

ASSOCIATION OF AUDIT COMMITTEE MEMBERS, INC.

OCTOBER 11, 2019
ANNUAL MEETING



LEGAL ETHICS ISSUES

Frederick D. Lipman. Esq.



LEGAL ETHICS ISSUES

You are the inside general counsel and vice-president-legal for a large private Delaware corporation in the health care field. You have received complaints from several employee whistleblowers about the corporation's compliance with certain rules on Medicare reimbursements.

Your internal auditor and HR Department have investigated these complaints and found them to be without merit. In one case your HR Department fired the employee whistleblower for poor work performance six months after the employee told his supervisor about the alleged Medicare rules violation.

The corporation has an audit committee composed of independent directors who have in their charter the responsibility for enterprise risk issues. Do you have any obligation to advise the audit committee of these facts under the U.S. Department of Justice Criminal Division in the Evaluation of Compliance Programs (Updated April 2019) ("DOJ Guidance").

Note: In *Gantler v Stephens*, 965A.2d 695 (2009), the Delaware Supreme Court made it clear that corporate officers are subject to the same fiduciary duties as directors. However, in contrast to directors, Section 102(b)(7) of the Delaware General Corporation Law does not permit the elimination of an officer's personal liability for monetary damages for breach of the fiduciary duty of due care.

PA RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

PA RULE 1.13 – ORGANIZATION AS CLIENT

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

PA RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

PA RULE 1.13 – ORGANIZATION AS CLIENT (Cont.)

1. asking for reconsideration of the matter;
2. advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
3. Referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign in accordance with Rule 1.16.

(d) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(e) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

PA RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

PA RULE 1.13 – ORGANIZATION AS CLIENT (Cont.)

Comment:

... [3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. However, different considerations arise when the lawyer knows that the organization may be substantially injured by action of a constituent that is in violation of law. In such a circumstance, it may be reasonably necessary for the lawyer to ask the constituent to reconsider the matter. If that fails, or if the matter is of sufficient seriousness and importance to the organization, it may be reasonably necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. Clear justification should exist for seeking review over the head of the constituent normally responsible for it. The stated policy of the organization may define circumstances and prescribe channels for such review, and a lawyer should encourage the formulation of such a policy. Even in the absence of organization policy, however, the lawyer may have an obligation to refer a matter to higher authority, depending on seriousness of the matter and whether the constituent in question has apparent motives to act at variance with the organization's interest. Review by the chief executive officer or by the board of directors may be required when the matter is of importance commensurate with their authority. At some point, it may be useful or essential to obtain an independent legal opinion.

PA RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

PA RULE 1.13 – ORGANIZATION AS CLIENT (Cont.)

Comment (cont.):

[4] The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.

NY RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

NY RULE 1.13 – ORGANIZATION AS CLIENT

(a) When a lawyer employed or retained by an organization is dealing with the organization's directors, officers, employees, members, shareholders or other constituents, and it appears that the organization's interests may differ from those of the constituents with whom the lawyer is dealing, the lawyer shall explain that the lawyer is the lawyer for the organization and not for any of the constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action or intends to act or refuses to act in a matter related to the representation that (i) is a violation of a legal obligation to the organization or a violation of law that reasonably might be imputed to the organization, and (ii) is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organizations. Such measures may include, among others:

NY RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

NY RULE 1.13 – ORGANIZATION AS CLIENT (Cont.)

1. asking for reconsideration of the matter;
2. advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
3. referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly in violation of law and is likely to result in a substantial injury to the organization, the lawyer may reveal confidential information only if permitted by Rule 1.6, and may resign in accordance with Rule 1.16.

(d) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the concurrent representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

NY RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

NY RULE 1.13 – ORGANIZATION AS CLIENT (Cont.)

Comment:

...[3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer, even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. Paragraph (b) makes clear, however, that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. Under Rule 1.0(k), a lawyer's knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious. The terms "reasonable" and "reasonably" connote a range of conduct that will satisfy the requirements of Rule 1.13. In determining what is reasonable in the best interest of the organization, the circumstances at the time of determination are relevant. Such circumstances may include, among others, the lawyer's area of expertise, the time constraints under which the lawyer is acting, and the lawyer's previous experience and familiarity with the client.

[4] In determining how to proceed under paragraph (b), the lawyer should give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility within the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant consideration. Measures to be taken may include, among others, asking the

NY RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

NY RULE 1.13 – ORGANIZATION AS CLIENT (Cont.)

Comment (Cont.):

constituent to reconsider the matter. For example, if the circumstances involve a constituent's innocent misunderstanding of law and subsequent acceptance of the lawyer's advice, the lawyer may reasonably conclude that the best interest of the organization does not require that the matter be referred to higher authority. If a constituent persists in conduct contrary to the lawyer's advice, it may be necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Any measures taken should, to the extent practicable, minimize the risk of revealing information relating to the representation to persons outside the organization. Even in circumstances where a lawyer is not obligated by Rule 1.13 to proceed, a lawyer may bring the attention of an organizational client, including its highest authority, to matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization. See Rule 1.4.

[5] The organization's highest authority to which a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.

ABA MODEL RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

RULE 1.13: ORGANIZATION AS CLIENT

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- (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuse to act in a matter related to the representation that is a violation of a legal obligation to the organization or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

ABA MODEL RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

RULE 1.13: ORGANIZATION AS CLIENT (Cont.)

(c) Except as provided in paragraph (d), if

1. despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and
2. the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend an organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

ABA MODEL RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

RULE 1.13: ORGANIZATION AS CLIENT (Cont.)

- (e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) and (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.
- (f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
- (g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

ABA MODEL RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

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Comment:

... [3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. Paragraph (b) makes clear, however, that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Rule 1.0(f), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious.

[4] In determining how to proceed under paragraph (b), the lawyer should give due consideration to the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Ordinarily, referral to a higher authority would be necessary. In some circumstances, however, it may be appropriate for the lawyer to ask the constituent to reconsider the matter; for example, of the circumstances involve a constituent's innocent misunderstanding of law and subsequent acceptance of the lawyer's advice, the lawyer may reasonably conclude that the best interest of the organization does not require that the matter be referred to higher authority. If a constituent

ABA MODEL RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS

RULE 1.13: ORGANIZATION AS CLIENT (Cont.)

Comment (Cont.):

persists in conduct contrary to the lawyer's advice, it will be necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Any measures taken should, to the extent practicable, minimize the risk of revealing information relating to the representation to persons outside the organization. Even in circumstances where a lawyer is not obligated by Rule 1.13 to proceed, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.

[5] Paragraph (b) also makes clear that when it is reasonably necessary to enable the organization to address the matter in a timely and appropriate manner, the lawyer must refer the matter to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law. The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.

ACCOUNTANT ETHICS ISSUES

Frederick D. Lipman. Esq.



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RESOURCES

- AICPA Code of Professional Conduct
- The ethical requirements of the member's state CPA society and authoritative regulatory bodies such as state board(s) of accountancy
- The Securities and Exchange Commission (SEC)
- The Public Company Accounting Oversight Board (PCAOB)
- The Government Accountability Office (GAO)
- Federal, state and local taxing authorities
- Any other body that regulates a member who performs professional services for an entity when the member or entity is subject to the rules and regulations of such regulatory body.

Excerpt from Lipman, “Enhanced Corporate Governance: Avoiding Unpleasant Surprises”(2019)

INDEPENDENT AUDITORS

Some CEOs and Boards believe that their independent auditors are capable of identifying significant enterprise risks and will so advise them. Nothing can be further from the truth. Even the Public Company Accounting Oversight Board (“PCAOB”) agrees. The PCAOB has stated that “an audit made in accordance with PCAOB auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.” [See: AS2405.8]

It is not the function of independent auditors to identify enterprise risks unless the auditor is informed by the client of the illegal act or “there is evidence of a government agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in audit of financial statements.” Of course it is possible for an auditor to be specifically employed to identify enterprise risks. However, this is rare. Even when they are so employed, their opinions are so chocked full of qualifications and limitations that they are of little value.

Excerpt from Lipman, Enhanced Corporate Governance: Avoiding Unpleasant Surprises” (2019) (Cont.)

Procedures used by the independent auditor for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor’s attention. Such procedures including reading minutes, inquiring of the client’s management, legal counsel, and the audit committee.

However, for the most part the overwhelming majority of independent auditors never detect enterprise risks and rely upon management representations. The PCAOB specifically sanctions such reliance in the following statement:

“The auditor also obtains written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. (See AS 2085, *Management Representations*.) The auditor need perform no further procedures in this area absent specific information concerning possible illegal acts.”

