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:

PCAOB QC Proposal Could Impact Auditor/Audit Committee Relationship

On November 18, the Public Company Accounting Oversight Board proposed a new standard to strengthen and update the requirements for the quality control (QC) systems of public accounting firms registered with the Board. The Board also proposed changes to various other standards, rules, and forms, including the standard governing communications with audit committees (AS 1301) and the standard on the auditor's responsibility to respond to audit deficiencies that come to the auditor's attention after completion of the engagement (AS 2901). If adopted, the new QC standard, QC 1000, would supersede the Board's existing quality control standards. These changes may be of interest to audit committees because of their potential to affect the auditor's work. Several would also have an impact on the audit committee's relationship with the auditor.

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.

Elements of the QC Proposal

The release proposing the new quality control regime states that the Board is seeking to improve audit firm QC systems and to promote compliance with audit requirements. Themes of the proposal include:

- Requiring a risk-based approach to quality control, including quality objectives and a systematic effort to identify and manage risks to achieving those objectives.

- Emphasizing firm governance, including "tone at the top," and individual accountability.

- Providing more direction regarding QC monitoring and remediation of identified deficiencies "to encourage an ongoing feedback loop that drives continuous improvement."

The Board also states that its proposals are intended to address "changes in the audit practice environment, including the increasing participation of other firms and other outside resources, the role of firm networks, the evolving use of technology and other resources, and the increasing importance of internal and external firm communications."

The Board's Fact Sheet on the proposals lists "key improvements" to the existing quality control standards that would result from adoption of the proposal:

- Reporting on QC effectiveness. The proposal would require firm annual reporting on quality control system effectiveness to both the PCAOB and client audit committees. QC 1000 would require a registered firm to annually evaluate its quality control system and that evaluation would be the basis for the firm's reporting. The audit committee communication aspect of this proposed requirement is discussed in more detail below.

- Accuracy of performance metrics. The proposal seeks to ensure the accuracy of firm-level or engagement-level information that audit firms publish, such as performance metrics and financial data. The release notes that some firms publicly communicate such information by issuing transparency reports or through other vehicles. "Regardless of the form of communication and the type of information presented, we believe that firms' QC systems should address the integrity of firms' external communications about themselves. Such information can influence the views of relevant stakeholders, including audit committees determining whether to engage or retain an auditor and investors determining whether to ratify such an appointment."

- Independent voice in governance. Proposed QC 1000 would require the governance structure of accounting firms that annually issue more than 100 public company audit reports to maintain an oversight function for the audit practice that includes at least one independent person. That person could not be a firm partner, shareholder, member, other principal, or employee and could not have any commercial, familial, or other relationship with the firm "that would interfere with the exercise of independent judgment with regard to matters related to the QC system."

- Correction of audit deficiencies. The proposal would expand the responsibility of auditors to correct audit deficiencies identified after completion of an engagement. This aspect of the proposal is discussed in more detail below.

- Integrity and ethics standard. The Board proposes to rescind its existing ethics and independence standard and replace it with a new standard, EI 1000, Integrity and Objectivity. Among other things, this new standard would address the situation in which a person associated with a registered accounting firm has a disagreement or dispute with his or her supervisor over professional and legal requirements or how to apply or comply with them. EI 1000 would provide that, if, in the view of the associated person, the firm does not take appropriate action, he or she should consider notifying third parties of the matter, including regulatory authorities and audit committees.

- <u>Use of technology</u>. Proposed QC 1000 includes a technology risk factor "to prompt consideration of technology as part of the firm's risk assessment process." In order to be "more adaptable to future developments and less likely to discourage the use of emerging technologies," the proposal does not however include any specific requirements related to how a firm should employ emerging technology in either its audit practice or QC system. The Board notes that it has an ongoing research project assessing the need for regulatory actions in light of the increased use of technology-based tools by auditors and preparers.

<u>Audit Committee QC Communication</u>

The aspect of QC 1000 that would most directly impact audit committees is the proposed requirement that firms report to client audit committees on the effectiveness of their system of quality control. As noted above, audit firms would be required to annually evaluate the effectiveness of their QC system. A firm would be required to conclude, as of November 30 of each year, that the system (1) is effective with no unremediated QC deficiencies; (2) is effective except for one or more unremediated quality control deficiencies that are not major quality control deficiencies; or (3) is not effective (i.e., one or more major quality control deficiencies exists). Firms would be required to file a report with the PCAOB stating their conclusion concerning QC system effectiveness and, where applicable, describing any deficiencies. This report would be nonpublic.

