Dan Goelzer

AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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This Update summarizes recent developments relating to public company audit committees and their oversight of financial reporting and of the company's relationship with its auditor.

In This Update:

2020 PCAOB Large Firm Inspection Reports

Acting Chief Accountant Stresses Auditor Independence and Audit Committee Oversight

Slight Increases, Some Stagnation: CAQ and EY Report Cards on Audit Committee Transparency

Restatements Decline for the Sixth Straight Year, Notching a New Twenty-Year Low

Adverse Management Assessments and Auditor Opinions on ICFR Effectiveness are Down, But Better Controls May Not Be the Reason

Sustainability Reporting: (Almost) Everybody Does It

On the Update Radar: Things in Brief

- SEC Unveils its PCAOB Make-Over
- IFRS Foundation Announces the International Sustainability Standards Board and Consolidation with CDSB and SASB
- Deloitte Finds that Too Few Audit Committees are Climate Ready

The Audit Blog

2020 PCAOB Large Firm Inspection Reports

On November 1, the PCAOB released the 2020 inspection reports for the U.S. affiliates of the six global network audit firms. The overall percentage of these firms' inspected audits that the PCAOB found deficient fell from 24 percent in 2019 to 16 percent in 2020. The drop in aggregate deficient engagements was largely driven by a major improvement in PwC's inspection results. In 2019, the Board

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Dan Goelzer is a retired partner of a major global law firm. He is a member of the Sustainability Accounting Standards Board and advises a Big Four accounting firm on audit quality issues. From 2002 to 2012, he was a member of the Public Company Accounting Oversight Board and served as Acting PCAOB Chair from August 2009 through January 2011. From 1983 to 1990, he was General Counsel of the Securities and Exchange Commission.

found deficiencies in 18 out of 60 (30 percent) of the PwC audits it inspected. In 2020, the Board found only one deficient audit (2 percent) out of 52 engagements inspected – a record low for any Big Six firm. Like PwC, Deloitte's deficiency rate also dropped into the single digits at 4 percent. In contrast, the Board found deficiencies in over half of inspected BDO engagements, up from 42 percent last year.

This item presents a summary and analysis of the 2020 inspection reports. As discussed in the Comments section below, the 2020 reports suggest five observations:

- Overall, large firm audit quality appears to have improved modestly in 2020.

- Changes in the inspection process do not appear to have significantly impacted deficiency findings.

- There are pronounced differences between the inspection results of the six large firms.

- ICFR audit deficiencies seem to be leveling off.

- Assumptions underlying estimates and use of information provided by the entity are stumbling blocks in financial statement audits.

<u>2020 Inspection Cycle Report Synopses</u>

Part I.A of a firm's inspection report describes audit deficiencies of such significance that it appeared to the PCAOB that the firm had not obtained sufficient appropriate audit evidence to support its opinion on the financial statements and/or internal control over financial reporting (ICFR) of the issuer (i.e., the public company under audit) at the time the opinion was released. Part I.B of an inspection report describes instances of non-compliance with PCAOB standards or rules that do not relate directly to the sufficiency or appropriateness of the evidence supporting the firm's opinions.

Below is an overview of Part I.A and Part I.B the 2020 inspection reports for the six U.S. affiliates of the global network firms:

- <u>BDO USA, LLP</u>. The PCAOB reviewed 24 BDO issuer audits, 17 of which were integrated audits of both the financial statements and ICFR. In 13 of the 24 audits (54 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to BDO's 42 percent deficiency rate in 2019. Seven of the 13 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; four included only a financial statement audit deficiency; and two included only an ICFR audit deficiency. The PCAOB described 61 deficiencies, associated with 64 auditing standard violations, in the 13 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 16 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support its opinion.

- <u>Deloitte & Touche LLP</u>. The PCAOB reviewed 53 Deloitte issuer audits, 50 of which were integrated audits of both the financial statements and ICFR. In two of the 53 audits (4 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to D&T's 10 percent deficiency rate in 2019. One of the two engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; one included only a financial statement audit deficiency. The PCAOB described nine deficiencies, associated with ten auditing standard violations, in the two engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 19 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support its opinion.

- Ernst & Young LLP. The PCAOB reviewed 52 EY issuer audits, 47 of which were integrated audits of both the financial statements and ICFR. In eight of the 52 audits (15 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to EY's 18 percent deficiency rate in 2019. Four of the eight engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; four included only a financial statement audit deficiency. The PCAOB described 18 deficiencies, associated with 21 auditing standard violations, in the eight engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified two instances of non-compliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support its opinion.

- Grant Thornton LLP. The PCAOB reviewed 29 Grant issuer audits, 27 of which were integrated audits of both the financial statements and ICFR. In five of the 29 audits (17 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to Grant's 23 percent deficiency rate in 2019. All five of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR. The PCAOB described 23 deficiencies, associated with 27 auditing standard violations, in the five engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified three instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support its opinion.

- KPMG LLP. The PCAOB reviewed 53 KPMG issuer audits, 47 of which were integrated audits of both the financial statements and ICFR. In 14 of the 53 audits (26 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to KPMG's 29 percent deficiency rate in 2019. Nine of the 14 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; one included only a financial statement audit deficiency; and four included only an ICFR audit deficiency. The PCAOB described 50 deficiencies, associated with 57 auditing standard violations, in the 14 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 6 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support its opinion.

- PricewaterhouseCoopers LLP. The PCAOB reviewed 52 PwC issuer audits, 50 of which were integrated audits of both the financial statements and ICFR. In one of the 52 audits (2 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to PwC's 30 percent deficiency rate in 2019. The engagement in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR. The PCAOB described five deficiencies, associated with six auditing standard violations, in the engagement in Part I.A. In Part I.B of the inspection report, the PCAOB identified 18 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support its opinion.

Comparisons of Firm Performance

The table below summarizes the results of the 2020 inspections of the six firms. A similar table, which appeared in 2019 PCAOB Large Firm Inspection Reports, January-February 2021 Update, showing results of the 2019 inspections, follows the 2020 table.

2020 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS (All reports are dated September 30, 2021, and were released on November 1, 2021			
Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	24	13	54%
Deloitte & Touche	53	2	4%
Ernst & Young	52	8	15%
Grant Thornton	29	5	17%
KPMG	53	14	26%
PwC	52	1	2%
2020 Global Network Firm Totals	263	43	
2020 Global Network Firm Average	44	7	16%

2019 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS (All reports are dated December 17, 2020, and were released on February 2, 2021			
Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	26	11	42%
Deloitte & Touche	58	6	10%
Ernst & Young	60	11	18%
Grant Thornton	31	7	23%
KPMG	58	17	29%
PwC	60	18	30%
2019 Global Network Firm Totals	293	70	
2019 Global Network Firm Average	49	12	24%

The tables above focus on the percentage of inspected engagements found to have at least one audit deficiency. Other indicators of the relative performance of the six firms are the number individual audit deficiencies in each report and the number of auditing standards violations associated with those deficiencies. These metrics differ from the percentage-of-deficient engagements measure because an engagement included in Part I.A may involve more than one deficiency and a deficiency may be associated with a violation of more than one auditing standard. The following table compares the performance of the six firms based on the number of audit deficiencies in each inspection report and the number of auditing standards associated with those deficiencies.