WHY SHOULD THE AUDIT COMMITTEE CARE ABOUT THE COMPANY'S CULTURE?

Patricia Oelrich
Frederick C. Peters, II
Joseph G. Poluka, Esq.



**U.S. Department of Justice
Criminal Division
Evaluation of Corporate Compliance Programs
(Updated April 2019)**

“Beyond compliance structures, policies, and procedures, it is important for a company to create and foster a culture of ethics and compliance with the law. The effectiveness of a compliance program requires a high-level commitment by company leadership to implement a culture of compliance from the top...

“Some companies survey employees to gauge the compliance culture and evaluate the strength of controls, and/or conduct periodic audits to ensure that controls are functioning well, though the nature and frequency of evaluations may depend on the company’s size and complexity...

“**Culture of Compliance** - How often and how does the company measure its culture of compliance? Does the company seek input from all levels of employees to determine whether they perceive senior and middle management’s commitment to compliance? What steps has the company taken in response to its measurement of the compliance culture?”

THREE EXAMPLES OF COMPANIES WITH CULTURE ISSUES

PG&E's Long Record of Run-Ins With Regulators: A 'Cat and Mouse Game' *The Wall Street Journal* (September 5, 2019)

"In-house audits at PG&E Corp. as early as 2010 said workers were falsifying records of ground-marking at excavation sites intended to protect buried electricity cables and gas pipelines. The workers made it appear they were keeping up with their workload when they were not.

"Midlevel managers told higher-ups by 2014 that an ambitious program director was pressuring people to burnish on-time results, according to sworn testimony from utility employees to a California regulator.

"The utility's response? It removed the midlevel managers, promoted the program director and reported as fact figures it had been given reason to doubt, according to the testimony and a state investigative report...

"David Applebaum was a manager PG&E recruited in 2013 from the federal Pipeline and Hazardous Materials Safety Administration. He formed a unit at PG&E to investigate causes of "dig-in" accidents in which excavators strike buried pipelines or electrical cables...

PG&E's Long Record of Run-Ins With Regulators: A 'Cat and Mouse Game' *The Wall Street Journal* (September 5, 2019) (Cont.)

"He was disturbed by some PG&E practices, such as going after contractors to pay for dig-in damages when the company bore some responsibility because it hadn't marked a site on time or had made mistakes, according to a transcript of what he told investigators. He said he complained to Mr. Higgins and others.

"After he complained, his unit was put under Mr. D's oversight, Mr. Appelbaum said. From then on, he said, the team was pressured to go easy on PG&E and he was reprimanded for sharing information with regulators.

"PG&E fired Mr. Applebaum in September 2015, saying he had violated its code of conduct. Mr. Applebaum denied that and filed suit, invoking California law's whistleblower protections and alleging wrongful discharge, which PG&E denied. Court records show the suit was settled in 2018 with a PG&E payment to Mr. Applebaum...

PG&E's Long Record of Run-Ins With Regulators: A 'Cat and Mouse Game' *The Wall Street Journal* (September 5, 2019) (Cont.)

“Once a pillar of the California corporate establishment, PG&E now is in bankruptcy court because of its role in accidentally causing wildfires, for which it has said its liability might exceed \$30 billion. PG&E also is under federal probation, following felony convictions for violating gas pipeline safety laws in a San Bruno, Calif., explosion that killed eight people and for obstructing a federal investigation.”

General Motors Company (“GM”) – Chevrolet Cobalt and Other Vehicles Faulty Ignition Switch

As of 2015, GM was allegedly responsible for 124 deaths and 274 injuries because of faulty ignition switches in the Chevrolet Cobalt and other vehicles. GM has to-date paid out more than \$2 billion in fines, penalties, and settlements, according to *The New York Times*, April 24, 2017.

Both the GM Audit Committee and the Public Policy Committee of the Board had responsibility for vehicle safety. However, the Public Policy Committee was responsible for vehicle safety only to the extent it affected GM’s reputation in the legislative and regulatory arenas. Therefore, the primary responsibility for safety was the Audit Committee of the GM Board.

The Valukas Independent Counsel Report (“Report”) stated:

“...the Audit Committee oversaw GM’s risk management process, including reviewing the ‘risk factors’ described in GM’s public disclosures, and meeting regularly with the Chief Risk Officer in the years his work was overseen by the Committee...”

General Motors Company (“GM”) – Chevrolet Cobalt and Other Vehicles Faulty Ignition Switch (Cont.)

“...no specific vehicle safety issue was brought to the Audit Committee’s attention as part of its oversight of risk management other than a risk [unrelated to Ignition Switch problem]...

“...Before 2014, none of the written reports to the Board included any information concerning the Ignition Switch. We have not identified any evidence that the Board was otherwise informed of this problem, of GM’s delay in addressing it, or of the fatalities or accidents associated with it. Moreover, none of the executives we interviewed who presented on quality or recall issues at Board meetings in the pertinent period were aware of the Ignition Switch problem...

“In 2002 a GM whistleblower named Courtland Kelley allegedly warned GM about other safety problems and he was allegedly pushed out of his job as quality manager by GM for threatening to take his concerns to the National Highway Traffic Safety Administration (“NHTSA”). According to the Report, as early as 2005 Steven Oakley, Mr. Kelley’s successor, was “reluctant to push hard

General Motors Company (“GM”) – Chevrolet Cobalt and Other Vehicles Faulty Ignition Switch (Cont.)

on safety issues” concerning the Chevrolet Cobalt because of his perception that Mr. Kelley “had been pushed out of his job from doing just that”, and in part because of assurances he received from certain GM engineers...

“The Wisconsin State Patrol (Wisconsin’s state police force) issued a “Collision Analysis & Reconstruction Report” (the “Wisconsin State Patrol report”) on February 14, 2007, about the crash...

“The ignition switch on the...vehicle appears to have been in the accessory position when it impacted the trees preventing the airbags from deploying.” He noted that a search of the NHTSA website revealed five complaints of 2005 Cobalts turning off while being driven, three of which ‘talk about the knee or leg touching the ignition or key chain causing the engine to turn off’...

Trooper Young then cited the October 2006 technical service bulletin which “discusses the potential for the driver to inadvertently turn off the ignition due to low key cylinder torque/effect.” Therefore, he wrote: “It appears likely that the vehicles’ [sic] key turned to Accessory as a result of the low key cylinder torque/effort.”

General Motors Company (“GM”) – Chevrolet Cobalt and Other Vehicles Faulty Ignition Switch (Cont.)

“The forensic evidence further shows that prior to 2017, the electronic copy of the report was not accessed by anyone in GM Legal, with the exception of a GM legal assistant whose responsibilities included locating claim documents for production to NHTSA in connection with GM’s TREAD Act reporting duties and who accessed the document in May 2007...

“Also in 2007, the Indiana University (“IU”) Transportation Research Center issued a report (“the Indiana University study”) commissioned by NHTSA on April 25 titled “On-Site Air Bag Non-Deployment Investigation” for the **[blackened out]** crash, the same fatal accident that was the subject of the report by the Wisconsin State Patrol. Although at least one person was able to find the IU study on NHTSA’s website, GM personnel did not. Moreover, GM personnel made no efforts to systematically monitor NHTSA’s website for such information and therefore did not obtain it until years later.”

The Report discussed GM’s culture in extensive detail and how that culture affected the Cobalt ignition switch issue. The following are some excerpts of that discussion:

General Motors Company (“GM”) – Chevrolet Cobalt and Other Vehicles Faulty Ignition Switch (Cont.)

“Some witnesses said that there was resistance to raise issues or concerns in the GM culture. For example, a Red X Manager said that, if an employee tried to raise a safety issue five years ago, the employee would get pushback. Mary Barra [GM’s then CEO] explained that problems occurred during a prior vehicle launch as a result of engineers being unwilling to identify issues out of concern that it would delay the launch. Similarly, an employee survey reflected an issue related to speaking up.

“Whether general ‘cultural’ issues are to blame is difficult to ascertain, but the story of the Cobalt is one in which GM personnel failed to raise significant issues to key decision-makers. Senior attorneys did not elevate the issue within the Legal chain of command to the General Counsel – even after receiving the evaluation in the summer of 2013 that warned of the risk of punitive damages because of a ‘compelling’ argument that GM had ‘essentially...done nothing to correct the problem for the last nine years.’ Engineers, too, failed to elevate the issue.