In addition to reporting to the PCAOB, firms would be required to report on their annual QC system evaluation to the audit committees of clients whose engagements are performed under PCAOB standards. Audit committee reports would include a brief overview of remedial actions for any quality control deficiencies that were unremediated at the time of the evaluation. Unlike reports to the PCAOB, reports to audit committees would not be required to include nonpublic inspection information. In the Board's view:

> "The proposed auditor communication requirement could enhance audit committee oversight by providing potentially valuable information about the firm and greater context and insight into the audit process. We believe that such information could be relevant to the audit committee's responsibilities in connection with auditor appointment and retention. We also note that firms performing audits of New York Stock Exchange-listed companies already communicate information about their quality control to their client's audit committees under applicable listing requirements. We believe that extending a similar requirement to all firms could promote beneficial dialogue between the auditor and the audit committee about QC matters." (footnote omitted)

<u>Audit Deficiencies</u>

Another aspect of the QC proposal that could impact audit committees is the enhanced requirement concerning deficiencies in a completed engagement. Under AS 2901, the existing standard, when an auditor concludes, after issuing its report, that procedures necessary at the time of the audit were not performed, the auditor must "assess the importance of the omitted procedure to his present ability to support his previously expressed opinion on the financial statements taken as a whole." If the auditor concludes that the omitted procedure "impairs his present ability to support the opinion" (and if the auditor believes the report is currently being relying on), the auditor must apply the omitted procedure or alternative procedures to provide a satisfactory basis for the opinion. On the other hand, if the auditor concludes that other procedures that were applied during the audit "tend to compensate" for the omitted procedure, or make its omission "less important," or that subsequent audits provide support of the previous opinion, the auditor need not take further action. In short, the current standard affords the auditor considerable latitude in deciding whether action to correct a deficiency is necessary.

The PCAOB is proposing to create a straightforward requirement that omitted procedures must be performed: In cases where, because of engagement deficiencies, the auditor did not obtain sufficient appropriate audit evidence to support the opinion that was issued, "the auditor should either perform procedures to obtain additional evidence, to the extent necessary, such that the opinion is supported by sufficient appropriate evidence" or take action to prevent future reliance on the opinion.

The new requirement could have the effect of making the consequences of deficiencies uncovered in PCAOB inspections or firm internal reviews more visible to audit committees. In these situations, the proposal would generally require further audit work to be performed, regardless of whether the auditor believes that the original opinion is already supportable because of other procedures performed or subsequent audits. Performance of additional work may highlight for audit committees the nature of the deficiency and the extent of the effort necessary to correct it.

Comments: As the QC effectiveness reporting requirement and the enhanced deficiency correction standard illustrate, the PCAOB's QC proposals, if adopted, would impact the auditor/audit committee relationship. More importantly, however, the proposal could have an impact on overall audit performance. The predicate of the proposal is that improving quality controls will strengthen audit quality. Audit committees should of course support that goal and, if the proposal is effective, should see the benefits of stronger firm QC in the performance of the company's audit. At the same time, there will be costs associated with new QC requirements, and those costs will likely be reflected in audit fees. As the Board observes in its economic analysis:

> "Audited companies may also incur indirect costs related to the proposed requirements. * * * Firms may pass on part of any increased costs they incur at the firm or engagement level by raising the fees they charge their clients. In addition, to the extent that the proposed requirements improve compliance with applicable professional and legal requirements, some audited companies could face additional costs to respond to their auditors' requests for additional or more extensive audit evidence. Audited companies may incur other costs due to changes in audit firm QC policies and procedures. For example, if the proposed QC standard results in changes to firms' client acceptance and continuance practices, firms may require greater fees or refuse to accept or retain high-risk clients."

For these reasons, audit committees may want to follow the progress of the PCAOB's QC proposal and may want to ask their auditor for its views on the specifics of the proposal and on whether and how it might impact the firm's work. The deadline for public comments is February 1, 2023.

Audit Committee Transparency Inches Ahead

On November 30, the Center for Audit Quality (CAQ) and research firm Audit Analytics (AA) released 2022 Audit Committee Transparency Barometer (Barometer), the ninth edition of their annual assessment of S&P Composite 1500 proxy statement disclosures concerning the work of the audit committee. According to the accompanying press release, the 2022 report reflects "a long-term positive trend of increased transparency in several areas by audit committee members." Among other things, the Barometer finds that cybersecurity disclosures continue to increase and that 54 percent of the S&P 500 audit committees reported having responsibility for cyber risk oversight. In addition, as a corollary to the growth in sustainability or ESG reporting (see Sustainability Reporting Reaches an All-Time High, But Investors Have Qualms About the Content in this Update), the report finds that 18 percent of S&P 500 audit committees disclosed having responsibility for ESG oversight.

Along with the Barometer, the CAQ released Audit Committee: The Kitchen Sink of the Board (Kitchen Sink). This publication, developed by the CAQ and academic researchers at the University of Tennessee Knoxville's Neel Corporate Governance Center and the Pamplin College of Business at Virginia Tech, "offers leading practices for audit committees, including how boards can effectively allocate oversight responsibilities to the audit committee, how audit committee members can keep up with an ever-evolving workload, and how audit committees can improve their disclosures related to their oversight responsibilities."

2022 Transparency Barometer

In general, the findings of the 2022 Barometer are consistent with last year. (For a summary of last year's Barometer, see Slight Increases, Some Stagnation: CAQ and EY Report Cards on Audit Committee Transparency, November-December 2021 Update.) Of the various topics surveyed, the highest rates of proxy disclosure related to non-audit services. Eighty-four percent of the S&P 500 discussed how non-audit services may impact auditor independence. Eighty-two percent of the S&P MidCap and 76 percent of the SmallCap companies made such disclosures. This topic also topped last year's list, and the disclosure percentages are essentially unchanged. (The Barometer breaks down S&P 1500 disclosures between the S&P 500 large-cap companies, the S&P MidCap 400, and the S&P SmallCap 600.)

