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In This Issue:

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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.

A re-vamped PCAOB inspection program will feature more communication with Audit Committees

In a October 18 speech, PCAOB Chairman William Duhnke provided a glimpse of some of the changes that the new PCAOB board (see SEC Appoints an All-New PCAOB (November-December 2017 Update)) has in mind for its public company auditing inspections program. More dialog with audit committees will be one element of the new approach. Chairman Duhnke described audit committees as "on the front lines of promoting audit quality" and commented that "an informed and engaged audit committee member is an effective force multiplier." The Board plans to put those ideas into action by including more audit committee interviews as part of its inspections and by making inspection findings more useful to audit committees.

Chairman Duhnke characterized the Board's strategic planning process as an effort to formulate a "new vision and strategy for the organization." A key concept that emerged from that process was that "[t]o succeed in promoting continuous improvement in the quality of audit services, we must focus our regulatory attention and our efforts not only on detecting and remediating audit deficiencies, as we have done in the past, but also on preventing them from occurring in the first place." With respect to inspections, he said that the Board was "revisiting the fundamental purpose of our inspections program, how we select audit engagements for inspection, what procedures we perform during an inspection, what data we collect and use as part of our inspections, and how, what, and when we report on our inspections."

The new inspections approach will begin to be implemented in the 2019 inspection cycle. Chairman Duhnke mentioned three specific changes:

- Increased focus on audit firm systems of quality control. PCAOB inspections look for deficiencies in particular public company audits. In the future, the emphasis will shift to quality control systems. "When quality control systems function effectively, they prevent audit deficiencies." In particular, Chairman Duhnke cited "strong root cause analysis, thoughtful engagement management, careful assignment of personnel, and risk-focused client acceptance and retention processes" as control measures that improve audit quality.

- Increased focus on audit risks. Under the current program, a PCAOB team is assigned to each inspected firm. Beginning the 2019, the Board plans to create additional teams that will perform inspection procedures aimed at specific issues across many firms. In addition to firm inspection reports, the Board will issue reports describing the results of these issue-targeted inspections.

- New inspection report format. Chairman Duhnke asserted that the core principles of inspection reporting should be timeliness and relevance. "More timely and relevant feedback provides investors and audit committees with useable information to aid their decision-making. Auditors will also be able to adjust their behavior before the same mistakes are made." To accomplish this, the Board plans to issue inspection reports that:

    - Provide insight about the nature and severity of inspections findings. Reporting will move away from simply reporting failures in individual audits. "We hope that our modified approach to inspections reporting will begin to shift the public dialogue away from a mere quantification of audit deficiencies to a more balanced and meaningful assessment of audit quality."

    - Take a more balanced approach by including both audit deficiencies and best practices. The Board will begin to include "behaviors and practices we observe that promote or enhance audit quality" in its reports. "To effectively prevent audit deficiencies, we need to spend as much time discussing audit 'successes' and what leads to them, as we do reporting about audit 'failures' and the deficiencies that cause them."

Chairman Duhnke also stated that the Board would increase its "interaction" with audit committees during inspections. "I've spoken with dozens of audit committee members over the past several months. Nearly all have emphasized the need for the PCAOB to engage more often and more directly with them. * * * [W]e believe that our inspections program provides us with one meaningful opportunity to do so."

Comment: During the early years of the PCAOB's inspections program, it was fairly common for the inspection staff to interview the audit committee chair as part of its review of an audit engagement. The primary objective of the interview was to understand whether and how the auditor was complying with requirements concerning information that must be provided to the committee. In recent years, these interviews have become less common. It is unclear whether Chairman Duhnke plans to revive the prior practice or whether he has in mind some broader form of audit committee involvement in inspections. Also, his references to interactions with "audit committees" seem to raise the possibility that the staff's contacts may not be limited to audit committee chairs, but may include all committee members.

