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# AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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

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## **SEC Chair, Chief Accountant, and Corporation Finance Director Have Some New Year's Resolutions for Audit Committees**

On December 30, Jay Clayton, the Chairman of the SEC, and two senior office heads, Sagar Teotia, the SEC's Chief Accountant, and William Hinman, Director the Division of Corporate Finance, issued a paper entitled, [Statement on Role of Audit Committees in Financial Reporting and Key Reminders Regarding Oversight Responsibilities](#) (Joint Statement). The Joint Statement reminds audit committees of their responsibilities and flags some specific issues that committees should consider in 2020. The purpose of the Joint Statement is to "assist audit committees carrying out their year-end work, including promoting efficient and constructive dialogue among audit committees, management and independent auditors in these and other areas." In addition, "[i]ssuers and independent auditors also should be mindful of these considerations with an eye toward ensuring that audit committees have the resources and support they need to fulfill their obligations."

The Joint Statement is divided into two parts – five general observations regarding financial reporting and auditing and three specific observations on current issues.

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## General Observations

The five general observations relate to ongoing audit committee responsibilities.

Tone at the Top. The Joint Statement encourages audit committees to focus on “tone at the top” with the goal of “creating and maintaining an environment that supports the integrity of the financial reporting process and the independence of the audit.” In this regard, audit committees should:

- Set an expectation for clear and candid communications to and from the auditor.
- Set an expectation with both management and the auditor that the audit committee will engage as reporting and control issues arise.
- Proactively communicate with the auditor to understand the audit strategy and status.
- Ask questions regarding issues identified by the auditor and understand their ultimate resolution.

Auditor Independence. The Joint Statement notes that compliance with the auditor independence rules is a “shared responsibility of the audit firm, the issuer and its audit committee” and that, under the Sarbanes-Oxley Act, the audit committees is directly responsible for overseeing the engagement of the auditor. Audit committees should periodically consider the sufficiency of the auditor’s and the company’s processes for monitoring compliance with the auditor independence requirements. Among other items, these processes should address corporate changes (such as new affiliates or business relationships that could affect auditor independence) and facilitate the timely communication of such developments to the auditor.

Generally Accepted Accounting Principles (GAAP). The importance of audit committee oversight of the implementation of new accounting standards “cannot be overstated.” Audit committees should “engage proactively with management and auditors” so that the committee understands management’s implementation plan, “including whether the plan provides sufficient time and resources to develop well-reasoned judgments and accounting policies.” The audit committee should also understand management’s controls and procedures over adoption of, and transition to, new standards.

ICFR. The Joint Statement Audit notes that audit committees are responsible for overseeing the company’s internal control over financial reporting (ICFR), including management’s assessment of ICFR effectiveness and the auditor’s ICFR attestation. If material ICFR weaknesses exist, “it is important for audit committees to understand and monitor management’s remediation plans and set an appropriate tone that prompt, effective remediation is a high priority.”

Communications to the Audit Committee from the Independent Auditor. The PCAOB’s standards require the auditor to communicate with the audit committee regarding certain matters, such as significant unusual transactions, and to obtain information from the audit committee. These requirements are intended to enhance auditor/audit committee communications, and the Joint Statement encourages audit committees “to incorporate this dialogue in carrying out their responsibilities.”

## Specific Observations.

The three specific observations address current financial reporting and auditing issues.

Non-GAAP Measures. The SEC staff has previously indicated that, when companies disclose non-GAAP measures and other performance metrics, the audit committees should understand the rationale for such measures and how management uses them. See [SEC Chief Accountant Outlines Audit Committee’s Non-GAAP Oversight Role \(Again\), April-May 2018 Update](#). The Joint Statement encourages audit committees “to be actively engaged in the review and presentation of non-GAAP measures and metrics to understand how management uses them to evaluate performance, whether

they are consistently prepared and presented from period to period and the company's related policies and disclosure controls and procedures."

Reference Rate Reform (LIBOR). Reference rate reform refers to the transition from referencing LIBOR – the London Interbank Offered Rate – in financial agreements and replacing it with new reference rates. LIBOR, which is used as a reference interest rate in many financial instruments and agreements, will no longer be reported after 2021. The transition to new reference interest rates will require the modification of a broad array of contracts (such as derivative contracts and variable rate debt agreements). The Joint Statement notes that the discontinuation of LIBOR may present a material risk for many companies. Audit committees should "understand management's plan to identify and address the risks associated with reference rate reform, and specifically, the impact on accounting and financial reporting and any related issues associated with financial products and contracts that reference LIBOR."

