Dan Goelzer

AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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This Update summarizes recent developments relating to public company audit committees and their oversight of financial reporting and of the company's relationship with its auditor.

In This Update:

We Have Some Questions for You. The PCAOB Releases a New Audit Committee Resource

The Public Company Accounting Oversight Board has issued a new publication for audit committees. The Board describes Spotlight: Audit Committee Resources "as a timely reference point for auditors, audit committee members, investors, and others." The publication contains a series of questions that audit committees might consider asking "as part of their engagement and discussion with their auditors,

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Dan Goelzer is a retired partner of a major international law firm. He advises a Big Four accounting firm on audit quality issues. He was a member the Sustainability Accounting Standards Board from 2017 to 2022. He was appointed to the Public Company Accounting Oversight Board as one of the founding members and served on the Board from 2002 to 2012, including as Acting Chair from August 2009 to January 2011. From 1983 to 1990, he was General Counsel of the Securities and Exchange Commission.

including how the auditors are responding to the financial reporting and audit risks posed by the current economic environment."

The questions in Audit Committee Resources are organized under six headings: Fraud and Other Risks, Initial Public Offerings and Mergers & Acquisitions,. Below are examples of the suggested questions in each of these areas.

Fraud and Other Risks (five suggested questions). Example:

- How have economic factors (e.g., supply chain disruption, inflation) influenced the auditor's risk assessment for the current year's audit?

This section also includes several questions that refer to the impact of the war in Ukraine on the audit.

Initial Public Offerings and Mergers & Acquisitions (two suggested questions). Example:

- How has the auditor considered the accounting implications of the key provisions in the debt and equity instruments that are issued to founders, sponsors, and private and public investors? (As noted in Fueled by SPACs, Restatements Surge, June-July 2022 Update, SEC guidance concerning the accounting treatment of warrants issued by special purpose acquisition companies triggered numerous restatements last year.)

Both questions in this section relate to SPACs.

Audit Execution (three suggested questions). Example:

- What is the audit firm doing to attract and retain talent to ensure that all engagement team members have appropriate levels of competency, degree of proficiency, training, and supervision?

How Firms Comply with Auditor Independence Requirements (two suggested questions). Example:

- What are the audit firm's policies or procedures for identifying, evaluating, and addressing any threats to independence that may impact the services provided to the company? What process is in place to ensure any regulatory independence violations are properly communicated to the audit committee?

As noted in Acting Chief Accountant Speaks Out on Auditor Independence, June-July 2022 Update, the SEC is currently emphasizing auditor independence issues, including audit committee oversight of independence.

Firms' Quality Control Systems (three suggested questions). Example:

- What are the open quality control criticisms in the nonpublic portion of the audit firm's recent [PCAOB inspection] reports, and what are the audit firm's plans to remediate those criticisms?

Technology (seven suggested questions). Examples:

- What is the auditor's view on management's cybersecurity risk assessment approach, overall cyber assessment, and conclusions?

- Are there any complexities (e.g., multiple systems) or concerns (e.g., data security) at the company preventing the use of technology by the auditor?

The Technology questions are grouped under three subheadings: Auditing Digital Assets, Responding to Cyber Threats, and Use of Data and Technology in the Audit.

Comment: The PCAOB's suggestions are a useful starting point for a dialog with the auditor on these six important topics. In each area, additional questions would be easy to formulate, depending on the company's specific circumstances. As the PCAOB points out, many of the suggested questions could also be posed to management as part of the audit committee's oversight of the company's financial reporting and internal controls.

Audit Committees Should be on the Look-Out for ESG Fraud Risks

Environmental, social, and governance issues appear with increasing frequency on board agendas. Emerging fraud risks to consider: ESG, an article in On the audit committee's agenda, a publication of the Deloitte Center for Board Effectiveness (Deloitte Center), points out that these issues may entail fraud risks that audit committees should recognize and consider. ESG-related fraud risks "should be top of mind for audit committees and a focal point in fraud risk assessments overseen by the audit committee." For example, many companies provide ESG information to investors that is not governed by the same types of controls as those that apply to financial reporting processes; this may present opportunities to manipulate the ESG-related information. Similarly, linking compensation to ESG metrics may elevate fraud risk by creating incentives to misstate ESG data.

The Deloitte Center article discusses some of these ESG risks, issues a "call to action" for audit committees to consider ESG in fraud risk assessments, and suggests questions audit committees should be asking in this area.