SEC says that cybersecurity is part of ICFR

On October 16, the Securities and Exchange Commission issued a report discussing investigations conducted by the Division of Enforcement concerning whether nine public companies that were the victims of cyber-related frauds violated the federal securities laws by failing to have sufficient systems of internal accounting controls. See **Report of Investigation Pursuant to Section 21(a) of**

the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements (Report). While the Commission determined not to bring enforcement actions against any of the companies involved (and the companies are not named in the **Report**), the Commission makes clear that, in designing internal controls, companies need to consider cyber threats. Companies that fail to do so could be charged with having inadequate controls, notwithstanding that the company was the victim of a fraud perpetrated by outsiders.

The cyber-scams that ensnared these companies fell into two categories. In one group of cases, the perpetrators emailed company finance personnel using email domains and addresses that made the communication appear to have originated with a senior company executive, such as the CEO. The email instructed the recipient to work with a purported outside attorney, who in turn directed the finance employee to make one or more large wire transfers to a foreign bank account. The fake email from the CEO typically asserted that the wire transfers were needed to complete a time-sensitive, highly confidential corporate transaction.

The other type of cyber-fraud involved bogus invoices and payment instructions that the perpetrators created based on information concerning actual company vendors. In these situations, personnel responsible for procurement were tricked by emails or other communications that appeared to originate with a vendor. These communications asked the procurement staff member to instruct the company's accounting department to change the vendor's banking information. As a result, company payments to the vendor were diverted to foreign bank accounts controlled by the impersonator. Typically, these schemes came to light when the real vendor began to complain about nonpayment of its invoices.

The **Report** states that each of the nine public companies investigated lost at least USD 1 million and that two companies lost more than USD 30 million. Total losses for the nine companies were nearly USD 100 million, most of which was never recovered.

Section 13(b)(2)(B) of the Securities Exchange Act requires SEC-registered public companies to devise and maintain a system of internal accounting control sufficient to provide reasonable assurance that (among other things) "transactions are executed in accordance with management's general or specific authorization" and that "access to assets is permitted only in accordance with management's general or specific authorization." The frauds described in the **Report** can be viewed as situations in which the company's internal controls failed to prevent transactions that were executed, and access to assets that was provided, without management authorization. The **Report** states:

> These examples underscore the importance of devising and maintaining a system of internal accounting controls attuned to this kind of cyber-related fraud, as well as the critical role training plays in implementing controls that serve their purpose and protect assets in compliance with the federal securities laws. The issuers here, for instance, had procedures that required certain levels of authorization for payment

> requests, management approval for outgoing wires, and verification of any changes to vendor data. Yet they still became victims of these attacks. The existing controls could be (and were) interpreted by the company's personnel to mean that the (ultimately compromised) electronic communications were, standing alone, sufficient to process significant wire transfers or changes to vendor banking data.

The Commission notes that it is "not suggesting that every issuer that is the victim of a cyber-related scam is, by extension, in violation of the internal accounting controls requirements." However, the **Report** concludes with this warning:

> [I]nternal accounting controls may need to be reassessed in light of emerging risks, including risks arising from cyber-related frauds. Public issuers subject to the requirements of Section 13(b)(2)(B) must calibrate their internal accounting controls to the current risk environment and assess and adjust policies and procedures accordingly. * * * Given the prevalence and continued expansion of these attacks, issuers should be mindful of the risks that cyber-related frauds pose and consider, as appropriate, whether their internal accounting control systems are sufficient to provide reasonable assurances in safeguarding their assets from these risks.

Comment: Boards often delegate cybersecurity risk oversight to the audit committee, and audit committee members consistently indicate that evaluating the company's management of cybersecurity risk is one of the top challenges they face. See **Audit Committee Members are Challenged By Risk Management and Think They Would Benefit From a Better Understanding of the Business**, January-February 2017 Update. In addition, audit committees normally have oversight responsibility for the company's accounting and internal control systems. The SEC's report illustrates the connection between these two responsibilities. Audit committees may want to use the **Report** as an opportunity to review with management the adequacy of controls that are intended to protect the company from falling victim to these types of frauds. The topic might also be one to place on the internal audit staff's to-do list.

