Dan Goelzer

AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

Update No. 56
November-December 2019

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

In This Update:

Audit Committee Transparency Plateaus

PCAOB Shares its Initial Observations on CAMs

When it Comes to the Ability to Deal with Risk, Boards are More Confident, But Less Well-Informed, Than Management

Switching Teams: Does Having an Audit Firm Alum on the Audit Committee Help or Hurt?

Sustainability Reporting Continues to Grow – Both Inside and Outside SEC Filings

The Audit Blog

Audit Committee Transparency Plateaus

During the last several years, there has been a significant expansion in voluntary disclosure about audit committee responsibilities and how they are discharged. See CAQ and EY Center Audit Committee Transparency Reports: Disclosure Continues to Grow Apace, October-November 2018 Update. In 2014, the Center for Audit Quality (CAQ) and research firm Audit Analytics (AA) began issuing an annual report tracking changes in these disclosures. On November 6, the CAQ and AA released the sixth of these reports, 2019 Audit Committee Transparency Barometer. The Transparency Barometer measures proxy disclosures by companies in the S&P Composite 1500, which consists of the S&P 500 index of large-cap companies, the S&P MidCap 400, and the S&P SmallCap 600.

While some areas of disclosure continue to grow, the 2019 report finds that many audit committee disclosure areas are "stagnant or slowing." Excluding cybersecurity disclosures, for S&P 500 companies, "only two disclosure categories have increased by more than 2% since 2018, with the largest increase of 4% for discussing criteria considered when evaluating the audit firm." Moreover, in some key areas, there continues to be only limited disclosure. In the press release announcing their findings, the CAQ and AA point to "several opportunities where audit committees can enhance transparency, including disclosure around significant areas of discussion between the audit committee and external auditor, auditor evaluation and engagement partner selection, and compensation."

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

Key 2019 Transparency Barometer findings include:

- Audit firm selection/ratification. Forty-two percent of S&P 500 company proxy statements disclose the considerations that were the basis for the audit committee's appointment of the audit firm, up from 40 percent in 2018. Thirty percent of MidCap companies discussed the audit committee's considerations in recommending the appointment of the audit firm (up from 27 percent last year), and 22 percent of SmallCap companies made such a disclosure (compared to 19 percent last year).

- Length of engagement. The percentage of S&P 500 companies that disclose the audit firm's tenure increased slightly from 70 percent in 2018 to 71 percent in 2019. For MidCap and SmallCap companies, the 2019 percentages were 54 percent and 55 percent, respectively; this was a 2 percent increase over 2018 for MidCaps and a 4 percent increase for SmallCaps. (Company disclosure of this data point is redundant, since tenure 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 committee fee negotiation responsibility and reasons for changes in audit fees. In 2019, 19 percent of S&P 500 companies disclosed that the audit committee is responsible for fee negotiations with the auditor. Such disclosure is less common at smaller companies – only 6 percent of S&P MidCap and 4 percent of SmallCap companies disclosed the audit committee's role in fee negotiations. While the frequency of this disclosure was essentially unchanged from 2018, disclosure of the reasons for changes in the audit fee declined significantly. In 2019, 23 percent of the S&P 500 discussed the reasons for fee changes, down from 28 percent in 2018. At MidCap companies, disclosure of the basis for fee changes fell from 26 percent to 18 percent, while at SmallCaps, there was a decline from 30 percent in 2018 to only 22 percent in 2019.

- Audit firm evaluation/supervision. The percentage of S&P 500 companies that disclosed criteria the audit committee considered in evaluating the audit firm increased from 46 percent in 2018 to 50 percent in 2019. Thirty-nine percent of MidCap companies and 33 percent of SmallCap companies discussed the audit committee's evaluation criteria, increases of 3 and 1 percent, respectively.

- Annual audit firm evaluation. In 2019, 29 percent of the S&P 500 disclosed that the audit committee performed an evaluation each year, a 3 percent increase over 2018. For MidCaps, this disclosure was made by 19 percent, up from 17 percent in 2018. Fourteen percent of SmallCaps made the annual evaluation disclosure, compared to 12 percent last year.