Climate factors driving ESG risk

Voluntary disclosure of climate-related information is one potential source of ESG-related fraud risk. Such information may include greenhouse gas emissions and metrics related to energy consumption or use of renewable energy. Audit committees may therefore want to challenge management and auditors to consider areas where fraud risk could be increasing. Specifically --

- Approach to climate. One risk is that ESG-related information provided to investors may differ from information in financial statements or other disclosures. "Companies can evaluate whether information they are providing in regulatory filings is consistent with sustainability reports, press releases, websites, other regulatory filings, and industry reports."

- Impact on controls. Consideration of the control environment should include ESG activities. Less mature controls – or no controls at all – over evolving or emerging ESG-related activities can increase opportunities for fraud.

- External risk factors. "Evolving regulatory and stakeholder expectations on ESG matters may create pressure for management and the board to appear well positioned to meet targets or comply with future regulations."

- Internal risk factors. ESG-related key performance indicators may be relevant to fraud risk analysis. This is especially true when ESG KPIs are incorporated into contracts or compensation programs.

- Estimates. ESG reporting may involve estimates, judgments, or forecasts that are subject to manipulation or bias. Audit committees may want to ask "how reliable data sources are, whether they could be manipulated, and how management could potentially be motivated to intentionally manage these ESG metrics."

Talent factors driving ESG risk

Companies may incur ESG-related fraud risk as a result of personnel challenges, such as vacancies and remote work. Talent-related scenarios that may heighten ESG-related fraud risk include:

- Turnover. Turnover or vacant positions raise questions about the consistency of control activities and proper segregation of duties. Audit committees may want to ask management how these issues are being addressed – for example, through training and contingency plans for key personnel absences.

- New responsibilities. When company personnel assume new or unfamiliar ESG-related responsibilities, mistakes may occur, and some employees may be tempted to hide errors with fraudulent activity. "The audit committee should understand corporate culture and management's approach to reporting mistakes or errors."

- Hybrid work. Remote or hybrid work arrangements may raise questions about how quality is managed and how disciplinary matters are handled. "The audit committee can challenge how management is promoting culture and tone at the top in these types of environments."

- Talent-related metrics. Many companies are developing ESG metrics about such matters as employee health and safety, engagement, or diversity, equity, and inclusion. Audit committees may want to ask management what controls are in place to promote completeness, accuracy, and reliability of these metrics.

Call to action: Consider ESG in fraud risks assessments

Both management and the auditor perform risk assessments to identify and address potential sources of fraud. As part of their oversight of the company's antifraud programs, processes, and controls, the audit committee should ask questions about the extent to which the company's fraud risk assessments consider the risk of fraud in ESG-related reporting activities. Audit committees should also understand the auditor's fraud risk assessment process and findings, including the auditor's assessment of the risk of management override of controls.

The Deloitte Center discusses six overarching principles for an effective fraud risk assessment. The discussion concludes with a recommendation concerning documentation: "Audit committees should ask management to share evidence of the risk assessment to understand the level of attention given to evolving ESG fraud risks and what measures are being taken to mitigate risks as ESG-related activities evolve."

Questions for audit committees to consider

The Deloitte Center lists seven questions audit committees may want to ask management in order to understand the company's approach to mitigating ESG-related fraud risks:

1. To what extent has management assessed the risk of fraud with respect to the company's growing focus on ESG strategy and reporting as part of its enterprise-wide fraud risk assessment?

2. Is the audit committee primarily responsible for ESG-related fraud risk, or is responsibility shared with other committees and/or the full board? How often does the audit committee discuss fraud risk, including ESG-related fraud risk? [This question seems more appropriate for board discussion, rather than discussion with management.]

3. Which member of management has authority over fraud risk, and does this person have a comprehensive view of the ESG-related fraud risks that could be present? For example, does this person's visibility and authority extend beyond financial reporting?

4. How is management developing metrics that are provided to stakeholders related to ESG strategies or initiatives? How is management developing reporting mechanisms and addressing the potential for fraud in these ESG strategies and initiatives?

5. What internal controls are in place with respect to the development of metrics and reporting mechanisms, especially those related to ESG? What process has management adopted for promoting completeness, accuracy, and reliability of ESG-related metrics and reporting?

6. What fraud risks have been identified? How have they been evaluated and prioritized? What mitigation measures are being implemented?

