probative and material to the attorney-whistleblower's claims, allegations, or response to defenses.

The Commission confirmed that it intended this result in its comments adopting the regulation:

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[14] *Pfizer Inc. v. Heckler*, 735 F.2d 1502, 1507 (D.C. Cir. 1984); *see also United States v. Bucher,* 375 F.3d 929, 932 (9th Cir. 2004) ("To interpret a regulation, we look first to its plain language."); *Forest Watch v. U.S. Forest Serv.*, 410 F.3d 115, 117 (2nd Cir. 2005) (a rule's plain meaning controls unless it leads to absurd result).

[15] A Part 205 report need not be a formal document or take any particular form. "*Report* means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing." 17 C.F.R. 205.2(n).

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> Paragraph (d)(1) makes clear that an attorney may use any records the attorney may have made in the course of fulfilling his or her reporting obligations under this part to defend himself or herself against charges of misconduct. It is effectively equivalent to the ABA's [Model Rule 1.6(b)(5)][16] and corresponding "self-defense" exceptions to client-confidentiality rules in every state. **The Commission believes that it is important to make clear in the rule that attorneys can use any records they may have prepared in complying with the rule to protect themselves**.

68 Fed. Reg. 6295, 6310 (emphasis added).

Wadler's complaint alleges that his compliance with his Part 205 obligations was the reason for his termination. His Part 205 report(s)—the information about potential material violations he conveyed to Bio-Rad management and its audit committee—are plainly probative and material to his claims and possibly to his refutation of Bio-Rad's defenses. This action is thus "litigation in which the attorney's compliance with [Part 205] is in issue."[17]

To the extent Bio-Rad suggests that Section 205.3(d)(1) only authorizes an attorney to use his or her Part 205 report in defending allegations against the attorney (*e.g.*, to an allegation that the attorney did not make a required report), the argument lacks any support in the text of the rule. Nothing in the rule (or the Commission's comments in promulgating the rule) limits use of a Part 205 report to defensive purposes. Rather, the clear language of Section 205.3(d)(1) explicitly contemplates an attorney's use of such communications whenever his or her

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[16] The Commission's comments originally cited to then-Model Rule 1.6(b)(3). In August 2003, the ABA reformatted its rules and re-numbered various provisions, including then-Model Rule 1.6(b)(3), which was renumbered as Model Rule 1.6(b)(5). The text and substance of the rule is identical to its prior version. Thus, for purposes of this brief, we refer to both versions of the rule as "Model Rule 1.6(b)(5)."

[17] Section 205.3(d)(1) applies where the client is an "issuer" as defined in 17 C.F.R. 205.2(h). Bio-Rad is an issuer because it maintains a class of publicly-traded securities registered pursuant to Section 12(b) of the Exchange Act. *See, e.g.*, Complaint (DE 1) at ¶ 50.

compliance is "in issue," regardless of whether it pertains to a claim or a defense. Interpreting the rule to only authorize defensive uses of a Part 205 report would be an unduly narrow construction that would require the Court to read non-existent limitations into the clear language of Section 205.3(d)(1) without any textual basis for doing so. *See, e.g., United Cigar Whelan Stores Corp. v. United States*, 113 F.2d 340, 345 (9th Cir. 1940) ("we are not at liberty" to "read into the regulation words not therein contained").

Moreover, such a limitation would incorrectly imply that a whistleblower retaliation action is purely an "offensive" use of a Part 205 report. An attorney-whistleblower retaliation complaint is quintessentially a *defensive* reaction to an employer's allegedly illegal adverse action—discharging, demoting, suspending, threatening, harassing, or in any other manner discriminating against the attorney "in the terms and conditions of employment"—in retaliation for whistleblowing. 18 U.S.C. 1514A(a) [SOX]; Exchange Act Section 21F(h)(1)(A) [Dodd-Frank]. Because in such litigation the issuer is alleged to have taken adverse employment action against the employee, and the employee is attempting to restore (rather than preserve) the status quo, it is reasonable to view the employee as acting in self-defense. Put differently, if an issuer had to file suit to fire an employee, and the employee countered by responding that the issuer was illegally retaliating against him for reporting potential violations, no one would doubt that the employee was employing a "whistleblower defense" to protect himself.[18] Indeed, in both situations, the attorney and client have become adversaries, and "[o]nce an adversarial

[18] *See, e.g., Coons v. Secretary of U.S. Dep't of Treasury*, 383 F.3d 879, 891 (9th Cir. 2004) (noting the "whisteblower defense").

1 relationship has developed, simple fairness demands that the lawyer be able to
2 present her claim or defense without handicap."[19]

3 In short, nothing in the plain language of Section 205.3(d)(1) can be
4 reasonably construed as barring an attorney's use of his or her Part 205 report
5 offensively, as a "sword," or as limiting an attorney's use of such communications to
6 defensive measures, as a "shield." Bio-Rad's argument that this is not a case in
7 which Section 205.3 applies runs contrary to the broad remedial purpose of the Part
8 205 regulations[20] and to the well-established proposition that whistleblower
9 protection provisions, such as SOX Section 806, Exchange Act Section 21F(h), and
10 Part 205, should be construed broadly to effectuate their remedial purposes.[21]
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13 [19] 1 Geoffrey C. Hazard & W. William Hodes, *The Law of Lawyering* §9.23 at 9-100.

14 [20] The Supreme Court has "repeatedly recognized that securities laws combating
15 fraud should be construed 'not technically and restrictively, but flexibly to
16 effectuate [their] remedial purposes.'" *Herman & MacLean v. Huddleston*, 459
17 U.S. 375, 386-97 (1983) (*quoting SEC v. Capital Gains Res. Bureau, Inc.*, 375 U.S.
18 180, 195 (1963)); *see also Lowe v. SEC*, 472 U.S. 181, 225 (1985) (White, J.,
19 concurring) (noting "our longstanding policy of construing securities regulation enactments broadly and their exemptions narrowly in order to effectuate their remedial purposes"); *SEC v. Zandford*, 535 U.S. 813, 819 (2002); *Pinter v. Dahl*, 486 U.S. 622, 653 (1988) ("Congress has broad remedial goals in enacting securities laws.") (internal quotation marks omitted); *SEC v. Ralston-Purina Co.*, 346 U.S. 119, 126 (1953).

20 [21] *Haley v. Retsinas*, 138 F.3d 1245, 1250 (8th Cir. 1998); *see also Bechtel Constr. Co.
21 v. Sec. of Labor*, 50 F.3d 926, 932 (11th Cir. 1995) ("it is appropriate to give a broad
22 construction to remedial statutes such as nondiscrimination provisions in federal
23 labor laws"); *Blackburn v. Reich*, 79 F.3d 1375, 1378 (4th Cir. 1996) ("The overall
24 purpose of the statute– the protection of whistleblowers– militates against an
25 interpretation that would make anti-retaliation actions more difficult."); *Haley v.
26 Fiechter*, 953 F.Supp. 1085, 1092 (E.D. Mo. 1997) ("Courts which have been called
27 upon to interpret different federal whistleblower statutes have uniformly held that such statutes should be broadly construed."); *U.S. ex rel Kent v. Aiello*, 836 F.Supp. 720, 725 (E.D.Cal. 1993) ("Whistleblower protection statutes are remedial in nature and thus should be liberally construed."); *Lambert v. Ackerley*, 180 F.3d 997, 1003 (9th Cir. 1999) (noting the "simple [approach], often used in construing statutes designed to protect individual rights", that remedial statutes must be interpreted broadly).

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II. Under Well-Settled Principles of Conflict Preemption, the Commission's Part 205 Rules Preempt California Laws that Interfere with the Federal Objectives the Part 205 Rules Address.

"There are three types of preemption: express, field, and conflict preemption."[22] The Commission agrees with Bio-Rad that the issue here is whether conflict preemption applies.[23]

"Conflict preemption consists of impossibility and obstacle preemption. * * * Obstacle preemption arises when a challenged state law 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"[24] Bio-Rad asserts that there is no conflict between Part 205 and California law because Section 205.3(d)(1) and the anti-retaliation provisions at issue are merely "permissive," *i.e.*, an attorney "may" file suit and "may" use a Part 205 report as evidence in such an action but isn't required to do either. DE 105 at ECF pp. 11-12. The practical effect of adopting Bio-Rad's reasoning would be to allow California law to take away the rights given by Congress and the Commission to California attorney-whistleblowers in all but the rare cases where he or she can prevail on a retaliation claim without using any material deemed "confidential" under California laws. The outcome advocated by Bio-Rad is a classic example where obstacle preemption overrides the interfering state law.

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[22] *Nation v. City of Glendale*, 804 F.3d 1292, 1297 (9th Cir. 2015), *citing Kurns v. R.R. Friction Products Corp.*, --- U.S. ---, 132 S.Ct. 1261, 1265-66 (2012).

[23] Bio-Rad also argues that Congress neither expressly preempted state laws governing attorneys' obligations to their clients nor indicated an intention to occupy that field of law. The Commission does not assert (nor, it appears, does Wadler) that either of those bases apply.

[24] *Nation*, 804 F.3d at 1297, *citing Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372-73 (2000).

1 The case on which Bio-Rad principally relies (*Barrientos v. 1801-1825 Morton*
2 *LLC*[25]) specifically addresses obstacle preemption and supports the Commission's
3 position. In *Barrientos*, a defendant-landlord wanted to evict tenants in order to
4 raise the rent on the apartment units. A Los Angeles law prohibited evictions for
5 that purpose, but a federal regulation by HUD permitted evictions for "good cause *
6 * * which may include [the] desire to lease the unit at a higher rental." *Id.* at 1202.
7 Bio-Rad reads *Barrientos* as suggesting that it is always the case that where state
8 law prohibits what federal law allows, but does not require, there is no conflict. DE
9 105 at ECF p. 10. But *Barrientos* cannot be read nearly that broadly. It is
10 noteworthy that the Supreme Court decided nearly three decades before *Barrientos*
11 that a conflict between an agency's regulations and state law "does not evaporate
12 because the [agency's] regulation simply permits, but does not compel,' what state
13 law prohibits." *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 155
14 (1982). If the state law's prohibition removes "flexibility" provided by the agency's
15 regulation, then it will be preempted. *Id.* This principle applies here as the relevant
16 California laws would limit the legal right to use probative evidence (the Part 205
17 report),and the flexibility to bring anti-retaliations claims, that federal laws provide
18 attorney-whistleblowers.
19 The *Barrientos* court was interpreting *de la Cuesta* as it applied to the
20 conflicting HUD and Los Angeles provisions.[26] While the court found that under the
21 circumstances of that case, the federal law did not preempt the Los Angeles
22 provision, its analysis supports the Commission's argument that Part 205 **does**
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[25] 583 F.3d 1197 (9th Cir. 2009).
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[26] "Applying *de la Cuesta*, we consider whether the agency intended to preempt the local law and whether [the Los Angeles law] stands as an obstacle to the accomplishment of Congressional purposes." *Barrientos*, 583 F.3d at 1209.
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preempt the California laws relied on by Bio-Rad. The reasons the Court held that HUD's "good cause" regulation did not preempt the Los Angeles ordinance were: (1) HUD did not intend to preempt local eviction controls, (2) the Los Angeles ordinance did not present an obstacle to the accomplishment of federal objectives, and (3) HUD's *amicus* brief and public guidance disavowed an intent to preempt state provisions like the LA ordinance. *Barrientos*, 583 F.3d at 1209-14. Application of these factors leads to the conclusion that Part 205 preempts the California laws at issue here.

