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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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

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We're From the PCAOB and We're Here to Help You: 2019 Staff Inspections Outlook for Audit Committees

PCAOB Chair Duhnke has stated that the Board is revising its approach to inspections and that one feature of the new inspections program will be greater interaction with the audit committees. See A Re-Vamped PCAOB Inspection Program Will Feature More Communication with Audit Committees, October-November 2018 Update. On March 14, the PCAOB staff released 2019 Staff Inspections Outlook For Audit Committees, which describes what this increased PCAOB/audit committee communication will entail, lists 2019 key areas of inspection focus, and suggests questions audit committees may want to raise with their auditor.

The Outlook For Audit Committees explains that one of the Board's strategic objectives is to engage in "more proactive communication" with stakeholders, including audit committees. In furtherance of that objective, during 2019, the inspections staff will "provide an opportunity for audit committee chairs of certain companies whose audits are subject to inspection to engage in a dialogue. The purpose of the audit committee dialogue is to provide "further insight into our process and obtain their views." The staff also plans to publish further updates regarding inspections, including "observations from these interviews and our inspection findings."

In December, the PCAOB issued an overview, aimed primarily at auditors, of the issues that it would target in 2019 inspections. See PCAOB Staff Releases its Annual Inspections Outlook, December 2018 Update. The Outlook for Audit Committees supplements that document with a list of seven topics on which 2019 inspections will focus:

- Technological developments affecting audits, including the use of software audit tools, and the audit response to risks associated with cybersecurity incidents, digital assets, and distributed ledgers.

- Audit firms' actions addressing past inspection findings in areas of repeat deficiencies, including auditing internal control over financial reporting, revenue recognition, allowance for loan losses, other accounting estimates, and assessing and responding to the risks of material misstatement such as consideration of any changes in external factors affecting the company.

- Audit procedures on new accounting standards, including internal control effects regarding revenue recognition (ASC 606 and IFRS 15), lease accounting (ASC 842 and IFRS 16), current expected credit losses (ASC 326), and financial instrument accounting (ASC 815 and IFRS 9).

- Audit firms' use of Audit Quality Indicators (AQIs) to monitor their audit work, including any discussions of AQIs with audit committees.

- Implementation of the new auditor's reporting model requirements, including understanding implementation experiences related to the auditor's reporting of critical audit matters (CAMs).

- Audit firms' systems of quality control, including the firms' cultures and their policies and procedures, and how firms promote consistency in audit quality.

- Auditor independence, with particular attention to recurring deficiencies in firms' monitoring procedures to identify independence violations

In addition to these key areas of focus, the Outlook for Audit Committees includes 17 questions that audit committees may want to discuss with their auditor. These sample questions are grouped under the headings listed below:

- Auditor Response to Identified Risks (e.g., "How has the auditor assessed potential risks of material misstatement related to the company's technology systems, including cyber security, and how has it addressed those potential risks?")

- Changes in Auditor's Report (e.g., "What items, if any, were considered 'close calls' but ultimately not identified as a CAM by the auditor? Why were these items not determined to be CAMs?" [Beginning this year, critical audit matters (CAMs) must be disclosed and discussed in the auditor's report – See PCAOB Issues New Guidance on CAM Reporting in this Update.)

- Implementation of New Accounting Standards (e.g., "What is the auditor's view of the company's readiness to adopt new accounting standards pertaining to lease accounting and valuation of financial instruments, including credit losses (if relevant)?")

- Quality Controls (e.g., "Did the audit include the use of software audit tools? If so, how were these tools used and how did the use of these tools affect the risk assessment and the quality of audit evidence?")

- Auditor Independence (e.g., "How can the audit committee and management assist the auditor in complying with independence requirements?")

- PCAOB Inspection Results and Corrective Actions (e.g., "If the firm has been inspected by the PCAOB, were there inspection findings? If so, what were those findings and what corrective actions has the firm taken?")

- Possible Indicators of Audit Quality (e.g., "How does the firm identify, set targets for, and monitor those key drivers [of audit quality] generally, and specifically with respect to this audit engagement?")

Comment: The PCAOB's goal of opening more channels of communication with audit committees and providing more transparency concerning its inspection processes is certainly laudable. The two-page Outlook is readable and should be a useful tool for audit committees. In particular, the suggested discussion questions deserve consideration as audit committees plan their oversight of the auditor's work.

