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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 Staff Summary of 2020 Inspections: Fewer Findings, But Still Room for Improvement**

The PCAOB staff has published its observations on the results of the Board's 2020 inspections. See [Spotlight: Staff Update and Preview of 2020 Inspection Observations](#) (Preview). In 2020, the Board inspected 153 audit firms (114 U.S. firms and 39 non-U.S.) and reviewed portions of 617 audits. The audits inspected in 2020 generally addressed financial reporting for years ending during 2019 or the first half of 2020. The staff states that, for the majority of the annually inspected audit firms (i.e., firms with

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more than 100 public company audit clients), “we identified fewer findings in 2020 compared to our 2019 inspections.” For firms with 100 or less public company clients, which are inspected on a 3-year cycle, “some improvements were noted, although deficiencies continue to remain high.” As of October 25, the underlying inspection reports on which the [Preview](#) is based had not yet been made public.

While much of the [Preview](#) is primarily of interest to accounting firms, aspects may be helpful to audit committees in their dialogue with the auditor. The 2020 [Preview](#), unlike the 2019 version, does not discuss communications with audit committees. See [PCAOB Previews 2019 Inspection Reports, October-November 2020 Update](#).

### 2020 Inspection Approach

The [Preview](#) notes that the 2020 inspections were impacted by COVID-19. All inspections were conducted remotely. In addition, the staff took various steps to understand firms’ consideration of, and responses to, the effect of the pandemic on audits. However, except for an optional 45-day deferral, “no other modifications were made to reduce the obligation of audit professionals to observe the PCAOB’s rules and other professional standards.”

### Common Deficiencies

Recurring audit deficiencies observed in the 2020 inspections were similar to those in prior years. See [PCAOB Previews 2019 Inspection Reports](#), above. The [Preview](#) describes five common deficiency areas.

- [Revenue and Related Accounts](#). By far, the highest percentage of deficiencies in both financial statement and internal control over financial reporting (ICFR) audits involved revenue and related accounts. Many such deficiencies related to implementation of FASB’s new standard on revenue recognition, which took effect for public companies at the end of 2017. Other revenue-related deficiencies included failure to test controls over the accuracy and completeness of company-provided data or reports on which audit procedures were based. The [Preview](#) reminds auditors that, “when using information produced by the public company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit.”
- [Accounting Estimates](#). Common deficiencies relating to estimates involved allowance for loan losses (ALL), business combinations, investment securities, and long-lived assets, including --
  - Auditors did not evaluate evidence supporting the reasonableness of the assumptions management used in determining ALL.
  - Auditors did not obtain sufficient evidence of the reasonableness of assumptions used to determine the fair value of acquired assets.
  - Auditors did not evaluate the appropriateness of valuation models and the reasonableness of assumptions used in determining the fair value of investment securities.
  - Auditors did not perform sufficient procedures to resolve known contradictory evidence when evaluating the recoverability of long-lived assets.
- [Inventory](#). In testing controls over inventory, auditors sometimes did not properly assess the reliability of cycle counts. (A cycle count program involves periodic counts of a subset of inventory, rather than an annual physical count of the entire inventory.) One common deficiency was that auditors limited their cycle count assessment procedures to management inquiries.
- [Critical Audit Matters](#). Audit opinions are required to contain a discussion of critical audit matters (CAMs). CAMs are aspects of the audit that involved especially challenging, subjective, or complex auditor judgment. Common deficiencies relating to CAM reporting included failing to

assess all matters that could potentially be CAMs for inclusion in the auditor's report. In addition, CAM discussions sometimes failed to accurately describe how the CAM was addressed in the audit or the principal considerations that led the auditor to determine that the matter was a CAM.

- Form AP. For each public company audit, the auditor is required to file Form AP disclosing the name of the engagement partner and other accounting firms that participated in the audit. These reports were sometimes not timely or contained inaccurate or incomplete firm information.

### Quality Control Observations

The Preview describes three common deficiencies in inspected firms' systems of quality control:

- Independence. Certain firms had a high rate of noncompliance with requirements that employees report their financial relationships to the firm. In addition, inspectors found deficiencies in compliance with the PCAOB's rules on audit committee preapproval of certain tax services and on communication with audit committees concerning independence.
- Engagement Quality Review. Before issuing an audit report, a partner not involved in the engagement is required to perform a review. The Preview states that, in some cases, engagement quality reviewers did not properly evaluate areas that the engagement team had identified as involving significant risk. Further, some reviewers did not maintain objectivity – for example, because they assumed responsibilities of an engagement team member.
- Internal Monitoring. The Preview states that some firm internal inspection procedures failed to identify deficiencies that were uncovered by the PCAOB's inspectors. This may suggest that the audit firm's internal inspection program is not suitably designed or effectively applied.

