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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 Unveils its Climate Disclosure Proposals

On March 21, the SEC published its long-expected proposed disclosure requirements to enhance and standardize public company climate-related disclosures. The proposals would create an extensive and detailed body of new disclosures, affecting both the text of SEC filings and the financial statements. In particular, as explained below, all companies would be required to disclose Scope 1 and Scope 2 greenhouse gas (GHG) emissions, and many larger companies – accelerated filers – would be required to disclose Scope 3 GHG emissions. Scope 1 and 2 GHG emission disclosures would be subject to independent third-party attestation requirements. Further, the financial statements of all companies, regardless of size, would be required to include footnote disclosure regarding impacts exceeding one

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percent of any line item of climate-related events and transition activities; these new financial statement disclosures would of course be subject to the audit. In addition, all public companies would be required to make detailed disclosure in their SEC filings concerning a variety of climate-related matters, including climate risk strategy, climate risk management, and climate risk governance.

The SEC's proposals draw on the disclosure recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) and on the Greenhouse Gas Protocol (GHG Protocol) created by the World Resources Institute and the World Business Council for Sustainable Development. Companies that are already making voluntary disclosures based on the TCFD recommendations and the GHG Protocol will have a head start in complying with the SEC proposals. However, the SEC's proposal is more detailed and contains many elements that are not features of the TCFD and GHG regimes. All companies, especially those not currently making TCFD disclosures, will need to create new information systems, controls, and disclosure procedures to comply with the SEC requirements, assuming they are adopted. For many companies, this will require a considerable investment of time, talent, and financial resources.

One consequence of the proposals is that audit committees will need to prepare for a major change in the nature and scope of their responsibilities. Most audit committees are not directly responsible for ESG oversight. However, financial statement preparation, the content of SEC filings, internal control over financial reporting, disclosure controls and procedures, and the work of the external and internal auditors are all core financial audit committee oversight responsibilities. The proposed climate disclosures would significantly affect these areas. Management and audit committees should begin to prepare now by analyzing the proposals and considering how compliance would affect their disclosure processes.

Proposed Disclosure Requirements

The SEC's proposals have six major aspects:

1. New Financial Statement Footnotes

The proposals would require financial statements filed with the SEC to include footnote disclosure of the impact on the financial statements of "climate-related conditions and events" (such as to droughts, floods, and other weather events and natural conditions) and of climate change transition activities (such as changes in asset salvage values or useful lives). The impact of such events and activities on financial statement estimates and assumptions would also have to be disclosed. Specifically:

- Financial impact metrics. A company would be required to make footnote disclosure of disaggregated information about the impact of climate-related conditions and events and transition activities on the consolidated financial statements unless the impact is less than one percent of any financial statement line item. Within each category (i.e., climate-related events or transition activities), impacts would be required to be disclosed on a line-by-line basis for all negative impacts and on a line-by-line basis for all positive impacts.

- Expenditure metrics. The expenditure metrics would require footnote disclosure of the aggregate amounts of annual expenditures and capitalized costs associated with climate-related events, transition activities, and climate-related risks. For each category, the notes would be required to disclose separately the amount incurred during the year for positive and negative impacts of climate-related events and of transition activities (including GHG emissions reductions and other steps to mitigate exposure to transition risks). The expenditure metrics would be subject to the same one-percent-of-a-line-item disclosure threshold as the financial impact metrics.

- Financial estimates and assumptions. Footnote disclosure would be required of the impact of risks and uncertainties associated with climate-related events and transition activities on estimates and assumptions reflected in the consolidated financial statements. The company would be required to provide a narrative description of how the development of estimates and

assumptions was affected by climate events and activities, including separate disclosure of the impact of climate-related events and transition activities, including identified transition risks.

Since these disclosures would part of the financial statements, they would, like any other financial statement disclosures, be subject to the requirements of internal control over financial reporting and to the external audit. The auditors would, in turn, be subject to PCAOB auditing standards with respect to their examination of these disclosures.

2. GHG Emissions

a. Disclosure

All public companies would be required to disclose their Scope 1 and Scope 2 GHG emissions. (Scope 1 emissions are those directly from facilities or operations owned or controlled by the company. Scope 2 emissions are those that result from the production of purchased electricity or other forms of energy.) Scope 1 and Scope 2 emissions would need to be disclosed separately, both in the aggregate (in absolute terms, not including offsets) and disaggregated by each constituent greenhouse gas (carbon dioxide, methane, nitrous oxide, nitrogen trifluoride, hydrofluorocarbons, perfluorocarbons, and sulfur hexafluoride). In addition, disclosure would be required in terms of intensity. The proposed rules would define “GHG intensity” to mean a ratio that expresses the impact of GHG emissions per unit of economic value (e.g., metric tons of CO2e per unit of total revenues) or per unit of production (e.g., metric tons of CO2e per unit of product produced).

