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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.

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PCAOB Staff Releases its Annual Inspections Outlook

On December 6, the staff of the Division of Registration and Inspections of the Public Company Accounting Oversight Board issued Inspections Outlook for 2019. The Outlook provides information about the potential focus areas of the PCAOB's 2019 inspections of public company and broker-dealer auditors. The Outlook may be useful to audit committees in understanding why the company's auditor may devote additional time and resources to certain aspects of the audit, whether the company's engagement is likely to be selected for PCAOB review, and, if so, what audit areas are likely to attract the attention of the inspection staff.

The Outlook states that inspections are designed "to drive improvement in the quality of audit services through a focus on efficient and effective prevention, detection, deterrence, and oversight of firms' remediation of audit deficiencies." For inspections conducted in 2019, there are ten key areas of focus.

- System of quality control. The audit firm's system of quality control is the "foundation for executing quality audits," and 2019 inspections will place increased emphasis on the design and operating effectiveness of these systems. This focus on QC will include understanding whether the auditor's procedures include evaluating whether companies audited have "an appropriate code of conduct, as well as compliance programs to avoid fraud, bribery, corruption, and other violations of law, including inadvertent violations, that may have a direct and material effect on the determination of financial statement amounts."

- Independence. In past inspections, the PCAOB has identified deficiencies in firm monitoring of compliance with independence requirements, and this area will be emphasized in 2019.

- Recurring inspection deficiencies. The Outlook cites the following as recurring deficiency areas: auditing internal control over financial reporting, revenue recognition, allowance for loan losses, and other accounting estimates, including fair value measurements (e.g., goodwill and intangible assets). Assessing and responding to identified risks material misstatement is also a recurrent issue. Inspections will focus on how firms identify and correct recurring audit deficiencies.

- External considerations. Risks of material misstatement can arise from factors external to a company, such as economic conditions, and the auditor's risk assessment procedures should include consideration of relevant external factors. In this regard, the inspections staff will also assess how firms evaluate audit evidence "obtained through external sources, such as industry or economic data that potentially contradicts management assertions."

- Cybersecurity risks. The staff will "continue to evaluate the audit procedures firms use to identify and determine whether cyber risks and actual breaches pose risks of material misstatement to companies' financial statements."

- Software audit tools. Inspections will monitor the use of software audit tools and will consider whether such tools are employed in a way that is consistent with due care, including professional skepticism.

- Digital assets. Inspections will focus on three aspects of digital assets: (1) audit responses to risks associated with digital assets (including cryptocurrencies, initial coin offerings, and distributed ledger technology), (2) client acceptance and retention decisions, resource management, and planned audit procedures, and (3) independence issues arising from new digital asset-related service lines.

- Audit quality indicators (AQIs). The PCAOB defines audit quality indicators as "a potential portfolio of quantitative measures that may provide new insights about how high quality audits are achieved." Inspections will include consideration of how audit firms use AQIs to monitor their audit work and of whether auditors discuss AQI results with audit committees. The Outlook characterizes this as "part of our information gathering activities."

- Changes in the auditor's report. The implementation of CAM reporting will be part of 2019 inspections. (See The CAQ Has Ten Audit Committee Questions About CAMs (and the Answers) in this Update.) Inspectors will monitor both pre-effective dry runs and compliance after the requirement becomes effective.

- Implementation of new accounting standards. 2019 inspections will focus on how new accounting standards affect audit firm procedures and on how firms audit implementation of new standards, including the impact of new standards on the design and operating effectiveness of internal controls. New standards referenced in the Outlook are revenue recognition, lease accounting, current expected credit losses, and financial instrument accounting.

Comment: The most recent prior preview of inspections priorities was issued on August 30, 2017. See PCAOB Staff Issues 2017 Inspections Road Map, September-October 2017 Update. While many of the issues identified in the 2019 Outlook are similar to those in the 2017 Inspection Brief, there are some noteworthy changes. For example --

- Audit firm quality controls have moved from last place to first place on the list and is the topic discussed in the most depth. This is consistent with PCAOB board member and staff statements that suggest the center of gravity in inspections may be shifting from finding deficiencies in particular audits to evaluating the audit firm's controls and procedures. See, e.g., Botic, Protecting Investors Through Change (December 12, 2018) and Hamm, Quality Control: The Next Frontier (November 30, 2018). Several other topics discussed in the Outlook are also described in a way that seems to put more emphasis on the design and implementation of audit firm QC procedures than on possible engagement deficiencies (e.g., independence, digital assets, software tools, and new accounting standards).