First, unlike the situation in *Barrientos*, the Commission expressly intends its regulation to preempt inconsistent state laws. In fact, the first section of Part 205 specifically states:

> Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

17 C.F.R. 205.1 (emphasis added). In its comments adopting the regulations, the Commission explained:

> A number of commenters questioned the Commission's authority to preempt state ethics rules, at least without being explicitly authorized and directed to do so by Congress. * * * The language we adopt today clarifies that this part does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, **the Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices**.

68 Fed. Reg. at 6297 (emphasis added). Then, in a public statement in response to a Washington State Bar Association Proposed Interim Formal Opinion Regarding the Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations Under the Rules of Professional Conduct, the Commission (through its then-General Counsel) stated unequivocally that its regulations under Part 205

"will take precedence over any conflicting provision" of state law.[27] Additionally, in two *amicus* briefs (this one, and *Jordan v. Sprint Nextel Corporation*[28]), the Commission reiterated its position that Section 205.3(d)(1) preempts any state law that would present an obstacle to whistleblower-attorneys using as evidence their Part 205 reports in litigating anti-retaliation claims. *Barrientos* recognizes that an agency "'is entitled to further deference when it adopts a reasonable interpretation of regulations it has put in force.' Further, an agency's position in an amicus brief is entitled to deference if there is 'no reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter.' * * * Agencies 'have a unique understanding of the statutes they administer and an attendant ability to make informed determinations about how state requirements may pose an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"[29]

The California laws involved here clearly present an obstacle to the accomplishment of federal objectives. Congress, in Section 307 of SOX, directed the

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[27] Although the specific provision at issue was Section 205.3(d)(2), which permits attorneys to make disclosures to the Commission in certain circumstances, the preemption analysis and conclusion in the Commission's response applies equally to Section 205.3(d)(1). Statement available at https://www.sec.gov/news/speech/spch072303gpp.htm.

[28] *See* Redacted Brief of the Securities and Exchange Commission, *Amicus Curiae*, Dep't of Labor Admin. Review Bd. Case No. 06-105, filed August 3, 2009, *available at* https://www.sec.gov/litigation/briefs/2009/jordan0809.pdf.

[29] *Barrientos*, 583 F.3d at 1214, internal citations omitted. *See also Roth v. Perseus, LLC*, 522 F.3d 242, 247 (2nd Cir. 2008) ("we defer to the SEC's interpretation of the Rule, including one articulated in its amicus brief, so long as the interpretation is not plainly erroneous or inconsistent with the law"); *Auer v. Robbins*, 519 U.S. 452, 461-62 (1997) (agency interpretation of its own regulation is controlling even if presented in amicus brief); *Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984); *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 128 (2nd Cir. 2000) ("We are bound by the SEC's interpretations of its regulations in its amicus brief, unless they are plainly erroneous or inconsistent with the regulation[s]").

1 Commission to promulgate "minimum standards of professional conduct for
2 attorneys appearing and practicing before the agency" in representing issuers,
3 specifically "including a rule" requiring them to report material violations up the
4 ladder within the issuer.[30] In response to this Congressional mandate, the
5 Commission promulgated Part 205,[31] which requires an attorney representing an
6 issuer to report material violations "up the ladder" within that issuer. Section
7 205.3(b) requires an attorney to report evidence of a material violation first to the
8 issuer's chief legal officer. If the attorney does not receive an "appropriate
9 response"[32] from the chief legal officer (or if, as here, the attorney *is* the chief legal
10 officer), the attorney must continue reporting up the management chain, including
11 to the audit committee or the board of directors, until an appropriate response is
12 received.

13 When an attorney-whistleblower who has made a Part 205 report believes he
14 or she has been retaliated against for making that report, both SOX and Dodd-
15 Frank grant the attorney the right to file an action for unlawful retaliation. A
16 central issue in any such action (including this one) is whether the attorney can use
17 his or her Part 205 report—which will nearly always contain attorney-client
18 communications, client confidences, or both—as evidence. In Section 205.3(d)(1), the
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20 [30] 15 U.S.C. 7245.

21 [31] 17 C.F.R. 205.1 *et seq*. *See also* 68 Fed. Reg. 6295 *et seq*.

22 [32] An "appropriate response" is "a response to an attorney regarding reported
evidence of a material violation as a result of which the attorney reasonably
23 believes:

24 (1) ... no material violation ... has occurred, is ongoing, or is about to occur;

25 (2) ... the issuer ... has adopted appropriate remedial measures ...; or

26 (3) ... the issuer ... has retained or directed an attorney to review the reported evidence of a material violation."

27 17 C.F.R. 205.2(b).

1 Commission specifically addressed this issue and answered it with a clear "yes": any
2 Part 205 report, or the response thereto, "may be used by an attorney in connection
3 with any investigation, proceeding, or litigation in which the attorney's compliance
4 with this part is in issue."

5 Section 205.3(d)(1) is entirely consistent with the rule—established by 47
6 state bars, the ABA's Model Rules of Professional Conduct ("Model Rules"), as well
7 as the federal common law—that an attorney may use client confidences in support
8 of "claims or defenses" in litigation against a client. Notably, Congress enacted the
9 whistleblower retaliation protections of Dodd-Frank eight years **after** instructing
10 the Commission to issue the regulations that became Part 205, and seven years
11 after those regulations—including Section 205.3(d)(1)—were promulgated. Yet
12 Congress did not single out attorneys as a group without recourse; instead, it
13 extended the broader Dodd-Frank protections to "**any** lawful act done by the
14 whistleblower … in making disclosures that are **required or protected under**
15 **the Sarbanes-Oxley Act of 2002** * * *[33]—which would include attorney-
16 whistleblowers. If interfering state laws are not preempted, then Congress's interest
17 in protecting attorney-whistleblowers, reinforced by its extension of those
18 protections in the Dodd-Frank Act, and the Commission's interest in encouraging
19 attorneys to comply with its Part 205 rules, would be seriously undermined.

20 The Supreme Court has consistently upheld the authority of federal agencies
21 to implement rules of conduct that conflict with state laws that address the same
22 conduct. *See, e.g., Sperry v. State of Florida*, 373 U.S. 379 (1963) (Florida could not
23 enjoin non-lawyer registered to practice before the Patent and Trademark Office
24 from prosecuting patent applications in Florida, even though non-lawyer's actions
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[33] Exchange Act Section 21F(h)(1)(A) (emphasis added).

constituted unauthorized practice of law under Florida bar rules). Importantly, the Ninth Circuit has specifically held that ethics rules approved by the Commission in accordance with the Exchange Act preempt conflicting California ethics standards. *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119, 1128 (9th Cir. 2005). In *Credit Suisse*, California adopted heightened disclosure and disqualification standards for neutral arbitrators that conflicted with Commission-approved rules of a private self-regulatory organization (the NASD, now known as FINRA).[34] The *Grunwald* court's analysis and conclusion is even more persuasive where, as here, the rules at issue are the Commission's own regulations that were promulgated in response to a Congressional mandate and after robust notice and public comment.[35]

In sum, the Court should reach the same conclusion the Department of Labor's Administrative Review Board (which was entrusted by Congress with the responsibility of deciding SOX whistleblower cases in the first instance) reached in an analogous case: "SOX Section 307 requiring an attorney to report a 'material violation' should impliedly be read consistent with SOX Section 806, which provides whistleblower protection to an 'employee' or 'person' who reports such violations. Thus, attorneys who undertake actions required by SOX Section 307 are to be protected from employer retaliation under the whistleblower provisions of SOX Section 806, even if it necessitates that attorney-client privileged communications be held admissible in a [] whistleblower proceeding.

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[34] The Supreme Court of California reached the same conclusion on nearly identical facts. *Jevne v. Superior Court*, 35 Cal.4th 935, 111 P.3d 954 (Sup.Ct.Cal. 2005).

[35] *See also McDaniel v. Wells Fargo Investments, LLC*, 717 F.3d 668 (9th Cir. 2013) (state law prohibiting employers from "forced patronage" was preempted by the Exchange Act because the state law restricted what federal law permitted); *Whistler Investments, Inc. v. Depository Trust and Clearing Corp.*, 539 F.3d 1159 (9th Cir. 2008) (plaintiff's state law claims were challenges to Commission-approved rules of self-regulatory organizations and thus preempted).

"Consequently, we conclude that **under [Section] 205.3(d)(1),** if an attorney reports a 'material violation' in-house in accordance with the SEC's Part 205 regulations, **the report, though privileged, is nevertheless admissible** in a SOX Section 806 proceeding **as an exception to the attorney-client privilege** in order for the attorney to establish whether he or she engaged in SOX-protected activity. Furthermore, in accord with the ALJ's rationale that SOX Section 307 should impliedly be read consistent with SOX Section 806, **we similarly conclude** that Congress also intended that **any other relevant attorney-client privileged communication that is not a Part 205 report is also admissible** in a [] whistleblower proceeding in order for the attorney to establish whether he or she engaged in SOX protected activity."[36]

III. Both a Part 205 Report and Other Privileged or Confidential Evidence are Admissible Under the Federal Rules of Evidence and the Federal Common Law.

Bio-Rad argues that Federal Rule of Evidence 501, which incorporates the federal common law on attorney-client privilege, also bars Wadler's use of his Part 205 report as evidence at the upcoming trial. DE 94 at ECF pp. 13-14. But common-law evidentiary principles are trumped where an agency has properly promulgated regulations pursuant to statutory authority, because those regulations "have the force and effect of law" as to the matter covered by the regulations.[37] Section

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[36] *Jordan v. Sprint Nextel Corp.*, Case No. 06-105, 2009 WL 3165850 (Dep't of Labor, Admin. Review Bd. Sept. 30, 2009) (emphasis added). *Jordan* was decided before the Dodd-Frank Act added another set of whistleblower protections for SOX Section 307 reports, but the ARB's rationale and analysis apply equally to SOX and Dodd-Frank claims.

[37] *See, e.g., Milwaukee v. Ill.*, 451 U.S. 304, 314 (1981); *Chrysler Corp. v. Brown*, 441 U.S. 281, 295 (1979) ("[P]roperly promulgated, substantive agency regulations have the force and effect of law.") (internal quotation marks omitted); *Batterton v. Francis*, 432 U.S. 416, 425 n. 9 (1977) (recognizing that regulations "issued by an agency pursuant to statutory authority and which implement the statute, as, for

205.3(d)(1) is an express provision of federal law that takes priority over the federal common law (even though, as we discuss below, federal common law is consistent with the Commission's Part 205 rule) and permits use of the evidence notwithstanding Rule 501.

