BoardroomDirect

The monthly newsletter for PwC's Center for Board Governance – April 2014

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10Minutes on revenue recognition takes a look at the single global standard the FASB and IASB are set to release and how it can affect such areas as compensation, contracts, technology, taxes, controls, and investor relations.

Worth reading

Executive compensation: Clawbacks

This study is an analysis of 100 large public companies' clawback policies from 2009-2012. Clawback policies, although not new, have been receiving more attention in recent years. The companies sampled featured a wide range of triggers in their clawback policies, but the most common reason is when there is a restatement, either with or without employee involvement, or misconduct.

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For more information or to submit feedback about this newsletter, contact Gary Larkin.

Issue in focus

Proposed changes to the auditor's reporting model

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The Public Company Accounting Oversight Board (PCAOB) has proposed standards and amendments setting out a new auditor's reporting model and the auditor's responsibility regarding other information. Earlier this month these proposed changes were the focus of a two-day public meeting of the PCAOB in Washington, D.C. The meeting, which included directors, audit firms, investors, and other parties involved in the financial reporting process, focused on:

- The proposed inclusion of critical audit matters in the auditor's report;
- The proposed changes to the auditors' responsibility regarding "other information" outside the audited financial statements; and
- International developments on the auditor's report.

The proposed standards were released for comment August 2013. The comment period, which originally ended in December 2013, was reopened and now ends on May 2.

The proposed standard titled *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and related amendments, would require the auditor to disclose additional information in the auditor's report about the audit and the audit firm, including, among other matters, a discussion of critical audit matters specific to the audit. **[For more information on this proposed standard, read PwC's *In brief: PCAOB proposes significant changes to the auditor's report*.]**

The proposed standard titled *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report,* and related amendments, which would require the auditor to perform additional procedures with respect to other information, and to communicate certain information in the auditor's report. **[For more information on this proposed standard, read PwC's *In brief: PCAOB proposes new auditing standard on other information*.]**

"The proposed standards are intended to make the audit report more relevant to investors by establishing criteria and a framework for the auditor to provide deeper insights from the audit based on information the auditor already knows from the audit," PCAOB Chair James Doty said at the public meeting.

He pointed out that while these proposed standards and amendments could result in major changes to the auditor's report, the PCAOB will retain the pass/fail model of the opinion.

"By requiring and providing a framework to report critical audit matters, the proposed standards would keep the auditor in their area of expertise – the audit," he said. "No one wants to return to the days before the pass/fail model was instituted when auditors' free-form writing could obscure disclaimers of assurance on financial statements."

Critical audit matters

Joan Amble, a director for three public companies, told the PCAOB board members that she had discussed the proposal to include critical audit matters in the auditor's report with several audit committee members.

"Along with the vast majority of audit committee members with whom I have had the opportunity to discuss this matter . . . I believe including critical audit matters in the auditor's report would lead only to much longer, but not more useful, reports by including information already adequately provided by management in footnotes or MD&A," Amble said.

Mike Gallagher, Managing Partner, Assurance Quality at PwC, stressed to the PCAOB members that while the firm supports including critical audit matters in its report, it believes such matters should be limited to those that were material to the financial statements and resulted in the most significant interaction with the audit committee.

'"We believe these changes, and the others we suggest in our comment letter, would add meaningful information to the audit report while not placing the auditor in the position of being the original source of information about the company," Gallagher said. "It will also minimize the potential that including critical audit matters in the audit report will chill the dialogue between auditors and management, something which could have an adverse effect on audit quality."

Peter Clapman, a director for Wi-Fi network provider iPass and former investor counsel for TIAA-CREF, also spoke at the PCAOB meeting and called the PCAOB's critical audit matters proposal a modest change to the reporting system that should be embraced. He mentioned that while the current pass/fail system would be retained, it should not be to the exclusion of providing more information to investors.

"Often a company might pass, but only after the auditor had to reconcile serious questions in the audit process," Clapman said in written testimony. "In my view, the fact that serious questions surfaced should be disclosed to investors."

Other information

The crux of the issue regarding the inclusion of other information in the auditor's report is whether it enhances the current reporting model and if the benefits of that extra effort exceed the costs. Jeremy Perler, director of research at Schilit Forensics, explained to the PCAOB members why he believes it is worth the extra effort.

"Enhancing auditor responsibility over this information by, as the Board proposes, requiring the evaluation of these disclosures with a focus on material inconsistencies and material misstatements is common sense and will no doubt strengthen and add robustness to our financial reporting system," Perler said. "Ultimately, it will lead to fewer cases of willful or negligent misrepresentation."