- While the auditing of internal control over financial reporting remains on the list, it seems to be de-emphasized. ICFR audit deficiencies have, for the last several years, been the great majority of Part I findings in PCAOB inspection reports on the major firms. See Three-Firm 2016 Inspection Reports Summary, August-September 2018 Update. The PCAOB's strict inspections approach to ICFR auditing has had spill-over effects on public companies, and most public companies would regard less scrutiny in this area as a welcome development.

- The auditor's review of public company codes of conduct, anti-bribery compliance programs, and other aspects of legal compliance is a new area of emphasis this year. This has not traditional been an area in which the PCAOB has found audit deficiencies, and it is unclear what highlighting it will mean in practical terms.

- "External considerations" are treated at a higher level than in the past. Previous bulletins of this type have discussed specific macroeconomic developments that may affect audit risk (e.g., Brexit, low interest rates, M&A activity, fluctuating oil and gas prices). The 2019 Outlook does not cite any specific trends and seems to treat external events as primarily impacting the auditor's evaluation of management assumptions and disconfirming evidence.

- The use of audit quality indicators, by both audit firms and audit committees, has been added to the list. The PCAOB issued a concept release on AQIs in 2015, but has not followed up. See PCAOB Publishes Concept Release on Audit Quality Indicators, July 2015 Update. Using the inspections program to gather information may foreshadow renewed PCAOB interest in AQIs.

Audit committees may have opportunities to discuss these issues with the PCAOB's inspections staff. While not mentioned in the Outlook, in a recent speech, PCAOB Chair Duhnke stated that many engagement inspections will include audit committee interviews. See A Re-Vamped PCAOB Inspections Program Will Feature More Communications With Audit Committees, October-November 2018 Update.

The CAQ Has Ten Audit Committee Questions About CAMs (and the Answers)

As discussed in several prior Updates, last year the Public Company Accounting Oversight Board adopted a requirement for auditors of SEC-registered companies to include in their audit opinions a discussion of critical audit matters (CAMs) – the most challenging or complex aspects of the audit. See PCAOB Adopts New Auditor's Reporting Model, May-June 2017 Update. This requirement will take effect for large accelerated filers for audits of fiscal years ending on or after June 30, 2019; for other public companies, the requirement will apply to fiscal years ending on or after December 31, 2020.

A CAM is defined as matter that was communicated, or required to be communicated, to the audit committee and that relates to accounts or disclosures that are material to the financial statements, and involved especially challenging, subjective, or complex auditor judgment. CAM disclosure in audit opinions will mark a major change in auditor reporting and in the relationship between public companies and their auditors. In order to prepare, many auditors have performed "dry runs" of CAM reporting with their clients. In a dry run, the audit firm identifies CAMs, discusses them with management and the audit committee, and drafts the CAM disclosure that would appear in the auditor's report if the new requirement were already in effect.

On December 10, 2018, the Center for Audit Quality (CAQ) released Critical Audit Matters: Lessons Learned, Questions to Consider, and an Illustrative Example. This publication summarizes some of the points that have come out of the dry runs and contains ten questions that audit committees should consider in connection with CAM reporting. The new publication also contains an illustrative example of a CAM (relating to goodwill impairment) and appendices setting out the basics of the CAM reporting requirement and a list of additional resources. A prior CAQ publication on CAM reporting, Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements, was discussed in CAQ Explains CAMs, June-July 2018 Update.

Dry Run Lessons Learned

The CAQ describes four points as early lessons learned from the dry runs.

- Determining which matters are CAMs involves applying a principles-based approach and significant auditor judgment.
- It is important for the auditor to communicate with management and the audit committee early and often in the process of identifying and drafting CAMs.
- Auditors, preparers, audit committees and others should plan accordingly for the time it will take to determine and draft CAMs
- Drafting CAMs can be challenging.

CAM Audit Committee Questions

Based on the dry runs experience, the CAQ formulated questions to promote dialogue and to assist audit committees in understanding the impact of identifying and communicating CAMs. These questions, along with a brief synopsis of the CAQ's commentary on each, is below.