### Other Observations – Cybersecurity and Distributed Ledger Technology

The 2020 inspections reviewed how auditors responded to cybersecurity incidents and to distributed ledger technologies. Deficiencies were identified in both areas. With respect to cybersecurity, some auditors did not consider whether a cybersecurity incident affected the identification or assessment of misstatement risk or whether modifications to audit procedures were necessary. With respect to distributed ledger technology, inspectors found instances in which auditors did not properly evaluate the sufficiency and appropriateness of audit evidence over the existence and valuation of crypto assets.

Comment: The Preview may be useful to audit committees in understanding what aspects of the company's future audits are likely to attract the PCAOB inspection staff's attention. Examples include the Board's emphasis on revenue recognition, cybersecurity incidents, evaluation of management assumptions that underlie estimates, and testing controls over company-provided data or reports on which the auditor relied. All auditors, whether or not they received adverse PCAOB comments on particular recurring audit deficiencies, can be expected to devote attention to these areas in anticipation of possible PCAOB scrutiny. Therefore, the Preview may also aid audit committees in understanding their auditor's risk assessments and resource allocation decisions and in discussing these matters with the engagement team.

## **The SEC Turns Up the Heat on EPS and Other Accounting Abuses**

On August 24, the SEC brought the third case in its long-running program to detect and prosecute quarterly earnings per share (EPS) manipulations. See [SEC Charges Healthcare Services Company and CFO for Failing to Accurately Report Loss Contingencies as part of Continuing EPS Initiative](#). In addition to serving as a reminder that the Commission continues to be vigilant with respect to efforts to manipulate EPS to meet analyst expectations, the case may also signal renewed SEC enforcement interest in accounting and financial reporting matters generally. To underscore that point, shortly after the

Healthcare Services case, the Commission filed an action against Kraft Heinz Company (Kraft) alleging a scheme to overstate earnings by understating costs. See [Company Will Pay \\$62 Million to Settle Charges Related to Inflated Cost Savings that Caused it to Restate Several Years of Financial Reporting](#).

### The EPS Initiative and the Healthcare Service Group Case

In 2018, the SEC reportedly commenced an enforcement effort to detect quarterly EPS manipulations. This initiative was apparently triggered by academic research suggesting that the number four rarely appears in the first post-decimal digit of EPS. Since EPS amounts that end in .5 cents can be rounded to the next highest whole cent, there appears to be an incentive to make accounting adjustments that raise EPS calculations ending in .4 cents to .5. See [Does Your Company Suffer From Quadrophobia? The SEC is Investigating the Fear of Four](#), June-July 2018 [Update](#). Two years later, in 2020, the Commission filed two actions pursuant to the EPS initiative. See [SEC Charges Companies, Former Executives as Part of Risk-Based Initiative](#).

The third EPS case was brought against Healthcare Services Group (HCSG), a provider of house-keeping, dining, and other services to healthcare facilities. The [SEC's order](#) finds that, in 2014 and 2015, HCSG violated GAAP by failing to timely accrue and disclose material loss contingencies related to private litigation against the company. Not recording these loss contingencies in the proper quarters caused HCSG's reported EPS to meet analyst consensus EPS estimates. The failure to book these loss accruals in the appropriate quarter also resulted in HCSG reporting multiple quarters of EPS growth, including record-high EPS. In addition to the company, the SEC's order charges HCSG's former CFO and its controller with causing various securities law violations. Without admitting or denying the SEC's findings, HCSG, the CFO, and the controller agreed to cease and desist from future violations and to pay civil penalties of \$6 million, \$50,000, and \$10,000, respectively. The CFO also agreed to a suspension from appearing and practicing before the SEC as an accountant.

In the [SEC's announcement of the HCSG action](#), Gurbir Grewal, the new Director of the SEC's Division of Enforcement said, "As today's actions demonstrate, we will continue to leverage our in-house data analytic capabilities to identify improper accounting and disclosure practices that mask volatility in financial performance, and continue to hold public companies and their executives accountable for their violations."

### The Kraft Heinz Case

Less than two weeks after filing the HCSG case, the SEC announced an action against Kraft alleging a multi-year expense management scheme that resulted in Kraft's reporting inflated earnings before interest, taxes, depreciation, and amortization – EBITDA – which the SEC described as "a key earnings performance metric for investors." While the Kraft case is unrelated to the EPS initiative, it also illustrates the SEC's enforcement emphasis on financial reporting.

According to the [SEC's administrative order](#), between 2015 and 2018 Kraft engaged in various types of accounting misconduct, including recognizing unearned discounts from suppliers and maintaining false and misleading supplier contracts, that improperly reduced the company's cost of goods sold. These efforts were designed to create the appearance that the company had achieved cost reductions, as predicted in connection with the 2015 merger of Kraft and Heinz. The SEC's order finds that Kraft and its former Chief Operating Officer violated the anti-fraud, reporting, books and records, and internal accounting controls provisions of the federal securities laws and that the former COO provided inaccurate information to Kraft's auditors. The Commission also filed a civil action against the company's former Chief Procurement Officer, charging him with similar violations.