7. To what extent are these metrics and ESG-related reports reviewed by internal auditors and independent auditors?

Comment: As ESG reporting becomes more extensive and more heavily relied on by investors, the risks and consequences of intentional (and unintentional) ESG material misstatements are also growing. As discussed in prior Updates, many companies began their ESG disclosure efforts outside the control framework of traditional financial disclosures. As a result, the accuracy and reliability of these disclosures may be subject to under-appreciated risks. This could have both adverse reputational and legal consequences. The SEC has formed a task force in the Division of Enforcement "to proactively identify ESG-related misconduct." This unit, which recently brought a case against a public company alleging inaccurate material ESG disclosures, is likely to be aggressive in pursuing similar actions. See SEC is Serious About ESG Disclosure Enforcement, April-May 2022 Update. For these reasons, audit committees should be actively considering the risks of ESG disclosure fraud and misstatement. The Deloitte Center's article provides some useful ideas regarding how to begin that process.

Audit Committee Agenda Advice for the Second Half of 2022

Earlier this year, the Update summarized accounting and consulting firm publications that suggested issues on which audit committees should focus during 2022. See What Should be on the Audit Committee's 2022 Agenda? January-February 2022 Update. Below is a brief overview of two new papers that highlight potential audit committee agenda items in connection with second quarter reporting and for the balance of 2022.

How audit committees can prepare for 2022 Q2 reporting (EY Center for Board Matters)

In How audit committees can prepare for 2022 Q2 reporting, the EY Center for Board Matters summarizes recent and upcoming developments for audit committees to consider in connection with second quarter reporting. The EY Center identifies three "key points":

- Inflation, rising interest rates, supply chain disruptions, and market volatility continue to be significant focus areas for audit committees.

- Audit committees should consider how to prepare for potential regulatory changes that may impact reporting requirements, disclosures, and enforcement trends.

- Audit committees are looking for more from the internal audit function on environmental, social and governance matters. EY discusses in detail six ways that internal audit can incorporate ESG into its audit agenda.

The EY Center discusses three other topics in depth -- risk management, accounting and disclosures, and SEC and other reporting considerations. With respect to these topics, the EY Center suggests questions the audit committee may want to pose to management and/or to the auditor. For example –

- How is management understanding and monitoring the effectiveness of risk management of critical third parties with respect to financial and operational resiliency; IT security; data privacy; culture; and ESG factors?

- Does the company have sufficient controls and procedures over nonfinancial data? Is internal audit providing any type of audit coverage on ESG-related data, or is the company obtaining any external assurance?

- Has the engagement team identified any incremental risks and/or adjusted its audit response in light of the war in Ukraine? If so, what are the impacts to the engagement's audit strategy and overall approach to the interim reviews?

The Top 10 Topics for Audit Committees to Consider in 2022 (Forvis)

Forvis, which was created by the merger of accounting firms BKD and Dixon Hughes Goodman, has released The Top 10 Topics for Audit Committees to Consider in 2022. This paper discusses issues that financial institution audit committees should focus on in with discussions management, internal and external auditors, and other advisors. These topics, many of which appear to be relevant beyond financial institutions, are:

1. LIBOR Transition. Use of the London Interbank Offered Rate (LIBOR) as a reference interest rate has been discontinued, requiring the amendment of millions of contracts. Audit committees should closely monitor their institution's progress as it relates to LIBOR transition.

2. Environmental, Social, & Governance (ESG). Forvis recommends that audit committees gain an understanding of their institution's ESG program so that they will not "be scrambling to respond to mandatory reporting requirements." Forvis recommends a four-phase approach to building an ESG program: Assess ("Define what success looks like"), Design ("Develop an ESG narrative and messaging plan"), Implement ("Draft a report, using a structured, machine-readable format"), and Monitor ("Actively seek key stakeholder feedback; measure and refine reporting").

3. Tax Considerations. Forvis describes several tax law developments that affect, or may affect, financial institutions.

4. Current Expected Credit Loss (CECL). Large public companies have been required to apply the FASB's new standard on credit losses since the beginning of 2021; smaller public companies and private companies must comply in 2023. Forvis suggests questions and issues for audit committees of financial institutions in either of these categories.

5. Cybersecurity. Forvis notes that the cybersecurity threat landscape has dramatically changed over the last several years. It recommends that financial institutions transition from "perimeter security design to a well-thought-out 'zero-trust' network design architecture."

