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The SEC's Continued Focus on Financial Reporting in 2016: What Does It All Mean for Public Companies?

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With the end of the Securities and Exchange Commission (“SEC”)’s 2016 fiscal year fast approaching, a few observations on the state of the agency’s regulation of financial reporting are in order. Most notably, the SEC continues to wage a vigorous, multi-front campaign to promote “[c]omprehensive, accurate and reliable financial reporting” – a campaign that began when SEC Chair White took office in April 2013. Not coincidentally, the number of financial reporting enforcement proceedings more than doubled over the intervening two-year period, from a total of 53 in the SEC’s fiscal 2013 (ending September 30, 2013) to 114 in fiscal 2015 (ending September 30, 2015).² Even if, as a recent report suggested, the number of SEC enforcement proceedings has declined thus far in 2016,³ the Chair and senior members of the agency’s Office of the Chief Accountant and the Divisions of Corporation Finance and Enforcement appear to have stepped up their efforts outside of the enforcement context to remind key “gatekeepers” of the financial reporting system – in particular, corporate audit committees and external auditors – of their special responsibilities under the federal securities laws. These efforts have been coordinated carefully with the Public Company Accounting Oversight Board (“PCAOB”), which oversees registered accounting firms, to communicate the same messages on such important topics of common concern to public companies and their auditors as the effectiveness of corporate internal control over financial reporting (“ICFR”) and auditor independence.

Through a series of speeches delivered by the SEC Chair and senior staff officials over the past few years at high-profile conferences, including most recently during the Practising Law Institute’s SEC Speaks conference held in Washington, D.C. on February 19-20, 2016, and the December 2015 AICPA National Conference on Current SEC and PCAOB Developments conference also held in the nation’s capital, the agency has highlighted the importance to the integrity of the financial reporting process of two statutory gatekeepers – the audit committees of reporting companies and the independent registered public accounting firms

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2. See Andrew Ceresney, Director, SEC Division of Enforcement, *Directors Forum 2016 Keynote Address* (San Diego, California, Jan. 25, 2016) (“Ceresney, 2016 Directors Forum Remarks”), available at <http://www.sec.gov/news/speech/directors-forum-keynote-ceresney.html>.
 3. See Cornerstone, *SEC Enforcement Activity Dips in 2016* (August 2016), available at <https://www.cornerstone.com/Publications/Research/SEC-Enforcement-Activity-Dips-in-2016>. This report did point out, however, that accounting-related cases represented 15 percent of overall SEC enforcement activity during Q1-Q3 of that agency’s 2016 fiscal year (beginning October 1, 2015), on par with 14 percent for the same period in the SEC’s FY 2015 ending September 30, 2015.

responsible for auditing the financial statements and ICFR of these companies.⁴ Guidance to senior management charged with preparing the financial statements and other core elements of periodic reports has been furnished not only through these speeches, but also through the Division of Corporation Finance’s updated Financial Reporting Manual, Compliance and Disclosure Interpretations (“CDI”s), and the comment-letter process. Last but not least, the accountability of each pillar of the metaphorical “three-legged stool” of corporate financial reporting – the senior managers who prepare and certify to the accuracy and completeness of issuer financial statements and report on the effectiveness of ICFR, the external auditors of those financial statements and ICFR, and the audit committees whose members oversee the performance of both management and the auditors⁵ – has been reinforced through the SEC’s Enforcement program, which has evolved substantially in the last two years.

On a parallel track, the SEC has been considering the need for financial disclosure reform through the rulemaking process pursuant to the Division of Corporate Finance’s Disclosure Effectiveness Initiative.⁶ Despite some promising signs,⁷ however, the SEC has yet to propose substantive regulatory changes in this area. Accordingly, this article will concentrate on existing financial accounting and auditing requirements, with a particular focus on the obligations of the two gatekeepers whose

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4. *See, e.g.*, Keynote Address of SEC Chair Mary Jo White, at the 2015 AICPA National Conference on Current SEC and PCAOB Developments, *Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility* (Washington, D.C., December 9, 2015) (“White, 2015 AICPA Keynote”), available at <https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html>; Remarks of SEC Chief Accountant James V. Schnurr before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Washington, D.C., December 9, 2015) (“Schnurr, 2015 AICPA Remarks”), available at <https://www.sec.gov/news/speech/schnurr-remarks-aicpa-2015-conference-sec-pcaob-developments.html>.
 5. *See* Remarks of SEC Chief Accountant James V. Schnurr before the UCI Audit Committee Summit (Newport Beach, CA, Oct. 23, 2015) (“Schnurr, UCI Remarks”), available at <http://www.sec.gov/news/speech/schnurr-speech-uci-audit-committee-summit.html>.
 6. *See* SEC Concept Release, *Business and Financial Disclosure Required by Regulation S-K*, SEC Release No. 33-10064 (April 13, 2016) (“SEC Regulation S-K Concept Release”), available at <https://www.sec.gov/rules/concept/2016/33-10064.pdf>.
 7. *See, e.g.*, SEC Proposing Release, *Disclosure Update and Simplification*, SEC Release No. 33-10110 (July 13, 2016), available at <https://www.sec.gov/rules/proposed/33-10110.pdf>; SEC Release No. 33-9929, *Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant* (Sept. 25, 2016), available at <https://www.sec.gov/rules/other/2015/33-9929.pdf>.

roles were re-defined and enhanced by the Sarbanes-Oxley Act of 2002 (“SOX”) – the audit committee and the external auditor.

What follows is an update on the current SEC and PCAOB developments relating to financial reporting and auditing of interest to public companies, along with an analysis of what these developments may signal during what ultimately may turn out to be a transitional year for both regulators given the upcoming Presidential election. Specific topics covered include the views of the SEC and PCAOB on the role and responsibilities of audit committees and external auditors, and the latest financial reporting “hot topics” affecting the preparation of periodic reports. This discussion is interspersed with the important messages to be drawn from SEC enforcement cases targeting accounting and auditing deficiencies, which sometimes (but not always) follow an extended period of SEC “jaw-boning” via speeches from Commissioners and staff, along with the issuance of staff interpretive guidance and comments based on staff review of periodic and current reports under the Securities and Exchange Act of 1934, as amended (“Exchange Act”).

I. SPOTLIGHT ON KEY FINANCIAL REPORTING “GATEKEEPERS” – THE AUDIT COMMITTEE AND THE OUTSIDE AUDITOR

A. The Audit Committee’s Central Role in Financial Reporting

1. Core Responsibilities Under SOX and the SEC’s “Overload” Concerns

SEC officials continued to use the “bully pulpit” throughout 2015 and 2016 to emphasize the role of the audit committee as a “critical gatekeeper in the chain responsible for high-quality, reliable financial reporting” by public companies. Both the SEC’s Chair and Chief Accountant expressed concern at the December 2015 AICPA conference⁸ about the increasing demands being made on audit committees that could detract from their primary mission, “with many audit committees now being charged with overseeing additional risks, including incredibly important areas such as cybersecurity.” The Chair warned that: “Audit committees of every company must remain entirely committed to ... oversight of

8. White, 2015 AICPA Keynote, above; Schnurr, 2015 AICPA Remarks, above.

financial reporting,” and recognize that “an increasing workload may dilute ... [their] ability to focus” on the performance of their core duties under SOX. These core duties are: (1) the selection and oversight of the independence, compensation and performance of the outside auditor with respect to the integrated audit of corporate financial statements and ICFR; (2) the oversight of management’s design, operation and assessment of the effectiveness of the company’s ICFR; (3) the establishment and oversight of the company’s whistleblower complaint policies and procedures relating to accounting and auditing matters; and (4) reporting to shareholders in the proxy statement.⁹

Many boards of directors have been wrestling with thorny questions of how best to allocate their collective oversight duties in light of new and ever-evolving compliance risks – including but not limited to cybersecurity. Although the SEC has no power directly to dictate how such risk oversight duties are assigned by boards outside the realm of financial reporting, the practical reality is that SOX has “federalized” corporate law when it comes to the fundamental responsibilities of listed company audit committees. The SEC’s concerns about the potential adverse consequences of audit committee “overload” for the effectiveness of the financial reporting process therefore should be carefully considered by the boards of directors of listed companies, particularly given the mounting pressure for more transparency in proxy statements regarding audit committee performance of SOX-prescribed responsibilities (as outlined above, and as discussed further in Part I.A.3., below), and the threat of SEC enforcement action should an audit committee member be viewed after-the-fact as having willfully or deliberately failed to perform his or her SOX-prescribed oversight duties (see Part I.A.4., below, for a discussion of recent SEC enforcement proceedings against audit committee chairs).

2. Specific Areas of Audit Committee Oversight Subject to Heightened SEC Scrutiny in 2015 and 2016

Beginning in the Fall of 2015, SEC Chair White and Chief Accountant James Schnurr delivered speeches making specific suggestions to audit committees regarding the “nitty gritty” aspects of their SOX-delineated responsibilities to oversee, on behalf of

9. White, 2015 AICPA Keynote, above; Schnurr, 2015 AICPA Remarks, above; Schnurr, UCI Remarks, above.

investors, the work of both the preparers (i.e. management) and external auditors of corporate financial statements and ICFR.¹⁰ SEC Enforcement Director Andrew Ceresney underscored the consequences of audit committee SOX oversight failures in a major speech delivered to the Directors Forum in late January 2016, as further discussed in Part I.A.4., below.¹¹ The PCAOB likewise has weighed in with tips for registrant audit committees derived in major part from the organization’s auditor inspection program.

Against this background, it would be prudent for audit committees to pay particular attention this year to the exercise of their oversight responsibilities in the following areas of financial reporting compliance identified as priorities by the SEC (and, indirectly, by the PCAOB through its shared oversight with the SEC of the outside auditor):

- Management’s plans for implementation of the new revenue recognition standard promulgated by the Financial Accounting Standards Board (“FASB”) subject to SEC oversight;
- Management’s use of non-GAAP measures in the wake of new Division of Corporation CDIs published in May 2016;
- Management’s design, implementation and reporting on the effectiveness of the company’s ICFR;
- Management’s judgments underpinning financial statement disclosures, particularly in the areas of fair-value measurement and impairment (goodwill, financial instruments), revenue recognition, segments, and income taxes (to name just a few of the “hot button” accounting and auditing issues outlined below in Part II of this article);
- Executive perquisites;
- Related party transactions accounting and disclosure;
- The effectiveness of company whistleblower complaint systems, as measured against standards set in a recent series of SEC anti-retaliation enforcement proceedings; and
- The independence of the outside auditors, as well as the quality of their financial statement and ICFR audit work for the company.

