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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.

In This Update:

PCAOB Issues Guidance for Audit Committees on New Estimates and Use of Specialists Standards

What is the Audit Committee's Role in ESG Oversight?

Happy New Year! Protiviti's 2021 Audit Committee Agenda Suggestions

SASB Can Help Companies Comply with the SEC's Human Capital Disclosure Requirement

On the Update Radar: Things in Brief

- Congress Takes Aim at Listed Chinese Companies but Might Hit Some U.S. Multinationals
- If at First You Don't Succeed: SEC Adopts Revised Resource Extraction Disclosure Rule
- The CAQ on Auditors and Cybersecurity Disclosure

The Audit Blog

PCAOB Issues Guidance for Audit Committees on New Estimates and Use of Specialists Standards

The Public Company Accounting Oversight Board has released an Audit Committee Resource entitled New PCAOB Requirements Regarding Auditing Estimates and Use of Specialists. The six-page document provides audit committees with "key takeaways" and questions about the Board's requirements for auditing accounting estimates, including fair value measurements, and for auditor use of the work of specialists. The PCAOB's new standards on these topics took effect for audits of fiscal years ending on or after December 15, 2020.

In 2018, the board adopted a new standard for auditing accounting estimates, including fair value measurements, and a new standard on how auditors should consider the work of specialists who have been hired either by the financial statement preparer or by the auditor. According to the Board, the new estimates

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standard is more responsive to risk and reinforces the auditor's professional skepticism, while the specialists standard strengthens the requirements for evaluating the work of specialists. These topics are related since specialists are often retained to assist in establishing or auditing valuation estimates.

The PCAOB staff publication highlights four points that audit committees should keep in mind regarding these new standards.

- The effects of the new requirements will not be uniform across all audits. For some audit firms, particularly large firms, the new standards may simply codify existing practices and will not change the auditor's methodology. Audits performed by smaller firms may be more substantially affected.

- The extent of effects of the new requirements will depend on the nature and extent of accounting estimates included in the company's financial statements, and also on whether the company uses a specialist. While the new standards allow the auditor to use the work of the company's specialist (as did the prior standards), the new standards may prompt an auditor to begin using its own specialist in areas with high risk of material misstatement (e.g., significant unusual transactions or estimates that involve a high degree of subjectivity).

- The new standard and amendments do not change the requirements for the auditor's communications with audit committees, including those communications related to critical accounting estimates. Under the PCAOB's standard on audit committee communications, auditors are required to provide the audit committee with an overview of their audit strategy, including the use of specialists, the significant risks identified in their risk assessment, and other matters that may bear on the auditing of estimates and fair value determinations.

- Auditors are applying these new requirements in extraordinary times and in situations that continue to evolve due to the COVID-19 pandemic. The current environment may have a significant effect on the complexity of accounting estimates and measurement uncertainty.

The PCAOB staff suggests seven questions that audit committee may want to consider in connection with the implementation of the new standards.

1. How might the audit of my company's estimates be affected by the PCAOB's new requirements?

2. To what extent does my company engage specialists to be involved in the preparation of financial statements?

3. Does my auditor involve specialists? If so, in what areas, and how are the specialists used?

4. Is my auditor using a specialist this year for the first time or in a different way than in past audits?

5. Were there any significant changes in my auditor's approach compared to prior years due to the new requirements?

6. Did my auditor have any particular challenges in applying the new requirements at our company?

7. How does my auditor address potential management bias in accounting estimates?

Comment: Financial reporting has evolved over the last several decades to incorporate a growing number of accounting estimates, including in areas such as fair value measurement, impairment of intangible assets, inventory obsolescence, collectability of receivables, and contingent liabilities. Developing these estimates inevitably involves subjectivity, and auditing estimates is often challenging and dependent on judgment. Discussion of these challenges in both PCAOB inspection reports and CAMs underscores the complexity of auditing estimates. For these reasons, audit committees should have a good understanding of how the management derives key estimates and how the auditor intends to approach its review of that work. While the PCAOB's new estimates and specialists standards will not, in most cases, result in fundamental changes in the

auditor's work, the PCAOB staff's paper is a reminder of the significance of estimates in most audits. The questions it suggests that audit committees consider provide a starting point for oversight of the auditor's work in this area.