Importantly, the Court does not have to parse through the evidence to sort Part 205 evidence from relevant but non-Part 205 evidence, because if there is any of the latter evidence, the federal common law permits its use at trial.[38] Supreme Court Standard 503(d)(3)—often cited as a restatement of the federal common law on attorney-client privilege[39]—states that there is no protection "[a]s to a communication relevant to an issue of **breach of duty** by the lawyer to his client or **by the client to his lawyer**[.]" (Emphasis added.) The natural reading of the anti-retaliation provisions of both SOX and Dodd-Frank is that Congress imposed a legal duty on Bio-Rad not to take an adverse action against Wadler for reporting potential material violations of federal law as required by Part 205. Thus, under federal common law, any communications relevant to Wadler's claim that Bio-Rad breached its legal duty not to retaliate against him are not privileged.

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example, the proxy rules issued by the Securities and Exchange Commission . . . have the force and effect of law.") (quoting U.S. Dep't of Justice, *Attorney General's Manual on the Administrative Procedures Act* 30 n. 3 (1947)).

[38] *See also* the ARB's decision in *Jordan*, quoted above, which reached the same conclusion on the grounds that there is "strong evidence of congressional intent" to allow attorney-whistleblowers to use otherwise privileged materials in a retaliation action even where Part 205 does not apply. *Jordan*, 2009 WL 3165850 at *9-10.

[39] Supreme Court Standard 503 is the proposed, but never adopted, Federal Rule of Evidence 503. *See* Rules of Evidence for the United States Courts and Magistrates, 56 F.R.D. 183, 235-36 (1972). It is often cited as a restatement of the common law of attorney-client privilege applied in the federal courts at that time. *See, e.g., United States v. Mosony*, 927 F.2d 742, 751 (3rd Cir. 1991).

That conclusion is bolstered by developments in the law since Standard 503 was first proposed in 1972. The federal common law on privilege is meant to reflect "well-established [state law] exceptions" to the attorney-client privilege.[40] Over the past 40-plus years, the Code of Professional Responsibility (from which Standard 503 drew) has been replaced by ABA Model Rule 1.6(b)(5), which has been adopted either in whole or in relevant substance by 47 states (so far).[41] The modern rule clearly permits an attorney to use otherwise privileged or confidential information "to the extent the lawyer reasonably believes necessary: *** to establish a **claim or defense** on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client[.]"[42] (Emphasis added.)

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[40] *See* Advisory Committee Notes to Standard 503, 56 F.R.D. at 239-40 (noting that Standard 503 was drafted with reference to established state rules).

[41] *See* Ala. Rule 1.6(b)(2); Alaska Rule 1.6(b)(2); Ariz. ER 1.6(d)(4); Ark. Rule 1.6(b)(5); Colo. Rule 1.6(c); Conn. Rule 1.6(d); Del. Rule 1.6(b)(5); Fla. Rule 4-1.6(c)(2); Ga. Rule 1.6(b)(1)(iii); Haw. Rule 1.6(c)(3); Idaho Rule 1.6(b)(5); Ill. Rule 1.6(b)(5); Ind. Rule 1.6(b)(5); Ia. Rule 32:1.6(b)(5); Kan. Rule 1.6(b)(3); Ky. Rule 1.6(b)(2); La. Rule 1.6(b)(2); Me. Rule 1.6(b)(5); Md. Rule 1.6(b)(5); Mass. Rule 1.6(b)(2); Minn. Rule 1.6(b)(8); Miss. Rule 1.6(b)(2); Mo. S. Ct. Rule 4-1.6(b)(2); Mont. Rule 1.6(b)(3); Neb. Rule 1.6(b)(3); Nev. Rule 156(3)(b); N.H. Rule 1.6(b)(2); N.J. Rule 1.6(d)(2); N.M. Rule 16-106(D); N. Car. Rule 1.6(b)(6); N. Dak. Rule 1.6(e); Ohio Rule 1.6(b)(5); Okla. Rule 1.6(b)(3); Ore. Rule 1.6(b)(4); Pa. Rule 1.6(b)(4); R.I. Rule 1.6(b)(2); S. Car. Rule 1.6(b)(2); S. Dak. Rule 1.6(b)(3); Tenn. Rule 1.6(b)(3); Tex. Rule 1.6(c)(5); Utah Rule 1.6(b)(3); Vt. Rule 1.6(c)(2); Va. Rule 1.6(b)(2); Wash. Rule 1.6(b)(5); W. Va. Rule 1.6(b)(2); Wisc. Rule 1.6(c)(2); Wy. Rule 1.6(b)(2).

[42] Indeed, the Commission's comments when it adopted Part 205 specifically noted that its rule permitting use of otherwise privileged information at trial "is effectively equivalent to the ABA's [Model Rule 1.6(b)(5)] and corresponding 'self-defense' exceptions to client-confidentiality rules in every state." 68 Fed. Reg. at 6310.

This exception to the general rule of confidentiality is notably broad. Numerous courts, both before and after the Commission adopted Section 205.3(d)(1), have held that the claim-or-defense rule (in some states referred to as the self-defense rule) allows attorneys to use client confidences to prove wrongful discharge or whistleblower claims.[43] Indeed, the ABA has specifically noted that a wrongful-discharge action is a "claim" under ABA Model Rule 1.6(b)(5).[44]

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[43] *See, e.g., Schaefer v. GE Co.*, 2008 WL 649189 at *6 (D. Conn. 2008) ("The plain language of Model Rule 1.6 is quite broad, allowing a lawyer to use the claim . . . exception in a controversy between the lawyer and the client" in an action for sex discrimination); *Van Asdale v. Int'l Game, Tech.*, 498 F.Supp.2d 1321, 1329 (D. Nev. 2007), *overturned on other grounds* (allowing plaintiff to use confidential client information in SOX whistleblower action, explaining that the "Model Rules permit a lawyer to reveal confidential information relating to the representation in order to establish a claim . . . on behalf of the lawyer in a controversy between the lawyer and the client"); *Burkhart v. Semitool, Inc.*, 5 P.3d 1031, 1042 (Mont. 2000) (discharged in-house counsel could use client confidences as reasonably necessary to prove wrongful-discharge claim); *Alexander v. Tandem Staffing Solutions, Inc.*, 881 So.2d 607, 610-12 (Fla. App. 2004) (allowing employer's former general counsel to use client confidences to support claim under Florida's Whistleblower Act); *Spratley v. State Farm Mut. Auto. Ins. Co.*, 78 P.3d 603, 608 (Utah 2003) (former in-house counsel could use client confidences to prosecute wrongful-discharge claim); *Crews v. Buckman Labs Int'l, Inc.*, 78 SW.3d 852, 863-64 (Tenn. 2002) (adopting a new provision to its conduct rules that follows Model Rule 1.6 and "permit[s] in-house counsel to reveal the confidences and secrets of a client when the lawyer reasonably believes that such information is necessary to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer or the client"); Oregon Formal Ethics Op. 136 (1994) (permitting the use of client confidences by attorney in wrongful-termination case after analyzing Oregon's rule that, like Model Rule 1.6(b)(5), expressly applies to either a "claim or defense"). *See also* Geoffrey C. Hazard & W. William Hodes, *The Law of Lawyering* at 9-99 (Rule 1.6(b)(5) "permits a lawyer to reveal client confidences when needed to 'establish a claim,' which is a matter of offense rather than defense").

[44] The ABA's Standing Committee on Ethics and Professional Responsibility explained that "[r]etaliatory discharge actions provide relief to employees fired for reasons contradicting public policy," and that in-house attorneys who are improperly discharged may rely on the exceptions contemplated in the Model Rule to utilize confidential client information to pursue "a retaliatory discharge claim or similar claim" against their former employers. ABA Formal Op. 01-424 at 3-4 (Sept. 22, 2001) (noting that an attorney cannot divulge client confidences "except . . . as permitted by Rule 1.6" and identifying now-Rule 1.6(b)(5) as such an exception).

IV. The Court Can Use its Equitable Tools to Limit Public Disclosure of Bio-Rad's Sensitive Information at the Upcoming Trial if it Deems Such Protections Advisable.

Bio-Rad argues that even when an attorney-whistleblower case is sufficiently meritorious to warrant trial, the Court should exclude the evidence of the Part 205 report (and other possibly privileged information) to keep it out of the public domain rather than use its inherent equitable powers such as sealing the record or entering a protective order to restrict public access. DE 94 at ECF pp. 18-19 and DE 105 at ECF pp. 17-18. Of course, the attorney-whistleblower will likely rely on the *same* evidence it intends to use at trial to fend off a motion to dismiss and/or for summary judgment. It would be a perverse (and unwarranted) result to allow the attorney-whistleblower to use key evidence to demonstrate to the court that his case has merit, but then be precluded from using the same evidence to prove his claim at trial.

In addition, Bio-Rad's argument is grounded in the mistaken conclusion that the communications reflected in the Part 205 report are still privileged. But as discussed above, Part 205 and the federal common law "claim or defense" provisions are *exceptions* to the general rule of privilege.[45] The evidence supporting Mr. Wadler's claims is thus admissible even if it was once privileged or confidential.

The Ninth Circuit's controlling decision in *Van Asdale v. Int'l Game Tech.* confirms that the attorney-whistleblower's need to use once-privileged information

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[45] For the same reason, Bio-Rad's argument that allowing Wadler to use the evidence is an affront to the purposes of Federal Rule of Evidence 502 (DE 105 at ECF pp. 6-7, 17) is misplaced. Rule 502 addresses litigants' concerns that producing privileged information, even inadvertently, in the discovery process could constitute a waiver. Certainly there are many cases where a party obtains information in discovery that it cannot actually use at trial—because the documents have not lost their privileged status, and no other exception applies. Here, of course, the point is that the evidence **has** lost its protections as a result of Part 205 and/or the federal common law, and accordingly the no-waiver protections of Rule 502 are not implicated.

1 from his or her Part 205 report is **not** a basis for preventing an otherwise valid SOX
2 retaliation claim from proceeding to trial:

> There are few federal circuit court cases addressing the right of in-house counsel to use attorney-client privileged information in a retaliation suit. In *Willy v. Administrative Review Board,* 423 F.3d 483 (5th Cir. 2005), an in-house attorney brought suit against his former employer, alleging retaliation as a result of a report he had written; it was undisputed that the contents of the report were covered by the attorney-client privilege. *Id.* at 494 n. 48. The Fifth Circuit allowed the suit to go forward, rejecting the notion "that the attorney-client privilege is a *per se* bar to retaliation claims under the federal whistleblower statutes, i.e., that the attorney-client privilege mandates exclusion of all documents subject to the privilege." *Id.* at 500. However, *Willy* involved a claim before an administrative law judge and the Fifth Circuit expressly reserved the question of whether its holding would apply to "a suit involving a jury and public proceedings." *Id.* at 500–01.
>
> Similarly, in *Kachmar v. SunGard Data Systems, Inc.,* 109 F.3d 173 (3rd Cir.1997), the Third Circuit held that a former in-house attorney could maintain a Title VII suit for retaliatory discharge; the Third Circuit reasoned that "concerns about the disclosure of client confidences in suits by in-house counsel" did not alone warrant dismissal of the plaintiff's action. *Id.* at 181. Rather, the Third Circuit suggested that a district court should "balanc[e] the needed protection of sensitive information with the in-house counsel's right to maintain the suit," while considering any protective measures that might be taken **at trial** to safeguard confidential information. *Id.* at 182.
>
> Although neither case is precisely on point, **we agree with the careful analysis of the Third and Fifth Circuits and hold that confidentiality concerns alone do not warrant dismissal of the Van Asdales' claims**. … [W]e agree with the Third Circuit that **the appropriate remedy is for the district court to use the many "equitable measures at its disposal" to minimize the possibility of harmful disclosures**, not to dismiss the suit altogether. *Id.* at 182.
>
> We also note that the text and structure of the Sarbanes–Oxley Act further counsel against IGT's argument. Section 1514A(b) expressly authorizes any "person" alleging discrimination based on protected conduct to file a complaint with the Secretary of Labor and, thereafter, to bring suit in an appropriate district court. **Nothing in this section indicates that in-house attorneys are not also protected from retaliation under this section**, even though Congress plainly considered the role attorneys might play in reporting possible securities fraud. *See, e.g.,* 15 U.S.C. § 7245. We thus agree with the district court that dismissal of the Van Asdales' claims on grounds of attorney-client privilege is unwarranted.