Critical Audit Matters. As discussed in prior Updates (see, e.g., [PCAOB Shares its Initial Observations on CAMs, November-December 2019 Update](#)), the PCAOB's new requirement that the auditor's report identify and discuss critical audit matters (CAMs) began to take effect last year. The Joint Statement urges audit committees to discuss expected CAMs with the auditor and to understand the nature of each CAM, the auditor's basis for determining that a matter is a CAM, and how each CAM will be described in the auditor's report. "In short, we would expect that the discussion of the CAM in the auditor's report will capture and be consistent with the auditor-audit committee dialogue regarding the relevant matter."

Comment: Audit committees should review the Joint Statement and consider whether they are addressing the issues that it discusses. In particular, the three specific topics highlighted – non-GAAP measures, reference rate reform, and CAMs -- are issues that the SEC can be expected to focus on during 2020. Audit committees should take the Joint Statement as a warning that the SEC may devote attention to how companies address these topics and how audit committees oversee management's responses.

## **What the PCAOB Heard: Report on Conversations with Audit Committee Chairs**

During the 2019 inspection cycle, the PCAOB inspected 241 audit firms and spoke with nearly 400 audit committee chairs. According to the Board, these conversations focused on audit quality, including the audit committee's views of the auditor, new auditing and accounting standards, and technology and innovation. On December 18, the PCAOB released [Conversations with Audit Committee Chairs: What We Heard & FAQs](#), which summarizes these conversations and includes comments regarding practices that the chairs thought were improving audit quality. The report also provides an overview (in Q&A format) of the PCAOB's inspection process, geared to informing audit committees about inspections, and responses to several FAQs that arose during the audit committee conversations.

### Views of Audit Committee Chairs

The report addresses four topics from the discussions with audit committee chairs – audit quality, relationship and communication with the auditor, new auditing and accounting standards, and technology driven changes.

Audit Quality. Most audit committee chairs evaluate audit quality based on the performance of their engagement team, with less emphasis on the characteristics of the audit firm and firm-wide metrics. The majority were not familiar with the concept of audit quality indicators (AQIs), although many were familiar with some of the metrics commonly thought of as AQIs (e.g., industry expertise, use of the work of specialists, workload). Many audit committee chairs were aware that their audit firm used shared service centers as part of the audit but were not concerned about the role of service centers.

The report lists five practices that chairs said were working well in promoting audit quality:

- Asking the auditor if the audit firm has an annual audit quality or transparency report (or other document that outlines how the firm measures audit quality).
- Understanding and discussing the processes that the auditor has in place to address the previous year's PCAOB inspections report.
- Reviewing other audit firms' inspections reports to see if there are any lessons learned or questions about potentially similar issues that could be discussed with the auditor.
- Selecting relevant AQIs to discuss with the engagement team and use as part of an annual evaluation.
- If the audit firm is using shared service centers, discussing at least annually the audit procedures performed at the shared service centers, what controls are in place, the impact on the quality of the work product, and whether the audit firm is considering additional shared service centers.

Relationship and Communication with the Auditor. Most audit committee chairs were satisfied with the committee's relationship with the auditor, including the service provided and the engagement team's skepticism and judgment. They were also generally happy with the level of auditor communications, including the information the auditor provided regarding independence issues and key issues on which the committee should focus.

Practices reported as working well in the area of relationship and communication with the auditor were:

- Holding a pre-call or meeting with the audit committee chair and lead engagement partner prior to an audit committee meeting to review and refine the meeting agenda and materials.
- Conducting an assessment—on at least an annual basis—of the engagement team and audit, including discussions around what went well and what could be improved.
- If the company's audit is selected for PCAOB inspection, asking the audit firm about any matters that arose during the inspection.
- Having the audit committee chair visit the component locations for multi-location audits.
- Dedicating some audit committee meetings to deep dives on specific topics (e.g., governance processes, cybersecurity, etc.) and having the auditor provide feedback on best practices or other trends in those areas.

New Auditing and Accounting Standards. Audit committee chairs reported discussing new accounting and auditing standards, and "some were concerned about the effects that the overlapping timing of implementation of several new accounting and auditing standards could have on both internal and external auditors' resources and time." Most companies had not yet implemented critical audit matter (CAM) reporting, although the chairs generally thought that "preparations were going smoothly, and they did not anticipate that CAMs would create significant changes to their communications with the auditor."

