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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:

2022 PCAOB Inspections Preview Says 40 Percent of Audits Reviewed Had Deficiencies

The staff of the Public Company Accounting Oversight Board anticipates that approximately 40 percent of the audits inspected in 2022 will have one or more deficiencies included in Part I.A of the audit firm's inspection report, up from 34 percent in 2021 and 29 percent in 2020. Spotlight: Staff Update and Preview of 2022 Inspection Observations (Preview Report) presents aggregate observations from the PCAOB's 2022 inspections of 710 public company audits performed by 157 audit firms. In a statement, PCAOB Chair Erica Williams described the 40 percent deficiency rate as "completely unacceptable." Ms. Williams also urged audit committees "to hold audit firms accountable on behalf of investors" and noted that the report

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"includes important questions audit committees should ask their audit firm" regarding its inspection results. (For a discussion of last year's inspections preview, see [PCAOB Staff 2021 Inspections Preview Reports Rising Deficiencies], [January 2023 Update].)

Key Findings

According to the Preview Report, the 2022 inspections resulted in four key findings:

- Audit deficiencies rose in 2022. As noted above, the staff expects that 40 percent of all audit engagements inspected in 2022 will be included in Part I.A of an inspection report. (Part I.A discusses deficiencies that were of such significance that, in the PCAOB's view, the firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion on the financial statements and/or internal control over financial reporting (ICFR).) For the six largest U.S. firms (i.e., the six U.S.-based audit firms that are part of global networks), Part I.A deficiencies rose from 16 percent in 2020 and 21 percent in 2021 to 30 percent in 2022.

- Noncompliance with PCAOB standards and rules rose in 2022. Deficiencies not related to the sufficiency of audit evidence also rose in 2022. Forty-six percent of the 710 engagements inspected in 2022 are expected to be included in Part I.B of an inspection report, up from 40 percent in 2021 and 26 percent in 2020. Part I.B discusses deficiencies that relate to instances of noncompliance with PCAOB standards or rules other than those where the firm had not obtained sufficient appropriate audit evidence to support its opinion and other than those related to independence. This increase was largely due to an increase in deficiencies related to critical audit matters.

- Audit firms can learn from good practices. The PCAOB staff also observed "positive practices" that may be effective in enhancing a firm's quality control system and audit quality. These good practices, which are described at the end of the Preview Report, include effective risk assessment procedures; use of audit practice aids, such as tools and templates; utilization of Individuals with specialized skills or knowledge, such as subject matter experts; and supervision and review practices that include timely involvement of partners and other supervisors and the use of concise, top-down supervision and review practice aids.

- The percentage of randomly selected engagements expected to be in Part I.A is lower than the percentage expected for risk-based selections. For the larger firms (i.e., those inspected annually) the PCAOB selects some engagements for review based on the perceived difficulty or riskiness of the engagement and some on a random basis. In 2022, 48 percent of randomly selected engagements resulted in at least one deficiency, and approximately 26 percent will be included in Part I.A. In comparison, 64 percent of the risk-based selections resulted in at least one deficiency and approximately 42 percent will be included in Part I.A.

Common Deficiencies Found By 2022 Inspections

The Preview Report states that deficiencies observed in the 2022 inspections are similar to those identified in prior years. "Many of these deficiencies are in areas that are inherently complex and in turn generally include greater risks of material misstatement and hence demand more attention from the auditor."

1. Deficiencies in Auditing ICFR

   The Preview Report notes that deficiencies in auditing ICFR remain high and that "it is important that auditors continue to focus on auditor performance" in three areas where ICFR audit deficiencies are common:

   - Review controls. The auditors did not sufficiently evaluate whether controls with a review element selected for testing operated at a level of precision sufficient to prevent or detect material misstatements.

- Company-provided information. Engagement teams did not perform procedures to test the accuracy and completeness of company-produced information that the auditor used for testing user access and change management controls.

- Controls that address risk of material misstatement. Auditors did not identify and test controls that were important to the auditor's conclusions about whether the issuer's controls sufficiently address the assessed risk of misstatement for relevant assertions.

2. Deficiencies in Auditing Financial Statement Areas

   The top five financial statement areas in which inspectors have found deficiencies are listed below. The Preview Report notes that these areas have remained consistent during the 2020 to 2022 period.