General Motors Company (“GM”) – Chevrolet Cobalt and Other Vehicles Faulty Ignition Switch (Cont.)

“The Cobalt Ignition Switch issue passed through an astonishing number of committees. We repeatedly heard from witnesses that they flagged the issue, proposed a solution, and the solution died in a committee or with some other *ad hoc* group exploring the issue.

“One witness described the GM phenomenon of avoiding responsibility as the ‘GM salute,’ a crossing of the arms and pointing outward towards others, indicating that the responsibility belongs to someone else, not me. It is this same cabining of responsibility, the sense that someone else is responsible, that permeated the Cobalt investigation for years.

“Similarly, Mary Barra described a phenomenon known as ‘GM nod.’ The GM nod, Barra described, is when everyone nods in agreement to a proposed plan of action, but then leaves the room with no intention to follow through, and the nod is an empty gesture. It is an idiomatic recognition of a culture of that does not move issues forward quickly, as the story of the Cobalt demonstrates.”

Michigan State University/USA Gymnastics

In May, 2019, Michigan State University (“MSU”) stated it had reached a \$500 million settlement with more than 300 women and girls who alleged that Larry Nassar, the former USA Gymnastics and MSU doctor, sexually abused them. In 2018 Nassar was sentenced to 175 years in a Michigan State prison after pleading guilty to seven counts of sexual assault on minors.

MSU president Lou Anna Simon resigned in January 2019, hours after Nassar’s sentencing. A Detroit News investigation found that no fewer than 14 MSU coaches, trainers, and other representatives knew of allegations against Nassar in the nearly 20 years before his arrest. At least eight women – including the four athletes who talked to ESPN – and girls had made complaints, including one who contacted local police officials in 2004.

An independent counsel report on behalf of the MSU football program and its Athletic Department found that these groups complied with MSU’s policy “by promptly and accurately reporting the information they learned about the underlining incidents to departments within the University that are tasked with investigating and responding to such incidents”. In June 2019, the MSU Board of Trustees decided to hire a law firm to conduct its own independent investigation.

Culture is the “how” of the company

- How things get done
- How people work together
- How value is **protected**
- How value is **created**
- How people are motivated
- How people take and make decisions

Culture is a strategic asset

Risk Culture – protecting value through people
Strategy Culture – creating value through people

Why is culture such a challenge for directors?



- Directors tend to rely on their “gut” because they don’t think culture is measurable
- It’s tough to know which questions to ask
- Boards hear from senior management but not enough from the other employee levels (“mood in the middle” and “buzz at the bottom”)

Some things for Directors to think about culture?

- “Tone in the middle” is just as critical as “tone at the top”
- Leaders’ reactions to failure or bad news reveals much about the organization’s risk culture
- Poorly structured compensation plans can drive culture problems—but few are revisiting their plans
- Excessive focus on short-term results is particularly problematic
- Transparency and resilience are indicators of a positive risk culture
- Embedding cultural attributes in recruiting and onboarding processes will attract and keep employees whose values align with the company’s



Questions Boards should ask themselves

1. How do you figure out whether your concerns are symptoms of a real problem with corporate culture?
2. What actions or information do you find most helpful in assessing corporate culture?

Indicators of an Ineffective Risk Culture

▪ Leadership and Strategy

- Inconsistent direction from management, no clear vision or set of values
- Lack of awareness among employees of long-term and short-term strategies and objectives
- Misalignment of corporate and business-unit objectives
- **Unethical or non-compliant practices**
- Focus on extreme “stretch” goals
- **Low tolerance for failure or opposing viewpoints**
- Insufficient attention to risk management and/or internal audit functions
- Fighting amongst leadership
- Limited transparency into organizational decision-making
- All information runs to the board runs through the CEO
- Complacency and resistance to discuss culture

▪ People and Communication

- **Bad news is not well received by management or shared, and employees do not feel comfortable reporting incidents**
- Lack of training on risk management
- **Debate and challenge are not encouraged**
- Insufficient skilled resources/high turnover rates by business unit, race, age, gender function, etc.
- Inconsistent execution of performance review process and limited transparency on factors for promotion or success
- Inadequate interdepartmental or cross-organizational communication

Adapted from the following sources:

Identifying and Responding to A Dysfunctional Culture – Key Actions for Boards – womencorporatedirectors.org
The Risk Culture Survey (New York, PwC, 2012). P. 3.

Indicators of an Ineffective Risk Culture

- **Accountability and Reinforcement**

- Individual accountability for objectives is unclear
- Lack of understanding policies
- Incentive focus on short-term objectives
- Inconsistent application of disciplinary action
- Compensation plans and/or financial goals focused on short term
- **Strong focus on individual results or a “get it done at all costs” attitude**

- **Risk Management Infrastructure**

- Inconsistent or nonexistent understanding of risk
- Absence of emphasis on risk management or control by management
- Absence of processes to manage change
- Inadequate controls
- No performance measures in place
- Barriers to producing quality risk reports (systems, people, resources, etc.)

- Highlighted indicators seem to correspond to the situation at PG&E and GM – see case studies in the slides

Adapted from the following sources:

Identifying and Responding to A Dysfunctional Culture – Key Actions for Boards – womencorporatedirectors.org

The Risk Culture Survey (New York, PwC, 2012). P. 3.

Actions Inside the Board Room

Full Board

- Consider cultural issues in CEO selection
- Capture a comprehensive range of information relating to corporate culture
 - Employee engagement survey results
 - Customer complaints and trends
 - Customer service/satisfaction survey results
- Ensure culture is regularly scheduled board agenda item

Audit Committee

- Review compliance updates
- Review ethics/code of conduct training certification results
- Review whistleblower hotline reports
- Examine deep-dive data from employee surveys

Compensation/HR Committee

- Ensure compensation structure, performance evaluation process and compensation awards supports desired culture and ethical behavior
- Consider how culture-related elements are factors of executive compensation
- Review HR data for trends
 - Exit interview debriefs
 - Turnover statistics, attrition rate of high performers vs. overall attrition rate
 - 360 degree feedback for executives

Nominating/Governance Committee

- Consider culture in director selection and diversity of boards
- Review succession planning and process for senior executive officers

Actions Outside the Board Room

Diagnose the culture

- Explore cultural issues when onboarding
- Visit sites to better understand day-to-day
- Build relationships beyond C-suite to get honest feedback
- Review external feedback on the organization (e.g., social media, external press)
- Apply experience and judgment to be attuned to culture “warning signs”

