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.

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Shoot the Wounded! SEC Charges that Inadequate Cybersecurity is an Internal Accounting Control Violation

On June 18, the Securities and Exchange Commission charged R.R. Donnelley & Sons Co. (RRD), a global provider of business communication and marketing services, with internal accounting control and disclosure control violations stemming from a 2021 ransomware attack on the company. According to the

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Dan Goelzer is a retired partner of Baker McKenzie, a major international law firm. He chairs a Big Four accounting firm's Audit Quality Advisory Council. From 2017 to July 2022, Dan was a Sustainability Accounting Standards Board member. The SEC appointed him to the Public Company Accounting Oversight Board as one of its founding members, and he served on the PCAOB from 2002 to 2012, including as Acting Chair from 2009 to 2011. Dan was on the Securities and Exchange Commission's staff for 16 years and served as SEC General Counsel from 1983 to 1990.

Commission's administrative order, RRD failed to devise and maintain "cybersecurity-related internal accounting controls" sufficient to provide reasonable assurance that access to RRD's assets (i.e., its information technology systems and networks) was permitted only in accordance with management authorization. Applying the Foreign Corrupt Practices Act requirement that companies maintain internal accounting controls to cybersecurity practices is novel, and two Commissioners issued a statement asserting that the Commission was "stretch[ing] the law to punish a company that was the victim of a cyberattack" and "distorting a statutory provision."

The Commission's Order

The Commission finds that RRD's information technology network regularly stored and transmitted confidential data and personal identifying information belonging to its clients. RRD maintained intrusion detection systems that generated alerts that were reviewed initially by a third-party managed security services provider (the "MSSP"). After its initial review, the MSSP would escalate certain alerts to RRD's cybersecurity personnel, and both RRD's personnel and the MSSP would handle response and remediation. According to the SEC, this process was flawed in several respects.

- RRD did not reasonably manage the MSSP's allocation of resources.
- RRD failed to establish a sufficient prioritization scheme for review and escalation of alerts.
- RRD did not have sufficient procedures to audit or otherwise oversee the MSSP to confirm that the MSSP's work was consistent with RRD's instructions.
- RRD staff that reviewed escalated alerts had other significant responsibilities and insufficient time to dedicate to escalated alerts and general threat-hunting.
- RRD's internal policies failed to sufficiently identify lines of responsibility, set clear criteria for alert and incident prioritization, and establish clear workflows for response and reporting.

Between November 29 and December 23, 2021, RRD experienced a ransomware network intrusion. Alerts from RRD's internal systems and the MSSP indicated malware activity and a phishing campaign. Despite these alerts, RRD did not take action to isolate the infected computers or to investigate further. The MSSP also reviewed, but did not escalate, at least 20 other alerts related to the same activity, including malware on multiple computers and a compromised domain controller server. The attacker used deceptive techniques to install encryption software and exfiltrated 70 GB of data, affecting 29 of RRD's 22,000 clients.

RRD began responding to the attack on December 23, 2021, after a company with shared access to RRD's network alerted RRD's Chief Information Security Officer to anomalous internet activity from RRD's network. RRD then initiated a rapid response, shutting down servers and notifying clients and authorities. RRD issued public statements regarding the attack starting December 27, 2021.

Based on these facts, the SEC found that RRD committed two violations.

- Internal accounting controls. Securities Exchange Act Section 13(b)(2)(B) requires public companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance, among other things, that access to company assets is permitted only in accordance with management's general or specific authorization. RRD violated Section 13(b)(2)(B) in that its cybersecurity alert review and incident response policies and procedures failed to adequately establish a prioritization scheme and to provide clear guidance on procedures for responding to incidents. In addition, RRD failed to establish sufficient internal controls to oversee the MSSP's review and escalation of the alerts. As a result, during the 2021 ransomware incident, RRD's external and internal security personnel failed to adequately review these alerts and take adequate investigative and remedial measures.

- Disclosure controls. Securities Exchange Act Rule 13a-15 requires public companies to maintain disclosure controls and procedures designed to ensure that information required to be disclosed under the Act is recorded, processed, summarized, and reported within the required period. RRD violated Rule 13a-15 in that its cybersecurity procedures and controls were not designed to ensure that all relevant information relating to alerts and incidents was reported to RRD's disclosure decision-makers promptly and did not provide guidance on the personnel responsible for reporting such information to management. As a result, RRD failed to adequately assess information regarding the ransomware intrusion from a disclosure perspective.

Without admitting or denying the Commission's findings, RRD consented to an order requiring it to cease and desist from further violations of these provisions and to pay a $2.125 million civil penalty.

Statement of Commissioners Peirce and Uyeda

Commissioners Peirce and Uyeda issued a statement, Hey, look, there's a hoof clear! Statement on R.R. Donnelley & Sons, Co., critical of the internal accounting control charge in the RRD order, which they characterize as "break[ing] new ground with its expansive interpretation of what constitutes an asset under Section 13(b)(2)(B)(iii)." They examine the history of Section 13(b)(2) and conclude that the clause regarding access to assets only in accordance with management's authorization does not encompass all corporate assets, but only those that are the subject of corporate transactions.