6. Enterprise Risk Governance. Regulatory expectations for financial institutions are increasing, and institutions should have internal controls, information systems, and internal audit programs that are commensurate with their size, sophistication, and complexity. Forvis recommends implementation of a board-approved risk appetite statement, identification and assessment of risks on a regular basis, and a risk culture framework supported by training at all levels.

7. Culture & Conduct Risk. "With the shift to more companies adopting a remote or hybrid work structure for employees, maintaining a strong ethical culture where employees feel connected to

other team members with a shared purpose is even more important due to the complications of employees working in various locations."

8. Regulatory Compliance – Impact of the Russia-Ukraine War. As a result of Russia's invasion of Ukraine, sanctions have been imposed on Russia. Audit committees should monitor compliance programs designed to prevent penalties for non-compliance with Russia sanctions.

9. Emerging Technologies. The audit committee has a critical role in monitoring the impact of new technologies on financial reporting. Forvis recommends use of the CAQ's publication Emerging Technologies: An Oversight for Audit Committees. See The CAQ Gives Audit Committees Some Help on Oversight of Emerging Technologies, January-February 2019 Update.

10. Press the Reset Button. The "Press the Reset Button" topic is essentially a call for the audit committee to step back and assess its structure, priorities, and performance. Forvis suggests that the audit committee "take some time to review the committee's focus to determine top priorities." Further, a "rigorous self-assessment of the audit committee, including skill sets or expertise that can help with succession planning for future board members" should be considered. "Press the reset button, study the current state of the committee, and prioritize changes that may be needed to establish your committee as best in class."

Comment: A high-level review of these papers, along with those released earlier this year, could be helpful to an audit committee as a check that it is not overlooking topics that should be on its agenda. As noted in What Should Be on the Audit Committee's 2022 Agenda, above, there are many common themes. As the recent papers illustrate, in the past six months, some new topics have emerged – e.g., the impact of the Ukraine-Russia war – and others have changed in scope – e.g., the potential impact on ESG disclosure of the SEC's climate-change disclosure proposals.

Ineffective ICFR is More Common; Staff Shortages May be the Cause

Audit Analytics (AA) has released its annual report on Sarbanes-Oxley Act (SOX) Section 404 reporting, SOX 404 Disclosures: An Eighteen-Year Review. AA found that the percentage of companies filing a management assessment that reported ineffective internal control over financial reporting (ICFR) has increased across all company sizes. For fiscal year 2021, 23.7 percent of all management reports were adverse (i.e., reported ineffective controls), up from 21.7 percent in 2020. This is the highest percentage of adverse management assessments since SOX 404 reporting began in 2004. Adverse auditor opinions on control effectiveness also rose in 2021 – from 4.8 percent of all ICFR opinions in 2020 to 5.8 percent in 2021. (Auditor ICFR reporting is only required for larger companies -- accelerated filers -- while all public companies must file a management report.) Despite the increase in 2021, the percentage of adverse auditor reports remained far below its all-time peak of 15.8 percent in 2004.

Lack of qualified accounting personnel was the most frequently cited control issue in adverse ICFR assessments -- 71.5 percent of adverse management assessments and 48.7 percent of adverse auditor assessments identified lack of qualified staff as a cause of ineffective controls. (For a discussion of the last year's AA report on Section 404 reporting, see Adverse Management Assessments and Auditor Opinions on ICFR Effectiveness are Down, But Better Controls May Not Be the Reason, November-December 2021 Update. Note that statistics for 2020 and earlier years in the current AA report appear to have been adjusted from those appearing in the prior report.)

Background – SOX 404

Section 404 of SOX requires public company managements to perform and disclose an annual assessment of the effectiveness of the company's ICFR. Section 404 also requires companies to obtain a report from their external auditor expressing the auditor's opinion on the effectiveness of the company's ICFR. For either a management assessment or an auditor's report, the existence of one or more ICFR material weaknesses means that controls are ineffective and requires the issuance of an adverse assessment or opinion.

In 2010, the Dodd-Frank Act modified the original Section 404 scheme by excluding companies that qualified as non-accelerated filers under the SEC's rules from the auditor ICFR attestation requirement. The JOBS Act of 2012 added an exclusion for emerging growth companies, as defined in that legislation.

The SEC's accelerated filer definition has changed over time. For many years, any company with a public float of $75 million or more was an accelerated filer; any company with a public float less than $75 million was non-accelerated filer. In 2020, the SEC added a revenue test. As a result, companies with between $75 million and $700 million in public float are now accelerated filers only if they also have $100 million or more in revenue. This rule change increased the number of smaller public companies that are exempt from the ICFR external audit requirement.