Without admitting or denying the SEC's findings or allegations, Kraft consented to cease and desist from future violations and to pay a civil penalty of \$62 million. The former COO also consented to cease and desist from future violations, to pay disgorgement and prejudgment interest of \$14,211.31, and to pay a civil penalty of \$300,000. The former CPO consented to an injunction against future violations, a civil penalty of \$100,000, and a bar against serving as an officer or director of a public company for five years.

Comment: While the investigations that resulted in the HCSG and Kraft cases were undoubtedly initiated many months, if not years, in the past, these matters may indicate that, under Chair Gensler, the SEC's Enforcement staff will be active in pursuing accounting and financial reporting matters. Indeed, in an [October 13 speech](#), Enforcement Director Grewal said:

“With respect to corporate responsibility, Congress has enacted many laws and the SEC has adopted many rules to ensure that corporations are being responsible and playing fair. But too often, they ignore these rules and fail to implement sufficient controls or procedures to ensure compliance. In some cases, firms are practically inviting fraud or waiting for misconduct to occur; in others, they are actively covering it up or minimizing it. All of this serves to undermine public trust and confidence. Enhancing it will require, among other things, robust enforcement of laws and rules concerning required disclosures, misuse of nonpublic information, violation of record-keeping obligations, and obfuscation of evidence from the SEC or other government agencies.”

For audit committees, the HCSG case could serve as a basis to revisit the controls around discretionary accounting adjustments and quarterly earnings reporting. Given the publicity surrounding the topic, it would be prudent to ask whether there are controls in place that would prevent or detect small adjustments intended to bring quarterly results in line with analyst estimates. More broadly, audit committees should be aware that the recent financial reporting cases and Commissioner and staff statements seem to suggest an aggressive SEC approach to financial reporting matters.

## **Flying Blind? The Impact of Climate Change Disclosures on Financial Reporting**

The Center for Audit Quality (CAQ) and Deloitte have each issued papers on the relationship between climate change and financial reporting. On September 9, the CAQ released [Audited Financial Statements and Climate-Related Risk Considerations](#). In a [press release](#) announcing the publication, the CAQ explained that it is intended to provide “investors and other stakeholders with a foundational understanding of current climate-related reporting and auditing requirements in the U.S. and how they are applied.” In a September 30 [Financial Reporting Alert](#), Deloitte explains the potential impacts of climate-related matters on accounting and reporting. [Financial Reporting Considerations Related to Environmental Events and Activities \(Alert\)](#) is a detailed analysis of ways in which regulatory developments in response to climate change and company climate change strategy can affect financial reporting under existing accounting guidance and SEC requirements.

Carbon Tracker, a non-profit organization that analyzes the impact of energy transition on capital markets, has a somewhat different perspective on the intersection of climate change and financial reporting. It has released [Flying blind: The glaring absence of climate risks in financial reporting](#). This report examines whether 107 carbon-intensive firms and their auditors considered material climate-related risks in their financial reporting. Carbon Tracker concludes that, “[d]espite significant financial risks faced from the climate crisis, and net-zero pledges made by many we found little evidence that companies or their auditors considered climate-related matters in the 2020 financial statements.”

Together, these three reports illustrate that company strategies and commitments related to climate change (or other ESG matters) can have immediate, material financial reporting implications. In light of the SEC's focus on climate-related disclosures, audit committees should consider whether their company's sustainability disclosures and commitments are consistent with its financial reporting.

### CAQ: Audited Financial Statements and Climate-Related Risk Considerations

The CAQ observes that “[w]e are at a pivotal moment for climate and other environmental, social and governance (ESG) reporting,” particularly because the SEC will soon propose ESG-related disclosure requirements. See [The SEC's Agenda – ESG Tops the List, July 2021 Update](#). Despite uncertainty

about the specifics of SEC ESG rulemaking, the CAQ believes “it is important for users of the audited financial statements to be aware of what climate-related reporting is currently required under US Generally Accepted Accounting Principles (GAAP). Understanding current financial statement requirements can be a useful starting point for investors and others as they consider how and where to obtain their desired climate-related information to make capital allocation decisions \* \* \* .”

The CAQ states that forward-looking climate-related risks that could impact financial statements fall into two categories: (1) physical risks (e.g., the risk that an entity’s facilities will be damaged by a severe weather event or that a company will need to relocate its facilities away from low-lying coastal areas) or (2) the risks associated with the transition to a low-carbon economy (e.g., regulatory risk associated with required changes to a company’s business and/or the impact of a company’s net-zero commitments on management’s evaluation of impairment or the useful lives of assets). The CAQ report includes examples, involving a manufacturing company that announces a commitment to achieve net-zero carbon emissions by 2030, of how a climate-related commitment can impact financial reporting.

