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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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SEC Charges Audit Committee Chair with Fraud

The SEC seldom charges audit committee members in cases alleging company accounting or disclosure violations. However, SEC v. Joshua A. Weiss and Grainne M. Coen, is the exception that proves the rule. In that action, filed in the Southern District of New York on September 16, the SEC alleges that Grainne M. Coen, former chair of the audit committee of Kubient, Inc., engaged in fraud, made false statements to the company's auditor, and aided and abetted false SEC filings in connection with the overstatement of the company's revenue. The Commission is seeking an injunction against future violations, civil money penalties, and a bar against Ms. Coen's serving as an officer or director of a public company. The complaint also charges Joshua Weiss, Kubient's former Chief Financial Officer, with participating in the

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scheme to misstate revenue. The Commission filed a separate action against Paul D. Roberts, Kubient's former Chair, CEO, and president. Roberts pleaded guilty to securities fraud in a related criminal case.

The complaint alleges that, before Kubient's initial public offering in August 2020, Roberts caused Kubient to fraudulently inflate its revenue to demonstrate that Kubient Artificial Intelligence ("KAI"), a product that Kubient marketed as able to detect fraud during digital advertising auctions, was commercially successful. According to the complaint, KAI had in fact not generated any meaningful revenue and Roberts "fabricated fraud analyses that he claimed were prepared by KAI for two customers as part of beta tests despite Kubient not obtaining the customers' data to analyze." Further, "Kubient claimed it received over $1.3 million in 'revenue' for analyzing the customers' data when, in fact, Kubient never performed the analyses to generate revenue." The $1.3 million represented about 94 percent of Kubient's reported revenue at the time of the IPO and over 74 percent of its total 2020 revenue.

Later in 2020, Kubient made a secondary public offering. On the day of that offering, Mr. Weiss and Ms. Coen allegedly learned that the beta tests had not been performed. The SEC claims that, despite discovering this fact, "neither [Weiss nor Coen] investigated the circumstances of Kubient recording the $1.3 million in revenue, and instead both continued the CEO-initiated scheme. They did not correct the public statements to investors about the tests and the associated revenue, and indeed made additional false statements in Kubient's later public filings."

Some of the specific acts that Ms. Coen, the audit committee chair, is alleged to have taken in furtherance of the fraud include:

- An employee ("Employee 3) had informed Ms. Coen that the data scanned as part of the KAI beta test had not come from the customers represented as its source. Nonetheless, "Coen did not take meaningful steps to understand the circumstances underlying Employee 3's discovery, did not confirm or try to understand whether the Customers provided any data to Kubient, how Kubient could have analyzed the wrong data, or whether Kubient ever provided a KAI fraud analysis to the Customers."

- Ms. Coen did not inform Kubient's independent auditor of, and the auditor did not attend, the audit committee meeting at which the committee discussed Employee 3's concerns even although Ms. Coen invited the auditor to attend other committee meetings during the relevant period. No minutes were prepared for that meeting, although minutes were prepared for other audit committee meetings.

- During the independent auditor's 2020 year-end audit interview, Ms. Coen orally advised the auditor, in response to questions, that she was not aware of any tips or complaints regarding the company's financial reporting, that she and the audit committee did not have knowledge of any fraud or suspected fraud affecting the company, and that she was not aware of any other matters relevant to the audit. In light of Employee 3's concerns about the source of the customer information used in the beta testing, The Commission alleges that these statements were false and misleading.

- Coen signed various SEC filings that contained false and misleading statements about the $1.3 million in KAI revenue and about the success of the KAI beta test.

Audit Committee Takeaways

This case is unlike most SEC enforcement actions that involve reporting violations in that, according to the Commission's allegations, the audit committee chair was aware of information that, at minimum, raised serious questions about the accuracy of the company's disclosures. Moreover, Ms. Coen was not merely passive in the face of information that called the company's revenue into question. She took affirmative steps to prevent the company's auditor from learning that an employee – in effect, a whistleblower – had brought to her attention facts that, if true, undermined the company's accounting. Further, she continued

to sign SEC filings that reflected the revenue. In short, based on the Commission's allegations, Ms. Coen appears to have made herself a participant in the fraud.

In the press release announcing the filing of its actions, Jason J. Burt, Director of the SEC's Denver Regional Office said: "This case should send an important signal to gatekeepers like CFOs and audit committee members that the SEC and the investing public expect responsible behavior when critical issues are brought to their attention." Audit committees should of course follow this advice. While cases against audit committee members are likely to remain rare, the SEC can be expected to act aggressively when an audit committee member ignores obvious red flags and takes steps to conceal them from the company's auditor.

PCAOB Spotlight on Independence Deficiencies Includes Advice for Audit Committees

The staff of the Public Company Accounting Oversight Board has issued Spotlight: Inspection Observations Related to Auditor Independence (September 2024). The Spotlight highlights PCAOB inspection observations on independence and describes common deficiencies that resulted in the issuance of inspection comments. The Spotlight also discusses good practices and reminders for audit firm compliance with the SEC and PCAOB independence standards and rules. The report concludes with suggestions regarding audit committee oversight of auditor independence.