DEFICIENCIES AND ASSOICATED AUDITING STANDARD IN SIX FIRM 2020 INSPECTION REPORTS

Firm	Engagements Inspected	Deficient Engagements	Total Deficiencies	Standards Referenced	Average Per Inspected Engagement Deficiencies	Average Per Inspected Engagement Standards Referenced
BDO	24	13	61	64	2.54	2.67
Deloitte & Touche	53	2	9	10	0.17	0.19
Ernst & Young	52	8	18	21	0.35	0.40
Grant Thornton	29	5	23	27	0.79	0.93
KPMG	53	14	50	57	0.94	1.08
PwC	52	1	5	6	0.10	0.12
2020 Global Net Firm Totals	263	43	166	185		
2020 Global Net Firm Average	44	7	28	31	0.64	0.70

Aggregate Deficiency Data

The auditing standards most frequently cited as the basis for audit deficiencies in Part I.A of the 2020 inspection reports of the six firms are listed in the table below. The table also shows the percentage of all deficiencies in the six reports that were based on each auditing standard. The same auditing standard may have been cited more than once in an engagement described in Part I.A if the inspectors found more than one deficiency based on that standard.

AUDITING STANDARDS REFERENCED IN SIX FIRM PART I DEFICIENCY FINDINGS

PCAOB Auditing Standard	Number of Times Standard Cited as Deficiency Basis	Percentage of Total Deficiencies Citing Standard
AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements	91	49.2%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	27	14.6%
AS 1105, Audit Evidence	18	9.7%
AS 2315, Audit Sampling	17	9.2%
AS 2502, Auditing Fair Value Measurements and Disclosures	9	4.9%
AS 2501, Auditing Accounting Estimates	8	4.3%
AS 2810, Evaluating Audit Results	6	3.2%
AS 2305, Substantive Analytical Procedures	4	2.2%
S 2310, The Confirmation Process	3	1.6%
AS 2101, Audit Planning	1	.5%
AS 2503, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities	1	.5%

In each inspection report, the PCAOB lists the most frequently identified audit deficiencies, divided between the most frequent deficiencies in financial statement (FS) audits and the most frequent deficiencies in ICFR audits. The table below aggregates these frequent deficiencies lists for the six firms. The table also indicates what percentage of the engagements in Part I of the six reports included these deficiencies. Only deficiencies that were identified more than once are included.

MOST FREQUENTLY IDENTIFIED AUDIT DEFICIENCIES IN 2020 SIX FIRM INPSECTION REPORTS

Deficiency Description	Number of Times Deficiency Was Identified	Audit Affected	Percentage of All Deficiencies
Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing.	24	ICFR	21.8%
Did not perform substantive procedures to obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls).	18	FS	16.4%
Did not identify and/or sufficiently test controls over accuracy and completeness of data and reports issuer used in the operation of controls.	15	ICFR	13.6%
Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate.	12	FS	10.9%
Did not identify and test any controls that addressed the risks related to a significant account or relevant assertion.	12	ICFR	10.9%
Did not perform sufficient testing of the accuracy and completeness of data and or reports used in the firm's substantive testing.	8	FS	7.3%
Did not perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	4	FS	3.6%
Did not perform sufficient, appropriate analytical procedures when analytical procedures were intended to provide substantive evidence.	4	FS	3.6%
Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.	4	FS	3.6%
Did no perform sufficient, appropriate analytical procedures when Analytical procedures were intended to provide substantive evidence.	3	FS	2.7%
Did not appropriately evaluate control deficiencies.	2	ICFR	1.8%

The PCAOB also lists the financial statement accounts or audit areas most frequently cited in the Part I.A deficiencies in that report. For the six firms, on an aggregate basis, these areas were:

- Revenue and related accounts – 24 deficiencies
- Business combinations – 5 deficiencies

- Investment securities – 4 deficiencies
- Inventory – 4 deficiencies
- Allowance for loan losses – 3 deficiencies
- Expenses – 2 deficiencies
- Income taxes – 2 deficiencies
- Goodwill and intangibles – 2 deficiencies

Part I.B Deficiencies

As noted above, Part I.B of an inspection report describes auditing standard or PCAOB rule violations discovered in the inspection that did not directly affect the auditor's opinion. It appears that the PCAOB does not review all inspected engagements for every type of Part I.B deficiency. Therefore, the number of Part I.B violations in a firm's inspection report is not directly comparable to the number in other firms' reports or to the number reported in prior years.

In 2020, the PCAOB found an aggregate of 64 such violations (based on a review of 431 engagements). These violations related to:

- AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (requiring the auditor to perform procedures to identify critical audit matters (CAMs) and to discuss CAMs in the auditor's report) – 25 violations (out of 134 engagements reviewed).
- AS 1301, Communications with Audit Committees (requiring the auditor to communicate certain matters to the audit committee) – 13 violations (out of 73 engagements reviewed).
- Rule 3211, Auditor Reporting of Certain Audit Participants (requiring the auditor to file Form AP with the PCAOB for each public company audit, identifying, among other things, other audit firms that participated in the engagements and disclosing certain information concerning participating firms) – 11 violations (out of 54 engagements reviewed).
- AS 1215, Audit Documentation (requiring the auditor to assemble a final set of work papers) – 8 violations (out of 129 engagements reviewed).
- AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (requiring the auditor to communicate ICFR deficiencies to the audit committee and requiring the auditor's report on ICFR audit to include certain language and disclosures) – 5 violations (out of 17 engagements reviewed).
- Rule 3524, Audit Committee Pre-approval of Certain Tax Services (requiring the auditor to describe in writing to the audit committee certain information concerning permissible tax services and to document the substance of related discussion with the audit committee) -- 2 violations (out of 24 engagements reviewed).

Comments: In its inspection reports, the PCAOB cautions that its "inspection results are not necessarily comparable over time or among firms." Accordingly, drawing reliable conclusions about firm or profession-wide trends in audit quality from inspections reports is problematic. While that caveat should be kept in mind, below are five observations that seem to emerge from the 2020 reports.

1. Overall, large firm audit quality appears to have improved modestly in 2020. As measured by these PCAOB inspection findings, audit quality seems, at first glance, to have improved significantly, compared to last year. For the six global network firm affiliates as a group, the overall deficient engagement rate fell by one-third -- from 24 percent of inspected engagements in 2019 to 16 percent in 2020. For the Big Four, the deficient engagement rate declined from 25 percent in 2018 and 22 percent in 2019 to 12 percent of all inspected engagements in 2020.

   These headline numbers are, however, a bit misleading. As noted earlier, PwC's deficient engagement rate fell from a 30 percent (18 engagements) in 2019 to a record-setting low of 2 percent (one engagement) in 2020. Most of the performance improvement for the six firms as a group was the result of PwC's turnaround. However, even acknowledging the impact of the PwC results, the 2020 reports seem to reflect an ongoing trend of audit quality improvement. Five of the six firms had lower deficient engagement rates in 2020 than in 2019. (The exception was BDO; its deficient engagement rate rose from 42 percent in 2019 to 54 percent in 2020.) Like PwC, Deloitte's deficient engagement rate dropped into the single digits at 4 percent, continuing that firm's multi-year record of declining deficiencies.

