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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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PCAOB Interim Analysis Finds that Investor Interest in CAMs is Still Evolving

The PCAOB has released [Interim Analysis Report](#) (October 29, 2020) ([Interim Analysis](#)), an assessment of the initial impact of auditor reporting on critical audit matters (CAMs). The [Interim Analysis](#) finds that audit firms devoted considerable time and effort to CAM reporting implementation, but that, at least so far, investors have shown only limited interest. In addition, there is no evidence of significant unintended consequences, such as a chilling of auditor/audit committee communications.

As described in earlier [Updates](#) (see, e.g., [Audit Analytics Provides Two Updates on CAM Disclosures, June, 2020 Update](#)), the requirement that the auditor's report include a discussion of CAMs took effect for large accelerated filers (companies with a public float of \$700 million or more) for fiscal years ending on or after June 30, 2019. A CAM is any matter arising from the audit of the financial statements that was (1) communicated or

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required to be communicated to the audit committee, (2) relates to accounts or disclosures that are material to the financial statements, and (3) involved especially challenging, subjective, or complex auditor judgment. The auditor's report must identify each CAM, describe the main considerations that led the auditor to determine that the matter was a CAM, describe how the auditor addressed the CAM in the audit, and refer to the financial statement accounts or disclosures related to the CAM.

The PCAOB's Office of Economic and Risk Analysis performed several studies to gain an initial understanding of audit firm and engagement team responses to the CAM requirements, investor use of CAMs, and audit committee and preparer experiences. The PCAOB staff also evaluated whether the initial evidence suggested significant costs, benefits, or unintended consequences from CAM reporting. Some highlights of the findings include:

- Audit Firms. The PCAOB surveyed the eight accounting firms that have 15 or more large accelerated filer audit clients. The four largest firms estimated that, on average, each devoted around 23,000 hours (53 percent at the partner level) to developing processes and procedures to support CAM implementation and 14,600 hours (32 percent at the partner level) to attendance at CAM-related training. The other four firms surveyed estimated spending, on average, 3,100 hours each. The PCAOB staff estimates that this corresponds to approximately \$6.5 million of implementation costs for each Big Four firm and \$1 million for each of the other four firms.
- Engagement partners. The PCAOB also surveyed 902 engagement partners at the eight firms. They reported that, on average, about one percent of total audit hours were spent identifying, developing, and communicating CAMs. The impact on the audit seems to have been limited; only three percent of engagement partners reported spending additional effort on audit areas related to CAMs. The impact on company disclosure was more significant. Thirty-nine percent of partners said that a client made changes to its financial statement disclosures or other reporting because of CAMs.

In addition, 139 engagement partners responded to an open-ended question about CAM reporting. These responses were somewhat critical of the new requirement:

- Sixty-seven of these partners said that the information in CAMs provides little value to investors or financial statement users.
 - Twenty-six partners said that there were significant administrative burdens associated with the CAM communication process, and eight reported that that CAM implementation required large amounts of documentation.
 - Nineteen partners reported that they felt pressure to identify at least one CAM, even though they did not believe that any individual matter met the definition of a CAM.
 - Seven partners reported that audit committees expressed a strong preference that their CAMs be similar to those of other companies in the same industry.
- Investors. The PCAOB staff also conducted an investor survey. Sixty-three percent of the 97 investor respondents had heard of CAMs, but only 31 percent had seen a CAM in an audit report. Those who had seen a CAM were asked about their future use of CAMs. Of the 21 who responded, eight said they would use CAMs, four said they might, and nine said they would not. Those who said they would not use CAMs thought that "CAMs are not specific enough to provide useful information or do not provide additional value above and beyond what is already included in financial statements."
 - Audit Committee Chairs and Preparers. The staff interviewed twelve audit committee chairs and ten financial statement preparers (e.g., CFOs) at large accelerated filers. These interviews disclosed that:
 - None of the audit committee chairs thought that CAMs had negatively impacted audit committee communications with the auditor. (Two percent of the engagement partners

reported that the CAM requirement constrained auditor communications with the audit committee, while 41 percent reported that the CAM requirement enhanced communications.)

- None of the interviewees were concerned that CAMs had disclosed information that the company had not previously made public.
- None of the interviewees reported receiving any direct investor feedback on CAMs.
- Preparers reported some costs associated with CAM reporting (e.g., management time, increased audit fees), but most said that these additional costs were inconsequential.
- **Statistical Analysis.** The PCAOB staff performed statistical analyses of the impact of initial CAM implementation on audit hours, audit fees, time to issue audit reports, and capital markets.” These analyses found that, on average:
 - CAM reporting did not increase engagement costs (audit fees and audit hours). In general, auditors did not pass along the costs of CAM implementation to issuers in the initial year.
 - CAM implementation did not increase the time required to issue the audit report.
 - Stock market data provided no evidence that investors responded to the information in CAMs.