Inspection Observations Related To Independence

The Spotlight discusses eleven types of independence deficiencies that the PCAOB staff observed during the 2021-2023 inspection cycles. These eleven independence deficiency areas are:

- Audit committee pre-approval of services/communication with the audit committee.
- Independence representations/ personal independence compliance testing.
- Prohibited financial relationships.
- Permissibility of non-audit and tax services.
- Business and employment relationships.
- Indemnification clauses.
- Independence policies.
- Partner rotation.
- Restricted entity list.
- Contingent fees.
- Mutual interest/unpaid fees.

For each deficiency area, the report presents the percentage of independence-related comment forms issued concerning the deficiency, summarizes the applicable SEC or PCAOB independence rule or standard, and provides inspection observations regarding the deficiency.

Issues in the first category, audit committee pre-approval of services and communication with the audit committee, were the most frequent source of independence-related inspection comments. In 2023, 43 percent of independence-related comments related to that issue. Inspection observations included:

- The auditor was unable to provide the inspectors with evidence that audit committee pre-approval had occurred before the audit firm commenced audit, non-audit, and/or tax services (or that the pre-approval requirement had been waived).

- Before its initial audit engagement, the auditor did not describe, in writing, to the potential audit client's audit committee the scope of non-audit services it had provided that might reasonably be viewed as bearing on the audit firm's independence.

- The auditor did not describe, in writing, annually to the audit client's audit committee non-audit services it provided that might reasonably be viewed as bearing on the audit firm's independence. In some cases, the audit firm's communication to the audit committee was inaccurate (e.g., did not include ownership and sale of shares of the audit client by an audit firm covered person).

Good Practices and Reminders For Auditors

The Spotlight describes some practices the inspection staff believes contribute to compliance with the independence requirements. These "good practices" include using technology-based tools to promote early detection of potential independence violations (e.g., frequent comparison of audit personnel time charges to financial holdings or automated access to audit personnel brokerage accounts to compare financial holdings and transactions to the firm's restricted list). Other good practices include more frequent (e.g., quarterly) independence compliance representations from audit personnel and use of engagement letter templates for clients subject to SEC and PCAOB independence standards to avoid inadvertent use of indemnification clauses or contingent fees.

The Spotlight also includes a series of reminders for auditors regarding independence. These include reviewing the engagement letters of other auditors involved in a public company audit to make sure they do not contain prohibited terms, not presuming that an audit committee has or will approve or pre-approve services, and "continuous conversations" with audit clients about their plans, such as IPOs or acquisitions.

Audit Committee Considerations

The Spotlight notes that audit committees are responsible for the engagement and oversight of the company's independent auditor and suggests some audit committee independence oversight considerations:

- Audit committees are required to consider whether any services provided by the audit firm may impair the audit firm's independence in advance.

- Audit committees should be aware that certain financial relationships between the company and the independent auditor are prohibited.

- Audit committees should consider whether the public company's policies and procedures require that all audit and non-audit services be brought before the audit committee for pre-approval.

- Audit committees should not approve engagements that remunerate an independent auditor on a contingent fee or a commission basis, as such remuneration is considered to impair the auditor's independence.

- Audit committees should consider whether their auditor has implemented processes to identify prohibited relationships.

- Audit committees should discuss with the audit firm (1) Processes the audit firm uses to ensure complete disclosure of all relationships with the public company and its affiliates; and (2) Relationships the audit firm may have with officers, board members, and significant shareholders.

- If the audit committee pre-approves services using pre-approval policies and procedures, the audit committee should consider whether the pre-approval policies and procedures are sufficiently detailed as to the services to be provided so that the audit committee can make a well-reasoned assessment of the impact of the service on the auditor's independence.

- Independence is a shared responsibility between the entity under audit, its audit committee, and its auditor. It is important for the company to have policies and procedures to proactively alert auditors to proposed or pending merger and acquisition activity that could have an impact on the auditor's independence.

Audit Committee Takeaways

Auditor independence is a perennial area of SEC and PCAOB focus. In the last several years, both the Commission and the Board have also stressed the importance of auditor-audit committee communications regarding independence and the audit committee's responsibility to monitor the independence of the company's auditor. See, e.g., More PCAOB Audit Committee Communications Cases in this Update, Acting Chief Accountant Speaks Out on Auditor Independence, June-July 2022 Update, and Acting Chief Accountant Stresses Auditor Independence and Audit Committee Oversight, November -December 2021 Update. Audit committees should review the PCAOB's suggested audit committee independence oversight considerations and integrate them into their work.

PCAOB Files More Audit Committee Communications Cases

On September 24, the Public Company Accounting Oversight Board announced settled disciplinary proceedings against four audit firms for violating the Board's rules related to communications with audit committees. Two of the cases also allege failures to document audit committee pre-approval of tax services. These cases are part of a continuing PCAOB crackdown on firms that fail to make required communications to client audit committees.