- Engagement partner selection. In 2018, slightly more than half – 52 percent – of the S&P 500 disclosed that the audit committee is involved in engagement partner selection. The frequency of this disclosure decreased in 2019 to 50 percent. For S&P MidCap companies, 22 percent disclosed that the audit committee played a role in engagement partner selection (up from 20 percent in 2018), while 10 percent of SmallCaps made such a disclosure, unchanged from last year.

Cyber security is the one area of audit committee responsibility in which there were sharp increases in disclosure. In 2019, 34 percent of S&P 500 companies disclosed that the audit committee is responsible for cybersecurity risk oversight, compared to 19 percent in 2018. For MidCap companies, this disclosure doubled between 2018 and 2019, from 13 percent to 26 percent. At SmallCaps, 13 percent made such a disclosure in 2019, up from 7 percent in 2018. Further, 23 percent of S&P 500 disclosed in 2019 whether the board has a cybersecurity expert, an increase of 9 percent from 2018. Fifteen percent of S&P MidCaps disclosed whether the board included a cybersecurity expert, as did 7 percent of SmallCaps.

As noted above, the 2019 Transparency Barometer report points to three areas in which the CAQ and AA see opportunities to enhance disclosure:

- Significant areas of audit committee discussion with the auditor. None of the S&P 500 companies make this type of disclosure. The report notes that auditors are now required to disclose critical

audit matters (CAMs) in the auditor's report and suggests that this affords audit committees an opportunity to provide their perspective on CAMs.

- Disclosures around audit firm evaluation and audit engagement partner selection. Criteria considered when evaluating the audit firm and audit committee's involvement in engagement partner selection are disclosed by only half of S&P 500 companies and by still fewer MidCap and SmallCap companies. The CAQ and AA assert that these "disclosures are critical and should be tailored to company-specific policies and procedures." In their view, useful disclosures include:

  - How often is the audit firm evaluated?

  - What is the mechanism for evaluation, and who is involved?

  - What are the key considerations when evaluating the audit firm?

  - What is the process for selecting the audit partner, and who is involved?

- Disclosure around audit firm compensation. The report urges that audit committees provide more insight into how the audit fee is negotiated and considered in connection with audit quality, explain changes in fees, and disclose the audit committee's responsibility for fee negotiation. Suggested disclosures include:

  - What level of detail related to fees is provided to the audit committee?

  - How does the audit committee consider the appropriateness of hours in balancing the need for an effective and efficient audit?

  - What caused changes in fees, including advances in technology, implementation of new accounting standards, and company-specific activities such as mergers and acquisitions?

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 own disclosures to match. The kinds of disclosures the Barometer identifies as common among S&P 500 companies are generally not controversial and would rarely involve disclosing confidential information or exposing the audit committee to increased litigation risk. Enhanced voluntary disclosure in these areas may, however, head off shareholder demands for more SEC-mandated audit committee information and is becoming a best practice.

The CAQ/AA recommendation that audit committees disclose significant areas of discussion with the auditor is more problematic. As the Barometer notes, no S&P 500 company audit committee made such a disclosure this year. Going forward, the auditor's CAM disclosure will illuminate certain challenging topics that were communicated to the audit committee (see next item in this Update). While there may be exceptions, most audit committees are likely to conclude that there is little benefit to supplementing the auditor's comments with an audit committee discussion of CAMs.

PCAOB Shares its Initial Observations on CAMs

In 2017, the PCAOB adopted a requirement that auditor discuss critical audit matters (CAMs) in their audit reports, beginning this year for the largest public companies. See CAM Reporting Begins: Goodwill and Intangible Assets Top the List; Many Companies are Considering Disclosure Changes, September-October 2019 Update. The PCAOB is monitoring the implementation of CAM reporting and, on December 10, released Critical Audit Matters Spotlight, which provides observations on CAM implementation from Board inspections and from its outreach and data analysis. Most public companies have not yet experienced CAM reporting, but the PCAOB's Spotlight reports on its review of initial CAM reporting companies.