Areas in which there were relatively low levels of disclosure included audit committee responsibility for audit fee negotiations, explanation of a change in audit fees, and discussion of how the audit committee considers auditor compensation and its connection to audit quality. For example, only 23 percent of the S&P 500 and S&P MidCap 400 provided an explanation for a change in audit fees; disclosure of reasons for fee changes was slightly more frequent among smaller companies – 26 percent of the SmallCap 600 discussed such changes. The least popular disclosure tracked by the Barometer was discussion of the connection between audit fees and audit quality. Only six percent of the S&P 500 discussed this topic; two percent of the MidCaps and SmallCaps did so. Although very low, these figures reflect an increase over 2021, when none of the S&P 1500 companies made such a disclosure.

Other highlights of the 2022 Barometer include:

- Auditor tenure. Auditor tenure is a common audit committee disclosure. Seventy-one percent of the S&P 500 disclose the length of time the auditor has been engaged, as do 59 percent of the S&P Midcaps and 55 percent of SmallCaps. In contrast, very few audit committees (nine percent for S&P 500, five percent of MidCaps and two percent of SmallCaps) disclose how the audit committee factors in length of auditor tenure when deciding whether to re-appoint the external auditor. Since 2018, auditor tenure has been a required disclosure in the auditor's report, and audit committee tenure disclosure could therefore be viewed as redundant. As the Barometer points out, stakeholders would likely prefer to learn from the audit committee how it thinks about audit firm tenure in relationship to auditor independence and audit quality.

- Engagement partner selection. Half (51 percent) of the S&P 500 disclose that the audit committee is involved in engagement partner selection, while 24 percent of MidCaps and twelve percent of SmallCaps make such a statement. These percentages are essentially unchanged from last year. The Barometer states that, according to an academic study, the audit partner selection process is positively associated with audit quality and suggests that audit committees explain their role in selecting the engagement partner.

- Cybersecurity. As noted above, disclosure related to audit committee responsibility for oversight of cybersecurity risk has increased during the last several years. In 2022, 54 percent of the S&P 500 disclosed that the audit committee is responsible for cybersecurity (compared to 46 percent last year); 41 percent of S&P MidCaps (34 percent last year) and 32 percent of S&P SmallCaps (24 percent last year) made such a statement. In 2016, only eleven percent of the S&P 500 (and five percent of Mid-Caps and four percent of SmallCaps) discussed audit committee responsibility for cybersecurity risk oversight. The Barometer also reports that 39 percent of the S&P 500 disclosed having a cybersecurity expert on the board, as did 26 percent of the MidCap 400 and 18 percent of the SmallCap 600.

- ESG. Eighteen percent of S&P 500 audit committees disclose having responsibility for ESG oversight, as do ten percent of MidCaps and seven percent of SmallCaps. While the audit committee may be involved in ESG disclosure, substantive responsibility for ESG strategy and oversight is often assigned to another committee or to the full board.

An appendix to the Barometer includes examples of effective disclosure from specific audit committee reports or other proxy statement discussions for each type of disclosure tracked in the annual analysis. Another appendix contains a pro forma description of an audit committee and its responsibilities, along with a model audit committee report. A final appendix, "Questions to Consider When Preparing Audit Committee Disclosures", lists twelve questions to aid in drafting disclosure concerning the work of the audit committee. These questions mirror the issues addressed in the Barometer annual report.

Audit Committee: The Kitchen Sink of the Board

To assist companies and audit committees in managing their responsibilities and improving their disclosures, the CAQ simultaneously issued the Kitchen Sink study. The authors describe the purposed of this publication as follows:

> "Audit committees are an essential component to the health of our financial reporting ecosystem and capital markets. It's vital that they have the tools and resources they need, including peer insights and leading practices, to play an effective role in oversight and, ultimately, investor protection. This report provides a step-by-step guide for audit committee members to provide ideas for managing this evolving workload and enhancing their disclosures."

Kitchen Sink is based on interviews with audit committee members, investors, and those involved in preparing disclosures. The report addresses three topics:

- How Can Boards Effectively Allocate Oversight Responsibilities to the Audit Committee? Among other things, the report finds that "[p]erpetually assigning emerging risks to the AC (i.e., the 'kitchen sink' approach) can lead to suboptimal oversight due to overworked ACs and a 'check the box' mentality" and that "[t]raditional AC skill sets relate to financial reporting and internal controls."

- How Can Audit Committee Members Keep Up With An Ever-Evolving Workload? Suggestions on this topic include "Regularly evaluate whether AC refreshment is needed to keep up with the necessary skill sets to properly oversee evolving risks" and "Carefully manage the AC agenda by mapping out risks to allow for deep dives on a rotation of topics throughout the year."

- How Can Audit Committees Improve Their Disclosures Related To Audit Committee Oversight Responsibilities? Kitchen Sink recommends and describes a four-step approach:

    1. Define Your Goals. "[I]nvestors communicated two consistent themes that indicate disclosures can provide value: (1) be transparent about audit committees' duties and actions and (2) provide confidence that the audit committee is fulfilling its fiduciary duty."