The opportunity for audit committee chairs to have a dialogue with the inspections staff is also a positive step. Many audit committee chairs would welcome the opportunity to gain a better understanding of the PCAOB's inspection process and offer their suggestions. Whether these conversations would also include discussion of the PCAOB staff's findings with respect to the company's audit is not clear. The PCAOB staff will likely be unwilling to provide specific information concerning the results of the inspection. However, if that were to occur, it could raise thorny questions in some cases. For example, the PCAOB inspection staff sometimes concludes that the company's financial statements reflect a GAAP error that the auditor failed to detect or that the auditor's opinion is not supported by sufficient evidence (thus calling its reliability into question.) If an audit committee chair were to receive that type of information from the PCAOB inspection staff, his or her next call should be to securities counsel.

PCAOB Staff Issues New Guidance on CAM Reporting

On March 18, the PCAOB staff added to the growing body of advice and guidance on the implementation of the new requirement for auditors to discuss in their reports critical audit matters (CAMs). The PCAOB released three documents:

- Implementation of Critical Audit Matters: The Basics
- Implementation of Critical Audit Matters: Staff Observations from Review of Audit Methodologies
- Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs

In a press statement, the PCAOB noted that the content of these documents was "informed by discussions with auditors regarding their experiences conducting dry runs of CAMs with their audit clients, the staff's review of methodologies submitted by 10 U.S. audit firms that collectively audit approximately 85% of large accelerated filers, and other outreach efforts." As part of its efforts to assist in CAM reporting implementation, the PCAOB has also created a website page entitled New Auditor's Report. Large accelerated filer CAM reporting will begin for fiscal years ending on or after June 30, 2019. For other public companies, reporting starts with fiscal years ending on or after December 15, 2020.

The Basics

As its title suggests, The Basics provides an overview of the Board's new CAM reporting standard. A CAM is defined as any matter arising from the audit of the financial statements 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.

The standard includes a list of six factors that auditors should consider in determining whether a matter involved and especially challenging, subjective, or complex auditor judgment. The Basics also discusses what auditors are required to communication about CAMs in the auditor's report and the workpaper documentation requirements for CAMs. For each matter arising from the audit that was communicated or required to be communicated to the audit committee and that relates to material accounts or disclosures, the workpapers must contain documentation of whether the matter was determined to be a CAM and the basis for that determination.

The paper also contains a brief section entitled "Interactions with the Audit Committee and Management." That section states:

> "Any matter that will be communicated as a CAM should already have been discussed with the audit committee, and the auditor is required to provide a draft of the auditor's report to the audit committee and discuss the draft with them * * *. As the auditor determines how best to comply with the communication requirements, the auditor could discuss with management and the audit committee the treatment of any sensitive information."

<u>Staff Observations from Review of Audit Methodologies</u>

The <u>Staff Observations</u> paper reports the results of the Office of the Chief Auditor's review of "CAM methodologies, practice aids, training materials, and examples" from ten firms that collectively audit the great majority of large accelerated filers. <u>Staff Observations</u> highlights "thematic observations" identified during that review. This paper appears to be intended primarily for auditors and offers "helpful insights" for audit firms as they prepare to implement CAM reporting. Three of the thematic observations are relevant to audit committees:

> <u>Source of CAMs - audit committee communications</u>. Some audit firm methodologies excluded certain audit committee communications from the source of CAMs. It is important to note that the standard does not exclude any audit committee communication from the population of potential CAMs.
>
> <u>Publicly available information</u>. When communicating CAMs in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM or how the matter was addressed in the audit.
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> Some methodologies identified "publicly available" information only as information disclosed in financial statements or a document containing the financial statements. Information can be made publicly available by the company in a variety of ways, however, including the annual report, press releases, or other public statements.
>
> <u>Discussing CAMs with the audit committee</u>. Some audit firm methodologies indicated that the auditor would provide draft CAMs for the audit committee's review and feedback. While the auditor is required to provide to and discuss with the audit committee a draft of the auditor's report and a dialogue regarding CAMs is expected, auditors should remember that CAMs are the responsibility of the auditor—not the audit committee.