As described in earlier Updates (see, e.g., More PCAOB Advice for Audit Committees on CAMs, July, 2019 Update), a CAM is any matter arising from the audit of the financial statements that was (1) communicated or 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 principal 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. For large accelerated filers with fiscal years ending on or after June 30, 2019, the auditor's report must include a discussion of CAMs identified during the audit. (A large accelerated filer is a company that has been subject to the SEC's reporting requirements for at least a year and that has a public float of $700 million or more.) CAM reporting will become effective for audits of most other public companies for fiscal years ending on or after December 15, 2020.

The PCAOB selected 12 audits of large accelerated filers with fiscal years ending on or after June 30, 2019, and reviewed how the auditors of these companies implemented CAM reporting. Based on this review, the PCAOB staff provides five observations:

- Framework for implementing CAMs. Audit firms made significant investments in "methodologies, tools, and training as well as providing targeted support for audit teams implementing the new requirements for the first time." These investments, along with the pre-effective practice runs, made important contributions to CAM implementation.

- Preliminary CAM determination and drafting. Some audit teams began determining and describing CAMs as early as the second or third quarter of the company's fiscal year. "Starting early provided ample time to draft the CAM descriptions for the audit report and discuss the matters identified as well as the draft language with all relevant parties, including management and audit committees."

- Ongoing CAM evaluation. Even if CAM determination and drafting began early in the audit, audit teams continued to evaluate the draft CAMs so that the final CAM determinations and CAM descriptions reflected the facts and circumstances of the current year's audit.

- Subject matter expertise. "Audit teams reported that it was helpful to involve a firm's national office as well as experts in tax, information technology, and other areas early and throughout the CAM determination and drafting process."

- Management and audit committee involvement. "Timely and robust engagement with management and the audit committee were important factors in the CAM implementation process." Audit committees generally began discussing CAMs with their auditor in 2017 or 2018. "[R]egular dialogue among the audit team, management, and the audit committee was helpful in building a common understanding of the purpose of the CAM requirements and in discussing CAM determinations and draft CAM descriptions." Contrary to one of the concerns that was expressed during the CAM rulemaking proceeding, the preliminary results from PCAOB outreach to audit committees suggest that "CAM implementation has not changed their interactions with the auditor."

The PCAOB's Spotlight also provides some statistical information concerning initial CAM filings. As of November 30, 2019, 189 auditor reports containing CAMs had been filed with the SEC. The average number of CAMS per report was 1.7, while the number of CAMs ranged between one and four. The most frequently communicated CAMS (along with the number of CAMs in each area) were:

- Goodwill and other intangible assets (88 CAMs)

- Revenue recognition (64 CAMs)

- Taxes (43 CAMs)

- Business combinations (40 CAMs)

The PCAOB intends to conduct at preliminary analysis in 2020 to evaluate whether CAM implementation suggests significant costs or unintended consequences. As part of this analysis, the Board will seek to understand how auditors responded to CAM requirements, whether (and how) investors are using CAM communications, and audit committee and preparer experiences. In addition, sometime after the completion of December 2020 audits, the Board will conduct "a full post-implementation review." This review will "reevaluate the costs and benefits of the requirements, including any unintended consequences, to understand the overall impact on the audit firms, public companies, audit committees, and investors."

Comment: The PCAOB's Spotlight report presents some useful implementation data and seems largely consistent with other analyses of initial CAM reporting. See CAM Reporting Begins: Goodwill and Intangible Assets Top the List; Many Companies are Considering Disclosure Changes, September-October 2019 Update. It underscores the importance of dry runs and early dialogue between the auditor, audit committee, and management concerning potential CAMs. While companies that are not large accelerated filers still have time to prepare for CAM reporting, the audit committee should make sure that they participating in the kind of "timely and robust engagement" the PCAOB's study found to be important in CAM implementation and in building a common understanding of CAM determinations and descriptions.