The PCAOB released two white papers that provide technical details of the staff’s work. See [Staff White Paper Stakeholder Outreach on the Initial Implementation of CAM Requirements](#) and [Staff White Paper Econometric Analysis on the Initial Implementation of CAM Requirements](#). The staff’s underlying [data set](#), an Excel spreadsheet of over of over 4,000 CAMs, is also available on the PCAOB’s website.

Comment: CAM reporting is still at an early stage. It is, however, encouraging that the PCAOB’s interim analysis suggests that fears that CAM reporting would chill auditor/audit committee communications do not seem to have materialized. See [Audit Committee Members Are Still Dubious About the PCAOB’s Proposal to Expand Audit Reports, September 2016 Update](#). On the other hand, expectations concerning the value of CAM disclosure to investors also do not seem to have been realized – at least so far.

As noted above, the [Interim Analysis](#) found that 39 percent of engagement partners reported company changes to financial statement or other disclosure because of auditor CAM reporting. For audit committees, this underscores that most companies will want to make sure that the substance of any issue that gives rise to a CAM is disclosed in the company’s filings. This enables the company to present the issue from its perspective and avoids the risk that the CAM will disclose new information or might seem to imply that the company ignored or concealed a reporting challenge. As part of their oversight of financial reporting, audit committees should compare potential CAMs to the company’s disclosures regarding the same issue.

PCAOB Previews 2019 Inspection Reports

While the PCAOB has not yet released its 2019 inspection reports for the large accounting firms, it has provided a preview of its 2019 findings. See [Spotlight: Staff Update and Preview of 2019 Inspection Observations](#) (October 8, 2020) ([Preview](#)). The Board suggests that auditors “may find this information useful as they plan and perform their audits, and audit committees may find it useful as they engage with their auditors.” While much of the [Preview](#) is primarily of interest to accounting firms, several aspects may – as the PCAOB suggests – be helpful to audit committees in their dialogue with the auditor.

Recurring Deficiencies

Recurring audit deficiencies observed in 2019 inspections were similar to those in prior years. See [PCAOB Staff Previews 2018 Inspections Results, May-June 2019 Update](#). The [Preview](#) highlights four areas:

- Revenue. Several types of deficiencies related to implementation of the new revenue recognition accounting standard, including failure to consider “other relevant factors” in validating contractual performance obligations or allocating prices; failure to evaluate whether the reporting company had an enforceable right to payment prior to recognizing revenue; and failure to perform procedures to test the reporting company’s evaluation of whether products created and sold to a specified customer had an alternative use.
- Independence. Some inspected firms had a high rate noncompliance with reporting by firm personnel of financial relationships. In addition, some firms did not comply with PCAOB rules requiring pre-approval of certain tax services and communication with audit committees concerning independence.
- Accounting Estimates. As in past inspection cycles, inspectors found deficiencies related to auditing estimates, particularly financial institution allowances for loan losses (ALL) and the valuation of assets acquired in business combinations. For example:
 - Auditors did not evaluate the reasonableness of qualitative factors that management considered in calculating the general reserve component of ALL. “In certain instances, the audit procedures were limited to inquiry of the issuer’s personnel * * * without corroborating the information with appropriate audit evidence.”
 - Auditors did not sufficiently test the reasonableness of projections used in determining the valuation of acquired assets. “Auditors limited their procedures to inquiry of the issuer’s personnel and comparing one year of forecasted projections to actual results.”
- Internal Control Over Financial Reporting. Deficiencies in ICFR testing have been a theme in PCAOB inspection reports for the past decade. Common problems identified in 2019 inspections include:
 - Auditors did not sufficiently evaluate whether controls with a review element operated with sufficient precision to prevent or detect material misstatements.
 - Auditors did not sufficiently test controls related to relevant assertions of significant accounts. For example, where a company had multiple streams of revenue, the auditor may only have identified and tested controls that addressed risks related to one of the streams.
 - With respect to management review controls over accounting estimates, auditors did not identify and test controls over the accuracy and completeness of system-generated reports which were used by control owners in the operation of these controls.

Cybersecurity Risk

The PCAOB reviewed audits of companies that experienced a cybersecurity incident during the audit period, focusing on how the auditor considered the cybersecurity incident in its risk assessment. Inspectors found that, in some cases, the auditor “did not consider whether the incident affected the auditor’s identification or assessment of risks of material misstatement; whether modifications to the nature, timing, or extent of audit procedures were necessary; and whether the incident could be indicative of deficiencies in ICFR.”