    2. Actively Seek Out Disclosure Examples. "AC participants recognize that they do not necessarily desire to be at the front of the pack with their disclosures, but they also do not want to fall far behind. * * * [I]t is important for audit committees to refer to peer disclosures to understand what stakeholders are seeing from peer organizations."

    3. Advocate For Your Disclosures. "One troubling aspect gleaned from our interviews was the number of AC participants who believed that enhanced disclosures would introduce litigation risk, either for them personally or for the full board of directors. In contrast, our interviews with general counsels revealed less concern about litigation risk. * * * If a GC is not willing to work with the AC, then that is perhaps a sign of a larger issue about

management culture that suggests that they are not willing to be transparent with shareholders."

4. Regularly Revisit Disclosures. "Perhaps the most consistent thing we heard from all interview participants is the concern that governance disclosures face a high risk of becoming rote and stale. When this occurs, the disclosures are no longer useful to investors and become solely a compliance exercise. * * * [G]iven the ever-evolving set of business risks that companies face each year, it is unlikely that governance operated exactly the same as the prior year."

The authors of Kitchen Sink have also prepared an academic paper based on their research which provides additional insight into their views on the shortcomings of current audit committee reporting. See Academic Study Finds that Audit Committee Disclosures Don't Meet Investor Needs in this Update.

Comment: The 2022 Barometer report discusses the benefits of audit committee transparency, including "a positive correlation between transparent disclosure and high audit quality," providing investors with information about the audit committee's oversight of the auditor and financial reporting broadly, and promoting trust. To capture these benefits, audit committees should, as Kitchen Sink suggests, be aware of the types of disclosures their peers are making. The kinds of voluntary disclosures the Barometer identifies as common among S&P 1500 companies are generally not controversial and would rarely involve disclosing confidential information or exposing the audit committee to increased litigation risk.

Audit committees should also consider taking their disclosure to the next level by providing, not just a description of what they do, but insight into how they do it. As the Barometer states, "Providing detailed disclosures about how the audit committee executes its oversight responsibility, instead of relying on boilerplate language, provides investors with useful information into the processes, considerations, and decisions made by the audit committee to support audit quality."

SEC Disclosure Enforcement is in High Gear

Both Securities and Exchange Commission Chair Gensler and Division of Enforcement Director Grewal have been vocal about the importance of an active and aggressive SEC enforcement program, particularly with respect to public company disclosure. See, e.g., Gensler, This Law and Its Effective Administration, Remarks Before the Practising Law Institute's 54th Annual Institute on Securities Regulation (November 2, 2022) ("Make no mistake: If a company or executive misstates or omits information material to securities investors, whether in an earnings call, on social media, or in a press release, we will pursue them for violating the securities laws.") and Grewal, Remarks at Securities Enforcement Forum (November 15, 2022). Two recent reports on the fiscal year 2022 activities of the SEC's Division of Enforcement demonstrate that enforcement has accelerated, and that, along with other enforcement priorities, cases involving public company disclosure are on the upswing. This emphasis on disclosure enforcement is a change from the priorities of the previous SEC administration. See SEC Enforcement Ticks Up, but not for Financial Reporting, December 2018 Update.

SEC Division of Enforcement

On November 15, the SEC announced the fiscal year 2022 results of its enforcement program. During FY 2022 (ended September 30, 2022), the SEC filed 760 enforcement actions, a nine percent increase over the prior year. Monetary payments ordered in SEC actions (i.e., civil penalties, disgorgement, and pre-judgment interest) totaled $6.439 billion, the most in SEC history and up from $3.852 billion in fiscal year 2021. The 2022 total includes $4.19 billion in civil penalties (a record) and $2.25 billion in disgorgement of illegally-obtained gains (six percent less than in 2021).

The SEC's announcement of its 2022 enforcement record made several points related to public company disclosure cases:

- Financial fraud and issuer disclosure. "Public company disclosure is the bedrock of our securities markets. The SEC places a high priority on pursuing issuers or their employees who make materially inaccurate disclosures, as well as auditors and their professionals who violate applicable laws and rules in connection with such disclosures. The Division's attorneys and accountants regularly investigate and recommend enforcement actions charging misconduct by issuers, auditors, and their employees." Fiscal year 2022 examples of this emphasis on disclosure include actions against –

    - The Boeing Company and its former CEO for misleading investors about the safety of the company's 737 MAX planes following crashes in 2018 and 2019. See In the Matter of The Boeing Company (September 22, 2022) and In the Matter of Dennis A. Muilenburg (September 22, 2022).

    - Compass Minerals International for misleading investors about a technology upgrade the company erroneously claimed would reduce costs and for failing to properly assess whether to disclose financial risks created by their excessive discharge of mercury in Brazil. See In the Matter of Compass Minerals International, Inc. (September 23, 2022).

    - NVIDIA Corporation for inadequate disclosures concerning the impact of crypto mining on the company's gaming business. See In the Matter of NVIDIA Corporation (May 6, 2022).

    - RSM and three senior-level employees for failing to properly audit a client's financial statements over a four-year period during which the client was improperly inflating revenues. See In the Matter of RSM US LLP (September 30, 2022).