Three things that chairs cited as working well in this area were:

- Discussing new accounting and auditing standards with the auditor as early as possible, at least a year in advance of implementation deadlines.

- Creating a timeline to make sure the appropriate processes are in place and milestones are met for implementation of new standards, including the auditing of the implementation.
- Using outside consultants or experts to educate the audit committee on new or complex accounting standards.

Technology Driven Changes. Audit committee chairs “had basic familiarity with auditing software tools and technologies” and with audit firm use of data analytics, although some were unsure whether technology would “improve or detract from audit quality.” As to cybersecurity, the majority indicated that the audit committee has primary responsibility and that the issue is a top priority.

Audit committee chairs described three practices that were working well with respect to technology driven change:

- Using project management software or a site where the audit committee, auditor, and management can all track the status of the audit plan.
- Discussing the technology and software tools the audit firm is using and how they are being used.
- Learning more about technology and scheduling time on the audit committee agenda to do deep dives on new and emerging technologies.

### PCAOB Inspections Basics

During the audit committee chair conversations, the PCAOB received many questions about the inspection process. The report includes staff responses to ten questions regarding inspections. These responses provide a basic primer on PCAOB inspections from an audit committee perspective.

Most of the information in the responses is not new, although the responses do provide a bit of insight on the PCAOB’s effort to interview inspected company audit committee chairs. The report notes that the Board decided to increase the scope of these interviews “to respond to feedback that indicated audit committees wanted more direct and frequent interaction” with the PCAOB. The interviews serve two purposes: To assist the inspectors in assessing compliance by the audit firm under inspection with PCAOB standards and to inform audit committee chairs concerning PCAOB oversight activities and external communications. The audit committee chair conversations are apparently not, however, a vehicle for providing information about the inspection: “The PCAOB is prohibited from sharing information regarding our inspections during the audit committee calls because information related to an inspection is confidential and privileged \* \* \*. We encourage audit committee chairs to engage in a direct dialogue with the audit firm about matters that may arise during the inspection.”

### Audit Committee FAQs

In addition to the Q&As regarding the inspection process, the report includes responses to three other questions that frequently arose during the audit committee conversations:

- Does the PCAOB have resources, educational training, or events for audit committee members? The PCAOB’s webpage has a section entitled [Information for Audit Committees](#).
- Does the PCAOB do a cost-benefit analysis of standards? Economic analysis of the potential costs, benefits, and unintended consequences is part of the standards development process. The Board has also established a post-implementation review program for certain PCAOB rules and standards.

- AQIs: What is the PCAOB’s view? How are you seeing them used? Audit Quality Indicators could be an effective tool for measuring audit quality, and the Board’s strategic plan includes an objective to determine, develop, and communicate AQIs.

Comment: For audit committees, the various “what works well” comments reported by the PCAOB are a useful source of ideas. Audit committees may want to consider whether they are already following these practices or, if not, whether any are worth emulating. In addition, any audit committee chair who is contacted by the PCAOB inspection staff as part of an inspection of the company’s auditor should read the Report on Conversations. It provides a good sense of the PCAOB’s objectives in these interviews and what to expect during the interview.

## SEC Proposes Changes to the Auditor Independence Rules

On December 30, the SEC [proposed amendments](#) to its rules governing auditor independence. The Commission’s proposed amendments are intended to address some common situations in which the current independence rules raise issues that seem to go beyond their core purpose. In the [press release](#) announcing the proposals, the Commission stated that the changes would update aspects of the rules “so that relationships and services that would not pose threats to an auditor’s objectivity and impartiality do not trigger non-substantive rule breaches or potentially time consuming audit committee review of non-substantive matters.” SEC Chairman Clayton added, “In practice, the proposed amendments also would increase the number of qualified audit firms an issuer could choose from and permit audit committees and Commission staff to better focus on relationships that could impair an auditor’s objectivity and impartiality.”

The general auditor independence standard in the SEC’s rules is that the Commission “will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement.” In addition to this general standard, the SEC’s rules contain a detailed, non-exclusive, set of specific circumstances that are inconsistent with independence. The SEC’s proposals would make several changes to these specific circumstances. Four changes that address issues that audit committees often encounter under the current independence framework are described below.

