NASBA

STATE•BOARD•REPORT

A Digest of Current Developments Affecting State Accountancy Regulation

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UK Profession Scrutinized

Donald Brydon

The United Kingdom has named Donald Brydon, retiring chairman of the London Stock Exchange Group, to head a government-commissioned study of the audit market. The new group was announced just after three reports on the topic were released in mid-December: "Reforming the Auditing Industry" commissioned by the Shadow Chancellor of the Exchequer, John McDonnell, MP, and conducted independently by an academic team led by Professor Prem Sikka; "Statutory Audit Services Market Study" developed by the Competition and Markets Authority (CMA); and "Independent Review of the Financial Reporting Council (FRC)" by Sir John Kingman, chairman of UK Research and Innovation. These reports were called for in response to the collapse in early 2018 of Carillion, a British multinational facilities management and construction company that resulted in the loss of approximately 19,500 jobs. Professor Sikka's paper begins by stating: "Auditors have been unable to deliver independent and robust audits and the auditing industry is in disarray, dysfunctional and stumbles from one crisis to another." All three of the reports offer many recommendations on how to improve UK auditing, including changes to the Financial Reporting Council's role, and Mr. Brydon's group will be examining the future of audit as a practice and the quality of audit work in the UK.

All of the reports focus on the concentration of the audit work for the largest companies in the Big Four firms. "Competition and regulation should work together so that audit firms and individuals all have the strongest possible incentives to deliver quality," the CMA advises. The Big Four firms now account for over 97 percent of UK audit clients in the FTSE 350 (Financial Times Stock Exchange's largest companies by capitalization which have their primary listing on the London Stock Exchange) and over 99 percent of the audit fees. However, CMA's market study found: "Overall, the balance of views from audit committees and investors was that audit in the UK is generally of high quality…This positive overall view of quality is also reflected in the recent FRC survey of audit committee chairs, which suggested that 86 percent of respondents rated their external auditor as either 'excellent' or 'above average.'"

The European Union and the UK Competition Committee have put into place mandatory tendering of auditing firms every ten years, with switching auditors at least every 20 years. The CMA reports: "While the rate of switching has increased significantly since the introduction of the CC and EU remedies, we have found that switching has been almost entirely between the four largest auditors in the FTSE 350." Only five of the FTSE 350 companies switched: four went to Grant Thornton and one to BDO.

The CMA proposes several "remedies to create incentives for better audit quality, in tandem with improved regulation as recommended in the separate review of the FRC ":

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PCAOB Okays Estimate and Specialist Requirements

Following rounds of public comments, on December 20, 2018, the Public Company Accounting Oversight Board adopted enhanced requirements for *Auditing Accounting Estimates, Including Fair Value Measurements* and amended standards to strengthen requirements for an *Auditor's Use of the Work of Specialists*.

During 1988-2003 the auditing profession adopted three different standards related to auditing accounting estimates, PCAOB Chairman William D. Duhnke, III, pointed out. Those standards also predated the PCAOB's risk assessment standards. The objective of the standard adopted by the PCAOB on December 20 is to have "a single standard for auditing all accounting estimates that articulates a clearer, more consistent, risk-based approach." Chairman Duhnke said he believes the new standard "addresses known concerns and is well tailored to address this significant challenging audit area."

The two companion releases "work hand-in-hand," Board member Kathleen M. Hamm observed, "because auditors often use the work of specialists in auditing certain accounting estimates… Increasingly, complex accounting estimates dominate financial reporting frameworks. As a result, estimates have significant effects on companies' reported financial positions and results of operations. They also present a heightened risk of management bias, given their subjective nature."

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SEC Studying Quarterly Reports

The public is being asked to comment on how the Securities and Exchange Commission can enhance, or at a minimum maintain, the investor protection attributes of quarterly reporting while reducing the associated administrative and other burdens on reporting companies. On December 19 the SEC issued a "Request for Comment on Earnings Releases and Quarterly Reports" [File No. 57-26-18], which has a 90-day comment period after the date it is published in the Federal Register. Specifically, the SEC is asking for comments on the nature and timing of the disclosures that companies are required to provide in their quarterly reports filed on Form 10-Q, including when the disclosure requirements overlap with disclosures the companies voluntarily provide as an earnings release furnished on Form 8-K. The Commission is also requesting comments on whether there should be flexibility as to the frequency of periodic reporting, and how the existing periodic reporting system, earnings releases and earnings guidance may affect corporate decision making.