Accelerated filers (generally, companies with market capitalization in excess of $75 million) would also be required to disclose Scope 3 emissions. (Scope 3 GHG emissions are those in the company’s value change that are upstream and downstream from the company’s own activities, such as emissions that result from the activities of suppliers or from customer use of the company’s products.) However, Scope 3 disclosure would only be required if the company has set a GHG emissions target or goal that includes Scope 3 emissions or if Scope 3 emissions are material. Where required, Scope 3 emission disclosures would be in absolute terms, not including offsets, and in terms of intensity.

b. Safe Harbor

Determining Scope 3 emissions may require companies to rely heavily on estimates and assumptions. Accordingly, the proposal includes a safe harbor from liability under the securities laws for Scope 3 emissions disclosures an SEC filing. This safe harbor would provide that a Scope 3 emissions disclosure would not be deemed to constitute a fraudulent statement unless it were shown that the statement was made without a reasonable basis or was disclosed other than in good faith.

c. Attestation

Accelerated filers would be required to include in their SEC filings an attestation report from an independent third party on their Scope 1 and Scope 2 emissions. Non-accelerated filers would not be subject to the GHG emissions attestation requirement. The GHG emissions attestation provider could be – but would not be required to be – the company’s financial statement auditor. The attestation provider would however have to be an expert in GHG emissions and independent of the company and its affiliates. The attestation report would have to be provided pursuant to standards that are publicly available and that are established by a body that has followed due process procedures – such as the PCAOB, AICPA, or IAASB. While attestation would not be required as to Scope 3 emissions disclosures, if a company elected to voluntarily obtain and disclose such an attestation, it would have to meet the same requirements, and make the same disclosures, as apply to Scope 1 and 2 disclosure attestations.

Under the SEC’s proposed phase in of the climate rules, the assurance provider would initially only have to provide limited or negative assurance regarding GHG emission disclosures; the assurance opinion could simply state that, based on performing described procedures, the assurance provider had no

reason to believe that the disclosures were materially misleading. After a phase-in period (which depends on company size), reasonable assurance, the same level of assurance that must be provided with respect to the financial statements, would be required. For larger accelerated filers (generally companies with market capitalization in excess of $700 million), Scope 1 and 2 GHG disclosure would begin in fiscal 2023, limited assurance would be required for fiscal 2024, and reasonable assurance for fiscal 2026.

3. Climate Risk Governance

All companies would be required to describe the board's oversight of climate-related risks, including board committees responsible for climate-related risk oversight and whether any board member has expertise in climate-related risks (and the nature of such expertise). Disclosure would also be required about, among other things, whether and how the board considers climate-related risks as part of its business strategy, risk management, and financial oversight and whether and how the board sets and oversees climate-related targets or goals.

Companies would also be required to describe management's role in assessing and managing climate-related risks. This would include disclosure of management positions or committees responsible for climate-related risks, disclosure of the processes by which the managers or management committees are informed about and monitor climate-related risks, and disclosure about whether and how often the responsible managers or committees report to the board or a board committee on climate risks.

4. Climate Risk Strategy, Business Model, and Outlook

Companies would be required to describe any climate-related risks that are reasonably likely to have a material impact on the company's business or consolidated financial statements over the short, medium, and long term. This would include:

- Whether and how such impacts are considered as part of the registrant's business strategy, financial planning, and capital allocation and any material climate-related risks that have or are reasonably likely to affect the financial statements.

- The company's internal carbon price, if any, and how that price is determined.

- A description of the scenarios, assumptions, and projected financial impacts, if the company uses scenario analysis in the context of climate-related risks.

5. Climate Risk Management

All companies would be required to describe any processes for identifying, assessing, and managing climate-related risks. This disclosure would need to include, for example, how the company determines the relative significance of climate-related risks and considers existing or likely regulatory requirements. If the company has a climate transition plan, it would have to disclose and discuss the plan.

6. Climate-Related Targets and Goals

If a company publicly discloses climate-related targets or goals, it would be required to include in SEC filings information concerning such targets and goals, including the activities and emissions in the target, the period within which the target is to be achieved, and how the company intends to meet the targets or goals. Companies would also be required to provide annual progress updates.

Effective Dates

If adopted, the climate disclosure requirements would be phased in over time, beginning in fiscal year 2023, depending on the size of the company. The release proposing the climate change disclosures

contains two tables that summarize the schedule under which companies would be required to comply with the new requirements. Assuming adoption of the proposed rules with an effective date in December 2022, the disclosures would take effect under the following schedule:

Registrant Type	Disclosure Compliance Date		Financial Statement Metrics Audit Compliance Date
	All proposed disclosures, including GHG emissions metrics: Scope 1, Scope 2, and associated intensity metric, but excluding Scope 3.	GHG emissions metrics: Scope 3 and associated intensity metric	
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Same as disclosure compliance date
Accelerated Filer and Non-Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	
SRC	Fiscal year 2025 (filed in 2026)	Exempted	

Source: SEC Release No. 33-11042 (SRC means smaller reporting company).

The compliance dates for the GHG emissions disclosure attestation requirements would be:

Filer Type	Scopes 1 and 2 GHG Disclosure Compliance Date*	Limited Assurance	Reasonable Assurance
Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Fiscal year 2027 (filed in 2028)
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Fiscal year 2026 (filed in 2027)

Source: SEC Release No. 33-11042 (footnote omitted).

<u>Comments</u>: As noted above, the SEC's proposals would create an extensive and detailed body of new disclosures. Indeed, the climate risk proposals arguably represent the most far-reaching changes to the SEC disclosure requirements in many decades – perhaps the most far-reaching changes that have ever been proposed in a single release. In most cases, compliance would require major changes in data obtained from suppliers and customers, information systems, internal control over financial reporting, disclosure controls and procedures, relationships with the company's auditor (and possibly with other attestation providers), and other aspects of the company's disclosure infrastructure. Since the audit committee has oversight responsibility for these activities, the nature and scope of the committee's responsibilities would change substantially.

