

## Update

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## AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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.

### **SEC Chief Accountant Has Some Suggestions for Audit Committee “Critical Gatekeepers”**

Each year in early December, the American Institute of Certified Public Accountants convenes the AICPA Conference on Current SEC and PCAOB Development in Washington, DC. On December 5, SEC Chief Accountant Wes Bricker delivered this year’s the keynote address, [Working Together to Advance High Quality Information in the Capital Markets](#). His remarks, which touch on a range of SEC accounting and disclosure issues, included some advice for audit committees.

Mr. Bricker described audit committee members as “critical gatekeeper[s] in the chain responsible for credible, reliable financial reporting” who must “stay current on emerging issues, whether financial, control, or disclosure related, through continuing education and other means.” He urged that, in when necessary, audit committees retain “expert advisors as they carry out fully their responsibilities.” Other suggestions included:

- Maintain an open and direct relationship with the external auditor. “Audit committees of listed companies have clear oversight authority and responsibility over the external auditor, which promotes auditor independence and greater alignment of the auditor’s interests with those of investors. The audit committee helps set the tone for the company’s relationship with the external auditor. Auditors are in a unique position to provide feedback to the audit committee about management, the company’s processes, accounting policies, and internal control over financial reporting, among others. This oversight of management’s activities is crucial for investor protection, and it is important for both auditors and audit committees to keep and maintain the direct relationship they share.”

Ask four basic questions to generate dialogue. “While I was an audit engagement partner, in addition to addressing the communications required by the auditing standards and audit committee charter, I found the following types of questions from audit committee members helpful in generating a dialogue:

- If you as the auditor were in management’s shoes and solely responsible for preparation of the company’s financial statements, would they have in any way been prepared differently?
- If you as the auditor were in an investor’s shoes, would you believe that you have received the information essential to

understanding the company's financial position and performance?

- Is the company following the same internal control over financial reporting and internal audit procedures that would be followed if you were in the CEO's shoes?
- Are there any recommendations that you as the auditor have made and management has not followed?"

These questions are similar to the four questions Warren Buffet has recommended that audit committees ask. See [August 2016 Update](#).

- Don't let pressure to hold down costs compromise the audit. Mr. Bricker notes that auditors are accountable to the board of directors through the audit committee, not to management, and that the audit committee is responsible for overseeing the engagement terms and the auditor's compensation. He warns that, in discharging this responsibility, the audit committee should not let the audit fee become caught up in other kinds of cost containment. The audit committee "should work with other board committees as needed to monitor that important corporate objectives, such as cost reduction plans, are not unintentionally implemented in ways that would be at cross purposes with management meeting their financial reporting responsibilities or the external auditor's appropriate audit scope, engagement terms, and compensation. The design and operation of some of management's procurement policies and processes may be inappropriate if applied to the auditor selection, retention, and compensation decisions."
- Disclose more information concerning the audit committee's responsibilities. As noted in several prior [Updates](#) (see, e.g., [October-November 2016 Update](#)) audit committees are increasing making voluntary disclosures concerning how they perform their duties, and Mr. Bricker urged that this trend continue. "I encourage audit committees to be proactive in providing voluntary disclosures in the audit committee report, especially in describing how they execute their oversight responsibilities. I am encouraged by the trends in audit committee voluntary reporting. For instance, in a recent survey 82% of audit committees of Fortune 100 companies disclosed in 2016 that the audit committee is responsible for appointment, compensation and oversight of the external auditor. This has increased significantly from 42% just four years ago."

In addition, Mr. Bricker recommended that audit committees pay special attention to two topics. First, as discussed in the [October-November 2016 Update](#), the SEC recently brought two enforcement actions in which it alleged that auditor independence had been compromised by personal relationships between audit firm and company personnel. The Chief Accountant suggested that, in light of these cases, audit committees should consider whether any "enhancements by management are needed to corporate governance, policies, and procedures" to help avoid "costly independence issues from occurring."

Second, with respect to non-GAAP reporting, he stated that good financial reporting practices “place a premium on audit committee member understanding of the company’s non-GAAP policies, procedures, and controls” and urged audit committees to “seek to understand management’s judgments in the design, preparation, and presentation of non-GAAP measures and how those measures might differ from approaches followed by other companies.”

