Dan Goelzer

AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

Update No. 81
April 2023

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:

SEC Chief Accountant Discusses Audit Committee Oversight of Other Auditors

SEC Chief Accountant Paul Munter has issued a statement in response to the increased use in audits of SEC reporting companies of accounting firms and individual accountants other than the lead auditor ("other auditors"). In Responsibilities of Lead Auditors to Conduct High-Quality Audits When Involving Other Auditors (March 17, 2023), Mr. Munter discusses the responsibilities of the lead auditor with respect to the work of other auditors and points out some of the risks and issues that can arise from their use. He also

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

urges audit committees to actively engage with the lead auditor concerning the work of these firms and suggests questions that the audit committee should ask.

Use of Other Auditors

According to the Munter statement, in 2021, 26 percent of public company audit engagements involved the use of other auditors, often in countries with "different business cultures and languages from those of the lead auditor." However, academic research indicates that the quality of the work of other auditors is inconsistent. "Such findings highlight the importance of the lead auditor's role, and especially that of the lead engagement partner, to ensure investor protections by safeguarding against engagement performance failures due to inadequate planning, supervision, and oversight of other auditors."

Both PCAOB enforcement actions and SEC staff observations have revealed "shortcomings" in lead auditors' oversight of the work of other auditors. For example, a PCAOB case charged that the lead auditor used an affiliated audit firm to play a substantial role in an audit, but the affiliated firm was not registered with the PCAOB. In addition, the SEC staff has observed instances in which the lead auditor failed to accurately communicate the name, location, or planned responsibilities of other auditors to the audit committee. In some cases, the lead auditor's Form AP (a PCAOB filing which is required to list other participating auditors) has contained inaccurate or omitted information regarding other auditors, such as failing to report the correct legal entity or inaccurately disclosing the audit hours incurred by other accounting firms.

The Importance of Quality Controls

The deficiencies can be the result of inadequate controls. Audit firms are required to have systems of quality control supervision that encompass the work of other auditors. "We remind all auditors, regardless of their role as either lead or other auditor, of the importance of the proper design and application of quality control policies and procedures to sufficiently reduce the risks to audit quality that are inherent in audits involving other auditors."

Network Firms

The network structure of the large firms can also result in confusion regarding the use of other auditors. Many accounting firms operate within a network structured such that network member firms are distinct legal entities that may have different systems of quality control. Other stakeholders may not understand the network structure. For example, inaccurate or incomplete communications regarding other auditors may impact the audit committee's ability to perform its responsibilities.

> "[B]ecause many accounting firms operate within a network of separate accounting firms, instances of faulty or incomplete communication with the audit committee risks confusing or misleading the committee into thinking that the engagement involves a single registered public accounting firm rather than a lead audit firm and other auditors within the same network. Because audit quality may not be the same in all accounting firms within a network, clear, accurate communication with the audit committee about which firms performed the work and the steps the lead auditor took to drive greater consistency in audit quality throughout the performance of the engagement is critical to the audit committee's ability to oversee and evaluate the performance of the independent audit firm."

Mr. Munter adds that, while there are no requirements for network firms to apply the same quality controls across the network, there are benefits in doing so since "enforcement actions and adverse inspection results for one member firm could impact the reputation of the network as a whole."

Independence

Mr. Munter also notes that the involvement of other auditors increases the risk of independence violations. In particular, non-U.S. network member may not sufficiently understand SEC and PCAOB independence

requirements or have appropriate controls to prevent or detect violations. He recommends a firm-wide or network-wide approach to independence that "looks not only to the current impact of non-audit and business relationships on audit clients but also anticipates foreseeable future impacts, especially for those relationships that cannot be easily unwound."

Audit Committees

Audit committees "should be actively engaging with the lead auditor" to consider the sufficiency of the lead auditor's policies and procedures around supervision and evaluation of the audit work performed by other auditors. Audit committees should also give "careful consideration to the lead auditor's use of other auditors, especially in areas of significant risk." The statement suggests several questions that audit committees may want to ask their auditor concerning the use of other firms:

- Are there other participating accounting firms that play a substantial role in the audit?
- If so, are they registered with the PCAOB and subject to PCAOB inspections?
- How does the lead auditor supervise the audit work performed by other auditors?
- How does the lead auditor ensure that the work is being performed by other auditors that understand the requirements of the applicable financial reporting framework and the PCAOB's auditing and related professional standards?