It is of course not certain that the proposals will be adopted in their current form, although some form of enhanced SEC climate change disclosure requirements seems inevitable.   Comments on the proposed rules are due 30 days after its publication in the Federal Register or May 20, 2022, whichever is later, and

the SEC's phase in schedule assumes adoption of the rules before the end of 2022. This is an exceedingly tight timeframe for consideration of what is likely to be a large volume of comments and seems to suggest that the Commission does not intend to make significant changes to the proposals prior to adoption.

It is also possible that, regardless of the Commission's schedule, implementation of the rules will be delayed by legal challenges. At minimum, the proposals test the limits of the Commission's authority to require disclosure. Commission Peirce voted against the proposals and issued a strong dissenting statement which will likely provide a blueprint for legal challenges. She asserts that the proposal "steps outside our statutory limits by using the disclosure framework to achieve objectives that are not ours to pursue and by pursuing those objectives by means of disclosure mandates that may not comport with First Amendment limitations on compelled speech."

Against this background, audit committees should consider taking two steps. First, committees or their individual members may want to comment on the proposals. As noted, the proposals raise important legal and policy questions about the role of the SEC and the scope of its investor protection mandate. The SEC is required to consider whether its rules promote efficiency, competition, and capital formation and, in that context, the costs and benefits of its actions. Audit committees are well-positioned to provide input on these questions, particularly the potential costs of compliance.

Second, managements should be considering the steps that would be necessary to comply with the new disclosure requirements, if adopted, and audit committees should be active in overseeing that process. Some questions that audit committees might ask as part of that oversight include:

- What climate-risk related information does the company currently collect? What information does it disclose? What gaps are there between the information currently available and the disclosures required under the proposals?

- What is the quality of the climate-risk information currently available? Are the procedures and controls applicable to this information comparable to those applicable to existing SEC-required disclosures?

- When would Scope 1 and 2 GHG emissions disclosure phase in for the company? Is this information currently available? Would attestation be required? If so, when would limited assurance and reasonable assurance phase in?

- Would the company be required to disclose Scope 3 GHG emissions? If so, is this information currently available? How would the company obtain the necessary information to make such disclosures? What inputs are available from third parties, such as suppliers and customers?

- Is the company currently making voluntary disclosures (e.g., climate-related goals or targets) or using any internal tools (e.g., an internal carbon price, a climate transition plan, or scenario analysis) that would trigger mandatory SEC disclosures?

- What internal parties (e.g., finance, legal, investor relations, internal audit, the board and board committees) would be involved in compliance with the new rules? Are they aware of and pre-pared for the demands that would be placed on them? Would their position descriptions, functional responsibilities, charters, and policies and procedures need to be revised?

- What external parties (e.g., outside counsel, the independent auditor, independent assurance providers, consultants) would be involved in compliance with the new requirements? Are they aware of and prepared for the demands that would be placed on them?

- What changes would be necessary in the company's disclosure controls and procedures and internal control over financial reporting to comply with the new disclosure requirements?

SEC Proposes Cyber Risk Management and Attack Disclosure Requirements

On March 9, the SEC issued rule proposals to standardize public company disclosures regarding cybersecurity risk management, strategy, governance, and incident reporting. According to the SEC's Fact Sheet on the proposals, "Consistent, comparable, and decision-useful disclosures would allow investors to evaluate registrants' exposure to cybersecurity risks and incidents as well as their ability to manage and mitigate those risks and incidents." (Separately, Congress enacted a cyber incident reporting requirement, although the law will not require public disclosure. See New Legislation Requires Cyber Incident Reporting in this Update.)

The Commission's staff has previously issued interpretive guidance concerning disclosures that companies should make relating to cybersecurity risks and incidents. See SEC Issues Staff Guidance on Cyber Disclosure, Including the Board's Oversight Role, March 2018 Update. However, in the Commission's view, the resulting disclosures have been inconsistent. (For a discussion of cybersecurity disclosures, see EY Reports on the State of Cybersecurity Risk Disclosure, September-October 2021 Update). The proposed rules would in effect supersede prior guidance with specific requirements.

The proposals, which would apply to all SEC reporting companies, including both domestic and foreign companies, smaller reporting companies, and emerging growth companies, would require:

- Disclosure of certain information about material cybersecurity incidents within four business days after a company determines that it has experienced a material cybersecurity incident. A cyber-security incident would be defined as "an unauthorized occurrence on or conducted through a registrant's information systems that jeopardizes the confidentiality, integrity, or availability of a registrant's information systems or any information residing therein."

- Updated disclosure in quarterly and annual filings relating to previously disclosed cybersecurity incidents and disclosures. Companies would be required to report when a series of previously undisclosed individually immaterial cybersecurity incidents has become material in the aggregate.

- Disclosure regarding a company's policies and procedures for the identification and management of risks from cybersecurity threats. This disclosure would include whether management considers cybersecurity as part of its business strategy, financial planning, and capital allocation.

- Disclosure about the board's oversight of cybersecurity risk and management's role and expertise in assessing and managing cybersecurity risk and policies, procedures, and strategies.