While the **Report** does not comment on the role of the board or audit committee in cybersecurity oversight, the SEC and its individual Commissioners are clearly focused on that issue. See **SEC Issues Guidance on Cyber Disclosure, Including the Board's Oversight Role**, March 2018 Update. In addition, shortly before the issuance of the **Report**, SEC Commissioner Stein delivered a speech in which she observed:

> Boards have a fiduciary duty to shareholders. Shareholders and policymakers expect boards of directors to oversee and to evaluate corporate risk-taking. Board members need to proactively take action on the oversight of cybersecurity as a critical component of a company's risk management. I am not saying that the Board must manage the day-to-day risk of cyber threats. However, Boards must take charge of the oversight of cyber risks.

CAQ and EY Center Audit Committee Transparency Reports: Disclosure continues to grow apace

During the last several years, voluntary disclosure about audit committee responsibilities and how they are discharged has grown significantly. See **Transparency Rolls On: Audit Committees are Voluntarily Disclosing More About Their Work**, November-December 2017 Update. Disclosure regarding the work of the audit committee that goes beyond the regulatory requirements has become a best practice for larger (and many smaller) public companies. Two new reports illustrate that the trend to provide more insight into the committee's work is continuing.

CAQ transparency barometer

In 2013, the Center for Audit Quality (CAQ) and other organizations with an interest in audit committee transparency issued a "Call to Action" urging audit committees to strengthen their disclosures. See **Center For Audit Quality Calls for Greater Audit Committee Transparency**, November-December 2013 **Update**. Since the Call to Action, the CAQ and research firm Audit Analytics (AA) have annually prepared a report – the **Transparency Barometer** – on the state of audit committee disclosure. The 2016 **Transparency Barometer** was summarized in **New Studies Find More Progress on Audit Committee Transparency**, October-November 2016 Update.

On November 1, the CAQ and Audit Analytics (AA) released 2018 Audit Committee Transparency Barometer, their fifth annual disclosure report. The **Barometer** is an effort "to gauge how public company audit committees approach the public communication of their external auditor oversight activities, by measuring the robustness of proxy disclosures." The CAQ and AA state that they "continue to observe encouraging trends with respect to voluntary, enhanced disclosure around external auditor oversight, an important facet of the audit committee's broader financial reporting oversight role."

The CAQ/AA findings are based on an analysis of the proxy statements of the companies that comprise the S&P Composite 1500, which consists of the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600. Some highlights of the 2018 Barometer report include:

- Audit firm selection/ratification. Forty percent of S&P 500 company proxy statements disclose the considerations that were the basis for the audit committee's appointment of the audit firm, up from 37% in 2017 and 13% in 2014. Twenty-seven percent of MidCap companies discussed the audit committee's considerations in recommending the appointment of the audit firm (up from 24% last year and 10% in 2014), and 19% of SmallCap companies made such a disclosure (compared to 17% last year and 8% in 2014).

- Length of engagement. The percentage of S&P 500 companies that disclose the audit firm's tenure increased from 63% in 2017 to 70% in 2018. For MidCap and SmallCap companies, the 2018 percentages were 52% and 51%, respectively; in both cases, this was a 5% increase over 2017. (Company disclosure of this data point may become less important, since tenure is now a mandatory disclosure item in the auditor's report -- see **SEC Approves New Auditor's Reporting Model and Shifts the Discussion to Implementation**, November-December 2017 Update.)

- Audit firm fee negotiation responsibility. In 2018, disclosure that the audit committee is responsible for fee negotiations with the auditor continued at 20% of S&P 500 companies, the same as in 2017. Such disclosure is even less common at smaller companies – only 5% of S&P MidCap, and 4% of SmallCap, companies disclosed the audit committee's role in fee negotiations.

- Audit firm evaluation/supervision. The percentage of S&P 500 companies that disclosed criteria the audit committee considered in evaluating the audit firm increased from 38% in 2017 to 46% in 2018. Thirty-six percent of MidCap companies and 32% of SmallCap companies discussed the audit committee's evaluation criteria.