<u>2021 SOX 404 ICFR Effectiveness Disclosures</u>

In 2021, 6,731 management ICFR assessments were filed, up from 6,465 in 2020. There were 3,406 auditor's reports on ICFR, an increase from 3,213 the prior year. In 2021, 3,328 companies filed only a management assessment of ICFR, up from 3,251 management assessment-only filers in 2022. With respect to the reporting of ineffective controls in these filings, AA found:

- <u>Management reports</u>. The number of adverse ICFR management reports increased to 1,595 in 2021, up from 1,401 in 2020. As noted above, 23.7 percent of all 2021 management reports were adverse, up from 21.7 percent in 2020. This is the highest percentage of adverse management reports filed since the inception of SOX 404 reporting.

- <u>Auditor attestations</u>. The number of adverse ICFR auditor attestations increased to 197 in 2021, up from 153 in 2020. As noted above, 5.8 percent of all attestations were adverse, compared to 4.8 percent in 2020. Since the SOX ICFR reporting requirements took effect in 2004, 2010 had the lowest percentage of adverse auditor attestations (3.5 percent) and 2004 had the highest (15.8 percent).

- <u>Management only reports (i.e., reports filed by companies not required to obtain an auditor's opinion on ICFR effectiveness)</u>. In 2021, the number of adverse ICFR management-only reports increased to 1,398. This represents 38.4 percent of all management-only reports filed for the year, down from 41 percent in 2020. The number of companies eligible to file a management-only report under SOX 404(a) increased in 2020, as a result of the rule change (described above) that excluded additional smaller companies from the SEC's accelerated filer definition.

- <u>First-time filers</u>. For companies filing their first management ICFR assessment in 2021, 55.2 percent reported that their controls were ineffective, an all-time high and an increase from 44.4 percent in 2020. AA observes that these companies "are often small with fewer resources to devote to internal controls, contributing to overall higher percentages of ineffective ICFR in the first management assessment." Similarly, a significant percentage -- 28.4 percent – of first-time auditor ICFR attestations (i.e., opinions filed by companies that had newly become accelerated filers) reported ineffective controls. This was also an all-time high and an significant increase over the 20.9 percent of adverse first-time auditor reports in 2020.

<u>Nature of Control Weaknesses and Related Accounting Issues</u>

Adverse auditor's reports and management assessments are required to describe the reasons controls were ineffective. AA found:

- <u>Management reports</u>. For all reporting companies, the top five 2021 control weaknesses were accounting personnel resources (71.5 percent); segregation of duties (personnel) (58.4 percent);

inadequate disclosure controls (25.8 percent); non-routine transaction controls (20.0 percent); and information technology (18.2 percent). For companies filing only a management assessment, the top four weaknesses were the same, except that inadequate audit committee replaced information technology as the fifth most common weakness.

The top five accounting issues in adverse management reports were debt and warrants (12.7 percent); revenue recognition (6.5 percent); accounts receivable, investments and cash (6.1 percent); tax expenses (3.9 percent); and expense reporting (2.7 percent). The recording of debt and warrants presumably topped the accounting issues list because of restatements stemming from the SEC's April 2021 staff statement addressing accounting for debt and warrants issued by special purpose acquisition companies (SPACs). For companies filing only a management assessment, the top five accounting issues were the same.

- Auditor attestations. In 2021 auditor's reports, the five most common control weaknesses were accounting personnel resources (48.7 percent); information technology (44.2 percent); segregation of duties (personnel) (34.5 percent); inadequate disclosure controls (23.9 percent); and material year-end adjustments (14.7 percent). The top five accounting issues cited in adverse auditor ICFR assessments were revenue recognition (20.8 percent); tax expense (13.2 percent); accounts receivable, investments & cash (10.7 percent); acquisitions and mergers (10.2 percent); and property, plant, and equipment, intangibles (9.1 percent).

Comment: In general, the rate of adverse management assessments and ICFR audit opinions has been relatively steady or declining in recent years. The significant increases in 2021 seem to have two primary causes. First, difficulty in hiring qualified accounting personnel and the related challenge of maintaining segregation of duties in the face of staffing shortages had a negative impact on control effectiveness. (Recruiting and retention challenges are of course economy-wide phenomena and are not unique to personnel involving in accounting and controls.) Second, there has been an increase in the number of new reporting companies, likely driven by companies going public through SPAC mergers. As AA points out, these companies typically have fewer resources to devote to controls. Also, as the Update has noted in the past, the relatively higher, and more constant, level of adverse management assessments at smaller companies may reflect the fact that, without the discipline of an independent ICFR audit, there is less incentive for these companies to correct control deficiencies.