2. Changes in the inspection process do not appear to have significantly impacted deficiency findings. It is of course possible that what is changing is the inspection program, not the performance of the inspected firms. There is no concrete evidence that this is the case. Two inspection-process factors may however have played some role in the improvement in aggregate firm deficiency rates.

   First, as discussed in last year's inspection summary (see 2019 Large Firm Inspection Reports, January-February 2021 Update), during the last several years the PCAOB has increased the percentage of inspected engagements selected for inspection at random, rather than based on risk. In 2018, 18.7 percent of inspection selections were random. In 2019, that figure grew to 23.7 percent. In 2020, 24.7 percent were random selections, slightly more than in 2019. The PCAOB argues that random selection is desirable because it makes it harder for firms to predict which audits will be reviewed. At the same time, deficiencies are presumably less likely to be found in engagements selected at random than in those selected based on an assessment of the engagement's inherent difficulty or risk.

   Second, due to Covid, the 2020 inspections were conducted remotely, rather than by in-person visits to firm offices and meetings with engagement team members. Further, the PCAOB has stated that in 2020 it adjusted its "inspection approach to consider the impact of COVID-19 on the audits to public companies." See Spotlight: Staff Update and Preview of 2020 Inspection Observations. While these steps were certainly appropriate, it is possible that remote inspection procedures and a focus on how firms dealt with the pandemic caused inspectors to be less likely to turn up audit deficiencies that would have been detected in traditional inspections.

3. There are pronounced differences between the inspection results of the six large firms. In 2019, the gap between the global network firm with the lowest deficient engagement percentage (D&T) and the firm with the highest (BDO) was 32 percent. In 2020, that gap rose to 52 percent (2 percent for PwC versus 54 percent for BDO).

   There are also stark distinctions between the inspection results for these six firms based on the numbers of deficiencies and auditing standards violations cited in Part I.A of each report. On average, the inspectors found 0.64 deficiencies and referenced 0.70 auditing standards in each engagement they inspected in 2020. However, the averages mask a wide dispersion between firms. In the PwC inspection, five deficiencies with six associated standards violations were found (all in one engagement) out of 52 engagements inspected – an average of 0.10 deficiencies and 0.12 standards per inspected engagement. At Deloitte, 53 inspections found nine deficiencies with ten associated standards (all in two engagement) or 0.17 deficiencies and 0.19 standards per engagement. At the other end of the spectrum, in 24 BDO engagements

inspected, the staff found 61 deficiencies and cited 64 standards, an average of 2.54 deficiencies and 2.67 standards per inspected engagement – 25 times more deficiencies per inspected engagement than at PwC. In between these extremes, EY, Grant, and KPMG had total deficiency rates ranging from 0.94 to 0.35 deficiencies per inspected engagement.

4. ICFR audit deficiencies seem to be leveling off. Continuing a decade-long trend, the 2020 inspection results highlight the PCAOB's focus on ICFR auditing, although ICFR audit deficiencies may be starting to plateau. The inspectors found ICFR audit deficiencies in 14 percent of the integrated audits they inspected, down from 23 percent in 2019 and 26 percent in 2018. This year, 77 percent of all audit engagements in Part I.A included an ICFR deficiency. In 2019 and 2018, 81 percent and 89 percent, respectively, of Part I.A engagements included an ICFR deficiency. In 2019, over half (55.3 percent) of the most frequently cited deficiencies affected the ICFR audit. In 2020, frequent deficiencies affecting the ICFR audit fell to 50 percent. It will be interesting to see whether this trend of declining ICFR violations continues in 2021.

5. Assumptions underlying estimates and use of information provided by the entity are stumbling blocks in financial statement audits. The PCAOB found violations in the financial statement audit in 14 percent of the engagements it inspected, and 86 percent of engagements in Part I.A included a financial statement audit deficiency. In 2019, the Board found financial statement audit deficiencies in 21 percent of the audits it inspected, and 87 percent of all deficient engagements included at least one financial statement audit deficiency. (Deficiencies in the financial statement audit do not, of course, necessarily mean that the financial statements were misstated.)

   The most frequent Part I.A deficiency affecting the financial statement audit was a consequence of deficiencies in control testing: "Did not perform substantive procedures to obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls)." The second most frequent financial statement audit deficiency was "Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate." Deficiencies related to evaluating assumptions underlying estimates is a perennial audit challenge. This issue topped the 2019 and 2018 lists of financial statement audit deficiencies. The third most frequent financial statement audit deficiency was " Did not perform sufficient testing of the accuracy and completeness of data or reports used in the firm's substantive testing." This presumably refers to auditor use of reports generated by the client's IT system without adequate testing of report accuracy.

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As noted in past years, the audit deficiency description and auditing standard deficiency tables could be used as a checklist for topics audit committees may want to discuss with their auditor to understand how the auditor addressed, or plans to address, the most challenging areas in the company's audit.

Acting Chief Accountant Stresses Auditor Independence and Audit Committee Oversight

On October 26, SEC Acting Chief Accountant Paul Munter issued a statement urging "all gatekeepers in the financial reporting ecosystem (auditors, management, and their audit committees) to maintain constant vigilance in the faithful implementation of the requirements of [the Sarbanes-Oxley Act (SOX)] by fulfilling their shared responsibilities to continue to produce high quality financial disclosures that are decision-useful to investors and maintain the public trust in our capital markets." See The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors. Mr. Munter added that "an integral part of the faithful implementation of SOX is for * * * audit committees to take ownership of their oversight responsibilities with respect to the independent auditor." Further, "[e]ffective oversight by strong, active, knowledgeable and independent

audit committees significantly furthers the collective goal of providing high quality, reliable financial information to investors."

The thrust of the statement is the importance of the assurance provided by an independent audit to the credibility of financial reporting. Mr. Munter states that the "independence of the auditor, in both fact and appearance, is foundational to the credibility of the financial statements" and that "compliance with auditor independence rules is a shared responsibility of the issuer, its audit committee, and the auditor. As to the specifics of the audit committee's responsibilities for auditor independence, he outlines two things audit committees should do:

- Consider the sufficiency of the auditor's and the issuer's monitoring processes. This includes monitoring that addresses corporate changes or other events that potentially affect auditor independence. "This is particularly relevant in the current environment as companies seek to access public markets through new and innovative transactions, and audit firms continue to expand business relationships and non-audit services."

- Proactively seek to inform themselves of any potential impact to auditor independence, in fact and appearance, as companies negotiate potential transactions with third parties. "This proactive monitoring requires management, the audit committee, and the independent auditor to each consider the potential effects of the auditor's existing business and service relationships with other companies on the auditor's ability to remain independent of the issuer if a contemplated transaction is consummated."