While Canada, Hong Kong and Japan have quarterly reporting requirements similar to those in the U.S., the European Union and other jurisdictions have recently developed different requirements to address concerns about the frequency of reporting, the SEC notes. The Commission reports there was a 2017 study that found when the United Kingdom no longer required companies to quarterly report, there was no significant difference between the levels of corporate investment in the UK companies that stopped quarterly reporting and those that continued quarterly reporting.

Among the questions being posed by the SEC are:

- "What is the impact of the auditor review requirement of quarterly financial information on investors, companies, and other market participants?"
- "Do investors value the independent auditor review of quarterly financial information? Why or why not?"
- "Does the auditor review requirement have a relationship to the cost of capital for companies? If so, how?"
- "To what extent are auditors involved with earnings releases? Does such involvement or the auditor review of the quarterly financial statements contribute to any delay between publication of an earnings release and the filing of a Form 10-Q?"

SEC Chairman Jay Clayton stated: "We recognize the importance of this information to well-functioning and fair capital markets. We also recognize the need for companies and investors to play for the long term. Our rules should reflect these realities." ♦

China Info Access Problem Continues

Despite the Public Company Accounting Oversight Board's having arranged cooperative agreements with foreign regulators to share inspection results, it has not been able to inspect the audit work and practices of PCAOB-registered auditing firms in China with respect to their audit work of US-listed companies with operations in China. On December 7, SEC Chairman Jay Clayton, SEC Chief Accountant Wes Bricker and PCAOB Chair William D. Duhnke, III, released a joint statement that announced the PCAOB is facing obstacles in inspecting the principal auditor's work for 224 US-listed companies (with $1.8 trillion combined market capitalization).

While there are information barriers in multiple jurisdictions, the SEC and PCAOB leaders state that they believe the resolution of issues with China are the most significant to investors. They observe that despite the SEC and PCAOB having sought constructive dialogues with Chinese officials over recent years, they have not made satisfactory progress. The statement concludes: "…we note that, depending on various facts and circumstances, including company-specific considerations, if significant information barriers persist, remedial actions involving US-listed companies may be necessary or appropriate. In the past, remedial measures have included, as examples, requiring affected companies to make additional disclosures and placing additional restrictions on new securities issuances." ♦

UK Profession Scrutinized (Continued from page 1)

1. Close scrutiny of audit appointment and management by the regulator, to secure audit committees' accountability and independence from companies.
2. FTSE 350 audits should be carried out jointly by two firms, at least one of which is outside the Big Four. As an alternative, a market share cap.
3. Firms' audit and non-audit businesses should be split into clearly defined separate operating entities, with separate management, accounts and remuneration, but with the ability to remain under the same organizational umbrella.
4. Peer review of audits should be commissioned by and reported to the regulator.

The review of the FRC by Sir John Kingman offers 83 recommendations beginning with: "The FRC should be replaced as soon as possible with a new independent regulator with clear statutory powers and objectives. It should be named the Audit, Reporting and Governance Authority." This new body would be accountable to Parliament and receive a remit letter at least once each Parliament, as the Financial Conduct Authority and the Prudential Regulation Authority do. In commenting on the FRC's weaknesses, the report states: "The FRC's work on audit quality does not command the same credibility as that of, for instance, the Public Company Accounting Oversight Board (PCAOB) in the United States." The US system is also pointed to when the report recommends "… give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from operation of the Sarbanes-Oxley regime in the US."

Professor Sikka's report, commissioned by the Labor Party, provides 49 recommendations that begin with: "Statutory Auditors of large companies and other entities must act exclusively as auditors." This report also calls for the creation of a new independent regulator and that there be "no statutory regulatory powers for the Financial Reporting Council or any of the accountancy trade associations."

Some of the uncommon recommendations include: "There must be personal liability for audit failures upon partners responsible for audits," and "All accounting standards must be stress tested." ♦

2019 – Meeting the Challenge of Change

Ken L. Bishop
President & CEO

Last month, I ended 2018 by reflecting on the highlights of the year. While "reflection" is important, the success of any organization is predicated on anticipating the challenges and opportunities it faces. In December's memo, I mentioned the challenge of "gaining universal acknowledgement of the key changes [technology advances] that are occurring." That continues to be a challenge for the new year.

I read recently that Chevrolet will discontinue the *Impala*, and Ford will discontinue the *Taurus* in 2019. Interestingly, just a few years ago the *Impala* was the first American car to be named "Car of the Year" by *Consumer Reports* in over 20 years. Less than a decade ago, the *Taurus* was the best-selling car in the United States for five years running. General Motors and Ford invested millions to update and modernize these profitable family sedans and did not recognize that consumer choice had changed. Ironically, Chevrolet also announced that the highly acclaimed *Volt*, the first plug-in hybrid car made in the United States, will also be discontinued in 2019. The cause was not the economy, nor energy consumption, but the increase in popularity of the SUV. The lesson is the critical importance of recognition and then acknowledgement of change.