When it Comes to the Ability to Deal with Risk, Boards are More Confident, But Less Well-Informed, Than Management

Since the 2008 financial crisis, risk management has become a major focus for most corporate boards. In many cases, this responsibility is assigned to the audit committee. However, a new study from the Institute of Internal Auditors (IIA) raises questions about how well-informed boards are about the risks facing their company and whether directors tend to be unrealistic about the company's ability to handle those risks.

On October 15, the IIA issued, OnRisk 2020: A Guide to Understanding, Aligning, and Optimizing Risk. The accompanying press release summarizes the report's findings:

> "Boards are significantly overconfident when it comes to addressing the thorniest issues facing organizations today. Board members have greater confidence in their organizations' ability to manage key risks than members of management actually do * * *. The reason for the skewed sense of security on risks ranging from data protection and new technology to culture and sustainability: Boards may receive information from management that's incomplete or misleading, then compound the problem by failing to ask critical questions."

OnRisk 2020 combines the results of 90 in-depth boardroom, C-suite, and internal audit interviews with a quantitative survey on risks as viewed by more than 600 chief audit executives (CAEs). As a predicate for these surveys, the IIA first identified 11 risks that are likely to affect organizations in 2020. These risks are: (1) cybersecurity, (2) data protection, (3) regulatory change, (4) business continuity/crisis response, (5) data and new technology, (6) third party (i.e., reliance on third parties for services, especially IT), (7) talent management, (8) culture, (9) board information, (10) data ethics, and (11) sustainability (i.e., environmental, social, and governance influences on organizational decision-making).

Based on its survey, the IIA reaches six "key findings" regarding board ability to manage these risks:

- "Boards are overconfident. Boards consistently view the organization's capability to manage risks higher than executive management, evidence of a critical misalignment between what executive management believes and what is communicated to the board." Board perception of the ability to manage risk exceeded management's perception in all 11 risk categories. The gap between the board's view and management's was largest with risk to third party risk, while the board and management were most closely aligned as to business continuity and crisis management.

- "Boards generally perceive higher levels of maturity in risk management practices." Directors over-estimate risk knowledge and capability making them more likely to believe risks are better managed.

- "'Acceptable misalignment' on risk is a prevalent and dangerous mindset. * * * While misalignment around individual knowledge of a risk may be acceptable based on varying roles, misalignment on the perception of the organization's capability to manage a risk is a serious concern." Of the 11 risk areas, directors had the highest degree of confidence in their personal knowledge of company culture and the lowest in regulatory change. Management, on the other hand, thought it had the best personal knowledge of talent management and the lowest of data ethics.

- "Some industries are lagging in adopting systematic approaches to risk." Based on the views of CAEs, the healthcare, retail/wholesale, and public/municipal industries have the lowest low percentages of systematic risk management. The finance/banking industry ranked highest in systemic risk management.

- "Cybersecurity and Data and New Technology represent critical knowledge deficits. Low reported knowledge and high relevance of these risks suggest risk management players should prioritize building knowledge in these two key risk areas." Data protection and business continuity are also risks as to which there is high relevance and low knowledge. The IIA states that these four risks share a common element: "All four involve outside entities constantly acting against the organization, whether hackers devising sinister new ways to attack or technology advancing faster than organizations can adapt and adopt."

- "Data and New Technology, Data Ethics, and Sustainability risks are expected to grow in relevance. CAEs predict brisk growth in relevance for these three key risk areas in the next five years, identifying an opportunity for organizations to take a more proactive approach." While these three risk areas are expected to increase the most in relevance, cybersecurity, data protection, and data and new technology are the risks expected to have the highest relevance in the next five years.

- "Talent Management (and retention) are at the center of future concerns. Respondents recognize the importance of good talent and how people drive the success of a business — particularly when it comes to data and IT skills. An important shift is underway from an insufficient availability of resources to an inability to attract and retain talent with business-critical skills."