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577 F.3d 989, 995-96 (9th Cir. 2009) (emphasis added).[46]

In short, the Ninth Circuit has already taken a position consistent with the Commission's: the issuer's confidentiality concerns do not warrant dismissing a retaliation lawsuit. The Court may (but does not have to) use its equitable tools to limit public access to sensitive information.[47]

Conclusion

The Commission has a strong interest in ensuring that public companies do not retaliate against the attorneys who often play a key role in protecting investors and the integrity of the securities markets by ensuring their clients' compliance with the federal securities and related laws. The Commission's interest extends to ensuring that attorney-whistleblowers who honor their responsibilities have a meaningful ability to exercise the rights granted by Congress in SOX and Dodd-Frank to bring an action for illegal retaliation. Congress' intent, the Commission's regulations, the Model Rules of Professional Responsibility, the rules governing lawyers in 47 states, and the federal common law are all in accord: An attorney-whistleblower can use otherwise privileged or confidential information to support a

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[46] Bio-Rad cites *Van Asdale* for the proposition that "these issues will rarely, if ever, be appropriately resolved at the motion to dismiss stage." DE 105 at ECF pp. 7, 9. But *Van Asdale* did not involve a motion to dismiss—it involved a motion for summary judgment. After the Ninth Circuit's decision that summary judgment was not appropriate, the case did in fact proceed to trial (where the Van Asdales prevailed).

Bio-Rad also dismisses *Van Asdale* as inapposite because it interpreted Nevada law. DE 105 at ECF p. 9. But the court did not rely on Nevada (or Illinois, or any other state) law. The Ninth Circuit did not even reference Nevada's state ethics rules; rather, both the district and appellate courts indicated that federal law governed. *See* 577 F.3d at 995 *and* 498 F.Supp.2d at 1326-27.

[47] Of all the equitable tools available to the Court—sealing, protective orders, etc.—Bio-Rad focuses on arguing that the Court could limit the admissibility of evidence. DE 105 at ECF p. 17. But as the entire preceding discussion establishes, it would not be appropriate to limit evidence on the grounds of privilege or confidentiality (or state law) alone.

1 claim of illegal retaliation. We respectfully ask the Court to hold that Part 205
2 preempts California Business & Professions Code Section 6068(e) and California
3 Rules of Professional Conduct 3-100 to the extent either of those would *preclude* an
4 attorney-whistleblower from using evidence that Part 205 *permits* the attorney to
5 use.

6 December 13, 2016

Respectfully submitted,

7 */s/ Thomas J. Karr*
8 THOMAS J. KARR* (D.C. Bar No. 426340)
Assistant General Counsel

9 Attorneys for *Amicus Curiae*
10 SECURITIES AND EXCHANGE COMMISSION

11 Of counsel:

12 KAREN J. SHIMP*
Special Trial Counsel
13 DC Bar # 456265

14 ERIC A. REICHER*
Senior Counsel
15 DC Bar# 490866

16 Office of the General Counsel
SECURITIES AND EXCHANGE COMMISSION
17 100 F Street NE
Washington, DC 20549-9612
18 Tel: (202) 551-5007 (Shimp)

19 * Appearing pursuant to Civil L.R. 11-2.

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PROOF OF SERVICE

I am over the age of 18 years and not a party to this action. My business address is:

U.S. SECURITIES AND EXCHANGE COMMISSION,
100 F Street NE, Washington, DC 20549-9612
Telephone No. (202) 551-5163; Facsimile No. (202) 772-9263.

On December 13, 2016, I caused to be served the document entitled ***Amicus Curiae* Brief of the Securities and Exchange Commission in Support of Plaintiff** on all the parties to this action addressed as stated on the attached service list:

☐ **OFFICE MAIL:** By placing in sealed envelope(s), which I placed for collection and mailing today following ordinary business practices. I am readily familiar with this agency's practice for collection and processing of correspondence for mailing; such correspondence would be deposited with the U.S. Postal Service on the same day in the ordinary course of business.

☐ **PERSONAL DEPOSIT IN MAIL:** By placing in sealed envelope(s), which I personally deposited with the U.S. Postal Service. Each such envelope was deposited with the U.S. Postal Service at Los Angeles, California, with first class postage thereon fully prepaid.

☐ **EXPRESS U.S. MAIL:** Each such envelope was deposited in a facility regularly maintained at the U.S. Postal Service for receipt of Express Mail at Los Angeles, California, with Express Mail postage paid.

☐ **HAND DELIVERY:** I caused to be hand delivered each such envelope to the office of the addressee as stated on the attached service list.

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I declare under penalty of perjury that the foregoing is true and correct.

Date: December 13, 2016 *_/s/ Thomas J. Karr_*
Thomas J. Karr

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Wadler v. Bio-Rad Laboratories, et al.
United States District Court—Northern District of California
Case No. 3:15-cv-2356-JCS

SERVICE LIST

Michael John von Loewenfeldt
Mvl@kerrwagstaffe.com
Kenneth Paul Nabity
Nabity@kerrwagstaffe.com
Kevin Brooke Clune
Clune@kerrwagstaffe.com

KERR & WAGSTAFFE LLP
101 Missions Street, 18th Floor
San Francisco, CA 94105-1528
(415) 371-8500
Counsel for Plaintiff

James Robert Asperger
Jimasperger@quinnemanuel.com

QUINN EMANUEL URQUHART & SULLIVAN LLP
865 S. Figueroa Street, 10th Floor
Los Angeles, CA 90017
(213) 443-3223

John Mark Potter
Johnpotter@quinnemanuel.com
Karin A. Kramer
Karinkramer@quinnemanuel.com

QUINN EMANUEL URQUHART & SULLIVAN LLP
50 California Street, 22nd Floor
San Francisco, CA 94111
(415) 875-6600
Counsel for Defendants

9. Final Verdict Form in *Wadler v. Bio-Rad Laboratories, Inc.* (February 3, 2017)

FILED
FEB 06 2017
SUSAN Y. SOONG
CLERK, U.S. DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

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4 UNITED STATES DISTRICT COURT
5 NORTHERN DISTRICT OF CALIFORNIA
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7 SANFORD S. WADLER,	Case No.15-cv-02356-JCS
8 Plaintiff,	
9 v.	**FINAL VERDICT FORM**
10 BIO-RAD LABORATORIES, INC., et al.,	
11 Defendants.	

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14 Dated: February 3, 2017
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18 JOSEPH C. SPERO
United States Magistrate Judge
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United States District Court
Northern District of California

I. RETALIATION IN VIOLATION OF THE SARBANES-OXLEY AND DODD-FRANK ACTS—DEFENDANTS BIO-RAD AND NORMAN SCHWARTZ

1. Did Mr. Wadler engage in protected activity under the Sarbanes Oxley Act?

Answer: ____Yes (circled)____ No

If your answer to Question 1 is "yes," proceed to Question 2. If your answer to Question 1 is "no," stop here, answer no further questions, and have the jury foreperson sign and date this verdict form.

2. Were the circumstances sufficient to raise an inference that Mr. Wadler's engaging in this activity was a contributing factor in Norman Schwartz and Bio-Rad's termination of Mr. Wadler?

Answer: ____Yes (circled)____ No

If your answer to Question 2 is "yes," proceed to Question 3. If your answer to Question 2 is "no," stop here, answer no further questions, and have the jury foreperson sign and date this verdict form.

3. Did Bio-Rad and Norman Schwartz prove by clear and convincing evidence that they would have terminated Mr. Wadler at the same time based on wholly legitimate reasons even if Mr. Wadler had not engaged in protected activity?

Answer: _____ Yes ____No (circled)

Proceed to Question 4.

United States District Court
Northern District of California

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II. WRONGFUL DISCHARGE IN VIOLATION OF PUBLIC POLICY—DEFENDANT BIO-RAD

2 3

4. Was Mr. Wadler's engaging in protected activity under the Sarbanes-Oxley Act a substantial motivating reason for Bio-Rad's discharge of Mr. Wadler?

4

Answer: ____(Yes)____ No

5 6 7

If your answer to Question 4 is "yes," proceed to Question 5. If your answer to Question 4 is "no," but you answered "yes" to Question 2 and "no" to Question 3, proceed to Question 6. Otherwise, stop here, answer no further questions, and have the jury foreperson sign and date this verdict form.

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5. Did the discharge cause Mr. Wadler harm?

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Answer: ____(Yes)____ No

10 11

*If you answered "yes" to Question 2 and "no" to Question 3, **or** if you answered "yes" to Question 5, proceed to Question 6. Otherwise, stop here, answer no further questions, and have the jury foreperson sign and date this verdict form.*

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United States District Court
Northern District of California

III. COMPENSATORY DAMAGES

6. What are Mr. Wadler's damages, if any, for past economic loss as a result of his termination?

Answer: $ 2,960,000

Proceed to Question 7.

7. What are Mr. Wadler's damages, if any, for future economic loss as a result of his termination?

Answer: $ Ø

Proceed to Question 8.

8. What are Mr. Wadler's damages for mental suffering, loss of enjoyment of life, inconvenience, grief, anxiety, humiliation, and emotional distress?

Answer: $ Ø

Proceed to Question 9.

United States District Court
Northern District of California

IV. PUNITIVE DAMAGES—DEFENDANT BIO-RAD

9. Did Defendant Bio-Rad engage in the conduct upon which you base your wrongful termination in violation of public policy claim with malice, oppression, or fraud?

Answer: ___Yes___ (circled) No

If your answer to Question 9 is "yes," then answer Question 10. If you answered "no," stop here, answer no further questions, and have the jury foreperson sign and date this verdict form.

10. What amount of punitive damages do you award against Defendant Bio-Rad as a result of his termination?

Answer: $ 5,000,000

When you have finished, have the jury foreperson sign and date this verdict form.

Dated: 2/6/17

By: [signature]
[NAME]
PRESIDING JUROR

After this Verdict Form has been completed and signed, notify the courtroom deputy that you are ready to present your verdict in the courtroom.