Multi-location Audits

The PCAOB deployed “target teams” to focus on multi-location audits based in the U.S. and on audits in which the U.S. firm played a role but was not the principal auditor. These teams observed improved audit quality when there was “regular, consistent communication between the principal auditor and the other auditors” including the “good practice” of visits by the principal auditor to the offices of the participating auditors in other jurisdictions. However, multi-location audit quality could be improved by enhancing documentation, better compliance with the PCAOB rule requiring disclosure of other firms that participate in the audit, and improving engagement letter templates to exclude indemnification clauses.

Audit Committee Communications

In its 2019 inspections, the PCAOB spoke with the audit committee chairs of most U.S. companies with audits that were reviewed. See [What the PCAOB Heard: Report on Conversations with Audit Committee Chairs, January 2020 Update](#). While audit committee chairs generally reported “frequent and thorough” communication with their auditor, the inspectors’ testing revealed that certain smaller firms “did not communicate all significant risks identified during audit planning—including changes to those risks—to the audit committee.”

Comment: The [Preview](#) may be useful to audit committees in understanding what areas of the company’s future audits are likely to attract the attention of the PCAOB’s inspection staff. In particular, the recurring audit deficiencies identified by the PCAOB in 2019 are indicators of challenging audit areas to which the company’s auditor may devote extra attention in anticipation of possible future PCAOB scrutiny. The [Preview](#) may also aid audit committees in understanding their auditor’s risk assessments and resource allocation decisions. For example, obtaining an in-depth understanding of how review controls operate is a necessary response to a common PCAOB inspection finding. The [Preview](#) also makes clear that auditor/audit committee communication is an area on which the PCAOB is focusing.

As Transparency Inches Forward, Audit Committees are Disclosing More About Cyber Risk Oversight, But Less About Audit Fees

On October 12, the Center for Audit Quality and research firm Audit Analytics released [2020 Audit Committee Transparency Barometer](#) (2020 Transparency Barometer), their annual assessment of S&P Composite 1500 proxy statement disclosures related to the work of the audit committee. (The S&P Composite 1500 consists of the S&P 500 index of large-cap companies, the S&P MidCap 400, and the S&P SmallCap 600.) Audit committee disclosure has increased significantly since the first Transparency Barometer in 2014, although the growth in these disclosures has leveled off in recent years. See, e.g., [Voluntary Audit Committee Disclosures Continue to Increase – But Only Slightly, September 2020 Update](#) and [Audit Committee Transparency Plateaus, November-December 2019 Update](#). The [2020 Transparency Barometer](#) is consistent with these trends.

The [2020 Transparency Barometer](#) highlights three areas in which audit committee disclosure has changed:

- **Cybersecurity.** Disclosure related to audit committee oversight of cybersecurity has increased sharply during the last five years. In 2020, 39 percent of the S&P 500 disclosed that the audit committee is responsible for cybersecurity; 28 percent S&P MidCaps and 18 percent S&P SmallCaps 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) did so in 2016. In 2020, 28 percent, 20 percent, and eight percent, respectively, disclosed that the board had a cybersecurity expert. In almost all cases, that disclosure indicated that the cybersecurity expert was on the audit committee.
- **Auditor compensation.** Disclosure related to oversight of auditor compensation is “stagnant.”
 - Only four percent of the S&P 500 included a discussion of audit fees and their relationship to audit quality; two percent of the S&P MidCap 400 and one percent of the S&P SmallCap 600 discussed this issue. Such disclosures have declined significantly in the past seven years. In 2014, the comparable percentages were 13 percent, four percent, and one percent. Similarly, in 2020 three percent of the S&P 500 provided a discussion of how the audit committee considers auditor compensation, and only one percent of the other S&P tiers discussed that issue.
 - Eighteen percent of the S&P 500, seven percent of the S&P Mid-Caps, and four percent of the S&P SmallCaps stated that the audit committee is responsible for fee negotiations with the auditor. The frequency of such disclosure has essentially been flat for the past five years.

- Nineteen percent of the S&P 500 included an explanation for a change in audit fees, while 14 percent S&P Mid-Cap 400 and 21 percent S&P SmallCap 600 provided a fee change explanation. In 2014, such disclosure was more common -- 28 percent for the S&P 500, 30 percent for Mid-Cap companies, and 24 percent for SmallCaps.
- CAMs. A few disclosures have begun to refer to critical audit matters. See [PCAOB Interim Analysis Finds that Investor Interest in CAMs is “Still Evolving”](#) in this [Update](#). “Over 6 percent of companies mention CAMs within their audit committee disclosures, stating that the audit committee has discussed CAMs with the auditor.” Audit committee CAM discussion is likely to increase in the future.