- Annual audit firm evaluation. Disclosure that the audit committee performs an annual evaluation of the auditor seems to be gaining ground, although it is still far from common. In 2018, 26% of the S&P 500 disclosed that the audit committee performed an evaluation each year, a 5% increase over 2017. For MidCaps, the disclosure was made by 17%, up from 11 % in 2017. Twelve percent of SmallCaps made the annual evaluation disclosure, compared to 8% last year.

- Engagement partner selection. In 2018, slightly more than half – 52% – of S&P 500 companies disclosed that the audit committee is involved in engagement partner selection. This reflected an increase from 49% in 2017 and from only 13% in 2014. For S&P MidCap companies, 20% disclosed that the audit committee was involved in engagement partner selection, while 10% of SmallCaps made such a disclosure.

EY center for Board Matters

The EY Center for Board Matters ("**Center**") annually prepares a study similar to the **Transparency Barometer**, but focused on just the largest US public companies. The Center's Audit committee reporting to shareholders in 2018, reports on proxy statement disclosures by Fortune 100 companies relating to their audit committees. The Center began reviewing Fortune 100 disclosures in 2012 and has released a report each year since that time. See, e.g., **Audit Committee Disclosures Continue to Grow**, **Especially About Cybersecurity Oversight**, June-July 2018 Update, and **Transparency Rolls On: Audit Committees are Voluntarily Disclosing More About Their Work**, November-December 2017 Update. The new report finds that, "[a]lthough the change in percentage of companies providing these voluntary disclosures is smaller in 2018 than in recent years, there has been a dramatic increase in disclosures in most categories since we began examining these disclosures in 2012."

The Center's 2018 report finds:

- Seventy-one percent of companies disclosed the length of their auditor's tenure – virtually the same as the 70% incidence of tenure disclosure for the S&P 500. In 2017, 64% of the Fortune 100 made tenure disclosure, while only 25% did so in 2012.

- Sixty-two percent of companies disclosed the factors the audit committee uses in assessing the work and qualifications of the external auditor. In 2017, 58% of companies made such disclosure, while only 18% did so in 2012. (As noted above, 46% of the S&P 500 make this disclosure.)

- Eighty-nine percent of the 100 companies disclosed that the audit committee considers non-audit fees and services when assessing auditor independence. This was an increase from 86% in 2017 and only 12% in 2012.

- The percentage of companies that provided an explanation for a change in **total** fees paid to the external auditor decreased slightly (i.e., by one company) from 45% in 2017 to 44% in 2018. The percentages are, however, more than four times higher than the 10% that provided such an explanation in 2012. With respect to the audit fee component of total fees, 16% explained any change, down from 19% last year.

In addition to the 89% disclosure rate for audit committee consideration of non-audit fees and services noted above, the most frequent voluntary disclosures by or about audit committees identified in the Center's 2018 report were:

- An explicit statement that the audit committee is responsible for appointment, compensation and oversight of the external auditor (88%).

- Inclusion of the name of the external audit firm in the audit committee's report (79%).

- Statement that the audit committee is involved in selection of the lead audit partner (78%).

- Statement that the choice of external auditor is in the best interest of the company and/or its shareholders (74%).

The Center observes that increased transparency regarding the audit committee "can increase investors' confidence in financial reporting and their confidence in the role of the audit committee in overseeing the audit process and promoting audit quality in the interest of investors."

Comment: As noted in prior **Updates**, audit committees should be aware of the types of voluntary disclosures concerning the committee's responsibilities and activities that their peers are making and consider expanding their own disclosures to match. The kinds of disclosures that the **Barometer** and the Center's report identify are not controversial and would rarely, if ever, involve disclosing confidential information or exposing the audit committee to increased litigation risk. Enhanced voluntary disclosure may, however, head off shareholder demands for more SEC-mandated audit committee information, and is, as noted above, becoming a best practice.