The Munter statement also includes a broad declaration of the link between audit committee oversight and auditor independence, financial reporting quality, and audit quality:

> "An effective audit committee enhances the accountant's independence by, among other things, providing a forum apart from management where the accountants may discuss their concerns. It facilitates communications among the board of directors, management, internal auditors and independent auditors. An effective audit committee also enhances auditor independence from management by exercising its responsibilities in appointing, compensating and overseeing the work of the independent auditors. Because audit committees have financial reporting and audit oversight authority and responsibility, they also are instrumental in setting the tone at the top for the quality of the issuer's financial reporting to investors. In selecting, retaining, and evaluating the independent auditor, the audit committee always should be focused, in the first instance, on audit quality." (footnote omitted)

Comment: One likely motive for the issuance of the statement at this time can be found in Mr. Munter's references to "new and innovative transactions" by which companies access public markets (e.g., SPAC mergers) and to the continued expansion of audit firm "business relationships and non-audit services." Both of these trends increase the potential for the auditor's relationship with a third party to create an unanticipated independence challenge for existing audit clients. These independence challenges can in turn become issues for the audit committee.

The statement is quite explicit that auditors, managements, and audit committees all need to be vigilant in identifying independence threats. Having publicly made this point, SEC Chief Accountant's staff may not be sympathetic when companies find themselves in the position of confronting a potential violation of the Commission's requirement to file an audit report issued by an independent auditor, if the issue could have been anticipated in advance. Audit committees should take seriously Mr. Munter's suggestions that they monitor the auditor's and the company's processes for identifying independence threats and stay "proactively informed" of events and transactions that could impact the auditor's independence.

Slight Increases, Some Stagnation: CAQ and EY Report Cards on Audit Committee Transparency

On November 10, the Center for Audit Quality (CAQ) and research firm Audit Analytics released 2021 Audit Committee Transparency Barometer, an annual assessment of S&P Composite 1500 proxy statement disclosures related to the work of the audit committee. Several weeks earlier, on October 26, the EY Center for Board Matters (EY Center) published its annual review of Fortune 100 audit committee-related proxy disclosures, Audit committee reporting to shareholders in 2021. Together, these reports reflect modest, but steady, increases in voluntary disclosures about the audit committee and its work, continuing a decade-long trend toward more openness. While transparency has increased substantially over the eight years it has published the Barometer, the CAQ summed up this year's report as reflecting "slight increases with some stagnation among disclosures that have been tracked over the years."

One exception to the incremental level of change in 2021 was cybersecurity oversight disclosure, which the CAQ finds has increased by five to seven percent each year since 2016. The CAQ notes that "COVID-19 has changed how we work, with some companies opting to go permanently remote, resulting in an increased dependence on technology. Audit committees have reacted positively by increasing disclosure of how they oversee the company's cybersecurity risks." EY also reports additional disclosure regarding audit committee oversight of risks not directly related to financial reporting, such as cybersecurity and ESG.

CAQ/AA: 2021 Transparency Barometer

The 2021 report is the CAQ's eighth annual Transparency Barometer. (For a summary of the 2020 Barometer, see As Transparency Inches Forward, Audit Committees are Disclosing More About Cyber Risk Oversight, But Less About Audit Fees, October-November 2020 Update.) The CAQ's report breaks down S&P 1500 disclosures between the S&P 500 large-cap companies, the S&P MidCap 400, and the S&P SmallCap 600. Highlights of the 2021 Transparency Barometer include:

- The highest rates of disclosure related to non-audit services and their potential impact on independence, auditor tenure, criteria considered to evaluate the audit firm, and audit committee involvement in engagement partner selection. For example--

  - Eighty-three percent of the S&P 500 discussed how non-audit services may impact auditor independence. Eighty percent of the S&P MidCap and 76 percent of the SmallCap companies made such disclosure.

  - Half of the S&P 500 stated that the audit committee is involved in engagement partner selection, while 22 percent of MidCaps and 12 percent of SmallCaps made such a statement.

- Topics as to which the CAQ found "moderate" rates of disclosure included engagement partner rotation, considerations when appointing the external auditor, and a statement that the committee evaluates the external auditor at least annually. For example, the percentage of S&P 500, S&P MidCap, and S&P SmallCap companies that disclosed that the engagement partner rotates every five years were 49, 24, and 16 percent, respectively. The comparable percentages for discussion of audit committee considerations in appointing the auditor were 44, 31, and 24 percent.

- Areas in which there were relatively low levels of disclosure included audit committee responsibility for audit fee negotiations, explanation of a change in audit fees, and discussion of how the audit committee considers auditor compensation and its connection to audit quality. For example, only 17 percent of the S&P 500 disclosed an explanation for a change in audit fees. However, unlike most other topics, disclosure of reasons for fee changes was more frequent among smaller companies – 24 percent of SmallCaps and 20 percent of MidCaps discussed such changes.

- The least popular disclosure tracked by the Barometer is significant areas discussed with the auditor. None of the S&P 1500 companies made such a disclosure in 2021. By comparison, in 2014, three percent of the S&P 500, two percent of the MidCaps, and one percent of the SmallCaps disclosed significant areas addressed with the auditor.

As noted above, disclosure related to audit committee responsibility for oversight of cybersecurity risk has increased sharply during the last five years. In 2021, 46 percent of the S&P 500 disclosed that the audit committee is responsible for cybersecurity (compared to 39 percent last year); 34 percent of S&P MidCaps (28 percent last year) and 24 percent of S&P SmallCaps (18 percent last year) made such a statement. In contrast, only eleven percent of the S&P 500 (and five percent of Mid-Caps and four percent of SmallCaps) discussed audit committee responsibility for cybersecurity risk oversight in 2016.

For many of the disclosure areas the Barometer tracks, the CAQ discusses why the disclosure matters to investors. For example, as to the impact of non-audit services on independence, the CAQ states: "Disclosure describing the oversight by the audit committee in reviewing any permitted non-audit services provided by the independent auditor to the company helps stakeholders understand how non-audit services are reviewed and factors considered by the audit committee. Such disclosure reinforces the oversight of the auditor's independence, a foundation of audit quality." In addition, the Barometer includes examples from audit committee reports or other proxy statement discussions of each type of disclosure tracked.

EY: Fortune 100 Audit Committee Reporting to Shareholders

The EY Center began its annual reviews of Fortune 100 audit committee disclosures in 2012. (For summaries of recent prior EY reports, see Voluntary Audit Committee Disclosures Continue to Increase – But Only Slightly, September 2020 Update, and CAQ and EY Center Audit Committee Transparency Reports: Disclosure Continues to Grow Apace, October-November 2018 Update) This year's EY report is based on an analysis of the proxy disclosures of the 72 companies on the 2021 Fortune 100 list that filed proxy statements each year since 2012 and that held annual meetings through July 2021.

Like the CAQ, the EY Center finds that disclosure about the work of the audit committee has increased over time, but that the rate of change has slowed: "Voluntary audit committee-related disclosures have grown significantly over the past 10 years that [EY] has been tracking them, although the pace of change has slowed in recent years. While the COVID-19 pandemic has had a great deal of impact on publicly traded companies, it does not appear to have altered the upward trend in voluntary disclosures about audit committees, albeit incremental." Some new disclosure areas are however appearing: "2021 disclosures also indicate that some audit committees are expanding their remits to include issues increasingly relevant to today's investors, such as environmental, social and governance (ESG) matters, cybersecurity and more."