> "While RRD's computer systems constitute an asset in the sense of being corporate property, computer systems are not the subject of corporate transactions. At most, computer systems process transactions in corporate assets, but the internal accounting controls are concerned with the use and disposition of the corporate assets themselves. The controls associated with the means of processing transactions in corporate assets are more appropriately categorized as administrative controls involving management decisions prior to authorizing transactions.
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> "* * * By treating RRD's computer systems as an asset subject to the internal accounting controls provision, the Commission's Order ignores the distinction between internal accounting controls and broader administrative controls. This distinction, however, is essential to understanding and upholding the proper limits of Section 13(b)(2)(B)'s requirements."

Commissioners Peirce and Uyeda see the RRD order as opening the door to the Commission dictating public company security practices. "As this proceeding illustrates, a broad interpretation of Section 13(b)(2)(B) to cover computer systems gives the Commission a hook to regulate public companies' cybersecurity practices. Any departure from what the Commission deems to be appropriate cybersecurity policies could be deemed an internal accounting controls violation."

Audit Committee Takeaways

The RRD case illustrates the broad potential scope of the internal accounting control provisions of the Foreign Corrupt Practices Act and the Commission's ability to use those provisions to regulate cybersecurity (and other) corporate administrative and managerial practices. The case is also a reminder of the Commission's increasing reliance on the disclosure controls requirement in Rule 13a-15 to bring enforcement actions in which it is dissatisfied with the speed at which a company considered a potential disclosure issue, even if it does not charge a disclosure violation. See The SEC is Zeroing in on Disclosure Controls, April 2023 Update.

Audit committees (particularly those with responsibility for cybersecurity oversight) may want to use the RRD case as an opportunity to discuss with the CISO or other relevant members of management whether the company's cybersecurity procedures could be viewed as having any of the same flaws as the SEC identified at RRD. For example, committees and management may want to review the oversight of any third-party service providers involved in evaluating and responding to cybersecurity incidents, including

lines of communication with company staff and decision protocols under which service providers operate. The adequacy of company staffing, relative to the number of alerts and threats the company receives, is also an issue that should be revisited periodically. Finally, it is important to ensure that the cybersecurity staff has a clear understanding of the criteria under which it should bring alerts or cyber incidents to the attention of those charged with making decisions regarding public disclosure.

In 2023 PCAOB Conversations with Audit Committee Chairs, the Economic and Audit Environments Were Top of Mind

Each year, the Public Company Accounting Oversight Board's Division of Registration and Inspections staff invites audit committee chairs of U.S. public companies selected for inspection to participate in "candid conversations in an informal setting." In 2023, 230 audit committee chairs accepted this invitation; 69 percent of these chairs had not previously engaged in such a dialogue with the PCAOB staff. Of the 230 chairs that spoke with the PCAOB in 2023, half had over 10 years of audit committee experience. Spotlight: 2023 Conversations With Audit Committee Chairs (2023 Conversations Report) presents the staff's "high-level observations and takeaways from those conversations." This is the fifth year the PCAOB has published a summary of the inspection staff's interactions with audit committee chairs. For last year's report, see No Surprises, Please. 2022 PCAOB Conversations with Audit Committee Chairs, October 2023 Update.

According to the 2023 Conversations Report, the PCAOB staff asked audit committee chairs what topics they discussed with their auditors regarding the current economic and audit workforce environments.

- Economic environment. Topics mentioned included interest rate fluctuations, inflation, supply-chain challenges (e.g., delays in or an inability to obtain necessary materials), and the economic impacts of the Russia-Ukraine war. The report states that these discussions "largely concerned the risks that these issues presented in the audit and how the audit team was addressing them."

- Audit workforce environment. The audit committee chairs were "pleased with their auditors' ability to retain a skilled workforce and with their use of technology" in the audit. In contrast, last year chairs worried that audit staff turnover may have impacted audit efficiency. See No Surprises, Please, above. However, consistent with the prior year, some audit committee chairs voiced concerns about the impact of remote and hybrid work environments on audit quality, although most of those interviewed were confident in the quality of audits notwithstanding remote or hybrid work elements. The chairs also noted that the prevalence of remote and hybrid work could adversely affect the long-term development of audit professionals.

The PCAOB staff also asked audit committee chairs to describe other topics they discussed with their auditors. In addition to communications required under the auditing standards, respondents identified such matters as "goodwill impairment, interest rates, internal control deficiencies, fraud, liquidity, cybersecurity, and auditor independence." They also noted that many of these discussions resulted in critical audit matters – CAMS -- in the auditors' reports. (One of the CAM criteria is that the matter was communicated or required to be communicated to the audit committee.) In general, the audit committee chairs that spoke to the PCAOB were satisfied with the level of their communications with their auditor and specifically with communications concerning CAMs.

Finally, the inspectors asked the audit committee chairs how their committee monitors the quality control systems and independence of their auditor. Interviewees cited discussion of "auditor presentations" and of the firm's PCAOB inspection report, including how the firm is remediating deficiencies. However, the 2023 Conversations Report notes that "some audit committees did not appear to spend the same amount of time on this review."

Audit Committee Takeaways

The 2023 Conversations Report provides insight into the current views and concerns of audit committee chairs. Committees may want to use it as an indicator of the issues that their peers are raising with their auditor. In addition, an audit committee chair contacted by the PCAOB staff as part of an inspection may want to review the 2023 Conversations Report and prior reports on these dialogues to prepare for the interview.