Mr. Munter also warns public companies and their audit committees that the activities of other auditors can potentially result in the company committing a securities law violation: If an accounting firm that is not registered with the PCAOB plays a "substantial role" in a company's audit (as defined in the PCAOB's rules), the company's financial statements would be considered not audited. As a result, "Any accompanying annual report, proxy statement, or registration statement containing or incorporating by reference such financial statements creates potential liabilities for the issuer and others and may result in time consuming and costly remediation efforts." To protect against this possibility, management and the audit committee should discuss the PCAOB registration status of other auditors that participate in the audit with their lead auditor.

Comment: The fact that the Chief Accountant issued this statement indicates that oversight of the work of other auditors is an SEC concern. As a matter of professional standards, supervision of the participation of other auditors is a responsibility that falls to the lead auditor. It is however significant that Mr. Munter asserts that audit committees have a role to play in that oversight and pointedly reminds audit committees and public companies that the improper participation of other firms can, at least in theory, cause the reporting company to violate the securities laws.

Audit committees should be aware of the concerns Mr. Munter raises and should make his suggested questions part of their dialogue with the engagement partner. In the event of an audit breakdown involving a participating firm, the SEC may ask whether the company's audit committee took any steps to engage with the lead auditor regarding the work of other firms.

COSO Issues Guidance on Internal Control Over Sustainability Reporting

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has published guidance on the application of its internal control framework to sustainability reporting. Achieving Effective Internal Control Over Sustainability Reporting (ICSR): Building Trust and Confidence through the COSO Internal Control—Integrated Framework states that "akin to internal control over financial reporting (ICFR), we are now seeing the emergence of what we call internal control over sustainability reporting (ICSR)." The paper

explains in detail how the 17 principles in COSO's Internal Control—Integrated Framework, as revised in 2013 (ICIF-2013), apply to sustainability reporting.

Background

COSO, which is a group of five global accounting and auditing organizations, was founded in 1985 in response to concerns about the quality of financial reporting. In 1992, COSO published Internal Control—Integrated Framework to define internal control and provide a common framework for evaluating and improving internal control systems. In 2002, the Sarbanes-Oxley Act required public companies to report on the effectiveness of their ICFR and, for larger companies, required the auditor to attest to management's report. This reporting must be based on a suitable internal control framework that meets certain criteria. The SEC has indicated that the COSO framework satisfies those criteria and, as a practical matter, virtually all ICFR reporting is based on COSO.

In 2013, COSO updated its framework to incorporate a risk-based approach to designing, assessing, and reporting on internal controls and to expand the objectives to include other important forms of reporting, such as nonfinancial and internal reporting. ICIF-2013 defines internal control as "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance." ICIF-2013 is comprised of five components:

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring Activities

Each of the five components contains three to five principles, for a total of 17 principles. Each principle is subdivided into "points of focus" that explain how the principle works in practice. An organization has an effective system of internal controls when all 17 principles are present and functioning.

Applying ICIF-2013 to Nonfinancial Information

The bulk of the COSO paper consists of explanation and interpretation of how the 17 ICIF-2013 principles apply to sustainability. The discussion of each principle includes the ICIF-2013 points of focus regarding that principle and provides "insights" on how the principle can be implemented with regard to sustainability information. These insights are based on proposed regulations, evolving professional standards, organizational practices, "authoritative and thought leadership materials" and the authors' interviews with professionals with a variety of relevant backgrounds. In addition, the principles discussion references publicly available corporate ESG reports that illustrate the application of the various principles to sustainability.