The CAQ also describe four aspects of the audit that may be affected by climate-related matters:

- Risk assessment. The auditor’s risk assessment includes consideration of climate-related risks and their potential impact on the financial statements. The CAQ lists a series of questions auditors might consider asking to understand potential climate-related risks.
- General audit considerations. Although auditors are not required to perform procedures with respect to climate-related disclosures outside of documents that contain the financial statements, they have a responsibility to consider the financial statement implications of such disclosures.
- Critical audit matters. Climate-related considerations may be included in the auditor’s discussion of critical audit matters. For example, auditing climate-related assumptions could be especially challenging or require complex auditor judgment.
- Other information. Auditors have a responsibility to read other information included in documents that contain the audited financial statements for consistency with the financial statements and to consider whether such information contains material misstatements of which the auditor is aware. Therefore, the auditor must read and consider climate-related disclosures in SEC filings that contain the financial statements.

#### Deloitte: Financial Reporting Considerations Related to Environmental Events and Activities.

Deloitte notes that many companies are considering how climate and other ESG matters will affect their business strategies, operations, and long-term value. Business strategies designed to address these issues need to be “considered in a consistent manner for both sustainability reporting and the preparation of the financial statements.” The Alert discusses eleven specific financial reporting issues that may arise as a result of climate-related matters:

- Potential Accounting and Reporting Implications of Environmental Objectives. Companies frequently make public statements regarding their plans to address the impacts of climate change, such as commitments to become carbon neutral by a specified date or to reduce greenhouse gas emissions by a target amount. Deloitte explains the impact of these types of commitments on the valuation and useful life of existing assets and on the creation of obligations that should be accounted for as liabilities. Entities should also evaluate whether their climate-related public statements, plans, or actions require financial statement foot-note disclosure, even if they conclude that there is nothing to record in current-period statements.
- Developing Estimates and Maintaining Consistency of Assumptions and Estimates. Accounting for climate-related initiatives may require companies to select assumptions and to develop estimates that are used for more than one purpose. “When a single assumption is used in

multiple analyses, entities should verify that the same assumption is being used in each analysis unless the guidance in U.S. GAAP permits otherwise. In addition, entities should verify that assumptions and estimates outside of the financial statements (e.g., sustainability reports) are consistent with those used when preparing estimates required by U.S. GAAP.”

- Use and Recoverability of Long-Lived Assets. Entities need to continuously evaluate the accounting and reporting impact of climate-related goals or targets on the use and recoverability of long-lived assets, including goodwill, other indefinite-lived intangible assets, and property, plant, and equipment.
- Inventory. Climate-related events could materially affect net realizable inventory value estimates. “For example, wildfires could significantly damage crops, or floods could significantly damage goods held in a warehouse. In addition, an entity’s operations may be affected by new regulations, customer preferences, or its own initiatives related to environmental concerns — for example, a ban on the use of plastic bags \* \* \* .”
- Taxes. Environmental initiatives could result in changes to operations that affect profitability and thereby affect income tax accounting.
- Leases. Both lessees and lessors may encounter situations in which leased assets are impaired as a result of climate-change driven technological advances or changes in customer preferences. The Alert discusses the accounting implications for such events. Similarly, energy service agreements and virtual power purchase agreements raise a variety of accounting issues, including the possible existence of embedded leases.
- Insurance Recoveries. Climate-related events may raise issues concerning accounting for insurance recoveries. For example, business interruption insurance may provide coverage for lost profits caused by a suspension of operations due to weather-related events.
- Financial Instruments and Contract Assets. To demonstrate their commitment to ESG, companies may issue sustainability-linked bonds or loans (debt instruments with terms tied to environmental factors). Both issuers and holders of such debt need to consider whether the arrangement contains embedded features that must be separately accounted for as derivatives.
- Environmental Obligations. Changes in laws and regulations may affect the timing and cost of environmental remediation obligations and thereby impact liabilities.
- Asset Retirement Obligations (AROs). Climate strategy may affect AROs -- legal or contractual obligations to perform remediation activities resulting from the intended use of a long-lived asset. “Changes in operations that result in a change in management’s intended use of an asset — including a change in its plans to maintain the asset, extend its useful life, or abandon the asset earlier than previously expected — may affect the recorded amount of an ARO associated with the asset, including the timing associated with the retirement activities.”
- Compensation Arrangements. Companies may link incentive pay for executives and employees to environmental (or other ESG) metrics. Such arrangements raise a variety of accounting issues. Among other things, entities should have a clear method of measuring and monitoring performance against these metrics so they can calculate the bonus accrual throughout the year.