Comment: For each of the 11 risk areas, the OnRisk 2020 report includes an analysis of the perception gaps between directors, management, and CAEs, along with suggested actions for each group to mitigate these gaps and better address the risk area. The report recommends that boards, managements, and CAEs, review and analyze the data for each of the 11 key risks and conduct a similar analysis of the knowledge and capability perspectives in their own organization.

One of the most troubling aspects of OnRisk 2020 is the conclusion that the misalignment between boards and managements may be the result of the quality and completeness of information flowing to boards. Boards–and particularly audit committees that are tasked with risk oversight--may find the suggestions for improved information in the gap analysis section of the report useful in addressing this issue.

Switching Teams: Does Having an Audit Firm Alum on the Audit Committee Help or Hurt?

Former partners of large accounting firms are attractive candidates for audit committee seats. They qualify as financial experts and typically have deep knowledge of accounting, financial reporting, and auditing. Concerns may, however, be raised about whether it is desirable to include a former partner in the same firm as is serving as the company's auditor. When an audit committee member is an alumnus of the incumbent auditor, there could be a risk – or at least the perception of a risk – that he or she will be reluctant to

exercise critical oversight of the work performed by their former firm or too generous in negotiating engagement terms.

A research paper appearing in Auditing: A Journal of Practice & Theory seems to allay these concerns. In Affiliated Former Partners on the Audit Committee: Influence on the Auditor-Client Relationship and Audit Quality, Brant E. Christensen, Thomas C. Omer, Marjorie K. Shelley, and Paul A. Wong find:

> "improved audit quality and increased effectiveness of auditor effort when affiliated partners serve on the audit committee. * * * [T]his quality improvement occurs contemporaneously with a reduction in audit fees and time spent on fieldwork, suggesting increased efficiency. Our study provides evidence that affiliated former partners on audit committees extend the tenure of the auditor-client relationship while also improving audit processes and outcomes."

The study authors obtained a sample of former Big Four accounting firm partners and their audit committee appointments and combined that data with information concerning the public company audit firms. The sample period was 2004 to 2012 (i.e., post-Sarbanes Oxley Act) and included 22,849 company-year observations. On average, 6 percent of audit committees in the sample had at least one audit committee member who had been a partner at the company's current Big Four audit firm.

As might be predicted, the researchers do find that having a former firm partner on the audit committee has advantages for the audit firm. According to the paper, audit committee affiliations "incrementally increase" the likelihood of hiring the affiliated audit firm. Further, companies with formerly affiliated partners on the audit committee are "significantly less likely" to dismiss the audit committee member's former firm in the next year.

However, the study also finds that audit quality and financial reporting benefit when a former partner of the auditor serves on the audit committee. For example, companies with affiliated partners on the audit committee are 21 percent less likely to restate the financial statements and 26 percent less likely to be late in reporting material weaknesses. "Thus, affiliated audit committee members appear to improve audit quality by preventing uncorrected material misstatements."

As to audit fees, the study authors conclude that there is no evidence that ex-partners seek to enrich their former firm by increasing audit fees. On the contrary, they find that companies with audit firm alumni on the audit committee, on average, pay 3 percent lower audit fees than other companies. They hypothesize that audit quality increases, while fees decline, because

> "affiliated audit committee members can help improve group communication and cohesion during the audit process. Thus, we suggest that affiliated audit committee members improve audit quality by working with the audit firm to perform the appropriate audit procedures, not merely more tests. In this case, audit teams could become more efficient and effective, thus improving quality while reducing hours (i.e., audit fees). Further, affiliated audit committees can help the existing level of auditor effort be more effective in reducing the risk of material misstatement."