United States District Court
Northern District of California

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10. PCAOB News Release: PCAOB Sanctions Former Deloitte Brazil Chairman and CEO for Violations Related to Failures to Cooperate with a Board Investigation (March 29, 2017)

PCAOB Sanctions Former Deloitte Brazil Chairman and CEO for Violations Related to Failures to Cooperate with a Board Investigation

WASHINGTON, March 29, 2017

The Public Company Accounting Oversight Board today announced sanctions against the former Chairman and the former Chief Executive Officer of Brazil-based Deloitte Touche Tohmatsu Auditores Independentes for violations related to failures to cooperate with a Board investigation.

In today's orders, the PCAOB found that Michael John Morrell, the former Chairman of Deloitte's governing body in Brazil, contributed to the firm's failure to cooperate with a PCAOB investigation. Also, Juarez Lopes de Araújo, Deloitte Brazil's former CEO and managing partner, refused to cooperate with the investigation.

These actions follow a December 2016 PCAOB enforcement order against Deloitte Brazil in which the Board found that the firm and certain individuals attempted to cover up audit violations, including through improper alteration of documents and provision of false testimony to investigators.

"The order announced today against the former Chairman of Deloitte Brazil makes clear that the misconduct at the firm went all the way to the top, and our investigation persisted until we uncovered the extent of wrongdoing," said Claudius B. Modesti, Director of PCAOB Enforcement and Investigations. "The order against the former CEO demonstrates that individuals who refuse to cooperate with Board investigations face some of the stiffest sanctions."

According to an order released today, Morrell became aware during the investigation into Deloitte Brazil that firm personnel had improperly altered work papers and were giving false documentation and information to PCAOB investigators. He concurred in the plan to continue misleading the PCAOB.

The PCAOB order censures Morrell, bars him from associating with a PCAOB-registered firm for five years, and imposes a civil penalty of $35,000.

In another order, the PCAOB sanctioned Araújo for refusing to testify in the PCAOB investigation about any knowledge he had of the firm's provision of false documents and information to PCAOB investigators.

The PCAOB order censures Araújo and permanently bars him from associating with a PCAOB-registered firm.

Morrell and Araújo neither admitted to nor denied the findings in their respective orders. Neither is currently associated with Deloitte Brazil.

The investigation of Morrell and Araújo was conducted by PCAOB enforcement staff members David Ware, Carol Der Garry, Arthur Lowry, and Tiffany Johnson, and was supervised by William Ryan and Marion Koenigs.

The PCAOB oversees auditors' compliance with the Sarbanes-Oxley Act, professional standards, and PCAOB and Securities and Exchange Commission rules. Further information about the PCAOB Division of Enforcement and Investigations is available on the PCAOB website. Firms or individuals wishing to report suspected misconduct by auditors, or to self-report possible misconduct, may visit the PCAOB Tip & Referral Center.

11. PCAOB News Release: PCAOB Sanctions Former PricewaterhouseCoopers Brazil Partner for Audit Failures (March 20, 2017)

PCAOB Sanctions Former PricewaterhouseCoopers Brazil Partner for Audit Failures

WASHINGTON, March 20, 2017

The Public Company Accounting Oversight Board today announced sanctions against a former partner of PricewaterhouseCoopers Auditores Independentes in Brazil for audit failures and violations of PCAOB rules and standards.

Wander Rodrigues Teles was the lead partner for PwC Brazil's 2010 and 2011 audit work on the Brazilian subsidiaries of Sara Lee Corporation, including Sara Lee Cafés do Brasil Ltda.

The PCAOB found that Teles failed to adequately respond to indications that Sara Lee Cafés may have overstated its accounts receivable.

"Audit quality is a global issue," said PCAOB Chairman James R. Doty. "As this order demonstrates, the Board is committed to investigating and disciplining auditors who present risks to investors in the U.S. markets, regardless of where the audit is conducted."

In 2012, Sara Lee restated its 2010 and 2011 financial results, citing accounting irregularities in its Brazil operations, including the overstatement of accounts receivable.

According to the settled disciplinary order, Teles knew that a material amount of Sara Lee Cafés' accounts receivable was overdue and disputed by customers. He also was aware that the subsidiary was extending the due dates of overdue receivables, indicating that Sara Lee Cafés may have overstated its accounts receivable.

The PCAOB found that Teles failed to adequately respond to these risks with appropriate due care and professional skepticism, and failed to obtain sufficient evidence to support his audit conclusions.

"Faced with indications of possible material misstatements, the lead partner did not exercise appropriate professional skepticism," said Claudius B. Modesti, Director of PCAOB Enforcement and Investigations. "He repeatedly ignored information suggesting that the company's financial information was materially misstated."

In the settled order, Teles is censured, fined $10,000, and barred for two years from associating with a registered public accounting firm.

Teles did not admit to or deny the findings in the order.

PCAOB enforcement staff members Joshua Cutler, Carol Der Garry, and Hazel Mak led the investigation, which was supervised by Mark Adler and Marion Koenigs.

The PCAOB thanks the Dutch Authority for the Financial Markets for its assistance in this matter.

The PCAOB oversees auditors' compliance with the Sarbanes-Oxley Act, professional standards, and PCAOB and Securities and Exchange Commission rules. Further information about the PCAOB Division of Enforcement and Investigations is available on the PCAOB website. Firms or individuals wishing to report suspected misconduct by auditors, or to self-report possible misconduct, may use the resources in the PCAOB Tip & Referral Center.

12. PCAOB News Release: PCAOB Announces $8 Million Settlement with Deloitte Brazil for Violations Including Issuing Materially False Audit Reports and 12 Individuals Also Sanctioned for Various Violations (December 5, 2016)

PCAOB Announces $8 Million Settlement with Deloitte Brazil for Violations Including Issuing Materially False Audit Reports and 12 Individuals Also Sanctioned for Various Violations

The firm admitted to certain violations, the first admissions the PCAOB has obtained from a global network firm

WASHINGTON, Dec. 5, 2016

The Public Company Accounting Oversight Board today announced that Brazil-based Deloitte Touche Tohmatsu Auditores Independentes will pay an $8 million civil penalty, the largest ever imposed by the PCAOB, to settle charges including issuing materially false audit reports and attempting to cover up audit violations by improperly altering documents and providing false testimony.

The PCAOB also announced sanctions against 12 former partners and other audit personnel of the firm, including certain firm leaders, for violations including noncooperation with a PCAOB inspection and subsequent investigation. A former engagement partner also was charged with causing the firm to issue materially false audit reports.

Deloitte Brazil admitted that it violated quality control standards and failed to cooperate with a PCAOB inspection and investigation, the first admissions the PCAOB has obtained from a global network firm.

"Deloitte Brazil failed in its public watchdog role to protect the interests of investors by issuing materially false audit reports," said Claudius B. Modesti, director of the PCAOB Division of Enforcement and Investigations. "The orders released today detail some of the most serious misconduct the PCAOB has ever uncovered."

The PCAOB found that Deloitte Brazil knowingly issued materially false audit reports for the 2010 financial statements and internal control over financial reporting of its client, a Brazilian airline. In advance of a 2012 PCAOB inspection, a Deloitte Brazil engagement partner, who also served as the firm's audit practice leader, directed junior personnel to alter work papers from the 2010 audit to conceal known audit deficiencies. The firm presented the improperly altered work papers, as well as other misleading documents and information, to PCAOB inspectors.

After the PCAOB began an investigation of the audit, Deloitte Brazil took additional steps to conceal its audit deficiencies and work paper alterations, with the knowledge and participation of senior firm leaders. Multiple firm partners provided false testimony under oath and made false representations to PCAOB staff about the 2010 audit in an attempt to obstruct the PCAOB investigation.

In addition to the $8 million civil penalty, Deloitte Brazil agreed to sanctions including:

- Censure
- Undertakings to improve the firm's system of quality control
- Appointment of an independent monitor to review and assess the firm's progress toward achieving remedial benchmarks
- Immediate practice limitations, including a prohibition on accepting certain new audit work until the monitor confirms the firm's progress in achieving its remedial benchmarks
- Additional professional education and training for the firm's audit staff

"The firm leaders who participated in the misconduct not only set a tone of disregard for compliance with PCAOB rules, standards, and oversight, but also actively subverted that oversight," noted Director Modesti.

The 12 former Deloitte Brazil partners and other audit personnel sanctioned in the case included partners who held the senior leadership positions of risk and reputation leader, national professional practice director, and audit practice leader, in addition to six other partners and three other audit personnel. All but one were barred or suspended from associating with a registered public accounting firm.

The Board granted significant credit for extraordinary cooperation to one individual — a senior manager on the audit — after he reported to PCAOB staff that senior firm management was obstructing the PCAOB investigation. The Board also granted credit to two other individuals for providing substantial assistance to the investigation.

The individual respondents and their sanctions can be found in an accompanying attachment.

The investigation that uncovered the misconduct and resulted in the settlements announced today originated with information obtained through the PCAOB inspection program. PCAOB enforcement staff members David Ware, Carol Der Garry, Arthur Lowry, and Pamela Woodward conducted the investigation, which was supervised by William Ryan and Marion Koenigs.

The PCAOB oversees auditors' compliance with the Sarbanes-Oxley Act, professional standards, and PCAOB and Securities and Exchange Commission rules. Further information about the PCAOB Division of Enforcement and Investigations may be found on the PCAOB website. Firms or individuals wishing to report suspected misconduct by auditors, or to self-report possible misconduct, may do so using the PCAOB Tip & Referral Center.

More Information

- Individuals named in separate orders
- All settled disciplinary orders

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13. PCAOB News Release: PCAOB Announces $750,000 Settlement with Deloitte Mexico for Failing to Effectively Implement Quality Control Policies and Procedures for Audit Documentation (December 5, 2016)

PCAOB Announces $750,000 Settlement with Deloitte Mexico for Failing to Effectively Implement Quality Control Policies and Procedures for Audit Documentation

Three individuals also were sanctioned for violations including improperly altering work papers

WASHINGTON, Dec. 5, 2016

The Public Company Accounting Oversight Board today announced that Mexico-based Galaz, Yamazaki, Ruiz Urquiza, S.C. (Deloitte Mexico) was censured and will pay a $750,000 civil penalty for failing to effectively implement quality control policies and procedures for audit documentation.

Two former Deloitte Mexico partners and another former auditor also were sanctioned for violations including audit deficiencies and improper alteration of work papers on a 2010 audit of a large U.S.-based mining company.

From 2011 to 2015, Deloitte Mexico failed to archive audit documentation of numerous public company audits within 45 days of the audit report release date in violation of Auditing Standard No. 3, *Audit Documentation*. The firm also violated PCAOB quality control standards by failing to effectively implement policies and procedures to ensure the timely archiving of audit documentation by its engagement teams.

"By failing to prevent repeated late archiving of its audit documentation over many years, Deloitte Mexico undermined its own quality control system and increased the risk that work papers might be improperly altered," said Claudius B. Modesti, director of the PCAOB Division of Enforcement and Investigations.

After the 2010 audit, the three individuals sanctioned — the engagement partner, a second partner, and another auditor on the engagement team — participated in the deletion and improper alteration of the archived audit documentation in advance of an internal audit practice review conducted as part of the firm's system of quality control.

The two partners then made available the improperly altered work papers to PCAOB staff during an inspection. During a subsequent PCAOB investigation, the engagement partner once again made available to PCAOB staff the improperly altered documents, as well as other misleading information.