- Individual accountability. Individual – as opposed to only corporate – responsibility for disclosure and other types of violations has been an SEC enforcement theme for several years. In fiscal year 2022, more than two-thirds of the SEC's stand-alone enforcement actions involved at least one individual defendant or respondent. These individuals included senior public company executives. For example, Dennis Muilenburg, Boeing's former CEO, was charged with making materially misleading public statements about the safety of the company's 737 MAX airplanes (see above). In addition, under Sarbanes-Oxley Act Section 304, the SEC ordered executives at several firms to return bonuses and compensation following misconduct resulting in accounting restatements, even though the executives were not charged with the misconduct.

- Focus on gatekeepers. The SEC brought numerous actions in 2022 charging disclosure gatekeepers, including auditors and lawyers, with various lapses. See, e.g., EY Fined $100 Million for Ethics Exam Cheating, June-July 2022 Update. Director Grewal has emphasized that "gatekeepers must foster a proactive culture of compliance and responsibility – both for themselves and for their clients." Testimony on Oversight of the SEC's Division of Enforcement Before the United States House of Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets (July 21,2022).

- Environmental, social, and governance (ESG). ESG has become increasingly important to investors, and SEC enforcement has focused on these issues with respect to public companies and investment products and strategies. For example, the Commission charged Vale S.A., one of the world's largest iron ore producers, with allegedly making false and misleading claims about the safety of its dams prior to the collapse of the Brumadinho dam in Brazil, which killed 270 people. See SEC is Serious About ESG Disclosure Enforcement, April-May 2022 Update.

NYU Pollack Center and Cornerstone Research

New York University's Pollack Center for Law & Business and Cornerstone Research paint a similar picture in SEC Enforcement Activity: Public Companies and Subsidiaries--Fiscal Year 2022 Update. The Pollack Center/Cornerstone report, which focuses on fiscal year 2022 SEC actions against public companies and their subsidiaries, finds that the SEC filed 68 enforcement actions against these types of entities in 2022 (which, they note, was the first full year of SEC Chair Gensler's tenure). The 68 actions reflected a 28 percent increase from FY 2021. "Issuer Reporting and Disclosure" was the most common category of allegation against public companies in FY 2022, representing 38 percent of these actions. (Allegations in the Broker Dealer classification were the second most common.) Other significant categories of cases against public companies included the Foreign Corrupt Practices Act (9 percent) and Securities Offerings (6 percent).

Seventy-five public company and subsidiary defendants settled with the SEC in 2022. Monetary settlements were imposed against 97 percent of defendants in these actions, totaling $2.8 billion, the largest amount in any fiscal year since the Pollack Center and Cornerstone began tracking SEC public company enforcement in 2010. The median monetary settlement in FY 2022 was $9 million, and the average was $42 million. (Monetary settlements in cases alleging recordkeeping failures against 16 public company broker-dealer subsidiaries were 44 percent ($1.2 billion) of total monetary settlements.) Eighty-two percent of the monetary penalty total represented civil penalties, while the balance was disgorgement of illicit profits. The terms of SEC settlements can be substantially affected by whether the SEC credits the defendant with cooperating in the investigation. The SEC noted cooperation in 63 percent of public company and subsidiary settlements in FY 2022.

Comment: Audit committees should be aware that the risk of enforcement inquiry is rising with respect to disclosures that the SEC views as inaccurate, incomplete, or misleading. The increasing possibility of an SEC enforcement action is something that every company needs to bear in mind in connection with its disclosure and financial reporting, especially when confronted with what appear to be "close calls" or the temptation to omit or downplay unfavorable information. As the Update has observed in the past, the best protection against litigation is diligence and care in overseeing the company's financial reporting.

Restatements Will Trigger Compensation Claw Backs Under New SEC Rule

On October 26, 2022, the Securities and Exchange Commission, by a 3-to-2 vote, adopted a rule that will require exchange-listed companies to have a policy mandating the recovery of erroneously awarded incentive compensation following an accounting restatement. Evaluations of whether a restatement is necessary often require the exercise of judgment, and audit committees should be aware of the impact that this new rule could have on management restatement decisions.

The SEC originally proposed the claw back rule, which implements Section 954 of the Dodd-Frank Act, in 2015. Following a lengthy period of inaction, the Commission re-opened comment on the proposal in 2021. See SEC Revives Proposal to Require Compensation Claw Backs After Restatements, September-October 2021 Update. A third comment period commenced in October 2021. See SEC Rulemaking is in Hyperdrive: Spring 2022 Regulatory Agenda, June-July 2022 Update. Although the Commission states that commenters "broadly supported the objectives" of the proposal, some aspects, particularly the scope of the restatements to which it should apply (discussed below), have been controversial.

New Securities Exchange Act Rule 10D-1 directs national securities exchanges to amend their listing standards to require listed companies to adopt and comply with a compensation recovery policy. The policy must provide that, in the event of an accounting restatement to correct a material error, the company will recover from current and former executive officers any incentive-based compensation received that exceeds the amount that would have been paid under the restatement. The recovery policy must apply to incentive compensation received by both current and former executives during the three-year period preceding the restatement.