### Carbon Tracker: Flying blind: The Glaring Absence of Climate Risks in Financial Reporting

Carbon Tracker examined whether 107 publicly traded carbon-intensive firms considered material climate-related risks in their 2020 financial reporting. The report notes that the International Accounting Standards Board ([link here](#)), the International Auditing and Assurance Standards Board ([link here](#)), and the Financial

Accounting Standards Board ([link here](#)) have issued guidance on consideration of climate change issues in the preparation and audit of financial statements. Carbon Tracker asserts that climate-related matters

“can impact current financial reporting since many of the numbers in the financial statements include estimates and assumptions about the future. For example, climate matters can lead to shorter estimated useful lives for productive assets or changes to the assumptions used to determine expected future cash flows for impairment testing, resulting in impairments and altering the reported amounts of assets and liabilities. Similarly, shifting product demand may result in inventory obsolescence, leading to increased costs, reduced revenues and profits and lower returns on capital which can impact a company’s ability to continue as a going concern. If a company ignores the clear signs that dramatic changes lie ahead, it runs the risk of overstating assets, or understating liabilities, all to the detriment of the company and ultimately its investors.”

Carbon Tracker’s analysis concludes that the companies it studied did not adequately consider climate-related matters in the preparation of their financial statements, nor did their auditors consider such matters. The report’s six “key findings” are:

1. There is little evidence that companies incorporate material climate-related matters into their financial statements. Over 70 percent of the 107 companies did not indicate that they considered climate matters in preparing their 2020 financial statements, “despite the fact that significant institutional investors have identified these companies as highly carbon exposed.”
2. Most climate-related assumptions and estimates are not visible in the financial statements. Only 25 percent of the companies provided disclosure of at least some of the quantitative assumptions and estimates used in preparing the financial statements.
3. Most companies do not tell a consistent story across their reporting. For 72 percent of the companies, the treatment of climate matters in the financial statements appeared to be inconsistent with disclosures of climate-related risks and commitments in other reporting.
4. There is little evidence that auditors consider the effects of material climate-related financial risks or companies’ announced climate strategies. Eighty percent of these companies’ auditors “provided no indication of whether or how they had considered material climate-related matters, such as the impact of emissions reduction targets, changes to regulations, or declining demand for company products, in their audits.”
5. Even with considerable observable inconsistencies across company reporting (‘other information’ and financial statements), auditors rarely comment on any differences. “We had significant concerns for 59% of the consistency checks that the auditors were required to perform. For the remaining 41%, around half of the companies’ discussions of and responses to climate matters were consistently limited across their reporting.”
6. Companies do not appear to use “Paris-aligned” assumptions and estimates. None of the companies used assumptions and estimates that were “Paris-aligned”. (“Paris-aligned” refers to the Paris Agreement, an international treaty on climate change adopted in 2015, which calls for limiting global warming to no more than 1.5°C and reducing emissions to net zero by 2050.)

Comment: Audit committees should consider whether their company’s disclosures and commitments concerning climate change and other ESG matters have material accounting implications and, if so, whether those implications are properly reflected in the financial statements. As the CAQ and Deloitte reports make clear, public commitments to achieving carbon neutrality or net zero emissions can have significant financial statement consequences, particularly with respect to the value and impairment of existing assets. Commitments to make major changes in the company’s products or supply chain for climate-related reasons may also affect financial reporting. Senior executives who make such commitments are not always aware of the financial statement implications for their public declarations.

Audit committee attention to the links between corporate sustainability policies and financial reporting is particularly important because of the increasing attention that investors, interest groups, and regulators are paying to these issues. The Carbon Tracker report is a good example. Similarly, both the SEC's Division of Corporation Finance and Division of Enforcement have announced initiatives to review company climate and other ESG disclosures for consistency with other corporate disclosures and for compliance with existing SEC climate disclosure interpretations. See, e.g., [SEC Announces Enforcement Task Force Focused on Climate and ESG Issues](#). On September 22, the SEC Corporation Finance staff released a [sample letter](#) that highlights the types of comments it may issue to public companies regarding climate-related disclosures. It would not be surprising if the SEC were to bring one or more enforcement actions based on allegations that companies have made climate-related commitments without reflecting those commitments in their financial statements in accordance with GAAP.

## EY Reports on the State of Cybersecurity Risk Disclosure

The EY Center for Board Matters has released [How cybersecurity risk disclosures and oversight are evolving in 2021](#), its fourth annual analysis of cybersecurity-related disclosures in the proxy statements and Form 10-K filings of Fortune 100 companies. EY reports that “[m]any companies are enhancing their cybersecurity disclosures related to the identification of director skills and expertise” and that there have also been “notable increases in disclosures related to the assignment of board-level committee oversight and discussing workforce education and training efforts and cybersecurity insurance.” EY found that 68 percent of Fortune 100 companies assign cybersecurity oversight to the audit committee – a one percent increase over 2020. Nine percent of the Fortune 100 disclosed a material cybersecurity incident, a decrease from 12 percent last year.