It should be noted that there are regulatory constraints on the ability of an audit firm partner to leave the firm and joint a client audit committee. Therefore, the individuals that the study refers to as "affiliated partners" will generally have left the audit firm at least three years before joining the audit committee of a firm client. New York Stock Exchange and Nasdaq listing standards would not deem a director as independent if he or she had been a partner at the listed company's audit firm during the prior three years. In addition, the SEC's auditor independence rules require a one-year cooling off period before a former audit firm employee can assume a financial reporting oversight role (such as audit committee member) at an audit client. The independence rules also require a former partner in such a role to have severed all financial relationships with the firm.

The study authors seem to believe that the benefits of a former firm partner on the audit committee are so clear that these regulatory constraints should be re-visited. "[G]iven other governance checks and balances in place in the current environment, our results suggest that rules restricting former partners from serving on

audit committees until after completing a cooling-off period could delay qualified individuals from improving the audit process and the resulting financial reporting quality of financial statements."

Comment: Although some boards might be reluctant to appoint someone who was formerly affiliated with the company's auditor to the audit committee, this research suggests that there may be tangible benefits in doing so. Nonetheless, financial statement users may have a perception of bias on the part of a former firm partner who is placed in a position of overseeing the work of his or her colleagues. The SEC and stock exchange cooling off period requirements should ameliorate that risk; in general, it would be reasonable to view an individual who has not been affiliated with a firm for three years as capable of objectively overseeing its work. A distinction might however be drawn between a former firm partner who participated in the company's audit and one who did not. The study authors note that data limitations prevented them from determining instances in which former partners serving on audit committees had previously served as lead partners on the audits of the company. In such a case, it would be prudent for a board to require a significantly longer cooling off period.

Sustainability Reporting Continues to Grow – Both Inside and Outside SEC Filings

As discussed in several prior Updates, institutional investors are demanding that public companies disclose increasing amounts of information concerning their performance and strategy regarding a wide range of environmental, social, and governance (ESG) issues. See Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture, March 2018 Update. However, U.S. public companies are not generally subject to mandatory ESG disclosure, and there is no clear consensus on how and where this disclosure should be made. Two recent reports provide snapshots of the growth of sustainability or ESG disclosure and of the choice companies are making between including this type of information in SEC filings or in separate sustainability reports.

NACD BoardTalk

ESG Risks Trickle Into Financial Filings, an October 21 item in BoardTalk, the blog of the National Association of Corporate Directors (NACD), analyzes ESG disclosure in the Risk Factors and Management's Discussion and Analysis (MD&A) sections of Form 10-K filings of companies in the Russell 3000 index. Researcher Leah Rozin compared these companies' disclosures, by industry, for three key ESG risks -- climate change risk, human capital management risk, and water scarcity risk.

In 2019, 66 percent of companies in the Russell 3000 Index discussed ESG risks in their Form 10-K. However, viewed by industry sector, the frequency of disclosure varied significantly:

- Energy & Mining – 97 percent
- Industrial Products – 87 percent
- Retail & Consumer – 76 percent
- Financial Services – 64 percent
- Health Industries – 49 percent
- Technology – 47 percent
- Pharmaceutical & Life Sciences – 45 percent
- Entertainment, Media & Communications – 41 percent

Disclosure also varied widely with respect to the three ESG components reviewed by BoardTalk:

- Climate change: Ms. Rozin found that 30 percent of Russell 3000 companies discussed climate change as a risk factor in their Form 10-K, while 3 percent discussed it in their MD&A. The Energy and Mining sector had the highest number of companies making climate change risk disclosure, while the Health Industry sector had the fewest. While the SEC has no specific rules on climate change disclosure, in 2010, the Commission issued an interpretive release providing guidance regarding how its disclosure requirements apply to climate change matters. This may have had the effect of increasing such disclosure in filings.

- Human capital management: In 2019, 8 percent of the Russell 3000 disclosed a risk for human capital management, with the highest number of reporting companies in the Technology sector. The relatively low frequency of disclosure is interesting in light of the fact that the SEC has proposed to amend its disclosure requirements to add human capital as a disclosure topic, including any human capital measures or objectives that management focuses on, to the extent material. The low level of current human capital risk reporting found by BoardTalk may be somewhat misleading because, as Ms. Rozin notes, her analysis looked only for the phrase "human capital management" and did not include references to elements of human capital management, such as employee hiring and retention or training.