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs

- 1. Is the corporation's compliance program well designed?
 - a. Risk Assessment
 - i. Risk Management Process: Has the company identified, assessed, and defined its risk profile?
 - ii. Risk-Tailored Resource Allocation: Is the company's compliance program appropriately tailored to its risk profile?
 - iii. Updates and Revisions: Is the company's compliance program periodically updated in light of lessons learned?
 - b. Policies and Procedures
 - i. Does the company have a Code of Conduct?
 - ii. Does the company have policies/procedures that incorporate a culture of compliance into operations?
 - 1. Design: what is the company's process for designing/implementing? Who is responsible? Who is consulted?
 - 2. Comprehensiveness: has the company made efforts to monitor and update risks and regulatory/legal changes to its policies and procedures?
 - 3. Accessibility: how has the company communicated its policies and procedures?
 - 4. Responsibility: who is responsible? How is it rolled-out? How to ensure employee understanding? What internal controls exist?
 - 5. Gatekeepers: What guidance and training is provided to key gatekeepers in control process? Do they know what to look for, who to report to?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- c. Training and Communications
 - i. Risk-based Training:
 - 1. Does training adequately cover prior compliance issues?
 - 2. Does the company train directors, officers, relevant employees, and, where appropriate, agents and business partners on relevant control functions?
 - ii. Form/Content/Effectiveness of Training:
 - 1. What is the form of training? Is it in an appropriate language? At an appropriate location (online or in-person)? How does company determine?
 - 2. How does company measure effectiveness of compliance? Are employees tested? What if an employee fails?
 - iii. Communications about Misconduct
 - 1. Has senior management communicated company's position regarding misconduct?
 - 2. What communications have there been generally when an employee is terminated or disciplined for failure to comply with policies/procedures/controls?
 - iv. Availability of Guidance
 - 1. What resources are available to employees?
 - 2. How does the company assess knowledge/willingness of employees to seek guidance/report misconduct?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- d. Confidential Reporting Structure and Investigation Process
 - i. Effectiveness of the Reporting Mechanism
 - 1. Does the company have an anonymous/confidential reporting system for suspected or actual misconduct?
 - 2. Does the company create a workplace culture without fear of retribution?
 - 3. Are company employees educated about reporting system?
 - 4. Are whistleblower protections in place?
 - ii. Properly Scoped Investigations by Qualified Personnel
 - 1. How does the company handle complaints?
 - 2. Who determines whether the company should conduct an investigation?
 - 3. How does the company ensure investigations are independent, objective, and documented?
 - iii. Investigation Response
 - 1. Does the company respond timely?
 - 2. Does the company monitor outcome of investigation?
 - 3. Does the company have a process for ensuring accountability and responding to findings?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- iv. Resources and Tracking of Results
 - 1. Does company provide adequate resources to report and investigation mechanisms?
 - 2. How has the company used the information collected, tracked, and analyzed to improve?
 - 3. Does the company periodically review for patterns of misconduct, red flags, or other compliance weaknesses?
- e. Third Party Management
 - i. Risk-based and Integrated Processes
 - 1. Does the company's third-party management risk process correspond to nature/level of risk?
 - 2. Is the third-party management risk process integrated into procurement and vendor management systems?
 - ii. Appropriate Controls
 - 1. What due diligence does the company do prior to contracting with a third-party?
 - 2. What mechanisms exist to ensure contract terms are adequate for risk?
 - 3. Are the payment terms commensurate for the work to be performed?
 - iii. Management of Relationships
 - 1. Has the company analyzed compensation/incentive structures against compliance risks?
 - 2. How does the company monitor third parties?
 - 3. Does the company have audit rights and has it exercised those rights?
 - 4. What training does the company provide its employees related to compliance risks posed by third-parties?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- iv. Real Actions and Consequences
 - 1. Does the company track red flag issues and how they are addressed?
 - 2. Does the company have a system to prevent use of terminated/risky third-parties?
- f. Mergers & Acquisitions
 - i. Due diligence process
 - 1. What was the due diligence process?
 - 2. Who conducted the review?
 - 3. Was the misconduct or risk identified as part of due diligence review?
 - ii. Integration in the M&A Process
 - 1. How has the compliance function been integrated into the M&A Process?
 - iii. Process Connecting Due Diligence to Implementation
 - 1. How has the company remediated misconduct or misconduct risks identified during the M&A process?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- 2. Is the corporation's compliance program being implemented effectively?
 - a. Commitment by Senior and Middle Management
 - i. To what extent has the company's top leaders – the board and executives – set high-level commitment to culture of ethics and compliance?
 - ii. To what extent has middle management reinforced the standards set by the top leaders?
 - iii. What oversight mechanisms are in place and how active are top leaders in oversight?
 - b. Autonomy and Resources
 - i. Structure
 - 1. Does the company have a compliance function appropriately structured for its size and risks?
 - 2. To whom does the compliance function report?
 - 3. At what level is the compliance function housed?
 - 4. What is the justification for the company's structure?
 - ii. Seniority and Stature
 - 1. How are compliance personnel treated compared to others in terms of stature, compensation, rank, title, etc.
 - 2. What role does the compliance officer actually play in strategic and operational decisions?
 - 3. How has company reacted to specific issues raised by compliance officer?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- iii. Experience and Qualifications
 - 1. Do the compliance/control personnel have appropriate experience and qualifications?
 - 2. Who reviews and determines performance of compliance function?
- iv. Funding and Resources
 - 1. Has the company devoted appropriate resources to train and audit compliance personnel?
 - 2. Have any requests for resources by compliance personnel been denied?
- v. Autonomy
 - 1. Do compliance personnel have direct report to Board of Directors or audit committee?
 - 2. How often does compliance meet with Board? Is senior management also present?
 - 3. How does company ensure independence of compliance and control personnel?
- vi. Outsourced Compliance Functions
 - 1. Has the company outsourced its compliance function?
 - 2. If so, why? Who oversees?
 - 3. Level of access to company information by external firm or consultant?
 - 4. How does company measure effectiveness?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- c. Incentives and Disciplinary Measures
 - i. Human Resources Process
 - 1. Who participates in making disciplinary decisions?
 - 2. Is same process followed regardless of misconduct?
 - 3. Are reasons for discipline communicated to employee?
 - 4. Does company restrict information for legal/investigation-related reasons or pre-textual reasons for protect company from outside scrutiny?
 - ii. Consistent Application
 - 1. Are disciplinary actions fairly and consistently applied?
 - 2. Are similar instances of misconduct treated disparately?
 - iii. Incentive System
 - 1. Does the company incentivize ethical behavior?
 - 2. Who determines compensation, bonuses, of compliance personnel?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- 3. Does the Corporation's Compliance Program Work in Practice?
 - a. Continuous Improvement, Periodic Testing, and Review
 - i. Internal Audit
 - 1. How frequent? More frequent for high risks?
 - 2. What issues identified?
 - 3. What reports to management and board?
 - 4. Follow-up by management and board?
 - ii. Control Testing
 - 1. Has company reviewed/audited compliance in connection with misconduct?
 - 2. How is data collected, interviews conducted, results reported, actions tracked?
 - iii. Evolving Updates
 - 1. How often does company update its risk assessments/policies/procedures?
 - 2. When was gap analysis last performed?
 - iv. Culture of Compliance
 - 1. How does company measure culture?
 - 2. Input from employees concerning perceived commitment to compliance by management?
 - 3. How does company reinforce culture of compliance?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- b. Investigation of Misconduct
 - i. Properly Scoped Investigation by Qualified Personnel
 - 1. How does the company ensure the investigation is independent, objective, appropriately conducted, and properly documented?
 - ii. Response to Investigations
 - 1. How has the company responded to investigative findings?
 - 2. Is senior leadership informed?
- c. Analysis and Remediation of Any Underlying Misconduct
 - i. Root Cause Analysis
 - 1. Has the company identified root cause of misconduct?
 - 2. Identified systematic issues?
 - 3. Who within company involved in process?
 - ii. Prior Weaknesses
 - 1. What controls failed?
 - 2. If policies existed, were they effectively implemented?
 - 3. Accountability for ownership of policies/procedures not implemented?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- iii. Payment Systems
 - 1. How was misconduct funded?
 - 2. What processes could have prevented improper use of funds?
 - 3. Has the company improved its processes?
- iv. Vendor Management
 - 1. Process for vendor selection?
 - 2. Due Diligence for vendor selected?
- v. Prior Indications
 - 1. Prior opportunities to detect?
 - 2. If missed, why?
- vi. Remediation
 - 1. What measures has the company taken to reduce risk of reoccurrence of the misconduct?
 - 2. How has the company addressed the root cause and missed opportunity analysis?

2019 DOJ Guidance: Evaluation of Corporate Compliance Programs (Cont.)

- vii. Accountability
 - 1. What disciplinary actions taken? Timely?
 - 2. Managers held accountable for misconduct under their supervision?
 - 3. How many disciplinary actions taken by company relating to types of conduct at issue?
 - 4. How many terminations?



U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General

Washington, D.C. 20530

September 9, 2015

FROM:

Sally Quillian Yates 
Deputy Attorney General

SUBJECT:

Individual Accountability for Corporate Wrongdoing

Fighting corporate fraud and other misconduct is a top priority of the Department of Justice. Our nation's economy depends on effective enforcement of the civil and criminal laws

“The rules have just changed. Effective today, if a company wants any consideration for its cooperation, it must give up the individuals, no matter where they sit within the company. And we’re not going to let corporations plead ignorance. If they don’t know who is responsible, they will need to find out. Remarks at NYU School of Law Thursday, September 20, 2015

Yates Memorandum

- September 9, 2015
- “One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing.”
- “[I]t can be difficult to determine if someone possessed the knowledge and criminal intent necessary to establish their guilt beyond a reasonable doubt.”
- November 29, 2018 Revisions.

Yates Memorandum – Six Key Steps

1. To be eligible for any cooperation credit, corporations must provide to the DOJ all relevant facts about the individuals involved in corporate misconduct.
2. Both criminal and civil corporate investigations should focus on individuals from the inception of the investigation.
3. Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.
4. Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals.
5. Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires and declinations as to individuals in such cases must be memorialized.
6. Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.

**Should Leaders of Organizations Manage the Culture and,
if Necessary, Change It?**

How a Leader Can Change the Culture of an Organization.

