Auditing and Accounting: What's New in 2020

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Accounting Practices: Spotlight on SEC Enforcement

Last year at this time, companies and boards were wrestling with the impact of the new revenue recognition standard and the new lease accounting standard. The next big innovation in accounting standards is the new Current Expected Credit Losses (CECL) model for recognizing credit losses, which takes effect in 2020 for most public companies.

The significant impact will be mainly at financial institutions, but even companies with limited financial assets face challenges for implementation and related internal controls. In addition to the technical accounting considerations, major changes of this kind present disclosure and governance challenges, which most companies and boards have learned to address in revenue recognition and lease accounting exercises over the last two years.

Board members should consider the implications of two important recent enforcement cases. One has implications about management practices that may not be unusual, while the second is a good cautionary tale for companies with significant regulatory proceedings.

— ***Marvell and Its "Pull-ins***." Marvell Technology Group, a producer of semiconductor components, will pay $5.5 million to settle SEC charges arising from its use of "pull-ins:" obtaining a customer's agreement to reschedule an existing order from a future quarter into the current quarter. Marvell used pull-ins to meet revenue guidance and to mask declining demand and falling market share, as well as reduced future sales; these effects were not disclosed to the public, the board or the auditors. Unlike many revenue-related enforcement cases, the SEC

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did not find fault with how the sales were accounted for; instead it found that Marvell made misleading public statements and failed to disclose a material trend, event or uncertainty in MD&A. According to media reports, the SEC is pursuing a similar theory in an investigation involving Under Armour.

The Marvell case is worth noting because so many public companies provide guidance on expected revenue, and many of them have management practices they can use to affect the timing of revenues (or expenses). Boards should make sure they understand how these tools are used and whether their material effects are disclosed. Our blog post on the case can be found here.

— ***Mylan and Its Regulatory Proceedings***. In October 2016, Mylan, maker of the EpiPen, announced that it had settled for $465 million a US Department of Justice case involving classification of the EpiPen. (It had not previously disclosed the existence of government investigations into whether the product was properly classified.) In September 2019, the SEC settled its action against Mylan. The SEC alleged that (i) Mylan should have disclosed the DOJ investigation, because a loss was reasonably possible, at least by October 2015 (in its third quarter 2015 10-Q); and (ii) Mylan should have accrued for a loss, because it was probable and reasonably estimable, at least by May 2016 (in its second quarter 2016 10-Q).

The Mylan case is a classic illustration of the challenge companies regularly face in determining when to disclose proceedings and when to accrue a loss. As Mylan's experience shows, disclosing a major case for the first time when it is settled is a lightning rod for SEC attention. Our Alert Memo on the Mylan case can be found here.

Focus on Auditor Independence

In 2019, the SEC adopted amendments to Rule 2-01 of Regulation S-X to ease a burdensome element of auditor independence rules related to loans, and in December the SEC proposed additional changes to those rules. Compliance with these standards remains a practical challenge for audit firms, as the SEC and Public Company Accounting Oversight Board (PCAOB) have continued to bring cases against many of the major audit firms during the past year. Some of these violations appear to be "foot faults;" others are more substantive. PCAOB rules allow an auditor to continue the engagement despite an independence violation when the audit firm and the audit committee each determine that the auditor remains "capable of exercising objective and impartial judgment" and that a reasonable investor with knowledge of all relevant facts and circumstances would agree. The PCAOB has stressed the audit committee's "important role in representing the interests of the audit client's investors" in this regard.[1]

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A whistleblower letter sent to Mattel in August 2019, in addition to alleging accounting errors that ultimately led to the restatement of its 10-K, questioned the independence of the company's auditor. The letter claimed that the audit firm knew about the errors but did not insist on reporting them to senior management or the board, and that the lead audit partner took certain HR-related actions that violated the independence rules. Following an investigation, Mattel's audit committee and auditor

[1] *See* PCAOB Staff Guidance, Rule 3526(b) Communications with Audit Committees Concerning Independence, available here.

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concluded that the objectivity and impartiality of Mattel's auditor had not been impaired. The audit committee retained the firm as its auditor, though the lead partner and certain other members of the audit team were replaced.