   - Revenue and related accounts. The Preview Report states that the inspection staff frequently identifies deficiencies pertaining to basic auditing principles, including "Appropriate response to a significant fraud risk," "Sampling of transactions, confirmation procedures of related receivables," and "Sufficient procedures to test presentation and disclosure."

   - Accounting estimates. Accounting estimates are often among the areas of greatest audit risk. "The challenges of auditing estimates may be compounded by cognitive bias, which could lead auditors to anchor on management's estimates and inappropriately weight confirmatory over contradictory evidence."

   - Business combinations. The Preview Report notes that business combinations "impact many accounts and include a broad spectrum of accounting and estimates, including fair value." Among other things, inspectors found instances of "Insufficient or no risk assessment procedures related to an acquisition and inappropriate or no basis for a conclusion that no risk exists," "Insufficient procedures to evaluate whether significant financial statement disclosures are complete and accurate," and "Insufficient procedures to evaluate the relevance and reliability of a company's specialist report."

   - Inventory. Inventory often presents a heightened risk of material misstatement due to the complexities of determining inventory cost and of measuring inventory at a point in time.

   - Long-lived assets. "The valuation of long-lived assets requires considerable judgement and professional skepticism, and an appropriate assessment of the risks of material misstatement at the financial statement level and the assertion level. The process to assess if an impairment exists and, if necessary, to perform valuation is often complex, including both qualitative and quantitative factors."

3. Deficiencies Related to Other PCAOB Standards or Rules

   The most common Part I.B deficiencies relate to critical audit matters (CAMs) and to audit committee communications. CAMs, which must be disclosed in the audit report, are matters arising from the financial statement audit that the auditor communicated to the audit committee and that relate to accounts or disclosures that are material to the financial statements and involve especially challenging, subjective, or complex auditor judgment. Inspection deficiencies with respect to CAMs primarily involved instances in which auditor's procedures to determine whether matters were CAMs did not include every matter communicated, or required to be communicated, to the audit committee. Deficiencies of this type do not necessarily mean that the auditor should have included additional CAMs in the audit report.

As to audit committee communications, common deficiencies include the auditor's failure to communicate such things as –

- Significant risks identified during risk assessment procedures, including fraud risks.
- Overall audit strategy and timing of the audit.
- The auditor's evaluation of, and conclusions about, the qualitative aspects of significant accounting policies and practices of the public company's financial reporting.
- A complete list of material weaknesses identified during the audit prior to the issuance of the auditor's report.
- The auditor's evaluation of the company's ability to continue as a going concern.
- The uncorrected and corrected misstatements identified by the auditor.
- The engagement team's evaluation of the company's accounting for, and disclosure of, transactions with related parties.

Observations Related to Quality Control Systems

In addition to reviewing audit engagements, PCAOB inspections include a review of the inspected firm's quality control system. The Preview Report discusses quality control findings in four areas.

- Independence. Inspectors identified potential violations of the SEC's independence rules, mainly at smaller accounting firms. These potential violations included such things as prohibited financial relationships, employment relationships, or business relationships between the auditor and the client; prohibited non-audit services; contingent fees; and lack of audit committee administration of the engagement.
- Engagement Quality Review. PCAOB rules require that public company audits include an engagement quality review (EQR) – a second partner review of key aspects of the audit and concurrence before issuance of the audit opinion. EQR deficiencies included failure to perform an EQR or failure to perform with due care, reviewers that lacked competence, failure to document the EQR, and issuance of audit reports before the reviewer had provided concurring approval.
- Monitoring. Some firms did not have policies and procedures to monitor compliance with professional standards applicable to their accounting and auditing practice. At some firms, the documentation of the quality control system included internal inspection procedures, but the firm either did not actually perform internal inspections or such inspections were not suitably designed.
- State Practice Qualification Requirements. Inspections revealed instances in which audit firms performed public company financial statement audits in jurisdictions where the firm was not registered or licensed to practice.

Suggested Questions for the Audit Committee

The Preview Report suggests that, in light of increased inspection findings, audit committees may want to consider asking these four questions in discussions with their independent auditors:

- Has our audit engagement been inspected, and, if so, would you share the results? Were there any audit areas that required significant discussions with the PCAOB that did not result in a comment form?

- Has the engagement partner been inspected on other engagements? If so, what were the results of that inspection?