**Gaye van den Hombergh, Senior Consulting
Partner at Partners in Leadership, LLC.**



**TO WHAT EXTENT CAN THE AUDIT COMMITTEE RELY
UPON INTERNAL RISK AND CONTROL PERSONNEL
(such as internal auditor, compliance personnel,
insider general counsel and HR Department) AND THE
INDEPENDENT AUDITOR?**

**James S. Carter
Michael J. Purcell
Frederick D. Lipman, Esq.**



The Wells Fargo Disaster

Starting in 2014, Wells Fargo became embroiled in a series of disasters involving fictitious credit cards and bank accounts which were created to benefit from the Wells Fargo incentive sales plan, auto insurance which car loan customers did not need, and improper fees to lock an interest rate for a home mortgage. According to The Wall Street Journal of December 28, 2018, the bank has paid “more than \$4 billion in settlements and fines since September 2016. Federal regulators fined Wells Fargo approximately \$1 billion for misbehavior in its auto and home mortgage business alone, and 50 state regulators were paid \$575 million for improper retail sales practices, auto loan and mortgage charges. More than 800,000 people who took out car loans from Wells Fargo were charged for auto insurance they did not need, and some of them are still paying for it. John Stumpf, the Wells Fargo long-time CEO, was either fired or forced to resign. Carrie Tolstedt, Wells Fargo’s Senior Executive Vice-President, who reported to John Stumpf, resigned.

Wells Fargo Disaster (Cont.)

By 2010, approximately 700 Wells Fargo employees made whistleblower complaints to senior bank management related to gaming the incentive plans. The response by Senior Executive Vice President Tolsted to the bank examiner was that “the culture encourages valid complaints which are then investigated and appropriately addressed.” Some of the employee whistleblowers were fired and filed retaliation claims.

The Report of Independent Counsel to the Independent Directors of the Wells Fargo Board, dated April 10, 2017 (“Report”) made it very clear that the Wells Fargo Board was never informed of the fictitious sales practices prior to 2014. According to the Report, prior to 2014, sales practice or sales integrity issues were not flagged as noteworthy risks either to the Board of Directors as a whole or to any Board committee.

Director Proactive Steps

Proactive Step	Cost
1. Form a risk committee of the Board or specifically assign risk responsibilities to an existing committee.	Nominal
2. Test your ethics line or hotline by making an anonymous call to report some alleged (but fictitious) significant enterprise risk and then determine whether the information is reported back to both the risk committee of the Board and senior management.	Nominal
3. Have dinner with a former employee who voluntarily quit the company. Note: Current employees, fearing retaliation, may not be truthful and employees who were fired may have a personal agenda based on their involuntary termination.	Nominal

Director Proactive Steps (Cont.)

Proactive Step (Cont.)	Cost
4. Employ an independent firm to test the employee culture through surveys and permit anonymous responses. Questions could include, among others, whether an employee would report unethical or illegal activity or enterprise risk to both senior management and risk committee of the Board or only to their supervisor or through the employee hotline or otherwise	Moderate Cost
5. Make certain that at least one Board member is reading all whistleblower reports and determining that any reports that appear legitimate are independently investigated	Moderate Cost
6. Employ an independent firm to survey all supervisors on an anonymous basis to determine whether they would immediately report employee complaints of unethical or illegal activity or enterprise risk to both senior management and risk committee of the Board.	Moderate Cost

Director Proactive Steps (Cont.)

Proactive Step (Cont.)	Cost
7. Periodically have independent counsel review selective risk topics such as safety issues, compliance with the Foreign Corrupt Practices Act, risk issues recently reported by other industry members, etc.	Expensive



AACMI Annual Meeting PCAOB Update: CAM & the Audit Committee

- **October
2019**



PCAOB Updates

2019 Staff Inspections Outlook for Audit Committees

What's Included

- The PCAOB's plans to communicate with audit committees about our core activities.
- Information for audit committees on the PCAOB's key areas of focus during its 2019 inspections cycle.
- Relevant topics for audit committees to consider discussing with their auditors throughout the audit.

PCAOB Developments

As a supplement to the PCAOB's December [guidance](#) regarding its 2019 objectives and potential focus areas, the PCAOB issued a March [Outlook for Audit Committees](#) containing a list of sample questions to consider during engagement with the auditor throughout the audit cycle.

The December 2018 [Outlook](#) detailed the PCAOB's objectives and potential focus areas for planned 2019 inspections of audits of issuers and brokers and dealers. The PCAOB has indicated the following potential areas of focus for 2019 and are each explored further in BDO's [alert](#):

- ▶ Audit Firms' Systems of Quality Control
- ▶ Independence
- ▶ Recurring Inspection Deficiencies
- ▶ External Considerations
- ▶ Cybersecurity Risks
- ▶ Software Audit Tools
- ▶ Digital Assets
- ▶ Audit Quality Indicators
- ▶ Changes in the Auditor's Report
- ▶ Implementation of New Accounting Standards

- ***PCAOB is making its intentions clear to more heavily involve the audit committee (AC) in the inspections process.***

PCAOB Overview of 2018 Inspection Findings

In May, as part of continued efforts to increase audit quality, the PCAOB issued its “lookback” [Staff Preview of 2018 Inspection Observations](#), expanded from prior years to include *additional observations of specific areas* and *good practices* emphasizing the Board’s desire to enhance how and what the PCAOB is communicating and to make the process more forward-looking.

BDO

AN OFFERING FROM THE BDO CENTER FOR CORPORATE GOVERNANCE AND FINANCIAL REPORTING

FLASH REPORT CORPORATE GOVERNANCE

JUNE 2019 / www.bdo.com

PCAOB STAFF PREVIEW OF 2018 INSPECTION OBSERVATIONS



For the past several years, the percentage of audit deficiencies for the largest audit firms has remained relatively consistent at a rate that the PCAOB finds unacceptable and includes a number of recurring audit deficiencies. In recognition of the need to drive improvement in audit quality, the PCAOB has indicated their objective to conduct their inspection activities to provide more timely and relevant feedback to stakeholders. As part of a series of continuing communications, the PCAOB recently issued the [Staff Preview of 2018 Inspection Observations](#), which includes observations and good practices regarding efforts to improve audit quality, areas of common audit deficiencies observed in 2018, observations on technology, implementation of new accounting and auditing standards and rules, and audit committee communications. We encourage audit committees, management teams, auditors, and other stakeholders to review this and other PCAOB resources in anticipation of current year financial reporting.

Access [BDO's Flash Report here](#)

Good Practices
Regarding Efforts to
Improve Audit

Audit Deficiencies
Observed Across
Audit Firms

Implementation
New Accounting and
Auditing Standards

PCAOB Developments: Staff Preview of 2018 Inspection Observations

- Areas of common audit deficiencies observed in 2018:
- **Internal Control Over Financial Reporting** -
 - Insufficient testing of the design and operating effectiveness of controls that include a review element.
 - Did not select controls for testing that address specific risks of material misstatement.
- **Risk of Material Misstatement** - Design and performance of audit procedures that address the assessed risk of material misstatement, particularly auditing of revenue
- **Accounting estimates** – allowance for loan and lease losses, business combinations and fair value of financial instruments
- **Engagement Quality Reviews** – e.g., too much reliance on discussions with engagement teams or insufficient reviews

PCAOB Developments: Staff Preview of 2018 Inspection Observations

Observations and good practices to improve audit quality:	Examples of BDO's aligned actions to promote audit quality:
Expanding accountability for AQ beyond the lead engagement partner	Quality Matters Process: identification and grading of audit quality events inclusive of: Technical Partners, Audit Quality Team leaders, Regional and Office Managing Partners
Developing and refining guidance to help auditors identify and assess risk of material misstatements (RMMs)	Specific guidance on RMMs w/in BDO Audit Methodology and our public company-specific BDO Audit Manual
Revising training programs to include real-world examples illustrating "what could go wrongs"	Issuer training that incorporates video simulation of audit scenarios and integration of our Professional Judgment Framework
Providing additional support from experienced personnel not assigned to the audit	Focused coaching and audit milestones monitoring programs
Establishing a network of specialized professionals to address emerging risks	Leverage Assurance/Tax/Advisory professional subject matter experts
Providing new or enhanced audit tools in areas of significant judgment	Newly created Issuer Audit Resources Centers: Risk Assessment, ICFR, Management Review Controls, revenue, inventory, goodwill, CAMs, etc.