10. White, 2015 AICPA Keynote, above; Schnurr, 2015 AICPA Remarks, above; Schnurr, UCI Remarks, above.

11. Ceresney, 2016 Directors Forum Remarks, above.

With respect to this last point, SEC Chair White and Chief Accountant James Schnurr have stressed the importance of diligent audit committee oversight of both the quality of the work, and the independence, of the external auditor. In December 2015, for example, the Chair emphasized that audit committees “must ask questions about the auditor’s work, and satisfy themselves of the job the auditors are doing, particularly when it is time to select the right auditor and recommend to shareholders that they ratify the company’s choice.”¹² Mr. Schnurr made similar recommendations to audit committee members and others attending an October 2015 audit committee summit.¹³

Although the PCAOB has no jurisdiction over public companies and their audit committees, the organization formally initiated a direct dialogue with audit committee members in May 2015 to share insights into audit quality gleaned primarily, but not exclusively, from the PCAOB’s auditor inspection program.¹⁴ The first in a planned series, the PCAOB’s May 2015 guidance identifies both recurring and emerging areas of audit deficiencies uncovered during PCAOB inspections and outlines specific questions audit committees may want to pose to their companies’ auditors regarding such critical topics as the audit of ICFR, assessing and responding to risks of material misstatement, auditing fair value measurements and other management estimates, and referred work to other audit firms in connection with cross-border audits.

Since publication of the May 2015 guidance, PCAOB members and staff have continued to communicate with audit committee members through formal and informal means. In a June 2016 speech, for example, Board member Jay Hanson described the PCAOB’s ongoing, “robust dialog” with audit committees relating to the organization’s audit quality rulemaking project.¹⁵ One of the

12. White, 2015 AICPA Keynote, above.

13. Schnurr, UCI Remarks, above.

14. See PCAOB Release No. 2015-003, Audit Committee Dialogue (May 7, 2015) (“PCAOB Audit Committee Dialogue”), available at <http://pcaobus.org/sites/digitalpublications/Documents/AuditCommitteeDialogue.pdf>. This is not the first time the PCAOB has published guidance addressed specifically to audit committees. See, e.g., PCAOB Release No. 2012-003 (Aug. 12, 2012), *Information for Audit Committees About the PCAOB Inspection Process*, available at http://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf.

15. Remarks of Jay D. Hanson, Board Member, PCAOB, to the 2016 SEC and Financial Reporting Institute, *PCAOB Update – Recent Activities and Next Steps* (Los Angeles, California, June 9, 2016), available at <http://pcaobus.org/News/Speech/>

objectives of this project is to identify audit quality indicators designed to “help frame” – for audit committees and audit firms alike – “the oversight and evaluation of a current or pending audit.”¹⁶ As noted in an April 2016 report on auditor compliance with PCAOB standards and rules governing communications with the audit committee, moreover, the PCAOB disclosed that PCAOB Inspections staff had interviewed unnamed audit committee chairs to elicit their views.

3. SEC Emphasis on Audit Committee Reporting Obligations

According to Chair White, the SEC is now considering the nature and scope of the audit committee’s “critical responsibility” to report to shareholders, as evidenced, for example, by the SEC’s July 2015 concept release requesting public input on whether improvements should be made to existing audit committee reporting requirements set forth in Item 407(d) of Regulation S-K.¹⁷ The disclosures called for by Item 407(d) usually appear in the Audit Committee Reports found in company proxy statements, and must include the following items of information: (1) whether the audit committee has reviewed and discussed the company’s financial statements included in the Form 10-K with management; (2) whether the audit committee has discussed with the outside auditors those matters identified in applicable PCAOB auditing standards; (3) whether the audit committee has received and reviewed certain written information from the outside auditor relating to that firm’s independence; and (4) whether, based on the review and discussions outlined in (1)-(3), above, the audit committee recommends to the full board of directors that the audited financial statements be included in this year’s Form 10-K. This release, which does not propose any specific rule changes, asks numerous questions about the costs and benefits of requiring possible additional disclosures relating to the audit committee’s oversight and communications with the outside

[Hanson-SEC-FinReporting-Conference-060916.aspx](#), discussing PCAOB Release No. 2015-005, Concept Release on Audit Quality Indicators (July 1, 2015) (“AQI Concept Release”), available at http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf.

16. AQI Concept Release, above.

17. White, 2015 AICPA Keynote, above, discussing SEC Concept Release, *Possible Revisions to Audit Committee Disclosures*, SEC Rel. No. 33-9862 (July 1, 2015), available at <http://www.sec.gov/concept/2015/33-9862.pdf>.

auditor, the committee’s process for selecting the outside auditor, and the committee’s process for evaluating the qualifications and work of the external audit team.

While it is difficult at this point to predict the outcome of the SEC’s rulemaking project during an election year – the agency’s recently published “request for comment” on Item 407 of Regulation S-K, along with other line items in the S-K 400 series, offered no insights in this regard¹⁸ – the SEC has made clear that there is more companies can do on a voluntary basis to improve disclosures under the current requirements. In this connection, SEC Chair White made the following observation: “[T]he audit committee report serves as a place for engaging with shareholders on important subjects, and the report must continue to meet the needs of investors and their interests and expectations evolve with the marketplace.”¹⁹ In a similar vein, a senior SEC accountant encouraged members of listed company audit committees “to continue to consider the usefulness of their audit committee disclosures and consider whether providing additional disclosure into *how* the audit committee executes its responsibilities would make the disclosures more meaningful.”²⁰

4. Getting the Message Out Through the SEC Enforcement Process

Notwithstanding the SEC’s rhetoric regarding the importance of the audit committee’s SOX-imposed “gatekeeper” status and its members’ ultimate accountability for the integrity of corporate financial reporting, the agency rarely holds audit individual committee members primarily responsible for corporate accounting fraud and other federal securities law violations. On the relatively few occasions when a particular audit committee member is believed to have been reckless or willful in abdicating his or her oversight duties, however, the SEC will bring an enforcement action.

18. See SEC Release No. 33-10198, *Request for Comment on Subpart 400 of Regulation S-K Disclosure Requirements Related to Management, Certain Securityholders and Corporate Governance Matters* (Aug. 25, 2016), available at <https://www.sec.gov/rules/other/2016/33-10198.pdf>.

19. White, 2015 AICPA Keynote, above.

20. For additional details on what companies have been doing voluntarily to enhance the quality of audit committee reports, see this Weil publication, *What’s New for the 2016 Proxy Season* (Jan. 26, 2016), available at <http://www.weil.com>.

During a January 2016 Directors' Forum held in San Diego, California, SEC Enforcement Director Andrew Ceresney discussed three recent cases brought against individual audit committee chairs "that provide helpful guidance on the types of [audit committee] failures that will attract our [Enforcement Division] attention." In all three cases, the audit committee members sued had "approved public filings [by the company] that they knew, were reckless in not knowing, or should have known were false because of other information available to them."²¹ As Mr. Ceresney put it, "[t]he takeaways from these cases is straightforward: when an audit committee member learns of information suggesting that company filings are materially inaccurate, it is critical that he or she take concrete steps to learn all relevant facts and cease annual and quarterly filings until he or she is satisfied with the accuracy of future filings."

The most recent of these cases is an administrative proceeding that was filed and settled in September 2015, in which the SEC brought charges against the ex-chair of Musclepharm Corporation's audit committee, as well as the company itself and three other individuals. The charges arose from a series of accounting and disclosure violations, including the company's failure to disclose certain executive perks in its proxy statements. With regard to the materially deficient perks disclosure, Mr. Ceresney explained that the audit committee chair had "subjected himself to liability when he substituted his wrong interpretation of SEC rules for the views of [legal] experts the company had hired, resulting in an incorrect disclosure."²² This director had signed several SEC filings containing the inaccurate disclosures before he learned, through an internal company review, that certain perks had been omitted and should be disclosed. He was targeted by the SEC primarily because he disregarded the findings and conclusions of the "independent consultant Musclepharm had hired [to conduct the review], resulting in additional filings with incorrect perk disclosures."

More than a year earlier, in March 2014, the SEC brought two unrelated cases against former audit committee chairs for ignoring "red flags" signaling serious management misconduct. In the first of these cases, the SEC charged an animal feed company and its

21. Ceresney, 2016 Directors Forum Remarks, above.

22. *Id.*, citing SEC Press Release No. 2015-179 (Sept. 8, 2015), *SEC Charges Sports Nutrition Company With Failing to Properly Disclose Perks for Executives*, available at <http://www.sec.gov/news/pressrelease/2015-179.html>.

top executives with “conducting a massive accounting fraud” involving the repeated falsification of revenues from the company’s Chinese operations.²³ While the company was engaged in capital-raising and acquisition activities, the audit committee chair learned of facts indicative of fraud from a high-level employee who had visited the China operations. Ignoring these facts, as well as a former director’s recommendation that the company undertake a full internal investigation, the audit committee chair signed off on the filing of defective financial statements with the SEC despite these “red flags of fraud.”

In the other case instituted and settled in March 2014, the audit committee chair charged had signed an annual report that “she knew or should have known contained a false Sarbanes-Oxley certification” by “a purporting acting CFO when, in fact, the person selected for that [CFO] role had rejected the offer to serve in the position.”²⁴

More recently, the SEC used enforcement settlement orders to deliver cautionary messages to audit committees whose members were neither sued nor named in the order. In each of two settled administrative proceedings brought against a company for materially misstated financial statements and inadequate ICFR, which was settled without any admission or denial of culpability, the corresponding SEC order stated that the inadequacies of the audit committee’s review of a particular accounting methodology contributed to that company’s violations of the federal securities laws.²⁵ Specifically, each audit committee was faulted for failing to “give sufficient consideration” to the relevant fair value calculation that led to a material misstatement, notwithstanding its obligations to undertake such consideration as set forth in the particular committee’s charter.

23. *Id.*, citing SEC Press Release No. 2014-47, *SEC Charges Animal Feed Company and Top Executives in China and the U.S. with Accounting Fraud* (March 11, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541102314>.

24. *Id.*, citing SEC Press Release No. 2014-79, *SEC Announces Fraud Charges Against Coal Company and CEO for False Disclosures About Management* (March 27, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541317697>.

25. *See In the Matter of Ocwen Financial Corp.*, SEC Release No. 34-76938 (Jan. 20, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-76938.pdf>; *In the Matter of Home Loan Servicing Solutions, Ltd., Ltd.*, SEC Release No. 34-76074 (Oct. 5, 2015), available at <https://www.sec.gov/litigation/admin/2015/34-76074.pdf>.