What is the Audit Committee's Role in ESG Oversight?

During the past year, many public companies have focused on the opportunities and challenges that environmental, social, and governance (ESG) factors present in shaping corporate value creation strategy and public disclosures. This focus has been driven in part by changing views of the relationship between companies and their stakeholders. See, e.g., the Business Roundtable's 2019 Statement on the Purpose of a Corporation. Another key factor is the increasingly vocal demands of institutional investors for disclosure of information on the company's ESG performance and strategy. See, e.g., Blackrock Chairman and CEO Larry Fink's 2020 Letter to CEOs and the Investment Company Institute's December 7 announcement that its board has unanimously called on all U.S. public companies to provide enhanced ESG reporting, including by implementing the Sustainability Accounting Standards Board's (SASB) disclosures.

These watershed developments raise questions about how boards of directors should structure their oversight of ESG strategy and disclosure and about the role of the audit committee. Two major accounting firms have recently presented their perspectives on the relationship between the audit committee's work and ESG disclosure and oversight.

Deloitte

The November, 2020 edition of the Deloitte Center for Board Effectiveness's publication, On the board's agenda, includes Defining the role of the audit committee in overseeing ESG which provides background on how boards are addressing ESG oversight and suggests questions for audit committees to consider in defining their role.

Deloitte analyzed the 2020 proxy statements of the S&P 500 to determine whether the full board or a specific committee was primarily responsible for oversight of ESG initiatives. Deloitte found that considerable variability in the allocation of ESG oversight. The committees to which this responsibility was assigned were:

- Nominating and Governance committee (41 percent)
- ESG/Sustainability committee (10 percent)
- Other committees (8 percent)
- Full board (7 percent)
- Health and Safety committee (5 percent)
- Audit committee (1 percent)
- Not disclosed (28 percent)

Deloitte's research also highlighted industry variability in board-level in ESG oversight, although no industry sector relied heavily on the audit committee. (At three percent, the Consumer sector had the highest percentage of companies that assigned ESG oversight to the audit committee.) Although audit committees rarely have substantive responsibility for ESG oversight, Deloitte notes that ESG issues have a nexus to several core audit committee functions.

- Risk. The audit committee typically has responsibility for financial risk and for oversight of the company's overall risk management efforts, although specific risk areas may be allocated to other committees. Deloitte suggests that the same may be true for board ESG oversight. "An important

consideration with regard to ESG oversight is the intersection of risk oversight responsibilities and the need for alignment of key risks that may fall under the environmental or societal categories of ESG" within the purview of other committees.

- Disclosure substance. Disclosure oversight is an audit committee responsibility, and, as ESG disclosures become more critical, audit committees will need to focus on them. For example, the SEC's recent Regulation S-K amendments require enhanced human capital disclosure in financial filings. See SASB Provides Guidance on How its Standards Can Help Companies Comply with the SEC's New Human Capital Disclosure Requirement in this Update. While other committees may also be involved, the audit committees should have a role in these disclosures. "Human capital management initiatives, including diversity and inclusion initiatives, may fall under the "S" category and be allocated to the compensation, management development committee, or its equivalent. However, the audit committee should be involved in understanding whether there are appropriate disclosure and internal control procedures associated with any metrics being disclosed."

- Disclosure practice. With respect to ESG disclosure generally, audit committee members "should understand how ESG risks are identified, prioritized, and serve to inform disclosure objectives and practices. They should also understand how materiality is defined when identifying ESG metrics for disclosure, the framework being used to tell the ESG story, the internal controls in place around associated metrics, and how those metrics are included on the company's website and/or disclosed (i.e., in a separate sustainability report or integrated in an SEC filing)."

- Auditor oversight. The audit committee's external auditor oversight may expand to encompass oversight of assurance of ESG disclosures. The audit committee will have a "larger role to play in setting the tone with regard to the importance of assurance on ESG information." Also, as suggested in a recent speech by PCAOB Board Member Brown, auditor discussion of ESG risks with the audit committee may result in ESG issues becoming critical audit matter disclosures.