<u>A Deeper Dive on the Determination of CAMs</u>

The <u>Deeper Dive</u> provides auditors with more information on the process of determining whether a matter is a CAM. It begins with a discussion, including examples, of the application of the requirement that a CAM must relate to accounts or disclosures that are material to the financial statements. The paper then lists the seven factors that the auditor should consider in deciding whether a matter involved especially challenging, subjective, or complex auditor judgment. The balance of the <u>Deeper Dive</u> consists of nine FAQs regarding CAM determinations. These FAQs may be of interest to audit committee members that are seeking a better understanding of how their auditor will identify CAMs. However, except for references to the fact that CAMs are selected from the universe of matters communicated, or required to be communicated, to the audit committee, none of the FAQs related specifically to audit committees.

<u>Comment</u>: The three staff guidance papers contain a useful overview of CAM reporting issues and constitute good, basic reading on the topic. The only aspect of the guidance that seems potentially problematic is the somewhat vague statement in the <u>Staff Observations</u> paper that could be read to discourage audit firms from providing draft CAMs for the audit committee's review and feedback, prior to presenting the full, draft audit report. The staff is certainly correct in stating that "CAMs are the responsibility of the auditor—not the audit committee." However, discussion and dialogue between the

auditor and the audit committee concerning the issues underlying CAM determinations and how the auditor plans to publicly describe CAMs in the audit report are appropriate and useful. It seems desirable for that discussion to occur as early as possible, rather than immediately before the report is issued.

International Securities Regulators List Good Practices for Audit Committees

The Board of the International Organization of Securities Commissions (IOSCO) has issued [IOSCO Report on Good Practices for Audit Committees in Supporting Audit Quality](). The IOSCO Report, which is intended to assist audit committees in promoting audit quality, contains a list of 86 "good practices" related to the structure and functioning of audit committees in the context of supporting the external auditor's work. The IOSCO Report does not address other aspects of audit committee responsibilities, such as oversight of financial reporting or of the internal auditor.

IOSCO is an international forum for national securities regulators. Its membership includes 115 regulators that collectively oversee more than 95 percent of the world's securities markets. The IOSCO Board, which issued the IOSCO Report, is comprised of 34 securities regulators, including both the SEC and the CFTC as U.S. representatives.

IOSCO's good practices do not have the force of law. As the IOSCO Report recognizes, "[n]ot all measures described in this paper may be able to be applied under the legal framework and governance structures in some jurisdictions," and "[i]rrespective of the good practices outlined in this report, audit committees should follow any laws and regulations of national or other jurisdictions that apply to the listed company."

The 86 good practices are organized under eight headings, one related to the features or attributes of an audit committee and the other seven related to particular audit committee functions. With respect to the features of an audit committee that support audit quality, the IOSCO Report lists 15 good practices (GPs), including:

- The audit committee should comprise only non-executive directors. GP#1
- There should be some introductory and periodic ongoing training for audit committee members in financial reporting, audit and the industry in which the company operates to ensure their capabilities and skills are appropriate and up-to-date. GP#4
- The audit committee should be the key representative body with which the external auditor interacts. GP#13
- The audit committee should conduct peer assessments of the performance of each of its members and assessments of its own effectiveness. GP#15

Below are the seven audit committee functions as to which the IOSCO Report describes good practices aimed at supporting audit quality, along with examples of the suggested practices:

- Recommending the Appointment of an Auditor to Members/Shareholders.
  - The audit committee should ensure that:
    - Audit fees are not reduced where this may compromise audit quality (e.g., by inadequate resourcing or insufficient work being performed). GP#18
    - Requests for tenders include objective criteria relating to both audit quality and fees with fees not being given undue weight in selecting an auditor. GP#19

    - The audit committee should assess whether the auditor adequately addresses any general findings reported publicly by an audit oversight regulator from audit firm inspections, as well as any firm and engagement specific findings from inspections of the firm and from the firm's own internal quality reviews. GP#29

- Assessing Potential and Continuing Auditors.

    - The audit committee should assess whether senior audit team members (particularly the engagement partner) are sufficiently involved throughout the audit, including at critical times, and demonstrate a good knowledge of the company's businesses, the industry and environments in which it operates, risk areas and key issues. GP#32

    - The audit committee should consider the extent to which, where the auditor uses the work of other auditors for audit work on components within a group (e.g. local or foreign branches, and subsidiaries), the auditor has processes to determine that their participation in the audit is sufficient and to satisfy the auditor regarding their qualifications and work. GP#36

    - The audit committee should discuss with the audit engagement partner how the audit firm and its affiliate firms, engagement partner, review partner, specialists and audit team members are appropriately held accountable for audit quality within their firm or network. For example, audit quality is a key consideration in performance assessments and setting remuneration. GP#40

- Setting Audit Fees.