- Water scarcity: While investors are increasingly focused on the risks of water scarcity, reporting on this issue in SEC filings is rare. Ms. Rozin found that 32 percent of Russell 3000 companies discussed water risk or water scarcity risk in their Form 10-K disclosure. Eighty-seven percent of these disclosures were in risk factors, while 13 percent were in MD&A.

Ms. Rozin notes that investor expectations regarding ESG disclosure are "unlikely to wane" and recommends that directors ask management four questions to demonstrate effective oversight:

- Has our company identified the most salient environmental, social, and governance (ESG) risks to our business operations?

- If the company has identified risks, are they incorporated into our broader enterprise risk management system?

- Are our disclosure practices around key ESG risks in line with those of our industry and proxy peers?

- What questions are shareholders, regulators, employees, customers, or other stakeholders asking about long-term strategy and the potential impact of ESG risks on corporate performance?

Governance & Accountability Institute Flash Report

While the NACD's BoardTalk looked at disclosure in SEC filings, many companies present more ESG information in a freestanding ESG report, which is not filed with the Commission, than in their Form 10-K. Earlier this year, the Governance & Accountability Institute (G&A), a sustainability consulting firm, released the results of its eighth annual analysis of sustainability reporting by S&P 500 companies. G&A found that 86 percent of companies in the index published a sustainability or corporate responsibility report in 2018. See Large Company Sustainability Reporting Inches Up Still Further, May-June 2019 Update.

G&A has now expanded this research to the Russell 1000. In a Flash Report released September 4, G&A found that 60 percent of the Russell 1000 published sustainability reports in 2018. However, only 34 percent of the smaller half (by market capitalization) of the Russell 1000 issued such a report. In a statement included in the Flash Report, Louis Coppola, G&A's EVP & Co-Founder, predicted that smaller company sustainability reporting would increase. "Due to numerous pressure points from investors and

other important stakeholders building up over the last few years, we anticipate that this group of smaller companies is reaching a tipping point in terms of beginning their reporting on sustainability matters."

G&A also looked at sustainability reporting by industry sector for the 500 companies in the bottom half of the Russell 1000. The sectors with the highest percentages of companies that issued a sustainability report were Utilities (82 percent), Materials (63 percent), and Consumer Staples (53 percent). The sectors with the lowest rates of sustainability reporting were Health Care (10 percent), Communications (14 percent), and Financials (16 percent).

Comment: As noted in prior Updates, sustainability reporting is rapidly becoming the norm for large public (and many smaller and private) companies. Most companies face some level of investor, customer, and/or supplier demand for more transparency concerning ESG issues, particularly those related to its supply chain integrity and climate change response. For audit committees, these types of disclosures will pose oversight challenges involving compliance with new reporting requirements and controls and procedures to assure the accuracy and reliability of non-traditional disclosures.

Over time, there is likely to be substantial pressure to standardize disclosures on an industry-by-industry basis, so that investors will be able to compare company performance. Comparison is currently difficult because each company is free to present whatever information it thinks appropriate in whatever format it chooses. In this regard, SEC reporting companies and their audit committees should consider becoming familiar with the Sustainability Accounting Standards Board's ESG disclosure standards that apply to the industry or industries in which they operate. See SASB Releases its Codified Standards, December 2018 Update. SASB's standards provide a framework for disclosure of material information that is decision-useful to investors and that permits comparison between companies in the same industry.

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 –

- The Impact of Disclosing Engagement Partner Identity: No Clear Answer (Dan Goelzer, November 7, 2019
- Would Auditing Improve if the PCAOB Brought More Enforcement Actions? (Dan Goelzer and Tom Riesenberg, September 16, 2019)

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

For further information, please contact:

Daniel L. Goelzer
301.494.4551
dangoelzer@gmail.com

Prior Updates issued after January 1, 2019 are available here.