Recovery of compensation is mandatory, regardless of whether the officers from whom recovery is sought were responsible for the errors that resulted in the restatement and regardless of whether the inaccurate financial reporting was the result of misconduct. Narrow exceptions to the recovery requirement are permitted if the cost of enforcing the policy would exceed the amount to be recovered, if recovery would violate home country law, or if recovery would cause a tax-qualified retirement plan to become non-qualified. A company would be subject to delisting if it failed to adopt and enforce the recovery policy.

The Commission also adopted new disclosures to complement the compensation recovery policy. A company will be required to file its recovery policy as an exhibit to its annual report. In the event of a restatement, the company must disclose, among other things, the aggregate dollar amount of erroneously awarded compensation, amounts due from any current or former named executive officer that have been outstanding for 180 days or more, and details regarding reliance on any of the recovery policy exceptions.

The rule encompasses a broad range of restatements. As originally proposed in 2015, the claw back requirement would only have applied to accounting restatements that correct a material error in previously issued financial statements (a "Big R" or reissuance restatement). However, the final rule also requires compensation recovery when the company is required to prepare an accounting restatement that corrects an error that is not material to previously issued financial restatements but that would result in a material misstatement in the current (or a future) period if the error were left uncorrected (a "little r" or revision restatement). Little r restatements are far more common than Big R restatements. Excluding restatements by SPACs, only 24 percent of 2021 restatements were reissuance or Big R restatements. See Fueled by SPACs, Restatements Surge, June-July 2022 Update. The claw back rule does not capture restatements made for reasons other than error correction – e.g., to reflect the retrospective application of a change in accounting principle or retrospective revisions for stock splits, stock dividends or other changes in capital structure.

Comment: The new rule potentially affects the work of the audit committees by changing the stakes of a decision to restate. As the disincentives to restate increase, audit committees will need to become more vigilant in making sure that they are fully and evenhandedly informed in situations in which a restatement is a possibility. In this regard, the SEC's release adopting the recovery policy rule notes the role of audit committees in overseeing restatement decisions:

> "Requiring recovery analysis for both "Big R" and "little r" accounting restatements does not eliminate the risk that an issuer could avoid a recovery obligation by manipulating its materiality analysis of an error. While this is an inherent risk, we note the involvement of an independent auditor in evaluating management's materiality analyses, with the oversight of the audit committee, protects investor interests by helping ensure that material errors do not go uncorrected by an issuer seeking to avoid the recovery of erroneously awarded compensation. Furthermore, we note the potential serious consequences, including but not limited to Commission enforcement action and private litigation, of mischaracterizing material accounting errors as immaterial."

The SEC's Acting Chief Accountant has also recently noted the risk of bias in restatement decision-making and emphasized that audit committees should play an active role in overseeing restatement decisions. See Acting SEC Chief Accountant Warns Against Bias in Restatement Materiality Decisions, March 2022 Update. In this environment, any decision that an accounting error does not require a restatement is likely to attract scrutiny. Such decisions should be carefully considered and fully documented.

Sustainability Reporting Reaches an All-Time High, But Investors Have Qualms About the Content

In 2022 Sustainability Reporting in Focus, the eleventh annual edition of its research series tracking sustainability reporting trends, the Governance & Accountability Institute (G&A) finds "all-time highs across the board in sustainability reporting." For example, 81 percent of Russell 1000 companies published a sustainability report in 2021; of the 500 largest companies, 96 percent issued such a report.

Moreover, 68 percent of the bottom half of the Russell 1000 published such a report in 2021–a substantial increase over 2020.

While sustainability reporting has become nearly universal, there are significant questions as to how well this reporting is meeting the needs of investors. In How can corporate reporting bridge the ESG trust gap?, the EY Global Corporate Reporting and Institutional Investor Survey finds "a significant disconnect between the expectations and goals of companies and their investors when it comes to corporate and sustainability reporting."

GA&I

G&A released its 2022 report on sustainability reporting by companies in Russell 1000 indices on November 16. According to the press release accompanying the report, key findings include:

- Eighty-one percent of Russell 1000 companies published a sustainability report in 2021, "an impressive increase" from 70 percent in 2020.

- The smallest half of the Russell 1000 index by market cap had the largest increase in reporting, with 68 percent publishing a report in 2021, up from 49 percent in 2020.

- Ninety-six percent of the largest half of the Russell 1000 index (i.e., the S&P 500 companies) published a report in 2021, up from 92 percent in 2020.

- Sixty-seven percent of sustainability reports aligned with the reporting standards of the Sustainability Accounting Standards Board (SASB). For the first time, SASB was the reporting standard most frequently used by Russell 1000 companies.

- Eighty-nine percent of sustainability reports published by Russell 1000 companies in 2021 discussed the impact of the COVID-19 pandemic.

G&A first published an analysis of S&P 500 company sustainability reporting in 2012, covering 2011 reporting. Since that time, sustainability reporting has gone from relatively rare to almost universal; G&A's initial report found that just 20 percent of S&P 500 companies published sustainability reports or disclosures in 2011. In 2019, G&A expanded its research to include all companies in the Russell 1000 Index and reported that 60 percent of Russell 1000 companies published sustainability reports in 2018. For a summary of the 2021 G&A report, see Sustainability Reporting: (Almost) Everybody Does It, November-December 2021 Update.