5. Oversight of Whistleblower Complaint Systems

The SEC's Exchange Act Rule 10A-3(b)(3), which has been implemented by the national securities exchanges through listing standards in accordance with Exchange Act Section 10A-3(m)(4) (added by SOX in 2002), makes the audit committee of a listed company responsible for "establishing procedures for ...the receipt, retention and treatment of complaints" submitted to the company regarding accounting, internal accounting controls and auditing matters. In addition, this rule and applicable listing standards require the audit committee "to establish procedures for ... the confidential, anonymous submission by employees of concerns regarding questionable auditing and accounting matters." Corporate compliance with these whistleblower complaint requirements has become even more important with the advent in 2010 of the whistleblower bounty and anti-retaliation provisions added to the Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which the SEC implemented in 2011 through rulemaking (Regulation 21F under the Exchange Act) and the creation of the Office of the Whistleblower within the Division of Enforcement. Both the SEC and aggrieved whistleblowers may enforce the statutory anti-retaliation protections.

Complaints and tips received by the SEC under the Dodd-Frank whistleblower bounty program have become an increasingly important source of leads for Division of Enforcement financial reporting investigations.²⁶ For the SEC's fiscal year ended September 30, 2015, the agency received close to 4,000 complaints and/or tips, with the largest category of allegations (accounting for 17.5%) involved Corporate Disclosures and Financials, according

26. The Dodd-Frank whistleblower and employee anti-retaliation protections are not limited to the accounting and auditing matters covered by the SOX-mandated whistleblower complaint procedures, but instead extend to allegations of "possible violation of the federal securities laws that has occurred, is occurring or is about to occur." As Enforcement Division Director Ceresney recently pointed out, however, the Dodd-Frank whistleblower bounty program, together with the Division's witness cooperation incentives, enable the Enforcement staff "to glean valuable information regarding potential financial frauds from company insiders. Since the inception of the whistleblower program, tips related to potential financial fraud have accounted for a significant volume of whistleblower reports [w]histleblowers are indispensable to our efforts to find wrongdoing." Ceresney, 2016 Directors Forum Remarks, above.

to the latest SEC whistleblower report to Congress.²⁷ During fiscal 2015, the SEC paid more than \$37 million in bounty payments to a total of eight whistleblowers. This trend continues into 2016, with payments of almost \$2 million made to three whistleblowers in March,²⁸ following the announcement of a \$700,000 award paid in January 2016.²⁹ More recently, on August 30, 2016, the SEC announced the award of a \$22 million bounty to a former company insider who had assisted the agency in halting a “well-hidden fraud” – the second largest payment made to an individual in the history of the Dodd-Frank whistleblower program.³⁰

The SEC’s Dodd-Frank whistleblower bounty rules encourage, but do not compel, whistleblowers to resort in the first instance to internal corporate complaint mechanisms before “reporting out” to the SEC. Questions eventually arose as to whether those whistleblowers who elected to pursue their complaints internally without contacting the SEC were precluded from invoking the Dodd-Frank employee anti-retaliation remedy. In August 2015, the SEC published an interpretive release “clarifying” that the statute and SEC rules thereunder preserve the right of employee complainants who do not lodge their complaint with the SEC to sue their employers for retaliation in federal court.³¹ In a 2015 opinion, the influential U.S. Court of Appeals for the Second Circuit agreed with the SEC’s position (asserted in that case in an *amicus* brief).³²

For its part, the SEC has brought (and settled) several administrative cease-and-desist enforcement proceedings in the past year

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27. SEC 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program (Nov. 2015), available at <https://www.sec.gov/whistleblower/reportpubs/annual-reports/owb-annual-report-2015.pdf>.
 28. SEC Press Release No. 2016-41 (March 8, 2016), available at <https://www.sec.gov/News/Pressrelease/2016-41.html>.
 29. SEC Press Release No. 2016-10 (Jan. 15, 2016), available at <https://www.sec.gov/News?Pressrelease/2016-10.html>.
 30. See SEC Press Release No. 2016-172 (Aug. 30, 2016), available at <https://www.sec.gov/news/pressrelease/2016/2016-172.htm>.
 31. See SEC Interpretive Release No. 34-75592 (August 4, 2015), available at <https://www.sec.gov/rules/interp/2015/34-75592.pdf>.
 32. See *Berman v. Neo@Ogilvy LLP*, 801 F. 3d 145 (2d Cir. 2015). This ruling created an apparent conflict with an opinion of the U.S. Court of Appeals for the Fifth Circuit, in *Asadi v. G.E. Energy (USA) LLC*, 720 F. 3d 620 (5th Cir. 2013), which held that the employment anti-retaliation protections are not available unless a complainant brings his or her concerns to the attention of the SEC. Resolution of this conflict must await another day, as Neo@Ogilvy ultimately decided not to seek Supreme Court review.

challenging confidentiality clauses and other language in corporate severance agreements that the agency views as impairing Dodd-Frank whistleblower rights.

The first of these proceedings was instituted in April 2015 against Houston-based KBR, challenging the use of employee confidentiality agreements that could be construed as discouraging employees from bringing whistleblower complaints to the SEC without permission from the company's General Counsel in the context of internal investigations involving (among other matters) securities fraud. Even though KBR had not enforced the challenged provisions against any employee, the company opted to settle the matter by paying a \$130,000 penalty and amending its confidentiality agreements to include language acceptable to the SEC.³³

At issue in SEC administrative proceedings brought against two corporate employers in August 2016 – BlueLinx Holdings Inc.³⁴ and Health Net, Inc.³⁵ – were various contractual restrictions on post-employment disclosure of confidential corporate information, and waivers of rights to recover Dodd-Frank whistleblower awards in the event complaints of possible securities law violations were made to the SEC. BlueLinx consented to the SEC's entry of a permanent cease-and-desist ("C&D") order imposing a \$265,000 penalty (without admitting or denying liability), and undertook to incorporate SEC-prescribed language in all severance and related agreements. The Health Net settlement similarly involved the company's consent (without admission or denial of culpability) to a permanent C&D order and payment of a substantial penalty (\$340,000), but did not require the company to include specified language in standard severance agreements – presumably due to the company's amendment of these agreements in October 2015 to remove the problematic language. Each company also agreed to: (a) contact former employees who had signed the offending documents to inform them of the SEC's order and advise them that the company does not prohibit seeking and obtaining whistleblower bounties from the SEC; and (b) to provide written certification of its compliance with (a) to the Division of Enforcement.

33. See *In the Matter of KBR, Inc.*, SEC Release No. 34-74619 (April 1, 2015), available at <https://www.sec.gov/litigation/admin/2015/34-74619.pdf>.

34. See *In the Matter of BlueLinx Holdings Inc.*, SEC Release No. 34-78528 (Aug. 10, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78528.pdf>.

35. See *In the Matter of Health Net, Inc.*, SEC Release No. 34-78590 (Aug. 16, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78590.pdf>.

In a private anti-retaliation litigation milestone, a federal magistrate in the Northern District of California declined in late October 2015 to dismiss a complaint filed by a former employee against the directors of a Fortune 100 company seeking to hold them personally liable under the anti-retaliation remedial provisions of both Dodd-Frank and SOX. The individual directors were alleged to have participated in the company's decision to terminate the plaintiff-whistleblower. In *Wadler v. Bio-Rad Labs, Inc.*,³⁶ the plaintiff was Bio-Rad's former general counsel, who had raised concerns internally regarding potential FCPA violations in China. After an outside law firm engaged by the audit committee determined that there was no evidence of such violations, the CEO fired the plaintiff. As noted, the full board voted to approve the termination – this was the degree of participation deemed sufficient to pass muster on a motion to dismiss Dodd-Frank and SOX anti-retaliation claims. Because this litigation apparently is still pending, the outcome is difficult to predict.

Given these recent developments, companies would be well-advised to re-examine their whistleblower complaint policies and procedures, codes of conduct and severance agreements to ensure that current and former employees are not discouraged from reporting any concerns to the SEC on accounting and auditing matters. In addition, as discussed above, companies should take care to enable their audit committees to focus on their SOX-prescribed financial reporting oversight duties, which encompass the corporate whistleblower complaint mechanism. Finally, boards of directors should keep in mind the risk that non-employee directors, as well as corporate management, may have personal liability exposure under the anti-retaliation provisions of Dodd-Frank and SOX.

36. Case No. 15-cv-02356-JCS, 2015 WL 6438670 (N.D. Cal., Oct. 23, 2015). There are additional claims based on California law, which are not discussed in this article. The judge granted in part and denied in part a motion to dismiss filed by the corporate and individual defendants, finding (in pertinent part) that: (a) the claims against the outside directors under the whistleblower anti-retaliation provisions of both Dodd-Frank and SOX could proceed; (b) deferring to the SEC's interpretation of Dodd-Frank anti-retaliation provision, the plaintiff's internal reporting alone, without also reporting "out" to the SEC, was sufficient to support his Dodd-Frank anti-retaliation claim; and (c) the SOX anti-retaliation claim against the company and the CEO could proceed. The SEC filed an *amicus* brief supporting the plaintiff on point (b), above; the judge observed that the Ninth Circuit was considering this issue in an unrelated case.

B. The Outside Auditor

1. Audit Quality

External auditors are viewed by the SEC as investor “watchdogs” of reliable, high-quality financial reporting, responsible for “protect[ing] investors by applying auditing standards to evaluate whether financial statements are fairly stated in all material respects.”³⁷ Accordingly, when audit failures occur – whether they come to the fore through PCAOB inspections, SEC investigations of financial reporting fraud or otherwise – the conduct of both the auditors and management preparers inevitably attracts close regulatory scrutiny. Companies should be aware that PCAOB inspections, which entail (among other things) the selection of specific corporate audit engagements for PCAOB staff review, may lead not only to negative inspection findings against the audit firm but also to referrals to the SEC Enforcement Division for further investigation with a view possible civil or administrative action.

The SEC sued two major accounting firms in 2015, in what the Enforcement Division Director later described as “the first cases against national firms for audit failures since 2009.”³⁸ In each of these cases, both of which were settled, the audit firm admitted wrongdoing and agreed to “very detailed undertakings and remedial measures.” The audit firms in question, BDO and Grant Thornton, acknowledged that responsible personnel – including, in the case of BDO, three members of the firm’s National Office – had failed to heed “numerous warnings and red flags” relating to fraudulent activities perpetrated by their corporate clients and ultimately succumbed to management pressure.