Adverse ICFR opinions are beginning to decline

Research firm Audit Analytics (AA) has published a report finding that adverse auditor opinions on internal control over financial reporting (ICFR) declined in 2017 after increasing each year since 2012. At smaller companies, where only a management assessment is required, the number of adverse management assessments declined as well. As to the causes for ineffective controls, auditors tend to cite the frequency of material adjustments and short-comings in accounting personnel, while management assessments sometimes point to the audit committee.

AA prepares an annual analysis of ICFR management assessments and audit opinions. See **ICFR Auditing is Improving, But Material Weaknesses are Going Up**, September 2016 **Update**. In October, AA released its 2018 report (covering 2017 disclosures) on trends in ICFR reporting, **SOX 404 Disclosures: a Fourteen Year Review**. The report is available for purchase from AA. The comments in this **Update** are based on AA's public blog summary of the 2018 report.

Section 404 of the Sarbanes-Oxley Act requires public company managements to perform, and disclose the results of, an annual assessment of the effectiveness of the company's ICFR. Section 404 also requires companies to obtain a report from the company's external auditor expressing the auditor's opinion on the effectiveness of the company's ICFR. The SEC has, however, exempted smaller public companies – non-accelerated filers, defined generally as companies with less than USD 75 million in publicly-traded securities – from the external audit requirement. Therefore, these smaller companies are only required to disclose management's assessment of control effectiveness. For either a management assessment or an auditor's report, the existence of one or more ICFR material weaknesses means that controls are ineffective and requires the issuance of an adverse assessment or opinion.

According to AA's analysis, in 2017, auditors issued 176 adverse ICFR opinions. This represents a 28% decrease from the 246 adverse opinions in 2016. The decrease is a sharp reversal in the prior trend: Between 2012 and 2017, the number of adverse opinions increased every year. Prior to 2010, adverse opinions were much more frequent, with an all-time high of 492 ineffective control opinions in 2005, the second year of Section 404 reporting. Since the number of accelerated filers is not constant, it is useful to look at these numbers on a percentage basis. In 2017, the percentage of adverse auditor opinions was 4.9%. This compares to 6.7% in 2016. The all-time high was 15.9% in 2004, and the all-time low was 3.5% in 2010.

For the smaller companies that are required only to perform a management assessment, the frequency of ineffective controls disclosure is far higher than at larger companies. Non-accelerated filers disclosed 1,191 adverse assessments in 2017, reflecting ineffective ICFR at 38.1% of these companies. On a percentage basis, adverse assessments in 2017 were down slightly from 38.9% in 2016 and from the peak of 40.8% in 2014. The variation over time in the number and percentage of adverse assessments at non-accelerated filers is lower than at large companies. Between 2011 and 2013, the number of adverse assessments was virtually constant at 1,616 or 1,617 per year, but has declined modestly each year since 2013.

Adverse auditor's reports and management assessments are required to describe the reasons why controls were found to be ineffective. In 2017 auditor's reports, the five most commonly disclosed control weaknesses were:

- Material and/or numerous auditor/year-end adjustments.
- Accounting personnel resources, competency/training.
- Inadequacy disclosure controls (timely, accurate, complete).
- Segregation of duties/design of controls (personnel).
- Information technology, software, security and access issues.

In the case of management-only assessments, the top five 2017 control weaknesses were:

- Accounting personnel resources, competency/training.
- Segregation of duties/design of controls (personnel).
- Ineffective, non-existent or understaffed audit committee.
- Inadequacy disclosure controls (timely, accurate, complete).
- Material and/or numerous auditor/year-end adjustments.

As these lists indicate, explanations for material weaknesses tend to focus heavily on issues stemming from inadequate staffing or incompetent personnel. Managements sometimes also identify audit committee deficiencies as a source of control weaknesses.

