Baker McKenzie.

# Update

August-September 2018 | No. 46


**In This Issue:**

Companies continue to struggle with Lease Accounting as the deadline looms, but the FASB throws a lifeline

Three-Firm 2016 Inspection Reports Summary

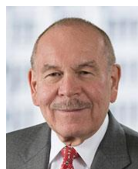
ISS is looking for advice on evaluating Audit Committees

SOX compliance requires more hours than ever, and the cause may lie in reporting changes or at the PCAOB

While popular with Asset Managers, ESG ratings lack consistency and transparency



Prepared by:



Daniel L. Goelzer
+ 1 202 835 6191
daniel.goelzer
@bakermckenzie.com


# 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.

## Companies continue to struggle with Lease Accounting as the deadline looms, but the FASB throws a lifeline

As the January 1, 2019 compliance deadline approaches, many companies still have a long way to go in implementing the new lease accounting rules. But, the Financial Accounting Standards Board (FASB) has taken a step to ease the transition.

### Background

In 2016, the FASB adopted a new standard governing financial reporting for leasing activities. ASU No. 2016-02, Leases (Topic 842) will require financial statement recognition of most leases with terms of more than 12 months. See **FASB Adopts New Lease Accounting Standard**, February-March 2016 Update and **FASB is on Track to Overhaul Lease Accounting**, December 2015 Update. For public companies, the new lease accounting requirements will take effect for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For private companies, the standard is effective for fiscal years beginning after December 15, 2019, and for interim periods beginning after December 15, 2020.

The new leasing rules will affect the financial statements of most companies, although the impact will vary by industry. A large company could easily have thousands of leases, including lease arrangements that are embedded in other types of contracts. Identifying and inventorying all of these leases has not previously been necessary. As a result, the threshold implementation step of simply compiling all of a company's leases in a database and analyzing their terms can be a massive effort.

### KPMG survey

Studies of the pace of company preparations to implement the standards have reached unsettling conclusions. See, e.g., **Despite Progress, Some Companies Are Still Behind Schedule on Lease Accounting**, March 2018 Update. KPMG's most recent survey, Lease Accounting is Right Around the Corner, is not an exception. KPMG concludes:

> We believe many companies may have underestimated just how time-consuming the process would be and are currently running out of time to meet the deadline. Therefore, as the compliance date approaches, companies that are behind schedule may be forced to use interim measures that do not reflect their ultimate, preferred end-state processes, and which may have significant and costly implications in the future.

KPMG surveyed nearly 400 companies, 75% of which were public and two-thirds of which had revenue of USD 1 billion or more. Some key findings include:

1. Fourteen percent of survey respondents have not yet begun to assess the accounting impact of the new standard. Only 21% have completed their assessment.

2. Of the 86% of companies that have begun their accounting impact assessment, only 40% have completed the inventory of leases. Fifty-four percent have selected lease accounting software. KPMG observes: "Many companies may not fully understand their accounting, operation, and process gaps first, before determining what type of system change is needed. This could result in the selection of software that is not optional for their particular needs."

3. Only 25% of companies said that their implementation was "on track". Top challenges cited were identifying embedded leases in contracts (35 percent) and abstracting and entering leases into a leasing system (28 percent).

4. Thirty-three percent of respondents have requested additional funding for lease accounting implementation. Twenty-eight percent have hired an external accounting advisor, 23% have hired additional internal resources, and 21% have had to "hire/manage multiple venders."

## FASB action

On July 30, the FASB eased some of the pain of transition to the new lease accounting regime. ASU 2018-11, Leases (Topic 842), Targeted Improvements gives companies the option of applying the standard at the adoption date (January 1, 2019, for calendar year companies), rather than retrospectively to the earliest period presented in the financial statements.

As issued, ASU 2016-02 required reporting companies to adopt the new standard using a "modified retrospective" transition method. Under that approach, the standard must be applied at the beginning of the earliest period presented in the financial statements. Calendar year companies are required to adopt the new standard for the year beginning January 1, 2019, and this means that the 2017 and 2018 financial statements must be restated in accordance with the new rules. As the FASB explained in ASU 2018-11, under the original requirement, "starting on January 1, 2017 (for those calendar-year-end public business entities just described), lessees must recognize lease assets and liabilities for all leases even though those leases may have expired before the effective date. Lessees also must provide the new and enhanced disclosures for each period presented, including the comparative periods."