The four firms, the sanctions to which they consented, and the nature of the violations are:

- Accell Audit & Compliance, P.A. – $40,000 civil money penalty, censure, and undertaking to implement certain remedial actions. The PCAOB's order alleges that Accell failed to communicate to a client's audit committee (1) the name, location, and planned responsibilities of another firm that participated in the audit and (2) material ICFR weaknesses identified during the audit. At another client, Accell failed to communicate to the audit committee (1) a significant audit risk, (2) a corrected misstatement identified by the engagement team, and (3) certain information concerning the company's ability to continue as a going concern.

- Crowe MacKay LLP (Canada) – $30,000 civil money penalty, censure, and an order requiring compliance with firm policies and procedures relating to communications with audit committees and the documentation of those communications. The PCAOB's order alleges that Crowe MacKay failed to document in its work papers audit committee pre-approval of certain tax return preparation services and services in connection with Crowe MacKay's consent to use of a prior audit report in an SEC registration statement. Crowe MacKay also failed to describe in writing to the audit committee the scope and fee structure of the tax return preparation services or to document the substance of discussion with the audit committee concerning the potential effects of the tax services on the firm's independence. At another client, Crowe MacKay failed to document audit committee pre-approval of the performance of the audit.

- Ernst & Young AG (Switzerland) – $45,000 civil money penalty, censure, and an order requiring compliance with firm policies and procedures relating to communications with audit committees. The PCAOB's order alleges that EY-Switzerland failed to inform a client's audit committee of the name, location, and planned responsibilities of 15 other firms that participated in the audit.

- Grant Thornton LLP (Canada) – $30,000 civil money penalty, censure, and an order requiring compliance with firm policies and procedures relating to communications with audit committees and the documentation of those communications. The PCAOB's order alleges that GT-Canada failed to document in its work papers audit committee pre-approval of tax return preparation services provided to a company subsidiary by another Grant Thornton International member firm. GT-Canada also failed to describe in writing to the audit committee the scope and fee structure of the tax return preparation services or to document the substance of discussion with the audit committee concerning the potential effects of the tax services on the firm's independence.

This is the third set of firms the PCAOB has charged with failing to comply with the audit committee communications requirements. In February, the Board settled similar charges against four other firms. See PCAOB Charges Four More Firms with Audit Committee Communications Violations, February 2024 Update. In July 2023, the Board brought audit committee communications cases against five more firms. See PCAOB Charges Five Firms with Audit Committee Communications Failures, August-September 2023 Update. As explained in the February 2024 Update, these actions arise from a PCAOB "enforcement sweep" focused on noncompliance with the audit committee communications rules.

Audit Committee Takeaways

The auditor's failure to comply with the communications requirements can deprive the audit committee of important information, such as significant audit risks affecting key financial statement accounts or the conditions and events that the auditor viewed as indicators that there is substantial doubt concerning the company's ability to continue as a going concern. Audit committees should have a general understanding of the types of information their auditor is required to communicate and should ask questions if they do not receive the required communications.

CAQ Finds that 92 Percent of Institutional Investors Rely on CAMs

A survey of 100 institutional investors conducted by KRC Research for the Center for Audit Quality finds that 92 percent of respondents use critical audit matters (CAMs) when making investment decisions. KRC conducts quarterly research on topics related to the views of institutional investors on the financial statement audit process, assurance on other corporate reporting, and other audit firm-related matters. The results of KRC's third quarter survey research, conducted online from July 9-22, 2024, are reported in The Center for Audit Quality Critical Audit Matters Survey Research Findings--Q3 Survey. In a blog post on the survey results, Dennis McGowan, CAQ's Vice President for Professional Practice and Anti-Fraud Initiatives, said "[I]t is gratifying to see evidence that the efforts of standard setters and auditors to increase transparency around the audit process with the communication of CAMs is benefiting the capital markets."

Under the PCAOB's auditing standards, a CAM is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment. The audit report must include a description of any CAMs and how the auditor addressed them in the audit.

KRC's Q3 research assessed four issues: (1) The use of CAMs in the investment decision-making process; (2) Level of training or information investors received related to CAMs; (3) Satisfaction with CAMs; and (4) How CAMs could be improved. Respondents were professional investors employed at companies with a minimum of $500 million in assets under management who serve at the director level or higher and had at least 5 years of experience.

Key survey findings include:

- Ninety-two percent of respondents use CAMs when making investment decisions. Specific examples of CAM topics that impact decision-making were valuation of assets/goodwill appraisal/intangible assets evaluation (22 percent), financial statement/occurrence of financial misstatements (21 percent), revenue recognition (18 percent), compliance issues/fraud (14 percent), and management estimates/management judgment (12 percent).

- Eighty-eight percent of respondents reported having received either "significant" or "some" training and/or a written explanation on the value and utilization of CAMs. Sources of CAM training included Seminar/Webinar/Conference (27 percent), University Courses/Online Courses (25 percent), Financial Experts/AICPA/Auditing Experts (24 percent), At Work/Company-Provided/In-House (24 percent), and Written Material/Reports/Journals (22 percent).