Gallagher stated that PwC supports the Board's intent to enhance the existing standard by requiring communication about the nature of the auditor's responsibility for other information in the auditor's report but that the proposed standard as drafted poses significant challenges and should be carefully examined, including to determine that the costs don't exceed the benefits. He said the firm believes the proposed other information standard will lead to a significant increase in the audit effort for information not directly related to the audited financial statements.

In order to meet the spirit of the proposed standard, which is to have the auditor report on other information based on work performed under existing practice, Gallagher suggested that some of the language be changed.

"We recommend replacing the proposed performance standard of 'read and evaluate' …Specifically, we believe the proposed other information standard should include an overall requirement that the auditor read all of the other information regardless of whether the other information is directly related to the audited financial statements," he said. "The auditor should then perform a prescriptive set of procedures, similar to comfort letter procedures with respect to material other information directly related to the financial statements."

International developments

At the PCAOB's public meeting, there was discussion about international developments, including in the UK where a new requirement for the auditor's report and enhancements to audit committee reports are now effective. Further, there was discussion that enhanced audit committee reporting requirements that exist in the UK can be looked to as an example because some believe they might mitigate some of the concern around the auditor being the original source of information about the company.

In June 2013, the Financial Reporting Council (FRC) in the United Kingdom finalized its auditor reporting standard. The following month the International Auditing and Assurance Standards Board (IAASB) released for comment its proposed standard on auditor reporting. On April 28, 2014, the IAASB reproposed its standard that addresses other information, with comments due by July 18. **[For more information, read the IAASB's exposure draft *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*, *the press release announcing its other information standard reproposal* and PwC's *In brief: IAASB proposes fundamental changes to the auditor's report*.]**

In part, the FRC standard requires the auditor's report to describe the assessed risks of material misstatement that had the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team. The proposed IAASB standard includes certain elements consistent with the FRC standard ─ most notably requiring auditor reporting for listed entities of "key audit matters," similar to the PCAOB proposal for critical audit matters.

What directors can do

- Follow developments regarding the PCAOB's auditor reporting model proposals and the international developments related to this topic as the projects continue to influence each other.

- Consider how those proposals could potentially affect what is included in company filings as it pertains to what the auditor reports on regarding possible critical audit matters and the increased effort related to the auditor's responsibility regarding other information

- If interested, express their point of view on these proposals.

For more information about the proposed changes to the auditor's reporting model, you may also want to read the Center for Audit Quality's comment letter.

Issues in brief

Cybersecurity framework: A starting point for companies

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The National Institute of Standards and Technology's (NIST) new Cybersecurity Framework could be a starting point as companies work to mitigate the continuing cyber threat risk. The framework includes taxonomy and a risk management tool that allows companies to describe their current cybersecurity condition, assess progress toward their desired cybersecurity state, identify and prioritize opportunities for improvement, and communicate about cybersecurity risks to stakeholders.

Charles Beard, principal in PwC's forensics practice and former senior vice president and general manager of Science Applications International Corp.'s cybersecurity group, and the Honorable Tom Ridge, former US Secretary of Homeland Security and co-founder of Ridge-Schmidt Cyber, discussed cybersecurity risk during PwC's Center for Board Governance March 27 cybersecurity webcast.

"There are five things not addressed in the framework that are important for independent directors to understand," Beard said during the PwC webcast. They are as follows:

1. Duties and obligations of companies wherever they operate
2. The "technical debt" (the cost of deferred maintenance on technical projects that remain incomplete)
3. The identity of threat adversaries and actors (i.e. countries, hacktivists, employees)
4. How the company should think about cyber threats in terms of risk tolerance
5. The element of time (for larger companies, a cyber risk plan may take years)

"Cyber attacks are not only a clear and present danger; they are a permanent danger," Ridge said. "Companies need to look to see that they have a cybersecurity risk plan embedded in their overall risk plan."

Ridge called the NIST framework a modest step toward minimizing the cyber threat, and added that it should be used as a way for companies to start looking at their critical assets and how to protect them from hackers.

The framework includes a taxonomy and a risk management tool that allows companies to describe their current cybersecurity condition, assess progress toward their desired cybersecurity state, identify and prioritize opportunities for improvement, and communicate cybersecurity risks to stakeholders.

Additionally, the Department of Homeland Security (DHS) created the Critical Infrastructure Cyber Community (C3) Voluntary Program. It is designed to connect companies and governmental agencies with the DHS to help manage cyber risks.

A cybersecurity risk plan can help a board understand the risks involved as well as the plans around risk mitigation. Ridge has some questions directors should consider asking management:

- What is the governance structure around IT?
- Is there an individual or team accountable?
- How often do we get reports on this accountability? Is there a dashboard?
- Will our company be reactive or preemptive with regard to cyber threats?
- Do we need to engage a third party to help?