- Disclosure in annual reports and proxy filings regarding board member cybersecurity expertise This disclosure would include whether the entire board or only certain board members or committees are responsible for cybersecurity risk oversight; how the board is informed about cybersecurity risks and how frequently cybersecurity risks are discussed; and whether and how the board evaluates cybersecurity risks as part of its risk management, business strategy, and financial oversight. In addition, companies would be required to disclose the name of every board member who has expertise in cybersecurity (if any), along with a description of such expertise.

Comment: Companies will need to consider how these new reporting requirements, if adopted, affect their policies and systems for collecting and evaluating information regarding cybersecurity incidents, particularly incidents that may be immaterial but that could become material when aggregated with other incidents. In addition to oversight of these systems changes, two other aspects of the proposal may affect audit committees.

- Additional disclosure concerning the work of the audit committee. As noted in prior Updates, cybersecurity oversight is often – although perhaps not always appropriately – assigned to the

audit committee. (For example, EY's most recent survey of audit committee reporting found that nearly 70 percent of Fortune 100 companies disclosed that the audit committee oversees cybersecurity matters. See Slight Increases, Some Stagnation: CAQ and EY Report Cards on Audit Committee Transparency, November-December 2021 Update.) As noted above, under the SEC's proposal, companies would be required to provide specific disclosures about the board's oversight of cybersecurity risk. In many cases, the result will be new disclosures about the work of the audit committee, including the names of committee members with cyber expertise.

- Tension between disclosure and incident response. Companies that are victims of cyber attacks may face a difficult choice. The SEC rules, if adopted, will require public disclosure of the incident and its potential consequences within four business days. On the other hand, such disclosure may jeopardize the investigation into the source of the incident, and the law enforcement agencies involved in the investigation may urge that disclosure be delayed. The audit committee or full board is likely to become involved in resolving this dilemma.

SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions

In Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors, a statement issued on March 9, SEC Acting Chief Accountant Paul Munter discusses the concept of materiality and its application to financial statement errors. Mr. Munter asserts that materiality determinations should be made from the perspective of a reasonable investor and that the analysis "should put aside any potential bias of the registrant, auditor, or audit committee that would be inconsistent with" an investor perspective. His remarks signal that the SEC staff believes companies and their advisors have been taking an unduly narrow view of materiality and that many errors that have been treated as immaterial should have triggered restatement and reissuance of the affected financial statements. His comments also suggest that audit committees should play an active role in overseeing these decisions.

Background – Materiality and Error Correction

The Supreme Court has held that an omitted fact is material if there is a substantial likelihood that a reasonable investor would have viewed the fact "as having significantly altered the 'total mix' of information made available." In 1999, the SEC staff issued Staff Accounting Bulletin No. 99--Materiality (SAB No. 99) on the application of the concept of materiality to financial statement errors. SAB No. 99 takes the position that both quantitative and qualitative factors should be considered in evaluating materiality. For example, under SAB No. 99, a quantitatively small error may nonetheless be material based on qualitative factors, such as whether the error was intentional or whether the error caused the company to meet, rather than miss, earnings per share expectations.

The determination of whether an error in previously-issued financial statements is material affects the way in which the error must be corrected. Material errors must be corrected by restating and re-issuing the financial statements. If the error is not material to the affected financial statements, but either correcting the error or leaving the error uncorrected would be material to the current period, the error may be disclosed and corrected in the current period without restating the previous financial statements. A restatement of previously-issued financial statements is referred to as a reissuance or "Big R" restatement, while a correction in the current period is known as a revision or a "little r" restatement. Typically, a little r restatement attracts less attention than a Big R restatement. See Restatements Decline for the Sixth Straight Year, Notching a New Twenty-Year Low, November-December 2021 Update.

Applying Materiality to Errors

Materiality determinations are often not clear-cut and require an exercise of judgment. In close cases, there can be incentives to conclude that an error is not material. The Munter statement provides examples of these incentives: "[A] restatement of previously-issued financial statements may result in the

clawback of executive compensation, reputational harm, a decrease in the registrant's share price, increased scrutiny by investors or regulators, litigation, or other impacts." As noted by Mr. Munter and as discussed in prior Updates, the number of restatements has steadily declined in recent years and the percentage of little r restatements has increased. See Restatements Decline for the Sixth Straight Year, Notching a New Twenty-Year Low, above.

Mr. Munter warns that concerns about restatement impacts like reputational harm or share price declines should not be part of the analysis of the materiality of an error. "An assessment where a registrant's, auditor's, or audit committee's biases based on such impacts influenced a determination that an error is not material to previously-issued financial statements so as to avoid a Big R restatement would not be objective and would be inconsistent with the concept of materiality." Instead, in applying the TSC materiality definition to financial statement errors, "registrants, auditors, and audit committees need to thoroughly and objectively evaluate the total mix of information. Such an evaluation should take into consideration all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors, to determine whether an error is material to investors."

Bias in Accounting Error Materiality Assessments

Based on the SEC staff's interactions with companies and auditors, Mr. Munter describes several theories that are sometimes asserted to support of the view that a misstatement is not material. In his view, however, these theories "appear to be biased toward supporting an outcome that an error is not material to previously-issued financial statements, resulting in "little r" revision restatements."