2. Auditor Independence

Auditor independence remains a top priority of the SEC’s OCA, as well as the PCAOB. As Deputy Chief Accountant Brian

37. Ceresney, 2016 Directors Forum Remarks, above, citing White, 2015 AICPA Keynote, above.

38. Ceresney, 2016 Directors Forum Remarks, above, citing SEC Press Release No. 2015-272, *Grant Thornton Ignored Red Flags in Audits* (Dec. 2, 2015), available at <http://www.sec.gov/news/pressrelease/2015-272.html>, and SEC Press Release No. 2015-184, *SEC Charges BDO and Five Partners in Connection With False and Misleading Audit Opinions* (Sept. 9, 2015), available at <http://www.sec.gov/news/pressrelease/2015-184.htm> (“BDO”).

Croteau pointed out at the December 2015 AICPA conference, “[i]nvestor confidence in financial reporting is highly dependent on auditors’ commitment to maintaining independence in both fact and appearance.”³⁹ During the same conference, SEC Chief Accountant Schnurr expressed concern about the growth of accounting firm’s non-audit consulting practices.⁴⁰

A finding by the SEC (or its staff) that the external auditor is, or was, not independent during current or prior reporting periods could have such potentially disastrous consequences for the affected company as a determination by the Division of Corporation Finance staff that audited (and reviewed) financial statements to be filed or filed as part of the issuer’s periodic reports on Forms 10-K and 10-Q will be (or are) materially deficient and therefore may have to be re-audited by a new audit firm. Because vigilance regarding the external auditor’s independence is a shared responsibility of the auditor, audit committee and management, Mr. Croteau recommended last December that all three “evaluate whether there are any unacceptable threats that might bear on the auditor’s independence in applying the [SEC’s] general standard [set forth in Rule 2-01 of Regulation S-X].” Even after non-audit services are approved by the audit committee, OCA believes that it is “advisable” for audit committees and management “to have policies and procedures for ongoing monitoring of the provision of ... [such] services during their execution to address the risk of ‘scope creep’ that could result in a service becoming impermissible and impairing the auditor’s independence.”

As to the PCAOB, one member recently outlined his concerns regarding “emerging threats to auditor independence” raised by the proliferation of non-audit consulting and advisory services among the “Big Four” global network accounting firms. Noting that the U.S. arms of these firms now dominate the consulting market, he warned that the “Board is analyzing the business model of the firms with a focus on responding to potential risks to auditor independence and audit quality.”⁴¹

39. SEC Deputy Chief Accountant Brian T. Croteau, Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Washington, D.C., Dec. 9, 2015)(“Croteau, 2015 AICPA Remarks”)(emphasis in the original), available at <http://www.sec.gov/news/speech/croteau-2015-aicpa.html>.

40. See Schnurr, 2015 AICPA Remarks, above.

41. Remarks of Steven B. Harris, Member, PCAOB, before the International Corporate Governance Network (ICGN) Annual Conference, *Auditor Independence and*

3. Auditor Communications with Audit Committees

Certain PCAOB rules and standards require auditors to communicate with audit committees on specific topics including, most notably, Auditing Standard (“AS”) No. 16, *Communications with Audit Committees*.⁴² In effect for three annual audit cycles, AS No. 16 is intended to improve the audit process and otherwise assist the audit committee in discharging its own gatekeeping duties for the benefit of investors. Another important PCAOB rule, Rule 3526, prescribes specific auditor communications with the audit committee regarding that auditor’s independence, while AS No. 12 directs auditors to make certain inquiries of client audit committees about the risks of material misstatement, including but not limited to fraud risks.⁴³ As further discussed below (in Part II.B.1.), the new auditing standard on consideration of the issuer’s transactions and relationships with related parties, AS No. 18, also requires auditors to discuss such transactions and relationships with the issuer’s audit committee.

Earlier this year, the PCAOB published its observations on how well audit firms are doing thus far with respect to implementation of AS No. 16, and their compliance with other requirements relating to audit committee communications.⁴⁴ Based on staff findings derived from the 2014 and 2015 inspection cycles, the PCAOB indicated that it was “encouraged by the fact that most firms had incorporated the requirements of AS 1301 [AS No. 16] into their practices” and that, at least with respect to 93% of the audit firms

the Role of the PCAOB in Investor Protection (San Francisco, California, June 28, 2016).

42. Effective December 31, 2016, AS No. 16 will be redesignated as AS 1301. See PCAOB Release No. 2015-02 (March 31, 2015)(adopting amendments that reorganize and renumber PCAOB auditing standards), available at https://pcaobus.org/Rulemaking/Docket040/Release_2015_002_Reorganization.pdf. The SEC approved these changes in September 2015, in SEC Release No. 34-75935 (Sept. 17, 2015), and they become effective on December 31, 2016 (although auditors are free to use and reference the reorganized PCAOB standards and related interpretations prior to the effective date).
43. AS No. 12, *Identifying and Assessing Risks of Material Misstatement*, will become AS 2110 effective December 31, 2016.
44. PCAOB Release No. 2016-001, *Inspection Observations Related to PCAOB Rules and Auditing Standards on Communications with Audit Committees* (April 5, 2016) (“PCAOB Report on Auditor Communications with Audit Client Audit Committees”), available at <https://pcaobus.org/Inspections/Documents/2016-communications-audit-committees.pdf>.

inspected in 2014, there were no failures to comply with this standard.⁴⁵

II. FINANCIAL REPORTING “HOT BUTTON” TOPICS IN 2016

A. SEC

1. *Crafting Effective MD&A and Risk Factor Disclosure in a Volatile Economic Environment*

During the SEC Speaks conference in February 2016, Division of Corporate Finance Deputy Director Craig Olinger underscored the importance of meaningful disclosure in the Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) section of periodic reports. MD&A has long been a major area of recurring staff comment, and 2016 has been no exception. Not only should the MD&A provide insight into the company’s historical results, but it also must discuss and analyze those “known demands, commitments, events or uncertainties” that will have, or are reasonably likely to have, a material effect – whether positive or negative – on the company’s future liquidity, capital resources and/or results of operations.⁴⁶

Mr. Olinger indicated that the staff expects companies to consider, in crafting their MD&A, the implications of the present market turmoil, particularly fluctuations in the prices of oil, gas, metals and other commodities, and the uncertain interest-rate environment in the United States. Other Division accountants discussed the need for management to consider carefully how macro-economic changes have, or may, affect the company liquidity, capital resources

45. *Id.*

46. Once management has identified a given trend, demand, commitment, event or uncertainty, it must make the following assessment under Item 303(a) of Regulation S-K: (a) is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management decides that the particular contingency is **not** reasonably likely to occur, no disclosure is required; (b) but if management **cannot** make that determination, it must go on to evaluate objectively the consequences of the known trend, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required, unless management can decide that a material effect on the company’s financial condition or results of operations is **not reasonably likely to occur**. See SEC Rel. No. 33-6835 (May 18, 1989), available at <http://www.sec.gov/rules/interp/33-6835.htm>. The SEC has sought comment, in the July 2015 Regulation S-K Concept Release, on whether this two-step analysis should be eliminated.

and/or operating results, rather than simply “cutting and pasting” last year’s MD&A narrative and substituting this year’s numbers. Among the potentially significant external factors cited as candidates for “material trends, events or uncertainties” disclosure in the MD&A, in addition to commodity pricing and interest-rate fluctuations noted above by Mr. Olinger, are the continued strength of the U.S. dollar against other countries’ currencies and forecasts of lower U.S. consumer demand and general economic growth in 2016. Again, the material effects (e.g., of lower oil prices) for some companies could be positive as well as negative; either effect must be disclosed if material.

The staff went on, during the 2016 SEC Speaks conference, to emphasize that disclosure of these and other known trends, uncertainties and events deemed reasonably likely to have a material impact on a company’s future performance may be required outside the MD&A section of periodic reports; for example, in the Risk Factors and Business Description sections. From the staff’s perspective, companies should re-evaluate their risk factors on at least a quarterly basis to determine whether there has been any material change – either external or internal to the particular company – warranting modification or expansion of risk-related disclosure in interim reports on Form 10-Q, as well as on an annual basis for the Form 10-K.⁴⁷ The adequacy of cybersecurity risk disclosure in the wake of a material breach is a good candidate for re-evaluation in 2016, in light of observations made by the Division of Enforcement’s Deputy Director at this conference indicating that a company’s failure to comply with Division of Corporation Finance guidance published in 2011 might attract an enforcement inquiry.⁴⁸

Effective risk factor disclosure is not just a matter of compliance with SEC line-item requirements, in the form of Item 503(c) (risk factors) and Item 303 (MD&A) of Regulation S-K. Management’s inclusion in periodic reports of “meaningful cautionary statements” may afford companies substantial protection against private securities fraud litigation under the safe harbors for forward-looking information added to the Securities Act (Section 27A) and

47. See Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management’s Discussion and Analysis, SEC Rel. No. 33-9144 (Sept. 17, 2010), available at <http://www.sec.gov/rules/interp/33-9144.pdf>.

48. See SEC Division of Corporation Finance Disclosure Guidance: Topic No. 2, *Cybersecurity* (Oct. 13, 2011), available at <https://www.sec.gov/divisions/corpfin/cfguidance-topic2.htm>.

the Exchange Act (Section 21E) by the Private Securities Litigation Reform Act of 1995 (“PSLRA”). To meet PSLRA standards, however, risk-factor language must be “meaningful” and must “accompany” any forward-looking statements for which safe-harbor protection is sought.⁴⁹

A June 2015 decision by the D.C. Circuit, *In re: Harman International Industries, Inc. Securities Lit.*,⁵⁰ serves as a timely reminder of the need periodically to re-examine, and specifically update as necessary or appropriate, a company’s cautionary risk-related disclosures – regardless of whether the accompanying forward-looking statements are made in periodic reports filed with the SEC and/or during earnings conference calls – to ensure the continued consistency of the risk factors with evolving historical facts. In overturning the lower court’s grant of the Harman defendants’ motion to dismiss a private securities fraud complaint challenging certain forward-looking statements senior management made in the course of two earnings conference calls, the D.C. Circuit found that the risk factors accompanying these statements were misleading because they failed to warn investors that the disclosed

49. Alternatively, the plaintiff must plead (and prove) that a defendant had “actual knowledge” of the falsity of a specific forward-looking statement to negate safe harbor coverage of that statement. Neither prong of the statutory safe harbors (i.e. meaningful cautionary statements and no actual knowledge) is available for forward-looking statements included in GAAP-prescribed financial statements, tender offer filings and certain other documents.