1. How will CAMs relate to disclosures made by management in the Form 10-K outside the financial statements? Since CAMs, by definition, relate to accounts or disclosures that are material to the financial statements, there will necessarily be a relationship between the company's disclosures and the auditor's CAM reporting. In particular, MD&A disclosures may shed light on information in a CAM description.

2. Will there be a CAM for every critical accounting estimate disclosed by management? Not necessarily, since not every critical accounting estimate involves an especially challenging, subjective, or complex auditor judgment.

3. Will there be a CAM related to every significant risk identified by the auditor? Not necessarily, since not every significant risk involves an especially challenging, subjective, or complex auditor judgment. Conversely, some CAMs may arise from audit risks that emerge during the engagement and were not initially identified and communicated to the audit committee.

4. Can a significant deficiency in internal control over financial reporting (ICFR) be a CAM? Yes, although a significant deficiency is not, in itself, a CAM. The existence of a significant deficiency could, however, be a principal consideration in determining whether the matter to which the deficiency relates is a CAM.

5. What matters will likely be the more common CAMs? CAMs are most likely to arise in areas involving a high degree of "estimation uncertainty" and management judgment. Examples include the auditing of goodwill impairment, intangible asset impairment, business combinations, aspects of revenue recognition, income taxes, legal contingencies, and hard-to-fair-value financial instruments.

6. How comparable will CAMs be across companies in the same industry? CAMs are supposed to be specific to each company's audit. However, auditors of companies in the same industry could well identify similar matters as CAMs. Even if that occurs, the auditor's discussion of the CAMs in the audit report may vary because the auditor’s risk assessment and audit response will vary based on the company’s processes and controls.

7. Are CAMs similar to key audit matters? The auditor's report on an audit performed under the International Standards on Auditing (ISAs) must disclose key audit matters (KAMs). There are "commonalities" in the ways that KAMs are identified in an ISA audit and the identification of CAMs in a PCAOB audit. As a result, many of the same matters are likely to be disclosed by the auditor, regardless of which set of auditing standards governs the audit. The most significant difference is that CAMs must relate to a material account or disclosure, while KAMs are matters that required significant auditor attention and were the most significant to the audit. For example, implementation of a new IT system might be a KAM, but not a CAM, since IT implementation could affect the

audit, but does not relate to a material financial statement account or disclosure.

8. Is it expected that auditors will always communicate at least one CAM in the auditor's report? While it is possible that an audit could involve no CAMs, the PCAOB has stated that it expects auditors to identify at least one CAM in most audits.

9. What is the auditor's process for drafting the CAM section of the auditor's report, and at what point in that process should management and the audit committee expect to be involved? Audit firm processes will vary, but the auditor, management, and the audit committee should establish a process under which there will be ample opportunity for management and the committee to review and discuss draft CAM disclosure before the audit report is issued.

10. How can companies prepare for questions about CAMs from investors? Audit committee members and management should fully understand why each matter disclosed as a CAM involved especially challenging, subjective, or complex auditor judgment.

Comment: Audit committees should expect their auditor to perform a dry run, at least to the extent of informing the committee what the CAMs would be, if the new disclosure requirement were already in effect. This should help to avoid unpleasant surprises and, more importantly, to afford ample time for the company to consider whether it should expand its own disclosure with respect to the issues that will be disclosed by the auditor. Moreover, in some cases, CAMs may reflect control deficiencies or other issues that can be remedied now in order to avoid future CAM disclosure. Once the requirement is in effect, audit committees should expect the auditor to have a process in place that informs the committee of each year's CAMs, and provides draft disclosure concerning them, well in advance of the issuance of the auditor's report.

SEC Chief Accountant Focuses Again on Audit Committees

During the past several years, SEC Chief Accountant Wes Bricker has given a series of speeches outlining his expectations of public company audit committees. See SEC Chief Accountant Addresses the Purpose and Promise of Financial Reporting, June-July 2018 Update. In a December 10 statement submitted for the American Institute of Certified Public Accountants' annual conference on Current SEC and PCAOB developments, Mr. Bricker added to his body of commentary on audit committees.