Other [2020 Transparency Barometer](#) findings include:

- Audit firm selection/ratification. Forty-three percent of S&P 500 proxy statements disclosed considerations that were the basis for the audit committee's appointment of the audit firm, up slightly from 42 percent in 2019. Thirty percent of MidCap 400 companies discussed appointment considerations (flat from last year), and 23 percent of SmallCap 600 companies made such a disclosure (compared to 22 percent last year).
- Length of engagement. The share of S&P 500 companies that disclose the audit firm's tenure fell from 71 percent in 2019 to 69 percent in 2020. For MidCap and SmallCap companies, the 2020 percentages were 56 percent and 54 percent, respectively; this was a two percent increase over 2018 for MidCaps and a one percent drop for SmallCaps. (Company disclosure of tenure is redundant, since it is now a mandatory disclosure item in the auditor's report. See [SEC Approves New Auditor's Reporting Model and Shifts the Discussion to Implementation](#), [November-December 2017 Update](#).)
- Audit firm evaluation/supervision. Half of S&P 500 companies disclosed criteria the audit committee considered in evaluating the audit firm (compared to 50 percent in 2019 and 51 percent in 2020). Thirty-seven percent of MidCap companies and 36 percent of SmallCap companies discussed the audit committee's evaluation criteria, a decrease of two percent and an increase of three percent, respectively.
- Annual audit firm evaluation. In 2020, 31 percent of the S&P 500 disclosed that the audit committee performed an evaluation of the external auditor, a two percent increase over 2019. For MidCaps, this disclosure was made by 19 percent, the same as in 2019. Sixteen percent of SmallCaps made the annual evaluation disclosure, compared to 14 percent last year.
- Engagement partner selection. In both 2020 and 2019, half of the S&P 500 disclosed that the audit committee is involved in engagement partner selection. For S&P MidCap companies, 23 percent disclosed that the audit committee played a role in engagement partner selection (up from 22 percent in 2019), while twelve percent of SmallCaps made such a disclosure, up from ten percent last year.

Comment: Audit committees should be aware of the types of voluntary disclosures concerning committee responsibilities and activities that their peers are making and consider expanding their disclosures to match. The kinds of disclosures the [2020 Transparency Barometer](#) identifies as common among S&P Composite 1500 companies are generally not controversial and would rarely involve disclosing confidential information or exposing the audit committee to increased litigation risk. As in prior years, the report includes examples from audit committee reports or proxy statement discussions of each type of disclosure tracked. These examples provide good models for companies that are considering strengthening their disclosures.

KPMG Takes the Pulse of Audit Committees, and Deloitte Has Suggestions for Their Agendas as 2020 Draws to a Close

2020 has been an extraordinary year. For most audit committees, the issues that have dominated their agendas are far different from those that were anticipated in January. See, e.g., [CAQ Releases Key COVID-19 Auditor and Audit Committee Considerations](#) and [PwC Has COVID-19 Guidance for Audit Committees](#), [April-](#)

[May 2020 Update](#) and [What's on the Audit Committee's Agenda in 2020? Part II: COVID-19, February-March 2020 Update](#).

Two reports from major accounting firms shed further light on the challenges facing audit committees in the COVID-19 environment. KPMG has published the results of a “pulse survey” that describes the major issues that audit committees have addressed because of the pandemic. Deloitte has released an updated audit committee agenda listing some of the overarching topics of which audit committees should currently be aware. These papers are summarized below.

KPMG Pulse Survey

The KPMG Audit Committee Institute surveyed over 100 U.S. audit committee members to understand how COVID-19 is affecting audit committee oversight and operations. The survey results appear in [Challenges Presented by COVID-19: 2020 audit committee pulse survey report](#) (October 5, 2020). Six key findings were:

- The uncertain trajectory of COVID-19 and the economy--coupled with the extensive use of forward-looking information in financial statements and SEC filings--have made disclosures regarding the current and potential effects of COVID-19 a top area of focus. Seventy-nine percent of respondents reported discussion in company disclosures of the current and potential effects of COVID-19, including in risk factors, MD&A, liquidity, results of operations, and known trends and uncertainties. Other frequently discussed disclosure issues were Preparation of forward-looking statements (49 percent) and Impairment of nonfinancial assets (43 percent).
- Companies are reassessing, enhancing, or establishing new internal controls due to COVID-19-related disruption to business operations. The top areas on which companies were reported to have focused regarding internal controls were Return-to-work plans (73 percent); IT systems access and authentication to enable remote/virtual workforce (69 percent); and Cybersecurity (56 percent).
- Internal auditors are adjusting their audit plans and activities. Many respondents reported that the company's internal audit function had changed its focus due to the pandemic. The issues to which internal audit had shifted its attention included: Identifying emerging risks posed by COVID-19 (58 percent); Reviewing management's assessment of COVID-19 risks (5 percent); Assessing incremental fraud risks posed by COVID-19 (40 percent); and Assessing return-to-workplan and related risks (39 percent).
- Audit committee members expect some environmental, social, and governance (ESG) issues to get significantly more attention from the board as a result of COVID-19 and recent protests against systemic racism. The survey asked which aspects of ESG will receive significant board attention because of COVID-19 and protests against systemic racism. The five most-frequently cited topics were: Employee/workforce health, safety, and well-being (85 percent); Diversity within the company, including the boardroom (56 percent); Supply chain resilience, including health, safety, and well-being (53 percent); Corporate reputation among key stakeholders (39 percent); and Customer health and safety (36 percent).
- COVID-19 has prompted many audit committees to reassess the scope of their workload/agendas and risk oversight responsibilities. Audit committee members were asked which COVID-19 related risks their committee was responsible for (in addition to responsibility for financial reporting and control risks). The most common areas cited were: Financial risks (83 percent); Legal/regulatory risks (70 percent); Cybersecurity (62 percent); Data privacy (42 percent); and COVID-related government programs/regulatory relief (27 percent). In addition, 37 percent of respondents said that COVID-19 had caused their audit committee to reassess the scope of its workload/agenda “to a great extent”, while another 58 percent said their committee had reassessed workload “to some extent.”
- Audit committee members say the remote work environment necessitated by COVID-19 has had little impact on the efficiency and effectiveness of their interactions with management and auditors. Over 70 percent of respondents said that the remote work environment had no noticeable impact on their

interactions with the CEO, CFO, business unit leaders, internal audit function, and the external auditor. Thirty-nine percent said there had been a moderate increase in the frequency of their communications with the external auditor, while 57 percent said there was no change.

Deloitte's Audit Committee's Agenda

In [On the audit committee's agenda: Audit committee challenges and priorities in the upcoming quarter and beyond](#), the Deloitte Center for Board Effectiveness urges audit committees to be aware of issues that are “top of mind, trending, and ongoing” in the current environment, as well as the “tension points, challenges, and alternative solutions associated with those issues.” Below are Deloitte's descriptions of these issue categories, along with an example of the questions audit committees should be asking regarding each.

Top of Mind Issues

- **Forecasting:** Deloitte characterizes forecasting as “the single most challenging area for most companies in the COVID-19 environment.” Forecasts have both business implications and impact on significant accounting judgments, such as impairments and going concern determinations. Sample audit committee question: “Is data from the 2008 financial crisis being used to benchmark the timing and pattern of recovery from the current pandemic? Has management carefully considered the differences between the two economic periods?”
- **Communication with stakeholders:** Effective communication with stakeholders has increased importance in the current environment. “The call for enhanced transparency has come from both investors and the SEC, which is encouraging disclosures that help investors understand how management and the board are analyzing the current and expected impact of COVID-19 on the company's operations and financial condition.” Sample audit committee question: “In considering the use of non-GAAP measures, has the company considered what costs might be part of the ‘new normal’ and how certain non-GAAP adjustments may impact comparability in the future?”
- **Internal controls:** The pandemic has changed the environment in which controls operate. The statutory requirement for effective internal control over financial reporting (ICFR) is, however, unchanged and regulators have emphasized the importance of ICFR. Sample audit committee question: “How is the company planning to address physical inventory counts? Has management considered the views of its regulators and coordinated its approach with the company's auditors?”

Trending Issues

- The pandemic has created new issues for many companies, such as revisiting stock compensation plans, evaluating the company's real estate footprint, considering modification of financial instruments, and assessing eligibility for the Employee Retention Credit. Sample audit committee question: “Is the company considering abandoning property? Has the company evaluated the accounting consequences if subleasing the property in the future remains a possibility?”

Ongoing Issues

- Ongoing issues may also be significant or pervasive. Sample audit committee question: “Has the company modified any significant contracts, particularly contracts with customers and leases?”

Comment: Each company's situation is unique, and issues that are critical for one company may not be significant for another. Audit committees may nonetheless find it useful to review the issues that their peers see as the most challenging in the current environment (as reflected in the KPMG survey), and to consider the issues and questions on which Deloitte focuses in its agenda paper. Virtually all audit committees are likely to be dealing, in some form, with most of these topics. These two papers can serve as checklists to help audit committees in planning their agendas.

With Sustainability Reporting on the March, Protiviti Has Ten Questions Directors Should Ask

The rapid growth in voluntary public company sustainability, or environmental, social, and governance (ESG), reporting is one of the major corporate disclosure developments in the past decade. During a relatively brief period, and without (in the U.S. at least) any government mandate, this type of reporting has gone from the exception to the norm for large (and many smaller) public companies. This development has implications for audit committees because of their oversight of company disclosure and the controls and procedures to which disclosures are, or should be, subject.