To illustrate the paper's approach: The first of the five ICIF-2013 components is the control environment. The second control environment principle is "The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control." There are four ICIF-2013 points of focus for that principle. The COSO paper relates them to sustainability reporting as follows:

- Establishes oversight responsibilities. A board of directors executes its responsibilities over sustainable business management through a system of oversight that facilitates the organization's satisfaction of mandates and expectations. Often, the organization's board of directors establishes

structures, such as a designated committee or subcommittee, to oversee the organization's sustainable business activities and reporting. This may necessitate amending existing organizational documents such as the articles of incorporation, bylaws, or charters.

- Applies relevant expertise. A board of directors identifies requisite skills and areas of expertise for its own membership. Therefore, it ensures that board members charged with oversight responsibilities regarding sustainable business have the knowledge base and skill set to be effective.

- Operates independently. A board of directors operates independently from management with respect to oversight and responsibilities for decision making on sustainable business issues. This point of focus operates in the same way with respect to sustainable business activities as it does for all other organizational activities.

- Provides oversight of the system of internal control. The board oversees an organization's design, implementation, and performance of controls, systems, and processes related to sustainable business activities and reporting. Often, this is a check on management and an oversight of how the organization is utilizing its resources and processes to achieve sustainable business activities, such as programs around energy, waste, GHG emissions, supply chain, cybersecurity, and diversity, equity, and inclusion.

As an insight with respect to this principle, the COSO paper lists actions that an organization might take to enhance audit committee oversight of sustainability business information that is released to external stakeholders. Examples of these audit committee actions include:

- Revising charters to include oversight of external reporting of sustainability information and to include oversight of disclosures regarding the effectiveness of the organization's system of ICSR.

- Conducting educational sessions on recent developments regarding sustainable business.

- Overseeing the internal audit function and review of sustainable business information.

- Developing processes to operationalize oversight of external reporting, such as determining the frameworks, standards, and guidelines to follow for external ESG reporting.

- Reviewing external ESG reports before issuance.

- Determining the extent to which ESG information is subject to independent assurance or verification and determining the appropriate outside firm to perform independent assurance or verification.

As an example of the application of this principle to sustainability reporting, the COSO paper quotes from Travelers description of the roles of its various board committees.

Top 10 Takeaways

The COSO paper concludes with a list of ten takeaways. Those that appear most relevant to audit committees are:

- "Be committed to ensuring your organization has effective internal control over sustainability-related matters, including operations, compliance, and various types of reporting (external, internal, nonfinancial, and compliance)."

- "Work with others to determine the best organizational structures, roles, and responsibilities to create the desired results, achieve appropriate internal and external efficiencies, and achieve

effective internal control. This includes the board and board committees, management, operations, compliance, and internal audit."

- "Educating yourself on new topics like sustainability is critical. Take advantage of seminars, new publications, and certificate programs."

- "Internal assurance and confidence in sustainability reporting need to exist before external assurance. Take advantage of your internal audit function in this regard to provide objective assurance and other advice."

- "This is a fast-moving area, and there is bound to be lots of change over the next several years. So, monitoring activities are key in terms of evaluating progress and knowing when to make corrections and enhancements."

Comment: As discussed in prior Updates, in many cases public company sustainability reporting has developed without the kinds of controls over accuracy and completeness that are routine with respect to traditional financial disclosures. As investors rely more heavily on sustainability information in their decision-making and as regulators become more focused on these disclosures, it is imperative that companies create appropriate controls. See, e.g., ESG Meets Disclosure Controls in an SEC Enforcement Action , February-March 2023 Update and SEC is Serious About ESG Disclosure Enforcement, April-May 2022 Update. COSO's ICIF-2013 is the gold standard for controls over financial reporting and, as such, is familiar to public company reporting personnel, internal audit, auditors, and audit committees. Audit committees may want to consider how COSO's framework can be extended to their company's sustainability reporting.

The SEC is Zeroing in on Disclosure Controls

The Securities Exchange Act Rule 13a-15 requires SEC reporting companies to maintain disclosure controls and procedures to ensure that information required to be disclosed "is recorded, processed, summarized and reported" in a timely manner." Among other things, disclosure controls and procedures must be designed to ensure that information required to be disclosed "is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure."