    - The audit committee should assess whether the audit fees charged by the auditor appear adequate in relation to the work required to support an audit opinion without regard to fees that might be paid to the auditor for other services. GP#41

- Facilitating the Audit Process.

    - The audit committee should consider the extent to which the audit committee seeks explanations and advice supporting the accounting treatments chosen and, where appropriate, challenges the accounting estimates and treatments applied in the financial report. The audit committee should particularly seek external professional advice where a treatment does not reflect their understanding of the substance of an arrangement. GP#46

    - The audit committee should take reasonable steps to ensure that management has a tone and the company has a culture focused on financial reporting quality. GP#48

    - The audit committee should encourage management and staff to have a positive and helpful approach to the audit process and make enquiries of the auditor as to whether there has been a lack of cooperation. The auditor should be encouraged to raise any lack of cooperation and appropriate action should be taken by the audit committee to ensure that any lack of cooperation is addressed. GP#51

- Assessing Auditor Independence.

    - The audit committee should take reasonable steps to ensure that the audit committee has a policy regarding how to evaluate the auditor's independence. GP#53

  - The audit committee should report to the shareholders on the actions it has taken to safeguard the independence of the auditor, including satisfying itself that the auditor is independent in accordance with applicable standards. GP#60

- Communicating with the Auditor.

  - The audit committee should take reasonable steps to focus on the following:

    - The audit committee and management promptly inform the auditor of relevant correspondence or other communications from regulators or market operators (e.g. inquiries made, or concerns raised about, accounting policies, accounting estimates or material disclosures, or any matter that could have an impact on financial information reported to the market). The audit committee should also consider whether there are appropriate processes for its members to be promptly informed of any such communications. GP#64

    - If Key Audit Matters (KAMs) or Critical Audit Matters (CAMs) are required to be disclosed in the audit report, the audit committee discusses draft KAMs/CAMs with the auditor and how these affect disclosures in the financial report of accounting policies and sources of estimation uncertainty or risks in the management discussion and analysis. The audit committee should consider the need for any issues to be addressed by management or the directors (e.g. addressed in the finalization of the financial report or by improving systems and controls). GP#67

- Assessing Audit Quality.

  - The audit committee should consider the extent to which:

    - The auditor raises key issues affecting the financial report in a timely manner. GP#79

    - The auditor raises relevant and useful comments in their management letters. GP#80

    - If a regulator selected the company's audit for review, the audit committee has considered the review's scope and results when evaluating the auditor's performance and the quality of the audit. GP#84

    - If the auditor indicated that findings of an audit oversight regulator from the review of the audit files for the specific company were not significant (e.g. mere documentation matters or matters where judgements reasonably differ), the audit committee challenges this, as regulators do not generally report insignificant findings. GP#86

The IOSCO Report also suggests that audit committees consider voluntary public reporting on their role in supporting audit quality, "either in documents accompanying the financial report or another document (e.g. a statement on the company's website)." Such reporting might, for example, consist of a "discussion of the involvement of, and process undertaken by, the audit committee to support audit quality in recommending the appointment of auditors, assessing the auditor's ongoing performance, reviewing audit fees, or other areas."

Comment: Many of the IOSCO good practices are already commonly followed in the United States, or at least recognized as norms that should be followed. Nonetheless, the IOSCO Report provides a good overview of steps and procedures that support audit quality and the work of the external auditor. The IOSCO Report could be used as a checklist for audit committees that are seeking to evaluate their performance and to benchmark against the recommendations of a respected international body.

The IAA Says Boards Are Overlooking an Important Source of Risk Information – Internal Audit

On March 4, the Institute of Internal Auditors (IIA) released its annual survey of Chief Audit Executives (CAEs). The 2019 North American Pulse of Internal Audit, raises issues about potential mis-alignment between internal auditors and senior management and the board with respect to the identification and management of risks. A general theme of the survey report is that CAEs need to be aggressive in alerting audit committees (or the full board) to these risk misalignments. The report also recommends that internal audit play a role in providing assurance on information management provides to the board.

The IIA surveyed more than 500 CAEs to collect information about emerging issues and other topics of importance to the profession and internal audit management. The 2019 survey responses highlighted four key risk areas. Below is a summary of the Pulse Survey findings with respect to each, based on the survey report's Executive Summary:

- Cybersecurity and Data Protection.