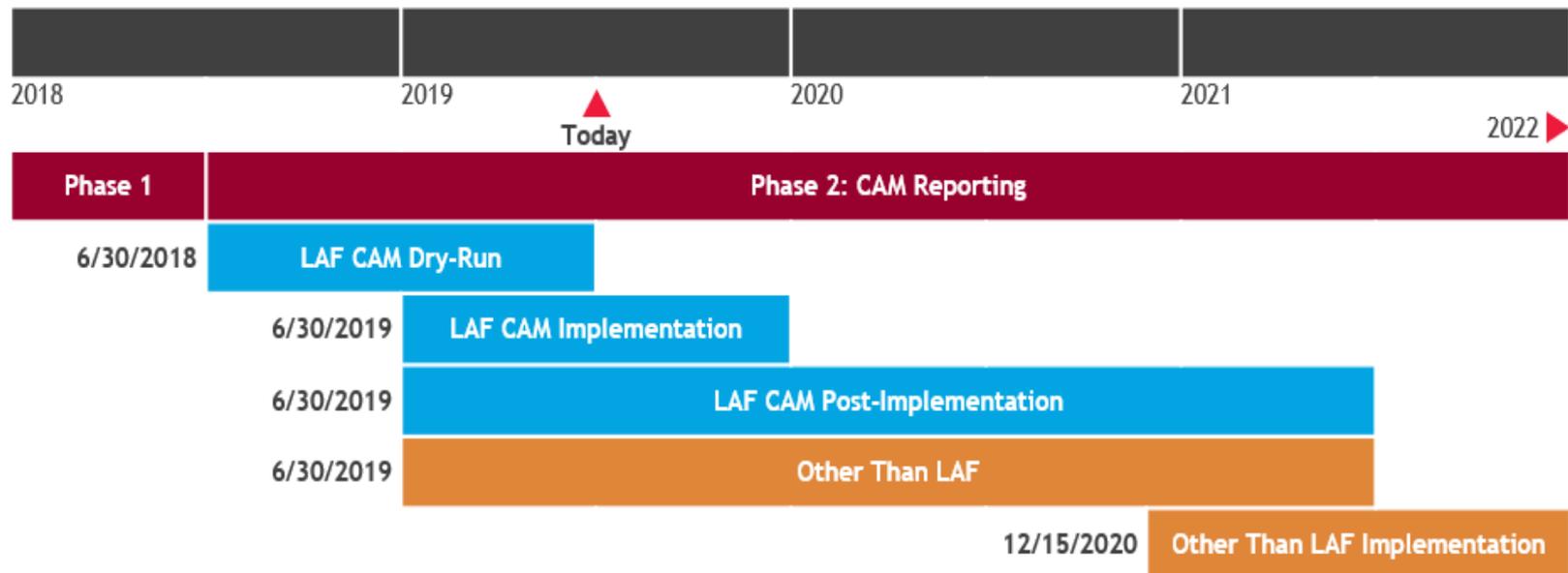
PCAOB Developments: Staff Preview of 2018 Inspection Observations

- Other General Observations
- **Cybersecurity Risk** - In 10% of audits reviewed, the company experienced a cybersecurity incident – reminder of importance for auditors to take steps to become aware of such incidents
- **Software Audit Tools** - Noted that emerging technologies used by or under development by auditors, including AI and robotic process automation, are being actively considered as well as current use of data analytics primarily as part of risk assessment and evaluation of large data sets (e.g., revenue and J/E testing) and enhanced auditors' identification of higher risk transactions
- **Audit Committee Communications** – Noted deficiencies in auditors failing to communicate significant risks identified in the audit, including changes to those risks and risks of fraud related to management override of controls
- **Implementation of New Standards and Rules** –
 - **Accounting Standards:** Noted audit firm revisions to audit methodologies, hosting of specific trainings, and regular engagement with clients on implementation
 - **Form AP:** Noted many registered audit firms were not submitting and disclosing names of engagement partners and certain other accounting firms that participated in the audit within new PCAOB Form AP in a timely manner or providing incomplete information
 - **Changes to the Auditor's Report:**
 - Noted most firms effectively implemented the first phase of the changes to the auditors report (e.g., inclusion of tenure) under AS 1301
 - Reviewed pilot testing of Critical Audit Matters (CAMs) for large accelerated filers



Critical Audit Matters (CAM) & the Audit Committee

PCAOB: Critical Audit Matters (CAM)



*Audit Committees are reminded Critical Audit Matter (CAM) auditor reporting requirements going into effect for large accelerated filers (LAFs) as of **June 30, 2019** and for Other than LAFs as of **December 15, 2020**.*

Frequent communication and education are critical to the successful implementation of this standard.

Critical Audit Matters

CAM DRY RUNS: CURRENT OBSERVATIONS

- CAM often relate to matters identified as significant risks, however, there is not a 1:1 relationship.
- Since CAM are defined as matters that involve *especially challenging, subjective, or complex auditor judgment*, not every significant risk identified by an engagement team would necessarily meet that definition and accordingly would not result in a CAM communication. Conversely, matters other than significant risks may also rise to the level of a CAM. One such example may be a nonrecurring transaction.
- Number of identified CAM vary and are unique to the nature of each audit. Since CAM are unique to a particular audit and are based on the facts and circumstances of each audit, there may be CAM even in an audit of a company with limited operations or activities.

PCAOB Resources: <https://pcaobus.org/Standards/Implementation-PCAOB-Standards-rules/Pages/new-auditors-report.aspx#resources>

Featured Videos on CAMs



In May 2019, Erin Dwyer joined the PCAOB as a direct point of contact for and liaison to investors, audit committees, and preparers. Erin shares some additional information about her role and these CAMs-related resources in this short video.



Chief Auditor and Director of Professional Standards Megan Zietsman describes some of the latest resources available on CAMs ahead of the effective dates.

BDO Board Survey Findings: Engaging on Critical Audit Matters

- *Beginning in 2019 with large public company audits, the PCAOB will require auditors to disclose CAM within the annual auditor's report.*
- *Has your audit committee **ACTIVELY** worked with your auditors to better understand the potential impact of CAM on financial reporting?*

	Total	Large/Mid Cap	Small Cap	Micro/Nano Cap
Yes	76%	92%	83%	59%
No	24%	8%	17%	41%

Source: 2019 BDO Board Survey



Intelligize Survey Finding: CAM Lessons Learned from Dry Runs

- Of the large accelerated filer survey respondents that participated in dry runs:
 - ▶ 62% reported 3–6 meetings with their auditors
 - ▶ 76% indicated that the process lasted 0–6 months
 - ▶ 43% of ACs identified additional controls that required implementation, while an additional 19% are still considering such changes

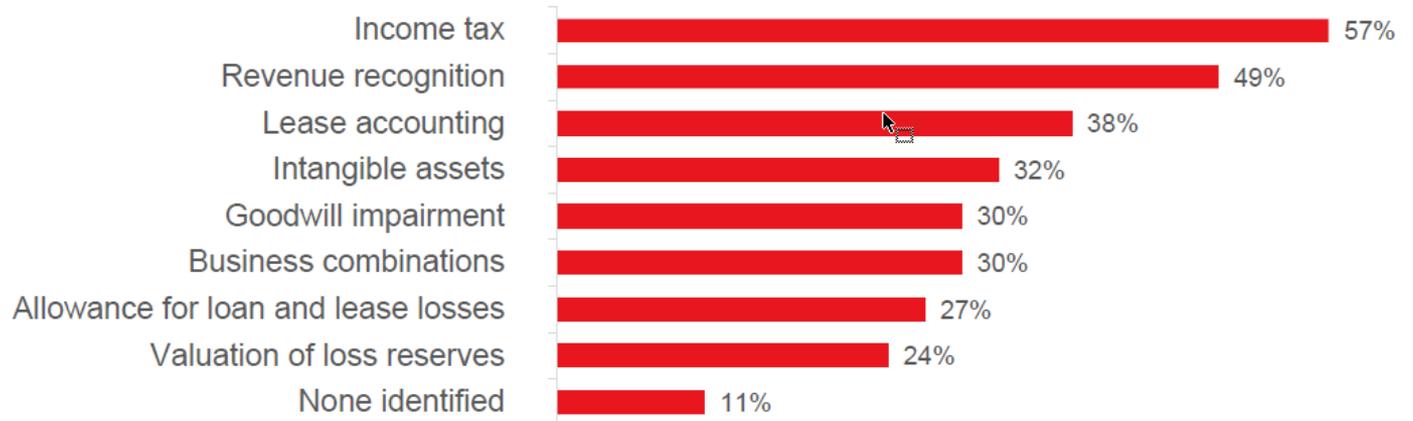
Source: Intelligize Survey: Critical Audit Matters: Public company adaptation to enhanced auditor reporting

Intelligize Survey Findings

CAM topics identified

What Critical Audit Matter (CAM) topics were identified during the dry run?