Historically, disclosure control violations have been something of an afterthought in SEC enforcement cases. During the last few years, however, disclosure control violations have moved, if not to center stage, at least out of the wings. See, e.g., SEC Takes a Dim View of Sugar-Coating Cybersecurity Breaches, August 2021 Update (company failed to disclose a known cybersecurity breach despite a cybersecurity risk factor because it failed "to maintain disclosure controls and procedures designed to analyze or assess such incidents for potential disclosure in the company's filings.") and ESG Meets Disclosure Controls in an SEC Enforcement Action, February-March 2023 Update (company failed to maintain disclosure controls and procedures to collect information relating to its ability to attract and retain talented personnel, one of its risk factors; no actual disclosure violation charged). Two recent SEC enforcement actions shine a spotlight on the importance of disclosure controls.

Blackbaud, Inc.

On March 9, the Commission filed an administrative enforcement action against Blackbaud, Inc., a South Carolina company that provides donor relationship management software to non-profit organizations. The SEC's order states that, in 2020, Blackbaud was the target of a ransomware attack, and that, on July 16, 2020, Blackbaud disclosed the cyberattack on its website. The website post indicated that the intruder did not access any donor bank account information or social security numbers. A few days after this post, the company's technology and customer relations personnel learned that the attacker had in fact accessed donor bank account information and social security numbers. These personnel did not, however,

communicate the new information to senior management responsible for disclosure, and no policy or procedure was in place to ensure that they did so.

On August 4, 2020, the company filed a Form 10-Q that discussed the cyberattack but did not disclose that donor financial information had been accessed and downloaded. Instead, the Form 10-Q contained a risk factor that treated the loss of sensitive donor information as merely a hypothetical possibility: "A compromise of our data security that results in customer or donor personal or payment card data being obtained by unauthorized persons could adversely affect our reputation with our customers and others, as well as our operations, results of operations, financial condition and liquidity and could result in litigation against us or the imposition of penalties." Almost two months later, on September 29, Blackbaud filed a Form 8-K which disclosed for the first time that the attacker had, in fact, accessed and removed unencrypted bank account information and social security numbers of some donors.

In its administrative order, to which the company consented without admitting or denying the allegations, the SEC finds that Blackbaud's disclosures concerning the ransomware attack were misleading and that it failed to maintain the required disclosure controls and procedures. With respect to the later, the order states:

> "[T]he company's senior management responsible for the company's disclosures were not made aware of these facts [i.e., that the attacker accessed and exfiltrated sensitive donor information] prior to the company filing its Form 10-Q on August 4, 2020, or indeed until several weeks later, nor were there controls or procedures designed to ensure that such information was communicated to senior management. The company did not have controls or procedures designed to ensure that information relevant to cybersecurity incidents and risks were communicated to the company's senior management and other disclosure personnel. As a result, relevant information related to the incident was never assessed from a disclosure perspective."

Blackbaud consented to a cease-and-desist order against further violations and to a $3 million civil penalty.

DXC Technology Company

On March 14, five days after the Blackbaud case, the SEC issued an administrative order against DXC Technology Company, an information technology company with its principal office in Virginia. The DXC matter involves the publication of misleading non-GAAP financial measures. Like many companies, DXC discloses non-GAAP net income, non-GAAP earnings per share, and certain other non-GAAP metrics. These non-GAAP numbers were derived by excluding transaction, separation, and integration-related ("TSI") costs. DXC described TSI costs as those "related to integration planning, financing, and advisory fees associated with the merger that formed DXC, other acquisitions, and the spin-off of a business." However, according to the Commission, DXC materially increased its non-GAAP earnings by misclassifying certain expenses as TSI costs and improperly excluding them from its non-GAAP measures. As a result, non-GAAP net income and non-GAAP diluted EPS in various periodic reports and earnings releases were materially misleading.