50. 791 F. 3d 90 (D.C. Cir. 2015), cert denied, 577 U.S. ___, 84 U.S.L.W. 3307 (U.S. Supreme Court Order List, Mon., Feb. 29, 2016). Interestingly enough, the *Harman* decision published in June 2015 did not allude to the Supreme Court’s March 2015 holding in *Omnicare v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318, 575 U.S. ___ (2015). *Omnicare* built on the foundation laid in *Virginia Bankshares* (a proxy antifraud case) to hold that opinions contained in a Securities Act registration statement could give rise to strict liability claims against the issuer under Section 11 of the Act, if the issuer either: (a) did not genuinely believe the disclosed opinion; or (b) even if the issuer subjectively believed the disclosed opinion, that issuer omitted material facts about the basis for its opinion that if, had these facts been disclosed, would have rendered the stated opinion materially misleading from the viewpoint of a reasonable investor. One logical reason for the Second Circuit’s silence with regard to *Omnicare*’s relevance to an Exchange Act Section 10(b)/Rule 10b-5 case may simply be that, as a trial court in a different circuit concluded, the *Omnicare* decision did not purport to address the PSLRA safe harbors’ coverage of forward-looking statements embedded in management expressions of opinion or belief. See *Firefighters Pension & Relief Fund of the City of New Orleans v. Bulmahn*, No. 13-3935, 2015 WL 745598 (E.D. La., Nov. 2015), notice of appeal filed by plaintiffs on December 15, 2015.

risks had actually begun to materialize. The appellate court was not receptive to a defense argument that one of the disputed forward-looking statements was mere “puffery” and therefore not actionable under Exchange Act Section 10(b) and Rule 10b-5, noting the Supreme Court’s recognition in the *Virginia Bankshares* case that “statements of reasons, opinions or belief” can be actionable in the proxy antifraud context.⁵¹

Given the effectiveness of the PSLRA safe harbors for forward-looking information inherent in risk factors, there is little doubt as to the wisdom of periodically re-evaluating and updating risk-factor language to alert investors to the inherent uncertainties underpinning management statements of opinion, belief or expectation regarding future corporate performance.⁵²

2. Internal Control Over Financial Reporting (ICFR)

Both the SEC and PCAOB emphasized the importance of effective ICFR throughout 2015, continuing well into 2016. (See Part II.B.2., below, for a discussion of the PCAOB’s positions). In her keynote speech at the December 2015 AICPA conference, SEC Chair White reminded preparers of financial statements that “management’s ability to fulfill its financial reporting responsibilities significantly depends on the design and effectiveness of ICFR.”⁵³ Senior SEC accounting officials observed that, while there had been some recent improvements in management’s identification of material weaknesses in ICFR before a restatement duty is triggered – what has been called the essential “could” factor in assessing the nature and scope of a control deficiency or deficiencies – the SEC will continue to monitor this area carefully pursuant the coordinated efforts of OCA, Corporation Finance (through the review and comment process) and Enforcement (through the enforcement program), as well as in connection with the agency’s oversight of PCAOB activities.

51. *Harman*, 791 F. 3d at 96, quoting from *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1091 (1991).

52. *See Firefighters*, cited above at note 50 (observing that the PSLRA safe harbors remain available for forward-looking statements of opinion challenged under Section 10(b) and Rule 10b-5, noting that because *Omnicare* did not involve such statements, the Supreme Court had not addressed this issue). *See also Tongue v. Sanofi*, 816 F. 3d 199 (2d Cir. 2016).

53. White, 2015 AICPA Keynote, above.

According to SEC Chief Accountant Jim Schnurr, the staff has “devoted a significant amount of time and effort” over the past year “to understanding and providing initial responses to concerns of various constituents regarding the ICFR assessments by companies, their interaction with the audits of ICFR and related inspection findings of the PCAOB.”⁵⁴ Some of the deficiencies in ICFR audits identified by the PCAOB inspection staff “may be, at least in part, indicative of deficiencies in management’s design or operation of controls, including management review controls.”⁵⁵ Mr. Schnurr and other senior OCA accountants have noted repeatedly that the SEC’s 2007 interpretive guidance on management’s ICFR responsibilities requires documentation of how the design of a control is tailored to the relevant financial reporting risk, along with evidence to support any management conclusion that this control is operating effectively.⁵⁶ This guidance calls for more evidence of the operating effectiveness of controls in higher risk areas.

Another senior OCA staff member who spoke at the December 2015 AICPA conference “strongly encourage[d] regular discussions among management, auditors, and audit committees on existing and emerging issues in assessment of ICFR,” pointing out that “the role of audit committees in this dialogue is equally important. After all, ICFR is an area subject to audit committee oversight as part of its financial reporting oversight responsibilities.”⁵⁷ Speaking a few months later, Mr. Schnurr repeated that “[w]e continue to encourage regular discussions between management, auditors, and audit committees on existing and emerging issues in assessments of ICFR.”⁵⁸

When asked during the December 2015 AICPA conference what action, if any, the SEC staff might take if a company has not yet shifted to COSO’s 2013 Internal Control Framework in connection with management’s annual ICFR evaluation and report included in the company’s fiscal 2015 Form 10-K, members of the

54. James V. Schnurr, SEC Chief Accountant, Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress (Philadelphia, Pennsylvania, March 22, 2016)(“Schnurr, 2016 Life Sciences Congress Remarks”), available at <https://www.sec.gov/Speech/schnurr-remarks-12th-life-sciences-accounting-congress.html>.

55. *Id.*

56. See SEC Rel. No. 33-8810 (June 27, 2007)(“2007 SEC Interpretive Release”), available at <http://www.sec.gov/rules/interp/2007/33-8810.pdf>.

57. Croteau, 2015 AICPA Remarks, above.

58. Schnurr, 2016 Life Sciences Congress Remarks, above.

SEC's accounting staff replied that they would not necessarily object to continued reliance on the 1992 framework. However, companies should be prepared for questions from the SEC staff and their investors (as well as the outside auditor) asking about management's rationale for using an outdated control framework that is no longer supported by COSO.

SEC Enforcement Director Ceresney subsequently made clear, in a January 2016 speech aimed at directors, that the SEC would bring charges against companies and senior management for violating the ICFR requirements, even in the absence of fraud charges. One month later, at the 2016 SEC Speaks conference, the SEC message regarding the importance of effective ICFR was, if anything, even stronger and more pointed. SEC Chief Accountant Schnurr explained that ICFR remains a top priority not only for his office, but also for the Divisions of Enforcement and Corporation Finance. Enforcement Division Chief Accountant Mike Maloney discussed that Division's dual focus on the compliance of corporate management and the outside auditors with their respective ICFR obligations. Division of Corporation Finance accountants weighed in, signaling that questions regarding ICFR would be raised in connection with that Division's 2016 filing review and comment process.

On March 10, 2016, the SEC reinforced this message by filing a series of related enforcement proceedings based solely on claims that a company, Magnum Hunter Resources Corporation, along with its former CFO and CAO, an outside consultant, and the audit engagement partner, failed to comply with their respective ICFR obligations. Due to these failures, as the SEC alleged, the company did not make the required disclosure of a material weakness in its ICFR system. Magnum agreed to pay a penalty of \$250,000 subject to bankruptcy approval, and the former CFO and CAO agreed to pay penalties of \$25,000 and \$15,000, respectively. The two CPAs – the outside consultant and the former audit engagement partner – each agreed to a suspension from appearing and practicing before the SEC as an accountant (with leave to seek reinstatement after one year).⁵⁹ All respondents settled without admitting or denying the SEC's allegations.

59. See SEC Press Release 2016-48 (March 10, 2016), *SEC Charges Company and Executives for Faulty Evaluations of Internal Control*, available at <https://www.sec.gov/News/Pressrelease/2016-48.html>.

According to the facts enumerated in the settlement order entered against the company,⁶⁰ Magnum’s difficulties originated with its rapid growth during the oil and gas “boom” years, which excessively strained its accounting resources. Management retained a consultant to assist in documenting and testing the company’s ICFR for the company’s fiscal years 2010, 2011 and 2012. The consultant’s report for fiscal 2011 identified “insufficient accounting staffing” as a “significant” control deficiency (rather than the “material weakness” the SEC obviously thought it was), without explaining why a deficiency the consultant found had created a “substantial risk of financial statement error” did not rise to the level of a “material weakness.” Both the CFO and CAO at the time accepted the consultant’s faulty assessment, improperly relying both on the consultant’s report and on the absence of an actual identified material error in the company’s financial statements.⁶¹ Finally, the company disclosed, incorrectly, that its ICFR for the 2011 fiscal year was “effective,” which the former CFO certified as accurate and complete.

According to the SEC order, the audit engagement partner in turn misapplied PCAOB Auditing Standards No. 3 (Audit Documentation) and No. 5 (ICFR Audit Integrated with Financial Statement Audit), in concluding that the control deficiency identified by management was a “significant deficiency” rather than a “material weakness” (in part because there was no material error in the 2011 financial statements and the company had hired more accounting staff as a remedial measure) without producing audit workpapers showing that he had performed the work necessary to support this conclusion. The audit engagement partner’s error was compounded by communicating his incorrect conclusion to the company’s audit committee, and causing his firm to issue an unqualified audit opinion.

It wasn’t until November 14, 2012, when Magnum filed an amended Form 10-Q for the second quarter (ended June 30, 2012) restating that quarter’s financial statements due to a material error relating to accounting for stock-based compensation (and certain other errors), that management concluded that material weaknesses existed as of the end of the second quarter and that ICFR was

60. See SEC Rel. No. 34-77345, *In the Matter of Magnum Hunter Resources Corp.* (Mar. 10, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77345.pdf>.

61. As discussed above, a material weakness may exist notwithstanding the absence of a concomitant material financial statement error, underscoring the SEC accounting staff’s emphasis on the incipient nature of the definition (i.e. the “could” factor).

therefore ineffective. The situation deteriorated further – the company reported multiple material weaknesses in its ICFR for the reporting periods covered by its Q3 2012 Form 10-Q and delinquent 2012 Form 10-K – and did not disclose that accounting staff inadequacies had been remediated until the Form 10-Q for Q3 of 2013 was filed.⁶²

Based on these facts, the SEC alleged that the company violated the books-and-records and internal accounting controls provisions of Exchange Act Section 13(b)(2)(A) and (B), respectively, as well as Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 (mandating the filing of periodic and other reports with the SEC by Section 12 registrants), and Rule 13a-15(a) (requiring companies to maintain ICFR). Although both the CFO and CAO were charged with causing the company to commit these violations; and with individually failing to comply with their duties under Exchange Act Rule 13a-15(c) to evaluate the effectiveness of the company’s ICFR as of the end of each fiscal year, the CFO alone was alleged to have violated Exchange Act Rule 13a-14 (requiring the CFO to certify that each company report on Form 10-K and Form 10-Q “does not contain any untrue statement of a material fact”).