Two Studies Find that Restatements Rates Remain Low, Although Big R Restatements Have Begun to Increase

During June, Ideagen Audit Analytics (IAA) and the Center of Audit Quality (CAQ) each released studies of public company financial statement restatements. Both studies show that the number of restatements filed annually by SEC-reporting companies is at or near historic lows and broadly indicate that financial reporting quality, as measured by restatements, is high. However, the studies also suggest a note of caution. Both find that the share of Big R or reissuance restatements has recently risen. Also, the CAQ (which employed a different methodology than IAA to count restatements; see below) finds that the total number of restatements has begun to increase.

Although the two studies address many of the same topics, their specific findings are not directly comparable. The studies cover different periods (2004 to 2023 for IAA and 2013 to 2022 for the CAQ). Also, the IAA study includes all SEC filer restatements, while the CAQ disregards special purpose acquisition company (SPAC) restatements that were based on a 2021 SEC staff statement discussing the accounting treatment of SPAC warrants. In addition, even for years before 2021, the two studies differ on the number of restatements that occurred. However, the overall themes that emerge from both studies are similar.

Big R and Little R Restatements

There are two types of restatements -- Big R (reissuance or Form 8-K Item 4.02) restatements and little r (revision) restatements. A Big R restatement occurs when a company determines that users can no longer rely on previously issued financial statements due to a material error in those statements. The company must disclose that determination by filing SEC Form 8-K within four business days and file corrected financial statements as promptly as possible. In contrast, little r restatements result from errors in previously issued financial statements that are determined to be immaterial but that have a cumulative effect that would be material to the current period, either if left uncorrected or if corrected in the current period. Little r restatements do not require a Form 8-K filing, and the company can correct the error in the current period's comparative financial statements by restating the prior period information.

Little r restatements attract less public attention (and securities market impact) than Big R restatements. In 2022, the SEC's then-acting Chief Accountant warned that companies and auditors may be biased in favor of little r restatements and urged greater objectivity in evaluating whether an error is material. See SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions, March 2022 Update.

Ideagen Audit Analytics

On June 24, IAA released Financial Restatements – IAA's annual report on trends in financial restatements. (For a summary of the prior IAA report and a discussion of the 2021 spike in restatements due to SPACs, see After a SPAC-Driven Surge, Restatements Are Returning to "Normal", November-December 2023 Update). IAA finds that restatements decreased by approximately 6 percent, from 458 in 2022 to 430 in 2023, "plateauing at the levels seen in the years just prior to 2021." The number of companies that filed restatements also remained relatively stable, falling from 424 to 401 between 2022 and 2023.

Highlights of IAA's report include:

- Restatement period. In 2023, the average period covered by restatements increased from 393 days in 2022 to 438 days, slightly shorter than the average restatement period prior to the 2021 SPAC restatement spike. IAA observes that "Lengthy restatement periods (greater than 360 days) indicate that an annual report, as well as quarter(s), were restated. An annual report restatement suggests that not only management but likely an independent accounting firm failed to identify a material error or omission."

- Number of accounting issues. The average number of accounting issues per restatement has risen in each of the last three years. In 2023, the average was approximately 1.5, and restatements with only one issue represented 54 percent of restatements. In 2020, 70 percent were one-issue restatements.

- Nature of accounting issues. Debt/equity accounting was the issue most frequently involved in restatements in 2023; this has also been the most frequent issue for the 20 years from 2004 to 2023. (Most SPAC restatements would be classified as based on debt/equity accounting errors.) The percentage of total restatements disclosing debt/equity errors in 2023 was 21 percent. The other top five issues in 2023 were revenue recognition (16 percent); expense recording (13 percent); liabilities, payables, reserves, and accrual estimates (12 percent); cash flow statement classification (10 percent); and tax expense/benefit/deferral (10 percent).

- Restatement type. In 2023, the total number of Big R or reissuance restatements increased to 209 from 191 in 2022, representing 52 percent of all domestic filer restatements; in 2022, Big R restatements were 44 percent of the total. Conversely, little r or revision restatements fell to 194 or 48 percent of the total, down from 239 in 2022.

- Income impact. In 2023, 52 percent of restatements disclosed an impact on net income or retained earnings. The net income impact was negative for 68 percent of these companies and positive for 32 percent. (Negative income impact restatements occur when the original financials overstated income.) During the past 20 years, negative restatements were at least 66 percent of all restatements that had an income impact. In 2023, the average amount of restatement negative impact on net income increased 27 percent to nearly $16 million. For the 71 restatements that had a positive net income effect, the average increase in income was $14.5 million. In 2022, the average negative restatement impact on net income was $11.6 million, while the average positive net income effect was $10.5 million.

- Filer type. As has been the case every year in the IAA study, smaller public companies filed most of the 2023 restatements. Nonaccelerated filers accounted for 215 restatements (62 percent of total restatements). (In 2022, non-accelerated filers made 245 restatements--54 percent of total restatements.) At the other end of the size spectrum, large accelerated filers accounted for 75 restatements (21 percent of the total). Accelerated filers (the size tier between non-accelerated filers and large accelerated filers) submitted 56 restatements (16 percent of the total).

- Filer industry. Companies in the technology industry accounted for 18 percent of 2023 restatements (76 filings). The trade and services industry sector was second, with approximately 15 percent of restatements. Energy and transportation companies disclosed the fewest restatements in 2023, with only 31 restatements, representing 7 percent of all restatements.