Oversight of the adequacy of internal control is one of the most fundamental responsibilities of a public company audit committee. Audit committees may want to reflect on whether frequently cited control weaknesses described in the AA report are affecting their company's controls and whether any steps should be taken to address these issues. Separate from the disclosure and audit requirements of SOX Section 404, the federal securities laws require all public companies to establish and maintain a system of internal accounting control to provide reasonable assurance that (among other things) transactions are recorded as necessary to permit preparation of GAAP financial statements. The SEC typically charges violations of this requirement in cases involving financial reporting matters.

After 20 Years, It May be Time to Update Your SOX Compliance Program

The Sarbanes-Oxley Act (SOX) became law on July 30, 2002 – 20 years ago. For public companies, the most significant aspect of SOX was Section 404, which requires management to report on the effectiveness of the company's internal control over financial reporting (ICFR). Large public companies must also obtain an opinion from the company's financial statement auditor on ICFR effectiveness. Although the federal securities laws have contained an explicit requirement that public companies establish and maintain adequate internal control since 1977, Section 404 triggered extensive and expensive efforts at many companies to strengthen and upgrade controls.

In SOX modernization: Optimizing compliance while extracting value, Deloitte points out that, in many cases, controls have not been rethought since the initial post-SOX upgrade and may have become stale:

> "In the years since this federal law was enacted, there have been significant developments in technology, methodology, and business and operating environments; however, the SOX program at many companies may not have evolved at the same pace, or at all. Over the years, some SOX programs may have even continued to layer on additional controls while spending the same amount or more to achieve compliance without being able to extract value from the program."

Deloitte recommends that companies "refresh, rethink, and modernize" their SOX programs in order to "achieve efficiencies, extract value and insights to share with other areas of the organization, and potentially lower the related cost of compliance while still achieving reasonable assurance for regulatory compliance." Such a modernization program should have three pillars -- operating model optimization, program enhancements, and technology and automation opportunities.

Operating model optimization

An established SOX governance structure and clear accountability are fundamental to an effective operating model and should be periodically revisited. One way to drive accountability is to focus, not on controls, but on the risks that controls are intended to mitigate. "If the focus shifts to the risk, stake-holders have an opportunity to drive change to focus on those controls that mitigate that risk more effectively and efficiently." Another approach to optimizing the operating structure is to consider how and when resources should be involved in the SOX program. Deloitte suggests five questions to consider regarding the SOX program structure:

- What resources are needed, and how can those resources be flexible across compliance?
- Do current resources have the required expertise?
- Should there be a dedicated pool of resources in-house, and should they be centralized or global teams?
- Would a co-sourcing or outsourcing model be beneficial in certain areas?
- How can SOX resources and control owners continue to be up-skilled as risk, technology, and the industry evolves?

Program enhancements

A risk assessment can help management identify areas of material misstatement risk and determine where to focus its efforts. "Over time, risks evolve, or new risks are identified, and the response may have been to design new controls without always taking into consideration if any existing controls should be modified or removed." In addition, existing controls may not appropriately match the level of risk, "which could result in not spending enough time in areas of significant risk or spending too much time in areas of lower risk." Control deficiency remediation also depends on effective risk assessment: "If the company tries to remediate all control deficiencies without considering the risk level, they may not remediate those with the highest impact in a timely manner." Risk assessments should encompass both quantitative and qualitative considerations," including:

- Degree of complexity or judgment in the process.
- Volume of activity, complexity, and homogeneity of the individual transactions.
- Prior period errors identified.

- Whether the resources performing the control activities are new to the role.
- Footnotes and disclosures.
- Assessment at a more granular level, such as the business unit level.

Another benefit of a risk assessment is that it is an opportunity for companies to harmonize ICFR with other compliance activities. Collaboration may "drive integration of compliance activities across the organization, including breaking down silos, having those cross-functional conversations, and leveraging data to be able to identify trends and create visualizations to gain deeper insights and add value."