- Amend the definitions of “affiliate of the audit client” and “investment company complex” to focus on affiliate relationships that are material to the company under audit.

Under the current rules, the auditor and its affiliates must be independent of the audit client and its affiliates. The definition of “affiliate of the audit client” includes (among other things) an entity that is under common control with the audit client; such entities are referred to as “sister affiliates”.

The requirement that the auditor be independent with respect to audit client sister affiliates can sometimes result in violations that do not substantively impact the auditor’s independence. For example, situations sometimes arise in which one of the auditor’s foreign network member firms has – unknown to the U.S. firm -- performed a non-audit service (such as book-keeping) for a foreign sister affiliate of the audit client. When these situations are brought to the SEC’s attention, the staff, in many cases circumstances, does not object to the U.S. firm continuing to perform the audit. The proposed amendments would address this kind of situation by adding a materiality qualifier to the definition of “affiliate of the audit client”. Accordingly, if the proposals are adopted, an auditor will not necessarily need to be independent with respect to sister affiliates of the audit client that are not material to the controlling entity. However, even where a sister affiliate is immaterial, the auditor and audit client would still need to apply the general independence standard to any relationships between the auditor (including its affiliates) and the client’s sister affiliates. That is, it would still be necessary to determine whether, under all the relevant facts and circumstances, a reasonable investor would view the auditor as capable of exercising objective and impartial judgment.

A similar proposed change would amend the definition of “investment company complex” so that the independence analysis with respect to an audit client that is a portfolio company would not include other entities in the fund complex that are not material to the investment adviser or fund sponsor.

- Amend the definition of the “audit and professional engagement period” to shorten the look-back period during which an IPO company’s auditor must have been in compliance with the SEC’s independence requirements.

Currently, the auditor must be independent of the audit client, under the SEC’s rules, throughout the “audit and professional engagement period,” which is defined to include the period covered by the financial statements being audited and the period of the engagement to perform the audit. Domestic companies making an initial public offering must generally provide three years of audited financial statements; therefore, the independence analysis for an IPO company’s auditor must look back at least three years. However, the independence rules applicable to private company audits differ somewhat from the SEC’s independence rules. Therefore, a company planning an IPO may discover that, even though its auditor complied with the applicable independence rules at the time that the prior years’ financial statements were audited, the auditor was not independent under the SEC’s rules. As a result, the prior years must be re-audited by a new firm. The look-back period may also preclude the IPO company from selecting a firm as its auditor because that firm performed non-audit services for the company, if those services ended less than three years prior to the IPO.

The proposals would address this issue by limiting the IPO look-back period to one year. So long as the auditor was independent under the rules applicable at the time of earlier audits, the fact that the firm was not independent under the SEC’s rules would not be fatal to its ability to serve as the IPO auditor. The SEC believes that IPOs are generally planned sufficiently far in advance so that a one-year look-back will provide an opportunity for the auditor to comply with the SEC’s rules. The one-year look-back proposal would confirm the requirements for domestic IPO company auditors to those already applicable to foreign companies entering the U.S. markets.

- Limit the scope of the “substantial stockholders” of the company under audit as to which the auditor must be independent to beneficial owners of the company’s shares that have significant influence over the company.

The SEC’s rules prohibit the audit firm from having any direct or material indirect business relationship with the audit client or with “persons associated with the audit client in a decision-making capacity, such as an audit client’s officers, directors, or substantial stockholders.” The proposal would replace “substantial stockholders” with “beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the audit client.” This would, for example, eliminate from the independence analysis financial institutions that are nominal holders, on behalf of their customers, of the stock of the company under audit, but do not exercise any influence over the company.

- Create a transition framework to address inadvertent independence violations that arise as a result of merger and acquisition transactions.

Independence violations sometimes result from mergers and acquisitions, such as were the audit client acquires a company for which its auditor is performing non-audit services that are inconsistent with independence. In these cases, the acquisition causes what had been permitted non-audit services or relationships to become prohibited in violation of the auditor independence rules. This could, in turn, lead to “termination of audit work midstream or termination of the non-audit service that is in progress in a manner that is costly to the audit client.”