The December 10 statement is a comprehensive update on the work of the SEC's Office of the Chief Auditor and on current accounting and auditing oversight issues. With respect to audit committees, Mr. Bricker makes several points.

- Role of the audit committee. Both management and directors have a "vital interest" in the quality of the company's books and records and related internal accounting controls. Auditing and financial reporting generally are enhanced by strong, independent audit committees. The audit committee must be committed to oversight of financial reporting, and this requires "a

properly balanced agenda" geared to the accounting, internal control over financial reporting (ICFR), and reporting requirements.

- Audit committee membership. "Companies and directors should carefully choose who serves on their audit committees, selecting those who have the time, commitment, and experience to do the job well. Just possessing financial literacy may not be enough to understand the financial reporting requirements fully or to challenge senior management on major, complex decisions. Audit committees must stay abreast of these issues through adequate, tailored, and ongoing education."

- Audit committees and ICFR. As business, technology, accounting, and reporting requirements change, it is crucial that the audit committee understand management's approach for designing and maintaining effective internal controls. "To illustrate, does the audit committee understand management's approach to attract, develop, and retain competent individuals who have responsibility for the design and operation of manual control activities, which are applicable when reasonable judgment and discretion is required, such as may arise in the application of the revenue recognition standard?" The audit committee can also glean insights into the company's controls from discussion with the auditor about "whether, where, and why they were unable to rely on internal controls."

- Auditor/audit committee communications. The audit committee's expectations for clear and candid communications from the auditor should not be taken lightly, particularly when it is time to evaluate the relationship with the auditor. Conversely, the auditor should expect appropriate support and tone from the audit committee when issues arise.

- Audit committee's role in the implementation of new accounting standards. The audit committee plays a significant role in the oversight of management's implementation of new accounting standards. Audit committees should understand management's plans to help achieve a high-quality implementation and ongoing application of a new standard. Audit committee oversight can also foster management rigor in establishing appropriate controls and procedures over transition; maintaining appropriate controls and procedures over ongoing application of the new standard; and understanding how the effects of the new standard are communicated to investors.

- Audit committee transparency. Many audit committees voluntarily provide enhanced disclosure regarding their role in auditor oversight. Listed company audit committees should communicate how they carry out the listing requirements related to the appointment, compensation, and oversight of the work of the company's accounting firm. Mr. Bricker discussed some of the findings of the Center for Audit Quality/Audit Analytics survey of S&P 1500 proxy statement disclosures concerning the work of the audit committee. (This survey is described in CAQ and EY Audit Committee Transparency Reports: Disclosure Continues to Grow Apace, October-November 2018 Update.) He

characterizes the survey as showing "positive trends * * * but with opportunities for more progress among mid- and small-cap companies."

Comment: Taken together, Mr. Bricker's speeches on audit committee responsibilities are a primer on what public company audit committees should be doing. Also, as noted in prior Updates, his comments provide insight into how the SEC staff views the role of audit committees and what the staff may look for in situations in which the audit committee's performance is an issue.

Protiviti Has Suggestions for the Audit Committee's 2019 Agenda

Global consulting firm Protiviti has published Setting the 2019 Audit Committee Agenda, its annual list of topics that audit committees should consider during the coming year. Protiviti's suggested agenda items are based on "input from our interactions with client audit committees, roundtables and surveys we conducted during 2018, as well as discussions with directors in numerous forums." Setting the 2019 Audit Committee Agenda also contains guidance for an audit committee effectiveness self-assessment, including illustrative questions that audit committees should ask as part of such a self-assessment.

Protiviti identifies eight audit committee topics, which it divides into two groups -- Enterprise, Process and Technology Risk Issues and Financial Reporting Issues. The four Enterprise, Process and Technology Risk Issues are:

1. Understand and consider risks that could affect the business and its reporting. To fulfill its financial reporting responsibilities, the audit committee must be aware of business and enterprise risks facing the company and how those risks are changing. "Geopolitical events, digital disruption trends, organizational culture dysfunction, cybersecurity incidents, new laws and regulations, litigation and pending unasserted claims, and other developments should be identified in a timely manner, and their financial reporting implications understood." In this regard, Protiviti lists the top ten risks for 2019 -- all of which it says are increasing compared to last year and most of which arise from technology. Briefly summarized, these ten risks are:

- Operations and IT infrastructure may not be able to meet expectations compared to the performance of competitors, especially competitors that are "born digital".
- Succession and talent attraction and retention may limit the company's ability to meet goals.
- Regulatory changes and scrutiny may increase.
- Cyber threats may disrupt operations or damage the brand.
- Resistance to change may restrict the ability to make necessary changes.
- Disruptive innovations resulting from new technology may require significant business model changes.