G&A's findings with respect to three key topics – industry breakdown of reporters and non-reporters, use of disclosure frameworks, and external assurance on sustainability reporting -- are summarized below.

- Industry sectors and sustainability reporting. In four of the eleven Russell 1000 industry sectors – Consumer Staples, Materials, Real Estate, and Utilities -- all companies issued sustainability reports in 2021. At the other end of the spectrum, almost half (44 percent) of the companies in the Communications sector failed to issue a sustainability report (19 non-reporters out of the 43 companies in the sector). Communications was also in last place in 2020 and 2019, although four more companies reported in 2021 than in 2020. Second-from-the-bottom was Health Care with 31 percent of the sector not reporting (38 non-reporters in the 121-company sector). Information Technology was third lowest with 29 percent of the 184 companies not reporting.

- Use of ESG disclosure frameworks. As noted above, SASB's standards were the most-used reporting framework in 2021 among the Russell 1000, with 67 percent of sustainability reports aligning with SASB. An additional nine percent referred to the SASB standards but did not align their disclosure with SASB. Fifty-four percent of the Russell 1000 companies aligned with or referred to the Global Reporting Initiative (GRI) framework, compared to 52 percent in 2020. Sixty percent of those companies reported in accordance with GRI's "Core" option and four percent utilized the more extensive "comprehensive" level of GRI reporting; the remaining 36 percent referenced GRI but were not fully in accord with its standards.

G&A also analyzed several other approaches to sustainability disclosure. Use of the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) rose to 34 percent, double the 17 percent that used TCFD in 2020. In addition, 449 Russell 1000 companies responded to the CDP Climate Change Questionnaire. For the 500 largest companies, the percentage of CDP responders was 69 percent, while only 20 percent of the smaller half of the Russell 1000 responded to CDP. In 2021, 456 companies referenced the UN's Sustainable Development Goals (SDGs) in their reporting, and 409 of those companies disclosed alignment to specific SDGs and their relation to the company's ESG strategy, initiatives, and other factors; the remaining 47 companies broadly referenced the SDGs.

- External assurance on sustainability reporting. A growing number of companies obtain external assurance from an auditor or other professional on their ESG disclosures. In 2020, 38 percent of Russell 1000 reporters obtained external assurance on their non-financial ESG disclosures, up one percent from 2020. Eighteen percent of companies in the smallest half of the Russell 1000 obtained such assurance, unchanged from 2020. Forty-nine percent of the companies in the largest half obtained assurance, compared to 44 percent in 2020. As it did last year, G&A states that "assurance provides increased recognition, transparency, and credibility * * * while reducing risk. Seeking external assurance often indicates strong internal reporting and management systems. Overall, assurance improves stakeholder communication and trust."

G&A concludes with this observation: "G&A's 2022 research findings show corporate sustainability reporting is no longer just a best practice for mega-cap and large-cap companies; it is rapidly becoming a best practice for mid-cap companies as well. We expect this trend to continue trickling down as smaller-cap companies face increasing pressure from investors and other stakeholders to provide more disclosures on sustainability and ESG strategies and initiatives."

EY

In How can corporate reporting bridge the ESG trust gap?, the EY Global Corporate Reporting and Institutional Investor Survey presents the views of 1,040 senior finance leaders at companies that issue ESG reports and of 320 institutional investor users of such disclosures. EY reports that three themes emerged from its survey:

- The disconnect between companies and investors. Seventy-eight percent of investors surveyed think companies should make investments that address ESG issues relevant to their business, even if it reduces profits in the short term. In contrast, only 55 percent of finance leaders believe their company should address ESG issues if the result is a short-term reduction in financial performance and profitability. Ironically, companies apparently see investors as the cause of their inability to prioritize long-term sustainable performance; 53 percent of companies surveyed with annual revenues of over $10 billion said that they "face short-term earnings pressure from investors, which impedes our longer-term investments in sustainability."

- The importance of effective corporate reporting. Ninety-nine percent of investors surveyed said that they utilize company ESG disclosures as a part of their investment decision-making (including 74 percent of investors who said they use a "rigorous and structured approach.") However, most investors do not believe that current ESG disclosures meet their requirements and expectations. For example, 76 percent of investors agreed that "companies are highly selective in what information they provide to investors, raising concerns about greenwashing" and 88 percent thought that "unless there is a regulatory requirement to do so, most companies provide us with only limited decision-useful ESG disclosures." Company finance leaders also had reservations about the usefulness of ESG disclosures, although their concerns were somewhat different than those of investors. Forty-two percent of finance leaders thought that "lack of assurance and supporting evidence to provide trust in the information" is a challenge to the usefulness and effectiveness of company sustainability reporting. Forty percent were concerned about the "disconnect between ESG reporting and mainstream financial information."

- Understanding expectations. EY suggests that, to close the gap between investors and companies on ESG reporting, "companies should build a better understanding of the sustainability expectations of long-term investors and earn their trust by defining the involvement of the finance function in ESG disclosures." EY summarizes its findings by recommending a "change in mindset. Those companies that embrace transparency — including being open when initiatives are not going according to plan — will be more likely to earn the trust of their shareholders and stakeholders."