The Governance & Accountability Institute (G&A Institute), which tracks sustainability reporting, has issued a paper that illustrates the spread of such reporting from the 500 largest public companies to the next tier of the Russell 1000. And, consulting firm Protiviti, picking up on the G&A Institute's prior reports, has published a series of questions that boards and managements of the growing list of companies that issue sustainability reports should be asking.

G&A Institute

As discussed in [G&A Finds That Ninety Percent of the S&P 500 Publish a Sustainability Report, July-August 2020 Update](#), the G&A Institute reported earlier this year that 90 percent of companies in the S&P 500 Index issued a sustainability report in 2019, up from 86 percent the prior year. On October 26, the G&A Institute issued [2020 Flash Report Russell 1000®: Trends on the sustainability reporting practices of the Russell 1000 Index companies](#), which expands the analysis to the Russell 1000. This report finds that 65 percent of the companies in the Russell 1000 published sustainability reports in 2019, an increase from 60 percent in 2018. Among the 500 companies in the index with the smallest market cap, sustainability reporting increased to 39 percent in 2019, up from 34 percent in 2018.

Like its S&P 500 report, the G&A Institute's Russell 1000 report looked at 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 Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). The G&A Institute research also tracked disclosure through responses to the CDP Climate Change Questionnaire and disclosure of company alignment with the United Nation's Sustainable Development Goals (SDGs). It found that, in 2019, 47 percent of the reporting companies used GRI, 23 percent referenced or aligned with SASB, and 14 percent mentioned or aligned with the TCFD. In addition, 32 percent included disclosure of alignment with the UN's SDGs, and 41 percent responded to the CDP questionnaire. Some companies presumably report under more than one framework or disclosure vehicle.

The G&A Institute notes that a growing number of the Russell 1000 companies obtained external assurance for their environmental and/or social disclosures and that "external assurance often indicates strong internal reporting and management systems." In 2019, 24 percent of the Russell 1000 reporters sought such assurance, about two-thirds of which were in the largest half of the index by market capitalization.

The Russell 1000 industry sectors with the highest percentage of companies that issued sustainability reports in 2019 were Utilities, Materials, and Energy; all 38 of the companies in Utilities issued such reports, as did 82 percent of those in Materials (46 companies out of 56 in the sector) and 37 percent of those in Energy (37 reporting out of 45 in the sector). The industry sector with the lowest percentage of companies issuing reports was Communication (29 non-reporters/59 percent of the 49 companies in the sector). Second-from-the-bottom was Information Technology (73 non-reporters/46 percent of the 157-company sector). These industry sector results are similar to those G&A reported in July for the S&P 500.

Protiviti

Because of the increasing frequency of, and investor demand for, ESG reporting, directors are becoming increasingly involved in overseeing these disclosures. Citing the July G&A Institute report on the S&P 500

(referenced above) and the accelerating pace of TCFD and SASB disclosure by public companies, consulting firm Protiviti has developed a list of ten questions that boards and management teams of companies that issue sustainability reports should be asking. See [10 ESG Reporting Questions Directors Should Consider](#).

These questions, with a brief excerpt from Protiviti's commentary on each, are:

1. Have we set compelling sustainability targets and goals that appeal to the marketplace? "ESG should be integrated into the overall corporate strategy rather than be a mere afterthought, making it equivalent to a compliance activity."
2. What story are we telling the street? "Directors should inquire whether the company's ESG storyline is resonating in the market and impacting the company's valuation."
3. Can we integrate our ESG reporting with financial reporting? "[I]t may be more meaningful to investors to integrate ESG reporting into financial reports, quarterly earnings calls and investor roadshows consistent with the convergence of investor interest in financial and ESG performance."
4. What reporting framework are we using, and why? "The use of an established framework, such as the SASB's, is an effective way to avoid 'greenwashing,' or overstating ESG efforts."
5. What accountabilities have we set for ESG-related performance? "ESG performance should be integrated with financial and operational performance monitoring; otherwise, it may become an appendage and receive less C-suite attention."
6. Is our ESG reporting satisfying the needs of the investment community and other stakeholders? "The board should inquire as to management's process for engaging and understanding the expectations of ESG stakeholders."
7. What are our ESG risks, and how well are we managing them? "ESG objectives and activities * * * should be considered through the company's enterprise risk management lens." Protiviti notes that the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the World Business Council for Sustainable Development have issued guidance on this process. See [Applying Enterprise Risk Management to Environmental, Social and Governance-Related Risks](#) (October 23, 2018).
8. What have we done to ensure that our ESG-related disclosures are reliable? "Directors should gauge management's confidence that the company's disclosure controls and procedures are effective as they relate to ESG metrics and reporting."
9. Does -- and if not should -- our independent auditor have a role in ESG reporting? "ESG reporting may elevate the importance of independent attestation over time, particularly for companies active in the capital markets."
10. How has the COVID-19 pandemic affected our ESG reporting? "For example, the approach to social issues around health and safety, the distributed workplace, and overall employee wellness has changed."