- Ensuring privacy and information security may require significant resources.

- Inability to utilize data analytics to develop market intelligence and increase productivity may affect operations and planning.

- The organization's culture may not encourage identification of risk issues.

- Changing preferences and demographics may erode customer loyalty.

2. Understand the impact of change on finance and its ability to deliver on expectations. Digital technology is rapidly changing the finance function, particularly finance's role in providing more timely and reliable information for senior management decision-making. The audit committee needs to understand these changes and make sure that finance has adequate resources to meet its new expectations. "It is not good enough to merely ask the auditors for their view on the finance team. * * * [I]t is worthwhile for committee members to spend one-on-one time with the CFO and other senior finance leaders to ascertain whether they have the right skills, number of people and other resources in their department to manage the company's financial and reporting risks."

3. Pay attention to ESG and integrated reporting developments. As investor interest in using environmental, social, and governance (ESG) criteria in decision-making grows, companies "are finding it compelling, for a variety of reasons, to disclose their performance against ESG criteria." As ESG disclosures increase, the audit committee needs to focus on the effectiveness of controls and procedures that provide reasonable assurance that these disclosures are fairly presented. (This point has been a theme of numerous Update items. See, e.g., Institutional Investors Want the SEC to Require Standardized ESG Disclosure, October-November 2018 Update.)

Protiviti also recommends that audit committees monitor the trend toward integrated reporting -- a single report that addresses the company's stewardship in deploying various forms of capital in the business, including financial, manufactured, intellectual, reputational (social, cultural and community relationships), human and natural. "As with ESG reporting, the audit committee's oversight emphasis on integrated reports -- if the company were to issue one -- should be on the effectiveness of the related disclosure controls and procedures."

4. Ensure that internal audit is evolving to its highest and best use. Like finance, internal audit is being disrupted by technology. Protiviti's research indicates that the "maturity" of digital technologies and data analytics in internal audit processes "remains relatively low, particularly in North America." Audit committees should encourage internal audit to make greater use of analytics. As to substantive areas on which internal audit should focus, fraud, cybersecurity threats, third-party risk, enterprise risk management and corporate culture are top internal audit priorities in 2019. Other matters that Protiviti suggests internal audit consider include EU and state legislation regarding the collection and use of personal data, new accounting standards (e.g., revenue recognition and lease accounting), and ESG and sustainability reporting.

The four Financial Reporting Issues are:

1. Oversee the financial reporting process and implementation of the new lease accounting standard. The audit committee's core responsibility is overseeing the fairness of management's approach to presenting the enterprise's financial position, results of operations, and cash flows. Protiviti highlights three aspects of this responsibility --

- Making sure that corporate initiatives, such as cost-reduction plans, don't compromise financial reporting.

- Understanding the purpose for the disclosure of non-GAAP measures and key performance indicators and the effectiveness of the processes and controls that generate this information and ensure its consistency with prior periods.

- Overseeing the implementation of new accounting standards, such as revenue recognition and lease accounting.

2. Focus on critical audit matters raised by the auditor. The CAM reporting will be a major issue for most audit committees. See The CAQ Has Ten Audit Committee Questions About CAMs in this Update. Protiviti emphasizes that CAMs may represent an opportunity to evaluate whether improvements need to be made to the financial reporting process. "For example, if there are significant judgmental issues on which management and the auditor do not see eye to eye or if management is applying aggressive accounting principles, they represent an opportunity for the organization to streamline and improve the entity's accounting and reporting."

3. Understand issues raised by the PCAOB and the SEC that might impact the audit process. As to PCAOB inspections, Protiviti recommends that audit committees "remain vigilant" in audit areas where significant deficiencies have been found in recent PCAOB inspections, including internal control over financial reporting, accounting estimates and fair value determinations, goodwill impairment analyses, valuations of ill-liquid securities, going concern assessments, and income tax disclosures. With respect to the SEC, Protiviti asserts that the Commission appears to be more concerned with issues that don't directly affect audit committees, but can "raise issues affecting the company's public reporting at any time in a variety of ways."