As to disclosure controls and procedures, the Commission alleges that DXC had no formal guidance to determine which costs could be classified as TSI and instead relied on an informal process. That process lacked documentation of the basis on which an expense might be classified as a TSI cost, of how the expense related to a transaction or integration project, or of the expected amount or duration of the cost. These problems were compounded by the fact that individuals in the controller's office who reviewed and approved the classification of TSI costs for non-GAAP reporting purposes apparently believed that the unit responsible for initially identifying and recommending TSI cost "had more robust procedures than it actually did for analyzing and vetting the TSI costs before forwarding the aggregated costs to the controllership." The order states:

> "[T]he company had no process by which its employees evaluated whether proposed TSI costs were consistent with the description of TSI costs included in its non-GAAP disclosure. In turn, there was similarly no process by which the individuals and reviewers responsible for the TSI disclosure actually

assessed the nature of specific TSI costs to determine whether the description in the disclosure matched DXC's practices."

On the basis of these facts, the Commission found that DXC committed various disclosure and reporting violations, including violations of the Commission's rules relating to non-GAAP financial measures. In addition, the Commission finds that DXC violated Rule 13a-15 in that "DXC lacked company-wide disclosure controls and procedures to ensure that TSI costs were identified, reviewed, and approved for appropriate inclusion in the TSI adjustment in a manner consistent with their disclosure." In settling the case, DXC consented, without admitting or denying the allegations, to develop and implement various policies and disclosure controls and procedures related to the disclosure of non-GAAP measures. The company also consented to a cease-and-desist order against further violations and to an $8 million civil penalty.

Comment: Disclosure controls and procedures have become a hot button issue. The SEC enforcement actions in this area suggest several lessons that audit committees may want to keep in mind when discussing disclosure controls with management. For example –

- The relationship between cybersecurity breach investigations and disclosure is an area of focus. In particular, there should be controls that make sure that the technology staff that investigates breaches is in communication with management personnel responsible for disclosure. The risks of communications breakdowns in this area are underscored by the fact that the SEC has proposed, and will likely soon adopt, new disclosure requirements around cybersecurity incidents. See SEC Proposes Cyber Risk Management and Attack Reporting Requirements, March 2022 Update.

- There should be a match between risk factor disclosure and disclosure controls and procedures. If a risk is significant enough to be included in risk factor disclosure, there should be controls that ensure that information bearing on this risk comes to the attention of disclosure management so that consideration can be given to the need for additional or modified disclosure. See and ESG Meets Disclosure Controls in an SEC Enforcement Action, February-March 2023 Update.

- Risk factors are necessarily often phrased in hypothetical terms – highlighting the possible consequences of events that may occur. However, continuing to describe a risk and its consequences as hypothetical after an relevant event has actually occurred is a red flag. Controls focused on risk factors need to encompass, not just whether to disclose the event, but also whether to modify the risk factor. See SEC Takes a Dim View of Sugar-Coating Cybersecurity Breaches, August 2021 Update.

CAQ's Guide to Audit Quality Reports

Most large accounting firms publish reports describing how the firm seeks to maintain, promote, and strengthen audit quality. Since these reports are voluntary, their content varies and is tailored to each firm's specific facts and circumstances. Nonetheless, as the Center for Audit Quality (CAQ) observes, these reports "provide valuable information to stakeholders at the firm level about how an accounting firm defines, approaches, and executes its audit quality mission." Audit committees are undoubtedly one of the target audiences for audit quality reports.

The CAQ has prepared an analysis of the audit quality reports issued as of February 2023 by the eight firms represented on the CAQ's governing board -- BDO International, Crowe LLP, Deloitte & Touche LLP, EY, Grant Thornton LLP, KPMG LLP, RSM US LLP, and PwC LLP. Audit Quality Reports Analysis: A Year in Review examines both the qualitative disclosures and quantitative metrics that frequently appear in these reports and provides commentary on how each metric may provide insight into the firm's audit quality.

The qualitative disclosures in audit quality reports describe in narrative form the accounting firm's audit quality activities and "provide context to quantitative metric disclosures." The CAQ's analysis found that there are six common categories of qualitative disclosure –

- Firms' Messages and Commitments to Stakeholders (a message from firm leadership, often highlighting the centrality of audit quality to the firm's mission, how the firm defines audit quality, and its commitment to stakeholders and the public interest).