Here are links to more information on cybersecurity:

- SEC's March 26, 2014 Cybersecurity Roundtable
- NIST Advisory Committee 2013 Annual Report Highlights Cybersecurity and Manufacturing
- NIST's Framework for Improving Critical Infrastructure Cybersecurity
- The Center for Audit Quality's Alert: Cybersecurity and the External Audit
- PwC's Answering your cybersecurity questions: The need for continued action

Views on raising ownership threshold needed to file shareholder proposals

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Calling the current shareholder proxy proposal system outdated, burdensome and costly, SEC Commissioner Daniel Gallagher and NASDAQ General Counsel and Chief Regulatory Officer Edward Knight have separately called for the commission to raise the ownership threshold shareholders need to meet in order to file a proxy proposal.

In a March 27 speech to Tulane University Law School, Gallagher said the SEC should limit its involvement in issues related to corporate governance and that rules, such as minimum required shareholdings and the amount of time shares are held, should be revised.

Gallagher says the $2,000 limit, which was instituted in 1998, is "absurdly low" and proposes it be raised to $200,000 or maybe even $2 million. Ultimately, however, he said the limits should be based on a fixed percentage that is "scalable, varies less over time, better aligns with the way many companies manage their shareholder relations, and is more consistent with the commission's existing requirements."

In an OpEd article **(Registration required)** in the March 26 *Wall Street Journal*, Knight said the current shareholder proposal process is costly for companies. He suggests the SEC update the 1998 rule and require those shareholders with only a minimum $2,000 level of shareholder ownership to demonstrate a wider level of support, perhaps 5% or 10% of a company's outstanding shares, in an online vote.

In his speech, Gallagher calls for the SEC to institute a "three strikes and you're out" policy when it comes to shareholders resubmitting proposals. "That is, if a proposal fails in its third year to garner majority support, the proposal should be excludable for the following five years," he said. "The thresholds for the prior two years should be high enough to demonstrate that the proposal is realistically on the path toward 50%, for example, 5% in favor [in the first year] and 20% in favor [in the second year]."

Knight and Gallagher both point to the cost to companies and the high failure rate of shareholder proposals as reasons to change the proxy proposal system. Citing his experience at NASDAQ OMX, Knight states that a proposal costs a minimum of $50,000 to process. He says that includes staff hours, outside counsel, proxy firm outreach, and outreach to investors. Gallagher adds that only 7% of proposals were approved in 2013 even though the number of proposals increased to 820 from 739 in 2012.

The Council of Institutional Investors Executive Director Ann Yerger wrote in a March 27 *Wall Street Journal* letter to the editor that shareholder proposals are important and do not overburden many public companies.

"The number of shares held by a proponent is irrelevant; what matters is how shareholders at large view the issue the proposal raises," Yerger wrote. "In the end, these shareholder proposals, while generally nonbinding, have led to profound improvements in director accountability and corporate governance practices and regulations."

More on the SEC and proxy advisory firms

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Last month SEC Chair Mary Jo White told attendees at the US Chamber of Commerce's Capital Markets Summit that the Commission expects to review regulations for proxy advisory firms. This comes three months after the SEC held a roundtable discussing the need for regulation in that sector.

"The staff now will be making recommendations to me in the very near term about what additional action might be taken on these issues," a March 19 Reuters article quoted White. She did not offer any details on any rules or changes that could be in store for proxy advisory firms, including Glass Lewis and Institutional Shareholder Services.

White's comments come after a December SEC roundtable on proxy advisory firms where various stakeholders in the capital markets told the commission about the advantages and disadvantages of regulation. **[For more information about the roundtable, visit the SEC Proxy Advisory Services Roundtable web page or read November 2013 BoardroomDirect Issues in brief (SEC roundtable to address proxy advisory firm issues).]**

Audit committee issues

EU moves further on its path to controversial audit reforms

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On April 14 the Council of Ministers of the European Union ratified the European Directive on Statutory Audits of Annual and Consolidated Accounts and a Regulation on Statutory Audit of Public Interest Entities (PIEs or public companies) after they were approved by the European Parliament. The regulation places restrictions on independent auditors providing non-audit services to companies, requires mandatory audit firm rotation after 10 years (with the option to extend to 20 years upon a competitive tender after 10 years or to 24 years where joint auditors are to be involved), establishes oversight of auditors and audit firms at the EU level, and creates the Committee of European Audit Oversight Bodies.

Now the legislation has to be signed into law by the presidents of the Council and the Parliament. The Federation of European Accountants (FEE), which represents the accountancy profession in Europe, expects them to be in effect by 2016. Member states will have to implement their own legislation to make the directive effective in their countries.