- Seventy-eight percent of respondents said that they "always" or "often" read the CAMs section of the auditor's report on companies they invest in or are researching. On the other hand, five percent said that they never read CAMs, while two percent do so rarely.

- Ninety-three percent of respondents said that CAMs play a "very important" or "somewhat important" role in their decision-making analysis of a potential investment. The remaining seven percent cited several reasons why CAMs were not significant, including "the information is overly standardized," CAMs are "relevant only to a subset of financial statement accounts/areas," and "portfolio I manage does not have an investment policy on utilizing CAMs."

- Ninety percent of respondents are either "satisfied" or "very satisfied" with the quality and clarity of CAMs.

As to ways in which CAM reporting could be improved, survey respondents had a variety of suggestions:

- Fifty-eight percent of respondents would prefer more CAMs in the auditor's report. On the other hand, 21 percent would prefer fewer CAMs, and 19 percent had no preference as to the number of CAMs. Half of respondents (51 percent) expect the number of CAMs in the auditor's report to be either two or three. Twenty-one percent of respondents thought the expected number of CAMs varies by industry.

- Fifty-one percent of respondents would like more detail in the auditor's discussion of CAMs. A quarter of respondents recommended that CAMs be required in certain audit areas, including Revenue Recognition/Revenue Audit, Asset Valuation/Value Estimates, Management Estimates, and Complex Transactions.

- Respondents cited several types of additional information related to CAMs they would find important to their investment decisions. Some frequently requested types of additional information included Financial Impact/Effect on Future Earnings/Reliability of Reports, Risk Profile/ Understanding & Pinpointing Risks, Origins of CAMs/What Qualifies as a CAM/How Auditor Identified CAMs, and Management Response & Reactions.

Audit Committee Takeaways

1. The high level of institutional investor usage of CAMs is a bit surprising and seems to suggest a sea-change in investor attitudes toward CAMs. In 2020, the PCAOB released an assessment of the initial impact of auditor CAM reporting. It found that only 31 percent of the 97 investor respondents had seen a CAM in an audit report. Those who had seen a CAM were asked about their future use of CAMs. Of the 21 who responded, eight said they would use CAMs, four said they might, and nine said they would not because "CAMs are not specific enough to provide useful information or do not provide additional value above and beyond what is already included in financial statements." See PCAOB Interim Analysis Finds

that Investor Interest in CAMs is Still Evolving, October-November 2020 Update. During the past four years, investors, at least those at large institutions, have apparently rethought the utility of CAMs.

2. If institutional investors are in fact taking CAMs as seriously in their decision-making as the CAQ-KRC survey indicates, audit committees should also pay close attention to their company's CAMs. In particular, audit committees should consider whether any CAMs in their company's audit report suggest weaknesses in the company's financial reporting processes that could be remediated.

3. The PCAOB is also conducting a study of CAMs. The Board's research agenda includes a project that will explore why the average number of CAMs has decreased and whether there is a need for guidance or PCAOB standards changes to improve the information provided in CAMs. See PCAOB Updates its Agendas and Adds a CAMs Review, November-December 2023 Update. If the PCAOB's findings are consistent with those reported in the CAQ-KRC survey, it is possible that the Board will consider incorporating some of the institutional investor suggestions into the CAM standard.

2023 PCAOB Target Team Report: Crypto, Multi-Location Audits, and Significant Transactions

The Public Company Accounting Oversight Board has released Spotlight: Observations From the Target Team's 2023 Inspections. The Board's annual inspections program includes a "target team" -- a group of inspectors that conduct reviews across many audit firms with a focus on specific emerging audit risks and other issues. The Spotlight report on the target team's 2023 work summarizes the team's observations, including deficiencies the team identified and good practices. For a discussion of the 2022 target team activities, see PCAOB Target Team Zeroed in on First-time Audits, Shared Service Centers, and Climate, January 2024 Update.

In 2023, the target team focused on reviewing audits that included risks in three areas: (1) material crypto asset activities, (2) multi-location audits, and (3) significant or unusual events or transactions. Because of banking sector instability in 2023, the target team also focused on the interim reviews of certain banks. The team's observations on these interim reviews are described in another Spotlight report, Bank Financial Reporting Audits.

The target team Spotlight report describes inspection results (i.e., any audit deficiencies the team uncovered), observations (matters of interest concerning audit performance that the team noted), and good practices (audit procedures or methodologies the team saw that may contribute to audit quality). Below are some highlights for each target team focus area.

Crypto Assets

Most of the deficiencies the team identified were in audits involving crypto assets. In five audits, performed by three firms, the inspectors found deficiencies related to--

- The auditor's response to the risks of material misstatement with respect to crypto asset revenue recognition.
- In the ICFR audit, testing the design and operating effectiveness of controls over various aspects of safeguarding crypto assets.
- Sufficiency of audit evidence related to information used in testing controls.
- Reporting on Form AP of non-U.S. audit participants.
- Determination of the independence of engagement team members.

The team's observations concerning audits involving crypto assets included discussion of--

- Possible audit deficiencies in the testing of information technology application controls.

- The audit implications of differing company approaches to controls over crypto asset private keys.