- What is the audit firm doing to address overall increased inspection findings?

- Are there any audit procedures that are unnecessarily complicated or not "straight-forward" because management is not providing clear, supportable information? (While not related to inspection reporting, this question "may encourage effective two-way communication to assist in understanding matters relevant to the audit.)

Comment: Although the causes of the increasing number of inspection deficiencies are not clear, the Preview Report does underscore the importance of the audit committees reviewing their firm's report and discussing it with the engagement partner. As Chair Williams stated in urging audit committees to engage in dialogue with their auditor regarding its inspection report, "There is no one-size-fits-all answer as to why deficiencies increased. The causes likely vary from firm to firm. So, the solutions will vary as well." The Preview Report can serve as a reference point for these conversations and as a tool in the audit committee's evaluation of the auditor.

The Preview Report also provides insight into issues the PCAOB is likely to focus on in future inspections and into what it regards as the audit areas likely to generate deficiencies. Audit committees may want to discuss with their auditor how it plans to address such areas. See also So Many Questions: PCAOB Suggests Questions Audit Committees Should Ask in this Update. The Preview Report may also be useful to audit committees in understanding what aspects of the company's future audits are likely to attract the PCAOB inspection staff's attention. Auditors can be expected to devote attention to these areas in anticipation of potential future PCAOB scrutiny. Therefore, the Preview Report may also aid audit committees in understanding their auditor's risk assessment and resource allocation decisions and in discussing these matters with the engagement team.

So Many Questions: PCAOB Suggests Questions Audit Committees Should Ask

The PCAOB staff has issued its 2023 list of questions to aid audit committees in communicating with their auditors. Spotlight: Audit Committee Resource "suggests questions that may be of interest to audit committee members to consider amongst themselves or in discussions with their independent auditors, particularly given today's economic and geopolitical landscape." The 2023 question list is an updated version of last year's suggestions. See We Have Some Questions for You. The PCAOB Releases a New Audit Committee Resource, August 2022 Update.

The Audit Committee Resource contains 38 questions, arranged under ten topics. The topics, and examples of the questions, are listed below:

Risk of Fraud (five suggested questions). Examples:

- Did the auditor identify any new risks of fraud in the current year audit? If not, what procedures did the auditor perform to identify risks of fraud, and were any procedures different from the prior year?

- Did the auditor's inquiries of management include whether possible illegal acts, such as potential noncompliance with sanctions and other laws or regulations, have occurred? If any acts were identified, what was the impact on the audit? (No question regarding legal compliance was included in last year's list. The PCAOB has recently proposed to expand the auditor's responsibilities to identify instances of noncompliance with laws and regulations. See PCAOB Proposes to Expand Auditor Responsibility for Financial Statement Fairness and for Legal Compliance, May-June 2023 Update.)

Risk Assessment and Internal Controls (seven suggested questions). Example:

- What has the auditor done to understand and/or select and test relevant controls? Has appropriate testing of data been performed for the data used in the operation of those selected and tested controls? Have management review controls been properly tested?

Auditing and Accounting Risks (six suggested questions). Examples:

- When a restatement exists in the public company's disclosures, what were the auditor's procedures to assess the sufficiency of management's materiality conclusion? What observations does the auditor have regarding management's analysis? (This question appears to be based on concerns SEC Chief Accountant Paul Munter has expressed regarding restatement materiality determinations. See Acting SEC Chief Accountant Warns Against Bias in Restatement Materiality Decisions, March 2022 Update.)

- How did the auditor consider potential management bias in developing significant estimates and assumptions? What observations, if any, did the auditor make about potential management bias during the audit?

Digital Assets (three suggested questions). Example:

- Does the auditor utilize any specialized technology-based tools with respect to digital assets in its audit? How has the use of these tools affected the nature, timing, and extent of audit procedures performed to address risks of material misstatement related to digital assets? (Regarding audit committee oversight of reporting and audit issues associated with digital assets, see Digital Assets: The Audit Committee's Journey Continues in this Update.)

Merger and Acquisition Activities (four suggested questions). Example:

- How did the auditor evaluate risks, if any, concerning mergers and acquisition activities? If the public company has been involved in a de-SPAC (special purpose acquisition company) transaction, what were the auditor's key considerations in evaluating management's determination of the accounting acquirer?