Comment: The increase in adverse ICFR audit opinions beginning in 2012 is likely a consequence of the PCAOB's increased inspections focus on ICFR auditing beginning at about the same time. While it is too early to identify a trend, it is possible that the decline in adverse opinions in 2017 indicates that auditors (and managements) have adjusted to the PCAOB's tougher scrutiny and that the control deficiencies which came to light have now been remedied. Conversely, the relatively higher, and more constant, level of adverse assessments at smaller companies may reflect the fact that, without the discipline of an ICFR audit, there is less incentive for these companies to correct their control deficiencies. Of course, higher deficiency levels at smaller companies are probably also a structural phenomenon, since smaller companies have fewer resources to devote to controls.

Investors have slightly less confidence in markets and financial reporting – and in Audit Committees

The Center for Audit Quality (CAQ) has released its 2018 Main Street Investor Survey. This annual survey measures retail investor confidence in the capital markets and in audited financial information. The survey findings are based on online interviews with a sample 1,100 individuals who have at least USD 10,000 in investments. Key survey results include:

- Eighty-one percent of respondents have confidence in the work of external auditors.
- Eighty percent have confidence in the ability of independent audit committees to perform their investor protect role.
- Seventy-eight percent of investors have confidence in investing in US publicly traded companies.
- Seventy-four percent have confidence in US capital markets.
- Fifty-six percent of investors have similar confidence in capital markets outside the US.

The survey report defined "confidence" as responses indicating "a great deal, quite a bit, or some" confidence. "No confidence" was defined as response indicating "very little or none at all."

While the 2018 confidence percentages are high, they are almost across-the-board lower than in 2017 (although many of the changes from 2017 to 2018 are within the survey's 3% margin of error). For example, while 78% of respondents expressed confidence in publicly-traded US companies, this is a drop from 83% in 2017. Further, 15% express no confidence in US companies, up from just 7% last year. Top reasons cited for lack of confidence were "only certain people benefit from US companies doing well"; "unethical practices"; and "US companies are exporting too many jobs overseas." The only survey category in which confidence rose (from 54% to 56%) was confidence in capital markets outside the US. The top reason for confidence in foreign markets was "when the US does well, so do other countries" while the top reason for lacking confidence in foreign markets was "fear of trade war or uncertainty around the status of free trade agreements."

With respect specifically to financial reporting and audit committees, confidence in audited financial statements fell three points (from 78% to 75%), while no confidence responses rose from 12 to 15%. (10% of respondents were either unsure or had no opinion.) The top reasons for confidence in financial statements were "reputations of companies are at stake, if they get caught in the wrong" and "auditors provide honest and independent third-party opinions." "Companies are not trustworthy" and "conflicts of interest" were the top lack-of-confidence reasons. Confidence in external auditors fell 3% (from 84% to 81%), and confidence in audit committees fell 2% (from 82% to 80%). The survey did not inquire into the reasons for confidence or lack of confidence in auditors or audit committees, and both changes from 2017 are within the margin of error.

Comment: The high levels of confidence in financial reporting, auditors, and audit committees reported in the **Main Street Investor Survey** seem to reflect the success of the Sarbanes-Oxley Act reforms in rebuilding trust that was eroded in the wake of the Enron scandal and other financial reporting debacles of the late 1990s and early 2000s. These confidence levels also highlight that the financial crisis – which deeply shook confidence in banks and other financial institutions (and their regulators) - was not generally perceived by the public as involving a breakdown in financial reporting.

Nonetheless, it is wise to keep in mind that confidence is hard to build and easy to lose. Outside the United States – particularly in the UK and South Africa – there have been a recent series of high profile corporate collapses that seem to have also involved audit failures. (The insolvency of British construction services and facilities management company Carillion plc is one example.) As a result, there is serious ongoing debate in the UK about the need to further regulate audit firms, such as by prohibiting non-audit services or limiting the number of large public company audit clients a firm may have. (Caps on the number of firm audit clients would operate as a limit on the ability of audit committees to retain their preferred auditor, if the firm had already reached its large public company client limit.) Hopefully, audit failures that generate demands for such limitations in the US audit market can continue to be avoided.