Protiviti describes companies that are not already issuing a sustainability report as "outliers" and urges their directors to ask management to explain why such a report is not being prepared. "Bucking this undeniable trend could mean much more than just being left behind. It can lead to high-profile proxy battles over ESG-related topics, threats to board seats, institutional investors redirecting capital elsewhere, and brand erosion. That is why quality and transparent ESG reporting should be a board priority."

Comment: One of the themes of the [Update](#) has been that audit committees need to be aware of the ESG disclosure revolution. Sustainability disclosures are increasingly recognized as material in a securities law sense. However, these disclosures are often not subject to the same controls and procedures as are

traditional financial disclosures. It is not uncommon for a company to begin its sustainability reporting journey by issuing a document prepared by company officials with substantive responsible for ESG issues or for investor relations, with little input or oversight from the board, senior management, or those involved in securities law disclosure. This raises risks that the sustainability report may be inconsistent with other company disclosures or that the accuracy of the information presented may not be verifiable. These risks should be of concern to audit committees because of their responsibility for disclosure oversight and for related controls and procedures. The Protiviti list is a good catalog of the kinds questions that audit committees and full boards should be asking as their oversight of sustainability reporting matures.

Two Studies Raise Questions About Audit Partner Rotation

In 2002, the Sarbanes-Oxley Act required audit partner rotation on a five-year cycle. The theory behind this requirement was that long audit partner tenures could lead to the partner becoming too closely associated with the client and that a “fresh look” by a newly-involved partner might turn up financial reporting issues that the prior partner had ignored or missed. The supposed benefits of a fresh look also lead the PCAOB to float the idea of mandatory audit firm rotation in a 2011 [concept release](#). The Board dropped the idea after the House of Representatives passed a bi-partisan bill in 2013 prohibiting the PCAOB from requiring companies to automatically change auditors.

Two recent academic studies examine the merits of the underlying rationale for partner rotation. These studies find no evidence that audit quality declines as engagement partner tenure increases – within the constraint of the five year tenure limit imposed by SOX – and no evidence that the incoming engagement partner’s fresh look uncovers reporting issues that his or her predecessor missed. On the other hand, these studies provide some support for the argument against rotation – that the new partner on an engagement is more likely to miss issues during the first year because he or she is still coming up the learning curve regarding the client business and financial reporting challenges.

Mandatory Audit Partner Rotations and Audit Quality in the United States

Mandatory Audit Partner Rotations and Audit Quality in the United States (available [here](#) for purchase) appears in the August 2020 issue of Auditing: A Journal of Practice and Theory (AJPT). The authors, Huan Kuang, Huimin Li, Matthew G. Sherwood, and Robert L. Whited, examined SEC filings and comment letters between 2003 and 2019 to identify partner changes that occurred after five years of partner tenure. They state that they “do not find evidence consistent with rotation materially improving audit quality.” Specific findings of their study include:

- No evidence that abnormal accruals (a measure of the likelihood of financial reporting manipulation) differ in financial reporting periods before and after mandatory partner rotation.
- Limited, but statistically significant, evidence that financial statements audited during the initial years after a mandatory change in audit partners are more likely to be subsequently restated than are those audited in the final years of the outgoing engagement partner’s term. This is particularly likely when the audit firm’s tenure with the client is short. While the sample size was small and material restatements are infrequent, the authors observe that “the weight of our evidence is not consistent with partner rotation yielding material improvements to the audit process due to the ‘fresh look’ of the new audit partner.”
- No evidence that audit firms materially increase or decrease audit fees following partner rotation. The authors note that this “could be because changing partners does not influence the number of audit hours or that the new partner does increase audit hours but does not pass these costs on to the client. * * * If there is a learning curve for the new partner who performs additional audit procedures when partner rotation occurs, then the audit firm may suffer financially in the year of partner rotation if profit margins are squeezed.”

On the Economics of Mandatory Audit-Partner Rotations and Tenure: Evidence from PCAOB Data

In [On the Economics of Mandatory Audit-Partner Rotations and Tenure: Evidence from PCAOB Data](#), Brandon Gipper, Luzi Hail, and Christian Leuz reach conclusions similar to those of Kuang, Li, Sherwood, and Whited regarding the audit quality implications of partner rotation. Gipper, et al. state that they “find no evidence for audit quality declines over the tenure cycle and, consistent with this result, little support for fresh-look benefits after five-year mandatory rotations.” However, they reach a different conclusion regarding the economic impact, finding that audit fees decline immediately after rotation, but subsequently rise. The results of this research will appear in a future issue of [The Accounting Review](#) and are currently available on SSRN, an online repository of scholarly research in the social sciences and humanities.