- Auditor responses to the risk of material misstatement when the audit client used a third-party custodian.

The team also noted that in two of the 77 public company audits it inspected, a critical audit matter was identified with respect to crypto asset transactions. Both CAMs related to auditing the existence and rights and obligations assertions over crypto assets "due to the nature and extent of the audit effort required to assess whether the public company controls the private cryptographic keys."

Good practices in audits involving crypto asset activity included the use of specialists in pricing desk services or crypto assets and staffing the engagement with team members possessing specialized skills related to crypto assets.

Multi-Location Audits

In two of the multi-location audits that the target team reviewed, it identified deficiencies in the accuracy of the Form AP information concerning other audit firms that participated in the audit. The same firm was the principal auditor in both cases.

The team's observations from its multi-location audit reviews included discussion of--

- Modification of audit strategy in response to newly identified risks identified, such as potential impairment charges on Russian assets, de-designation of Russian ruble hedges, suspension of operations in Russia, and establishment of reserves for receivable balances of customers in Russia, Belarus, and Ukraine.

- No group auditor site visits at certain locations due to pandemic travel restrictions in China or events in Russia and Ukraine. Instead, the group auditor increased interactions with component teams through remote meetings, video calls, and virtual reviews.

- Group auditor visits to Hong Kong as an alternative to visiting mainland China. In this case, the firm's Hong Kong office had full access to the China component team's audit work papers. In another audit, the group auditor used U.S. secondees on rotation in China to review work papers.

Good practices in multi-location audits included an audit firm that required documentation of the results of internal or external inspections of component auditors. Another good multi-location audit practice is a requirement that component auditors include in the final set of audit documentation a clearance memo affirming that the group auditor's referral instructions were completed via firm-provided practice aids. Such memos were required in all multi-location audits the target team reviewed.

Significant or Unusual Events or Transactions

Examples of significant or unusual events or transactions that the team reviewed included cybersecurity events or data breaches, gains or losses from lawsuits, interruptions to operations from natural disasters, and early retirement or restructuring of debt. The Spotlight describes no deficiencies in audits involving significant or unusual events or transactions.

The target team observed that, in three audits, issues involving legal contingencies, a restructuring event that resulted in the impairment of intangible assets, acquisitions, and cybersecurity events were

considered as possible CAMs. The Spotlight does not indicate whether any of these issues resulted in a CAM in the auditor's report.

Good practices in engagements involving significant or unusual events of transactions were voluntary consultations on novel accounting issues and the use of specialists, such as valuation specialists, in the planning, scoping, and risk assessment procedures related to such events or transactions.

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The Spotlight states that, during 2024, target team inspection activities will focus on the following topics:

- Initial audits by a successor auditor.
- Risk assessment.
- Auditor's assessment of a public company's use of artificial intelligence.
- Biotech startups.
- Audit firms' usage of shared service centers.
- Cash flow statement, segment reporting, and earnings per share.

Audit Committee Takeaways

The target team Spotlight could be useful to an audit committee in understanding what aspects of the company's audits are likely to attract PCAOB inspection staff attention. In addition, audit committees of companies where any of the 2023 focus areas are an aspect of the audit may want to review those topics in the Spotlight report as preparation for discussing with the auditor how it intends to address these issues in future audits.

What Backlash? ESG Reporting Continues to Grow

Over the past ten years, U.S. public company sustainability, or environmental, social, and governance (ESG), reporting has moved from a niche activity to standard practice for large public companies. New reports from two organizations that monitor the state of sustainability reporting provide insight into how widespread the practice has become and the evolution of these disclosures.

The Governance & Accountability Institute (G&AI)

G&AI released Sustainability Reporting In Focus 2024, the thirteenth edition of its annual series tracking sustainability reporting. The report analyzes trends in sustainability reporting by companies in the Russell 1000 index. G&AI observes that its research "continues to show a steady increase in the total number of companies publishing annual sustainability reports, which is now widely recognized as essential for both large- and mid-cap U.S. publicly-traded companies."

G&AI first published an analysis of S&P 500 company sustainability reporting in 2012. Since then, sustainability reporting has gone from rare to almost universal; G&AI's initial report found that, in 2011, just 20 percent of S&P 500 companies published sustainability reports or disclosures. In 2019, G&AI expanded its research to include companies in the Russell 1000. For a discussion of last year's G&AI report, see G&AI: Nine Out of Ten Russell 1000 Companies Publish a Sustainability Report, November-December 2023 Update.

The 2024 G&AI report covers sustainability reporting during the 2023 publication year. G&AI's press release accompanying the report notes that it reflects "substantial increases in sustainability reporting for both large-cap and mid-cap U.S. public companies as the U.S. regulatory environment moves to follow Europe on required ESG reporting." A record 93 percent of Russell 1000 companies published a sustainability report in 2023, an increase from 90 percent in 2022.