In general, cybersecurity disclosure trends identified in last year's EY report continued in 2021. (For discussion of the prior EY Center report, see [More Public Companies Are Disclosing the Board's Cybersecurity Risk Oversight Role, September 2020 Update](#).) Key findings of the 2021 report include:

- [Identification of director skills and expertise](#). In 2021, 56 percent of the Fortune 100 cited cybersecurity in at least one director biography, up from 44 percent last year and 27 percent in 2018. In most cases, the increase resulted from new directors joining boards, not re-written bios.
- [Management reporting to the board](#). Sixty-nine percent of companies provided insights into management's reporting to the board or to the committee overseeing cybersecurity matters, up from 61 percent last year and 58 percent in 2018. Forty-four percent identified at least one management official who engages in such reporting, most frequently the Chief Information Security Officer. Thirty-four percent disclosed that reporting occurs at least annually or quarterly.
- [Board-level committee oversight](#). Ninety percent of companies disclosed that at least one board-level committee has responsibility for cybersecurity oversight, up from 87 percent in 2020 and 75 percent in 2018. As noted above, the audit committee is the most frequent choice – 68 percent of boards assigned cybersecurity oversight to the audit committee. Thirty percent of boards assigned cyber to a committee other than audit, up from 19 percent in 2018. However, only about two thirds of the charters of audit committees with cybersecurity oversight responsibility expressly mention that responsibility.
- [Alignment with an external framework or standard](#). Ten percent of companies disclosed alignment of their cybersecurity program and information security practices with an external security process or control framework, up from one percent in 2018. Six percent cited the National Institute of Standards and Technology's (NIST) cybersecurity framework, with smaller numbers citing various other frameworks.

- Compensation incentives. Only 12 percent of these companies disclosed that cybersecurity or privacy is an executive pay consideration, up from 8 percent last year and one percent in 2018.
- Response readiness simulations and tabletop exercises. Last year, 7 percent of companies disclosed that they performed cyber-incident simulations (up from 3 percent in 2019). EY states that the percentage of companies disclosing such simulations in 2021 was “largely the same.” No company disclosed whether the board participated in the exercises.
- Use of external independent advisor. Seventeen Fortune 100 companies disclosed management use of an external independent cybersecurity consultant. Five of these companies disclosed that the board received a report from the independent third party.

Based on dialogue with directors and cybersecurity experts, EY describes nine “leading board practices” with respect to cybersecurity:

- Set the tone. Establish cybersecurity as a key consideration in all board matters.
- Stay diligent. Address new issues and threats stemming from remote work and the expansion of digital transformation.
- Determine value at risk. Reconcile value at risk in dollar terms against the board’s risk tolerance, including the efficacy of cyber insurance coverage.
- Embed security from the start. Embrace a “trust by design” philosophy when designing new technology, products, and business arrangements.
- Independently assess the cybersecurity risk management program. Obtain a third-party assessment of the cybersecurity risk management program with direct feedback to the board.
- Understand escalation protocols. Include a defined communication plan detailing when the board should be notified, including ransomware incidents.
- Manage third-party risk. Understand management’s processes to identify, assess and manage the risk associated with service providers and the supply chain.
- Test response and recovery. Enhance enterprise resiliency by conducting rigorous simulations, including restoring off-site backups and testing recovery time and arranging protocols with third-party specialists before a crisis.
- Monitor evolving practices and the regulatory and public policy landscape. Stay attuned to evolving oversight practices, disclosures, reporting structures, metrics, and regulatory and public policy developments.

The report concludes with a discussion of the U.S. public policy environment, including Executive Branch, Congressional, and SEC actions related to cybersecurity.

Comment: Cybersecurity disclosure also appears to be a priority of the new enforcement regime at the SEC. In a [recent speech](#), the SEC’s Director of Enforcement, Gurbir Grewal, promised to continue to be “vigilant in \* \* \* pursuing public companies that do not reasonably disclose material cybersecurity incidents. This includes charging public companies for misleading disclosures about cybersecurity events, or for inadequate controls related to such disclosures.” Audit committees should therefore be focused on the disclosures their company is making concerning both cybersecurity risk oversight and any breaches that may occur. If, in addition to disclosure, the audit committee is charged with oversight responsibility for cybersecurity, the EY Center’s best practices deserve consideration.

## The Audit Committee's Role in ESG Disclosure: Part II

[What is the Audit Committee's Role in ESG Disclosure, December 2020 Update](#), discussed a blog post in which Wes Bricker, PwC chair and assurance leader, and Paula Loop, the leader of PwC's Governance Insights Center, offer thoughts on the role of the audit committee in oversight of environmental, social, and governance (ESG) disclosure. In September, the Governance Insights Center issued [The audit committee's role in sustainability/ESG oversight](#) which outlines in more detail PwC's view of the audit committee's role in ESG disclosure oversight.