Some other findings of the 2021 EY report include:

- Seventy-one percent of Fortune 100 companies reviewed disclosed factors used in the audit committee's assessment of the external auditor's qualifications and work quality. Last year, 64 percent made such disclosure, and only 15 percent of these companies did so in 2012.

- Ninety-two percent of the reviewed companies disclosed that the audit committee considers non-audit fees and services when assessing auditor independence. Only 16 percent made that disclosure in 2012.

- Nearly 70 percent of reviewed companies stated that they consider the impact of changing auditors when assessing whether to retain the current external auditor, compared to three percent in 2012. Seventy-nine percent disclosed the tenure of the current auditor, up from and 23 percent in 2012. (Tenure is required to be disclosed in the auditors' report.)

- Approximately 76 percent of the reviewed companies included additional disclosures around risks beyond financial reporting that were overseen by the audit committee, including cyber-security, data privacy, enterprise risk management and ESG. For example—
  - Nearly 70 percent disclosed that the audit committee oversees cybersecurity matters.
  - Ten percent of reviewed companies discussed the audit committee's role in ESG matters, such as oversight of climate change risks as they relate to financial and operational risk exposures and environmental, health and safety related matters.
- Sixteen of the 72 reviewed companies' audit committee disclosures referred to the critical audit matters (CAMs) discussed in the auditor's report. (CAMs are matters communicated to the audit committee that involved especially challenging, subjective, or complex auditor judgment.) These disclosures noted that the audit committee reviewed and discussed with the external auditor CAMs that arose during the current period audit.

The EY report includes sample language on various types of audit committee disclosures from the proxy statements it reviewed. Also, similar to last year, the EY Center suggests that audit committees consider five questions in evaluating their company's disclosure:

- Does the company's proxy statement effectively communicate how the audit committee is overseeing and engaging with the independent auditor? Does it address areas of investor interest, such as the independence and performance of the auditor and the audit committee's key areas of focus?
- How has the role of the audit committee evolved in recent years (e.g., oversight of enterprise risk management, cybersecurity risk), and to what extent are these changes being communicated to stakeholders?
- In light of the changing environment, what additional voluntary disclosures might be useful to shareholders related to the audit committee's time spent on certain activities, such as cybersecurity, data privacy, business continuity, corporate culture and financial statement reporting developments?
- Has the audit committee considered how changes in the auditor reporting requirements may impact audit committee disclosures?
- How do director qualifications and board composition-related disclosures highlight the diversity considerations, expertise, experiences, and backgrounds of audit committee members?

Comment: As the CAQ observes, "disclosure of the multiple additional ways audit committees oversee the external auditor contributes to audit quality. Transparency and disclosure are key elements of trust in the financial reporting system. In line with this, the CAQ continues to encourage robust audit committee disclosures in proxy statements to promote high-quality performance by public company auditors and investor trust in the audit committee's oversight role."

Audit committees should be aware of the types of voluntary disclosures their peers are making and consider expanding their disclosures to match. The kinds of voluntary disclosures the Transparency Barometer and the EY Center report identify as common among S&P 1500 and Fortune 100 companies are generally not controversial and would rarely involve disclosing confidential information or exposing the audit committee to increased litigation risk. Both reports include examples from company filings that provide good models for companies that are considering strengthening their disclosures. In addition, the EY Center's suggested questions provide a framework for audit committee consideration of whether their company's disclosures should be enhanced.

Restatements Decline for the Sixth Straight Year, Notching a New Twenty-Year Low

Audit Analytics (AA) has released its annual report on public company restatements, 2020 Financial Restatements: A Twenty-Year Review. AA found that the number of restatements in 2020 fell to 364 – the fewest since AA began tracking restatements in 2001 and 26 percent fewer than in 2019. See How Low Can They Go? Restatements Hit Another New Low in 2019, September 2020 Update. After holding relatively constant from 2009 to 2014, the number of restatement disclosures has now declined for six years. The 364 restatements in 2020 were filed by 336 companies and, overall, 4.93 percent of the SEC public company filer population (excluding funds and trusts) restated their financial statements in 2020. This reflects a drop from 6.8 percent in 2019 and 17 percent at the peak in 2006.

Big and Little R

As explained in Restatements Hit Another New Low, and SOX Could Be the Reason, July 2017 Update, restatements fall into two categories. When a company determines that users can no longer rely on previously issued financial statements due to a material error, it is required to disclose that determination by filing SEC Form 8-K within four business days. Restated financial statements would normally be filed sometime later, after the company has had the opportunity to analyze and correct the errors. This type of restatement is referred to as a "reissuance" or "Big R" restatement.

In contrast, if a company determines that previously issued financial statements contain immaterial errors, and that, despite the errors, users can continue to rely on the financial statements, it is not required to file Form 8-K. Corrected financial statements may simply be included in a subsequent periodic SEC filing with the restatement disclosed in the footnotes to the current financial statements. These less significant restatements are called "revision" or "little r" restatements. Revision restatements typically attract less public attention and market reaction than reissuance restatements.

Out-of-period adjustments (OPAs) are a third method of correcting immaterial errors in prior financial statements. OPAs are corrections of prior period errors in the current period. OPAs are not restatements because previous financial statements are not affected.

2020 Report Highlights

In addition to the record low restatement numbers noted above, highlights of the 2020 AA report include:

- The great majority of restatements were deemed to be immaterial. Revision restatements (75.7 percent of all restatements) exceeded reissuance restatements (24.3 percent of the total) by slightly more than a 3:1 ratio.

- The average net income impact of restatements rose sharply in 2020. The 2020 average restatement net income impact was negative $17.6 million -- the fourth highest in the past 18 years. In contrast, the 2019 average impact of negative $1.7 was the lowest since AA has tracked this metric. AA attributes the surge in average net income impact to three factors. "First, there were several restatements in 2020 that had large negative impacts on net income. Second, the average adjustment for restatements that had a positive impact on net income was historically low. And third, 2020 saw the greatest proportion of restatements [37.2 percent] that had a negative impact on net income since 2011."

- Reissuance or Big R restatements were filed more quickly. AA tracked the period of time that elapsed between disclosure of the fact of the misstatement and the filing of the restatement. The average number of days to file a restatement in 2020 declined to 39.9 from 65.2 in 2019.

- The average number of days restated dropped for the fourth consecutive year. Days restated is a measure of restatement severity. In 2020, it averaged 447 days, compared to 451 days in 2019.

- The average number of accounting issues per restatement rose slightly. In 2020, the average number of issues disclosed per restatement was 1.57, slightly higher than the 1.51 issues per restatement in 2019. This metric peaked at 2.48 issues per restatement in 2005.

- Accelerated filers and foreign issuers were less likely to restate. Restatements by non-accelerated U.S. filers increased from 36.0 percent in 2019 to 53.3 percent of total restatements in 2020. Restatements by accelerated U.S. filers decreased from 46.0 percent to 31.3 percent. Restatements by foreign issuers decreased from 18.0 percent to 15.4 percent.