Key findings of the 2024 report include:

- Sustainability reporting is the norm. As noted above, 93 percent of Russell 1000 companies published a sustainability report in 2023; stated differently, only 70 of these companies did not issue such a report in 2023. The smaller half by market cap of the Russell 1000 had the greatest increase in reporting last year. In 2023, 87 percent of these 500 companies published a sustainability report, a five percent increase over 2022. For the larger half by market cap of the Russell 1000 (i.e., the S&P 500) nearly all companies are sustainability reporters. In 2023, 98.6 percent of the S&P 500 published a report (493 companies), an increase from 98.2 percent (491 companies) in 2022.

- Most companies use an ESG disclosure framework. The Sustainability Accounting Standards Board (SASB) disclosure standards are the most widely used disclosure framework. Eighty-one percent of Russell 1000 reporters aligned with SASB in 2023, up from 78 percent in 2022. Russell 1000 use of Global Reporting Initiative (GRI) disclosures remained fairly constant, increasing from 54 percent in 2022 to 55 percent in 2023. Alignment with the disclosure recommendations of the Task Force on Climate-Related Financial Disclosure (TCFD) also continued to increase. Sixty percent of Russell 1000 reporters followed TCFD recommendations in 2023, compared to 50 percent in 2022.

- More industry sectors joined the 100 percent reporting club. In 2023, all companies in six industry sectors engaged in sustainability reporting. These sectors were Real Estate, IT, Energy, Industrials, Materials, and Utilities. In 2022, only Energy and Utilities had 100 percent reporting. As in 2022, the sector with the lowest percentage of sustainability reporters was Communications, with 24 percent of companies failing to issue a sustainability report. Although it remained the laggard, Communications improved from only 40 percent reporting in 2022, an increase of seven new reporting companies. In all other industry sectors, ten percent or less of the sector's companies were non-reporting.

- External assurance on sustainability reporting continues to increase. In 2023, 48 percent of Russell 1000 ESG reporting companies obtained external assurance on their non-financial ESG disclosures, up from 40 percent in 2022 and 36 percent in 2021. Sixty-six percent of the companies in the largest half of the index (the S&P 500) obtained assurance, compared to 57 percent in 2022 and 49 percent in 2021. Twenty-seven percent of companies in the smallest half of the Russell 1000 obtained such assurance, an increase from 21 percent in 2022 and 18 percent in 2021.

- The scope, level, and providers of sustainability assurance services are changing slowly. For all Russell 1000 companies that obtained external assurance, only two percent obtained assurance over their entire sustainability report, a decrease from three percent in 2022. Fifty-seven percent obtained assurance over only GHG emissions data, essentially unchanged from 58 percent in 2022. Further, only six percent of assurance reports provided a reasonable/high level of assurance, compared to five percent in 2022. In contrast, 91 percent of assurance reports provided limited or moderate assurance. Engineering firms continued to be the most frequent sources of assurance, probably because GHG emissions were the most frequent topic of assurance. Engineering firms provided 66 percent of Russell 1000 assurance reports, down slightly from 68 percent in 2022. Accountants provided the assurance report in 21 percent of Russell 1000 assurance engagements (compared to 17 percent last year) and consulting firms were the provider in 12 percent.

Teneo

Teneo, a global advisory firm, published Stand by ESG? Our Annual State of U.S. Sustainability Reports, its fourth annual look at U.S. sustainability reporting. Teneo analyzed 250 sustainability reports from S&P 500 companies published in 2024 prior to September 11. Teneo notes two "mega-trends" affecting ESG reporting and strategy -- increasing requirements from regulators for more ESG disclosure and increasing anti-ESG political and activist pressure. Teneo provides twenty ESG reporting data points based on the 250 S&P 500 sustainability reports it reviewed. For example:

- The average length of a 2024 sustainability report is 83 pages, up from 70 pages in 2021.
- In 2024, 40 percent of companies issued a press release with their sustainability report, down from 70 percent in 2021.
- In 2024, 39 percent of companies used the word "Sustainability" in their report title, up from 33 percent last year. Twenty-four percent used "ESG," down from 35 percent in 2023. Other popular words in report titles were "Corporate Responsibility" (12 percent in 2024) and "Impact" (10 percent).
- The CEO alone signed the cover letter for 65 percent of 2024 sustainability reports. The CEO and other executives signed 14 percent of cover letters. Two percent of reports had no cover letter.

Teneo summarizes its findings in "Top Ten Takeaways From 2024 Sustainability Reports." These takeaways are:

- The acronym "ESG" is down but certainly not out. As noted above, 24 percent of companies used "ESG" in their report title, down from 35 percent in 2023
- Sustainability reports are getting longer, not shorter. As noted above, the average report in 2024 was 80 pages.
- More companies are now living in a double material world. The number of companies that completed a "double materiality" assessment rose from nine percent in 2023 to 27 percent in 2024. Double materiality refers to the concept that companies should report on both how sustainability issues materially affect their financial performance and how their activities materially impact society and the environment.
- CEOs are increasingly accountable for ESG strategies. CEOs were described as ultimately responsible for company ESG strategy in 32 percent of reports, compared to 18 percent in 2023.
- DEI will survive. Despite backlash, 94 percent of companies used "DEI" in their 2024 ESG reports.
- Sustainability reports are being issued with less pomp but with more circumstance. As noted above, fewer companies issued press releases announcing sustainability reports in 2024. However, more companies maintain ESG microsites as part of the company's website.
- The EU CSRD and IFRS disclosure frameworks begin to surface. Thirteen percent of 2024 reports referred to the European Union's Corporate Sustainability Reporting Directive (CSRD). See E.U. ESG Disclosure Requirements Will Affect Many U.S. Companies, October 2023 Update.
- External assurance increasingly includes "Social" data points. Thirty-two percent of companies that obtained assurance included both environmental and social data, an increase from 22 percent in 2023.
- Company ESG goals are in a transition phase. Fewer companies provided an ESG goals progress section in 2024 than in 2023.

- Responsible AI enters the ESG chat. Twenty-one percent of companies mentioned responsible use of artificial intelligence in their 2024 sustainability report.

Audit Committee Takeaways

As noted in prior Updates, ESG disclosure is becoming 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 company collects ESG information, how the disclosures impact financial reporting, and on the controls and procedures to which sustainability disclosures are subject.

Both the G&AI and the Teneo reports highlight another aspect of sustainability reporting oversight: While sustainability reporting has been voluntary in the United States, mandatory reporting will soon be a reality for many companies. G&AI states:

> "As a result of the flurry of new climate reporting regulations introduced over the past few years, mandatory sustainability and climate reporting will soon be inescapable for many companies. With EU CSRD reporting beginning in 2025 and SEC and California reporting in the U.S. slated to follow shortly after, the next few years will be a critical proving ground for companies navigating the transition from voluntary to mandated reporting.
>
> "Companies should use these next few years to review their existing disclosures, identify gaps, and develop strategic plans before the reporting deadlines. Companies who are experienced in reporting against voluntary frameworks like GRI, CDP, TCFD, and SASB will be well-positioned to produce high-quality disclosures, and the interoperability of many voluntary reporting standards with mandatory standards will ease the transition burden. Whether by the CSRD, U.S. SEC, or California, many companies will soon be required to obtain assurance over their disclosures, making it imperative to have robust data collection and control procedures in place."

Audit committees should consider whether management is prepared for this transition and how the company's reporting will be impacted by mandatory sustainability disclosures.

On the Update Radar: Things in Brief

CAQ Surveys Audit Committee Members and Investors on Engagement Performance Metrics. In April, the Public Company Accounting Oversight Board issued for comment two proposals that would significantly expand the disclosures that certain accounting firms must make regarding their performance of audit engagements (Firm and Engagement Metrics proposal) and their operational and financial condition (Firm Reporting proposal). A primary objective of these new disclosures would be to aid audit committees in their oversight. See PCAOB Proposes Engagement Metrics and Audit Firm Operational and Financial Reporting, April 2024 Update. In response to these proposals, the Center for Audit Quality conducted surveys of audit committee members and investors to gather data concerning how they evaluate audit quality. On August 1, the CAQ filed a supplemental comment letter with the PCAOB reporting the survey results.

The audit committee survey had 242 respondents, 96 percent of whom were on an audit committee or had served on a committee within the past five years; 78 percent were, or had served as, audit committee chair. Three-quarters of respondents were or had been on the board of a public company with at least $1 billion in market capitalization. Findings of the audit committee survey included:

- Ninety-five percent of audit committee members surveyed said the information currently available meets all (59 percent) or most (36 percent) of their needs in fulfilling their external auditor oversight responsibilities.

- Forty-three percent of audit committee members would like additional information on their company's audit engagement. Frequently identified types of additional information sought were partner and manager involvement (47 percent); more information about how my individual engagement is being performed (43 percent); details about what goes into auditor judgment (35 percent); and industry experience of audit personnel (30 percent).

- Most audit committee members surveyed "strongly agree" (48 percent) or "somewhat agree" (30 percent) with the statement "Mandated public disclosure of engagement-level performance metrics, including issuer name, could lead to unintended consequences and as such should be voluntary." Eleven percent disagree either strongly or somewhat.

- Seventy-three percent of audit committee members surveyed believe there are "potential challenges and limitations" in interpreting the data that would be disclosed under the PCAOB's Firm and Engagement Metrics proposal, particularly concerning measuring audit quality. In addition, 63 percent do not believe that the Firm Reporting proposed would be useful in their oversight role.

- Eighty-two percent of respondents have concerns about data specific to their audit being publicly available, and 40 percent think that public disclosure under the Firm and Engagement Metrics proposal could increase director liability.

- Fifty-nine percent of respondents said that the following statement most closely matches their view: "Boards and audit committees should consider some standard information about auditors should be considered when making their selection and performing their oversight responsibilities, but ultimately rely on their unique needs and knowledge of the company and its industry." In contrast, only one percent said that the statement "Boards and audit committees should defer to standardized metrics about auditor performance when selecting and overseeing their auditor" matched their views.