Comment: In addition to his suggestions to audit committees, Mr. Bricker’s keynote address provides a good overview of the SEC staff’s thinking a variety of current financial reporting issues, including internal control over financial reporting, implementation of the new revenue recognition standard (see separate item in this [Update](#)), non-GAAP reporting, auditor independence, and the future of the accounting profession. Other speakers at the Conference also discussed these and other current topics of importance to reporting companies and their audit committees. Several accounting firms have prepared summaries of the Conference (see, e.g., [Deloitte & Touche](#) and [PWC](#) summaries). These publications provide a useful way for audit committee members to obtain a quick overview of a wide range of matters with which they may need to deal in the coming year.

## Big Four 2015 Inspection Reports Summary

With the issuance of the KPMG report on December 6, the PCAOB has released reports on the 2015 inspections of all four of the largest accounting firms. Below is a tabular summary of the 2015 inspection results for these firms and, for comparison, a similar summary with respect to 2014 inspections.

2015 Inspections (Reports Issued in 2016)						
Firm	# of Engm’ts Inspected	Part I Engm’ts w/ Def’s		Part I Engm’ts with ICFR Deficiencies		
		#	% of Engm’ts Insp’d	#	% of Engm’ts Insp’d	% of All Engm’ts w/ Def’s
Deloitte & Touche	55	13	24%	13	24%	100%
Ernst & Young	55	16	29%	14	25%	88%
KPMG	52	20	38%	17	33%	85%
PWC	<u>55</u>	<u>12</u>	22%	<u>10</u>	18%	83%
2015 Total	217	61		54		
2015 Firm Average	54	15	28%	14	25%	89%
2014 Inspections (Reports Issued in 2015)						
Firm	# of Engm’ts Inspected	Part I Engm’ts w/ Def’s		Part I Engm’ts with ICFR Deficiencies		
		#	% of Engm’ts Insp’d	#	% of Engm’ts Insp’d	% of All Engm’ts w/ Def’s
Deloitte & Touche	53	11	21%	7	13%	64%
Ernst & Young	56	20	36%	19	34%	95%
KPMG	52	28	54%	27	52%	96%
PWC	<u>58</u>	<u>17</u>	29%	<u>11</u>	19%	65%
2014 Total	219	76		64		
2014 Firm Average	55	19	35%	16	29%	84%

The auditing standards most frequently cited in the 2015 inspection reports of the four largest firms as the basis for audit deficiencies described in Part I – the public portion – of these reports are listed in the following table. The table also shows what percentage of inspected engagements included a deficiency with respect to each standard and the percentage of deficient engagements in which the standard was cited. An auditing standard may have been cited as the basis for more than one deficiency in a particular audit engagement, and particular engagements may have included deficiencies based on more than one standard. The table only includes standards that were the basis for at least two Part I deficiencies.

<u>PCAOB Auditing Standard</u>	<u># of Part I Engm'ts Citing this St'rd</u>	<u>% of All Inspected Engagements</u>	<u>% of All Part I Engagements</u>
AS No. 5, <u>An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements</u>	54	25%	89%
AU 328, <u>Auditing Fair Value Measurements and Disclosures</u>	19	9%	31%
AS No. 13, <u>The Auditor's Response to the Risks of Material Misstatement</u>	18	8%	30%
AU Section 350, <u>Audit Sampling</u>	16	7%	26%
AU Section 342, <u>Auditing Accounting Estimates</u>	14	6%	23%
AS No. 14, <u>Evaluating Audit Results</u>	14	6%	23%
AS No. 9, <u>Audit Planning</u>	8	4%	13%
AU Section 329, <u>Substantive Analytical Procedures</u>	7	3%	11%
AS No. 15, <u>Audit Evidence</u>	5	2%	8%

In the Big Four inspection reports issued in 2016, the PCAOB included a list of the three most frequently identified deficiencies. The table below aggregates these deficiencies lists. The table also indicates what percentage of the engagements in Part I of the four reports included these deficiencies.