To address these situations, the SEC proposes to create a transition framework under which an audit firm’s independence would not be impaired as the result of an M&A transaction if the firm:

- (1) was in compliance with applicable independence standards when the service or relationship originated;
- (2) corrects the independence violations arising from the merger or acquisition as promptly as possible under the circumstances (six months would be the outside limit); and
- (3) has in place a quality control system that includes procedures and controls to monitor the audit client's merger and acquisition activity so that the firm will receive timely notice of a transaction and that allows for prompt identification of potential violations of the independence rules before transactions are consummated.

Comment: The proposed changes to the independence rules would eliminate some of the issues with which auditors and audit committees must occasionally grapple. The changes would also, in some circumstances, increase the range of firms eligible to serve as a company's auditor or avoid situations in which the company may be compelled to change auditors.

At the same time, the proposals would impose some new responsibilities on audit committees. For example, as noted above, even though auditor relationships with immaterial sister affiliates would not necessarily impair independence, the auditor and the audit committee would have to engage in a facts-and-circumstance analysis of whether a specific relationship was inconsistent with auditor objectivity and impartiality. In addition, while the M&A transition framework would require the audit firm to have procedures in place to monitor potential transactions, this information would necessarily have to come from the audit client. The audit committee would presumably have some responsibility to monitor the quality controls by which the audit firm identifies potential company mergers and acquisitions that could impair its independence and the company's processes for communicating this information to the auditor.

The proposals appear to be narrowly crafted and seem to avoid altering the current independence framework in ways that would unduly compromise either the fact or appearance of independence. That said, some investor advocates or others may regard any liberalization of the existing rules as undesirable. The Commission's proposals are open for public comment until March 16.

## **What's on the Audit Committee's Agenda in 2020? Part I: Suggestions from Protiviti and KPMG**

At the beginning of each year, various accounting and consulting firms release their views on the issues that audit committees should focus on during the coming 12 months. Typically, there is considerable overlap – but occasionally surprising differences – between the suggested audit committee agendas. This Update and the next will summarize some of these publications.

### Protiviti: Setting the 2020 Audit Committee Agenda

Global consulting firm Protiviti has published [Setting the 2020 Audit Committee Agenda](#), its annual list of topics that audit committees should consider during the coming year. Protiviti's agenda items are based on its interactions with audit committees, on insights from roundtables and surveys conducted during 2019, and discussions with directors. Protiviti observes that, “[w]ith new accounting standards coming online, an increasingly active Public Company Accounting Oversight Board (PCAOB) inspections agenda, the relevance of the traditional accounting and reporting model under fire, and continued uncertainty in the geopolitical, business and regulatory environment, audit committees indeed have their hands full.”

Protiviti identifies and discusses seven potential agenda topics. The first four relate to enterprise, process and technology risk, while the last three relate to financial reporting. Each topic is accompanied by one or more questions that capture the challenges the topic poses for the committee.

1. Use an understanding of the critical enterprise risks as a context for oversight. *Does the committee stay current with respect to emerging business risks and changes in critical enterprise risks? Does*



*it consider changes in these risks in exercising its oversight responsibilities?* The audit committee should annually review the company's risk profile and seek to understand how the company's view of risk compares to other companies in the same industry. Regardless of whether the committee has a formal role in risk oversight, an understanding of risk will aid the committee in putting issues such as CAMs and internal audit findings in context. (The discussion of this issue includes a list of the top 10 global risks for 2020, based on a recent Protiviti survey.)