The investor survey had 100 responses from institutional investors. Respondents were professional investors employed at companies with a minimum of $500M in assets under management who serve at the Director level or higher and have at least 5 years of experience. Findings of the audit committee survey included:

- Ninety-two percent of investor respondents thought that the information currently available to assess public company audit quality meets all (57 percent) or most (35 percent) of their needs.

- Forty-six percent of investors surveyed would like more information about the auditing process. Other types of additional information investors wanted included scope of the audit (25 percent), any amendments made to financial statements (24 percent), and engagement team specifics (20 percent).

- Most investor respondents agreed either "strongly" or "somewhat" with these statements: "Boards and audit committees should consider some standard information about auditors when making their selection, but ultimately rely on their unique needs and knowledge of the company and its industry." (84 percent); "Mandatory and standardized firm and engagement metrics are necessary for company management and audit committees to uphold fiduciary responsibilities to shareholders." (81 percent); and "Boards and audit committees lack access to the information they need to make an informed decision about selecting an auditor." (69 percent)

- Eighty percent of investors agreed "strongly" or "somewhat" that performance metrics alone without context cannot adequately communicate factors relevant to a particular audit engagement or firm. Eighty-three percent similarly agreed that mandated public disclosure of engagement-level performance metrics could lead to unintended consequences and that disclosure should be voluntary.

In its supplemental comment letter, the CAQ asserts that the results of the audit committee and investor surveys, support five findings:

1. More research is necessary to establish whether evidence supports the need for and benefits of proposed metrics.

2. Audit committees and many investors already have the information they need.

3. Any reporting should be voluntary.

4. Any changes to the PCAOB's standards should promote auditor-audit committee discussion.

5. A majority of investors and audit committee members are of the view that the PCAOB's auditing standards and rules have kept pace with change and require only targeted updating.

Its Enforcement Task Force is Gone, but the SEC is Still Bringing ESG Cases.

In 2021, the SEC announced the formation of a task force in the Division of Enforcement "to proactively identify ESG-related misconduct." See Climate Change is Rapidly Becoming an SEC Priority, March-April 2021 Update. While the Climate and ESG Task Force brought several cases against asset managers, enforcement actions against public companies alleging ESG-related disclosure violations have been rare. The only direct example of such a case is the Commission's 2022 action against Brazilian mining company Vale S.A. See SEC is Serious About ESG Disclosure Enforcement, April-May 2022 Update.

On September 12, Bloomberg reported that the SEC had quietly disbanded the Climate and ESG Task Force several months earlier. But a recent action filed almost simultaneously with that report demonstrates that the SEC is still interested in bringing ESG-related cases, even when the facts arguably fall outside the usual enforcement parameters.

On September 10, the Commission issued an order charging Keurig Dr Pepper Inc. with making inaccurate statements regarding the recyclability of its K-cup beverage pods. According to the SEC's order, Keurig's annual reports for fiscal years 2019 and 2020 stated that K-cup pods "can be effectively recycled." This statement was true in that Keurig had conducted testing which showed that pods could be sorted from other materials "to make it to a stage of the recycling process from which items have the potential * * * for purchase by parties who might further process the materials for their potential reuse." However, Keurig did not disclose that two of the largest recycling companies had expressed significant concerns to Keurig regarding the commercial feasibility of curbside recycling of K-cup pods and that they did not intend to accept the pods for recycling.

Based on this omission, the SEC finds that Keurig violated the provisions of the Securities Exchange Act and the Commission's rules that require companies to file complete and accurate annual reports. Without admitting or denying the findings in the order, Keurig agreed to a cease-and-desist from future violations and to pay a civil penalty of $1.5 million. In a press release announcing the settlement, John T. Dugan, Associate Director of the SEC's Boston Regional Office said, "When a company speaks to an issue in its annual report, they are required to provide information necessary for investors to get the full picture on that issue so that investors can make educated investment decisions."

SEC Commissioner Hester Peirce issued a dissent. She points out that the order does not allege that Keurig's statement concerning pod recycling was material. Keurig research in 2016 indicated that, for certain consumers, environmental concerns were a significant factor in deciding whether to purchase a Keurig brewing system. In Commissioner Peirce's view, it does not follow that recyclability was material to investors. She also argues that Keurig's statement that the pods could be recycled was accurate and was not "an implicit assertion that the pods *would* be recycled." She ends with the

statement that the Commission's "pedantic parsing of Keurig's recyclability statements and its $1.5 million penalty do little to disguise the weakness of this case."

It is of course a basic principle that disclosures must be complete and that the omission of important information that qualifies a statement or significantly changes its meaning can violate the federal securities laws. From that perspective, the Keurig case breaks no new ground. However, the Commission's willingness to bring this action on facts that are, as Commissioner Peirce's dissent underscores, far from overwhelming in terms of any impact on investors suggests that the SEC staff remains interested in finding cases with an ESG nexus. Companies and their audit committees should be alert for ESG-related statements in SEC filings or other disclosures, such as sustainability reports, that the Commission could characterize as incomplete or misleading.

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. Recent posts include --

- Enhanced Auditor Quality Control: Companies Will Feel the Effects (Dan Goelzer, September 20, 2024)

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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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