- The error is irrelevant to investors. Companies sometimes contend that specific errors have no impact on investment decisions. They may argue that the misstated item is inherently not useful or that the passage of time has made it irrelevant to current investment decisions. "We have not found these types of arguments to be persuasive because such views could be used to justify a position that many errors in previously-issued financial statements could never be material regardless of their quantitative significance or other qualitative factors." Mr. Munter also points out that prior period errors could be material because they distort trend analysis.

- The error is common in the industry and unintentional. Companies sometimes argue that an accounting error is not material because other companies made the same error and it "therefore reflects a widely-held view rather than an intention to misstate." Under SAB No. 99, management intent may provide evidence of materiality. "We have not found persuasive, however, arguments that attempt to apply that SAB No. 99 premise in reverse--that is, that the lack of intentional misstatement is viewed as providing evidence that the error is not material."

- The error is offset by other errors. Companies may argue that an error is not material because its effect is offset by other errors. Under SAB No. 99, companies and their auditors should consider both whether a misstatement is material, irrespective of its effect when combined with other misstatements, and whether an otherwise immaterial error, when aggregated with other misstatements, renders the financial statements taken as a whole materially misleading. "However, we do not believe this analysis of the aggregate effects should serve as the basis for a conclusion that individual errors are immaterial."

Accounting Errors and ICFR

The Munter statement also discusses the relationship between the determination of accounting error materiality and internal control over financial reporting (ICFR).

> "[T]he principles mentioned here regarding an objective assessment similarly apply to the ICFR analysis as to the severity of the control deficiency. Management's ICFR effectiveness assessment must consider the magnitude of the potential misstatement that could result from a control deficiency, and we note that the actual error is only the starting point for determining the potential impact and

severity of a deficiency. Therefore, while the existence of a material accounting error is an indicator of the existence of a material weakness, a material weakness may also exist without the existence of a material error."

Mr. Munter emphasizes the audit committee's role in identifying and communicating ICFR material weaknesses. "We encourage ongoing attention, including audit committee participation and training, as needed, regarding the adequacy of and basis for a registrant's ICFR effectiveness assessment—particularly where there are close calls in the assessment of whether a deficiency is a significant deficiency * * *."

Comment: In several places, Mr. Munter refers explicitly to the role of the audit committee in assessing the materiality of errors. "When an error is identified, it is important for registrants, auditors, and audit committees to carefully assess whether the error is material by applying a well-reasoned, holistic, objective approach from a reasonable investor's perspective based on the total mix of information." (This is consistent with Mr. Munter's prior comments regarding the role of the audit committee in identifying threats to auditor independence. See Acting Chief Accountant Stresses Auditor Independence and Audit Committee Oversight, November-December 2021 Update.) Audit committees should take seriously Mr. Munter's view of their responsibilities and make sure that they are informed of and involved in materiality determinations regarding errors. The SEC may inquire into the audit committee's role in cases where it disagrees with a company's determination regarding the handling of a financial statement error, and committees should be prepared to show that they provided active oversight.

In evaluating management's views on the correction of errors in previously-issued financial statements, audit committees should keep in mind the potential for bias stemming from the impact on senior management compensation. Mr. Munter alludes to this in his statement. In addition, as discussed in SEC Revives a Proposal to Require Compensation Claw Backs After Restatements, September-October 2021 Update, a pending SEC rule proposal would compel listed companies to adopt policies requiring recovery, on a no-fault basis, of incentive compensation paid to executive officers on the basis of accounting measures that are subsequently restated. In its current form, the proposal (like many existing claw-back policies) would apply only to Big R restatements. If this rule is adopted, it will raise the stakes – and increase the scrutiny – around restatement decisions.

The PCAOB Reports on its 2021 Conversations with Audit Committee Chairs

During its 2021 inspections, Public Company Accounting Oversight Board inspection teams spoke with more than 240 audit committee chairs of U.S. public companies. On March 24, the Board released 2021 Conversations with Audit Committee Chairs (2021 Conversations Report), which summarizes these discussions. This is the third year the PCAOB has published the results of the inspection staff's interactions with audit committee chairs. See The PCAOB Speaks – With Audit Committee Chairs, January-February 2021 Update and What the PCAOB Heard: Report on Conversations with Audit Committee Chairs, January 2020 Update.

The PCAOB's audit committee chair conversations were "largely open-ended or unstructured" and accordingly the 2021 Conversations Report provides insight into the issues on which chairs are focused. For example, the use of technology in auditing seems to be on the minds of many chairs, although their views are nuanced. On the one hand, several saw the auditor's use of technology as a strength and thought that automation, data analytics, and artificial intelligence had considerable potential to improve audit efficiency. In fact, some were concerned that their auditor was not deploying technology fast enough. At the same time, a recurring theme in the conversations was that technology is not a "silver bullet" and that reliance on technology "dulls auditors' ability or inclination to incorporate their business insights into procedures."

Another theme that emerges from the report is that environmental, social, and governance (ESG) matters are becoming a key topic of auditor/audit committee discussion. Some chairs characterized the issue as

“huge” and the PCAOB observed that “matters related to ESG are either already at the top of many audit committee agendas or they are gaining such prominence. A third recurring topic was the importance of timely auditor communications with the committee and of avoiding surprises. While most chairs had a positive view of the timeliness of their auditor’s communications and of their “proactive mindset,” some complained about “pileups” at year-end and indicated that they “challenge their auditors continually to adjust workflows” in order to avoid these sorts of crises.