2. Understand whether finance is positioned to deliver value. *Does the committee understand the priorities of finance as they relate to financial and public reporting? Is finance positioned to focus on matters such as security, data, analytics and other needs of internal customers? Is finance sufficiently focused on strategic matters as it is on operational issues?* In order to deliver “deep, impactful and proactive insights” for internal decision-making, CFOs are investing in innovation and emerging technologies. Gaps in skills and talent, along with tightening labor markets, are challenges for their organizations. The committee needs to understand the evolving and demanding world in which the CFO operates and whether their organization has appropriate resources to meet its responsibilities.
3. Ensure that internal audit is leveraging digital tools to deliver value. *Is internal audit embracing an agile, holistic approach focused on governance, methodology and technology to deliver stronger assurance and more valuable insights in an efficient manner? Does the CAE recognize the improvement opportunities and understand the essential capabilities for effecting change?* The audit committee should understand the chief audit executive's (CAE) plans to innovate and transform internal audit into an “agile, multiskilled and technology-enabled function.” As companies move to cloud computing and adopt artificial intelligence and machine learning, the CAE should have a transformation plan that will enable internal audit to stay relevant and efficient.
4. Monitor the quality of ESG-related disclosures. *Does the committee understand the quality of the company's disclosure controls and procedures over ESG disclosures in public reports?* Demands for transparency regarding company environmental, social, and governance (ESG) performance are increasing. (See, e.g., [BlackRock's CEO Calls for Portfolio Companies to Make SASB and TCFD Disclosures](#) in this [Update](#).) In this context, audit committees should consider three fundamental questions:
  - Does the company's sustainability reporting provide sufficient insight into its nonfinancial activities related to ESG matters? Are the disclosures sufficiently focused on the ESG criteria that investors and asset managers following the industry are using? Does management focus on ESG reporting as a public relations tool or compliance activity, or is it truly integrated with the corporate strategy?
  - Does the committee understand the quality of the company's disclosure controls and procedures over ESG disclosures in public reports? Is it satisfied that they provide reasonable assurance that such disclosures are fairly presented? Are the disclosures presented in accordance with an established framework, such as the Sustainability Accounting Standards Board (SASB) or the Global Reporting Initiative (GRI)? Or, are they customized to the company's specific needs and approach?
  - If the company does not issue sustainability reports, has the board considered whether it should? Are competitors issuing reports? Are major shareholders raising concerns?
5. Address critical audit matters. *If there are any critical audit matters, does the committee inquire of management as to whether such matters signal opportunities to improve the financial reporting process?* Critical audit matter (CAM) reporting has already begun for large accelerated filers and will take effect at the end of this year for other public companies. (See [PCAOB Shares its Initial Observations on CAMs, November-December 2019 Update](#)) Audit committees should make sure they understand the CAMs and that disclosures are clear. Management, in turn, “should take steps to address any underlying issues by improving the effectiveness and efficiency of the financial

reporting process and related internal controls over financial reporting.” If the company is not yet subject to CAM reporting, the audit committee should ask the auditor and management about the CAMs the auditor’s report is expected to address.

6. Continue the focus on implementing new accounting standards. *With the FASB’s decision to delay the effective dates of its various standards addressing leases, credit losses, hedging and long-duration insurance contracts, companies facing an extended timeline should stay the course.* The audit committee should “focus management on staying the course and remaining vigilant in preparations to comply” with new accounting standards.
7. Advocate for financial reporting by encouraging continuous learning and sustaining internal controls. *Are there prior-year learnings relating to revenue recognition, leasing, asset valuations, income tax reporting and other areas that warrant further refinement? Does the committee advocate for financial reporting in discussions regarding organizational change?* The audit committee should “serve as a vigilant advocate for financial reporting.” For example, the committee should ensure that corporate initiatives, such as cost-reduction plans or digital transformation efforts, do not unintentionally compromise the integrity of financial reporting.

Setting the 2020 Audit Committee Agenda also notes that it is common for boards and committees to undertake a periodic self-assessment of their performance. “In these dynamic times, we encourage committee members to periodically assess the committee’s composition, charter, agenda and focus in light of current challenges the company faces.” In a [separate document](#), Protiviti provides a list of illustrative questions that audit committees might consider as part of such an assessment.

#### KPMG: On the 2020 Audit Committee Agenda

The [January 2020 edition](#) of [Directors Quarterly](#), a publication of the KPMG Board leadership Center, includes [On the 2020 audit committee agenda](#), a list of audit committee priorities. KPMG notes that 2020 will be particularly challenging for audit committees because they will be operating “against a backdrop of global volatility and economic uncertainty -e.g., mounting trade tensions, resurging debt, a looming market correction, technology and business model disruption, cyber risk, regulatory scrutiny, investor demands for transparency, and geopolitics.” Based on insights from surveys and interactions with audit committee members and business leaders, KPMG flags seven potential 2020 audit committee agenda items:

1. Maintain (or regain) control of the committee's agenda. Nearly half of audit committee members responding to a 2019 KPMG survey said it is increasingly difficult to oversee the major risks on the audit committee’s agenda, along with the committee’s core financial reporting and auditor oversight responsibilities. Many audit committees have responsibility for such matters as cybersecurity and information technology risks, ESG risks, third-party, supply chain, and other operational risks, and legal and regulatory compliance. KPMG recommends that committees reassess whether they have the expertise and time to oversee all the risks it have been assigned to them.
2. Reinforce audit quality and set clear expectations for the external auditor. Audit committees should “[p]robe the audit firm on its quality control systems that are intended to drive sustainable, improved audit quality-including the firm’s implementation and use of new technologies.” Committees should also “consider the results of PCAOB and internal inspections and efforts to address deficiencies.”
3. Closely monitor management's progress on implementing FASB's new credit loss standard. The implementation of the new accounting standard requiring recognition of current expected credit losses (CECL) will be major challenge for many companies, particularly financial institutions. See [CAQ on CECL: Help for Audit Committees on Oversight of New Credit Losses Accounting Standard Implementation](#), [May-June 2019 Update](#). KPMG recommends that audit committees:
  - Understand how management determined the transition impact of CECL adoption (which must be disclosed in the company’s 2019 Form 10-K), what the external auditor did to

evaluate the transition impact, and whether the auditor had any recommendation regarding the disclosure.

- Discuss with management the company's readiness to implement and report under the new standard in 2020, including the impact on internal control over financial reporting and disclosure controls. The committee should also obtain the auditor's views on the company's CECL readiness.
4. Redouble your focus on the company's ethics, compliance, and whistle-blower programs. KPMG notes that, “[a]s a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and brand reputation are on full display.” Among other things, audit committees should “focus on the effectiveness of the company's whistle-blower reporting channels and investigation processes through a #MeToo lens.”
  5. Understand how technology is impacting the finance organization's talent, efficiency, and value-add. KPMG suggests three areas of focus:
    - “First recognizing that as much as 60 to 80 percent of finance's work involves data gathering, what are the organization's plans to leverage robotics and cloud technologies to automate as many manual activities as possible, reduce costs, and improve efficiencies?”
    - “Second, how will finance use data analytics and artificial intelligence to develop sharper predictive insights and better deployment of capital? \* \* \* As historical analysis becomes fully automated, the organization's analytics capabilities should evolve to include predictive analytics, an important opportunity to add real value.”
    - “Third, as the finance function combines strong analytics and strategic capabilities with traditional financial reporting, accounting, and auditing skills, its talent and skill-set requirements must change accordingly. Is finance attracting, developing, and retaining the talent and skills necessary to match its evolving needs?”
  6. Reassess the scope and quality of environmental, social, and governance (ESG)/sustainability reports and disclosures. The audit committee can “serve as a catalyst” for a management reassessment of the scope and quality of the company's ESG disclosures. This could “include benchmarking against peers, consideration of the methodologies and standards of various firms that rate companies on ESG practices, understanding the expectations of investors and other stakeholders, and reviewing various ESG reporting frameworks for possible use by the company.” The committee should ensure that disclosure controls and procedures are in place to support ESG reporting.
  7. Help ensure internal audit's eyes and ears are focused on key risks beyond financial reporting. The audit committee should work with the chief audit executive and chief risk officer to identify the risks that pose the greatest threats to the company's reputation, strategy, and operations and to ensure that internal audit is focused on these key risks and related controls. The committee should set clear expectations and ensure that internal audit has the resources, skills, and expertise to succeed.

Comment: Although each company's circumstances and challenges vary, lists of this nature can serve as useful checks as audit committees develop their plan for the coming year. It is interesting to note the similarities between the Protiviti and the KPMG lists. For example, both flag ESG reporting, impact of technology and talent on the CFO's organization, and the transformation of internal audit as potential agenda issues. Both lists also emphasize the importance of the audit committee having a comprehensive understanding the key risks facing the company.

## BlackRock's CEO Calls for Portfolio Companies to Make SASB and TCFD Disclosures

On January 14, Laurence Fink, Chairman and CEO of BlackRock, the world's largest asset manager, released his [2020 letter to CEOs](#). The theme of this year's letter is that "[c]limate change has become a defining factor in companies' long-term prospects" and that, as a result, "we are on the edge of a fundamental reshaping of finance." BlackRock will put this insight into practice:

"As a fiduciary, our responsibility is to help clients navigate this transition. Our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors. And with the impact of sustainability on investment returns increasing, we believe that sustainable investing is the strongest foundation for client portfolios going forward."

For public company audit committees, Mr. Fink's views are significant because of the link he draws between the impact of climate change on investment decisions and corporate disclosure. "[A]ll investors, along with regulators, insurers, and the public, need a clearer picture of how companies are managing sustainability-related questions. This data should extend beyond climate to questions around how each company serves its full set of stakeholders, such as the diversity of its workforce, the sustainability of its supply chain, or how well it protects its customers' data." While he recognizes that many companies already make sustainability disclosures, he calls for "more widespread and standardized adoption" of such disclosure.