- Audit Methodology and Execution (description of the firm's audit methodology and audit execution strategy and of the firm's views on compliance with professional standards, best practices, and role in the financial reporting ecosystem).

- People and Firm Culture (insight into how the firm attracts and retains talent and how it fosters a culture of quality, inclusion, and learning).

- Quality Management and Inspections (discussion of the firm's systems of quality management and of the types of inspections to which the firm is subject).

- Technology and Innovation (discussion of use of technology to digitize and innovate audits; some firms include discussion on how they employ data analytics and artificial intelligence or machine learning to enhance audit quality).

- The Future of the Profession (firm perspectives on the future of the profession, including how the firm is planning for ESG and other emerging assurance areas).

The quantitative metrics in audit quality reports "can provide additional information and data for understanding and discussing factors that contribute to quality audits, particularly when considered in conjunction with robust qualitative disclosures to provide appropriate context." The CAQ report lists 15 common quantitative metrics. For each metric, there is a description of what the metric includes, a discussion of how it may be useful to readers in assessing audit quality, and an example of the metric drawn from the quality report of one of the eight firms. The 15 metrics are:

- Metrics Related to Audit Firm Inspections (e.g., number of internal and external inspections and results).

- Metrics Related to Continuing Professional Education and Training for Partners and Professionals (e.g., annual or comparative quantities of training hours firmwide, by level or per person).

- Metrics Related to Use of Specialists, National Office or Center of Excellence Support (e.g., ratios, hours, or percentages of usage or availability of specialists, national office, or centers of excellence).

- Metrics Related to Audit Report Reissuances and Financial Statement Restatements (e.g., percentage or number of audit reports reissued or client financial statements restated).

- Metrics Related to Firms' Independence Monitoring or Consultation Programs (e.g., number of consultations or hours devoted to such consultations).

- Metrics Related to Partner or Professional Tenure at the Firm or Other Forms of Experience (e.g., average years at the firm for various levels of professionals).

- Metrics Related to the Firm's Personnel Composition by Level (personnel counts or percentages by level or position).

- Metrics Related to Personnel Oversight (e.g., ratio of partners to managers or managers to staff).
- Metrics Related to Personnel Turnover (e.g., professional turnover for comparative periods).
- Metrics Related to Firms' Investments in Technology and Audit Transformation (e.g., dollars or hours invested in developing or using advanced audit technologies).
- Metrics Related to Diversity (e.g., number or percentage of employees by various diversity categories).
- Metrics Related to Excess Hours Worked (e.g., hours worked by categories of firm personnel in excess of a standard work week).
- Metrics Related to Audit Milestone Completion (e.g., percentages or ratios of hours spent on various phases of audit engagements).
- Metrics Related to Staff Utilization (e.g., percentage of time spent on audit work relative to total hours worked).
- Metrics Related to Audit Preparation and Supervision (e.g., ratios of hours spent supervising audits relative to hours spent preparing audit documentation).

Comment: The CAQ's guide is a good introduction to the type of information found in audit firm quality reports, and the commentary on the relevance of the quantitative metrics is particularly useful. Audit committees should review their accounting firms' audit quality report as part of their evaluation of the firm's work. Information in the report, coupled with the CAQ's guide, could be the basis for a discussion with the firm about audit quality. These reports would also be a good source for audit committees of companies that are considering retaining a new firm.

On the Update Radar: Things in Brief

PwC Has Ten Items for Your Next Audit Committee Agenda. PwC's Governance Insights Center has agenda suggestions for your next audit committee meeting. (Based on PwC's list, it would be advisable to block out a considerable amount of time for the meeting). Q1 2023 Audit committee newsletter: Helping you prepare for your next meeting proposes ten agenda items:

1. New disclosures for supplier finance programs. Beginning in the first quarter of 2023, Accounting Standards Update No. 2022-04 requires companies to provide new disclosures about supplier finance programs. "The audit committee will want to understand the company's supplier finance program strategy, presentation considerations and how disclosures may be impacted."
2. ESG reporting: Checking in on the "big three" frameworks. The "big three" are the SEC's proposed climate disclosure rule, the EU's Corporate Sustainability Reporting Directive, and the draft standards of the International Sustainability Standards Board. "The audit committee will want to understand how management is keeping track of new international disclosure regulations and standards and their potential impacts on the company and its disclosures."
3. Proposal would require significant new income tax disclosures. The FASB has proposed new income tax disclosures, including a rate reconciliation table. "The audit committee will want to understand how management is considering the potential impacts of the new disclosures."
4. FASB makes key decisions on income statement disaggregation project. The FASB has tentatively decided to require footnote disclosure that disaggregates income statement expense

line items into four categories: (1) compensation, (2) inventory expenses, (3) fixed asset depreciation, and (4) amortization of intangibles. "The audit committee will want to understand management's processes for monitoring and scoping this standard."

5. FASB proposes accounting guidance on crypto assets. The FASB has issued an exposure draft on crypto asset accounting. "[A]udit committees will want to understand management's overall crypto strategy; the business and financial reporting risks; management's plan for monitoring, measuring and mitigating those risks; and the processes and controls put in place to support the appropriate accounting and disclosure for crypto activities."

6. Audit committee peer exchanges identify key areas of focus. PwC has hosted audit committee member "peer exchanges" at which nine high-priority matters have been identified: audit committee effectiveness; interaction with internal audit; ESG oversight; enterprise risk management; non-GAAP measures; talent management; cybersecurity oversight; SEC clawback rules; and board member continuing education.

7. Participating in shareholder engagement may be your future. Board members may be called on to interact with large or activist shareholders, and audit committee members should therefore understand the company's shareholder engagement priorities.

8. Risk oversight: An audit committee imperative. "[T]he audit committee will want to ensure that mechanisms are in place for it to receive appropriate reporting of management's risk identification, monitoring, measurement and mitigation efforts."

9. Re-examining the audit committee calendar. Audit committees should revisit their annual calendars because "agendas are changing rapidly, as they adjust to accommodate the evolving geopolitical and macroeconomic impacts on financial reporting and the oversight of an increasing number of and types of risks * * *."

10. Recurring agenda items. PwC lists items that should be on every audit committee meeting agenda (or at regular intervals): Hotline complaints and code of conduct violations; changes in the regulatory environment; executive sessions; related-party transactions; internal and external audit plan; and discussions with the CIO, CISO, General Counsel, and Head of Tax.

For other recent audit committee agenda suggestions, see What Should be on the Audit Committee's 2023 Agenda?, January 2023 Update and EY on SEC Priorities for 2023, February-March 2023 Update.

ISSB Prioritizes Climate Reporting and Defers Other Disclosures. On April 4, the International Sustainability Standards Board (ISSB) announced that companies that follow its standards will only be required to report on climate-related risks and opportunities in their first year of ISSB's compliance; reporting on other sustainability issues can be deferred to the second year. According to the ISSB's press release, "companies can prioritise putting in place reporting practices and structures to provide high-quality, decision-useful information about climate-related risks and opportunities in the first year of reporting using the ISSB Standards. Companies will then need to provide full reporting on sustainability-related risks and opportunities, beyond climate, from the second year."

The ISSB has previously announced a one-year delay in the reporting of Scope 3 greenhouse gas emissions (e.g., GHG emissions in the company's supply chain or resulting from use of the company's products). Accordingly, in their first year using the ISSB Standards, companies need not:

- Provide disclosures about sustainability-related risks and opportunities beyond climate-related information.
- Provide annual sustainability-related disclosures at the same time as the related financial statements.

- Provide comparative information.
- Disclose Scope 3 greenhouse gas emissions.
- Use the Green House Gas Protocol to measure emissions, if they are currently using a different approach.

In February, the ISSB announced that it had approved in principle its first two standards – IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and IFRS S2 (Climate-related Disclosures). These standards will be finalized and issued by June 30 and will take effect in January 2024. See ISSB Agrees in Principle on its First Two Standards, February-March 2023 Update. ISSB standards (which incorporate the standards of the Sustainability Accounting Standards Board) are not mandatory in the United States, but may become de facto global standards, and many U.S. companies may follow them voluntarily.