For the last couple of years, we have continued to put a bright light on the inevitability of changes in and consumer expectations of the accounting profession, including the reliance on data analytics, artificial intelligence and blockchain. In 2019 we will witness the increased momentum of this transition. Recently, the State of Ohio announced that it will accept cryptocurrency for the payment of some taxes and fees. In late 2018, Ohio State Treasurer Josh Mandell said that Ohio is looking to attract businesses using blockchain. Treasurer Mandell told CNBC: "We're doing this to plant the flag in Ohio as the national and international leader in blockchain technology." Since Ohio's action, several other states have announced they are considering the acceptance of cryptocurrency and some states, including Georgia and Arizona, have seen legislation introduced. There have also been discussions about federal acceptance in the future.

The question to State Boards, and to the profession, is whether small firms and sole practitioners, who provide the vast majority of business and individual accounting and tax services, have the skills and knowledge needed to work with blockchain accounting and cryptocurrency? Will they be ready for attestation of place and time valuation of currency that was designed to be anonymous? In 2019, CPAs in Ohio and other places will be asked to meet that challenge.

These changes are occurring at a time when the lack of meaningful regulation of cryptocurrency is becoming evident. According to the *Wall Street Journal,* more than 90 cases have been brought to the SEC over the past two years, and investors have lost billions as cryptocurrency values have dropped. Because of the anonymity and international nature of cryptocurrency, the best that federal and state regulators can do is try and manage how the digital coins are offered. SEC Chairman Jay Clayton warned that his agency "may not be able to effectively pursue bad actors or recover funds" lost through investments in cryptocurrency.

I have no doubt that the U.S. accounting profession will ultimately rise to the challenge and will become the world's experts in dealing with these technology-driven changes. With the acceptance of cryptocurrency by governments and the determination of the IRS that gains made in cryptocurrency investments are taxable, consumer losses will inevitably generate complaints and questions about what is the responsibility of regulators, including State Boards of Accountancy? NASBA, with our mission to "enhance the effectiveness of State Boards of Accountancy," will do all we can to provide the necessary resources to meet these challenges.

Let me end by wishing each of you a safe, prosperous and happy new year, with its new -and continuing - challenges and opportunities.

Semper ad meliora (Always toward better things).

— Ken L. Bishop
President & CEO

State Board Report

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The PhD Project's Accomplishments

The PhD Project Annual Meeting saw the capping of 12 of its new PhD Project professors. The focus of The PhD Project is to increase diversity in business school faculty and since 1994, when The PhD Project was launched, the number of minority faculty members has quintupled. Dr. Cinco Nicole Fuller became the 1,470th minority business school professor.

Moving in an additional direction, The PhD Project has found that there are fewer than 40 African American, Hispanic American and Native American deans of non-historically black universities' business schools in the US. Project AHEAD (Achieving Higher Education Administration Diversity) has been developed by The PhD Project to encourage tenured minority faculty to explore positions in administration, as it provides them with resources, support and mentors.

Over 300 universities are participating in The PhD Project. NASBA is a sponsor of The PhD Project. ♦

PCAOB Okays Requirements

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The Specialists amendments cover the use of the work of a company's specialist and of an auditor's specialist, providing enhanced guidelines for applying a risk-based supervisory approach. Similarly, the Auditing Accounting Estimates standard establishes a uniform, risk-based approach for auditing accounting estimates, including fair value measurements. In her support of the recommendations, Ms. Hamm stated: "Based on what we know today, I believe that each recommendation is sufficiently principles-based and flexible to appropriately accommodate continued innovation around data analytics and emerging technology."

Board member J. Robert Brown, Jr., noted: "In developing the standard for estimates, the staff, for the first time, considered behavioral economics in rulemaking, which 'incorporates a more realistic analysis of how people think and behave when making economic decisions.'"

Chairman Duhnke said the PCAOB would be monitoring the implementation of these requirements, which is for audits of financial statements for fiscal years ending on or after December 15, 2020. Board member Duane M. DesParte pointed out that aligns with the implementation dates for the new Current Expected Credit Loss accounting standard and ISA 540, *Auditing Accounting Estimates and Related Disclosures.*

The recommendations now await final approval by the Securities and Exchange Commission. ♦