Center for Audit Quality

In late June, the CAQ also released a report on restatements. Financial Restatement Trends in the United States: 2013 – 2022 focuses on restatements announced from January 1, 2013, through December 31, 2022 (the sample period). The introduction to the CAQ's report lists eight key findings:

- Restatements have declined overall with 4.02 [Big R] restatements exhibiting the most consistent decline throughout the sample period. According to the online summary of its report, the CAQ found "a steady decline in the total number of restatements * * * until the final year of the sample period." There were 858 restatements in 2013, the first year of the study period, and the year with the highest annual number. In 2021, there were 362 restatements, the lowest annual number. However, total restatements rose to 402 in 2022. The percentage of Big R restatements declined from 28 percent in 2013 to 18 percent in 2021. In 2022, that trend reversed, and Big R restatements grew to 38 percent of total restatements – the highest Big R share during the sample period.

- Expenses, specifically the misapplication of reporting rules for accruals, reserves, and estimates, are cited most frequently in restatement announcements. Thirty percent of restatement announcements referenced inappropriate accounting for accruals, reserves, and estimates. The second most common category of accounting issues was the misapplication of accounting standards for financing activities (e.g., accounting for the measurement of debt, quasi-debt, equity securities, and derivatives). Twenty percent of restatement announcements cited these issues. (As noted above, the CAQ excluded restatements based on the SEC's SPAC warrants guidance, which impacted debt/equity accounting.)

- Fraud is implicated in 3% of the total population of restatements and 7% of 4.02 [Big R] restatements overall. Approximately three percent of all restatements during the sample period were associated with fraud, as defined in the CAQ's study. For the Big R restatement subset, seven percent involved fraud during the ten years studied. In 2017, eleven of 109 Big R restatements (ten percent) involved fraud, but over the second half of the sample period (2018-2022), fraud dropped to only three percent (five of 153 Big R restatements).

- The industries contributing the most to the population of restatements are: 1) Financial, Banks & Insurance, 2) Healthcare & Pharmaceuticals, and 3) Computer & Software. Together, companies in the Financial, Banks & Insurance; Healthcare & Pharmaceuticals; and Computer & Software industries accounted for 45 percent of all restatements during the sample period. Healthcare & Pharmaceutical increased from eleven percent of restatements in 2013 and 2014 to 20 percent in 2021. Conversely, restatements by Energy, Mining & Chemicals companies decreased from 13 percent of all restatements in 2013 to only four percent in 2022. The industries with the lowest percentage of restatement filers during the sample period were Utilities & Water and Telecom & Broadcast; each accounted for three percent of total restatements.

- Companies that have announced restatements over the sample period are relatively small, in terms of average assets, and are increasingly traded on the NASDAQ. When compared to the population of U.S. companies covered by Compustat, restatement companies were smaller, as measured by average assets, in eight of the 10 years studied. Overall, restatement companies had average assets of $13 billion, compared to an average of $18 billion for all Compustat companies. The subset of companies announcing Big R restatements was even smaller, with average assets of $2.3 billion.

- Public companies that have announced restatements are more likely to have ineffective internal control over financial reporting (ICFR) based on management's assessment. In each sample period year, management at 80 percent of non-restating companies reported that the company had effective ICFR. In contrast, for restating companies, approximately 70 percent of management reports disclosed effective ICFR each year. For issuers that announced Big R restatements, about 55 percent of managements reported that ICFR was effective.

- Ineffective ICFR reports are generally issued after a restatement is announced, i.e., ICFR reports are not predictive of restatements. In advance of little r restatements, management reported a material ICFR weakness between 8 percent and 17 percent of the time. In the three years before a Big R restatement, restating companies reported at least one accounting issue underlying the subsequent restatement between 8 percent and 26 percent of the time. The CAQ report concludes

that "regardless of the materiality of the restatement, ICFR reports do not appear to be predictive of restatement events."

- Early evidence suggests CAMs do not provide information about restatement risk. The average number of critical audit matters (CAMs) per audit opinion for Big R restatement companies is only slightly higher than that of non-restating companies. Between 2019 and 2022, the years that CAM reporting has been in effect, restating companies had only three percent more CAMs than companies that did not restate. The CAQ's online summary concludes: "Based on the subset of restatements announced over the four years CAM reporting has been in effect (2019 to 2022), critical audit matters do not contribute to the public's understanding of restatement risk."

Audit Committee Takeaways

Both studies make clear that the long-term trend in restatements is down. The investments that companies have made in strengthening their internal control over financial reporting in the wake of the Sarbanes-Oxley Act seem to have paid off in less frequent material financial statement errors. Restatements today are concentrated in smaller public companies which typically lack the reporting and internal control resources of larger businesses.

The uptick in restatements in 2022 that the CAQ – but not IAA – reports is difficult to evaluate. It may be an artifact of the differences in methodology between the CAQ and IAA (see above). Even if the uptick is real, it is, as the CAQ recognizes, "too early to tell if the increase in restatements toward the end of the sample period is a true inflection point or simply a brief disruption of the previous downward trend." The 2022 increase in Big R restatements, which both studies report, is likely the result of SEC Chief Accountant Paul Munter's warning in March 2022 that the SEC staff believes companies and their advisors have been taking an unduly narrow view of materiality and that many errors treated as immaterial should have triggered a Big R restatement. See SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions, above. Mr. Munter's statement may also have led to an increase in total restatements.

As the Update has suggested in the past, audit committees confronted with errors in prior financial reporting and questions concerning whether and how to restate should make sure they fully understand management's materiality analysis and the reasons its choice between a Big R or little r restatement. The SEC may inquire into the audit committee's role in cases where it disagrees with a company's decisions regarding the handling of a financial statement error. Audit committees should be prepared to show that they provided active oversight.