As board-level ESG oversight evolves, Deloitte suggests that audit committees consider five questions:

- Has the board defined its governance structure to facilitate effective oversight of the company's ESG matters? Has the board defined the "primary" governance owner and further allocated key E&S factors to other relevant committees or the full board?

- How has management determined priority ESG impacts and dependencies and identified material ESG measures?

- What ESG standards or frameworks are being used to prepare ESG disclosures?

- Are ESG disclosures subject to disclosure controls and procedures?

- Has management considered obtaining assurance on its ESG disclosures? What level of engagement has management had with the independent auditor on ESG reporting?

PWC

In Defining the Audit Committee's Role in ESG Oversight, a November 18 post on NACD BoardTalk, the blog of the National Association of Corporate Directors, Wes Bricker, a PwC chair and assurance leader, and Paula Loop, a PwC partner who leads PwC's Governance Insights Center, offer thoughts on the role of the audit committee in ESG oversight. In several respects, PwC's views parallel those of Deloitte.

Like Deloitte, Mr. Bricker and Ms. Loop note the potential for audit committee risk oversight to include ESG risks. They observe that most public companies delegate significant risk oversight to the audit committee, and that the scope of these risks has expanded over time to include cyber risk, data privacy, and other reputational

risks. “PwC believes ESG is an area that warrants the committee’s attention, as well." In addition, Bricker and Loop see the audit committee as “a natural candidate to take on ESG reporting quality”:

- Disclosures. Two key issues with respect to ESG disclosures are where disclosures will appear and whether the company will report based on one of the ESG frameworks, like SASB. “Determining where the company will be disclosing its ESG messaging—such as in corporate responsibility reports, proxy statements, the company website, * * * annual and quarterly reports, or earnings calls—is an important decision to make. * * * Companies also need to think about the use of standards and frameworks. Reporting a metric that is aligned to a standard or framework can provide additional integrity to the disclosure.”

- Policies, procedures, and internal controls. “Companies will need to focus on the policies and procedures that feed the development of ESG metrics as well as the internal controls that ensure the metrics are accurate and consistently prepared.”

- Independent assurance. The audit committee may want to consider whether ESG disclosures should be subject to independent review “to provide confidence and trust in the quality and transparency of information reported” since “undefined or misaligned information” may jeopardize the company’s reputation and credibility.

As a board determines how ESG oversight responsibility should be allocated, Mr. Bricker and Ms. Loop suggest consideration of several questions:

- Will the full board take on the responsibility of broader categories of ESG oversight? Or is there a specific committee with the capacity, interest, and skills to take the lead on overseeing the company’s overall ESG efforts?

- Have we considered how ESG oversight responsibilities should be operationalized and embedded in the current committee structure? Have committee charters and proxy statements been updated to transparently disclose to shareholders and other stakeholders the board’s allocation of ESG oversight responsibility?

Comment: Given the increasing focus on corporate ESG performance and disclosure, it seems inevitable that these issues will become an important aspect of the audit committee’s work. As the Deloitte and PwC papers indicate, audit committee ESG oversight responsibilities fall into four areas:

(1) risks arising from ESG issues, particularly those not within the remit of another board committee;

(2) the substance and format of ESG disclosures, including both those made voluntarily and those pursuant to regulatory requirements;

(3) controls and procedures to ensure the accuracy and completeness of ESG disclosures; and

(4) external auditor or other third-party assurance with respect to ESG disclosures.

Audit committees that are not already doing so should focus on these responsibilities and how they will be overseen. As indicated in prior Updates, controls and procedures are an especially important area because ESG disclosures are often made outside of the controls that govern other company disclosures but are increasingly viewed by investors as material and relied on in decision-making.

Happy New Year! Protiviti’s 2021 Audit Committee Agenda Suggestions

With the arrival of 2021, audit firms, consultants, and others will be offering suggestions on issues that audit committees should focus on during the new year. Consulting firm Protiviti has published Setting the 2021

Audit Committee Agenda, which outlines eight major issues, and two additional topics, for audit committees to consider as they formulate their 2021 agendas. A summary appears below.

1. Consider shifts in the risk landscape to establish an appropriate business context. Have the implications of changes in the nature and severity of risks been considered by the committee in discharging its various responsibilities?