  Reputational damage from cyber breaches is a top concern of 70 percent of North American CAEs. Internal audit departments have increased their work related to cybersecurity and information technology, and this area accounts for about 20 percent of the average audit plan. However, cybersecurity and IT receive less attention than do operational, financial reporting, and compliance issues, especially at publicly traded companies. The survey report recommends "[c]andid discussions with the audit committee about obstacles to internal audit's performance ensure the issues are on the record in the event a future cyber issue arises."

- Third-party Risks.

  Nearly half of CAEs have significant concerns about how their organizations address risks associated with selecting and monitoring third-party vendors and their preparedness to manage poorly performing vendors. The survey report recommends that CAEs "educate stakeholders that third-party relationships are part of the organization's ecosystem of risk and cannot be viewed as separate. What's more, CAEs must elevate concerns about weak controls on third-party risks to the audit committee. These relationships require the same level of risk management as any that affect the organization directly."

- Emerging and Atypical Risks.

  Eighty percent of CAEs have confidence in the ability of their organization to identify and assess emerging or atypical risks. However, nearly half of respondents reported that management is surprised by such a risk each year. CAEs also indicated that boards are more likely to turn to management than to internal audit to identify and assess emerging risks. The survey report recommends: "CAEs should advocate for monitoring key risk indicators (KRIs) that include precursors to emerging risks."

- Board and Management Activity.

  At 85 percent of responding organizations, internal audit rarely or never provides assurance on management information sent to the board. This contrasts to a finding of the National Association of Corporate Director's Governance Survey that directors believe that the quality of information they receive from management needs improvement. As a corollary, CAEs also believe that internal audit findings and insights do not reach the board in key risk areas. To address these issues, the IIA recommends: "CAEs should be prepared to provide assurance on information going to the board and push to attend/participate in other key board committees, such as IT, risk, or compensation committees, to ensure internal audit's views are clearly communicated to the board."

The Executive Summary concludes with these observations:

> "By leveraging insights from this year's Pulse, CAEs can better inform stakeholders about potential underperformance in these key risk areas and take advantage of recommended strategies for identifying and addressing any areas of weakness or misalignment that may exist in their organizations. By having the discussion with the audit committee, concerns are put on the record for action. * * *
>
> "Any area of misaligned risk not only presents clear risks to the organization, it can also undermine the confidence in internal audit should things go awry. As is often the case in times of crisis, internal audit falls victim to the inevitable question of "Where were the internal auditors?" CAEs can protect against such criticism by raising their voices when misalignment or control weaknesses go unaddressed or when new risks are not properly addressed. After all, a risk not communicated is a risk assumed."

Comment: The Pulse Survey report provides insight on the perspective of CAEs on risk and how well (or poorly) informed boards are concerning it. While the capabilities and resources of internal audit staffs vary, the idea that internal audit could provide more support to the board in major risk areas, such as cybersecurity, is sound. In addition to its recommendations in the four risk areas discussed, the report contains an appendix which presents useful information on the survey responses regarding internal audit plans, staffing, and practices. Audit committees may find this data useful in evaluating the resources and activities of their company's internal audit function.

Morgan Stanley Finds that Three-Quarters of Asset Managers Use Sustainability Information, and PwC Has Advice on How to Provide It

Most institutional investment managers say that they have incorporated consideration of sustainability, or environmental, social and governance (ESG) factors, into their investment strategies. See Investor Demand for ESG Information is Growing, and the SEC and PCAOB Want to Help, June-July 2016 Update. Most large public companies (and many smaller companies) publish information concerning their ESG performance and the impact of ESG factors on the company and its strategy. See Sustainability Reporting and Responsibility are Becoming Part of Corporate Culture, March 2018 Update. However, surveys typically indicate that there is a wide gulf between the ESG information companies disclose and the ESG information their investors consider decision-useful. See Institutional Investors Say They Use ESG Information, But Aren't Satisfied with What They are Getting, April 2017 Update and The New Expectations Gap: ESG Disclosure, October-November 2016 Update.

Two recent reports highlight both sides of this divide and suggest ways of bridging the gap. Increasing investor demand for reliable, quantified ESG information is likely to make this problem and its solution an audit committee agenda item.