<u>Description</u>	<u>Part I Engagements That Include this Deficiency</u>
Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing.	41 (44%)
Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate.	20 (21%)
Failure to sufficiently test controls over, or sufficiently test the accuracy and completeness of, issuer-produced data or reports.	14 (15%)
Failure to identify and test any controls that addressed the risks related to a particular account or assertion.	11 (12%)
Failure to perform substantive procedures to obtain sufficient evidence as a result of relying too heavily on controls (due to deficiencies in testing controls).	7 (8%)

The financial statement or auditing areas that produced the most deficiencies reported in Part I of the Big Four inspection reports were revenue, including accounts receivable and deferred revenue (57 deficiencies); business combinations, including contingent consideration (29 deficiencies); inventory and related reserves (28 deficiencies); impairment of goodwill and intangible assets (18 deficiencies); and loans and allowance for loan losses (17 deficiencies).

Comment: As measured by PCAOB inspection findings, audit quality seems to be improving. As in the prior two years, the deficiency rate for these four large firms declined in 2015. In 2014, the Board concluded that 35 percent of the engagements it reviewed were deficient, while, in 2015 inspections, it found comparable problems in 28 percent of engagements. In 2013, the deficiency rate was 39 percent. At the same time, the gap between the firm with the lowest deficiency percentage and the firm with the highest narrowed from 33 percentage points in 2014 to 16 percent in 2015.

The 2015 inspection results also suggest that the PCAOB staff's focus on internal control over financial reporting (ICFR) continues unabated. In 2015, the Board found ICFR deficiencies in 25 percent of all inspected engagements, and 89 percent of all engagements with a deficiency included an ICFR lapse. These results are not significantly different than in 2014, when the Board found ICFR deficiencies in 29 percent of all inspected engagements, and 86 percent of all deficient engagements included an ICFR finding. By contrast, in 2013, the PCAOB found ICFR auditing breakdowns in 35 percent of inspected engagements, which represents the high-water mark (thus far). In past years, we have noted that auditors were likely to respond to the PCAOB's emphasis on ICFR by devoting more time and effort to the ICFR audit – and quite possibly by increasing fees as a result. Auditors are certainly likely to remain focused on ICFR. However, improvements in ICFR audit methodologies over the last several years should have a positive effect.

With respect to auditing standards other than AS No. 5 (which governs ICFR auditing), Board inspectors found the most deficiencies in the highly judgment-dependent areas of response to risk of misstatement (AS No. 13) and auditing of fair value measurements and disclosures (AU 328). This is generally consistent with prior years. Auditing accounting estimates (AU 342) also continued to be a common standards violation in 2015, and “failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate” was the second-most frequent Part I deficiency, exceeded only by “failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing.”

The audit deficiency description and auditing standard deficiency tables could be used as something of checklist for topics audit committees may want to discuss with the auditor in order to understand how the auditor addressed, or plans to address, the most challenging areas in the company's audit.

## **CAQ Provides a Map for Audit Committees on the Road to Implementing Revenue Recognition**

On December 13, the Center for Audit Quality (CAQ) released a “tool” to help audit committees assess the company's implementation of the new

revenue recognition standard. As discussed in prior [Updates](#) (see [August-September 2015 Update](#) and [March-April 2015 Update](#)), the Financial Accounting Standards Board and its international counterpart, the International Accounting Standards Board, have adopted a new, converged standard governing revenue recognition. The new standard applies to all public, private, and nonprofit entities that utilize U.S. GAAP or the international financial reporting standards (IFRS). For U.S. public companies, the new standard is effective for fiscal years beginning after December 15, 2017 – that is, for 2018 in the case of calendar year companies.

Revenue recognition is fundamental for all companies, although the impact of the new standard will vary from industry to industry. Numerous reports have indicated that many companies have been slow to analyze the effect of the revenue recognition changes on their financial reporting, accounting systems, and disclosures, and time is running short to complete implementation efforts. (A recent [PWC/Financial Executives Research Foundation survey](#) found that only 17 percent of public companies are in the implementation phase, while 75 percent indicate that they are still assessing the impact of the new standard, and 8 percent have not even begun assessment and implementation.) In addition, many companies will be required to evaluate their 2016 and 2017 financial information under the new rules in order to comply with the transition requirements in the standard.