Under the new option afforded by ASU 2018-11, companies will not be required to restate the two prior years of financial statements, nor will they be required to provide the disclosures required by ASC 842 for 2017 and 2018. Only the 2019 financial statements will need to reflect the impact of the new leasing rules. The FASB states that the optional transition method will allow companies "to initially apply the new leases standard at the adoption date (such as January 1, 2019, for

calendar year-end public business entities) and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption." The FASB took this step because "many preparers have cited their plan to implement new systems and are observing some unanticipated costs and complexities associated with the modified retrospective transition method * * *."

Comment: Audit committees should be monitoring the company's progress on leasing standard implementation. As KPMG's survey highlights, many companies still have a significant amount of work to do, and the audit committee should make sure that management has identified the open issues and has a realistic plan to deal with them. Internal controls around new accounting systems and processes are a particularly important aspect of the compliance effort that should not be neglected – especially if the company is going to be forced to rely on interim measures before permanent systems are in place. The KPMG survey report concludes with a section entitled "Getting Over the Finish" that briefly outlines steps companies that have not completed implementation should be taking now. These steps might serve as a useful oversight checklist for the audit committee. Three-Firm 2016 Inspection Reports Summary.

In late 2017, the PCAOB released reports on the 2016 inspections of three of the four largest US accounting firms. No report has yet been issued with respect to the 2016 inspection of the fourth firm, KPMG, and it is unclear when, if ever, the 2016 KPMG inspection report will be issued. (According to allegations in an SEC administrative proceeding, and other published reports, certain former PCAOB employees leaked confidential information to KPMG concerning the engagements that were to be inspected during the 2016 cycle.)

Below is a tabular summary of the 2016 inspection results for the three firms and a similar summary with respect to the 2015 Big Four inspections.

| 2016 Inspections (Reports Issued in 2017) | | | | | | |
|---|---|---|---|---|---|---|
| **Firm** | **# of Engm'ts** | **Part I Engm'ts w/ Def's** | | **Part I Engm'ts with ICFR Deficiencies** | | |
| | **Inspected** | **#** | **% of Engm'ts Insp'd** | **#** | **% of Engm'ts Insp'd** | **% of All Engm'ts w/ Def's** |
| Deloitte & Touche | 55 | 13 | 24% | 12 | 22% | 92% |
| Ernst & Young | 55 | 15 | 27% | 14 | 25% | 93% |
| PWC | **56** | **11** | 20% | **9** | 16% | 82% |
| 2016 Total | 166 | 39 | | 35 | | |
| 2016 Firm Average | 55 | 13 | 24% | 12 | 21% | 90% |

| 2015 Inspections (Reports Issued in 2016) | | | | | | |
|---|---|---|---|---|---|---|
| **Firm** | **# of Engm'ts** | **Part I Engm'ts w/ Def's** | | **Part I Engm'ts with ICFR Deficiencies** | | |
| | **Inspected** | **#** | **% 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 | **55** | **12** | 22% | **10** | 18% | 83% |
| 2015 Total | 217 | 61 | | 54 | | |
| 2015 Firm Average | 54 | 15 | 28% | 14 | 25% | 89% |

The auditing standards most frequently cited in the 2016 inspection reports of the three 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.

| PCAOB Auditing Standard | # of Part I Engm'ts Citing this St'rd | % of All Inspected Engagements | % of All Part I Engagements |
|---|---|---|---|
| AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements | 35 | 21% | 90% |
| AS 2501, Auditing Accounting Estimates | 17 | 10% | 44% |
| AS 2301, The Auditor's Response to the Risks of Material Misstatement | 13 | 8% | 33% |
| AS 2502, Auditing Fair Value Measurements and Disclosures | 8 | 5% | 21% |
| AS 2810, Evaluating Audit Results | 7 | 4% | 18% |
| AS 2305, Substantive Analytical Procedures | 6 | 4% | 15% |
| AS 2510, Auditing Inventories | 6 | 4% | 15% |
| AS 1105, Audit Evidence | 5 | 3% | 13% |
| AS 2101, Audit Planning | 5 | 3% | 13% |
| AS 2315, Audit Sampling | 5 | 3% | 13% |

In each inspection report, the PCAOB included a list of the three most frequently identified audit deficiencies. The table below aggregates these deficiencies lists for the three large firms. The table also indicates what percentage of the engagements in Part I of the three reports included these deficiencies.