Use of the Work of Other Auditors (four suggested questions). Example:

- Are there other participating accounting firms that play a substantial role in the audit? If so, are they registered with the PCAOB and subject to PCAOB inspections? (The questions suggested under this topic mirror those SEC Chief Accountant Paul Munter has suggested that audit committees should ask regarding the participation of other auditors in the company's audit. See SEC Chief Accountant Discusses Audit Committee Oversight of Other Auditors, April 2023 Update.)

Talent And its Impact on Audit Quality (three suggested questions). Example:

- Did the "great resignation" cause the audit firm to experience difficulties recruiting and retaining staff? If so, what is the audit firm doing to attract and retain talent to ensure that all engagement team members have appropriate levels of competency, degree of proficiency, training, and supervision?

Independence (two suggested questions). Example:

- What are the audit firm's policies or procedures for identifying, evaluating, and addressing any threats to independence, in fact or appearance? What processes are in place to ensure all relationships that may reasonably bear on independence are properly communicated to the audit committee?

Critical Audit Matters (one suggested question). Example:

- How has the auditor considered whether there is any audit matter that involved challenging, subjective, or complex auditor judgment? What preliminary determinations were made that ultimately did not result in the reporting of a critical audit matter?

Cybersecurity (three suggested questions). Example:

- How did the auditor's identification and assessment of possible risks of material misstatement consider changes to the cyberthreat landscape?

Comment: The PCAOB's suggested questions are a useful starting point for a dialog with the auditor on key audit issues. In each area, additional questions could be formulated, depending on the company's specific circumstances. Audit committees could also use many of the suggested questions as a basis for discussion with management as part of the committee's oversight of the company's financial reporting and internal controls. The ten topics in the 2023 Spotlight: Audit Committee Resource overlap to a large degree with the 2023 inspection priorities that the PCAOB staff has recently outlined. See 2023 PCAOB Inspections Will Prioritize Fraud, Financial Services, and Crypto, May-June 2023 Update. Audit committees considering issues to discuss with their auditor might want to review these two publications together.

SEC Accounting Enforcement Continues Apace

In its annual summary of SEC enforcement activity, Cornerstone Research found a sharp increase during the past year in SEC actions alleging accounting violations. Cornerstone also found that the number of cases involving individual defendants/respondents was well above the historical average, reflecting SEC Chair Gensler's commitment to holding individuals accountable. See Accounting Class Actions are Increasing Slowly While SEC Accounting Cases are Skyrocketing, May-June 2023 Update. Three recent SEC enforcement matters indicate that the focus on accounting and on individual culpability for accounting violations has not abated.

- In the Matter of View, Inc. and SEC v. Vidul Prakash. On July 3, 2023, the Commission filed a settled administrative proceeding against View, Inc., a manufacturer of "smart" windows. The order alleges that View failed to disclose $28 million in warranty-related liabilities for replacement of defective windows. From December 2020 to May 2021, View disclosed warranty liabilities of $22 million to $25 million, consisting of projected costs to manufacture replacements for the defective windows. However, View failed to include in its liability computation the additional cost to ship and install the new windows. Including those costs, View should have disclosed total warranty liabilities of $48-$53 million. View agreed to cease and desist from future violations.

  The SEC simultaneously filed a civil action in federal court against View's former CFO, Vidul Prakash, for his alleged negligent failure to ensure that View disclosed the full amount of warranty-related liabilities. Prakash is charged with antifraud, proxy disclosure, and books and records violations. The Commission is seeking a permanent injunction against future violations, civil penalties, and an order barring Prakash from serving as an officer or director of public company.

- SEC v. Brian H. Casutto, Matthew J. Zucco, and Kevin R. Harris, CPA and SEC v. Ryan C. Drexler. On June 27, 2023, the Commission filed civil actions against four former officers of MusclePharm Corp., a nutritional supplement company that is now in bankruptcy.

  Brian Casutto was MusclePharm Corp.'s former Executive Vice President of Sales and Operations, Matthew Zucco was the company's former Vice President of Sales, and Kevin Harris was the former Chief Financial Officer. The complaint against these three individuals alleges that Casutto, with the assistance of Zucco, engaged in a fraudulent scheme to prematurely recognize revenue and that Harris should have known that the revenue in question had been prematurely recognized.