CAQ's Annual Analysis Finds that More Companies are Using Their Auditor for ESG Assurance

The Center for Audit Quality (CAQ) has posted on its website S&P 500 ESG Reporting and Assurance Analysis, the annual update of its study of S&P 500 company environmental, social, and governance (ESG) disclosures. The CAQ found that 98 percent of S&P 500 companies publicly disclosed detailed ESG information in 2022, essentially unchanged from 99 percent in 2021. Seventy percent of S&P 500 companies that reported 2022 ESG information also obtained third-party assurance over at least some of that information, compared to 65 percent of ESG reporters that obtained assurance in 2021. About one-fifth (21 percent) of the companies that obtained assurance in 2022 retained a public company auditor – usually the same firm that audited their financial statements -- to provide ESG assurance, up from 18 percent in 2021.

To compile the information in its ESG reporting study, the CAQ reviewed S&P 500 company websites, CDP Climate Change Questionnaires, and third-party assurance or verification reports for reporting periods ending in 2022. (The analysis does not include information disclosed in SEC filings.) The CAQ found that most S&P 500 companies have an ESG page on their investor relations website where a standalone ESG report is available as a pdf. However, some companies issue ESG information in multiple reports such as

SASB, GRI, or TCFD indexes or reports. Other companies provide an ESG interface web portal to disclose ESG information.

Below is a summary of some of the highlights of the 2024 CAQ updated study.

ESG Reporting Frameworks and Standards

The CAQ tracked references to four ESG disclosure frameworks or standards: the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the Task Force on Climate Change (TCFD), and the Integrated Reporting Framework (IR). (The SASB standards are now under the oversight of the International Sustainability Standards Board (ISSB), which began to issue standards in late 2022.)

A substantial majority of S&P 500 companies referenced at least one of these reporting frameworks or standards in their 2022 ESG disclosure. Ten companies referred to all four, and 304 companies referred to three of the four. Twelve companies reported ESG information but did not reference any reporting framework. The most frequently referenced ESG disclosure framework or standard in 2022 was SASB (459 companies), followed by TCFD (411 companies), GRI (358 companies), and IR (13 companies).

Assurance or Verification

In 2022, 340 S&P 500 companies disclosed receiving some form of assurance or verification over certain of their ESG metrics, a 6 percent increase from the 320 companies that obtained assurance in 2021. Seventy percent of the companies that reported ESG information in 2022 obtained assurance over some part of that information.

Of the companies that obtained assurance in 2022, 74 utilized public company auditors, and 277 obtained assurance from other types of providers. The percentage of companies that engaged a public company auditor to perform their assurance engagements rose from 18 percent in 2021 to 21 percent in 2022. (Some companies used both a public company auditor and other providers.) Ninety-five percent of the companies that obtained assurance from a public company auditor in 2022 used the firm that performed their financial statement audit, up from 90 percent in 2021.

Assurance by Public Company Auditors

For those S&P 500 companies that used a public company auditor to provide ESG assurance, the information covered, standards used, and level of assurance varied.

- Thirty-nine companies obtained assurance over greenhouse gas (GHG) emissions and between one and three additional ESG metrics. (e.g., water, energy, or waste metrics), compared to 31 companies in 2021. Fourteen companies obtained assurance over GHG emissions only, while 21 obtained assurance over GHG emissions and more than three other metrics.

- U.S. public company auditors used the American Institute of Certified Public Accountants (AICPA) attestation standards to perform their assurance engagements, while non-U.S. auditors used either the International Auditing and Assurance Standards Board (IAASB) standards or the national assurance standard applicable in their country. One U.S. public company auditor used both the AICPA attestation standards and the IAASB assurance standards to perform an assurance engagement. In three cases, the assurance standard used could not be determined from the company's documentation.

- Seventy-nine of the 2022 assurance reports issued by public company auditors provided only limited assurance on the ESG disclosures they reviewed. Eleven of the public company auditor assurance reports provided reasonable assurance – the same level of assurance as is required in financial statement audits filed with the SEC. (These numbers exceed the number of companies

that obtained assurance from public company auditors because some companies had multiple assurance engagements performed.)

Assurance or Verification by Other Providers

For those S&P 500 companies that used ESG assurance providers that were not public company auditors, there was similar variation in the information covered, standards used, and level of assurance.

- Companies that sought assurance over their GHG emissions tended to utilize non-auditor assurance providers. In 2022, the CAQ found 108 instances in which such providers issued reports on GHG emissions only. In 107 other cases, companies obtained assurance over GHG emissions and between one and three additional ESG metrics from a non-auditor. Sixty-two obtained assurance over GHG emissions and more than three other metrics from a non-auditor.

- Non-auditor ESG assurance providers used one of three sets of standards in performing their work: International Standardization Organization (ISO) standards, IAASB standards, or AccountAbility's AA1000 assurance standard. The ISOs were the most popular. The CAQ found 242 instances in which non-auditors used the ISOs, compared to 192 for the IAASB's standards and 22 for AA 1000.

- Providers that were not public company auditors used three terms to describe the level of assurance they provided, "reasonable assurance" (51 instances), "limited assurance" (342 instances), and "moderate assurance" (20 instances). In three cases, the level of assurance provided could not be determined from the company's documentation. The 51 reports in which non-auditors provided reasonable assurance on ESG disclosures during 2022 were almost double the 26 non-auditor reasonable assurance reports in 2021. (As in the case of auditor assurance reports, the report numbers for non-auditor assurance exceed the number of companies that obtained assurance from non-auditors because some companies had multiple assurance engagements performed.)