Comment: As stated in prior Updates, given the increasing investor and regulatory emphasis on ESG disclosure, it seems inevitable that these issues will become an important aspect of the audit committee's work. Audit committees that are not already doing so should focus on what ESG disclosures their company makes, how the information is collected, and how the disclosures impact financial reporting. As investors rely more heavily on ESG disclosures in their decision-making, the reputational and liability risks associated with inaccurate disclosure increase. To address these risks, audit committees should explore with management the controls and procedures to which sustainability disclosures are subject. These controls should be as rigorous as those applicable to traditional financial reporting. Obtaining third-party assurance over sustainability disclosures should also be considered.

Audit committees might also want to ask management how it decided what to disclose and whether it has a basis to believe that the company's ESG disclosures are useful to investors. EY's study found that 80 percent of investors surveyed thought that "too many companies fail to properly articulate the rationale for long-term investments in sustainability, which can make it difficult for us to evaluate the investment." The question whether to make ESG disclosures has largely been resolved at most large companies. The focus should now shift to how to make those disclosures meaningful to investors.

On the Update Radar: Things in Brief

Academic Study Finds that Audit Committee Disclosures Don't Meet Investor Needs. Audit committee transparency – disclosure that exceeds regulatory requirements about the audit committee and its work – has increased during the past decade. See Audit Committee Transparency Continues to Inch Ahead in this Update. However, an academic study conducted by the authors of Audit Committee: The Kitchen Sink of the Board (discussed above) raises questions about the utility of this disclosure. The authors' conclusion is that "the current disclosure process has created a focus on standardized language following existing norms rather than signaling quality by 'telling the story' of the AC."

The findings in Audit Committee Disclosure Evolution: Evidence from the Field are based on interviews with U.S. public company audit committee members, with disclosure preparers (e.g., corporate secretaries, general counsels, and CFOs), and with investors, proxy advisors, and shareholder advocates. The study authors – Lauren M. Cunningham (University of Tennessee, Haslam College of Business), and Sarah E. Stein, Kimberly Walker, and Karneisha Wolfe (all from Virginia Tech's Pamplin College of Business) – conclude that "[m]any companies fail to develop meaningful disclosures and instead adopt an isomorphic strategy by mimicking one of two types of peers: the set of companies providing the minimal required boilerplate AC disclosures, or the set of companies voluntarily providing standardized language recommended by the CAQ and other large accounting firms." As a result, most companies fail to tell "a unique oversight 'story.'"

The authors believe that this mimicking strategy is due to companies not receiving feedback on their audit committee disclosures from investors. "The lack of feedback leaves ACs with a sense that investors are satisfied with current practices and removes incentive to evaluate the potential benefits of signaling through AC disclosure." This results in "ongoing frustrations for both ACs and investors." The study concludes with a prediction that interest in environmental, social, and governance disclosure may serve as a catalyst to change this dynamic since "increasing pressure for robust ESG information will likely bring AC disclosures back into the spotlight."

Audit Committees and Non-GAAP Measures–PWC's Recommendations. Non-GAAP measures: The role of the audit committee is PWC's primer for audit committees on non-GAAP measures, including suggested questions that committees should raise concerning their use. (For other perspectives on audit committee oversight of non-GAAP measures, see SEC Chief Accountant Outlines Audit Committee's Non-GAAP Oversight Role (Again), April-May 2018 Update and CAQ Adds Another Chapter to its Audit Committee Non-GAAP Guidance, March 2018 Update.)

Non-GAAP measures adjust a company's operating performance, financial position, or cash flows by excluding or including amounts from the most directly comparable measure based on generally accepted accounting principles (GAAP). As noted in the PWC paper, nearly all S&P 500 companies include at least one non-GAAP measure in their regulatory filings, earnings release, and other company disclosures, and investors increasingly evaluate companies based on such measures. "Given the ongoing global disruptions associated with the pandemic, other world events, and an overall uncertain global economic environment, more companies may consider non-GAAP adjustments to give effect to infrequent or unusual gains or charges."

PWC's publication discusses common non-GAAP financial measures, SEC rules around non-GAAP measures and common issues concerning these measures raised in SEC comment letters, and differences between non-GAAP measures and key performance indicators (KPIs). PWC concludes with a list of 19 questions that audit committees may want to ask management in fulfilling their oversight responsibilities with respect to non-GAAP measures. These questions are grouped under six headings:

- Why has management chosen to present the non-GAAP measure?
- What is management's process to calculate the non-GAAP measure?
- What are the incentives for possible "earnings management"?
- Is the presentation and disclosure fair, balanced, and transparent?
- Do the measures comply with the SEC regulations and the SEC staff's 2018 interpretive guidance?
- Are KPIs clearly defined and appropriately disclosed?

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 posts include –

- In Search of a Purpose – The PCAOB's Attestation Standards Review (Dan Goelzer, October 20, 2022)

- Supercharging PCAOB Enforcement May Encounter Some Speedbumps (Dan Goelzer, October 6, 2022)

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

The Update's website is www.auditupdate.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.