Technology and automation opportunities

Companies may be utilizing manual control processes and failing to take advantages of advances in technology that have occurred during the past 20 years. "Leveraging technology can enable a SOX program in a variety of ways and can lead to enhanced quality, increased efficiency, deeper insights, and can potentially reduce the total cost of compliance." Deloitte outlines four options for leveraging technology:

- Automate control testing. "Automated testing consists of profiling certain populations and transactions with real-time results, allowing a company to be able to test up to 100 percent of the population and potentially achieve more assurance for less time and cost."
- Automate controls. "Automated controls are inherently more reliable than manual controls when they are designed appropriately, and there is less opportunity for human error once implemented."
- Automate business processes. "A primary consideration in making the determination of which process has the most potential to be automated is to consider whether it is a highly manual process that occurs frequently and is defined by a standard set of activities. Automating processes could contribute to liberating resources to handle more complex tasks, reducing errors by removing human interaction, and reduce time and cost by having a more efficient process."
- Implement a governance, risk, and control (GRC) tool. A GRC tool can empower an organization to manage and streamline its SOX program and compliance risk overall.

Comment: Deloitte observes that by "refreshing and modernizing the SOX program, a company can identify opportunities to increase efficiency, shift focus and efforts to areas that matter most, potentially reduce the cost of compliance, and extract value and provide insights to other areas of the organization beyond finance and accounting, all while still achieving compliance." Consulting firm Protiviti, which publishes an annual survey of SOX compliance costs, has also documented the increasing use of technology in SOX compliance and the opportunities that automation affords for cost reductions. See Protiviti: Companies are Spending More Time and Money on SOX Compliance, June-July 2022 Update.

As Deloitte suggests, rethinking the fundamentals of a SOX compliance program that has not be revisited in many years may pay dividends in terms of effectiveness, efficiency, and insight into organizational performance. Audit committees may want to explore with management whether there are opportunities to modernize controls and whether management is taking full advantage of technology.

On the Update Radar: Things in Brief

IFAC Reports on the State of ESG Assurance. The International Federation of Accountants (IFAC) and the Association of International Certified Professional Accountants (Association), in partnership with research and data provider Audit Analytics (AA), have released The State of Play in Reporting and Assurance of Sustainability Information: Update 2019-2020 Data & Analysis. The publication examines global practices for sustainability reporting, including the extent to which companies are obtaining external assurance over their sustainability disclosures; which standards are used as the basis for third-party assurance; and what types of firms are providing sustainability assurance services. The new report updates the IFAC/Association/AA analysis published last year. See The State of Sustainability Assurance: It Varies, July 2021 Update.

The study reviews the reporting practices of 1,400 companies from 22 jurisdictions. Key findings include:

- 92 percent of the companies disclose some sustainability information, a slight increase from the 91 percent that made such disclosure in 2019.
- 58 percent of companies that report sustainability information provide some level of third-party assurance on it, up from 51 percent in 2019.
- Audit or audit-affiliated firms conducted 61 percent of these assurance engagements. This reflects a two percent decrease in the use of audit firms for ESG assurance, compared to 2019. For those companies that obtained ESG assurance from an audit firm, 71 percent used their financial statement auditor.
- 82 percent of all assurance engagements result in limited assurance reports, down slightly from 83 percent last year.
- 94 percent of assurance engagements employing an audit firm used the International Standard on Assurance Engagements 3000 (Revised), up from 88 percent in 2019. Other assurance service providers relied on a variety of assurance standards.
- 80 percent of companies reported using more than one ESG disclosure framework or set of standards. The most frequently used frameworks/standards were the UN's Sustainable Development Goals (76 percent) and the Global Reporting Initiative (GRI) (72 percent). While only 38 percent of these 1,400 companies used the Sustainability Accounting Standards Board standards, SASB use increased the most – by 153 percent – compared to 2019.

The State of Play report contains detailed information concerning reporting and assurance practices in different industries and on a country-by-country basis. Audit committees might find this material of interest in benchmarking their company's approach to ESG disclosure and assurance.

SEC Adopts Pay Versus Performance Disclosure. On August 25, the SEC adopted rules requiring U.S. public companies to disclose information reflecting the relationship between executive compensation actually paid and the company's financial performance. The Commission originally proposed pay-for-performance disclosure in 2015 but took no action. Comment on the 2015 proposals, with some modifications, was re-opened earlier this year. See SEC Wants to Hear More About Pay-For-Performance Metrics, January-February 2022 Update.