The scheme involved recording orders for MusclePharm products as sold and shipped to customers (and therefore recognizing revenue) when in fact the products were held in MusclePharm storage trailers or warehouses at the end of the quarter in which the “sale” was recorded. The SEC also alleges that Harris overstated revenue by misclassifying customer credits as advertising expenses, rather than as reductions to revenue. These maneuvers allegedly inflated the company' s quarterly revenues by as much as 25 percent and gross profits by as much as 49 percent. Messrs. Casutto, Zucco, and Harris consented to injunctions against future violations, disgorgement, and civil penalties. Casutto was also barred from serving as an officer or director of a public company for five years.

Ryan Drexler was MusclePharm’s former CEO. A separate complaint against Drexler alleges that he failed to ensure that MusclePharm had appropriate internal control over financial reporting and disclosure controls and procedures to ensure that its accounting for revenue, profit, and other financial metrics was correct and that he made false statements concerning MusclePharm’s controls and procedures. In addition, the SEC alleges that Drexler concealed from investors that a $10 million MusclePharm debt had been accelerated and was due. The complaint seeks injunctive relief, civil penalties, reimbursement of compensation paid based on inaccurate financial statements, and an officer and director bar.

- In the Matter of Cantaloupe, Inc. (formerly d/b/a USA Technologies, Inc.), In the Matter of Maeve M. Duska, and In the Matter of Michael K. Lawlor. On June 5, 2023, the Commission filed a settled administrative proceeding against Cantaloupe, Inc., formerly known as USA Technologies (USAT), a manufacturer and distributor of cashless payment devices. According to the SEC’s order, USAT attempted to maximize end-of-quarter revenue and meet its internal sales by entering into bill-and-hold sales transactions that did not conform to the company's sales and revenue recognition policies. In addition, USAT inflated quarterly sales revenue by deliberately shipping devices to its customers that the customers had not ordered or had explicitly told USAT they did not want. After these practices came to light, an audit committee investigation resulted in a restatement that reduced 2017 and 2018 revenue by $4.61 million or 3.5 percent. USAT consented to a cease-and-desist order against future violations and to payment of a $1.5 million civil penalty.

  The SEC simultaneously brought administrative proceedings against Maeve Duska, USAT’s former Vice President for Sales and Marketing, and Michael Lawlor, USAT’s former Chief of Services Officer. The SEC alleges that each participated in USAT’s efforts to maximize revenue and meet internal sales targets in contravention of its sales and revenue recognition policies and GAAP, including by participation in the shipment of devices to USAT customers who had not ordered the devices. Both individuals consented to cease and desist from future violations, pay civil penalties, and to disgorge bonuses they received based on the improperly recognized revenue.

Comment: While the View case is somewhat unusual in that it is based on a liability misstatement, the other two cases are classic examples of revenue recognition fraud, which has traditionally been a main focus of SEC accounting enforcement. As the three cases illustrate, the current SEC enforcement philosophy almost guarantees that the Commissions will charge individuals in actions based on financial reporting violations – and in many cases, will seek, not only an injunction against future violations and/or a fine, but also a bar from serving as a public company officer or director in the future. Audit committees should be vigilant as to the adequacy of controls around revenue, especially when revenue-based goals are a key part of measuring management performance and setting compensation.

Digital Assets: Next Steps on the Audit Committee’s Journey

The Center for Audit Quality (CAQ) has released Continuing Your Digital Assets Journey: A Tool for Audit Committees (May 2023). This publication examines digital asset-related topics and provides questions for audit committees to consider when discussing these matters with management and the auditor. Continuing Your Digital Assets Journey is aimed at audit committees of companies that hold or transact with digital assets and is an in-depth follow-up to the CAQ’s prior publication, Jumpstart Your Digital Assets Journey: A

Tool for Audit Committees. See CAQ Publishes a Primer for Audit Committees on Digital Assets, February-March 2023 Update.

Continuing Your Digital Assets Journey discusses five broad topics. For each topic, the discussion includes a list of questions the audit committee may want to ask management and the auditor. Below are brief excerpts from the topics, along with examples of the questions.

1. Regulatory, legal, and compliance with laws and regulation

"The digital asset legal and regulatory environment is rapidly evolving and audit committees should expect continued developments. It is important for audit committees to exercise oversight and understand whether management involves the appropriate parties to monitor, evaluate, and comply with applicable laws and regulations."