4. Focus on other financial reporting areas of significance. Along with revenue recognition, lease accounting and non-GAAP disclosures, the audit committee should "ensure that lessons learned from the preparation of the 2018 financial statements are internalized and addressed in 2019." In addition, financial institutions should focus on implementation of the new standard for measuring financial instrument credit losses, which becomes effective for public companies in 2020.

Comment: Many large accounting and consulting firms publish annual lists of issues that should be on the audit committee's radar during the coming year. Which each company's circumstances and challenges vary, these lists can serve as a useful check as audit committees develop their plan for 2019. In this regard, Protiviti's suggestions are worth considering.

SEC Enforcement Ticks Up, but not for Financial Reporting

Two reports on the SEC's 2018 enforcement efforts -- one issued by the Division of Enforcement itself -- portray the agency's enforcement program as active, even aggressive, but not particularly focused on financial reporting and auditing. While in line with historical averages, the number of enforcement cases involving public company financial reporting and disclosure declined in 2018, as compared to 2017.

SEC Division of Enforcement Report

According to the Annual Report of the Division of Enforcement, released on November 2, the Commission brought 821 enforcement actions during the fiscal year ended September 30, 2018. That reflects nearly a nine percent increase over the 754 cases commenced in fiscal 2017. In 2018, parties to SEC actions were ordered to pay in excess of $3.9 billion in penalties and disgorgement. Not including proceedings that were a follow-up to another enforcement case or cases involving only delinquent filings, the SEC brought 490 "stand-alone" law enforcement actions in 2018.

Individual culpability continued to be a hallmark of SEC enforcement. The Annual Report states that "individual accountability is critical to an effective enforcement program and is one of the core principles of the Division of Enforcement." In 2018, 72 percent of the stand-alone actions involved charges against one or more individuals, essentially the same as in the 73 percent that named individuals in 2017.

With respect to public company reporting and disclosure, the Enforcement Division reports that the Commission brought 79 stand-alone actions in 2018 (roughly one-sixth of all such actions), compared to 95 cases in 2017. In the 79 proceedings, 54 entities and 94 individuals were named. The allegations included financial reporting and disclosure violations in the following categories: "revenue and expense recognition problems; faulty valuation and impairment decisions; missing or insufficient disclosures; misappropriation through accounting misrepresentations; inadequate internal controls; and misconduct by financial reporting gatekeepers." The only auditing-related case including in the Division's list of "Noteworthy Enforcement Actions" didn't involve a public company; the six auditor defendants in that case were former PCAOB staff members and senior officials at an accounting firm to whom the PCAOB staffers leaked information concerning upcoming inspections.

Cornerstone Research Report

A report issued by economic consulting firm Cornerstone Research on fiscal 2018 cases, SEC Enforcement Activity: Public Companies and Subsidiaries, paints a similar picture. That report, released on December 11, analyzed data from the Securities Enforcement Empirical Database (SEED), which tracks information on SEC enforcement actions against exchange traded public companies and their subsidiaries. (SEED was created by New York University's Pollack Center for Law & Business in cooperation with Cornerstone.)

Cornerstone finds that, of the 490 stand-alone actions brought in 2018, 71 were against public companies, a nine percent increase over 2017. The 71 cases include actions alleging all types of violations, not just financial reporting and disclosure. In fact, 45 percent of the new cases against public companies involved broker-dealer, investment advisor, or investment company violations, while 13 percent alleged Foreign Corrupt Practices Act violations. However, the most common types of allegations against a public company or subsidiary were reporting or disclosure violations (34 percent of all such cases). This was down from 40 percent in 2017 and slightly below the average of 37 percent of public company cases during the period 2010 to 2017.

Cornerstone reports that individuals were named as defendants in 23 percent of the public company actions in fiscal 2018, consistent with the historical average of 24 percent. More than half of the individuals named in public company cases during 2018 were either CEOs or CFOs. Fifty-four percent of actions that involved reporting and disclosure violations also named an individual defendant.