| Deficiency Description | Part I Engagements That Include this Deficiency |
|---|---|
| Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing. | 27 (69%) |
| Failure to sufficiently test significant assumptions or data that the issuer used in developing an estimate. | 21 (54%) |
| Failure to sufficiently test controls over, or sufficiently test the accuracy and completeness of, issuer-produced data or reports. | 12 (31%) |
| Failure to perform sufficient testing related to an account or significant portion of an account or to address an identified risk. | 5 (13%) |

The financial statement or auditing areas that produced the most deficiencies reported in Part I of the three inspection reports were:

- Revenue, including accounts receivable and deferred revenue (17 deficiencies).
- Inventory and related reserves (8 deficiencies).
- Investment securities, including derivatives (5 deficiencies).
- Long-lived assets, including amortization, depreciation, or depletion (4 deficiencies).
- Loans and allowance for loan losses (3 deficiencies).
- Fixed assets (3 deficiencies).

Comment: As measured by PCAOB inspection findings for these three firms, audit quality seems to be relatively constant, compared to last year. As in the prior two years, the deficiency rate for the three large firms declined in the 2016 reports. In 2015, the Board concluded that 26% of the three-firm engagements it reviewed were deficient, while, in 2016 inspections, it found comparable problems in 24% of engagements. In 2014, the deficiency rate for these three firms was 29%.

For this subset of firms, the level of quality is quite similar. The gap between the firm with the lowest deficiency percentage in 2016 reports and the firm with the highest was only 7 percentage points (reflecting an additional four audits with deficiencies out of the 55 inspected per firm).

The 2016 inspection results also suggest that the PCAOB staff's focus on internal control over financial reporting (ICFR) continues unabated. For these three firms, in 2016 the Board found ICFR deficiencies in 21% of the engagements it inspected, and 90% of all deficient engagements included at least one ICFR deficiency. In 2015, the Board found ICFR deficiencies in 25% of inspected Big Four engagements, and 89% of deficient engagements included an ICFR lapse. While high, these results are an improvement over 2013 when the PCAOB found ICFR auditing breakdowns in 35% of inspected Big Four engagements. 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 seem to have had a measureable positive effect.

Board inspectors continue to find deficiencies in highly judgment-dependent audit areas, such as auditing estimates, response to risk of misstatement, and auditing of fair value measurements and disclosures. This is also generally consistent with prior years. Similarly, the second most common audit deficiency was failure to sufficiently test assumptions underlying estimates. The other top-three audit deficiencies were explicitly control related: "Failure to sufficiently test the design and/or operating effectiveness of controls that the Firm selected for testing" and

"Failure to sufficiently test controls over, or sufficiently test the accuracy and completeness of, issuer-produced data or reports".

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

## ISS is looking for advice on evaluating Audit Committees

Proxy advisory firm Institutional Shareholder Services Inc. (ISS) is trying to identify factors that can be used to determine the effectiveness of audit committees. Presumably, these factors might, in turn, be used as the basis for ISS recommendations with respect to proxy voting on audit committee members.

On July 30, ISS announced its Annual Policy Survey. A component of the annual survey, the ISS Governance Principles Survey, seeks views on a number of "global high-profile governance topics." One of this year's topics is audit committees. Survey question #6 asks:

1. What information should be considered by shareholders in evaluating the company's Audit Committee? (Check all that apply)

    - Skills and experience of audit committee members (including number of financial experts, if applicable)
    - Quality of the company's financial reporting (e.g., number of restatements; nature of restatements)
    - Significant financial reporting or audit controversies
    - The level of disclosure of factors used in the audit committee's assessment of the external auditor's independence, tenure, qualifications and work quality
    - Frequency of audit committee meetings
    - Frequency of audit committee refreshment
    - Other (please specify)

This question – and the broader issue of whether it is feasible to identify a standardized factors list to measure audit committee performance – drew a negative response from the Society for Corporate Governance. In its comment letter on the survey, the Society said:

> [A]udit committee effectiveness cannot be boiled down to a formulaic checklist of factors. In our view, none of the factors identified by ISS are indicative of audit committee performance (or a lack of performance) and, accordingly, none are appropriate for the purpose of developing a policy

> position that would generate voting recommendations against companies' audit committee members.
>
> [S]everal of the factors proposed by ISS (e.g., number of restatements, nature of restatements, significant financial reporting controversies) seem to be implicitly based on the notion that the audit committee has direct responsibility for the company's financial reporting. Of course, as ISS is no doubt aware, that is not the case. Moreover, the existence of any one of these factors is not necessarily a negative reflection on the audit committee – and in some situations, it may actually reflect positively on the committee. For example, if the audit committee is instrumental in causing a restatement that management is resisting, that is a positive thing – not a reason to replace the committee.