Below is a summary of the topics addressed in the 2021 Conversations Report.

Communications with the Auditor

PCAOB auditing standards require the auditor to communicate with the audit committee regarding certain matters related to the audit and to obtain certain information from the committee. The staff asked audit committee chairs which of the required communications topics occupied the most time during audit committee meetings. The responses cited the following topics:

- Accounting matters. The most frequently mentioned topic was accounting policies and practices (including impairments and goodwill accounting issues, accounting implications of the COVID-19, revenue recognition, and implementation of the new accounting standard on credit losses).

- CAMs. The auditor’s report must disclose critical audit matters (CAMs). Audit committee chairs said that CAMs were an important discussion topic, including how the auditor identified and disclosed CAMs.

- Audit process. Chairs reported discussion with their auditor about the conduct of the audit, including planning, scope, procedures, auditor needs, levels of cooperation, and new standards.

- Controls. Some audit committee chairs said they spent considerable time discussing matters related to controls, including cybersecurity incidents, implementation of information technology, and the control impact of spinoffs and other transactions.

- COVID-19. Audit committee chairs mentioned discussions with auditors regarding the impact of COVID-19 on company liquidity, going concern assessments, relevant disclosures, and management of the audit in the remote environment and the audit risk assessment.

- Independence. Audit committees cited discussion of independence, including any violations.

- Risks. Audit committee chairs frequently mentioned discussion of risk, including communication regarding high-risk areas and risks related to fraud, changes in accounting practices, and management override of controls.

Apart from required discussion topics, audit committee chairs mentioned three other issues: gauging management “tone at the top” and competence; big picture-topics, such as industry trends and challenges; and regulatory developments.

Auditor Strengths and Areas for Improvement

The PCAOB asked audit committee chairs where they thought auditors performed well and where they thought there was room for improvement.

- The areas in which the chairs thought that auditors were performing well were communicating in a comprehensive and timely manner (e.g., transparency, “plain English” and communications free from a promotional or “selling” tone); having deep knowledge of the company’s industry, especially industry-specific accounting issues; taking a proactive and responsive approach (e.g.,

promptly informing the committee of “yellow flag” issues); and using technology in the audit (e.g., using automation, data analytics, and artificial intelligence to improve audit efficiency).

- The areas in which chairs thought there was room for improvement were situations in which there were last-minute crisis (presumably referring to issues which arose shortly before filing deadlines), managing costs and fees, and addressing engagement team turnover. Other auditor weakness areas were the flipsides of strengths: Some audit committee chairs wanted more deployment of technology to improve the audit effectiveness, and some were concerned that technology might weaken the audit by eliminating human interaction. Similarly, some chairs cited inadequate communications with the engagement team, including a need to improve communication between internal and external audit.

PCAOB Inspection Reports

About 70 percent of audit committee chairs said they reviewed the audit firm’s PCAOB inspection report or discussed it with their auditor. On the plus side, chairs thought that these reports provided insight into trends in PCAOB inspection findings and facilitated their ability to compare firms. However, the PCAOB also heard complaints about the reports, including that they were not timely and lacked sufficient detail.

Firm Quality Control Systems

The PCAOB asked audit committee chairs for their views on their audit firm’s quality control system. The themes mentioned in response included the importance of importance “robust, consistent firm processes across the U.S. firms and the global networks,” of continuous education to keep audit staff current on changes in standards and audit methodologies, and of audit firm tone at the top. Chairs also expressed satisfaction, from a quality control perspective, with the multiple layers of review at the firms, including engagement quality reviewers, consultations with the national office, and industry or topic specialists. (This is surprising, since audit committees have been known to complain that multiple review layers and national office consultations hamper the quick resolution of issues.)

Annual Assessments of the External Auditor

The PCAOB inspectors asked audit committee chairs whether they performed an annual assessment of their auditor, and if so, to describe the assessments. About 75 percent of those who responded said they did perform an annual assessment of the external auditor. As to assessment techniques, frequently mentioned tools included surveys and checklists to gauge auditor proficiency, independence, engagement with management, and other topics. One audit committee chair described an assessment process that included three committee executive sessions—one with the auditors, one with management, and one with audit committee members only.

Use of Technology

As discussed above, the chairs saw both opportunities and challenges stemming from technology. On the positive side, they thought that data analytics, workflow automation, and automated testing had “transformative potential” and could help auditors in spotting anomalies, detecting fraud, and identifying and assessing risks. They were also optimistic that automation had the potential to enhance audit efficiency, constrain costs, and permit personnel to spend more time focusing on risks.

However, chairs expressed a variety of concerns regarding the use of technology in auditing, including:

- Cybersecurity. Chairs are concerned that technology systems at audit firms are vulnerable to hacking and that a ransomware attack affecting the company’s data would impact the audit.

- Quality control. Chairs emphasized the need for quality control in the use of technology and noted that “low-grade information cannot be predictive.”

- Room to improve and grow. Audit committee chairs noted that artificial intelligence and other technologies "are still in their early stages of adoption and utility" and underscored the need for auditors to educate the audit committee on its uses, benefits, and challenges.