The pay versus performance rules will require companies to provide a table disclosing executive compensation and financial performance measures for the company's five most recent fiscal years. With respect to compensation, this table must include, for the principal executive officer ("PEO") and as an average, for the other named executive officers (NEOs) in the Summary Compensation Table (required under the SEC's compensation disclosure rules), total compensation as it appears in the Summary Compensation Table and a measure reflecting "executive compensation actually paid," calculated as prescribed by the rule. With respect to performance measures, the new table must include:

- Total shareholder return ("TSR") for the company.
- TSR for the company's peer group.
- The company's net income.
- The company-selected measure. This is a company-chosen and company-specific financial performance metric that, in the company's assessment, represents the most important financial performance measure the company uses to link compensation actually paid to NEOs to company performance for the most recently completed fiscal year.

The new rules will also require a "clear description" of the relationships between each of the financial performance measures included in the table described above and the executive compensation actually paid to the PEO and, on average, to the other NEOs during the prior five years. The company must also describe the relationship between the company's TSR and its peer group TSR.

Finally, companies will be required to provide a list of the three to seven financial performance measures that are the most important measures in linking compensation actually paid to company performance. Companies may include non-financial measures in the list if they consider such measures to be among the three to seven most important measures.

The rules will apply to all SEC reporting companies, except foreign private issuers, registered investment companies, and emerging growth companies. Compliance will be required in proxy and information statements beginning for fiscal years ending on or after December 16, 2022.

At most companies, both the audit committee and the compensation committee will likely play a role in overseeing compliance with the pay versus performance disclosure rules. While the substance of how the company links pay and performance falls in the compensation committee's realm, oversight of the procedures and controls that will be necessary to support the new disclosures is within the audit committee's mandate.

Where's the Economy Headed? Ask Your Audit Partner. The Center for Audit Quality (CAQ) has released the results of a survey of U.S. public company audit partners on a range of topics, including the overall health of the economy, business transformation, and corporate disclosures. Audit Partner Pulse Survey is based on 700 responses from audit partners who work with small-, mid-, and large-market capitalization companies. The survey was conducted from May 14 to 27, 2022.

Audit partners are rather gloomy about the economy's prospects for the next 12 months -- only 16 percent have an optimistic or very optimistic economic outlook, while 44 percent are pessimistic, and 40 percent are neutral. Sixty-two percent of respondents listed inflation as the top economic risk facing companies. Other top economic risks, and the percentage of respondents that cited them, were labor shortages (52 percent), supply shortages and supply chain disruptions (50 percent), and cyber-security threats (39 percent). The survey also asked about company priorities for 2022. Talent/labor was selected by 53 percent of respondents, followed by growth (40 percent), cost management (38 percent), and financial performance (38 percent). (Percentages add to more than 100 percent because respondents could select three risks and priorities.)

The survey also asked respondents to identify the short- and long-term ESG priorities of companies in their industry by selecting up to three responses from a list. On an aggregate basis, the top short-term ESG priorities were cyber risk (55 percent), enhancing sustainability reporting (47 percent), and building a more diverse board/leadership team (45 percent). The top long-term ESG priorities were similar, except that climate-risk replaced diversity in the top three: Cyber risk (47 percent), enhanced sustainability reporting (44 percent), and climate-related risk (46 percent). Some industry-based and company size-based differences in ESG priorities are apparent in the disaggregated survey results.

Other topics addressed by the survey include corporate strategy, cryptocurrency, challenges in ESG reporting, cybersecurity, financial fraud risk, and human capital initiatives. The CAQ plans to conduct similar audit partner pulse surveys annually.

The Audit Blog

I am a co-founder of The Audit Blog and blog on developments in auditing and financial reporting, on auditor oversight and regulation, and on sustainability disclosure. Occasionally, items that appear in the Audit Committee and Auditor Oversight Update also appear on the blog.

The blog is available here. You can follow it @BlogAuditor on twitter or @the-audit-blog on medium.com.

For further information, please contact:

Daniel L. Goelzer
301.288.3788
dangoelzer@gmail.com

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The Update seeks to provide general information of interest to audit committees, auditors, and their professional advisors, but it is not a comprehensive analysis of the matters discussed. The Update is not intended as, and should not be relied on as, legal or accounting advice.

Updates issued after June 1, 2020, are available here. Updates issued between January 1, 2019, and May 31, 2020, are available here. An index to titles and topics in the Update beginning with No. 39 (July 2017) is available here.