Gipper, Hail, and Leuz based their work on a non-public PCAOB dataset that covers audits from 2008 to 2014 of over 3,300 clients of the six largest U.S. audit firms. This dataset includes 2,385 mandatory engagement-partner rotations and contains engagement information, including audit hours, partner hours, billing realization, review partner names and hours, and internal client-risk ratings. The findings of Gipper and his colleagues touch on the audit quality impact of rotation, firm management of partner rotation, and the economic impact of rotation.

- **Audit quality.** Like the authors of the study published in AJPT, Gipper, Hail, and Leuz find no evidence of a decline in audit quality over the five-year rotation cycle or of any fresh-look benefits from mandatory partner rotation. Moreover, like the other study, they find some evidence that audit quality declines in the first years after rotation. “We show that, for the average engagement of a Big-6 firm, audit quality is unrelated to partner tenure, except for announcements of restatements, which are more frequent in the first two years after rotation.”
- **Rotation quality management.** The study finds that audit firms manage partner rotation to reduce the likelihood of audit failures. In particular, audit firms employ “shadowing” – a practice in which the incoming partner observes the work of the outgoing partner during the last year of his or her tenure. However, the incidence of shadowing varies with the market and the experience level of the incoming partner. “[E]vidence of partner shadowing is present only in less concentrated local audit markets suggesting that audit firms dedicate more resources to minimize disruption and prevent client attrition in competitive environments where clients have more outside options. In addition, we find more evidence of shadowing for experienced partners, plausibly due to the importance or complexity of the clients assigned to them.”
- **Economic effects.** Unlike the AJPT study, the Gipper-Hail-Leuz paper finds that rotation does impact audit fees. Specifically, audit fees decline immediately after the new partner takes over, but subsequently decline. Conversely, audit hours, total partner hours and review partner hours rise significantly in the first year of the incoming partner’s tenure but fall in the following years. They state:

“When a new partner begins a five-year cycle, she needs additional time familiarizing herself with the client and the audit procedures in place. She may also consider updating procedures or ask audit staff to help her with the transition. As the new partner does not yet have a relationship with the client, it could be harder for her to ask for fee increases. Moreover, the client could use partner rotation as a way to mount fee pressures.”

Like shadowing, these economic effects of rotation differ depending on the competitiveness of the local audit market, client size, and partner experience. For example, auditors charge lower audit fees in more competitive audit market and encounter greater fee pressure. This results in lower fees in the first year after partner rotation. However, audit fees increase more steeply in these more competitive markets during the five-year cycle. Further, “newer, less experienced partners spend more time on the engagement in the first year of the rotation cycle, but also exhibit greater declines in hours in years four and five. This pattern is consistent with having a steeper learning curve than experienced partners.”

Comment: These findings do not in themselves either demonstrate that partner rotation has no benefits or, if it has benefits, that five years is the optimum rotation period. Gipper, Hail, Leuz observe that a “plausible explanation” for the lack of evidence that audit quality is related to partner tenure “is that in the relatively robust U.S. reporting and audit environment the five-year rotation mandate is sufficiently short to prevent, at least on average, major declines in audit quality over the partner cycle.” Further, their research “does not speak to the relation between partner tenure and audit quality beyond the five-year period. It could well be that a longer rotation term would yield similar results, while being less costly to auditors and clients.”

From an audit committee perspective, five-year partner rotation is a regulatory requirement and therefore unavoidable. Audit committees might however want to take note of the evidence in both studies that audit quality (as measured by the need to subsequently restate financial statements) declines in the first years after a new partner takes charge. “Shadowing” during the final year of the out-going partner’s tenure appears to be a logical step to reduce the risk that the incoming partner will miss a material error while still learning about the company and its financial reporting issues. But whether the audit firm employs shadowing seems to depend on factors like the competitiveness of the audit market, the experience of the incoming partner, and the size of the client. Audit committees facing a partner rotation should ask what steps the audit firm will take to ensure a smooth transition to the new partner and whether the new partner will shadow the old during his or her final year. If the firm does not plan on using shadowing, the committee should ask why not.

The Audit Blog

I am a co-founder of [The Audit Blog](#) and blog on developments in auditing and financial reporting, on auditor oversight and regulation, and on sustainability disclosure. Occasionally, items that appear in the [Audit Committee and Auditor Oversight Update](#) also appear on the blog. Recent posts include –

- [Listen to Your Auditor or Pay the Price Later](#) (Dan Goelzer, October 5, 2020)

The blog is available [here](#). You can follow [@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](#).