- Revenue recognition was the accounting issue most frequently involved in restatements. Revenue recognition was cited in 17.3 percent of restatements. The next four most common restatement accounting issues were: Debt and equity securities (14.3 percent); Liabilities and accruals (12.6 percent); Tax matters (12.1 percent); and General expenses (11.0 percent).

Comment: At least as measured by restatement frequency and severity, the substantial investment companies have made in strengthening and monitoring the effectiveness of their controls seems to have paid off. Restatements peaked in 2006 at 1,842. The 2006 peak occurred during the period when public companies and their auditors were devoting a new level of scrutiny to internal control over financial reporting in the wake of the implementation of the Sarbanes-Oxley Act requirement to assess and report on ICFR effectiveness. Since 2006, restatements have declined substantially and continue to decline.

The culture around restatements may also have changed. Whether to correct a prior error by a reissuance restatement or a revision restatement (which attracts less public attention) is to some degree a matter of judgment. The share of restatements that are little r rather than Big R has increased over the years and, as noted above, in 2020 over 75 percent of all restatements were by revision, not reissuance. AA notes that claw back policies can influence a company's desire to classify a restatement as a revision. Under a claw back policy, executive compensation based on reported financial results must be repaid to the company if the underlying financial statements are restated. Many companies have adopted such policies, and the SEC has proposed to require claw backs. See SEC Revives a Proposal to Require Compensation Claw Backs After Restatements, September-October 2020 Update. Under the SEC's proposal, repayment of executive compensation would be mandatory when a reissuance restatement is disclosed but would not apply to revision restatements.

Audit committees confronted with the need to restate should make sure they fully understand the reasons for the restatement method – reissuance or revision – chosen by management. This may become an area of greater SEC scrutiny in the future.

Adverse Management Assessments and Auditor Opinions on ICFR Effectiveness are Down, But Better Controls May Not Be the Reason

Audit Analytics (AA) has published SOX 404 Disclosures: A Seventeen-Year Review, its annual report on auditor opinions and management assessments of the effectiveness of internal control over financial reporting (ICFR). AA found that the percentage of companies with management assessments that report ineffective ICFR declined across all company sizes for fiscal year 2020. Accelerated filers had the most significant decline, with nearly 100 fewer adverse control assessments. In addition, fewer ICFR auditor opinions on control effectiveness (which only accelerated filers are required to obtain) were adverse. There were 146 adverse auditor opinions in 2020, 4.6 percent of the ICFR attestations filed, down from 6.9 percent in 2019.

These drops in adverse ICFR assessments do not, however, necessarily signal a sudden improvement in the effectiveness controls. During 2020, the SEC changed its accelerated filer definition to exclude

companies with revenue less than $100 million. AA found that 337 companies switched out of accelerated filer status between 2019 and 2020. In a blog post, AA stated that "[t]hese companies accounted for a huge portion of the positive trend in control assessments for accelerated filers."

SOX 404

Section 404 of the Sarbanes-Oxley Act (SOX) requires public company managements to perform and disclose an annual assessment of the effectiveness of the company's ICFR. Section 404 also requires companies to obtain a report from their external auditor expressing the auditor's opinion on the effectiveness of the company's ICFR. For either a management assessment or an auditor's report, the existence of one or more ICFR material weaknesses means that controls are ineffective and requires the issuance of an adverse assessment or opinion.

In 2010, the Dodd-Frank Act modified the original Section 404 scheme by excluding companies that qualified as non-accelerated filers under the SEC's rules from the auditor attestation requirement. The JOBS Act of 2012 added an exclusion for emerging growth companies, as defined in that legislation.

The SEC's accelerated filer definition has changed over time. For many years, any company with a public float of $75 million or more was an accelerated filer for SOX Section 404 purposes; any company with a public float less than $75 million was non-accelerated filer. However, in 2020, the SEC added a revenue test. As a result, companies with between $75 million and $700 million in public float are now accelerated filers only if they also have $100 million or more in revenue. This rule change increased the number of smaller public companies that are exempt from the external audit requirement and are only required to disclose management's assessment of control effectiveness.

2020 SOX 404 ICFR Effectiveness Disclosures

In 2020, 6,205 management ICFR assessments were filed, down from 6,240 in 2020. There were 3,142 auditor's reports on ICFR, down from 3,550 the prior year. In 2020, 3,064 companies filed only a management assessment of ICFR, up from 2,691 management assessment-only filers in 2019. With respect to the reporting of ineffective controls in these filings, AA found:

- Auditor attestations. "The number of adverse ICFR auditor attestations dropped to 146 in 2020. Since the inception of SOX requirements in 2004, 2020 had the second-lowest number of adverse auditor attestations, after the 139 adverse attestations in 2010. After 2010, there was a six-year upward trend in the number of ineffective ICFR auditor attestations, partially related to oversight activities of the PCAOB and other regulators. The number of adverse auditor attestations represents 4.6% of all auditor attestations filed for the fiscal year 2020, a decrease from the 6.9% seen in 2019. This is the lowest percentage of total reports containing an adverse auditor attestation since 2012."

- Management reports. "The number of adverse ICFR management reports dropped to 1,329 in 2020. This represents 21.4% of all management reports filed for the year, down from 22.4% in 2019. The number of adverse management reports has been steadily declining since a high point of 23.9% in 2014. Between 2013 and 2020, the percentage of adverse management reports has minimally fluctuated between 21.4% and 23.9%."

- Management only reports (i.e., reports filed by companies not required to obtain an auditor's opinion on ICFR effectiveness). "In 2020, the number of adverse ICFR management-only reports increased to 1,183. This represents 38.6% of all management-only reports filed for the year, down from 42.7% in 2019. The number of companies eligible to file a management-only report under SOX 404(a) increased in 2020, corresponding with amendments to the SEC's accelerated filer definition that became effective in April 2020."

In AA's view, the percentage decline in adverse ICFR management reports from non-accelerated filers reports resulted from the relatively high quality of controls at companies that switched from accelerated to non-accelerated filer status: "[T]he accelerated filers that transitioned to a non-accelerated filer status under the amended definition had already expended resources to establish an effective control system, and they additionally benefited from having an independent auditor review their control systems for deficiencies. Therefore, those companies are more likely to operate with effective controls after their transition * * *."

Nature of Control Weaknesses and Related Accounting Issues

Adverse auditor's reports and management assessments are required to describe the reasons controls were ineffective. AA found:

- Management reports. In the case of management assessments, the top five 2020 control weaknesses were accounting personnel resources; segregation of duties (personnel); insufficient audit committee; inadequacy disclosure controls; and material/numerous year-end adjustments. The top five accounting issues were debt and warrants; revenue recognition; accounts receivable, investments and cash; subsidiary/affiliate issues; and liabilities. The recording of debt and warrants presumably topped management's accounting issues list because of the SEC's April 2021 staff statement addressing whether warrants issued by a SPAC should be classified as equity or a liability.

  AA observes that the pandemic had little effect on the issues in adverse ICFR assessments. "The top two internal control issues cited in adverse ICFR management reports in 2020 – issues related to accounting personnel and segregation of duties – have been the top two issues for the previous five years. This illustrates that issues related to personnel are always common for smaller companies, regardless of circumstances arising from an event, such as the pandemic, that could significantly exacerbate existing deficiencies."