- Example of question for management: Has management considered how the company's business strategy related to digital assets may be impacted by future regulation?

- Example of question for auditor: What is the auditor's understanding of the legal and regulatory framework to which the company is subject?

2. Risk assessment and consideration of fraud

"Generally, transacting with digital assets can give rise to new or heightened risks, including fraud risks. The audit committee can utilize its oversight role to understand management's and the external auditor's risk assessment, including consideration of fraud risks arising from the company's digital asset activities."

- Example of question for management: Has management evaluated how relationships with service providers or other external parties may give rise to risks that the company may be a victim of fraud perpetrated by an external party?

- Example of question for auditor: What risks impacting the financial statements has the auditor identified based on how the company has structured their digital asset holdings and transactions?

3. Safeguarding digital assets

"Most digital assets are akin to bearer assets – meaning whoever has access to the private key for a digital asset has the ability to control the digital asset. Therefore, private key custody and private key management are essential aspects of safeguarding digital assets. * * * Depending on their specific facts, circumstances, and risk profile, digital asset holders may elect to self-custody their digital assets, where they are responsible for the safeguarding of their private keys in a non-custodial wallet, or they may choose to use a third-party custodian to safeguard digital assets on their behalf."

- Example of question for management: What are some of the key risks and responses that management has considered related to the company's safeguarding and custody practices?

- Example of question for auditor: What risks has the auditor identified related to the custody model selected by management?

4. Due diligence and third-party monitoring

   a. *Blockchain Due Diligence*. "It should be a priority for companies transacting with digital assets to understand the digital assets and underlying blockchain that the company is engaging with. As part of the risk assessment process and prior to engaging in digital asset transactions, companies should perform due diligence on the digital assets and underlying blockchain with which they intend to transact."

- Example of question for management: What due diligence procedures has management performed to assess the reliability of the blockchain(s) the company uses?

- Example of question for auditor: Does the auditor have experience and expertise dealing with the digital assets and blockchain(s) management engages with?

b. *Third Party Due Diligence*. "In addition to understanding the blockchain itself, it is important to understand the risks that arise from engaging with third parties in the digital asset ecosystem. The risks may vary based on the nature of the relationship between the company and the third party. Practicing careful due diligence and monitoring for changes with third parties is important to safeguarding a company's digital assets. It is also important to keep in mind that the pseudo-anonymity provided by the blockchain can sometimes make it hard to identify counterparties to transactions."

- Example of question for management: How does management perform due diligence on third parties? Based on due diligence procedures, what risks or concerns were identified?

- Example of question for auditor: Has the auditor identified any financial reporting risks related to the company's interactions with third parties related to its digital asset transactions?

c. *SOC 1 Type 2 Reports*. "There is a wide range of maturity of third-party service providers (exchanges, trading platforms, custodians, etc.) and the sophistication of internal controls over the service provider's activities and reliability of data may vary. * * * In most circumstances companies should obtain a SOC 1 Type 2 report from a service provider, if available, to understand and evaluate the control environment at the service provider." (A SOC 1 Type 2 report is a report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.)

- Example of question for management: Is management able to obtain a SOC 1 Type 2 report for service providers, including custodians? If not, what alternative procedures will management perform?

- Example of question for auditor: Is the auditor able to obtain sufficient appropriate audit evidence (through SOC 1 Type 2 report or alternative procedures) about the company's digital asset transactions with, or digital assets held at third parties?

5. <u>Accounting and auditing</u>

a. *Maintaining Independent Books and Records*. "Management may obtain information from the exchange where they trade digital assets or where digital assets are custodied. However, when obtaining information from third parties, it is important to consider the reliability of that data. * * * Additionally, it is important to validate that the company has the appropriate infrastructure to support the financial reporting process as it relates to digital asset transactions."

- Example of question for management: Does management have processes to reconcile its books and records to third-party data and the blockchain?

- Example of question for auditor: Has the auditor identified any risks related to the systems and controls that support recording digital asset transactions?

b. *Related Parties*. "From a financial reporting perspective, it is important for management to develop appropriate processes and controls to determine the identity of counterparties in transactions. This is essential to validate the completeness of related party transactions for disclosure in the financial statements. External auditors may also be focused on related party digital asset transactions that are not conducted at arms-length as such transactions could fraudulently inflate the price of a digital asset, particularly if the asset is thinly traded."