Morgan Stanley Institute for Sustainable Investing

The Morgan Stanley Institute for Sustainable Investing and Bloomberg L.P. commissioned a survey of 300 U.S. asset management professionals at firms with at least $50 million in client assets. The objective of the survey, which updates similar research in 2016, was to determine how asset managers are delivering sustainable investing solutions to clients and where they see growth and opportunity in this area. The survey report, Sustainability Signals: Growth and Opportunity in Asset Management, which was released on February 21, has four central themes:

- Sustainable Investment Goes Mainstream

  Seventy-five percent of respondents reported that their firm has adopted sustainable investing, an increase from 65 percent in 2016. Forty-four percent say their firm has "incorporated sustainable investing widely", while 31 percent are "exclusively focused" on sustainable investing. The way sustainability is incorporated into investment approaches varies, with 51 percent of those who have adopted sustainable investing reporting that they employ "ESG integration", that is, proactively considering ESG criteria alongside traditional financial analysis. Eighty-nine percent of respondents said that sustainable investing is "here to stay" and 63 percent expect adoption to grow in the next five years.

- A Financial Case for Sustainable Investing

  Most of those surveyed regard sustainable investment as financially driven, although 76 percent also recognize that there is a perception that sustainable investing requires a financial trade-off. The survey respondents themselves do not generally share that perception: 87 percent thought it was possible to "achieve financial returns alongside social or environmental impact", and 62 percent thought it was possible to maximize returns while investing sustainably. As to why investment management firms incorporate sustainability into their investment approach, the top reasons reported all suggest that the decision was a response to client demand.

- Product Types Proliferate, Expanding Investor Choice

  Sixty-two percent of respondents said that their firm offered mutual funds that integrate sustainability or ESG considerations into portfolio decisions. Other products offered included alternative investment vehicles (55 percent), exchange traded funds (51 percent), and separately managed accounts (45 percent). Forty-three percent of respondents said that their firms' practice "shareholder engagement as an approach to sustainable investing." (This would presumably include sponsoring or supporting shareholder resolutions and discussion with management regarding ESG issues.)

- Expertise, Better Data and Impact Reporting Support Customization and Drive Future Success

  Sixty-eight percent of respondents anticipate that growth in sustainable investing will come from customized products and portfolios. Eighty-nine percent said that their firm would devote more resources to sustainable investing in the next one to two years.

Morgan Stanley concludes that the asset management industry would benefit from "putting their support and resources" behind three developments:

1. Standardization of ESG definitions and metrics. There is "significant confusion around definitions of sustainable investing and approaches to measuring social and environmental impact", and a "common language of sustainable impact" is needed to overcome this challenge. The report refers to the efforts of the Sustainability Accounting Standards Board, which has promulgated industry-specific sustainability standards, including metrics. See SASB Releases its Codified Standards, December 2018 Update.

2. Training and development for ESG leaders. An ESG talent war could be looming in asset management. Individuals should see this as a career-building opportunity.

3. Proof of performance for sustainable investments. Research that demonstrates that there is no trade-off between sustainable investing and financial returns would help to accelerate growth.

PwC Governance Insights Center

In February, the PwC Governance Insights Center released Mind the gap: the continued divide between investors and corporates on ESG. This paper builds on an earlier PwC report discussing the differences between investors and companies with respect to ESG disclosure. See The New Expectations Gap: ESG Disclosure, October-November 2016 Update. PwC outlines the nature and reasons for the differing perspectives and suggests steps that companies can take to better meet their investors' expectations.

In PwC's view, the gap arises in part from the nature of investor demand for ESG information. For example, while investors as group may care about ESG information, their goals and motives differ. Passive investment managers care about long-term ESG-related risks, while a short-term active investor "may only care about the chance of an ESG-related disaster (or a new source of value) this quarter." And, investors that are primarily motived by ESG issues may focus on different issues than investors that are primarily return-driven. The result, from the company perspective, is confusing and "does not command a compelling response." In addition, companies may not perceive ESG in the same way as the investment community. For example, when companies "hear questions from portfolio managers about matters such as cybersecurity, privacy or board diversity, they may not recognize that these questions are part of the ESG landscape."

There are also structural obstacles to more useful ESG disclosure. For example, many companies have an individual or group with responsibility for sustainability, and that person or group prepares and issues the company's annual sustainability or corporate social responsibility report. "But this team or officer may not be integrated with the company's strategy development, asset allocation, risk assessment, financial reporting or investor relations teams." Further, executives who communicate with investors may be reluctant to discuss ESG issues because they "consider ESG discussions a risk in themselves. Such discussions, these leaders worry, could undermine valuation, trigger increased scrutiny or distract from their core narrative."