What lessons can be drawn from these proceedings? First, the SEC is quite serious about pursuing “ICFR-only” cases, on the theory that “[d]efficient internal accounting controls can lay the groundwork or create opportunity for future misstatement or misconduct that goes undetected.”⁶³ Second, the SEC is determined to hold individuals directly accountable for corporate ICFR failures, whether they are members of management, the outside audit team, or a third party consultant retained to assist management with assessing a company’s ICFR. Third, this is an opportune time for corporate managers to review the guidance outlined in the SEC’s 2007 interpretive release relating to their ICFR responsibilities,⁶⁴ and to refresh their understanding of how to apply the definitions of “significant deficiency” and “material weakness” set forth in Rule 1-02 (a)(4) of Regulation S-X (which are the same as those the auditors are applying under AS No. 5). As explained in the SEC’s 2007 interpretive release and emphasized in the various Magnum orders,

62. The company ultimately filed for Chapter 11 bankruptcy in December 2015, as reported in its Form 8-K filed December 15, 2015.

63. Ceresney, 2016 Directors Forum Remarks.

64. See SEC Release No. 33-8810 (June 20, 2007), available at <https://www.sec.gov/rules/interp/2007/33-8810.pdf>.

“the severity of a deficiency in ICFR does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company’s ICFR will fail to prevent or detect a misstatement on a timely basis.”

SEC Deputy Chief Accountant Wesley Bricker outlined the following “three important takeaways” from the Magnum case in a June 2016 speech:⁶⁵

- Company management “has the responsibility to carefully evaluate the severity of identified control deficiencies and to report, on a timely basis, all material weaknesses” in the company’s ICFR;
- It is critical that the company maintain, and augment with, “competent and adequate accounting staff resources to keep books, records, and accounts that accurately reflect the company’s transactions and ... maintain internal accounting controls designed to ensure that company transactions are recorded in accordance with management’s authorization and in accordance with GAAP.” Mr. Bricker observed that qualified accounting personnel “will be vital” to implementation of new accounting standards whose effective dates loom on the near horizon, such as revenue recognition (discussed in the next portion of this article); and
- Management cannot “outsource” its responsibility to assess ICFR to third-party consultants. Such consultants in turn “have obligations to uphold when assisting management in evaluating ICFR.”

3. Revenue Recognition

Management’s timely implementation of the new revenue recognition standard⁶⁶ is a top priority for the SEC. SEC Chief Accountant Schnurr urged audit committees last Fall to “review and critically evaluate management’s detailed implementation plan,” describing

65. Remarks of SEC Deputy Chief Accountant Wesley R. Bricker, Office of the Chief Accountant, before the 35th Annual SEC and Financial Reporting Institute Conference (Los Angeles, California, June 9, 2016)(“Bricker, June 2016 Remarks”), available at <https://www.sec.gov/news/speech/Bricker-remarks-35th-financial-reporting-institute-conference.html>.

66. See Accounting Standard Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, as amended by ASU 2015-14.

what he believes is a “thorough” implementation plan as including these basic elements: (a) identification of the key actions to be taken during the implementation phase; (b) the estimated timing of these actions; (c) how management is tracking against that timing; and (d) how management will identify and communicate with key constituents, including investors and analysts, regarding the impact the new standard is expected to have on the financial statements.⁶⁷ Because the impact of the new standard is unlikely to be limited to the financial statements, Mr. Schnurr further recommended that the audit committee evaluate whether management has taken a “holistic” analytical approach to implementation by considering the possible effects of application of the new standard on other aspects of the organization, such as the company’s information systems, business processes, compensation and other contractual arrangements (e.g., debt covenants), and tax planning strategies. Audit committees, in his view, should “provide effective oversight of the changes made by management to the company’s system of ICFR in transitioning to the new revenue recognition standard.”

In addition, management should be assessing whether it now has the information necessary to satisfy the enhanced disclosure requirements imposed by the new standard. New processes and controls may be required not only to gather the information but also to ensure its accuracy and completeness.⁶⁸ Significant changes may have to be made to ICFR during the extended transition period, and thus disclosed on a quarterly basis in upcoming periodic reports. Moreover, as discussed above, audit committees should take steps to assure themselves that management and the outside auditors are satisfying their respective ICFR obligations in this regard.⁶⁹

Mr. Schnurr further stated that companies should be developing appropriate disclosures regarding the impact of adoption of the new standard once it becomes effective in 2018 (for most companies, the shift to the new standard must be made for the first fiscal year beginning on or after December 15, 2017, which will capture fiscal years 2016 and 2017). The guidance in SAB 74 (Topic 11.M.) governing such disclosures in the financial statement footnotes should be carefully considered, given Mr. Schnurr’s

67. Schnurr, UCI Remarks, above. *Accord* June 2016 Bricker Remarks, above.

68. *See* Bricker, June 2016 Remarks, above (importance of ICFR readiness for implementation of new GAAP, including but not limited to the new revenue recognition standard).

69. *See* Schnurr, 2016 Life Sciences Congress Remarks, above.

admonition that “[w]e expect the level of these disclosures to increase between now and adoption and are looking forward to understanding more about the impacts during our review of the 2015 financial statements.” If companies do not know how they will be affected, the SEC staff recommends that this be disclosed along with information on when the company plans to complete this assessment. Once a decision is made on the transition method, that too should be disclosed.⁷⁰

Mr. Schnurr has made these observations repeatedly; for example, at the December 2015 AICPA conference, at the SEC Speaks conference held in February 2016, and in remarks delivered to a life sciences accounting and reporting congress on March 22, 2016. On each occasion, he expressed concern regarding the results of a November 2015 PwC survey indicating that many companies have not reached the requisite state of readiness.⁷¹ He also made clear that the SEC’s accounting staff expects domestic (as well as foreign) SEC registrants to follow guidance from the TRG’s deliberations, even though that guidance is not authoritative from a GAAP perspective. To this end, companies should consult the FASB’s website for minutes of TRG meetings reflecting discussions and possible consensus reached in connection with various adoption and/or implementation issues. OCA recommends that management preparers consult with the Staff if they intend to adopt a new revenue recognition accounting policy that is inconsistent with TRG discussions.⁷²

On March 17, 2016, the Division of Corporation Finance published a revision to its Financial Reporting Manual that reflects (among other updates) new staff guidance, set forth in Topic 11100, on various implementation questions that have been raised with the staff over the past few months.⁷³ Companies adopting the full retrospective transition method beginning with fiscal 2018 (for calendar-year registrants) – with 2015 as the first fiscal year of recast financial statements presented – similarly will be able to limit to

70. *Id.*

71. See 2015 PwC-Financial Executives Research Foundation Revenue Recognition Survey Results: The new revenue recognition standard: Assessing impact and implementation (2015).

72. See, e.g., Schnurr, 2016 Life Sciences Congress Remarks, above.

73. A summary of the updated guidance in the Financial Reporting Manual is available at <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.pdf#page=2>.

three years their tabular presentation of selected financial data (new 11100.1) and the ratio of earnings to fixed charges (11100.1).

Even as the SEC staff accountants warn of the urgent need for preparation for the new revenue recognition standard, the SEC's Division of Enforcement is vigorously pursuing cases involving the misapplication of the current standard. SEC cases targeting improper revenue recognition under existing GAAP have run the gamut from sham transactions and invalid bill-and-hold arrangements, to abuses of specialized accounting methods applied to record revenue under percentage-of-completion contracts. To illustrate, Enforcement Director Ceresney recently singled out as noteworthy an administrative cease-and-desist proceeding the SEC brought in June 2015 against Computer Sciences Corporation ("CSC") and eight former executive officers for manipulating financial results and concealing significant problems in connection with revenues received under the company's multi-billion contract with the United Kingdom's National Health Service, the company's largest customer. After learning that this contract would have to be modified because the company failed to meet certain deadlines, CSC took steps to avoid a major hit to earnings by manipulating the models used in applying its percentage of completion accounting methodology.⁷⁴ CSC and five of the eight executives settled the proceeding, with the company agreeing to pay a \$190 million penalty. The former CEO, who had approved the use of flawed accounting models, consented to a penalty of \$750,000 and a SOX compensation clawback to CSC of \$3.7 million. The former CFO agreed to pay a \$175,000 penalty and a \$369,000 SOX 304 clawback (to the company).

Another means of manipulating revenue is through inappropriate expense recognition practices. Such practices gave rise to the institution of an SEC administrative proceeding against Monsanto Company and three accounting and sales executives in February 2016. Monsanto and the executives were charged with improperly accounting for millions of dollars' worth of rebates offered to distributors of its leading product, herbicide Roundup, over a three-year period, which allowed the company to meet analysts' consensus EPS estimates for one of those years (2009). (A restatement in late 2011 may have attracted the SEC staff's attention.) Without

74. SEC Rel. No. 33-9804 (June 5, 2015), available at <https://www.sec.gov/litigation/admin/2015/33-9804.pdf>.

admitting or denying the SEC's allegations that the company materially misstated its consolidated earnings, along with its revenues and earnings for the Roundup business lines, in periodic reports filed for fiscal years 2009, 2010 and 2011, and that the individual named had caused the company to do so, all respondents agreed to settle charges based on Securities Act antifraud Sections 17(a)(2) and 17(a)(3) (because the materially misstated financial statements were incorporated by reference into the company's registration statements on Form S-8 and Form S-3ASR), various reporting provisions of the Exchange Act (Sections 13(a) and Rules 12b-20, 13a-1, 13a-11 and 13a-13), as well as the books and records and internal accounting controls provisions of Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B), respectively.⁷⁵ Monsanto agreed to pay an \$80 million penalty and retain an independent ethics and compliance consultant acceptable to the SEC who is responsible for ensuring that the company satisfies specific undertakings relating to remediation, and reports to the SEC. Although the SEC's investigation found no personal misconduct by the CEO and former CFO, they voluntarily reimbursed the company for cash bonuses and certain stock awards paid during the period of the alleged accounting violations; had this not occurred, as the SEC noted, the agency would have pursued a clawback action against these executives under Section 304 of SOX.⁷⁶

4. Non-GAAP Measures

In a speech delivered this June, SEC Chair White reaffirmed her view that audit committees should “carefully oversee their company's use of non-GAAP measures and disclosures,” and that companies should ensure that they have effective controls over such use.⁷⁷ Her remarks followed closely on the heels of the

75. SEC Rel. No. 33-10037 (Feb. 9, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10037.pdf>. Each of the three individuals consented, without admission or denial, to additional Exchange Act books and records and accounting controls violations, and agreed to pay penalties. Two individual respondents who are accountants also consented to suspensions from appearing and practicing before the SEC – which effectively precludes them from participating in the financial reporting and/or auditing of public companies.