The CAQ's guide, which is entitled [Preparing for the New Revenue Recognition Standards: A Tool for Audit Committees](#), is organized into four sections, each of which includes examples of questions audit committees may wish to ask of management to gauge the company's implementation efforts. The four sections are:

- [Understanding the New Revenue Recognition Standard](#). This section provides a brief overview of the new standard. The core principle is that “an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” The application of that principle requires a five-step analysis process. The CAQ's tool also describes the transition alternatives – full retrospective application or modified retrospective application. Under the full retrospective approach, 2016 and 2017 financial statements will have to be recast to reflect adoption of the new standard in the 2018 financial statements. Under the modified approach, 2016 and 2017 financials are not recast, but the new standard must be applied to contracts with customers that are not completed as of January 1, 2018, and an adjustment to retained earnings must be recorded to reflect the cumulative effect of initially applying the standard to ongoing contracts.
- [Evaluating the Company's Impact Assessment](#). This section assists audit committees in discussing with management the impact of the new standard on the company and its business. While the tool provides additional detail, at a general level it focuses on six questions:
  1. How has the impact of the revenue standard on the company been assessed?

2. What factors went into management's impact assessment?
  3. What is the impact of the standard on the company's revenue streams and related activities?
  4. What are other considerations that may impact the company under the new standard?
  5. When will management provide pro-forma financial statements, including disclosures, to the audit committee to demonstrate the expected impact of the new standard on revenue?
  6. How does the company's external auditor view the company's impact assessment?
- Evaluating the Implementation Project Plan. This section of the tool addresses the audit committee's efforts to understand and evaluate management's implementation plan. The CAQ outlines six aspects of implementation for audit committee consideration:
    1. The actual implementation plan, including milestones, progress reports to the audit committee, and the views of the external auditors on the plan.
    2. Culture and resources, including "tone at the top" support for implementation, the experience and management of the accounting team, and involvement of accounting personnel in advising on the business implications of the new standard.
    3. Involvement of stakeholders, including internal communications, training, and shareholder communications.
    4. Accounting policy and significant accounting judgments, including responsibility for accounting policy decisions, responsibility for reviewing revenue-producing contracts in light of the new standard, and comparison of accounting judgments to those of peers and competitors.
    5. Contracts, including the process for the review of new and existing sales contracts to determine revenue recognition under the new standard.
    6. Systems and controls, including design, testing, and documentation of new controls related to the adoption of the new standard; disclosure of control changes; changes in accounting systems; and ICFR implications (e.g., impact of existing control deficiencies on implementation of the new standard).
  - Other Implementation Considerations. This section alerts audit committees to additional considerations, such as transition methodology decisions and new disclosure requirements.

The tool also contains a list of resources concerning the new standards, including publications prepared by the major accounting firms.

Comment: The CAQ tool provides an excellent resource for audit committees that need to come up to speed on implementation of the new standard. As the CAQ states: “Implementation is a significant effort. If companies have not begun the process already, it is imperative to start preparing immediately.”

## **Audit Fees Are Still Climbing, But Some Large Companies May Have a Solution**

On December 1, the Financial Executives Research Foundation (FERF), the research affiliate of Financial Executives International (FEI), [announced](#) the results of its annual [Audit Fee Survey](#) (available for purchase from FEI). The survey indicates that, as in prior years, audit fees overall continue to rise, although, for the largest public companies, fees declined in 2015.

The FERF report is based on responses from 245 financial executives at a mix of public companies, private companies and non-profit organizations. The report also examines publicly-reported audit fees for 6,490 SEC filers. FERF’s 2016 survey, which covers 2015 audit costs, found that the median SEC filer audit fee rose 1.6 percent, compared to 2014. Smaller public companies experienced greater fee increases than larger companies: For non-accelerated filers, the median increase was 4.8 percent, while the largest public companies – large accelerated filers – enjoyed a 3.8 percent decrease in fees. In 2015, the average SEC filer audit fee was \$1.8 million; the median public company fee was \$522,205.