"As these orders against the individuals demonstrate, the Board has zero tolerance for improper alteration of audit documentation in connection with a PCAOB inspection or investigation," said Director Modesti.

The engagement partner for the 2010 audit also violated PCAOB rules and standards by failing to exercise due professional care and skepticism and failing to obtain sufficient audit evidence in several significant areas.

Specifically, he failed to obtain sufficient evidence to support the company's tax treatment of unremitted earnings of a foreign subsidiary, perform sufficient procedures to test journal entries for the existence of fraud, and perform necessary procedures regarding the specialists used on the audit.

The sanctioned individuals are listed below. They are no longer associated with Deloitte Mexico.

- **Arturo Vargas Arellano, CPC** – Censured, will pay a $50,000 civil penalty, and was barred for five years from association with a PCAOB-registered public accounting firm
- **Miguel Angel Asencio Asencio** – Censured, will pay a $25,000 civil penalty, and was barred for two years from association with a PCAOB-registered public accounting firm
- **Aldo Hidalgo de la Rosa** – Censured

In addition to the censure and $750,000 civil penalty, Deloitte Mexico agreed to undertake significant remedial measures designed to prevent future violations of AS No. 3.

All of the respondents neither admitted nor denied the allegations contained in their respective orders.

The investigation that uncovered the misconduct and resulted in the settlements announced today originated with information obtained through the PCAOB inspection program. PCAOB enforcement staff members Bernard McDonough, James Welch, Carol Der Garry, and Hazel Mak conducted the investigation, which was supervised by William Ryan and Marion Koenigs.

The PCAOB oversees auditors' compliance with the Sarbanes-Oxley Act, professional standards, and PCAOB and Securities and Exchange Commission rules. Further information about the PCAOB Division of Enforcement and Investigations may be found on the PCAOB website. Firms or individuals wishing to report suspected misconduct by auditors, or to self-report possible misconduct, may do so using the PCAOB Tip & Referral Center.

More Information

- All settled disciplinary orders

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14. Michael Young: After the Financial Crisis- Revisiting Audit Committee Independence

REPRINT

AFTER THE FINANCIAL CRISIS: REVISITING AUDIT COMMITTEE INDEPENDENCE

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PERSPECTIVES

AFTER THE FINANCIAL CRISIS: REVISITING AUDIT COMMITTEE INDEPENDENCE

BY **MICHAEL R. YOUNG**

As the financial crisis recedes into history, it is time to turn renewed attention to the risk of fraudulent financial reporting.

Ironically, a big reason is that times are getting better. Corporate profits are up. Companies are again expanding. The stock market has more than recovered.

But with renewed economic viability comes increased pressure for financial performance. When times are bad, as they were not too long ago, the pressure for spectacular results eases as expectations are low and cash flow and survival are at the top of the agenda. It is as good times return that the pressure for financial performance builds. And with that pressure comes the risk of performance exaggeration.

Some early warning signs are emerging. The US Securities and Exchange Commission has announced a new Financial Reporting and Audit Task Force and the development of enhanced computer searching capabilities to seek out telltale signs of fraudulent financial reporting. The SEC also reports that whistleblower tips are pouring in. Beneath the headlines, some audit committees find themselves needing to commission investigations of the sort that have been a blessed rarity over the last several years.

"It is as good times return that the pressure for financial performance builds. And with that pressure comes the risk of performance exaggeration."

One problem, though, is that the investigative machinery has gotten rusty. In particular, some seem to have lost sight of a key feature that is often at the center of a financial reporting system that has gone astray. That is the culture of the company's financial reporting environment.

The centrality of culture to fraudulent financial reporting means that, when credible evidence of accounting irregularities surfaces, the culpability of those with the biggest impact on the financial reporting culture must often be considered. That will vary from company to company, but normally those with the biggest impact on the culture will include members of senior management. Historically, many audit committees have been astonished to learn that members of senior management were themselves complicit in the fraud.

It is rarely an optimum approach to a credible investigation of accounting irregularities, therefore, for management to oversee it. The same goes for those reporting to management, such as the company's regular outside counsel. At the outset, when the information may be limited and the circumstances chaotic, the deployment of a familiar law firm overseen by company executives may seem like the best reaction. Such an approach, however, has the potential to create serious problems – for both the company and its audit committee – down the road.

One problem is that an investigation overseen by management can have a tough time gaining credibility with important constituents. For public companies, foremost among those constituents will be the SEC. A public company faced with potential accounting irregularities quickly learns that credibility with the SEC is crucial. A company's audit committee can often do an investigation of its own accounting faster and more efficiently than can the SEC staff. An audit committee may therefore find itself asking the SEC enforcement staff to hold off to give the audit committee time to itself figure out the problem. Often, the SEC staff will agree.

But the SEC cannot be expected to agree if the company's investigation lacks credibility because it is being overseen or undertaken by those whose objectivity is questionable. Rather, efforts to persuade the SEC staff to defer to the audit committee can be expected to face significant scepticism and challenge.

Another critical constituent for a credible accounting investigation is the company's stock exchange. The discovery of potential accounting irregularities may delay the filing of financial information with the SEC or

compromise the reliability of financial information already on file. One potential result is a violation of exchange listing requirements and delisting. As with the SEC, the company will want to rebuild credibility and buy time. The exchange, in turn, will want to be assured as to the objectivity of the investigation. Like the SEC, the exchange may be sceptical where objectivity is not apparent.

Another constituent that matters is the outside auditor of the company's financial statements. At public companies, auditors subject to US law have a responsibility to consider whether audit committees facing possible accounting irregularities are taking 'timely and appropriate remedial actions'. For non-public companies, auditing standards contain analogous requirements. Experience has taught that accounting investigations undertaken by management, or those who have historically reported to management, may not have the necessary indicia of objectivity to qualify as 'appropriate remedial actions' or to serve as the predicate for issuance of an audit report.

Often lost in all of this, moreover, is a constituent that in many ways has the strongest interest in the objectivity of an investigation: innocent executives themselves. The reason is that an investigation conducted otherwise will often be unable to accomplish a key objective – establishing with credibility those who are guilty and exonerating with credibility those who are innocent. If the investigators are not objective, determinations of innocence are immediately suspect, and the practical consequence is that the investigation is incapable of exonerating anyone. It only has credibility to the extent it finds executives guilty.

A failure to put in place an objective investigative capability at the outset, moreover, can create additional problems as circumstances evolve. For one thing, use of regular outside counsel to investigate may effectively disqualify that counsel from defence of related securities class action litigation since it can be awkward for the same law firm to both objectively investigate, and defend against, contentions of accounting impropriety. The same may be true regarding a parallel SEC or Department of Justice investigation.

Should the complicity of management be discovered, management's oversight of the investigation can place the audit committee in an exceedingly awkward spot. In some cases, audit committees have found it necessary to terminate the investigative team, engage a new one, and start the investigation over.

The inclination to seek the help of familiar faces at the outset of a potential accounting irregularity problem is understandable. However, it can prove to be counterproductive. The consequences can include lack of credibility with the SEC, lack of credibility with the stock exchange, a failure to obtain audited financial statements, unavailability of regular outside counsel to defend against parallel litigation or regulatory proceedings, and, overall, investigative findings that only have credibility to the extent executives are found guilty.

The far better approach is for the audit committee to plan ahead with recognition of the need for investigative objectivity and independence. RC

Michael R. Young
Partner
Willkie Farr & Gallagher LLP
T: +1 (212) 728 8280
E: myoung@willkie.com

15. Michael Young: Financial Fraud Prevention and Detection- Getting Back to Audit Committee Basics

FINANCIAL FRAUD PREVENTION AND DETECTION: GETTING BACK TO AUDIT COMMITTEE BASICS

Michael R. Young[*]

Fraudulent financial reporting is back in the news. The SEC has created a new "Financial Reporting and Audit Task Force" with innovative computer capabilities to dig out fraud. Dodd-Frank has created monetary incentives for whistleblowers with the SEC receiving an average of eight tips per day. Perhaps most ominously, the economy is painfully emerging from the Financial Crisis and earnings expectations are again starting to matter. During times of crisis, the pressure for spectacular financial results dissipates and with it the pressure for financial fraud. When the good times return, so does the pressure.

Getting Back to Basics

So it is time for audit committees to get back to basics. However, it will not be easy. For one thing, the trend favoring ever-expanding responsibilities for audit committees has many audit committees assuming explicit responsibility for all sorts of things, including "Enterprise Risk Management" – an area posing formidable challenges to a normal audit committee's expertise and resources. Even within its core responsibility of financial reporting oversight, the audit committee "to do" list has continued to increase. Two months ago, the PCAOB issued a new release proposing the largest makeover in the standard form of audit report in the last 70 years.

If we want to get back to basics, a good starting point is with a concrete articulation of the audit committee's core responsibility. Here it is: It is the responsibility of the audit committee to oversee the system of financial reporting. That is the responsibility specified by Sarbanes-Oxley. That is the responsibility identified by the Treadway Commission more than 25 years ago. If an audit committee is willing to accept responsibilities

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[*] Michael R. Young is a partner of Willkie Farr & Gallagher LLP in New York where he chairs the firm's securities litigation and enforcement practice. His books include *The Financial Reporting Handbook* (Wolters Kluwer 2003) and *Accounting Irregularities and Financial Fraud* (Harcourt 2000). This article highlights concepts from his latest book, *Financial Fraud Prevention and Detection: Governance and Effective Practices* (Wiley 2014).

beyond that, more power to it. But it should not lose sight of its core function.

But how is that function to be fulfilled? At this point, we all know about "the tone at the top" – and rightly so, for it is critical. The challenge facing audit committees is not to recognize the importance of the tone at the top. The challenge is how to operationalize it. In other words, at this point everyone recognizes the importance of the culture and environment in which the financial reporting system is to operate. The more immediate question is how to turn that recognition into action. What should the audit committee be doing differently at the meetings?

Operationalizing the "Tone at the Top"

A great deal of attention continues to be paid to corporate governance paperwork – ethics codes, mission statements, and the like. Let us candidly admit that such paperwork will offer no practical constraint on a financial reporting system that is going astray. True, it is certainly a good idea for a company to reaffirm fundamental values. But we have all long recognized that actions speak louder than words.

When it comes to actions, audit committees today are plunging with admirable energy into the substance and logistics of financial reporting systems. Thus, they find themselves digging into the minutiae of reported results, financial statement notes, accompanying disclosure, draft press releases, and everything else. Recently added to the list has been the perils of social media.

But an important question is whether audit committees are deploying their valuable time and efforts in the right direction. Stepping back, audit committees today are frequently searching for financial misreporting by essentially looking for two things. One is a failure of those within the financial reporting system to be sufficiently careful. The second is a deliberate effort to misstate financial results – that is, fraud.

As a matter of pure logic, such an approach would seem to make sense. If financial misreporting is to occur, it seems logical that it will result from either well-intentioned blunders or a deliberate attempt to cook the books. True, mistakes can happen even when people are acting reasonably and trying to get everything right. But there's not much an audit committee can do about that.

The problem is that an approach focusing on well-intentioned negligence or deliberate financial misreporting runs the risk of

overwhelming the audit committee with minutiae while misdirecting its efforts from how they can be most effectively deployed.