Large accelerated filers



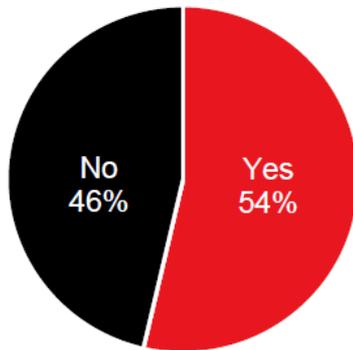
Base = 69 large accelerated filers

Intelligize Survey Findings

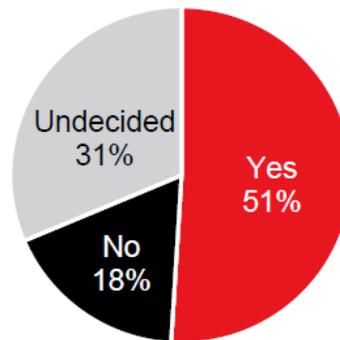
Conducting CAM dry runs

Do you conduct Critical Audit Matter dry runs? / Have you conducted, or do you plan to conduct, Critical Audit Matter dry runs? / Do you intend to conduct Critical Audit Matter dry runs before you drop emerging growth company status?

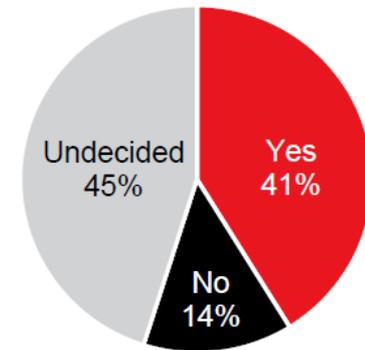
Large accelerated filers



Will report CAM on or after 12/15/20



Emerging growth companies

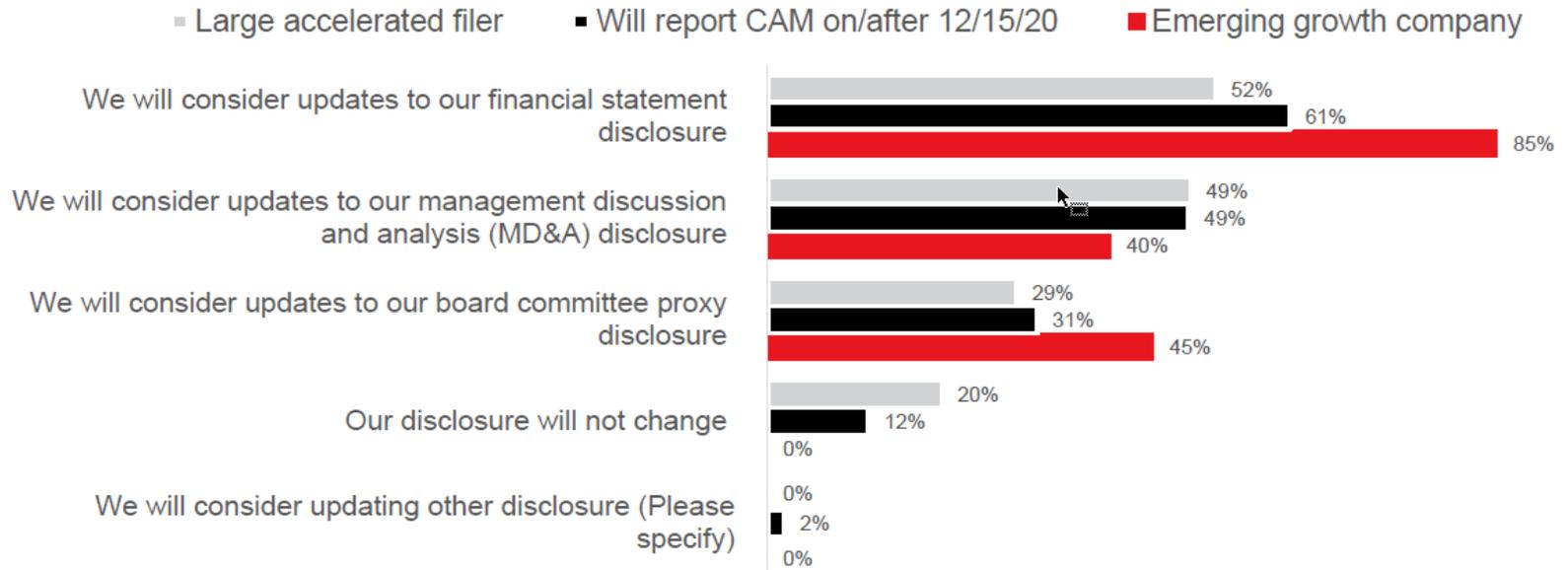


Base = 69 large accelerated filers; 51 will report CAM on/after 12/15/20; 51 emerging growth

Intelligize Survey Findings

CAMs impact on company's disclosure

How will (or how have) Critical Audit Matters (CAMs) impact(ed) your company's own disclosure?

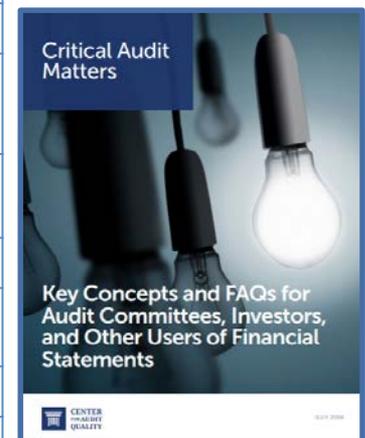
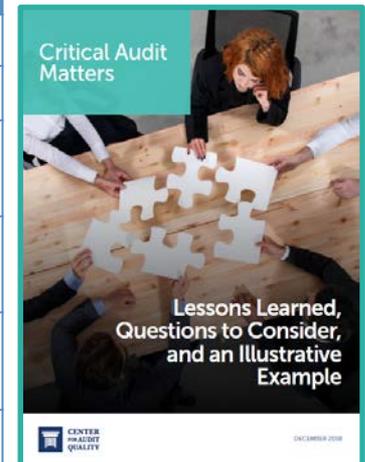


Base = 69 large accelerated filers; 51 will report CAM on/after 12/15/20; 51 emerging growth

Critical Audit Matters Resources

Recommended Resources	
<u>BDO Future of Auditor's Reporting is Here Resources</u>	Continually Updated
<u>PCAOB New Auditor's Report Resource Site</u>	Continually Updated
<u>Intelligize Critical Audit Matters: Public Company Adaptation of Enhanced Auditor Reporting</u>	September 2019
<u>PCAOB Implementation of CAM: A Deeper Dive on the Communication of CAMs</u>	May 2019
<u>PCAOB Webinars on Critical Audit Matters - 4/25 and 5/8</u> <u>PCAOB Webinar on Critical Audit Matters - 5/15</u>	April/May 2019
<u>CAQ Webinar: The Enhanced Auditor's Report is Here: Get the Facts on CAMs and More</u>	April 2019
<u>PCAOB Additional CAM Resources for Audit Committees</u>	March 2019
<u>CAQ Critical Audits Matters: Lessons Learned, Questions to Consider, and an Illustrative Example</u>	December 2018
<u>CAQ Issues "Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Stakeholders"</u>	July 2018
<u>The Future of Auditor Reporting is Here</u>	December 2017
<u>CAQ Tool: The Auditor's Report: Considerations for Audit Committees</u>	December 2017
<u>SEC Approves the New PCAOB Auditor Reporting Model</u>	November 2017
<u>PCAOB Adopts New Standard to Enhance the Auditor's Report</u>	June 2017
<u>PCAOB Staff Guidance</u>	Updated August 2018

CAQ Resources:





Appendix: Audit Committee Tools & Resources

BDO Audit Committee Resources

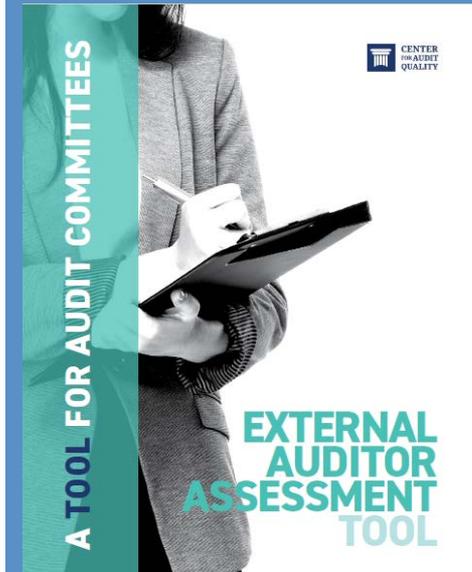
Recommended Resources	Intended Use
<u>BDO Audit Committee Self Assessment</u>	Tool to assist in evaluating how the Audit Committee is executing governance responsibilities.
<u>BDO Audit Committee Requirements Practice Aid</u>	Tool to assist Audit Committees in fulfilling their oversight responsibilities and documenting their activities.
<u>BDO Audit Committee Illustrative Charter</u>	Tool with example to assist Audit Committees in constructing their own company-specific charter to be used as a working document or practical roadmap of responsibilities and duties.
<u>BDO Professional Judgment Framework</u>	Tool to assist professionals in their capacity to logically assess situations or circumstances and to draw sound, objective conclusions that are not influenced by cognitive traps and biases or by emotion.