- Auditor attestations. In 2020 auditor's reports, the five most common control weaknesses were material/numerous year-end adjustments; accounting personnel resources; information technology; inadequacy disclosure controls; and segregation of duties (personnel). The top five accounting issues cited in adverse auditor ICFR assessments were revenue recognition; tax expense; liabilities; property, plant, and equipment, intangible or fixed assets; and inventory. Issues related to debt and warrants were sixth.

Comment: Because of the change in the SEC's definition of accelerated filer, it is difficult to draw any year-over-year conclusions from AA's 2020 findings. In general, the rate of adverse ICFR audit opinions has declined for companies subject to that requirement since the SOX 404 reporting requirements took effect in 2004. The rate of management adverse opinions has also declined for accelerate filers but, until 2020, has risen for non-accelerated companies. As the Update has noted in the past, the relatively higher, and more constant, level of adverse management assessments at smaller companies may reflect the fact that, without the discipline of an independent ICFR audit, there is less incentive for these companies to correct their control deficiencies. Higher deficiency levels at smaller companies are probably also a structural phenomenon, since smaller companies have fewer resources to devote to controls. See Fifteen Years of SOX 404 Reporting: Adverse ICFR Audit Opinions Rose Last Year, But Remain Below 2005 High, September-October 2019 Update.

Audit committees should bear in mind that, separate from the disclosure and audit requirements of SOX Section 404, the federal securities laws require all public companies to establish and maintain a system of internal accounting control to provide reasonable assurance that (among other things) transactions are recorded as necessary to permit preparation of GAAP financial statements. The SEC frequently charges violations of this requirement in cases involving financial reporting matters. Oversight of the adequacy of internal control is one of the most fundamental responsibilities of a public company audit committee.

Sustainability Reporting: (Almost) Everybody Does It

On November 16, the Governance & Accountability Institute (G&A) released 2021 Sustainability Reporting in Focus, its annual report on sustainability reporting trends among companies in the S&P 500 and Russell 1000 indices. According to the press release accompanying the report, key findings include:

- 92 percent of the S&P 500 published a sustainability report in 2020, up from 90 percent in 2019.
- 70 percent of Russell 1000 companies published a sustainability report in 2020, up from 65 percent in 2019.
- 49 percent of the smallest half by market cap of Russell 1000 companies published a sustainability report in 2020, up from 39 percent in 2019.

G&A concludes that sustainability reporting "has clearly become a best practice among the largest U.S. public companies." (The 2021 report focuses on the 2020 publication year, so it is possible that sustainability reporting rates this year are even higher, given the attention climate change and other ESG issues have received in the past 12 months.)

G&A began researching the sustainability reporting of the S&P 500 in 2012 (publication year 2011). Since that time, sustainability reporting has gone from relatively rare to almost universal; G&A's initial report found that just 20 percent of S&P 500 companies published sustainability reports or disclosures in 2011. Previously, G&A has published separate reports on the S&P 500 and the Russell 1000. See G&A Finds That Ninety Percent of the S&P 500 Publish a Sustainability Report, July-August 2020 Update and With Sustainability Reporting on the March, Protiviti Has Ten Questions Directors Should Ask, October-November 2020 Update (which discusses G&A's 2020 report on the Russell 1000). This year, G&A transitioned to one annual publication.

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

- Industry sectors and sustainability reporting. The Russell 1000 industry sectors with the highest percentage of companies that issued sustainability reports in 2020 were Utilities and Energy; all 38 of the companies in Utilities issued such reports, as did 94 percent of those in in Energy (34 reporting out of 36 in the sector). The industry sector with the lowest percentage of companies issuing reports was Communication (23 non-reporters/51 percent of the 45 companies in the sector). Communications was also in last place in 2019 and is the only sector in which a majority of companies do not issue a sustainability report. Second-from-the-bottom was Information Technology (83 non-reporters/45 percent of the 183-company sector). Health Care was third lowest with 44 percent of companies not reporting.

- Use of ESG disclosure frameworks. G&A analyzed whether companies that published a sustainability report used one of the recognized disclosure frameworks, such as the Global Reporting Initiative's (GRI) disclosure framework, the Sustainability Accounting Standards Board's (SASB) disclosure standards, or the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). G&A also tracked disclosure through responses to the CDP Climate Change Questionnaire and disclosure of company alignment with the UN's Sustainable Development Goals (SDGs). It found that 52 percent of reporting companies used the GRI standards; 39 percent aligned with the SASB standards; 17 percent followed the TCFD recommendations; 42 percent presented alignment with specific UN SDGs; and 40 percent of the Russell 1000 responded to the CDP questionnaire. (Many companies utilize more than one framework or disclosure vehicle.) Among other things, G&A's findings indicate significant increases in both GRI and SASB reporting, compared to 2019.

- External assurance on sustainability reporting. A growing number of companies obtain external assurance from an auditor or other professional on their ESG disclosures. In 2020, 35 percent of Russell 1000 reporters obtained external assurance on their non-financial ESG disclosures, compared to 24 percent in 2019. Eighteen percent of companies in the smallest half of the Russell 1000 obtained such assurance, up from 12 percent in 2019. Forty-four percent of the companies in the largest half obtained assurance, compared to 29 percent in 2019. G&A states that "assurance provides increased recognition, transparency, and credibility * * * while reducing risk. Seeking external assurance often indicates strong internal reporting and management systems. Overall, assurance improves stakeholder communication and trust."

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

On the Update Radar: Things in Brief

SEC Unveils its PCAOB Make-Over. On November 8, the Securities and Exchange Commission announced the appointment of four new members to the Public Company Accounting Oversight Board. The Commission also announced that current Board member and acting Chair Duane DesParte would retain his Board seat. New appointee Erica Williams will become the Board's Chair.

In June, the SEC removed William Duhnke from his position as PCAOB Chair and announced that it was seeking candidates to fill all five PCAOB board positions. See SEC Removes the Chair and Plans to Clean House at the PCAOB, May-June 2021 Update. In connection with those actions, SEC Chairman Gensler stated that he looked forward to setting the PCAOB "on a path to better protect investors." On September 30, two of the three remaining Board members resigned, leaving acting Chair DesParte as the only sitting Board member.

As a result of the SEC decisions announced on November 8, the members of the PCAOB will be:

Erica Y. Williams. Ms. Williams, a lawyer, is currently a litigation partner in the Washington, D.C. office of Kirkland & Ellis. She was previously on the SEC staff for more than a decade in various roles, including Assistant Chief Litigation Counsel in the Division of Enforcement trial unit. She also served as Special Assistant and Associate Counsel to President Obama.

Duane M. DesParte. Mr. DesParte has served on the PCAOB since 2018 and is currently the Board's Acting Chair. He joined the Board after and 15-year career at Exelon Corporation, including service as chief accounting officer and corporate controller. Before joining Exelon, he was a partner at Deloitte & Touche and, prior to that, at Arthur Andersen. He is a CPA.