- Example of question for management: Has management identified risks around related party transactions? What procedures and controls has management implemented to identify related party transactions?

- Example of question for auditor: Is the auditor able to obtain sufficient evidence about any related party transactions?

c. *Critical Audit Matters*. "Audit committees should also be aware that depending on the nature, complexity, magnitude, and materiality of digital asset transactions and account balances, the audit procedures over such accounts may involve especially challenging, subjective, or complex auditor judgement and may be determined to be a critical audit matter (CAM)."

- Example of question for auditor: Has the auditor identified any CAMs related to digital assets? How did the auditor reach their conclusion?

Comment: Continuing Your Digital Assets Journey concludes with this observation: "Audit committee oversight in areas such as compliance with applicable laws and regulations, identification and assessment of risks, and financial reporting, is essential as the digital assets landscape continues to evolve. An understanding of key digital assets topics as well as the questions to ask management and the auditor will help audit committees effectively exercise their oversight responsibilities." Audit committees of companies that are involved with digital assets may want to refer to this publication as they seek to increase their understanding of the risks inherent in this evolving field. The suggested questions for management and for auditors could also serve as a foundation for dialogue on these risks.

What is Audit Quality? The CAQ Updates its Disclosure Framework

The Center for Audit Quality (CAQ) has published a disclosure framework (Framework) to assist accounting firms in determining, assessing, and communicating information to help stakeholders in understanding how the firm supports and monitors audit quality. Audit Quality Disclosure Framework (Update), released in June, is a revised version of the CAQ's original audit quality disclosure framework, published in 2019. The CAQ believes that "a combination of metrics—taken as a whole and supplemented with robust discussion—may provide those overseeing the audit and other stakeholders with information and additional transparency into the firm's systems and processes that impact audit quality."

While the Framework is a tool to assist accounting firms in formulating their disclosures, a general understanding of the Framework may also be useful to audit committees, which are one of main audiences for firm audit quality disclosures. A high-level outline of the Framework is set forth below. Audit committees may also want to review the CAQ's recent publication, Audit Quality Reports Analysis: A Year in Review, which examines the audit quality reports issued by eight large U.S. accounting firms. See CAQ's Guide to Audit Quality Reports, April 2023 Update.

The Framework is voluntary and is intended to be illustrative. "A firm has flexibility to identify and tailor the information that it believes may be most relevant and meaningful to audit quality." The disclosures discussed in the Framework are firm-level, not engagement-level, disclosures. The Framework is organized at three levels of detail:

- Components of Audit Quality. The Framework discusses seven Components of Audit Quality. These are listed below.

- Points of Focus. For each Component of Audit Quality, the Framework identifies Points of Focus that describe potential processes, policies, and procedures that a firm may use to address or support that Component. Points of Focus are qualitative and lend themselves to narrative disclosure.

- Examples Performance Metrics and Other Qualitative Information. To enhance the understanding of a Point of Focus, a firm may consider supplementing a narrative description with firm-level performance metrics or other qualitative information, including measures and graphics.

The Framework discusses seven Components of Audit Quality, including Points of Focus with respect to each. The seven Components are:

- Governance and Leadership

- Relevant Ethical Requirements, Including Independence

- Acceptance and Continuance of Client Relationships and Specific Engagements

- Engagement Performance

- Resources

- Information and Communication

- Monitoring and Remediation Process

Comment: While the CAQ's guide seeks to assist accounting firms in preparing audit quality reports, it could also be helpful to an audit committee in understanding how to use and interpret such reports. Audit committees should review their accounting firm's audit quality report as part of their evaluation of the firm's work. The information in the report can provide a good basis for a discussion with the firm about its approach to audit quality and the metrics by which to judge the firm's efforts. These reports are also a potential source of information for audit committees of companies that are considering retaining a new firm.

KPMG Finds that Audit Committees Are Feeling the Effects of Increased Complexity

KPMG has released the results of a global survey of audit committee members. Seventy-four percent of the U.S. respondents identified "Increased complexity of business and risk environment -- e.g., cybersecurity, AI, supply chains, workforce challenges" as the "macrotrend" that will have the greatest impact on the audit committee's focus and agenda in the coming months. "Geopolitical and economic risks, including inflation and possible recession" (50 percent) and "Rigor of the control environment in light of business disruption and/or pressures from economic slowdown" (40 percent) placed second and third. As to the enterprise risks under the purview of multiple board committees that most concern U.S. audit committee members, 44 percent chose "Cybersecurity/data privacy/AI" and 29 percent identified "Human capital management."