   Protiviti notes that internal and external risk assessments "enable the committee to put into proper context the representations and assertions received from management, newly reportable critical audit matters, and audit scope changes raised by the external auditor and internal control concerns, errors and irregularities and other findings presented by internal audit."

2. Work with the CFO to review the finance function's resiliency. How effective and efficient was the financial reporting process during and since the lockdown with people working from home? What did we learn? How has the function improved its resiliency going forward?

   Protiviti suggests several questions audit committees should consider in evaluating the finance function, including whether employees have the technology and tools they need and whether there any priorities, like improving supply chain resiliency, that need to be addressed in 2021.

3. Encourage the CFO to function as a strategic partner in addressing cyber-security, privacy and other key priorities. Is finance sufficiently resourced to focus on such matters as evolving cyber threats, more advanced data analytics, internal customer expectations, financial planning and analysis, regulatory challenges, and internal controls as a strategic partner with the rest of the organization?

   The audit committee should support the CFO's efforts to address the increasing demands his or her office faces and to obtain adequate resources. Protiviti notes that this may be an appropriate discussion to have with the CFO in an executive session.

4. Work with the CAE [Chief Audit Executive] to formulate appropriate imperatives for internal audit to ensure the function's continued relevance. Is the CAE effective in achieving appropriate risk coverage, agile responses to new and emerging risks, and efficient delivery of value-added insights regarding risk culture, risk management capabilities and the internal control environment?

   In Protiviti's view, there is an opportunity "for internal audit to enhance its value proposition by becoming a problem-solver, rather than a mere problem-finder." This requires "next-generation capabilities" so that internal audit can "keep pace with the company's overall digital transformation and embrace change, improve continuously and maintain its relevance, paving the way to efficiency, adaptability, increased engagement and deeper, more valuable insights."

5. Address accounting and reporting implications of operational adjustments during the pandemic and recession. Have discontinued operations and divestitures, termination benefits, and the impact of contract modifications been reported properly? If the company received government assistance, is it being accounted for appropriately?

   "The company's decisions to adjust operations during the pandemic have accounting and reporting implications. The audit committee should address such matters with management and the external auditor."

6. Assess COVID-19-related impacts on financial reporting assertions. Are the pandemic's effects on estimation processes underlying asset impairments, valuation, net realizable value, loss contingencies and other accounting and disclosure matters understood and addressed?

   Audit committees should inquire of management and the external auditor regarding significant accounting estimates and their financial statement implications. (See PCAOB Issues Guidance for Audit Committees on New Estimates and Use of Specialists Standards, in this Update.) Protiviti

also reminds audit committees that financial reporting can be affected by information that becomes available after the balance sheet date but before issuance of the financial statements. "If significant subsequent events occur, companies are required to disclose their nature and either an estimate of the financial statement impact or a declaration that an impact assessment cannot be made."

7. Evaluate the pandemic's near-term and longer-term impacts on the internal control environment. How are recent and expected changes in the workplace and current plans for reopening physical locations affecting the company's internal control over financial reporting, cyber-threat landscape, and exposure to compliance and fraud risk?

   The audit committee is "the board's advocate for strong internal control over financial reporting." Audit committees should be alert to the impact on controls of pandemic-related changes in operations. Some of the questions that Protiviti suggests audit committees consider include:

   > "With respect to internal controls, have there been any significant changes? Has the flux in internal processes during the lockdown and with the planned re-entry affected the integrity of the company's internal control structure and execution of key internal controls over financial transactions and reporting? Have there been significant personnel changes from attrition, downsizing, the virus or reassignments? If so, have the changes affected the performance of any key controls? Are there any segregation-of-duties issues? Are the changes and the pandemic's effects material enough to warrant disclosure?"

8. Consider the nature of critical audit matters raised by the independent auditor. In the event the external auditor reports critical audit matters, has the committee evaluated them in consultation with the auditor and management?

   As discussed in prior Updates, auditors are now required to include in their audit report discussion of critical audit matters (CAMs) – issues that were discussed with the audit committee and that relate to material accounts or disclosures and involve especially challenging, subjective, or complex auditor judgments. Protiviti recommends that audit committees discuss CAMs with the auditor and management to gain an understanding of the underlying issues. "If there are significant judgmental issues on which management and the auditor do not agree, or if management is applying aggressive accounting principles, there may be an opportunity for the committee to inquire of management as to whether the company's accounting and reporting processes can be streamlined and improved."