Christina Ho. Ms. Ho most recently was Vice President of Government Analytics and Innovation at Elder Research. She has previously worked as Interim Chief Financial Officer at the University of Maryland; held various positions at the U.S. Department of the Treasury, including Deputy Assistant Secretary for Financial Transparency & Accounting Policy; and been a Senior Manager with Deloitte & Touche. Ms. Ho is a CPA.

Kara M. Stein. Ms. Stein served as an SEC Commissioner from 2013 to 2019. She is currently a Distinguished Policy Fellow and Lecturer-in-Law at the University of Pennsylvania Carey Law School and Director of the AI, Data, and Capital Markets Initiative at the Center on Innovation, University of California Hastings Law. Earlier in her career, she worked on the staff of U.S. Senator Jack Reed.

Anthony (Tony) C. Thompson. Mr. Thompson currently serves as Executive Director and Chief Administrative Officer of the Commodity Futures Trading Commission. He previously held senior positions at the Department of Agriculture and served in the United States Air Force for 32 years.

As of November 30, Ms. Ho and Ms. Stein had been sworn in, but Ms. Williams and Mr. Thompson had not yet joined the Board. When all five Board members are in place, the new Board will presumably reassess the PCAOB's strategic plan and provide some indication of its priorities and goals.

IFRS Foundation Announces the International Sustainability Standards Board and Consolidation with CDSB and SASB. On November 3, at COP 26, the UN global climate summit in Glasgow, the IFRS Foundation, the parent of the International Accounting Standards Board (IASB), announced the formation of a new International Sustainability Standards Board (ISSB). The ISSB will develop a comprehensive baseline of sustainability disclosure standards to meet investor information needs. The IFRS Foundation also announced that the ISSB will consolidate with two existing sustainability standard setting bodies. By June 2022, the Climate Disclosure Standards Board (CDSB) and the Value Reporting Foundation (VRF), which houses the Integrated Reporting Framework and the SASB Standards, will become part of the new ISSB.

According to the IFRS Foundation's announcement, the ISSB will promulgate IFRS Sustainability Disclosure Standards, which will include disclosure requirements that address companies' impacts on sustainability matters relevant to assessing enterprise value and making investment decisions. These standards will enable companies to provide comprehensive sustainability information for the global financial markets. The ISSB's standards are intended to be compatible with requirements that are jurisdiction-specific (e.g., any ESG disclosure requirements the SEC may adopt) or that are aimed at non-investor stakeholders. The existing standards and frameworks of the CDSB and the VRF (which includes the SASB standards), along with those of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) and the Forum Stakeholder Capitalism Metrics, will provide a basis for the work of the ISSB.

In conjunction with announcing formation of the ISSB, the IFRS Foundation published prototype climate and general disclosure requirements. These protypes were developed by the Technical Readiness Working Group (TRWG), which was formed by the IFRS Foundation to undertake preparatory work for the ISSB. The climate prototype builds on the TCFD's recommendations and includes industry-specific disclosures, while the general requirements prototype sets out overall requirements for disclosing sustainability-related financial information. The ISSB will consider the prototypes as part of its initial work.

The ISSB's activities will commence as soon as a Chair and Vice-Chairs have been appointed. The new Boards' first step will be public consultation to inform its work plan and to obtain views on proposals based on the TRWG's prototype recommendations. The ISSB will follow the IFRS Foundation's due process, including public discussions by the ISSB of feedback received through consultations and of possible improvements to the prototype proposals before they are finalized as ISSB standards.

Formation of the ISSB is a major step toward harmonizing and consolidating the various existing sustainability disclosure frameworks. Presumably, some jurisdictions will eventually require compliance with the ISSB's standards. However, assuming investors view the new board's work favorably, many companies are likely to feel compelled to follow the IFRS Sustainability Disclosure Standards, regardless of whether they are legally required to do so. For U.S. companies, it will, of

course, be important to see what sustainability requirements the SEC promulgates (see The SEC's Agenda – ESG Tops the List, July 2021 Update) and what the SEC's attitude is toward the work of the ISSB. In any event, the ISSB's standards may become de facto disclosure requirements, at least for large, multi-national public companies, and audit committees should follow the new board's work.

Deloitte Finds that Too Few Audit Committees are Climate Ready. Deloitte Global has released the results of a September 2021 survey of audit committee members to determine their readiness to response to climate-related issues. See The Audit Committee Frontier – Addressing climate change. In a separate paper summarizing the survey findings, Deloitte characterizes the results as "sobering" and notes that "much work remains to be done in many of today's boardrooms in order to come to grips with the climate emergency." Forty-two percent of the audit committee members that participated in the study "believed that their organizations' climate responses are too slow and lack strength." Further, nearly 50 percent reported that "they did not have the information, capabilities, and mandate to fulfill their climate related responsibilities."

The report is based on survey responses from 353 audit committee members from the Americas, Asia-Pacific, and Europe, Middle East, and Africa. The majority of respondents serve as audit committee chairs, and 67 percent serve on the audit committee of a publicly listed company. The largest group of respondents was from financial services (27 percent), followed by energy and manufacturing (15 percent).

Some highlights of the survey include:

- Nearly 60 percent of respondents said their audit committee does not discuss climate change at all or as a fixed agenda item. Only six percent said that they discuss the topic at every meeting.

- Nearly half of audit committee members did not consider their committee climate literate. Fifty-two percent said that some or all of their audit committee members are climate literate, while 48 percent said their committee was not climate literate or relied on just one committee member.

- Only eight percent of respondents said that their audit committee had overall responsibility for sustainability and climate. When asked to identify the aspects of climate related matters for which the committee had oversight responsibility, the top five topics mentioned were:

    - Risk management – the effectiveness of the processes for identification and assessment of climate-related risks (64 percent).

    - Corporate reporting outside the financial statements – the integrity of narrative reporting on climate risks, opportunities, and uncertainties (63 percent).

    - Corporate financial reporting – reflecting the impact of addressing climate risks and opportunities in the financial statements, including in relation to judgments and estimates in valuations and impairments (60 percent).

    - External audit – oversight of the approach taken by the external auditor to identifying and responding to climate-change related financial statement risks (56 percent).

    - Assurance – the effectiveness, independence and objectivity of assurance obtained over climate-related information and disclosure (48 percent).

- Seventy percent of respondents said their company had not completed a comprehensive climate change assessment; 52 percent believe the issue has no material impact on the company.

- When asked for advice they would offer to other audit committees regarding climate challenges, respondents suggested: More education on climate (87 percent); good management information

(79 percent); internal alignment around the company's climate strategy (78 percent); dedicated internal resources (67 percent); published plan on the company's position for investors (63 percent); and new board members with climate expertise (41 percent).

In addition to the survey results, The Audit Committee Frontier – Addressing Climate Change includes a discussion of the relationship between the work of the audit committee and climate change and guidance on improving committee climate performance. The report concludes with a set of questions to assess audit committee climate change reporting oversight and whether the company's annual report conforms to the principles of the Task Force on Climate-Related Financial Disclosures.

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.

For further information, please contact:

Daniel L. Goelzer
301.288.3788
dangoelzer@gmail.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.