76. SEC Press Rel. No. 2016-25 (Feb. 9, 2016), available at <https://www.sec.gov/news/pressrelease/2016-25.html>.

77. SEC Chair Mary Jo White, Keynote Address, ICGN Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP

Division of Corporation Finance’s publication, in May 2016, of significant new guidance⁷⁸ that the Chair described as “addressing a number of troublesome practices which can make non-GAAP measures misleading: the lack of equal or greater prominence for GAAP measures; exclusion of normal, recurring cash operating expenses; individually tailored non-GAAP revenues; lack of consistency; cherry-picking; and the use of cash per share data.”⁷⁹ The Chair “strongly urge[d] companies to carefully consider this [May 2016 staff] guidance and revisit their approach to non-GAAP disclosures.” A more detailed discussion of the new Division of Corporation Finance guidance can be found in this Weil publication.⁸⁰

Before the May 2016 guidance was published, Chair White offered this helpful blueprint for audit committee and management analysis of the appropriate usage of non-GAAP measures in corporate communications, recommending consideration of such key questions as:

- Why are you using the non-GAAP measure, and how does it provide investors with useful information?
- Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules?
- Are your explanations of how you are using the non-GAAP measures – and why they are useful for your investors – accurate and complete, drafted without boilerplate?
- Are there appropriate controls over the calculation of non-GAAP measures?

5. Segments

The proper identification and aggregation of segments are still of concern to SEC staff accountants in both the Office of the Chief

and Sustainability (June 27, 2016)(“White, ICGN Keynote”), available at <http://www.sec.gov/news/speech/chair-white-icgn-speech.html>, citing her remarks to the AICPA in December 2015 (White, AICPA Keynote).

78. See Division of Corporation Finance Compliance and Disclosure Interpretations on Non-GAAP Financial Measures (M, available at <https://www.sec.gov/divisions/corpfin/guidance//nongaapinterp.htm>).

79. White, ICGN Keynote, above.

80. Weil, Gotshal & Manges LLP Alert, *Focus for Q2: Practical Tips for ‘Self-Correcting’ Non-GAAP Disclosure in Light of the SEC’s Updated Guidance* (June 24, 2016), available at <http://www.weil.com>.

Accountant and the Division of Corporation Finance. At the February 2016 SEC Speaks conference, Division Deputy Chief Accountant Craig Olinger listed segments as among that Division’s “top three” areas of “perennial” accounting-related comment.

In the staff’s view, the ultimate decisionmaker of a company – generally the CEO – is not necessarily the Chief Operating Decisionmaker (CODM) for purposes of identifying operating segments under the FASB’s ASC 280. In many companies, the CODM could be the COO, or a group that includes the COO and CFO. Each company should identify the CODM by determining which individual or group of individuals is responsible for allocating resources to, and addressing the performance of, the company’s segments.

The Division’s accountants advised, in the course of an SEC Speaks workshop, that the following factors may trigger staff comments in 2016: (a) significant acquisitions or divestitures, restructurings – companies should be prepared to explain, as the case may be, why segments have or haven’t been modified to reflect these developments; (2) the company describes its businesses differently on earnings conference calls than it does in its SEC filings; and/or (c) how the company’s management reporting structure works. Regardless of how management defines a company’s operating segments, the company must disclose revenue generated by each product, service, or group of similar products and/or services. Information is also required regarding assets and revenues in each country in which the company conducts business.

Finally, the Division accountants reminded companies during the 2016 SEC Speaks that reasonable judgments are essential to the definition and aggregation of segments. Accordingly, every company should be able to document the design and effective operation of the relevant controls for segment reporting.⁸¹ If a change in segments is attributable to a material accounting error, the staff may ask the particular company whether its management has reconsidered previously disclosed conclusions regarding the effectiveness of the company’s ICFR system.

81. A member of the SEC’s Office of the Chief Accountant also made this point during the December 2015 AICPA conference. *See* Courtney D. Sachtleben, SEC OCA Professional Accounting Fellow, Remarks before the 2015 AICPA Conference on Current SEC and PCAOB Developments (Wash. D.C. Dec. 9, 2015), available at <https://www.sec.gov/news/speech/remarks-at-2015-aicpa-conference-sachtleben.html>.

6. *Income Taxes*

Citing this as among the Division of Corporation Finance’s “perennial top 3” accounting comments, the Division’s Deputy Chief Accountant Craig Olinger indicated, during SEC Speaks this February, that the staff will continue to focus on the adequacy of company disclosures of income tax activity and positions, particularly in the case of multinational corporations. Improvements are needed in the disclosure of overseas profits, taxes and cash, whether made in the financial statement footnotes, the MD&A (e.g., liquidity impact) and/or other public disclosures. When a company asserts that cash is indefinitely re-invested outside the home country, and/or that the company does not expect to incur tax liabilities on repatriation, companies will be asked by the staff to disclose the amount of that cash.

In the Division’s view, companies should use the income tax rate reconciliation as a starting point for meaningful income tax disclosure, whether in the financial statement footnotes or in the MD&A section of the Form 10-K. The staff suggested that this disclosure describe material information regarding the methodology and the susceptibility of the calculations to change. Although not required, the staff encouraged companies to use a disaggregated, tabular rate reconciliation by country, together with a narrative explanation of the tax outcomes disclosed in the table and how they might change.

If recent comments made by SEC Chair White are any guide, we can expect these and other areas of management judgment with respect to tax accounting-related disclosures, particularly those involved in deferred tax valuation allowances and determining uncertain tax positions, to remain on the Division’s radar screen this year. In discussing the Disclosure Effectiveness Initiative spearheaded by Corporation Finance during a January 2016 interview at the San Diego Securities Regulation Institute, the Chair identified foreign tax disclosures as an area “where there should be greater disclosure than perhaps under current rules.”⁸²

82. A Conversation with Chair Mary Jo White, Keynote Session, 43rd Annual Securities Regulation Institute (San Diego, California, January 26, 2016), available at <https://www.sec.gov/news/speech/securities-regulation-institute-keynote-white.html>.

7. Fair Value Measurements

Companies must recognize many of their financial and non-financial assets (or liabilities) at fair value under U.S. GAAP (ASC Topic 820), the application of which often involves the exercise of significant management judgment in the absence of observable market prices for a particular class of assets.⁸³ Staff accountants in the SEC's OCA and Division of Corporation Finance have addressed fair value measurement topics at recent conferences, and this continues to be a fertile area for both consultation (OCA) and comment (Division of Corporation Finance).

Under ASC 820, calculation of a fair value measurement assumes that a transaction to sell an asset or transfer a liability takes place either in the principal market (defined as the market with the greatest volume and level of activity for the asset or liability) or, in the absence of the principal market, the most advantageous market (the market that maximizes the amount that would be received to sell the asset, or minimizes the amount that would be paid to transfer the liability, after taking into account transaction and transportation costs) for that asset or liability. In addition, the company must have access to the principal or most advantageous market as of the measurement date. At the AICPA conference late last year, an OCA professional accounting fellow discussed in some depth the characteristics of an asset or liability that the staff believes may prevent a company from relying on observable prices in a certain market for fair value measurement purposes.⁸⁴

Division of Corporation Finance Deputy Chief Accountant Craig Olinger addressed fair value disclosures required in the financial statement footnotes at both the AICPA and SEC Speaks conferences. Mr. Olinger explained that the staff has been targeting two

83. Preparers of financial statements must use a valuation technique that is “appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.” ASC 820-10-35-24.

84. See Kris Shirley, Professional Accounting Fellow, SEC OCA, Remarks before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C. Dec. 9, 2015), available at <http://www.sec.gov/news/speech/shirley-remarks-2015-aicpa-conference-sec-pcaob-developments.html>. Mr. Shirley also discussed the circumstances in which preparers of financial statements to use the cost basis of an illiquid asset or liability (inclusive of capitalized costs) as a “good starting point” for measuring fair value, and the importance of ICFR for illiquid assets, especially when management engages a third-party valuation service.

key points in connection with the review and comment process: (1) the level of disaggregation of asset and liability classes from the line items presented in the statement of financial position noting, for example, that the different characteristics of certain financial instruments, such as U.S. treasury securities and collateralized debt obligations (“CDOs”), require that they be placed in separate classes; and (2) the description of the valuation techniques and inputs used to determine the fair value of assets or liabilities in each class. Investors have advised the staff that these disclosures are particularly significant in the case of illiquid (Level 2 or Level 3) assets. Where a company identifies fair value measurement as a critical accounting estimate or policy, the staff may request the inclusion in future filings of the sensitivity disclosures required by ASC 820.

B. PCAOB

PCAOB inspection reports, alerts and other communications often influence the outside auditor’s conduct of the integrated audit of the company’s financial statements and ICFR. In situations where the PCAOB inspection staff flags what are believed to be material accounting errors in course of the staff’s review of a particular audit engagement, it also may alert the SEC staff to the possibility of fraudulent financial reporting by companies and their responsible management. Based on the PCAOB inspection staff’s mid-year update on the 2016 inspection cycle,⁸⁵ discussed further below, companies should anticipate that these areas of heightened PCAOB concern (discussed below) will affect their outside audit firms and, potentially, attract SEC staff interest (e.g., via the Division of Corporation review-and-comment process and/or Division of Enforcement inquiry).

1. Related Party Transactions

Because 2015 was the first fiscal year for which the outside auditor was required to apply new auditing procedures specified in AS No. 18⁸⁶ to facilitate the auditor’s understanding of a company’s

85. See PCAOB Staff Inspection Brief, *Information about 2016 Inspections* (July 14, 2016) (“PCAOB Staff 2016 Mid-Year Inspection Brief”), available at <https://pcaobus.org/Inspections/Documents/Inspection-Brief-2016-3-Issuers.pdf>.

86. Effective December 31, 2016, AS 18 will be re-designated PCAOB Auditing Standard (“AS”) 2410, pursuant to amendments that reorganize and renumber current auditing standards.

relationships and transactions with related parties, including executive compensation and other financial relationships, as well as “significant unusual transactions” (defined to mean transactions that are outside the ordinary course of business or that otherwise appear unusual because of their timing, size or nature), some companies experienced more rigorous auditor inquiries and documentation requests in connection with their outside auditors’ integrated audit of their 2015 financial statements and ICFR. Expect this scrutiny to intensify as the PCAOB inspection staff targets auditor compliance with AS 18 this year.