In a survey, a majority of directors reported that their board had assigned ESG oversight to the full board. In PwC's view, it may nonetheless be desirable to assign specific aspects of ESG to specific committees. In this regard, "the audit committee has a critical role in helping companies develop investor grade ESG disclosures." PwC describes four facets of the audit committee's ESG disclosure oversight role and suggests questions the audit committee could ask to gauge management's progress in each area.

### Overseeing ESG Disclosures

In response to demand from investors and other stakeholders, many U.S. companies make voluntary ESG disclosures, often in a sustainability report. In approaching ESG disclosure, management faces several challenges, including determining which ESG information is financially and socially material to their company's operations and performance; choosing the most appropriate places to make the disclosures (e.g., a sustainability report, a regulatory filing, or on their corporate website); and ensuring that disclosure is consistent across platforms.

PwC suggests that, in overseeing management's process for determining ESG disclosures, audit committees ask the following questions:

- What has management identified as the company's ESG risks and opportunities?
- Which ESG frameworks or standards are they using? Why have they chosen a particular framework?
- What types of ESG information are key stakeholders asking for, and how is management planning to address them?
- How is management preparing for increased regulatory disclosure requirements?

### Overseeing ESG Processes and Controls

PwC states that the ESG information a company discloses should be collected, consolidated, and disclosed with the same rigor as financial information. Often, however, this is not the case. "Some companies are realizing they don't have the technology systems and information gathering processes in place to comply with the demands for greater ESG disclosure." Appropriate disclosure controls and procedures for ESG metrics "need to be designed, documented, and tested to ensure they operate as intended" and "cannot be developed overnight."

To oversee ESG processes and controls, PwC suggests that audit committees ask the following questions:

- How is the company collecting ESG information?
- What are the data collection policies?
- What controls are in place to ensure that ESG information is reliable and complete?

- What additional resources may be necessary to implement new ESG processes and controls?
- How is the disclosure committee involved in the process?
- What is internal audit's involvement? What are their findings and recommendations?

### Overseeing Financial Statement Impacts

Investments in technology, research, and development to meet corporate ESG objectives will impact the financial statements. "For example, as car companies make net zero commitments, they may need to develop new or transform existing manufacturing plants to build electric vehicles." The audit committee should pay close attention to how such investments are reflected in the financial statements. Audit committees will also need to monitor accounting for new types of assets, such as carbon offsets.

Regarding the financial reporting implications of ESG investments and commitments, PwC suggests the following audit committee questions:

- How will the company's ESG commitments impact its financial statements?
- Has management communicated its forecasted projections and necessary investments in financial statements?
- How is management keeping up with regulatory changes in these areas?
- What is the plan for evaluating the return on sustainability investments?
- Has management considered the impact of strategy changes on the valuations of existing assets and their useful lives?

### Overseeing ESG Assurance

Currently, 29 percent of S&P 500 companies obtain some form of third-party assurance for some or all of their ESG disclosures. See [The S&P 500 Are \(Almost\) All in on ESG Disclosure, August 2021 Update](#). Further, the European Commission recently adopted a requirement that companies subject to the EU Corporate Sustainability Responsibility Reporting Directive obtain limited assurance over their ESG disclosures. PwC anticipates a shift to mandatory ESG reporting that may require assurance in the U.S.

To oversee ESG assurance, the audit committee may want to ask the following questions:

- Have investors or other stakeholders requested assurance over the ESG reporting? If so, have they indicated what level of assurance they prefer?
- If the company includes ESG information in its SEC filings, has management considered whether some level of assurance would increase confidence in the disclosures?
- How is management keeping abreast of new and emerging regulatory assurance requirements?

**Comment:** As stated in several 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 the company is making, how the information is collected, and how these disclosures impact financial reporting. Controls and procedures are an especially important area because, as PwC suggests, ESG disclosures are often not subject to the same types of controls that govern other company disclosures. PwC's analysis of the audit committee's ESG disclosure oversight role and its suggested questions could be a useful tool for audit committees in assessing management's ESG disclosure progress.

## On the Update Radar: Things in Brief

### **SEC Revives a Proposal to Require Compensation Claw Backs After Restatements.**

The SEC has restarted rulemaking that would compel U.S. listed companies to adopt policies requiring recovery, on a no-fault basis, of incentive compensation paid to executive officers on the basis of accounting measures that are subsequently restated. The 2010 Dodd-Frank Act mandated that the SEC direct the exchanges to implement a claw back requirement as a listing standard. The Commission originally proposed such a rule in 2015. See [SEC Proposes to Require Companies to “Claw Back” Executive Compensation Following a Restatement](#), July 2015 Update. After receiving comment on that proposal, the Commission took no further action, but has now [issued a release](#) again inviting the public’s views. In a [written statement](#), SEC Chair Gensler described the proposal as “an opportunity to strengthen the transparency and quality of corporate financial statements as well as the accountability of corporate executives to their investors.”

