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Audit Committee Quarterly Update

THIRD QUARTER 2021

In this newsletter, we highlight some important 2021 third quarter issues facing audit committees. The content is not all-inclusive. You may also be interested in our quarterly publication that summarizes accounting, financial reporting, and regulatory matters that may impact both public and private companies.

Climate and environmental, social and governance (ESG) disclosures

As discussed in previous newsletters, disclosures related to climate risks and human capital matters are a focus of the SEC and investors.

SEC Chair Gensler discusses climate risk disclosures

In July 2021, SEC Chair Gary Gensler discussed the SEC's role in **climate risk disclosures**. In 2010, the SEC offered guidance on climate risk disclosure; however, a lot has changed since then, and investors do not have the ability to compare company disclosures to the degree that they need. He indicated that investors are looking for consistent, comparable, and decision-useful disclosures so they can put their money in companies that fit their needs. He also noted that there were more than 550 unique comment letters submitted in response to Commissioner Allison Herren Lee's statement on climate disclosures in March 2021 and that three out of every four of these responses support mandatory climate disclosure rules.

As a result, Chair Gensler has asked the SEC staff to develop a mandatory climate risk disclosure rule proposal for the SEC's consideration by the end of 2021. He said that he believes the SEC can bring greater clarity to climate risk disclosures. He has asked staff to consider whether these disclosures should be filed in the Form 10-K, living alongside other information that investors use to make their investment decisions.

Sample letter to companies regarding climate change disclosures

In September 2021, the Division of Corporation Finance posted a **sample letter** to companies regarding climate change disclosures. The illustrative letter includes sample comments it may issue to companies regarding their climate-related disclosure or the absence of such disclosure. The sample comments do not constitute an exhaustive list of the issues that companies should consider.

A number of existing SEC rules may require disclosure related to climate change. For example, and depending on the particular facts and circumstances, information related to climate change-related risks and opportunities may be required in disclosures related to a company's description of business, legal proceedings, risk factors, and management's discussion and analysis of financial condition and results of operations. Disclosure matters discussed in the **2010 Climate Change Guidance** include the following:

- The impact of pending or existing climate-change related legislation, regulations, and international accords
- The indirect consequences of regulation or business trends
- The physical impacts of climate change

Companies must also disclose, in addition to the information expressly required by SEC regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

We recommend that management and audit committees review this sample letter in connection with company disclosures in upcoming filings.

Center for Audit Quality (CAQ): S&P 500 and ESG reporting

In August 2021, the CAQ posted a summary and analysis of the most recent publicly available ESG data for S&P 500 companies. The information the CAQ examined was primarily outside of an SEC submission in a standalone ESG, sustainability, corporate responsibility, or similar report. The CAQ found that the timing and frequency at which companies report ESG information varies. As of June 18, 2021, roughly 54% of S&P 500 companies had published ESG data for periods ending in 2020. About 37% of S&P 500 companies published ESG data for periods ending in 2019.

CAQ white paper on Audited Financial Statements and Climate-Related Risk Considerations

In September 2021, the CAQ issued a white paper, **Audited Financial Statements and Climate-Related Risk Considerations**, that provides investors and other stakeholders with a foundational understanding of current climate-related reporting and auditing requirements in the United States and how they are applied. The CAQ released this report at a pivotal moment for climate-related and other ESG reporting, as investor and other stakeholder demand for this information continues to increase.

Currently, climate-related risks are considered and assessed by management and auditors, and overseen by audit committees, during the preparation and auditing of financial statements. Under current U.S. accounting rules, climate-related risks may have a direct impact on the financial statements, an indirect impact, or in some cases no impact at all. Understanding current financial statement requirements can be a useful starting point for investors and others as they consider how and where to obtain their desired climate-related information to make capital allocation decisions and bridge any information gap that may exist today ahead of future rulemaking by the SEC or others.

Management is responsible for preparing the financial statements of the entity in accordance with U.S. GAAP, including assessing whether they reflect all required

disclosures, including climate-related, if applicable. Although U.S. GAAP today does not include explicit references to climate-related risks, companies are required to consider such risks when the effect could reasonably be material to the financial statements. The financial reporting requirements for climate-related risks will vary from company to company and depend on several factors, including the nature of the company's business, its industry, geographic footprint, types of underlying transactions, and the significance of the climate-related risk to the entity's business, among others.

Forward-looking climate-related risks that could potentially impact an entity's financial statements typically fall into one of the following categories:

1. Physical risks (e.g., the risk that an entity's facilities will be damaged by a severe weather event or that a company will need to relocate its facilities away from low-lying coastal areas).
2. Risks associated with the transition to a low-carbon economy (e.g., regulatory risk associated with required changes to a company's business and/or the impact of a company's net-zero commitments on management's evaluation of impairment or the useful lives of assets).

The CAQ acknowledges that the time horizon for which climate-related risks come to fruition also will vary by company and industry; therefore, while risks may exist, the impact on the current-period financial statements may not be material.

The CAQ noted that it has observed a growing trend in companies making commitments to be carbon neutral or carbon negative by a specified date in the future. This trend seems to span across many industries, from energy companies that historically relied on fossil fuels committing to substantially reduce their carbon emissions, to automotive manufacturing entities committing to phase out production of traditional vehicles that are powered by fossil fuels. The impact of such commitments on a given company's financial statements and audit will vary depending on a number of factors, including actions management has taken or plans to take to achieve those commitments; the timing of those actions; and the costs associated with them. The white paper includes several examples for audit committees and management to consider.

Board diversity

In August 2021, the SEC approved Nasdaq's proposed rule changes requiring issuers to disclose certain information about the diversity of the company's board and to offer certain companies access to a complimentary board recruiting service. These rules will allow investors to gain a better understanding of Nasdaq-listed companies' approach to board diversity, while also ensuring that those companies have the flexibility to make decisions that best serve their shareholders.

As the SEC order discusses, the rules are consistent with the requirements of the Exchange Act and reflect calls from investors for greater transparency about the people who lead public companies. It was also noted that a broad cross-section of commenters supported the proposed board diversity disclosure rule.

The Nasdaq rule changes require companies to have at least two diverse directors on their boards or explain why they are not in compliance. Listed companies will be given one year of complimentary access to a board recruiting service to help identify diverse candidates.