Nasdaq, Inc. was a bit more positive, but also wary of ISS's ability to formulate a list of audit committee evaluation factors. Its letter warns:

> [W]hile these all may seem like reasonable factors to consider in evaluating an audit committee, Nasdaq cautions against a "one-size-fits-all" approach or attaching too much weight to any one individual factor. For example, factors that may be important in evaluating the audit committee of a global manufacturing company may be less important in evaluating the audit committee of an early-stage biotech company. Similar to the discussion on audit firm tenure above, Nasdaq especially cautions against overemphasizing the frequency of audit committee refreshment. Audit committee members gain specialized knowledge about a company, its risks, its accounting procedures and its external auditors over time, so audit committee members with longer tenure may actually provide a benefit to a company and its shareholders. (footnote omitted)

After analyzing survey responses and other inputs, ISS will open an additional public comment period on proposed changes to its policies for 2019 "in order to elicit feedback on the practical implementation of proposed policy updates before they are finalized and published."

Comment: As the Society for Corporate Governance and Nasdaq point out, attempting to evaluate audit committee performance based on a single, uniform set of criteria would be challenging at best and could in some cases be misleading. Whether or not ISS proceeds with its project, audit committees should, as suggested in prior **Updates**, consider providing more transparency in the audit committee report concerning their work. See **Audit Committee Disclosures Continue to Grow, Especially About Cybersecurity Oversight**, June-July 2018 Update. Lack of disclosure concerning the audit committee encourages others to attempt to fill the void with their own ideas about what investors should know and how they should evaluate the committee's work.

## SOX compliance requires more hours than ever, and the cause may lie in reporting changes or at the PCAOB

On August 13, consulting firm Protiviti released the 2018 edition of its annual survey of Sarbanes-Oxley Act compliance costs, Benchmarking SOX Costs, Hours and Controls. Among the key findings of the 2018 survey are:

- Compliance costs continued to rise for many companies, although the cost impact of SOX depended heavily on company size.
- Compliance hours increased significantly. Those increases may have been primarily the result of external forces that affected SOX compliance systems. The report refers specifically to changes in accounting for revenue recognition and leasing and to the continuing impact of PCAOB inspections.
- Automated control testing and robotic process automation (RPA) hold promise for greater efficiency and reduced costs, but those benefits are far from fully recognized.

More than 1,000 respondents from publicly-held companies participated in the 2018 survey, which was conducted online during the first quarter of 2018. Respondents held a variety of management positions, with the largest percentage self-identifying as "other C-suite executives," "audit managers," or "audit staff" (each of these three groups represented 16% of the respondents). Over half of the non-financial services organizations in the survey (55%) had USD 1 billion or more in annual revenue.

### Internal compliance costs

As noted above, compliance costs are closely related to company size.

- The average annual internal cost of SOX compliance for the largest public companies (large accelerated filers) declined in 2018 to USD 1.339 million from USD 1.142 million in 2017. However, the 2018 cost figure was slightly higher than the USD 1.335 million reported in the 2016 survey.
- For the next tier of public companies (accelerated filers), average annual internal costs averaged USD 997,00, up sharply from the USD 802,000 in the prior survey. Still-smaller companies (non-accelerated filers) averaged USD 560,700, down from USD 700,000 in 2017 and less than half of the USD 1.219 million these companies reported in 2016.
- As in prior surveys, the highest compliance costs – USD 1.391 million – were incurred by emerging growth companies (EGCs – certain recently-public companies with revenues of less than USD 1 billion). EGC SOX costs were higher in 2018 than in 2017 (USD 1.222 million), although less than the USD 1.430 million reported in 2016.

On an industry basis, companies in the health care sector had the highest internal SOX compliance costs (USD 1.318 million), followed by financial services at USD 1.176 million.

## Audit fees

For many companies, audit fees continue to rise. Half of large accelerated filers, and about a quarter of accelerated filers, reported that their external audit fee increased in fiscal 2017, while 6% of each of these filer groups reported a decrease. For non-accelerated filers, 39% reported an increase, and 11% reported a decrease. The category with the highest percentage of audit fee decreases – 58% – was emerging growth companies, although 25% of EGCs said their audit fee increased.

## Hours devoted to SOX compliance

Significant percentages of companies of all sizes reported that hours devoted to SOX compliance increased. About half (49%) of large accelerated filers said that their total hours increased in FY 2017, and half of those reported increases of 10% or more. The widest variation occurred among emerging growth companies. Thirty-four percent reported an increase in SOX hours, and, of those, 65% said that the increase was 10% or more. On the other hand, of EGCs that reported a decline in SOX hours, 94% said the decrease was 10% or more.