Information Outside the Audited Financial Statements

Of those audit committee chairs that reported discussing information outside the financials with their auditors, 70 percent cited ESG matters. This included discussion about the accuracy of ESG data and the potential need for new processes or controls with respect to ESG information. Audit committee chairs also frequently mentioned discussion with their auditors on the use of non-GAAP information.

Comment: The 2021 Conversations Report provides insight into what is on the minds of public company audit committee chairs. Audit committees may want to consider how their agenda and dialogue with their auditor match those identified in the report as recurring themes. In addition, the report includes a "What's Working Well: Communications Between Auditors and Audit Committees" section. While the suggestions in this section are general, audit committees might find them a useful source of ideas and may want to consider whether they are following these practices or, if not, whether any are worth emulating.

In 2022, the PCAOB will undoubtedly continue its practice of engaging in dialogue with audit committee chairs. An audit committee chair who is contacted by the PCAOB inspection staff as part of an inspection of the company's auditor may want to review the 2021 Conversations Report as a way of understanding what to expect during the interview.

On the Update Radar: Things in Brief

Companies are Preparing for Required ESG Disclosure, But Many Have a Lot Left to Do. On March 14, Deloitte released the results of ESG executive survey: Preparing for high-quality disclosures, a survey conducted of 300 senior finance, legal and sustainability executives concerning their companies' readiness to provide environmental, social, and governance (ESG) disclosures. The survey findings provide insight into the ability of companies to meet the demands of new ESG disclosure requirements, and are especially significant in light of the SEC's climate change disclosure proposals (see SEC Unveils its Climate Change Disclosure Proposals in this Update). According to Deloitte's press release, "Finance professionals will look to focus their efforts on improving data quality, governance, and technology resources. However, the finance leaders polled said they are unsure how to do so in a consistent way."

Key findings of the Deloitte survey include:

- Data preparedness. Thirty-two percent of survey respondents said that ESG data availability was their greatest challenge, while 25 percent cited data quality. Eighty-nine percent of respondents reported that their organization was likely to enhance its ESG control environment, while 92 percent believed that their organization needed to invest more in technology to address demand for consistent and reliable ESG measurement, reporting and disclosure.

- Disclosure readiness by ESG topic, including GHG emissions. The topics as to which respondents were "most confident" about their company's ability to make disclosure were human capital management (30 percent), climate change (24 percent), board diversity (24 percent), and cyber risk governance (22 percent). As discussed in this Update, the SEC has proposed both cybersecurity and climate-related disclosures, and the latter would include greenhouse gas (GHG) emissions. Fifty-eight percent of respondents said that their company was currently prepared to disclose Scope 1 GHG emissions, while 47 percent are prepared to disclose Scope 2 emissions. However, only 31 percent are prepared to disclose Scope 3 emissions.

- Cross-functional ESG strategy. Only 21 percent of respondents said their company had a cross-functional ESG council or working group to drive ESG strategic attention; however, 57 percent are actively working to establish such a group, while another 19 percent are "making plans" to do so. Only 3 percent said their company had no such committee and no plans to create one.

- ESG governance oversight. Fifty-four percent of respondents said the executive leadership team was responsible of ESG governance oversight. Various board-level bodies were also identified as having oversight responsibility: ESG/sustainability committee (41 percent), audit committee (39 percent), nominating and governance committee (39 percent), and full board (37 percent).

- Staffing adequacy. Only 17 percent of respondents were "completely confident" that their organization is properly staffed to meet the demands of ESG disclosure; another 45 percent were "mostly confident". The remaining respondents ranged from "somewhat confident" to "not at all confident." Concerns about staff resources are higher among those closest to the frontline. Ninety-one percent of non-C-suite executives were not completely confident regarding staff resources, compared to 77 percent of executives in C-suite positions.

- Assurance over ESG disclosures. A total of 299 companies represented in the survey currently disclose ESG performance, and 298 obtain assurance over some of these disclosures. The top three areas as to which companies obtain assurance are diversity, equity, and inclusion (53 percent), greenhouse gas emissions (49 percent), and health and safety metrics (44 percent). Among those that obtain assurance, 41 percent use their financial statement auditor, 38 percent use another CPA or chartered accountant, and 21 percent use a non-CPA/chartered accountant provider. (For more information on current ESG assurance practices, see The S&P 500 Are (Almost) All in on ESG Disclosure, August 2021 Update.)

The War in Ukraine Raises Accounting and Disclosure Challenges. The Russian invasion of Ukraine has resulted in massive human suffering and displacement and physical destruction. It has also raised accounting and financial reporting issues for companies that operate in Ukraine, Russia, and neighboring countries. In a Financial Reporting Alert, Financial Reporting Considerations Arising From the Russia-Ukraine War, Deloitte catalogues potential reporting impacts of the Russia-Ukraine war and discusses how they may affect public companies. Examples of issues that Deloitte believes are among the most pervasive and challenging include:

- Supply-chain disruption. Supply chain challenges may require entities to review their costs associated with accounting for inventory and revenue recognition practices.

- Preparation of forward-looking cash flow estimates. The range of uncertainty associated with the war's possible outcomes may influence an entity's long-term operating plan and related financial statement estimates in the affected countries.

- Recoverability and impairment of assets. Uncertainty associated with forward-looking information may affect the performance of the impairment tests for long-lived assets, intangibles, and goodwill.