Institutional investors want the SEC to require standardized ESG disclosure

A group of institutional investors, nonprofit organizations, and academics have filed a petition with the Securities and Exchange Commission asking that the SEC initiate rulemaking to develop "a comprehensive framework requiring issuers to disclose identified environmental, social and governance (ESG) aspects of each public company's operations." In support of SEC action, the petitioners state:

> Today, investors, including retail investors, are demanding and using a wide range of information designed to understand the long-term performance and risk management strategies of public-reporting companies. In response to changing business norms and pressure from investors, most of America's largest public companies are attempting to provide additional information to meet these changing needs and to address worldwide investor preferences and regulatory requirements. Without adequate standards, more and more public companies are voluntarily producing "sustainability reports" designed to explain how they are creating long-term value. * * * [We ask that the Commission] develop a comprehensive framework for clearer, more consistent, more complete, and more easily comparable information relevant to companies' long-term risks and performance. Such a framework would better inform investors, and would provide clarity to America's public companies on providing relevant, auditable, and decision-useful information to investors.

The petition's authors are two law professors, Cynthia Williams of Osgood Hall Law School in Toronto and Saul Fox of the University of Pennsylvania School of Law. The petition has over 60 co-signers, including the California Public Employees' Retirement System, New York State Comptroller Thomas P. DiNapoli, Illinois State Treasurer Michael W. Frerichs, Connecticut State Treasurer Denise L. Nappier, Oregon State Treasurer Tobias Read, and the U.N. Principles for Responsible Investment. The petition transmittal letter states that the co-signers represent more than USD 5 trillion in assets under management.

The bulk of the petition is devoted to six arguments in support of SEC rulemaking:

1. The SEC has clear statutory authority to require disclosure of ESG information, and doing so will promote market efficiency, protect the competitive position of American public companies and the US capital markets, and enhance capital formation;

2. ESG information is material to a broad range of investors today;

3. Companies struggle to provide investors with ESG information that is relevant, reliable, and decision-useful;

4. Companies' voluntary ESG disclosure is episodic, incomplete, incomparable, and inconsistent, and ESG disclosure in required SEC filings is similarly inadequate;

5. Commission rulemaking will reduce the current burden on public companies and provide a level playing field for the many American companies engaging in voluntary ESG disclosure; and

6. Petitions and stakeholder engagement seeking different kinds of ESG information suggest, in aggregate, that it is time for the SEC to regulate in this area.

Except for the general request that the Commission promulgate a "comprehensive framework" for disclosure of ESG information that is relevant to long-term risks and performance, the petition is not specific as to what ESG disclosure should be required or how the Commission should develop the substance of such a framework.

Comment: It seems unlikely that current the Commission will accept the invitation to commence rulemaking in the ESG arena. Unless a disclosure framework of the type the petitioners are seeking were limited to a general reminder that companies should disclose material information related to ESG issues, or to a requirement to follow some third-party ESG disclosure framework, formulating specific ESG disclosure guidelines would be a massive undertaking. It would likely also require expertise that the Commission does not possess.

Nonetheless, petitioners' fundamental point has merit – current voluntary sustainability disclosures lack consistency and comparability and are frequently not geared to the needs of investors. As discussed in prior **Updates**, the

Sustainability Accounting Standards Board (SASB) has developed industry-by-industry ESG disclosure standards which are aimed to providing comparable, decision-useful information concerning the subset of ESG issues that are material for each industry. See **SASB Publishes Sustainability Disclosure Exposure Draft Standards**, September-October 2017 Update. If more companies, perhaps with informal SEC encouragement, were to adopt SASB standards, the problems the petition seeks to address could be largely solved without the need for rulemaking.

However the SEC decides to deal with the petition, in the long run it seems inevitable that companies, in response to institutional investor and other demands, will continue to expand their disclosures of non-financial information related to the long-term risks and opportunities facing the company, especially those that fall under the ESG rubric. Audit committees, in turn, are likely to become more deeply involved in overseeing these disclosures and the controls necessary to assure the accuracy of such information.

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

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