Executives at 89 public companies responded to the survey component of the FERF analysis. At these companies, audit fees averaged \$6.5 million, with a median fee of \$2.4 million. The average percentage increase in audit fees reported was 4.5 percent, and the median increase was 1.6 percent.

About one-third of public company survey respondents indicated that “acquisition” was a reason for an audit fee increase; one-fifth selected “review of manual controls from PCAOB inspections” as a fee increase cause. Other reasons provided for audit fee increases included recent restatements and material weaknesses in internal controls; control deficiency remediation and additional substantive testing; and “auditor’s new SOX standards related to interpretation of PCAOB rulings.” FERF states that about 20 percent of SEC filers reported ineffective internal control over financial reporting in 2015. For those companies, the median audit fee increase was 5.1 percent.

The primary reason given for a decrease in audit fees was “negotiation with primary auditor,” which was cited by 26 percent of public company respondents. As noted above, audit fees declined for large accelerated filers. Fifty-four percent of large accelerated filer respondents indicated that, to mitigate audit fee increases, they had “increased audit preparedness.” Forty-three percent said they had improved their controls as a fee mitigation strategy.

Prior FERF surveys have highlighted the impact of the PCAOB on audit fees and compliance costs (see [December 2015 Update](#)), and the 2015 survey asked several questions focused specifically on the PCAOB:



- “Has your auditor requested that you make changes to your controls as a result of PCAOB requirements or inspection feedback?” Yes – 40 percent.
- “Has your auditor requested that you make changes to your controls documentation as a result of PCAOB feedback?” Yes – 52 percent
- “Did the PCAOB findings result in a restatement of your financial statements?” No – 54 percent; not applicable or don’t know – 46 percent.
- “Did the PCAOB findings result in a change in your auditor’s opinion?” No – 53 percent; not applicable or don’t know – 47 percent.

Public company respondents were also asked for their views on costs-versus-benefits of Section 404 of the Sarbanes-Oxley Act. (Section 404 requires management to assess and report on the effectiveness of the company’s internal control over financial reporting and, in the case of large companies, to obtain an ICFR opinion from the auditor). Thirty-three percent thought that Section 404 has resulted in better internal controls and was worth the added expense. However, almost the same percentage – 30 percent – thought that, while controls were better, Section 404 compliance was not worth the cost. Another 8 percent responded that the cost was “excessive,” while 7 percent thought there was no increase in control effectiveness arising from Section 404 compliance.

Comment: While many factors influence the level of a given company’s audit fee, one would expect the system-wide fee impacts of PCAOB inspections and ICFR auditing to level off, as audit firms and their clients adjust to these requirements and compliance becomes institutionalized. See [June 2015 Update](#). The decline in large accelerated filer fees may be evidence that this is finally beginning to occur. In the long run, increasing audit firm use of technology may also reduce audit costs. Offsetting these factors, however, are the challenges and costs incident to the implementation of new accounting standards, such as revenue recognition (see prior item in this [Update](#)) and new auditing standards, such as the PCAOB related party standard.

## **SASB on the State of Sustainability Disclosure: Too Much Boilerplate, Too Few Metrics**

On December 1, the Sustainability Accounting Oversight Board (SASB) released its first [Annual State of Disclosure Report](#). The report presents a review and analysis of current sustainability disclosures in SEC filings and is based on SASB’s review of the most recent annual report (generally FY 2015) on Form 10-K or Form 20-F for 713 companies in the 79 industries that SASB uses in its standard-setting. SASB intends this initial report to provide a baseline for evaluating sustainability disclosure. Because of increasing investor interest in sustainability disclosure, and particularly in disclosure that includes quantifiable measures that can be used to compare performance across companies, audit committees may want to see where their industry stands in the SASB rankings and consider whether voluntary use of parts of SASB’s standards would be appropriate.