## External Auditor reliance

Protiviti asked respondents what percentage of their control testing the external auditor relied on. For large accelerated filers, 35% of companies reported that the auditor relied on between 51 and 100% of the company's testing. In contrast, for non-accelerated filers and ECGs only 19% and 20% respectively reported 51-percent-plus reliance. This question was not asked in the 2017 survey. However, in 2017, 79% of accelerated filers and 71% of non-accelerated filers indicated that their auditor was relying "to the fullest extent possible" on the work of others (e.g., internal audit) to test controls over medium- and low-risk processes.

## Technology tools

Respondents were asked whether their organizations use technology tools (e.g., robotic process automation) in SOX Section 404 compliance. The five most frequently reported tools were:

- Automated process approval workflow tools (e.g., expense report approval process) (31%).
- Access controls/user provision/segregation of duties review tools (30%).
- Data analytics (30%).
- Automated reconciliation tools (29%).
- Process mining/analytics (27%).
- Continuous controls monitoring (27%).

## Role of the PCAOB

Last year, of those respondents who said that their audit firm required changes to the company's SOX compliance procedures, 42% attributed those changes to the PCAOB's inspection program "very much so", and 33% said the PCAOB's inspection was "probably" the cause. See **After 15 Years, SOX Compliance Costs Are Leveling Off**, July 2017 Update. While Protiviti did not ask that question in 2018, it did ask about the cost impact of PCAOB inspections on particular aspects of SOX compliance. Significant percentages of respondents believed that, in the following areas, the PCAOB's inspection program had either an "extensive" or a "substantial" cost impact:

- Testing review controls (55%).
- IT considerations (48%).
- Selecting controls to test (48%).
- Risk assessment and scoping (47%).
- Roll-forward of control testing from an interim date (44%).
- Testing system reports and other information provided by the entity (42%).
- Using the work of others (35%).

## SOX compliance benefits

Sixty-seven percent of public company respondents believed that the company's internal control over financial reporting (ICFR) had "significantly" or "moderately" improved since ICFR auditing became required. (In 2017, 73% believed there was either a significant or moderate improvement.) Primary benefits of SOX compliance included "Continuous improvement of business processes" (59%), "Enhanced understanding of control design and control operating effectiveness" (58%), "Improved ICFR structure" (45%), "Compliance with SEC rules" (36%), "Increased reliance by external audit on the work of internal audit" (33%), and "Ability to better identify duplicate of superfluous controls" (30%).

Comment: SOX compliance has imposed significant costs on companies of all sizes, and the impact on non-accelerated filers and ECGs has been substantial, given their more limited resources. A significant majority of survey respondents do, however, believe that SOX compliance costs have created value in the form of stronger and more reliable controls. And, the costs seem to be leveling off, at least for the largest companies that are in the best position to implement advanced technology solutions. As noted in **SOX Compliance Costs and Audit Fees Continue to Rise**, August 2016 Update, audit committees may want to consider whether there are opportunities to convert some of their company's SOX compliance costs into an investment in more effective and efficient financial reporting and information-gathering processes.

## While popular with Asset Managers, ESG ratings lack consistency and transparency

As discussed in several prior **Updates**, many large institutional investors have announced that they take environmental, social, and governance (ESG) factors into account in their investment decision-making. At the same time, most large public (and many smaller and private) companies have begun to publish sustainability reports or to make other disclosures aimed at providing information concerning their ESG profiles. See **Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture**, March 2018 Update. These trends have given birth to a new type of financial advisory service -- ESG rating agencies. These entities analyze company ESG disclosures and generate a score that is intended to reflect the company's ESG performance. While there are many ESG raters, the best-known are MSCI and Sustainalytics.

However, a study recently released by the American Council For Capital Formation (ACCF) casts doubt on the reliability of ESG ratings. The ACCF's Ratings that Don't Rate: The Subjective World of ESG Ratings Agencies concludes:

> [I]ndividual agencies' ESG ratings can vary dramatically. An individual company can carry vastly divergent ratings from different agencies simultaneously, due to differences in methodology, subjective interpretation, or an individual agency's agenda. There are also inherent biases: from market cap size, to location, to industry or sector – all rooted in a lack of uniform disclosure.