GHG Emissions Information

GHG emissions are the ESG metric for which companies most frequently obtain assurance or verification. In 2022, 337 of the 340 S&P 500 companies that obtained any type of ESG assurance obtained assurance over their GHG emissions -- 19 more companies than obtained assurance or verification over their GHG emissions in 2021. Of those 337 companies, 272 obtained assurance over Scope 1, 2, and 3 emissions, while 63 obtained assurance over only Scope 1 and 2 emissions. Two companies obtained assurance over only Scope 1 emissions. (Scope 1 GHG emissions are direct emissions from sources owned or controlled by an organization. Scope 2 GHG emissions are emissions associated with purchased electricity, steam, heat, or cooling. Scope 3 GHG emissions include all other emissions that occur in the upstream and downstream activities of an organization, such as those from the activities of suppliers or customers' use of the organization's products).

Other ESG Topics Subject to Assurance or Verification

In addition to GHG emissions, S&P 500 companies obtained assurance over a wide range of ESG metrics in 2022. Excluding "other," the top five assurance topics were energy (164 companies), water (141 companies), waste (91 companies), employee health and safety (56 companies), and human capital (50 companies).

Net-Zero or Carbon-Neutral Commitments

In 2022, 293 S&P 500 companies disclosed a net-zero and/or carbon-neutral commitment – a nine percent increase over the 268 companies that disclosed such a commitment in 2021. The most common commitment date was 2050, the same as in 2021.

Audit Committee Takeaways

The CAQ's findings are broadly consistent with those of other studies of ESG reporting. See Large Companies Worldwide Continue to Expand Their ESG Disclosure and Assurance, February 2024 Update. In brief, ESG reporting is almost universal among the largest companies, and third-party assurance over ESG disclosure is becoming the norm. While non-auditors dominate the ESG assurance market, public company auditors are slowly increasing their share.

The ESG disclosure revolution has many implications for audit committees. One of the themes of the Update has been that ESG disclosures are often not subject to the same controls and procedures as traditional financial disclosures. This creates risks that the sustainability report may be inconsistent with other company disclosures or that the accuracy of the information presented may not be verifiable. These risks should be of concern to audit committees because of their responsibility for disclosure oversight and for oversight of related controls and procedures.

The CAQ's report highlights another audit committee issue. Most companies that obtain assurance over GHG emissions or other ESG disclosures opt for limited, rather than reasonable, assurance. This is the case regardless of whether a public company auditor or some other type of professional provides the assurance. A limited assurance engagement results only in a statement that the assurance provider performed certain procedures and that nothing came to the provider's attention that would indicate the disclosure is inaccurate. While the cost of obtaining limited assurance is typically lower than the cost of reasonable assurance, the benefits are also lower. Investors may not understand what limited assurance engagements entail, and there is a significant risk that they will overestimate the value of limited assurance. See Sustainability Assurance is the New Expectations Gap, May-June 2024 Update. Audit committees should consider the benefits of obtaining reasonable assurance over the company's ESG disclosures. Committees that opt for limited assurance should ensure that the disclosure clearly explains to users the meaning of that assurance level.

On the Update Radar: Things in Brief

PCAOB Discloses Three 2019 Criticisms of EY's Quality Control. On July 11, the Public Company Accounting Oversight Board released portions of the previously nonpublic section of Ernst & Young's 2019 inspection report. This action indicates that, in the Board's view, the firm did not satisfactorily address the quality control issues discussed in those portions of the inspection report within 12 months of the report date. Criticisms of a firm's quality control system appear in Part II of a firm's inspection report, and, under the Sarbanes-Oxley Act, Part II is nonpublic when the report is issued. If the firm does not satisfactorily address a quality control criticism within 12 months, the Board makes the criticism public.

The now-public quality control criticisms in EY's 2019 inspection report relate to three topics:

- Supervision of the Audit. The 2019 inspection report states that EY's system of quality control does not provide reasonable assurance that supervisory activities, including engagement partner reviews of audit work, will meet the requirements of the Board's auditing standards. This finding is based on the PCAOB inspection team's identification of deficiencies that the engagement partner should have identified and appropriately addressed in eleven audits. In two of these audits, the engagement team had identified a significant risk, including in one case a fraud risk, in the area in which the inspection team found a deficiency.

- Internal Inspection Program. The 2019 inspection report found that EY's system of quality control related to monitoring did not provide reasonable assurance that the firm's internal inspection program is suitably designed and is being effectively applied. The PCAOB's inspection staff reviewed five audits that had also been inspected under the firm's internal

inspection program. In two of these audits, the same areas were reviewed, and the PCAOB identified deficiencies that the internal inspectors failed to detect.

- Policies for Financial Holdings Disclosures. The 2019 inspection report also found that EY's system of quality control did not provide reasonable assurance that KPMG personnel would comply with the firm's policies and procedures concerning independence-related regulatory requirements. EY conducts periodic sampling reviews to determine whether firm personnel are complying with internal requirements that they report certain financial relationships to the firm. In the reviews EY conducted during the period ended March 31, 2019, the firm found that 32 percent of the managers included in its sample had not reported financial relationships that were required to be reported under firm policies. The inspection report states: "These high rates of non-compliance with the firm's policies, which are designed to provide compliance with applicable independence regulatory requirements, provide cause for concern, especially considering that these individuals are required to certify on a quarterly basis that they have complied with the firm's independence policies and procedures."