- The roles and responsibilities of the Audit Committee continue to evolve adding to the continuing need to stay on top of accounting and audit regulations and mandatory and voluntary disclosures.
- BDO continues to compile tools and resources to assist Audit Committees in fulfilling their obligations and documenting their activities, designed so that members may focus on the risks at hand.
- Stay tuned for more

CAQ Updated External Auditor Assessment Tool

- **April 2019** – The Center for Audit Quality (CAQ) issued an updated tool with sample questions for ACs to consider in assessing the external auditor on a “1-5 satisfaction” scale:
 - Quality of services & sufficiency of resources provided within the audit engagement team
 - Quality of services & sufficiency of resources provided by the audit firm
 - Communication & interaction with the external auditor; and
 - Auditor independence, objectivity, & professional skepticism



- Learn more by reading [BDO's flash report](#).

CAQ Guide: Internal Control over Financial Reporting

- After the SEC recently fined a number of companies for failing to remedy material weaknesses in ICFR, the PCAOB released a [Staff Preview of its 2018 Inspection Observations](#), highlighting the testing of ICFR remains a common audit deficiency.
- ICFR remains an important component to fostering confidence in a company's financial reporting, and ultimately, trust in our capital markets. To assist in these concerns, the Center for Audit Quality (CAQ) has updated and re-released its popular [Guide to Internal Control over Financial Reporting](#) as an overview to assist stakeholders in understanding key ICFR concepts, roles and responsibilities, and what ICFR means for companies, investors, and the markets.

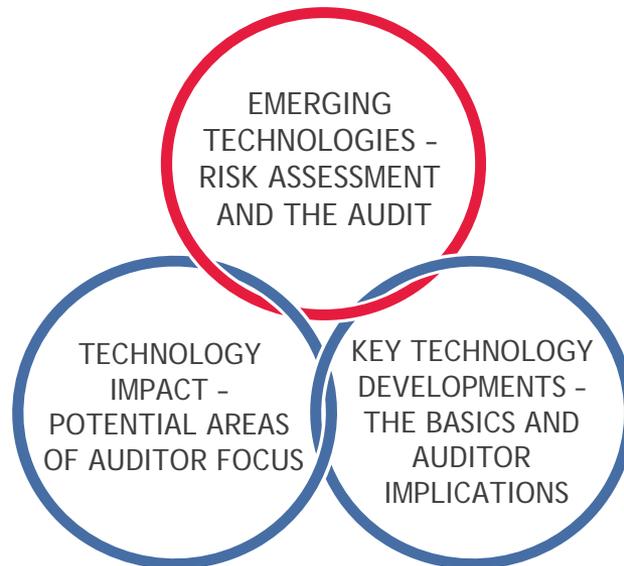


In addition to educating stakeholders on ICFR, this publication includes the addition of significant research demonstrating the importance and impact of ICFR and integrated audits on the quality of financial reporting.

- Access BDO's Alert [here](#).

CAQ: Digital Transformation & Audit

The CAQ has released Emerging Technologies, Risk and the Auditor's Focus: A Resource for Auditors, Audit Committees, and Management to highlight the financial reporting implications of the evolving use of technology together with the benefits, risks, and associated auditor considerations. Building on the previously released 2018 CAQ Emerging Technologies: An Oversight for Audit Committees, the CAQ provides insight to key stakeholders in the following areas:



CENTER FOR
AUDIT QUALITY



**EMERGING
TECHNOLOGIES,
RISK, AND THE
AUDITOR'S FOCUS**
A RESOURCE FOR AUDITORS,
AUDIT COMMITTEES, AND MANAGEMENT

BDO's release

Vital Role of the Independent Audit Committees

- Former SEC Chief Accountant Bricker is steadfast in his view of the vital role the AC plays in the financial reporting process. Areas of focus include:
- **Composition** – ensuring adequate time, commitment and experience
- **Effectiveness** – creating culture focused on integrity, ethics and professional skepticism with a balance agenda
- **Management Oversight** – understanding business reasons for changes to policies, corrections of errors, and compliance
- **Oversight of Controls** – ensuring controls are in place to achieve good business goals and not simply viewed as a compliance exercise
- **Self-Evaluations** – continual evaluation of member workload and independence; leveraging appropriate experts, when necessary
- **Auditor Communications** – setting appropriate tone with auditors and engaging in robust dialogue
- **Voluntary Disclosure** – considering enhancing disclosures with respect to oversight of external auditors

Leveraging Internal Audit

- ACs and Senior Executives are using the internal audit function both to assess quality and to drive value throughout the entire organization. In March, the Institute of Internal Auditor's (IIA) released their annual pulse survey of more than 500 Chief Audit Executives.
- Results reveal areas for improvement in leveraging internal audit in risk mitigation, particularly by playing a role in providing assurance on information the board receives from management.
- BDO offers an internal audit webinar series educating professionals on relevant topics throughout the year:

Internal Audit Programming	
<u>Innovative Use of Robotics in Internal Audit</u>	February 2019
<u>Internal Controls Impact on Unclaimed Property Compliance</u>	April 2019
<u>Effective Audit Ratings</u>	April 2019
<u>Audit Committee Best Practice for Oversight of Internal Audit</u>	June 20, 2019
<u>Audit Speed – Opportunities for Enhancement</u>	June 25, 2019
<u>Top IT Audit Risks</u>	September 24, 2019
<u>Transforming Internal Audit Methodology into Agile IA</u>	November 19, 2019

- At a time where risks continue to multiply, AC collaboration with Internal Audit is becoming increasingly important. The *IAA's 2019 North American Pulse of Internal Audit Survey* indicates four main areas where this collaboration may be able to be improved:
 1. Cybersecurity and Data Protection
 2. Third-Party Risks
 3. Emerging and Atypical Risks
 4. Board and Management Activity

The BDO Center for Corporate Governance and Financial Reporting



A dynamic and searchable on-line resource for board of directors and financial executives

- **RESOURCES AT YOUR FINGERTIPS**
- The BDO Center for Corporate Governance and Financial Reporting was born from the need to have a comprehensive, online, and easy-to-use resource for topics relevant to boards of directors and financial executives. We encourage you to visit the Center often for up-to-date information and insights you can rely on.
- What you will find includes:
 - ▶ Thought leadership, practice aids, tools, and newsletters
 - ▶ Technical updates and insights on emerging business issues
 - ▶ Three-pronged evolving curriculum consisting of upcoming webinars and archived self-study content
 - ▶ Opportunities to engage with BDO thought leaders
 - ▶ External governance community resources

To begin receiving email notifications regarding BDO publications and event invitations (live and web-based), visit www.bdo.com/member/registration and create a user profile.

If you already have an account on BDO's website, visit the [My Profile](http://www.bdo.com/member/my-profile) page to login and manage your account preferences www.bdo.com/member/my-profile.

For more information about BDO's Center for Corporate Governance and Financial Reporting, please go to: www.bdo.com/resource-centers/governance



BDO BOARD GOVERNANCE

Upcoming Webinars

Title	Date
<u>Quarterly Technical Update – Q4 2019</u>	Jan 2020
<u>Transforming Internal Audit Methodology Into Agile IA</u>	Nov 2019
<u>Quarterly Technical Update – Q3 2019</u>	Oct 2019
<u>How Audit Committees Manage Difficult Moments</u>	Sept 2019
<u>Top IT Audit Risks</u>	Sept 2019
<u>Audit Committee Best Practices for Oversight of Internal Audit</u>	July 2019

For a complete listing of BDO webinars and archived webinars, refer [here](#).



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Guest Speaker

Jennifer Arbittier Williams, First Assistant U.S.
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Q & A