Other Matters

Protiviti's also highlights two additional matters that audit committees should include on their agendas.

- Keep an Eye on ESG Developments

  Protiviti notes that "observable market forces continue to elevate the importance of ESG-related matters" and predicts that it is "a matter of when, not if, the market can expect more rulemaking and standard-setting on ESG-related impacts." Among other things, Protiviti cites the new SEC human capital disclosure requirements (see SASB Can Help Companies Comply with the SEC's Human Capital Disclosure Requirement in this Update). "The audit committee should review these new disclosures in light of developments occurring at the company."

- Self-Assess Committee Effectiveness

  Audit committees should periodically assess their performance, including the committee composition, charter and agenda focus in view of the current challenges the company faces. Protiviti lists 12 specific topics that it recommends be covered in an audit committee performance assessment.

Comment: Although each company's circumstances and challenges vary, lists of this nature can serve as useful checks as audit committees develop their plans for the coming year. Protiviti's reminders concerning the possible impact of the pandemic on risk, disclosures, and controls are particularly timely. Also, the highlighting of the need to be on the alert for potential ESG developments that may affect the audit committee's work seems very appropriate, given the growing investor interest in this area, and is likely to be echoed in other firms' audit committee agenda recommendations.

SASB Can Help Companies Comply with the SEC's Human Capital Disclosure Requirement

In August, the SEC dipped a toe into the burgeoning field of environmental, social, and governance (ESG) disclosure by amending Regulation S-K to include an enhanced disclosure topic on human capital resources. Under this new item, public companies must provide, to the extent material to an understanding of their business, a description of the company's human capital resources, including "any human capital measures or objectives that the registrant focuses on in managing the business." The requirement is principles-based, rather than prescriptive; that is, aside from requiring disclosure of employee headcount, it does not mandate specific information; instead, a company's disclosures must be "tailored to its unique business, workforce, and facts and circumstances." See SEC, Modernization of Regulation S-K Items 101, 103, and 105 (August 26, 2020).

While the SEC did not prescribe any particular disclosure approach, it recognized that there are existing, voluntary frameworks that can facilitate disclosure pursuant to the new human capital requirement. The Sustainability Accounting Standards Board (SASB) has followed up on this comment by issuing SASB Human Capital Bulletin, which provides an overview of the human capital-related topics in the SASB's standards to assist companies in preparing their disclosures. The Bulletin is both a primer on the SASB standards generally and a tool for companies that are formulating their response to the new Regulation S-K human capital requirement.