To accomplish that goal, Mr. Fink urges companies to follow the disclosure standards of the Sustainability Accounting Standards Board (SASB) and the climate disclosure recommendations of the Task Force on Climate-Related Financial Disclosure (TCFD):

"While no framework is perfect, BlackRock believes that the Sustainability Accounting Standards Board (SASB) provides a clear set of standards for reporting sustainability information across a wide range of issues, from labor practices to data privacy to business ethics. For evaluating and reporting climate-related risks, as well as the related governance issues that are essential to managing them, the TCFD provides a valuable framework."

As discussed in prior [Updates](#), SASB is an independent, non-profit standards-setting organization. Its mission is to facilitate disclosure by companies to investors of material, decision-useful environmental, social, and governance (ESG) information. See [SASB Releases its Codified Standards, December 2018 Update](#). SASB views sustainability as having five dimensions – environment (which includes climate change); social capital; human capital; business model and innovation; and leadership and governance. SASB standards are industry-specific, and SASB has issued disclosure standards for 77 industries. Compliance with SASB's standards, which can be downloaded for any of the 77 industries at [www.SASB.org](http://www.SASB.org), is voluntary. (The author of the [Update](#) is a member of the SASB standard-setting board.)

The TCFD was formed by the Financial Stability Board (FSB) in December 2015 to address the impact of climate change on companies and on the global financial system through disclosure. The TCFD, which is chaired by Michael Bloomberg, has 31 members, appointed by the FSB, and includes users and preparers of disclosures from a broad range of economic sectors and financial markets. In June, 2017, the TCFD issued disclosure [recommendations](#). These voluntary recommendations are intended to help companies identify and disclose the potential financial impacts of climate-related risks and opportunities on their businesses. The SASB standards are complementary to the TCFD recommendations. See [TCFD Implementation Guide](#), published by SASB and the Climate Disclosure Standards Board.

BlackRock has been engaging with companies for several years on their progress towards TCFD- and SASB-aligned reporting. Mr. Fink outlines three concrete steps that BlackRock will take this year to encourage that progress:

- "We are asking the companies that we invest in on behalf of our clients to: (1) publish a disclosure in line with industry-specific SASB guidelines by year-end, if you have not already done so, or disclose

a similar set of data in a way that is relevant to your particular business; and (2) disclose climate-related risks in line with the TCFD's recommendations, if you have not already done so. This should include your plan for operating under a scenario where the Paris Agreement's goal of limiting global warming to less than two degrees is fully realized, as expressed by the TCFD guidelines."

- "We will use these disclosures and our engagements to ascertain whether companies are properly managing and overseeing these risks within their business and adequately planning for the future. In the absence of robust disclosures, investors, including BlackRock, will increasingly conclude that companies are not adequately managing risk."
- "We believe that when a company is not effectively addressing a material issue, its directors should be held accountable. Last year BlackRock voted against or withheld votes from 4,800 directors at 2,700 different companies. Where we feel companies and boards are not producing effective sustainability disclosures or implementing frameworks for managing these issues, we will hold board members accountable. **Given the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them.**" (boldface in original letter)

Comment: BlackRock has nearly \$7 trillion in assets under management, and Mr. Fink's annual letter discussing the firm's investment policies attracts considerable attention because of BlackRock's leverage as a significant shareholder in many public companies. The commitment to use BlackRock's voting power to compel companies to enhance their ESG disclosures – and specifically to implement the SASB and TCFD disclosure frameworks – will likely add considerable momentum to the adoption of these investor-oriented disclosures. In light of Mr. Fink's statement – and of the audit committee agenda recommendations of Protiviti and KPMG (see prior item in this [Update](#)) – audit committees should review their companies' ESG disclosures and discuss with management bringing the company's reporting into conformity with SASB. As the SASB framework becomes more widely adopted, public companies that fail to do so are likely to attract unwanted attention as outliers.

## 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 –

- [BlackRock's New Push for Standardized ESG Disclosure](#) (Dan Goelzer, January 24, 2020)
- [The Impact of Disclosing Engagement Partner Identity: No Clear Answer](#) (Dan Goelzer, November 7, 2019)

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 after January 1, 2019 are available [here](#).