SASB is a non-profit organization which is developing industry-specific standards for the recognition and disclosure of material environmental, social and governance impacts by U.S. public companies. In formulating its disclosure standards, SASB views sustainability as having five dimensions – environment; social capital; human capital; business model and innovation; and leadership and governance. SASB is not a governmental body, and its standards have no legal effect. However, SASB is explicitly attempting to identify ESG information that is material to investors under the existing securities law definition of materiality. As SASB points out, the SEC’s Management’s Discussion and Analysis (MD&A) requirements call for a description of known trends, events, and uncertainties that are reasonably likely to have material impacts on the reporting company’s financial condition or results of operations. SASB describes its standards as “designed for integration into MD&A and other relevant sections of SEC filings.” Because of the link between securities law materiality and SASB’s standards, there is a possibility that its standards will influence the law of materiality and could become de facto disclosure requirements.

The SASB report finds that a large fraction of public companies include discussion of sustainability in their SEC filings. SASB states that 69 percent of companies reported on at least three-quarters of the sustainability topics in the SASB standard for the company’s industry, and 38 percent provided disclosure on every SASB topic in the relevant standard. Further, 81 percent of the filings analyzed, across all sectors and topics, included some form of SASB sustainability disclosure. According to SASB, “This is a clear indication that companies acknowledge the majority of the sustainability factors identified in SASB standards are currently having—or are reasonably expected to have—material impacts on their business.”

However, despite the widespread inclusion in SEC filings of some type of information related to the sustainability topics in SASB’s standards, the quality and detail of those disclosures does not generally comply with SASB’s requirements. “The most common form of disclosure—across the majority of industries and topics—was generic boilerplate language, which is inadequate for investment decision-making. Such vague, non-specific information was used 53 percent of the time when companies addressed a SASB topic.”

One of SASB’s objectives is to formulate quantifiable measures of sustainability performance. Such metrics facilitate comparison between companies and comparison of a company’s performance over time. SASB found that the use of sustainability performance metrics in SEC filings is not common today. “Companies used metrics—obviously more useful to investment analysis—in less than 24 percent of the cases where disclosure occurred. Importantly, even in these cases the metrics were non-standardized, and therefore lacked comparability from one industry firm to the next.” The SASB report characterizes current disclosures as “a minimally compliant approach to sustainability disclosure, providing the market with information that is inadequate for making investment decisions.”

SASB ranks the disclosure performance of the 79 industries recognized in its standards. The ranking methodology looks at three factors: Disclosure levels (“The frequency with which the entries analyzed provided some form of disclosure on SASB’s industry-specific topics.”);

use of metrics; and use of boilerplate. On that basis, SASB finds that the five highest ranking industries are education, car rental and leasing, cruise lines, gas utilities, and tobacco. The five lowest ranked industries are health care distributors, appliance manufacturing, real estate services, household and personal products, and building products and furnishings.

In analyzing the industry differences, SASB notes:

“Generally speaking, SASB’s analysis found that sustainability disclosure tended to be of somewhat higher quality overall in certain industries with business-to-customer (B2C) models (e.g., those in Transportation, Services, and Consumption I), as opposed to business-to-business (B2B) operations further up the value chain (e.g., Resource Transformation, Non-Renewable Resources). This may reflect the importance of brand value to such enterprises, and the susceptibility of intangible assets to impairment from reputational damage. Even so, the big-picture trends were found to hold across nearly all sectors and industries. Despite a generally higher level of disclosure in B2C industries, the analysis also found boilerplate language to be more common among these types of firms. Other industries, particularly those that are more strictly regulated (e.g., Financials, Non-Renewable Resources) tended to provide fewer but more tailored disclosures.”

Comment: Sustainability disclosure, and the controls and metrics supporting that disclosure, are becoming an important issue for many public companies and their audit committees. As noted in the [June-July 2016 Update](#), the SEC has invited comment on modernization of Regulation S-K, the nonfinancial disclosure requirements applicable to public companies. In the Regulation S-K release, the Commission also raised the possibility of mandatory sustainability disclosure. Despite the fact that sustainability was a minor part of the overall comment request, about two-thirds of the substantive comments the Commission received addressed that topic, and the majority of those comments sought some form of mandatory disclosure. While it remains to be seen whether a new SEC administration will pursue sustainability disclosure, investor interest appears to be significant and growing. Accordingly, companies and audit committees may want to become familiar with the SASB standards that apply to their industry and with the current state of their industry’s sustainability disclosure.

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