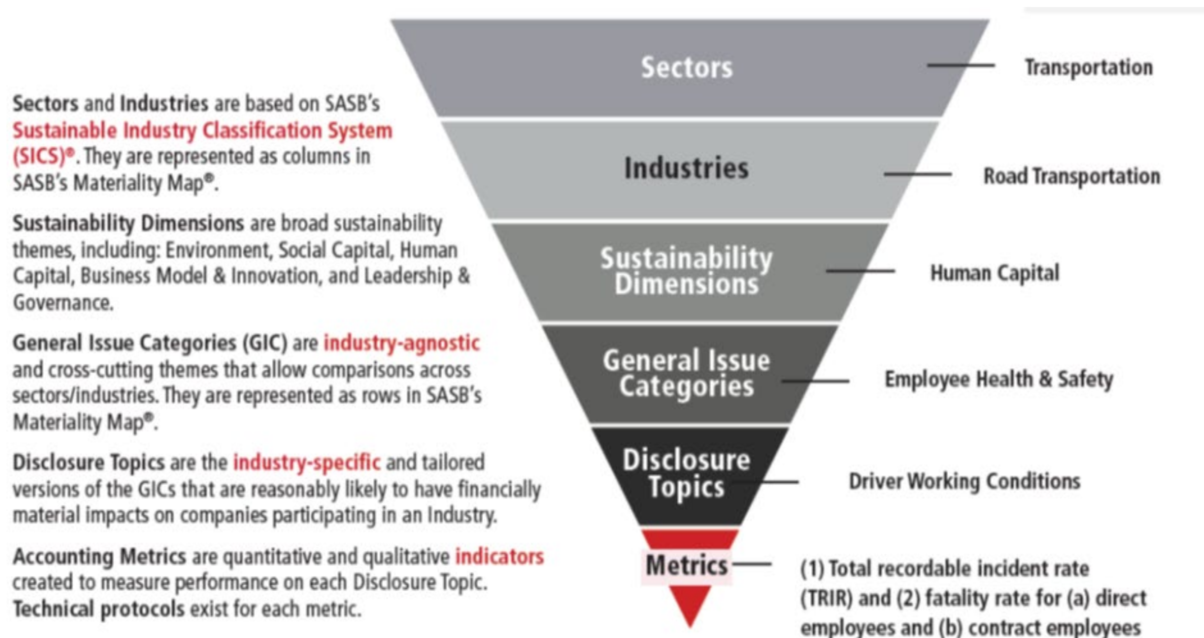
The SASB Standards

SASB's standards are intended to facilitate communication between companies and investors about financially material, decision useful, ESG information. SASB recognizes that material ESG topics vary from industry to industry. Accordingly, its standards are industry-specific, based on a classification system that recognizes 77 industries in eleven industry sectors.

SASB organizes the universe of ESG risks and opportunities that companies may face under five broad sustainability dimensions – Environment, Social Capital, Human Capital, Business Model & Innovation, and Leadership & Governance. Each of these five ESG dimensions incorporates various general issues categories (GICs), cross-cutting themes related to one of the sustainability dimensions. In total, there are 26 GICs. For each industry, SASB has identified a set of disclosure topics, which are industry-tailored versions of those GICs that are reasonably likely to have financially material impacts on companies in that industry. SASB has developed metrics for each industry disclosure topic. Metrics are quantitative or qualitative measures that are intended to provide a basis for gauging performance on the associated disclosure topic. Metrics are accompanied by technical protocols that explain how the metric should be applied in creating a disclosure.

Human Capital in the SASB Standards

As noted, Human Capital is one of the five SASB ESG dimensions. There are three GICs related to Human Capital -- Employee Health & Safety; Employee Engagement, Diversity, And Inclusion; and Labor Practices. For the majority of SASB's 77 industries, there are one or more disclosure topics with associated metrics relating to the Human Capital GICs. The chart below, which is taken from the Bulletin, illustrates how this framework applies to a specific industry – Road Transportation.



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As the chart indicates, Road Transportation is one of the industries in the Transportation sector. Employee Health & Safety is one of the GICs within the Human Capital sustainability dimension. SASB has determined that, for companies engaged in Road Transportation, the disclosure topic Driver Working Conditions is an aspect of Employee Health & Safety that is likely to be financially material. One of the metrics that SASB has promulgated to measure performance on this disclosure topic is the total recordable incident rate and the fatality rate for direct employees and for contract employees. The technical protocol for the metric explains how these rates should be determined and presented.

Using the SASB Standards to Develop Human Capital Disclosures

The Bulletin suggests that companies follow a two-step process in using the SASB standards to identify human capital-related topics and metrics for use in disclosures under the new SEC requirement.

The first step is to review the SASB human capital standards applicable to the industry or industries in which the company operates. For 48 of the 77 industries in SASB's classification system, SASB has identified one or more potentially material human capital-related disclosure topics and related performance metrics. The Bulletin lists these industries, and companies should refer to their applicable industry standard in developing their disclosures. (Presumably, this could entail including disclosure of the SASB human capital metrics for the company's industry in SEC filings, and could also, or alternatively, entail a company narrative discussion of the human capital disclosure topics SASB has identified for the industry.)

The second step is to review the human capital topics and metrics in industries that are similar to the industry or industries in which the company operates. As noted, for some industries, SASB does not currently have human capital-related disclosure standards. Moreover, companies in industries that have SASB standards may want to consider whether additional human capital-related disclosures beyond those in their industry standard would be material for the company. In this regard, the Bulletin recommends that companies review the disclosure topics and metrics for other industries under all three of the Human Capital GICs -- Labor Practices; Employee Health & Safety; and Employee Engagement, Diversity & Inclusion -- and also for Supply Chain Management. Supply Chain Management is one of the GICs under SASB's Business Model & Innovation ESG dimension. The Bulletin summarizes the scope and potential relevance of these GICs:

- Labor Practices. SASB disclosure topics associated with Labor Practices encompass issues such as pay structure, relations with organized labor, and policies in place to protect workforces.