ACCF states that widespread reliance on ESG ratings is partly driven by the United Nations Principles for Responsible Investment (PRI). PRI's roughly 1,800 asset manager signatories agree to incorporate ESG factors into their investment decisions. However, many of these asset managers do not have the resources to conduct their own ESG research and instead rely on ESG ratings agencies. In fact, ACCF notes that MSCI claims that it provides ratings to 46 of the top 50 global asset managers.

In ACCF's view, there are several fundamental problems with ESG ratings:

- Disclosure Limitations and Lack of Standardization. According to ACCF, ESG rating systems tend to give favorable ratings to companies that disclosure more ESG information, even if their actual ESG performance is weak. Further, ESG disclosures are not standardized, and are seldom audited. The lack of standardization results in sustainability reports that "invariably present companies in the best possible light, and rarely do they alert investors of looming problems." Moreover, the rating agencies apply assumptions and judgments in formulating their ratings, "which only adds to the subjective nature of ESG ratings."

- Company Size Bias. ACCF's analysis finds that companies with higher market capitalization tend to receive higher ESG ratings than mid-sized and small businesses. ACCF asserts that these higher ratings do not necessarily reflect better ESG performance.

- Geographic Bias. ACCF points out that ESG reporting requirements vary from country to country. These differences in reporting requirements tend to result in differences in ESG ratings, even though the ratings differences "may not fully reflect the quality of ESG practices, but instead the quality of reporting." In particular, because of the EU's non-financial disclosure requirements, North American companies are at a ratings disadvantage, relative to their European peers.

- Industry Sector Bias. Rating agencies claim to normalize or adjust their ratings based on the industry in which a company operates. This, in ACCF's view, can have the effect of inaccurately penalizing a company's rating because of its industry. "Company-specific risks and differences in business models are not accurately captured in composite ratings. Because of significant differences in business models and risk exposure, companies in the same industry are unfairly evaluated under the same model."

- Inconsistencies Between Rating Agencies. Company ratings may vary significantly between rating agencies. For example, ACCF cites a study which found that the correlation between MSCI and Sustainalytics ratings for companies in the S&P Global 1200 index was .32. In comparison, Moody's and S&P's credit ratings have a much stronger .90 correlation. ACCF states that these inconsistencies are the result of the lack of uniformity in "rating scales, criteria, and objectives." Further, since ESG disclosures are not standardized, rating agencies may take different approaches in deciding what inputs to focus on.

- Failure to Identify Risk. ESG ratings are not good predictors of ESG-related risks and "do not properly function as warning signs for investors in companies that experience serious mis-management issues." ACCF concludes that by "failing to identify risk ahead of severe stock price movements the rating agencies are not effectively assisting investors."

ACCF has four recommendations for improving ESG ratings:

1. ESG information already disclosed in regulatory filings should be standardized to incorporate risk.

2. ESG ratings need to adjust for company size, geographic reporting, and industry sector difference.

3. ESG rating agencies need to be transparent on how E, S, and G factors impact scores and prioritize those that are material.

4. ESG rating agencies should be carefully compared and should fully disclose their success rate in protecting investors from large underlying risks.

Comment: Even if one fully accepts ACCF's criticisms of ESG ratings, the fact remains that these ratings influence institutional investors, and companies therefore have an incentive to make disclosures that will have a favorable ratings impact. For audit committees, the ACCF report is yet another indicator of the importance that the market is attaching to ESG disclosure and of the likelihood that audit committee responsibilities will expand to encompass the nature and reliability of this type of reporting.

Many of the flaws in ESG ratings that ACCF identifies are traceable to the lack of a commonly-accepted public company ESG disclosure framework. Institutional investors may begin to insist that, rather than simply disclosing whatever information the company choses, companies utilize a recognized, third-party framework. As noted in prior **Updates**, the Sustainability Accounting Standards Board (SASB) has developed industry-specific ESG disclosures intended to provide decision-useful information to investors based on materiality under the federal securities laws. ACCF describes SASB's efforts as "genuine" but characterized by "sizeable complexity". Regardless of whether or not one views them as complex, SASB standards are, in the view of the **Update**, the best available alternative for investor-oriented disclosure.

Prior editions of the **Audit Committee and Auditor Oversight Update** are available here.

***By Daniel L. Goelzer, Washington, DC***

**www.bakermckenzie.com**

Baker & McKenzie
815 Connecticut Avenue
Washington, DC 20006-4078
United States

©2018 Baker McKenzie. All rights reserved. Baker & McKenzie International is a global law firm with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner or equivalent in such a law firm. Similarly, reference to an "office" means an office of any such law firm. This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.