- Loss of control, the ability to exercise significant influence, or cessation of operations. Companies may need to reconsider their accounting conclusions related to consolidation or equity method accounting.

- Foreign currency. As a result of sanctions against Russia, foreign currency restrictions, the development of multiple exchange rates, or high inflation could arise in certain countries. These events may affect financial statement recognition and measurement.

- Subsequent events. It may be challenging to distinguish between recognized and unrecognized subsequent events in an extremely volatile environment in which major developments occur daily.

- Going concern. Some entities may need to consider whether they can continue as a going concern within one year after interim or annual financial statement issuance date.

Deloitte's Alert addresses these and other reporting issues in detail. The Alert also discusses internal control considerations arising from the Russia-Ukraine conflict.

New Legislation Requires Cyber Incident Reporting. Shortly after the SEC announced its cyber security disclosure proposal (see SEC Proposes Cyber Attack Disclosure Requirements, in this Update), another cybersecurity reporting development occurred. Among other things, the Consolidated Appropriations Act, 2022, signed by President Biden on March 15, requires "critical infrastructure entities" to report cyber incidents to the Department of Homeland Security's Cyber-security and Infrastructure Security Agency (CISA) within 72 hours after the entity reasonably believes that it has been subject to a cyber incident. Critical infrastructure entities must also report payments in response to ransomware attacks to CISA within 24 hours. Reports to CISA, unlike those proposed by the SEC, will be non-public.

The reporting obligations in this legislation will not become effective until CISA promulgates rules defining the terms "critical infrastructure entity" and "cyber incident." In defining the entities covered by the reporting requirement, CISA is likely to look to an existing presidential directive which identifies sixteen critical sectors, including chemicals; communications; defense; emergency services; energy; financial services; food and agriculture; healthcare and public health; information technology; transportation; and water and wastewater systems.

Accounting and Auditing Enforcement was Down in 2021, But May Now be on the Upswing. A Cornerstone Research report, Accounting and Auditing Enforcement Activity—2021 Review and Analysis, finds that Securities and Exchange Commission enforcement cases involving accounting and auditing decreased in 2021 and that monetary settlements fell sharply. At the Public Company Accounting Oversight Board, enforcement activity increased in 2021, but remained below pre-pandemic levels. (For a comparison to 2018 enforcement activity, see SEC and PCAOB Cases Against Accountants Decline, While Accounting Class Actions Near Record Highs, May-June 2019 Update.) Both the SEC and the PCAOB experienced leadership changes in 2021, and, based on the rhetoric coming out of these agencies, Cornerstone suggests that accounting and auditing enforcement may be more active in 2022.

The SEC. In 2021, the SEC brought 34 accounting and auditing actions against 26 individuals and 20 firms, a decline of 32 percent from the 50 actions in 2020. The 34 cases filed in 2021 were a 41 percent decrease from the average of 58 actions initiated in the years 2016–2020 and the lowest number of new cases in the prior five years. While the overall number of cases fell, the number of actions involving auditors and audit firms increased by 33 percent, from 12 actions in 2020 to 16 in 2021.

Monetary settlements in SEC accounting and auditing cases totaled approximately $158 million, a decline of 90 percent from $1.4 billion in 2020. In eleven of the 49 settlements, the SEC reported that it considered the respondent's self-reporting, cooperation, and/or remedial efforts in determining the terms of the settlement.

As to what attracts SEC enforcement attention, 19 of the 34 SEC actions referred to a restate-ment announcement and five referred to disclosure of material weaknesses in internal control over financial reporting. The most common allegations related to revenue recognition and to violations of internal control requirements, each of which appeared in about one-third of the cases.

The PCAOB. In 2021, the PCAOB publicly disclosed 18 enforcement actions, a 38 percent increase from the 13 actions disclosed in 2020. The 18 actions involved 26 respondents, a four percent decrease from 2020. (The Sarbanes-Oxley Act prohibits the PCAOB from disclosing cases until they are settled or result in a decision against the respondent, so it is possible that the Board commenced additional actions in 2021 but that those actions are still pending.)

Twenty-six individuals or accounting firms settled with the PCAOB in 2021. Eighteen of these respondents entered into monetary settlements totaling approximately $1.1 million. The median settlement against both firms and individuals decreased in 2021; in the firm settlements, the median settlement and average settlement were less than half the comparable 2020 amounts. The PCAOB mentioned the respondent's cooperation in three of its 2021 settlements.

Forty percent of 2021 PCAOB actions alleged violations of the Engagement Quality Review standard (i.e., the requirement that a second partner review the audit before the opinion is issued), down from 70 percent in 2020. Seven of the eleven actions against accounting firms contained allegations related to the firm's system of quality control. Twenty-two percent of PCAOB actions in 2021 referred to restatements and/or to material weaknesses in internal control.

Cornerstone quotes statements from the SEC and PCAOB suggesting that accounting and auditing enforcement may pick up in 2022. For example, SEC Division of Enforcement Director Gurbir Grewal reportedly said at a conference in December 2021 that the Division would "target deficient auditing by auditors, auditor independence cases, cases around earnings management, rev rec cases" and that there is "a robust pipeline, unfortunately, of these cases, and you will see some of these in the very near future."

The Audit Blog

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

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

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