- Employee Health & Safety. SASB disclosure topics associated with Employee Health & Safety address a company's ability to create and maintain a safe and healthy workplace environment. These topics may encompass mental health in addition to physical wellbeing and incorporate training and culture.

- Employee Engagement, Diversity, & Inclusion. SASB disclosure topics associated with Employee Engagement, Diversity & Inclusion address a company's ability to ensure its culture, hiring, and promotion practices embrace the building of a diverse and inclusive workforce. This includes the issue of discriminatory practices.

- Supply Chain Management. SASB disclosure topics associated with Supply Chain Management incorporate externalities created by suppliers through their operational activities, such as environmental responsibility, human rights, labor practices, and ethics and corruption.

For each of these four GICs, the Bulletin includes examples of metrics found in the SASB standards. Companies may want to consider whether any of these metrics suggest disclosures that would be material to an understanding of their human resources management.

SASB Human Capital Management Research Project

The Bulletin also points out that SASB's human capital standards are a work in progress. SASB has undertaken a research project to assess the topic of human capital management with the objective of designing a framework to support the identification of financially material impacts related to human capital management. This framework may result in modifications to the existing SASB standards to incorporate new elements associated with human capital.

The research project has identified several core themes:

- Workforce Culture. "This broad concept embodies the values, processes, and outcomes of an organization and can drive its ability to produce a more productive, fair, and respectful work environment and therefore its ability to acquire, develop, and retain talent."

- Workforce Investment (including career and wealth-building opportunities). "The role of business in providing employees with career-building and wealth-building opportunities is becoming increasingly critical, and is associated with increased worker engagement and retention. It may also be associated with an ability to reskill or upskill workers to address labor shortages in some industries, and/or improve employee performance and productivity within others."

- Mental Health & Health-Related Benefits. "These issues include the increasing prevalence of stress, depression, and anxiety. In addition to mental health, the role of health benefits for workers, including benefits such as paid sick leave, may be associated with factors like job turnover, recruitment and retention, productivity, and lower rates of absenteeism."

- Alternative Workforce (contingent and contract labor). "This trend relates to the growing size of this worker classification and the expansion of the use of alternative workforces by a range of businesses."

Although the project's findings are preliminary and subject to revision, companies might also want to consider whether any of these themes are potential material to their human capital management and warrant disclosure.

Comment: In connection with their disclosure oversight responsibilities, audit committees will be considering their company's human capital disclosures pursuant to the SEC's new requirement. In addition, ESG disclosure

is becoming increasingly important to investors and it is likely that additional disclosures in this area will become mandatory in the future. Audit committees may want to review the SASB Bulletin, both as a source of guidance on human capital disclosures and as a way of becoming more familiar with SASB's standards and how they can support disclosure of material ESG information to investors. A growing number of companies are voluntarily making SASB disclosures, and the Bulletin provides a good introduction to SASB for those who are not already familiar with its framework.

On the Update Radar: Things in Brief

Congress Takes Aim at Listed Chinese Companies but Might Hit Some U.S. Multinationals. On December 18, President Trump signed the Holding Foreign Companies Accountable Act (HFCAA). The legislation, which passed both houses of Congress with bipartisan support, could ultimately result in the delisting of companies that trade on U.S. exchanges and are audited by accounting firms that the PCAOB cannot inspect because of the position of a foreign government. Under the HFCAA, if the SEC determines that the PCAOB is unable to inspect a reporting company's auditor for three consecutive years, the SEC would be required to prohibit the company's securities from trading on a U.S. securities exchange (or by any other method within the SEC's jurisdiction). Even prior to the triggering of the delisting provision, reporting companies with un-inspectable auditors will have to make various disclosures, including the percentage of shares owned by government entities in the company's home jurisdiction and information about any board members that are Chinese Communist Party officials.