An audit committee on the lookout for negligence, for example, will often find itself reading through pages upon pages of mind-numbing financial information and disclosure looking for problems. If that is the case, the audit committee may simply slip into an effort that is largely duplicative of the financial executives and professionals who have gone over the numbers many times before they reached the committee. The audit committee contributes little beyond still another layer of review.

But what about a search for dishonesty? Everyone understands that deliberate financial misreporting gave rise to Sarbanes-Oxley to begin with. The search for dishonesty would seem like something that should be at the top of the audit committee's list.

The problem with a search for dishonesty is that the audit committee is looking in the wrong place. Financial fraud typically does not start with dishonesty. And an audit committee on the lookout for dishonesty is not likely to catch fraud until it is much too late.

A Key Is Objectivity

So what does an audit committee look for? It is looking for something that is much more subtle, nuanced, and insidious than dishonesty. If an audit committee wants to nip financial fraud in the bud, one approach is to look for a loss of objectivity within the financial reporting system. That is, the audit committee will want to seek signs that the financial reporting system is being influenced by goals other than the fair and objective presentation of financial results. An omnipresent culprit is the susceptibility of the financial reporting system to influence resulting from a desire to meet financial targets such as quarterly analyst expectations.

The frightening thing is the insidiousness with which a financial reporting system can be so influenced. At one public company, the CEO each quarter told his accounting staff to inspect the books and records and search for corrections – particularly if the company was falling short of expectations. The CEO was crystal clear: Only honest corrections were to be made. Still, the accounting staff was very much aware that the CEO's goal was to increase earnings.

The CEO would later explain that he thought it was entirely proper to encourage the accounting staff to search for corrections. But he failed to appreciate one thing. The accounting staff's awareness of the CEO's goal

meant that it was not looking for corrections that went both ways. And the staff could be expected to place potential adjustments into one of three buckets. One bucket would be those adjustments forbidden by GAAP. Those would not be made. The second bucket would be those adjustments plainly required by GAAP. Those would be made. The third bucket would be judgment calls that could go either way. Those would be thought about. And as the staff grew weary and the quarterly deadline approached, adjustments in the third bucket would look increasingly tempting. The objectivity of the financial reporting system had been placed at risk.

Learning of Lost Objectivity

How does an audit committee learn of lost objectivity? A big part of the battle is getting those in the know to talk. An important lesson of the last 25 years is that, when financial systems are threatened by corruption, any number of well-meaning individuals will sense it, resent it, and seek to set the situation straight if given a non-threatening opportunity. The challenge for the audit committee is to give such individuals an opportunity to make their concerns known.

One device, of course, is a whistleblower hotline – but that is an extreme approach and it is far better to receive information through steadier and less dramatic means. A more accommodating approach is to put in place a system of sustained interaction with those who can serve as the eyes and the ears of the audit committee. Obvious candidates include both internal audit and the outside auditor.

But beyond those, the audit committee can engage regularly with carefully selected executives or operating personnel who happen to be positioned near the areas of greatest vulnerability in the financial reporting system. For example, an audit committee at a manufacturing company under pressure for quarterly results might want to learn what's going on in shipping. As one audit committee advisor once put it, "I like to talk to the guys on the loading dock. They'll tell you anything."

Unfortunately, it is a challenge to audit committee oversight – perhaps the biggest challenge – that the candor of executives and operating personnel will often be impeded by an understandable sense of caution rooted in the desire for self-preservation. In other words, they will not want to be perceived as criticizing anyone above them in the chain-of-command. An audit committee must both understand that and find ways to encourage candor nonetheless. Hence the emphasis on sustained interaction between such individuals and the audit committee – candid conversation becomes

much easier when an audit committee conversation does not become a big event. The audit committee must also appreciate that timely information about potential system corruption will ordinarily be vague and inconclusive. If a well-meaning executive waits for concrete information about fraudulent financial reporting before taking it to the audit committee, the communication will probably end up being too late.

In all of this, there are several things that, if not "worst practices," do not qualify as the best. One, an offshoot of a problem just mentioned, is to let an audit committee conversation become a big event. Candor is best enhanced by ongoing dialogue – sustained interaction. Another non-best practice is overreliance on powerpoint. Powerpoint certainly has its uses, but rare is the powerpoint slide that includes the bullet point, "We are perpetrating a fraud." Another non-best practice is for the audit committee to be tied too tightly to a fixed agenda. True, these days there is a long checklist of things to get through. But to miss the opportunity for freewheeling exchanges and brainstorming about system vulnerabilities is to miss a critical opportunity that is at the crux of audit committee oversight.

Conclusion: A Less Burdensome Approach

One benefit to an increased focus on the encouragement of candor is that suddenly audit committee oversight becomes not only more effective but less burdensome. One highly sophisticated audit committee member recently observed that preparation for a typical audit committee meeting included the receipt of literally thousands of pages of financial data and discussion. Looking for system inadequacies in such materials is like looking for a needle in a haystack. It may be buried in there somewhere, but good luck finding it.

A far better, and more efficient, approach is to encourage executives and personnel to speak up and highlight where things may be going wrong. Audit committee oversight should not be a grown-up game of "Where's Waldo." A big part is encouraging well-meaning employees to help the audit committee understand what's going on.

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16. Michael Young: The Board and Risk Management

THE BOARD AND RISK MANAGEMENT

Michael R. Young[*]

INTRODUCTION

The recent history of corporate governance seems to be the story of boards of directors struggling to play catch-up. There almost seems to be a pattern. Something bad happens. Questions about board-level oversight come from all directions. Lawsuits are commenced. The SEC issues new regulations. And boards of directors are left struggling to fulfill new expectations.

The corporate battle against fraudulent financial reporting provides all too recent an illustration. The problem was a dramatic upsurge in reported instances of accounting fraud and earnings restatements. Criticisms of boards of directors came from everywhere. Sarbanes-Oxley and new SEC regulations followed. And boards of directors, and audit committees in particular, found themselves trying to measure up against new responsibilities.

Now the pattern seems ready to repeat itself. This time the issue is not accounting fraud. It is risk management. We are slowly and painfully emerging from the worst of the credit crisis. Criticisms of board-level attentiveness to the management of risk abound. And, yet again, boards are faced with heightened expectations of performance and wondering how to fulfill them.

This is not an easy time to be a director. And the discipline of risk management promises to pose all sorts of new challenges. Exactly what risks are we actually talking about? What should be the role of the board? What is the role of the CEO? Should there be a "Chief Risk Officer?" How should all of the corporate apparatus interact?

Coming up with the questions – and there are plenty more – is much easier than coming up with the answers. At root, the challenge of risk management creates knotty issues of corporate governance, board oversight,

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[*] Michael R. Young is a partner of Willkie Farr & Gallagher LLP in New York. He served on the main advisory council of the Financial Accounting Standards Board during its development of the "fair value" accounting principles at issue in the subprime crisis. His publications include *The Financial Reporting Handbook* (2003) and *Accounting Irregularities and Financial Fraud* (3d ed. 2006).

independence, and putting in place the requisite expertise. Unfortunately, events have leapt forward in a way that does not give boards of directors a great deal of time to find answers. The objective of this article is to take a step in that direction.

WHAT IS BOARD-LEVEL "RISK MANAGEMENT"?

The first thing is to come to grips with exactly what we mean by board-level "risk management." The critical point here is that "risk management" is not a synonym for "risk reduction." The starting point, rather, is recognition that risk management at the board level basically seeks to accomplish three things. The first is the identification of those areas of risk warranting board-level attention. The second is the installation of a capability so that acceptable levels of risk can be determined. The third is establishment of a corporate governance mechanism that allows ongoing exposure to the risk to be managed. The overriding goal is risk management. It is not risk elimination.

None of this is easy, particularly since not all risks necessarily warrant meaningful oversight at the level of the board of directors. At the same time, some risks can be debilitating and serious board-level attention is warranted. Which risks are the ones the board would want to keep an eye on? That will largely depend on the business, but at many companies the following risks may be candidates for board-level attention:

- *Credit risk* – the potential loss arising from a counterparty's failure to meet its obligations to the company when due.

- *Liquidity risk* – the adverse consequences of an inability of the company to meet its own financial obligations to others when due.

- *Accounting risk* – the adverse consequences of a failure of the financial reporting system to fairly capture and report the company's financial results and position.

- *Market risk* – the potential loss arising from adverse fluctuations in interest rates, foreign exchange rates, equity and commodity prices, or other aspects of financial markets.

- *Legal & compliance risk* – the adverse consequences of a failure to comply with legal or regulatory requirements.

- *Operational risk* – the adverse consequences of inadequate or failed internal processes, people, or systems.

The breakdown into these areas of risk may at first seem a little random, but most of them share two characteristics. The first is the obvious emphasis on finance and the flow of money into, through, and out of the organization. Credit risk addresses the company's ability to collect money. Liquidity risk addresses the company's ability to pay money. Accounting risk addresses the company's ability to fairly report its financial performance and position. Market risk addresses threats to the company's financial position from adverse market shifts. The second characteristic is that each involves risks that, ineffectively managed, could bring down the company.

THE CEO AND THE CHIEF RISK OFFICER

With that as a starting point, the key question becomes: Exactly which individual within the organization is the best point person for effective management of all of these risks? In other words, which individual within the organization, more than anyone, will want to see to it that the quest for profitability is not out of sync with appropriate risk parameters?

The answer to that is fairly straightforward. As with every other aspect of corporate endeavor, the point person for acceptable risk will normally be the CEO. Some have questioned whether that should be the case – whether that individual should be someone higher or lower, either on the board or in management. But the more common view seems to be that, at its core, risk management is the balancing of risk and reward to maximize profitability. That is the essence of what being a CEO is all about.

Any sensible CEO will want to delegate as much as he or she reasonably can, which means that risk management in the first instance will almost always take place within the individual business units. This obviously makes sense since, for example, it is counterproductive for a sales representative to sell lots of product to a customer who can't pay the bills.

But there can be danger in over-reliance on business units for risk management. One is the perfectly natural inclination we all share to optimism which, at the business-unit level, can translate into disproportionate faith in the trustworthiness and financial strength of counterparties. That natural inclination to optimism can become even more pronounced when the business unit's success is measured against

performance targets that emphasize shorter-term objectives (such as revenue) rather than problems that may take longer to surface. Significant parts of the corporate machinery, therefore, can bias the business unit against complete objectivity in evaluating risk.

And even if that problem can be conquered, another problem from excessive reliance on individual business units can pose an additional challenge. It stems from the possibility that the separate business units will function as "silos" such that corporate-wide concentrations of risk might grow undetected. One business unit might find itself extending credit within a particular industry and think that the level of credit risk is acceptable. However, it may be that, unbeknownst to the manager of that business unit, a separate business unit is extending significant credit within the same industry. And maybe a third. Overall, therefore, each business unit may be approaching effective risk management in a completely sensible way. On an enterprise-wide basis, though, the company has inadvertently taken on a concentration of risk that is beyond its risk appetite.