The PCAOB inspection staff has been applying procedures developed for the 2016 inspection cycle in assessing the effectiveness of audit firms’ implementation of AS 18.⁸⁷ These procedures include reviews of firms’ relevant systems of quality control and assessments of compliance with the new standard in connection with selected audit engagements. Given the new requirement in AS 18 for auditor discussion of covered transactions and relationships with the audit committee to ascertain its members’ understanding of, and possible concerns regarding, these relationships and transactions, it is reasonable to assume that the PCAOB staff is or will be examining the nature and scope of auditor communications with corporate audit committees. No word yet from the PCAOB on what the inspectors are finding.

It is worth noting that nothing in AS 18 changed the existing U.S. GAAP definition of “related party” (set forth in ASC 850-10-20), which the SEC continues vigorously to enforce.⁸⁸ Companies should keep in mind that the GAAP definition of “related party” is somewhat broader than the “related person” definition codified in Item 404(a) of Regulation S-K. In addition, the GAAP standard does not have specific quantitative materiality threshold while the S-K line-item requirement establishes a \$120,000 de minimis floor.

87. See PCAOB Staff 2016 Mid-Year Inspection Brief, above; PCAOB Staff Inspection Brief, *Preview of Observations from 2015 Inspections of Auditors of Issuers* (April 2016) (“PCAOB Staff April 2016 Inspection Preview”), available at <https://pcaobus.org/Inspections/Documents/Inspection-Brief-2016-1-Auditors-Issuers-pdf>.

88. See, e.g., In the Matter of MusclePharm, SEC Release No. 33-9903 (Sept. 8, 2015) (company settled SEC administrative charges of, among other violations, failure to provide related-party disclosures required by U.S. GAAP, without admitting or denying culpability), available at <https://www.sec.gov/litigation/admin/2015/33-9903.pdf>.

2. ICFR

Despite some improvements identified in connection with PCAOB inspections completed in 2015, the PCAOB inspection staff is focusing once again on the quality of ICFR audits under Auditing Standard (“AS”) No. 5 (to be redesignated AS 2201, effective December 31, 2016).⁸⁹ The staff remains concerned about the adequacy of firms’ testing of the design and/or operating effectiveness of audit clients’ ICFR – in particular, those controls that contain a management review element.⁹⁰ As discussed above, senior SEC staff accountants have expressed similar concerns.

In this regard, the SEC and PCAOB have presented a relatively united front when speaking at high-profile conferences, highlighting the need for improved communication between and among management preparers, the outside auditors and audit committees, to enable each of the three legs of the financial reporting stool more effectively to discharge their respective SOX responsibilities for ICFR. Members of the SEC accounting staff have been involved in an ongoing, PCAOB-sponsored dialogue between preparers and external auditors of financial statements intended to facilitate such communications.⁹¹

3. Risks of Material Misstatement

During the 2015 audit inspection process (covering fiscal 2014 audit engagements), the PCAOB staff found that some audit firms “did not always sufficiently identify the risks [of material misstatement] or respond effectively to existing risks that they have identified, such as performing tests that are not always responsive to the assessed risks.”⁹² According to the PCAOB staff’s mid-year update on the 2016 inspection cycle, the staff is considering the following aspects of selected audit engagements: (1) the sufficiency of the auditor’s testing of the design and operating effectiveness of

89. See Presentation by PCAOB Member Jeanette M. Franzel to the American Accounting Association Annual Meeting, *Update on Trends and Issues in Audits of Internal Control over Financial Reporting* (New York City, New York, August 6, 2016), available at <https://pcaobus.org/News/Speech/Pages/Franzel-speech-internal-control-over-financial-reporting-AAA-08-06-2016.aspx>.

90. See PCAOB Staff 2016 Mid-Year Inspection Brief, above, at 3; PCAOB Staff April 2016 Inspection Preview, above, at 4.

91. See, e.g., Schnurr, 2016 Life Sciences Congress Remarks, above; Bricker, June 2016 Remarks, above.

92. 2015 PCAOB Staff Inspection Brief, above.

management controls to support the auditor's planned level of control reliance, including the audit client's controls over the accuracy and completeness of system-generated data and reports; (2) whether substantive procedures were specifically responsive to fraud and other significant risks identified; (3) the sufficiency of the auditor's evaluation of the presentation of the financial statements, including the accuracy and completeness of disclosures in the footnotes; and (4) the sufficiency of the auditor's evaluation of relevant audit evidence that appeared to contradict certain assertions made in the audit client's financial statements.

Companies should be prepared for even more rigorous examination by their auditors of related party transactions, significant and unusual transactions, and executive compensation arrangements, all of which the PCAOB believes are highly susceptible to fraudulent management conduct, given the new magnifying glass auditors are applying under AS 18 (see discussion above). As the PCAOB staff warned in December 2015 at the AICPA conference, and reiterated in its mid-year 2016 inspection brief, the inspections staff likewise is checking carefully this year to see how well outside auditors are doing in exercising the requisite professional skepticism in these areas.

4. Management's Accounting Estimates and Fair Value Measurements

The PCAOB inspections staff continued to uncover audit deficiencies in 2015 relating to the auditor's testing of key data and significant assumptions used by management to develop estimates. One good example is fair value measurements of financial and non-financial (e.g., goodwill impairment testing) assets; another is revenue recognition. PCAOB inspectors therefore are on the lookout for such deficiencies in their selection and review of audit engagements for fiscal 2015 as part of the 2016 inspection process. Helen Munter, the PCAOB's Director of Inspections, is quoted as stating during a late 2015 interview that "[i]nspections staff continued [in 2015] to identify instances in which auditors did not fully understand how [management] estimates were developed, or did not sufficiently test the significant inputs and evaluate the significant assumptions used by management." She reportedly went on to send this message to audit firms: "Due to the significant audit deficiencies identified [by PCAOB inspections staff], together with changing market conditions, a low interest rate environment,

and an increase in merger and acquisition activity, auditors should continue to remain focused on this area [in 2016].⁹³

5. New PCAOB Inspection Priorities Tied to the Current Economic Environment and Related Developments

Audit firms have been on notice that the PCAOB staff plans for the first time this year to scrutinize selected audit engagements in an effort to gauge auditors' response to potential risks to audit clients engendered by the recent M&A boom and global economic uncertainty. Areas of concern pinpointed by the PCAOB are therefore relevant to registrants – particularly those whose audit engagements are under the spotlight of the current inspection cycle. Specific areas of higher risk targeted for the first time in 2016 by PCAOB inspectors include:

- Increased M&A activity: How did auditors approach auditing management's accounting for M&A transactions in response to the related financial reporting risks when auditing the financial statements of the acquiring company? Among the risks of material misstatement associated with business combinations are complex fair value measurements of acquired assets and liabilities assumed by the acquirer, identification of all intangible assets, assignment of goodwill to reporting units, and contingent compensation measurements.
- Corporate treasurers' search for higher-yielding investment returns in a low interest-rate environment: The PCAOB suggests that there may be heightened risks of overvalued assets and errors in management's valuation of Level 3 securities.
- Effect of continued fluctuation in oil and natural gas prices: How well did audit firms respond to the financial reporting risks in some industries attributable to substantial fluctuation in oil and gas prices, including impairment and valuation risks and the collectability of loans and receivables? These risks are not unique to companies in the oil and gas industry, in the PCAOB's view.
- Segments: This item appeared on the PCAOB inspection staff's checklist at some point between April and July 2016. In

93. T. Whitehouse, *PCAOB's Top Inspector Shares Plans for 2016*, Compliance Week. Dec. 16, 2015.

its 2016 Mid-Year Inspection Brief, the staff indicated that it is examining how well external auditors understood and evaluated how their audit clients identified the CODM and determined the company's operating segments and reportable segments (e.g., focusing on aggregation decisions). Moreover, the PCAOB staff is scrutinizing auditor testing of controls over the preparation of segment disclosures and the monitoring of events that might require changes in management's segment determinations and disclosures from one reporting period to the next.

- Audit of income taxes: PCAOB inspectors have detected deficiencies in the auditing of management assertions that undistributed foreign earnings will be invested indefinitely outside the United States, as well as auditing controls over management's income tax accounting. (As discussed above, the SEC accounting staff likewise is focused on management's income tax accounting and related disclosures).
- Auditing cash flows statements: Noting that errors in cash flows statements are a frequent factor in restatements, the PCAOB staff will be evaluating auditor testing of controls over preparation of this statement. For example, the staff will be asking whether the auditor appropriately identified and addressed the risks of material misstatement in management's preparation of the cash flows statement.
- Cybersecurity risks: PCAOB inspectors are evaluating how well audit engagement teams assess the risks of material misstatement associated with corporate clients' cybersecurity systems and the related controls. Cyber-breaches could result in the theft of valuable corporate software, patents, trade secrets and other intellectual property, and/or compromise critical ICFR based on sophisticated information technology.

III. CONCLUSION

Given the developments discussed above, it seems clear that the SEC will not hesitate to bring complicated accounting and internal control cases against companies, senior management, outside auditors and even, in egregious situations, members of corporate audit committees who are deemed to have abdicated their SOX gatekeeper responsibilities. The SEC's Division of Enforcement has the enhanced resources – including the availability of more sophisticated electronic data analytics, greater

accounting and economics expertise, and a separate office dedicated to the efficient processing of whistleblower tips whose numbers have escalated with the advent of the Dodd-Frank whistleblower bounty program – to concentrate on corporate financial reporting. Moreover, the PCAOB is sharing with SEC staff members information on issuer accounting errors gleaned from the auditor inspection process, which may trigger further SEC inquiry.

All that said, there is plenty of concrete, practical regulatory SEC guidance available – in addition to the lessons learned from SEC enforcement cases – to enable companies to avoid popping up on the Division of Enforcement’s radar screen. Through a combination of staff comment letters, interpretations (e.g., the Division of Corporation Finance’s Financial Reporting Manual and C&DIs) and speeches, SEC staff members from the Division of Corporation Finance and OCA are providing insights into what the agency considers effective financial reporting. The SEC Chair likewise has used the “bully pulpit” to weigh in on specific compliance issues, including the compliant use of non-GAAP financial measures and the importance of audit committee oversight. Even the PCAOB is offering tips and suggestions to audit committees of public companies intended to facilitate auditor oversight, which are posted on its website. Monitoring these available resources and bringing them to the attention of the audit committee and senior management, as necessary or appropriate, can be very helpful to companies striving to minimize the risk of potential accounting and auditing problems in the future.

NOTES