Although the audit firm is often the party in the brightest spotlight when independence issues arise, responsibility for auditor independence is shared among the audit committee, management and the auditors, and if the SEC ultimately disagrees with the independence assessment, it can have implications for the company. On December 30, 2019, the SEC released a statement (available here) from Chair Jay Clayton, Chief Accountant Sagar Teotia and Director of the Division of Corporation Finance William Hinman reminding audit committee members of the importance of their role in financial reporting. One observation they emphasized was that the audit committees share responsibility for compliance with the auditor independence rules, and they suggested that the committees "periodically consider the sufficiency of the auditor's and the issuer's monitoring processes." Prior to the whistleblower letter, it is not clear whether any of the independence matters were discussed with Mattel's audit committee as part of the required annual communications between the auditor and the audit committee, but the case and the recent SEC statement both underscore the importance of the board's engagement on these issues.

Critical Audit Matters in Action

Last year, we began to see auditors include critical audit matters (CAMs) in audit reports, implementing a 2017 amendment to PCAOB standards. More CAMs will be coming in 2020, as the change takes effect for calendar year large accelerated filers, and in 2021 for most other issuers.

CAMs are matters that are communicated or required to be communicated to the audit committee and that (i) relate to accounts or disclosures that are material to the consolidated financial statements, and (ii) involve especially challenging, subjective or complex auditor judgments.

Some patterns are already clear from the several hundred Form 10-Ks already filed with CAMs, and from our conversations with clients so far. In general, the advent of CAMs may seem like something of an anticlimax, particularly in view of the buildup from the auditing profession and the PCAOB.

— ***Number of CAMs***. So far the average number of CAMs per filer is under two. It appears that no auditor has reported zero CAMs and none has reported more than four. Outside the United States, a very similar requirement to report "key audit matters" has typically yielded a larger number of topics for each issuer, and of course the "critical accounting estimates" disclosed in MD&A are usually more numerous. The risk that CAMs would be confused with critical accounting estimates seems to have been largely avoided.

— ***Leading Topics***. The CAMs most often reported relate to goodwill and intangible assets, revenue recognition and income taxes. There is of course variation among issuers depending on industry and on company-specific events, like a large acquisition or contingent liability. Which matters are CAMs for each issuer may also vary from year to year.

— ***Engagement***. The PCAOB and the audit firms have encouraged the use of "dry runs" for auditors to engage early on with the audit committee and management on what CAMs would be reported and how. At some companies these dry runs were early and disciplined, but at others the process has been lighter.

— ***Original Information***. A key concern about the CAMs requirement was that it will result in new disclosures that the issuer would otherwise have judged to be immaterial and sensitive. Anecdotally, this does not seem to have been a major issue so far. Of course, in delicate areas where disclosure of audit challenges might have implications for the issuer's disclosure practices (such as litigation provisions or uncertain tax positions), the difficult discussions stay behind the scenes.

Turmoil at the PCAOB

The PCAOB was in the media in 2019, and often in an unflattering light. In October, a whistleblower letter surfaced claiming that the agency has severe internal problems. According to media reports, the letter, signed by multiple PCAOB staffers, was delivered to the agency in May and to the SEC in August, and it claimed that the agency had slowed its work amid board infighting, multiple senior staff departures and an internal climate of fear. After receiving the letter, the SEC appointed one-time SEC Chair Harvey Pitt to review the PCAOB's corporate governance.

The letter came on the heels of the PCAOB's semi-public struggles with personnel issues, as senior staff positions remained unfilled for months. And of course it followed the dramatic KPMG scandal, which led to the March 2019 criminal conviction of the former No. 2 partner in the firm's US audit practice for, in effect, trying to cheat on PCAOB exams.

In late October, former SEC Chair Arthur Levitt published a *New York Times* opinion piece warning about the increasing politicization at the PCAOB. He charged that the board is being weakened by political appointments and internal strife.

The PCAOB has sought to address some of these concerns. It has emphasized engagement with stakeholders beyond the auditing profession itself, including companies and audit committees. At a conference in New York in December, Chair Duhnke said that the PCAOB has heard from all sides that it needs to undergo transformational change. He mentioned outreach to audit committees, saying that the PCAOB has already spoken to nearly 400 committee chairs and plans to publish a readout of takeaways soon. He also described internal steps to improve the agency's performance and sought to rebut some of Mr. Levitt's contentions.

Today, the PCAOB seems paradoxically aggressive and embattled at the same time. It is too early to tell whether boards and audit committees will see the impact of the turmoil. As the PCAOB implemented its mandate over the past decade and a half, and made auditing a more fully regulated profession, it had a significant impact on relations among companies, auditors and audit committees. If the agency is weaker or less proactive, the pace of change could slow or stop.