  This is the second consecutive year for which the PCAOB has found that EY failed to remedy this quality control deficiency. On October 17, 2022, the PCAOB made public the same finding which had also appeared in Part II of EY's 2018 inspection report. See PCAOB Gives EY a Partial Fail on 2018 Remediation, September-October 2022 Update. In both cases, there is no indication that the firm violated the independence requirements.

The date of EY's 2019 inspection report is December 17, 2020. Therefore, release of these portions of the inspection report indicates that EY failed to persuade the PCAOB that, as of December 17, 2021, it had satisfactorily remediated these quality control deficiencies.

Audit committees of EY clients may want to discuss with their engagement partner how the firm is addressing these matters, changes it has made since the PCAOB's determination that the deficiencies had not been remediated, and how the company's audit might be affected. In particular, the criticism of audit supervision raises issues that could potentially impact many audits.

FASB Moves Ahead with Requirement to Disaggregate Expenses. On June 26, the Financial Accounting Standards Board voted to require public companies (and other SEC filers) to disaggregate certain income statement expense line items by disclosing their component expense categories, such as inventory purchases, employee compensation, and depreciation. While the face of the income statement will not change, this additional information will be required in financial statement footnotes. Investors have long sought this type of expense breakdown. However, the new disclosures may be costly for companies and may require accounting systems changes.

FASB published the exposure draft of the income statement disaggregation proposal on July 31, 2023. The exposure draft states that investors have observed that more detailed information about expenses is "critically important in understanding an entity's performance, assessing an entity's prospects for future cash flows, and comparing an entity's performance both over time and with that of other entities" and have specifically asked for more granular information about cost of sales and selling, general, and administrative expenses. The proposed Accounting Standards Update (ASU) in the exposure draft responded to this request.

The proposed ASU would require detailed disclosure, in the notes to financial statements, of specified categories of expenses underlying certain expense captions in the income statement. These expense categories, as modified during the Board's deliberations on June 26, are:

- Purchase of inventory.

- Employee compensation.

- Depreciation.

- Intangible asset amortization.

- Depletion (depreciation, depletion, and amortization recognized as part of oil- and gas-producing activities).

Any expense caption on the face of the income statement that contains any of the five expense categories on this list would have to be disaggregated. The breakdown would be in tabular format and presented in the footnotes to annual and interim financial statements.

At the June 26 meeting, FASB instructed its staff to prepare a final ASU implementing the decision to require disaggregation. FASB's website indicates that the Board is expected to approve the final ASU in the fourth quarter of 2024. Disaggregation will be effective for fiscal years beginning after December 15, 2026, and for interim periods within fiscal years beginning after December 15, 2027. Early adoption will be permitted. See Project Summary, Disaggregation—Income Statement Expenses on FASB's website.

Audit committees may want to discuss with financial reporting management what changes in the company's accounting systems and processes will be necessary to implement the ASU, the cost of making those changes, and the timeline. Management and audit committees should of course also consider the impact of this new requirement on the company's internal control over financial reporting. For a more detailed discussion of FASB's June 26 deliberations on this issue, see Deloitte's Heads Up publication, FASB Directs Staff to Draft Final Standard on Disaggregation of Income Statement Expenses (DISE).

The PCAOB Isn't Slowing Down. At its public meeting on June 12, the Public Company Accounting Oversight Board adopted a previously proposed rule change affecting auditor liability and changes to its auditing standards regarding the use of technology in audits. The Board also proposed replacing the current auditing standard on substantive analytical procedures.

- Contributory Liability. The Board adopted amendments to PCAOB Rule 3502, Responsibility Not to Contribute to Violations. Rule 3502 governs the liability in PCAOB enforcement actions of an associated person of a registered public accounting firm who directly and substantially contributes to the firm's violations of the laws, rules, and standards that the PCAOB enforces. Previously, such a person would have to have acted at least recklessly to be charged. The Board lowered the liability threshold to negligence.

- Designing and Performing Audit Procedures that Involve Technology-Assisted Analysis of Information in Electronic Form. The Board adopted amendments to AS 1105, Audit Evidence, and to AS 2301, The Auditor's Responses to the Risks of Material Misstatement, and conforming amendments to other auditing standards. These amendments address the use of technology in audits, including designing and performing audit procedures that involve analyzing information in electronic form with technology-based tools. For example, according to the PCAOB's press release, these amendments clarify that technology-assisted analysis can be used for such purposes as analyzing "a population of transactions as part of identifying risks of material misstatement or to perform, after identifying such risks, substantive procedures on all items within a population" and identifying "transactions and balances that meet certain criteria and warrant further investigation."

- Substantive Analytical Procedures. The Board issued for public comment a proposal to replace AS 2305, Substantive Analytical Procedures, with a new standard. Substantive analytical procedures involve comparing an amount recorded by the company to an expectation of that amount developed by the auditor to determine whether there is a misstatement. According to the PCAOB's press release, the proposal is intended to

"strengthen and clarify the auditor's responsibilities when designing and performing substantive analytical procedures" and increase "the likelihood that the auditor will obtain relevant and reliable audit evidence." Among other things, the proposal would enhance the requirements for determining "whether the relationships to be used in the substantive analytical procedure are sufficiently plausible and predictable," preclude auditors from "develop[ing] their expectation using the company's amount or information that is based on the company's amount (so-called circular auditing)," and "strengthen and clarify existing requirements for determining when the difference between the auditor's expectation and the company's amount requires further evaluation." The comment deadline on this proposal is August 12.

