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Auditors and Audit Committees in the Spotlight (Again)

By John White and Kimberley Drexler, Cravath, Swaine & Moore LLP
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Following the spectacular failures of Enron and Worldcom a decade ago, Congress appropriately turned its focus on public companies' financial statements and the independent auditors that attest to those. The Sarbanes-Oxley Act followed, ushering in audits of internal controls, enhanced management accountability through CEO and CFO certifications, enhanced audit committee powers and responsibilities, and dramatically increased auditor oversight with the creation of the Public Company Accounting Oversight Board, as well as new rules concerning auditor independence. While SOX and its many provisions took several years to implement and then fine-tune, they seemed to work — catastrophic financial frauds and breakdowns in the financial reporting system were not the theme or apparent cause of the financial crisis that began in 2007. Or were they?

The Dodd-Frank Act seemed to answer that question "no." Its relatively few provisions that apply generally to public companies deal primarily with corporate governance and more specifically executive compensation. If audit committees received all the attention in the early 2000s, compensation committees got the initial attention in the early 2010s. But more recently some investors have become quite vocal about the responsibilities — and the perceived failures — of auditors this time around. In addition, a reinvigorated PCAOB, led by its new Chairman, James Doty, has launched a number of initiatives during this past year that once again put auditors and audit committees in the regulatory spotlight. Four separate, but seemingly related, PCAOB projects have the potential to bring about dramatic changes:

1. Auditor independence, including the possibility of mandatory audit firm rotation
2. Expanded audit committee communications
3. Audit "transparency," including naming the engagement partner
4. Examining the auditor reporting model, potentially expanding the auditor's report beyond the current "pass/fail" model

The biggest splash so far has come from the PCAOB's August 2011 Concept Release on auditor independence which raised the possibility of requiring that public companies change their audit firm after a certain number of years. The PCAOB highlighted the limited turnover of auditors at larger companies, noting that 20 of the 100 largest companies have used the same auditor for over 50 years. At the same time, some investors have expressed concern about auditor objectivity and skepticism, asking how could the financial crisis have hit the big banks the way it did if their auditors had been paying the appropriate type of detached attention? Critics respond that the two are not correlated and that requiring rotation would be expensive, could reduce audit quality in the years right after a forced rotation and would inappropriately intrude on audit committees who are better able (and already have the authority) to make this decision for their individual companies. The next step is a PCAOB roundtable later this month.

Although mandatory rotation is getting the mainstream press attention, the other three PCAOB projects may ultimately have more meaningful reverberations. The audit committee communications project would require auditors to have more robust discussions with, and provide more information to, audit committees. How this may change the work of, and the demands on, audit committees remains to be seen, but committee members will likely find themselves with new resources and perhaps new urgency in using them. The new audit transparency proposals include a requirement to identify the engagement partner by name. As public databases emerge, we will see what pressures this puts on engagement partner assignments. Both of these communications and transparency projects are likely to be in place by year-end.

The final project—looking at the form and substance of the audit report—is still at the Concept Release stage. But it asks profound questions aimed at requiring auditors to speak in more depth and to cover more topics in their expert attestations. One suggestion is to require an Auditor's Discussion and Analysis. Questions have emerged, however, whether such a move would actually benefit investors, since this may simply push management disclosures into conformity with what the auditors have said, rather than providing a more nuanced and individualized view from the eyes of management. Guiding principles in this area will become clearer when the PCAOB releases its proposal, which is expected in the second quarter of 2012.

One message is already clear: with these four PCAOB projects the regulatory winds have shifted. Some focus may still be on compensation committees in our new "say-on-pay" world, but audit committees are clearly back in the spotlight as well.

John White is a partner in the Corporate Department and the Co-Head of the Corporate Governance and Board Advisory practice at Cravath, Swaine & Moore LLP and was previously the Director of the Division of Corporation Finance at the Securities and Exchange Commission. Kimberley Drexler is a Senior Attorney in the Firm's Corporate Department and previously served in the General Counsel's office at the SEC and as the Senior Advisor to the Director of the Division of Corporation Finance.