[For more information on the European Directive and Regulation, read FEE FAQ.]

The directive amends provisions on independence and objectivity of independent auditors, creates a mechanism for companies to adopt International Auditing Standards on a European level, and contains new requirements for independent auditor reporting to the public and additional internal reporting to public company audit committees.

The regulation contains up to 21-member-state options that each of the 28 member states must elect. For example, member states can elect a mandatory audit firm rotation period shorter than 10 years and can elect not to provide the ability to extend. This will likely lead to a patchwork of rules across the EU, both in the areas of rotation and limits on non-audit services, and has the potential to create confusion and practical challenges for companies, including US-based companies with European subsidiaries and companies with multiple EU public companies.

“While some provisions will strengthen financial reporting and improve corporate governance, the CAQ [Center for Audit Quality] has expressed its concerns that other requirements, particularly severe limits on non-audit services and mandatory audit firm rotation, will undermine the role of independent audit committees acting on behalf of shareholders and reduce choice in the marketplace,” CAQ Executive Director Cindy Fornelli said.

“Looking forward, we are concerned that the implementation of these reforms will generate inconsistencies across jurisdictions, which could affect companies and their auditors in the United States, where the idea of mandatory firm rotation was recently considered and set aside for sound public policy reasons,” she said. “We hope that these new rules can be implemented with the greatest consistency possible across Europe with minimal extra-territorial impacts.”

PwC releases *2014 State of the Internal Audit Profession Study*

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The internal audit function needs to show that it can create more value in an increasingly complex and risky business landscape, according to the results of PwC’s 10th annual *State of the Internal Audit Profession Study*. Given adequate resources, opportunities exist for internal audit to increase its value and its contribution to the business. The study reflects the opinions of more than 1,900 chief audit executives, internal audit managers, senior management, and board members of companies in 24 industries across 37 countries.

Some key findings include:

- More than half of senior managers said they do not believe internal audit adds significant value to their organization.
- Approximately 30% of board members believe internal audit adds less than significant value.
- Sixty-four percent of board members and 49% of senior managers believe internal audit is performing well at delivering on expectations.

- Many respondents reported their internal audit functions made progress in the past year, although performance issues identified in previous years' research continue and stakeholders have said progress has not been sufficient to keep pace with the changing business environment.

Federal court upholds most of SEC conflict minerals disclosure rule

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On April 14 the Court of Appeals for the D.C. Circuit upheld most of the elements of the SEC's conflict minerals disclosure rule. The decision comes six weeks before the May 31 filing deadline.

In its opinion, the court affirmed the lower court's decision upholding the rule, except for one section that requires companies to label whether or not any of their products are "DRC (Democratic Republic of the Congo) conflict free." The court wrote that requiring companies to do so violated the First Amendment in that it constituted "compelled speech." **[For more information on the court's decision, read a client memo from Davis Polk.]**

The conflict minerals disclosure rule, mandated by the Dodd-Frank Act, requires public companies to disclose whether they use conflict minerals (tantalum, tin, tungsten, and gold) and whether the minerals originated in the DRC or adjoining countries. It responds to concerns that conflict minerals mined in these "covered countries" help finance armed groups that are responsible for violence in the region.

On April 7 the SEC added more questions and answers to its Frequently Asked Questions in order to provide further guidance to companies.

The nine new questions address the required independent private sector audit of a company's conflict minerals report and the temporary transition period companies are granted under the rules. Some of the questions relate to whether or not a CPA has to perform the audit, the scope of such an audit, and details of the company's due diligence and how it should be described in the conflict minerals report.

PwC has released the results of its 2014 Conflict minerals survey, which was taken in February across 15 industries. It found that at the time more than one-quarter of the 700 respondents were still in the early stages of conflict minerals compliance and two-thirds did not require an independent audit. The survey also showed that nearly two-thirds of respondents have full-time employees dedicated to conflict minerals.

[Editor's note: As of the writing of this newsletter, SEC Commissioners Daniel M. Gallagher and Michael S. Piwowar released a joint statement on the conflict minerals disclosure rule decision in which they say they believe the entirety of the rule should be stayed pending the outcome of the litigation.]

Resources, webcasts, and events

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Quarterly Webcast Archive: On March 27, former US Homeland Security Secretary and Pennsylvania Gov. Tom Ridge, who is also co-founder of Ridge-Schmidt Cyber, and Charles Beard, principal in PwC's forensics practice, discussed the new cybersecurity framework with Mary Ann Cloyd (Leader, PwC Center for Board Governance). To listen to the webcast, click here.

The Quarter close Directors edition Q1 2014: This quarter's publication looks at how profit-sharing arrangements are accounted for and gross versus net presentation of revenue transactions. To read the publication, click here.

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