Hence the trend in larger companies favoring the installation of an enterprise-wide "Chief Risk Officer" or "CRO." One of the main objectives of the Chief Risk Officer can be to seek information on risk across business units. The CRO can, among other things, look for otherwise undetected concentrations of risk tucked away at various parts of the company (residential mortgage risk is a timely example), make informed judgments about competing risk objectives, and assist everyone by highlighting risk concerns and encouraging enterprise-wide discussion on how they should be managed.

Increasingly, the Chief Risk Officers within companies are being supported by an enterprise-risk management capability known, naturally enough, as "enterprise risk management" or "ERM." The theory is that ERM reaches its tentacles into the critical aspects of corporate risk and basically does two things. One, it helps the business units understand the risks and take them into account – perhaps with more objectivity than if the business units were simply left to themselves. Two, it enables the collection of data for objective, and theoretically more disinterested, evaluation by the Chief Risk Officer himself.

That is not to say that ERM is purely a data-collecting and evaluation operation. Effective risk management can also involve the pre-establishment of bright-line constraints, and ERM can play a key role in

putting such constraints in place. ERM may also play a role in determining when exceptions to pre-established constraints should be allowed.

It is not the case, though, that the Chief Risk Officer and ERM, when putting in place parameters or when faced with a particular risk management decision, should necessarily be accorded final, dictatorial power to say "no." An important consideration is that the entire risk apparatus can sometimes be, in a sense, a bureaucracy with a built-in bias toward conservatism. The risk professionals may get no particular reward if things go well. But if things go badly, they will hear about it fast. The resulting temptation on the part of ERM personnel, therefore, may be in a direction that does not strike the optimum balance between risk and reward.

Often, therefore, it makes sense for acceptable parameters to be determined through discussion with the business leaders rather than through ERM dictate. Such an approach accepts the potential for optimism by the business unit, accepts the potential for conservatism by ERM, and theorizes that a healthy and candid discussion between the two will strike the right balance. If either side is left unsatisfied by the resolution, resort may be had to the CEO for additional input or, if that doesn't work, to the board of directors. An important benefit is that, in that way, the most difficult risk decisions can get escalated to the most senior levels.

It is at this point that one of the trickiest aspects of risk management comes to the fore. How should the board of directors structure itself to optimize its oversight of risk? Should, as some have suggested, the entire board assume full responsibility for risk management? Should responsibility go to a particular committee, such as the audit committee? Should there be a special "risk committee" of the board? Or should some other corporate mechanism be put in place?

Right now, the thinking is all over the place. Some argue for the full board; some argue for the audit committee; some argue for a special "risk committee"; some don't know what to do. At the board level, the "best practices" have yet to be written.

OVERSIGHT BY THE BOARD

The prevailing uncertainty on the best structure of board oversight of risk is an understandable reaction to a fundamental dilemma. At bottom, the problem involves putting in place a workable system of oversight that builds in sufficient accountability, expertise and manageability while still covering the full spectrum of risks warranting board attention. That system

will want to take into account, moreover, the potential need for a level of sophistication that allows the board to understand the weaknesses and vulnerabilities of the system even when they are not volunteered by those at lower levels.

Ideally, a director would not need to do that at all. In a perfect organization, problems involving risk – for that matter, problems involving anything – would naturally be identified by the various businesses, packaged, presented to the CEO, and then raised in the normal course with the board of directors for its consideration and reaction.

Unfortunately, few corporate governance systems are flawless. Nor can even well-meaning managers always be counted upon to volunteer their own weaknesses or, for that matter, to fully appreciate what they are. Rather than candid reports by managers as to exactly what they are doing wrong, board members can often find themselves staring at powerpoint presentations the titles of which seem to be "Everything Is Under Control." Hence the need for some level of board skepticism and sophistication on risk management.

And the need for sophistication and, in some instances, particular expertise cannot be taken lightly. Today, some of the most perilous risk management issues can involve the mind-numbing mathematics of modern-day risk analysis. Nor is sophistication or expertise in one area necessarily adequate for another. For example, the skill set for understanding liquidity risk may be completely different than the skill set necessary to understand, say, accounting risk or market risk. Rare is the director who would be able to hold his own against the experts on everything.

How is this being handled today? Even outstanding boards are struggling. And this struggle is necessarily taking place against a backdrop of pressure for enhanced oversight, newly-fashioned regulations and disclosure obligations, litigation, and heightened expectations. For some, the needs of the moment are being addressed by resort to the most analogous thing to a risk management committee already in place. At many companies, that means that broad areas of risk management are being turned over to the audit committee.

RISK AND THE AUDIT COMMITTEE

How did the audit committee earn this privilege? The answer probably lies more in recent history than logic. In the aftermath of Enron, the law turned to audit committees to take on what was perceived to be the biggest

risk of the moment – accounting risk. At the same time, some governance experts, sensitive to the need for risk management in non-accounting areas as well, defined audit committee responsibility with enough breadth that non-accounting risks tended to get swept in. The precise contours of these non-accounting risks, though, were not always clearly defined. Many audit committees, therefore, found themselves with responsibilities for risk management that, at the edges, were fuzzy.

The rules of the New York Stock Exchange probably illustrate the fuzziness as well as anything. The rules and the accompanying commentary accept the core audit committee responsibility for oversight of financial reporting. But they seek to expand that a bit by encouraging audit committees to take on an undefined category of "major financial risk exposures." True, they acknowledge that "the audit committee is not required to be the sole body responsible for risk assessment and management." Nonetheless, the audit committee is to "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken." Precision in responsibility, and therefore accountability, is not completely apparent.

The right question is whether the audit committee is optimally situated to take on these additional risks. Many audit committee members can be expected to argue that they already have enough to do just to stay on top of the ever-increasing workload of financial reporting. Another consideration involves the expertise of a typical audit committee which is directed, as a matter of law, to such things as debits, credits, and GAAP. If an audit committee has expertise in, say, the risks of international currency transactions, it is only going to be by coincidence.

A SEPARATE "RISK MANAGEMENT COMMITTEE"?

That takes us, logically enough, to think about a committee analogous to the audit committee but with a broader mandate – a "risk management committee." It is not surprising, therefore, to find that the suggestion of such a committee on risk, as the board-level overseer of risk management, increasingly is coming into vogue.

But such a committee still may lack the skill set for the complete spectrum of risks needing board attention. One with expertise in international currency transactions may not have the same skill set to ask the right questions about corporate credit risk models.

To remedy that shortcoming, some have proposed that the risk management committee hire its own set of risk experts. The thinking is that the committee could thereby field its own team on credit risk, liquidity risk, market risk, and so on. Thus, the risk management committee, and therefore the board, could have both the expertise and the information to understand what is really going on.

One reaction, though, is to question whether this additional bureaucracy is really the best approach. After all, the board of directors theoretically already has in place a system for ready access to information and expertise – the management it has employed. That management may include a Chief Risk Officer and ERM. If the board is concerned that it is not getting reliable information, that is a management problem and probably best dealt with in a way other than the installation of a parallel bureaucracy. Additional problems could include the access of the board's separate staff to risk management information. Rather than fostering within the company a collaborative and transparent effort directed to an optimum balancing of risks and rewards, one could see how a board committee armed with its own staff could send things in the opposite direction.

Another approach might be to deploy existing, and where needed additional, committees of the board, each with responsibility for the risk attendant to its own area. For example, a finance committee would have responsibility for credit and liquidity risk. The compensation committee would have responsibility for risks arising from compensation. The audit committee would have responsibility for accounting risk. And so on.

That seems logical as far as it goes, but it immediately encounters a different obstacle. One of the great hazards of risk management, suggested above, is the tendency for each group with responsibility for a particular area of risk to function in isolation from the others. The division of risk management across a spectrum of specialized committees, while perhaps maximizing the skill set needed to ask the tough questions, runs the risk of recreating the "silo" effect, now at the board level. Which committee, for example, would have responsibility for the impact of compensation on commodity trading?

A present-day issue illustrates this problem all too plainly. Today, everyone is preoccupied with liquidity risk. That is understandable, since many would point to liquidity risk as the cause of the failures of such companies as Bear Stearns and Lehman Brothers. In the aftermath, the risk management solution is centering on a recalibration of compensation to

give employees greater incentive to care about the longevity of their companies. Thus, compensation packages, for example, are including larger components of long-term stock compensation.

While that may be an effective device to manage liquidity risk, however, it may exacerbate a completely different area of risk – accounting risk. One of the lessons of the accounting scandals is that fraudulent financial reporting tends not to start with dishonesty but with pressure for performance in order to sustain stock price. If stock ownership by employees becomes a disproportionately large component of compensation, that pressure will potentially increase – particularly if employees have borrowed against their equity holdings to finance household cash flow. Recall, for example, the pressure to sustain the stock price placed upon the subsequently-imprisoned CEO of WorldCom who had borrowed more than $400 million collateralized by his WorldCom stock. It may be that, in focusing so intently on liquidity risk, we are falling into the trap of being less attentive to other risks – with overall risk management suffering as a consequence.

There are other downsides to board-level decentralization of risk oversight through a "multi-committee" approach. One is the possibility that the board of directors becomes a tower of babble with so many different committees that the whole thing collapses into confusion. Another may be a loss of accountability for risk management overall – no single committee thereby assumes "ownership" of the risk management system. Insofar as an important objective of that system would be to create a "culture" of risk sensitivity – and, where necessary, to protect the independence and effectiveness of the CRO – such a lack of accountability could operate to dissipate the effectiveness of the entire risk capability.

So where does all this end up? Taking everything into account, those favoring a centralized "risk management committee" at many companies may have the better argument. A single risk committee would serve as the focal point for risk management at the board level. There would be no dissipation of accountability. There would be a single spot if necessary for ultimate resolution of the tough risk management issues. Expertise and sophistication can be strengthened by having the Chief Risk Officer report directly to the risk management committee as well as to the CEO. The committee would thereby gain access not only to the CRO's views and analysis but to the information of the entire ERM organization. CRO and ERM independence would be strengthened thereby.

As a complement to a centralized committee on risk, separate board committees – compensation, audit, etc. – could continue to maintain responsibility for the risks falling within their respective areas. The CRO, and therefore the ERM apparatus, could report directly to these committees on their respective areas of risk.

But we still have to address the issue of silos among the differing committees and the need for breadth of membership expertise. One approach to those problems might be to populate the risk management committee mostly with representatives of the other committees. Thus, for example, the risk management committee could include the chair of the compensation committee, the chair of the audit committee, the chair of the finance committee, etc. In that way a compensation decision that, say, increases accounting risk can be talked through before the final decisions are made. A downside is the cumbersomeness of such a network of committees and the need for efficient interaction so that key corporate decisions are not unduly delayed. Discipline would similarly be needed to keep the risk management committee down to a manageable size. Nonetheless, such an approach might be the best way to capture both the desired expertise and sophistication while integrating information and perspectives.

CONCLUSION

Is there a one-size-fits-all approach for boards across the spectrum? Certainly not. And each board should be left to explore its own dynamics as to what may, or may not, work. But the SEC has already started rolling out new regulations on risk disclosure and has separately established a new risk division. Lawsuits on risk management in the subprime crisis have already been commenced. As has happened many times before, board-level oversight is in the crosshairs. So it is time to play catch-up again.

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