These disconnects cause investors to turn to third parties for ESG information on portfolio companies. However, "[m]uch of this third-party information is unverified. It may therefore be inaccurate, but without better corporate involvement, no one can be certain." Worse still, from the company's perspective, "by leaving a communications gap for third parties to fill, corporates are losing control over their ESG story."

PwC recommends that investors take certain steps to better align their priorities. More relevant from an audit committee standpoint, PwC also has six recommendations for companies in order to "establish best practices in ESG risk management and communications, [build] the company's brand in this area and [establish] credibility" with their investors:

- Engage with portfolio managers and analysts to first, understand how they are integrating ESG concerns into investment decisions and second, provide your own vision of how ESG performance should enter into investor models.

- Build a rigorous process to prepare ESG information (with executive certifications, description of control processes, and assurance) and communicate this process to investors.

- Put yourself in an investor's shoes and focus on the information that will help their decision making. One leading practice to consider is providing quantitative evidence of how your superior ESG risk management justifies a higher valuation.

- Promote interaction between the sustainability team, the chief risk officer, investor relations and finance to develop a succinct long-term value creation story that includes ESG risks and opportunities.

- Communicate your ESG risk-mitigation strategy clearly and fully (avoiding boilerplate language) in primary investor communications.

- Educate executives in the finance and investor relations departments on SASB and consider disclosing selected metrics in an investor-friendly format.

<u>Comment</u>: Investor demand for ESG disclosures is likely to make this area one to which audit committees will be required to devote attention. As these disclosures become more routine and standardized, issues surrounding the accuracy of non-traditional forms of information, the related controls over such information, and third-party assurance will become more pressing. The PwC paper provides good insight into the reasons for the current gap between what investors want and what most companies

are providing. Audit committees should consider how their company can be proactive in providing ESG disclosure so that, as PwC urges, the company can retain control of its ESG story, rather than ceding the narrative to third parties. As both Morgan Stanley and PwC suggest, disclosure based on the SASB standards is a good way to accomplish that goal.

PCAOB 2017 Inspections Status Report

On March 27, the PCAOB made publicly available the Report on 2017 Inspection of Grant Thornton LLP. During the 2017 inspection cycle, the PCAOB reviewed 34 Grant Thornton audits. In six of those audits (18 percent), the PCAOB staff identified deficiencies of such significance that it appeared to the inspection team that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to Grant's 24 percent deficiency rate in 2016. Five of the six engagements described in Part I of the report included deficiencies related to the audit of internal control over financial reporting.

The PCAOB has now released the public portion of the 2017 inspections reports with respect to the U.S. affiliate of three of the six global network accounting firms. (The Global Networks are described on the PCAOB's website.) No 2017 report has yet been issued for the U.S. affiliate of BDO International, Ernst & Young Global, or PricewaterhouseCoopers International. The table below summarizes the results of the 2017 inspection of the firms for which inspection reports are available.

2017 Inspections of U.S. Affiliates of Global Networks (Reports Made Publicly Available in 2019)

Firm	Report Date	Engagements Inspected	Part I Deficiencies*	Percentage
Deloitte & Touche	December 20, 2018	55	11	20%
Grant Thornton	March 21, 2019	34	6	18%
KPMG	January 24, 2019	52	26	50%

* The PCAOB describes deficiencies that are included in Part I of an inspection report as "of such significance that it appeared to the inspection team that the firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion."

After the PCAOB has made the 2017 inspection reports for the U.S. affiliate of all six global networks available, the Update will present an overview of the PCAOB's inspection findings concerning these firms.

Comment: Audit committees should discuss the results of the firm's most recent PCAOB inspection with their engagement partner. If the company's audit is mentioned in either the public or nonpublic portion of the inspection report, the audit committee should understand the reasons for the reference to the audit and how it will affect the engagement in the future. If the company's audit is not cited in the report, the audit committee should explore with the auditor how deficiencies identified in other audits might have affected the company's audit and how changes in the firm's procedures might affect future audits. Audit committees should also understand how the firm intends to remediate quality control deficiencies described in the nonpublic portion of the report.

For further information, please contact:

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