Under proposed Securities Exchange Act Rule 10D-1, each listed company would be required to develop a compensation recovery policy. The policy would have to provide that, in the event of an accounting restatement to correct a material error, the company will recover from current and former executive officers any incentive-based compensation received during the prior three fiscal years that exceeds the amount that would have been received under the restatement. Recovery would be mandatory, regardless of whether the officers were responsible for the errors that resulted in the restatement and regardless of whether the inaccurate financial reporting was the result of misconduct. A company would be subject to delisting if it failed to adopt or enforce the recovery policy.

Many companies already have voluntarily adopted such compensation recovery policies. As the disincentives to restate increase, audit committees need to make sure they are fully and evenhandedly informed in situations in which a restatement is a possibility. The claw back policies may also have an impact on compensation policy. Executive officers may seek to receive more of their compensation as base salary or in other forms that are not linked to financial reporting measures.

### **Delaware Issues a Warning on the Scope of Audit Committee Risk Oversight.**

On September 7, the Delaware Court of Chancery [denied a motion to dismiss](#) a shareholder derivative action alleging that the board of The Boeing Company breached its duty of oversight by failing to implement any airplane safety oversight procedures prior to two fatal crashes of 737 MAX aircraft and by ignoring safety red flags following the crashes. The opinion notes that suits alleging director liability for breach of the duty of oversight are “possibly the most difficult theory in corporation law upon which plaintiff might hope to win a judgment.” However, the Boeing decision suggests that Delaware may be becoming more open to such claims, especially in the case of companies engaged in activities that could potentially cause injury or death.

The Boeing decision may be significant for audit committees because they are frequently charged with broad responsibility for oversight of risk and compliance. At Boeing, no board committee had responsibility for airplane safety, although the audit committee had risk oversight responsibility. Despite that responsibility, the committee allegedly did nothing to focus on safety risks. The court states:

“Although the Audit Committee was tasked with handling risk generally, it did not take on airplane safety specifically. Its yearly updates regarding the Company’s compliance risk management process did not address airplane safety. For example, when the Board discussed audit plans in 2014 and 2017, respectively, it did not mention or address airplane safety. Specifically as to the 737 MAX, from its development through its grounding in 2019, the Audit Committee never mentioned “safety.” Nor did it address product safety issues related to the design, development, or production of the 737 MAX, or ask for presentations on the topic.

“Rather, consistent with Boeing’s emphasis on rapid production and revenue, the Audit Committee primarily focused on financial risks to the Company. \* \* \* “Even after the Lion Air Crash in 2018, [the chief compliance officer’s] risk management update to the Audit Committee in December 2018 did not identify product safety as a ‘compliance risk’ for 2018.”

The overall lesson of Boeing is that boards should have oversight and reporting processes for all core corporate activities. For audit committees, the decision is a warning that, although the committee may view its responsibilities as focused on financial risks and legal compliance, a court may read a committee charter provision that refers generally to oversight of risk and compliance broadly, particularly after the occurrence of a catastrophic event. Audit committees with charters that assign general risk and compliance oversight to the committee should either implement (and document) oversight processes for all risks associated with critical corporate functions or ensure that the board has expressly assigned all such risks to another committee or to the full board.

**More Researchers Find that Changes in Accounting Estimates Are Often Deployed to Meet Earnings Estimates.** Yet another academic study highlights the potential abuse of changes in earnings estimates (CAEs). In [Do Firms Time Changes in Accounting Estimates to Manage Earnings?](#), Philip Keunho Chung (Christopher Newport University), Marshall A. Geiger, Daniel Gyung Paik, and Collin Rabe (the later three at the University of Richmond) find that 28.1 percent of income-increasing CAEs occur in quarters where reported earnings would be below forecast, but for the CAE. They also find that income-decreasing CAEs are more likely to occur when pre-CAE earnings are relatively high “as a way to either smooth earnings or to ‘bury bad news’” or when pre-CAE earnings are already low, “as a way to take a financial ‘big bath’ and position the firm for positive future earnings.” These findings are consistent with other studies of CAEs. See [Accounting Quality Alarm Bell: Changes in Accounting Estimates, August 2021 Update](#). As noted in the August 2021 [Update](#), audit committees should make sure that they understand management’s basis and motivation for any CAEs and the rationale for their timing.

## The Audit Blog

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

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

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Prior [Updates](#) issued between January 1, 2019, and May 31, 2020, are available [here](#). [Updates](#) issued after June 1, 2020, are available [here](#).