Half of all public company cases (51 percent) were brought against companies in the Finance, Insurance, and Real Estate SIC industry division. No cases were brought against companies in Transportation, Communications, Electric, Gas, and Sanitary Services; Wholesale Trade; or Agriculture, Forestry, and Fishing divisions.

Comment: Public company financial reporting and disclosure cases don't seem to be a current SEC enforcement top priority. They are, however, year-in and year-out, a core component of the enforcement program. And, when such a case is brought, the odds are substantial that one or more individuals will be named, along with the reporting company, and that the CEO or CFO will be among those individuals. While such cases have been brought in the past, it does not appear that any 2018 financial reporting case involved an individual in his or her capacity as an audit committee member.

SASB Releases its Codified Standards

On November 7, the Sustainability Accounting Standards Board announced the publication of its codified standards for industry-specific disclosure of financially material sustainability information. Because of increasing investor interest in sustainability disclosure (see, e.g., Institutional Investors Want the SEC to Require Standardized ESG Disclosure, October-November 2018 Update), audit committees may want to be familiar with the SASB standards for their industry and to consider use of the standards. (The author of the Update is a member of the SASB Standards Board.)

SASB is an independent, non-profit standards-setting organization. Its mission is to facilitate disclosure of material sustainability information so that investors have access to environmental, social, and governance (ESG) information that is necessary to informed investment decisions. SASB is not a government agency, and compliance with its standards is voluntary.

SASB views sustainability as having five dimensions – environment; social capital; human capital; business model and innovation; and leadership and governance. Since the materiality of particular ESG issues varies, depending on the industry or industries in which a

company operates, SASB standards are industry-specific. Using an evidence-based process which includes company and investor input, SASB has identified sustainability topics that are likely to be material under the securities law definition of material for each of 77 industries. For each topic, SASB has developed metrics -- specific, quantifiable information that provides a basis for evaluating the company's performance on the ESG topic to which the metric relates. SASB standards are intended to be a useful guide for company disclosure; the final decision as to what ESG issues are material rests with the reporting company.The 77 industry-specific sets of sustainability accounting standards that comprise the codified standards include, on average, six disclosure topics and 13 performance metrics per industry. The standards focus on the most business-critical sustainability issues for each industry, such as water management for beverage companies, data security for technology firms, and supply chain management for consumer goods manufacturers and retailers. The SASB standards can be downloaded for any of the 77 industries at SASB's website, www.SASB.org.

The final SASB standards were formulated through a six year process that involved technical research and market consultation. Between August 2013 and March 2016, SASB issued provisional standards for the industries in its reporting universe. Based on market feedback on the provisional standards, and regulatory changes or scientific advances, SASB developed a series of proposed changes to the provisional standards. On October 2, 2017, SASB published exposure drafts of its proposed final standards for public comment. See SASB Publishes Sustainability Disclosure Exposure Draft Standards, September-October 2017 Update. In the press release, SASB stated that, in drafting the exposure draft standards, it gave priority to improving "the quality of the standard, including the materiality and decision-usefulness of the information the standard is designed to yield and the cost-effectiveness of implementation." After reviewing the public comment, SASB adopted the final, codified standards on October 16, 2018.

In connection with the publication of the codified standards, SASB Chair Jeffrey Hales stated: "What makes SASB standards unique in the marketplace is their focus on industry specificity and financial materiality, universal concepts that are important for investors and businesses around the world. This is an important milestone for global capital markets. Companies and investors around the world now have codified, market-based standards for measuring, managing, and reporting on sustainability factors that drive value and affect financial performance."

Comment: As noted in prior Updates, sustainability reporting is rapidly becoming the norm for large public (and many smaller and private) companies. See Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture, March 2018 Update. Most companies face some level of investor, customer, and/or supplier demand for more transparency concerning ESG issues, particularly those related to its supply chain integrity and climate change response. Corporate sustainability reports and other disclosures that seek to satisfy this demand are common.

However, these types of company-unique sustainability disclosures are not standardized, not necessarily focused on issues that are material, and frequently not designed to meet the needs of investors. Investment decision-making based on comparisons between companies (and

analysis of the same company over time) is often difficult. Voluntary adoption of SASB's standards would address these issues. As noted above, companies and audit committees should consider becoming familiar with the SASB standards that apply to the industry or industries in which they operate and consider incorporating SASB's standards into their sustainability disclosure.

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

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