Audit committees may want to ask their engagement partner whether the technology-related auditing standard changes or the substantive analytical procedures proposal will have any impact on the company's audit.

What's in Store for the Rest of 2024? SEC Reg Flex Agenda Update. On July 8, OMB's Office of Information and Regulatory Affairs released the federal government's Spring 2024 Unified Agenda of Regulatory and Deregulatory Actions, a listing of the rulemaking activities that federal administrative agencies plan to undertake. The SEC's contribution to this list, which is referred to as the agency's Reg Flex Agenda, includes 34 rulemaking projects. Below is the predicted timing regarding four disclosure-related projects of interest to audit committees.

- Human Capital Management Disclosure. The Division of Corporation Finance is considering recommending that the Commission propose rule amendments to enhance public company disclosures regarding human capital management. Target date for notice of proposed rulemaking: October 2024. (The target date for this proposal has been pushed back several times. See SEC Reg Flex Agenda Update – April May be a Busy Month, January 2023 Update.)

- Corporate Board Diversity. The Division of Corporation Finance is considering recommending that the Commission propose rule amendments to enhance public company disclosures about the diversity of board members and nominees. Target date for notice of proposed rulemaking: April 2025.

- Disclosure of Payments by Resource Extraction Issuers. The Division of Corporation Finance is considering recommending that the Commission review the rules under Section 1504 of the Dodd-Frank Act to determine if additional amendments might be appropriate. These rules require SEC-reporting companies that engage in resource extraction to disclose payments made to the U.S. federal government or foreign governments for the commercial development of oil, natural gas, or minerals. The current resource extraction rules became effective in 2021, following a successful legal challenge to the first version and Congressional action to invalidate the second version. See If at First You Don't Succeed: SEC Adopts Revised Resource Extraction Disclosure Rule, December 2020 Update. Target date for notice of proposed rulemaking: April 2025.

- Incentive-Based Compensation Arrangements. The Division of Corporation Finance is considering recommending that the Commission, together with the banking regulatory agencies, repropose regulations and guidelines with respect to incentive-based compensation practices at certain financial institutions that have $1 billion or more in total assets. These rules, which are required by Section 956 of the Dodd Frank Act, were originally proposed in 2011 and reproposed in 2016. Target date for notice of proposed rulemaking: October 2024.

Although the target action dates are not mandatory (and are frequently missed), the Reg Flex Agenda provides insight into the SEC Chair's regulatory priorities.

Why is Your Audit Fee So High? Perhaps Management is Telling Investors it's Honest. A research paper published in the Journal of Business Ethics finds that companies that use "trust words," such as "character," "ethics," and "honest," in the MD&A section of their SEC Form 10-K "have lower information content" in their earnings announcements than firms that do not use trust words. In Can We Trust the Trust Words in 10-Ks?, Myojung Cho (Lubin School of Business, Pace University), Gopal V. Krishnan (Department of Accountancy, Bentley University), and Hyunkwon Cho (SKK Business School, Sungkyunkwan University) also find that "firms using trust words are more likely to receive a comment letter from the SEC, pay higher audit fees, and have lower corporate social responsibility scores." In short, the use of trust words in the 10-K is "associated with negative outcomes, and trust words are an inverse measure of trust."

The authors counted the number of times 21 trust words appeared in the MD&A section of 3,595 reporting company Form 10-Ks from 1995 to 2018. The 21 words were: accountability, character, ethics, ethical, ethically, fairness, honest, honesty, integrity, respect, respected, respectful, responsible, responsibility, responsibilities, transparency, trust, trusted, truth, virtue, and virtues. About half of the sample used the trust words and the mean value of the number of trust words used was 1.8.

Study findings include:

- Market reaction to earnings announcements is lower for companies using trust words than for those that do not. This suggests "that the use of trust words is negatively associated with the information content of earnings."

- "Lower ability managers" are more likely to use trust words.

- Companies that use trust words are more likely to receive comment letters from the SEC, and these comment letters are likely to raise accounting issues.

- Companies using trust words tend to pay higher audit fees. "Our result suggests that auditors assess higher audit risk or/and exert greater audit effort for firms using trust words in 10-Ks., suggesting higher audit risk for these firms."

- There is a negative relation between the use of trust words and corporate social responsibility scores.

The overall conclusion of the paper is that "firms using trust words tend to invite more scrutiny from investors, the SEC, auditors, and others. Thus, the use of trust words seems to reflect the opposite of a firm's culture of trust * * *."

Based on their findings, the authors offer advice to investors, corporate management, and regulators:

> "Our results suggest that investors need to be mindful of firms using trust words and not fall prey to such unscrupulous behavior. To managers, our results indicate that impression management via trust words may do more harm than good. Thus, managers need to reconsider using trust words unless they plan to honor the sentiment. Finally, the SEC and the PCAOB could use trust word disclosures to flag registrants for further examination."

The overuse of trust words may be a symptom of underlying weaknesses in corporate culture. In reviewing MD&A and other company disclosures, audit committees may want to be alert to these words and consider whether they describe tangible corporate policies or are simply an attempt to create a favorable impression untethered to reality.

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. 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

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An index to titles and topics in the Update beginning with No. 39 (July 2017) is available here.

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