The Role of the Auditor in Climate Disclosure. A new Center for Audit Quality (CAQ) publication discusses the role that auditors can play in public company reporting of climate-related information. The Role of the Auditor in Climate-Related Information considers the impact of climate-related risks on the financial statement audit and on attestation engagements to provide assurance with respect to separate climate reports. The CAQs' paper, which is nontechnical and quite readable, is organized around six questions:

- What is driving demand for climate-related information?
- What types of climate-related information are companies disclosing?
- Why do companies seek assurance over climate-related information?
- What is the role of public company auditors in climate-related information?
- What factors and skillsets enable auditors to perform attestation engagements over climate-related information?
- Can a public company use the same independent accounting firm for its financial statement audit and attestation over its climate-related information?

The publication also contains an appendix describing the SEC's climate disclosure proposals and the EU's Corporate Sustainability Reporting Directive.

While the CAQ's paper is aimed at providing auditors with insight concerning their role in climate disclosure, it could also be useful to an audit committee that is considering how their auditor can aid in the company's climate disclosure initiatives. As the CAQ observes, "With significant growing demand for reliable climate-related information set to continue, regardless of how the various regulatory developments proceed, it is important for auditors to understand and embrace the role they can play in an SEC registrant's reporting of climate-related information not only as it affects the financial statements and ICFR but also the separate, standalone reporting of climate-related information." Similarly, audit committees need to understand the role that auditors can play.

For Audit Partners, Adverse ICFR Opinions May be a Career Hazard. An academic study finds that an adverse opinion on the effectiveness of a company's internal control over financial reporting (ICFR) may not just raise investor concerns about the reliability of the company's financial reporting. It may also lead to the demotion of the engagement partner.

Section 404(b) of the Sarbanes-Oxley Act requires larger public companies to obtain an opinion from the company's financial statement auditor on the effectiveness of the company's ICFR. ICFR is ineffective when there are one or more material weaknesses in the company's controls. Investor advocates generally assert that ICFR opinions provide valuable information concerning the reliability of

a company's financial reporting. Some critics of the profession have argued that material weaknesses are, however, under-reported because auditors face pressures not to issue adverse ICFR opinions. See Do Audit Committees Shun Accounting Firms That Uncover Material Weaknesses?, August 2019 Update.

How Do Audit Firms Treat Partners Who Issue Adverse Internal Control Opinions?, by Ashleigh L. Bakke (University of Kansas). Elizabeth N. Cowle (Colorado State University), Stephen P. Rowe (University of Arkansas), and Michael S. Wilkins (University of Kansas), seems to lend additional support to these concerns. The authors reviewed audit partners and their publicly traded clients with audit opinions filed from January of 2017 through December of 2020. They find that –

> "[A]udit firms are significantly more likely to remove a partner from a continuing engagement when the partner issued an adverse ICO [internal control opinion] to any of their clients in the previous year. More importantly, we find that individual partners issuing adverse ICOs experience unfavorable changes in their client portfolios in the form of lower fees and less prestigious client assignments. * * * Our results are consistent with audit partners experiencing negative consequences when they issue opinions that strain auditor-client relations, even though these opinions provide valuable information to capital market participants and are not likely to reflect lower audit quality."

The authors conclude with the observation that their "findings suggest a potential 'root cause' for why material weaknesses may be underreported."

It is difficult to gauge the extent to which the possible career impacts this study reports actually affect auditor behavior. However, audit committees may want to bear the study's findings in mind when they are confronted with situations in which the company's ICFR contains one of more significant deficiencies that do not, in the view of management and the auditor, rise to the level of material weaknesses. Audit committees should be alert to the possibility that career considerations could influence the auditor's views regarding control effectiveness.

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. Recent blog posts include –

- Oversight of Crypto Auditing: Asking the PCAOB to Go Out of Bounds (Dan Goelzer, February 28, 2023)

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

For further information, please contact:

Daniel L. Goelzer
301.288.3788
dangoelzer@gmail.com

The Update's website is www.auditupdate.com.

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