As a practical matter, the HFCAA would affect primarily U.S.-listed Chinese companies. The Chinese government does not permit foreign regulators to access the work papers of Chinese audit firms, and, unlike virtually all other jurisdictions, China has declined to negotiate inspection arrangements with the PCAOB. However, the provisions in the HFCAA that describe the companies that are subject to delisting are broadly written and could encompass U.S.-based companies that have operations in China. As part of the parent company's audit, the Chinese operations of a U.S. multinational may be audited by an un-inspectable Chinese accounting firm (typically, the Chinese member of the U.S. auditor's global network). In a statement entered into the Congressional Record, the sponsors of the HFCAA, Senator John Kennedy and Representative Brad Sherman, sought to exempt U.S. companies from delisting by explaining that the Act was not intended to apply where "not more than one-third of the company's total audit is performed by a firm beyond the reach of the PCAOB inspection" and that the SEC has "authority to determine how the size of an audit would be measured." Unfortunately, neither this intent nor this SEC authority appears explicitly in the text of the law.

Perhaps the PCAOB will be able to negotiate a solution to the problem of Chinese inspections before the HFCAA delisting provisions are triggered in three years. If not, the SEC will likely find a way to avoid delisting U.S. or foreign companies that have only a limited a portion of their operations audited by un-inspectable firms. Nonetheless, it would be prudent for audit committees to make sure that they are informed of the inspection status of all firms that participate in their audit, particularly any that are based in China.

If at First You Don't Succeed: SEC Adopts Revised Resource Extraction Disclosure Rule. On December 16, the SEC adopted rules that will require domestic or foreign SEC-reporting companies that engage in resource extraction to disclose payments made to the U.S. federal government or to foreign governments for the commercial development of oil, natural gas, or minerals. The rules implement Section 13(q) of the Securities Exchange Act, enacted by the Dodd-Frank Act in 2010. Although the rules take effect 60 days after publication in the Federal Register, there is a two-year transition period, after which affected companies will be required annually to disclose their extraction payments on Form SD no later than 270 days after the end of their fiscal year. The new rules contain "conditional exemptions" for situations in which a foreign law or a pre-existing contract prohibits the disclosure and for smaller reporting companies and emerging growth companies.

This is the SEC's third attempt at rulemaking to implement Section 13(q). The first set of resource extraction payment rules, adopted in 2012, was invalidated by the U.S. Court of Appeals for the District of Columbia Circuit. The second version was invalidated by Congress pursuant to the Congressional Review Act in 2017. See Congress Invalidates Resource Extraction Payment Disclosure; SEC is Reconsidering Conflict Minerals and Pay Ratio Rules (January-February 2017 Update).

Audit committees of companies that engage in resource extraction should be aware of this new disclosure requirement and monitor management's efforts to determine how it applies to the company and the steps necessary to prepare for implementation.

The CAQ on Auditors and Cybersecurity Disclosure. The Center for Audi Quality has released The Role of Auditors in Company-Prepared Cybersecurity Information: Present and Future. The CAQ provides an overview of the SEC's requirements regarding cybersecurity risks and of the types of disclosures that companies have made concerning cybersecurity, both in response to those requirements and voluntarily. The publication also focuses on the role that cybersecurity risk plays in the financial statement audit and how auditors are addressing cybersecurity risks. The CAQ outlines additional advisory or attestation services that auditors could provide (subject to the independence requirements) to "bring discipline to management's voluntary cybersecurity disclosures and to the organization's cybersecurity risk management program." The final section of the paper lists considerations and key questions the board may want to consider when it engages in discussion regarding cybersecurity information with management and the auditor. While not aimed specifically at audit committees, the CAQ's publication is useful background on cybersecurity oversight.

The Audit Blog

I am a co-founder of The Audit Blog and blog on developments in auditing and financial reporting, on auditor oversight and regulation, and on sustainability disclosure. Occasionally, items that appear in the Audit Committee and Auditor Oversight Update also appear on the blog. The blog is available here. You can follow @BlogAuditor on twitter or @the-audit-blog on medium.com.

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Prior Updates issued between January 1, 2019 and May 31,2020 are available here. Updates issued after June 1, 2020 are available here.