The KPMG Board Leadership Center and Audit Committee Institute conducted the survey, which included 768 responses from respondents in 19 countries, in February and March 2023. 2023 Audit committee survey insights reports the views of the 144 U.S. audit committee members and chairs that participated in the survey. Significant findings based on the responses of the U.S. survey cohort are summarized below. (Note that most questions permitted respondents to provide multiple answers, so response percentages are greater than 100. Only the top five responses are included in this summary).

- Risks as to which the audit committee has significant oversight responsibilities (in addition to financial reporting and related control risks): Management's enterprise risk management processes (74 percent), Cybersecurity and IT (72 percent), Legal/regulatory compliance (67 percent), Data governance (e.g., privacy, protection, ethics, AI and algorithm bias) (53 percent), Supply chain and other operational activities and Geopolitical and economic (tied at 19 percent).

- How audit committee is addressing workload concerns: Improving focus of meeting agendas, materials, and management presentations (45 percent), Not concerned -- agenda/workload is appropriate (42 percent), Reassessing the committee's skills/expertise and composition (16 percent), Re-allocating risk oversight responsibilities among committees (15 percent), Reassessing the audit committee's charter (12 percent).

- Audit committee role with respect to ESG-related issues: Oversees ESG-related disclosures in regulatory filings (51 percent), Considers management's disclosure committee activities related to ESG disclosures -- including controls and committee composition (46 percent), Oversees compliance with ESG-related legal and regulatory requirements (29 percent), Oversees management's processes to determine which ESG issues are material to the business (26 percent), Oversees company's voluntary ESG/sustainability reporting (quality and disclosure controls) (23 percent).

- Elements of the risks posed by the company's data/digital activities that are particularly concerning or challenging from the audit committee's oversight perspective: Cybersecurity -- including ransomware and IP risk (78 percent), Vulnerabilities posed by third parties/vendors (56 percent), Data privacy—including national and international regulatory compliance (39 percent), Reputational risks (22 percent), Insider threats to network/systems (16 percent).

- Top challenges facing the finance organization: Attracting and retaining talent (50 percent), Strategic thinking and leadership (40 percent), Preparing for new regulatory disclosures on climate, cybersecurity, HCM, and other ESG-related issues (37 percent), Managing digital disruption/transformation (33 percent), Other (6 percent).

- Ways in which internal audit can increase its value to the audit committee: Greater focus on critical enterprise risks (55 percent), Evolving its data/technology-related skills and capabilities (47 percent), Helping to connect dots and seeing the big picture (46 percent), Gauging the culture/tone throughout the organization (31 percent), Ensuring CAE has stature/visibility at the board and C-suite level (19 percent).

- Concerns about the audit committee's composition and skills: No concerns (44 percent), Lack of expertise in cybersecurity, technology (29 percent), Overreliance on the chair or a single member who has deep background/experience to oversee complex financial reporting, disclosures, and control issues (24 percent), Lack of expertise in climate and other ESG issues (22 percent), Committee size—potential need to add members to spread the workload and/or expertise (17 percent).

Comment: The KPMG survey results provide insight into what issues are on the minds and agendas of U.S. audit committee members and how committees are addressing challenges in the current environment. As with similar surveys conducted by other organizations (see, e.g., Scope Creep is Affecting Audit Committee Composition and Focus, January 2023 Update), audit committees may want to use the KPMG survey results as a way of benchmarking their agendas and approaches against those of their peers.

On the Update Radar: Things in Brief

ISSB Issues its Inaugural Disclosure Standards. On June 26, the International Sustainability Standards Board (ISSB) issued its first two sustainability standards – IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and IFRS S2 (Climate-related Disclosures). Use of the ISSB standards is not mandatory in the United States, but they are likely to be adopted in most of the rest of the developed world and to become de facto global standards. Many U.S. companies are likely to make ISSB disclosures voluntarily, either in response to investor demand or as a way of providing disclosures that are comparable to those of peer companies. IFRS S1 and IFRS S2 are effective for annual reporting periods beginning on or after January 1, 2024, with earlier application permitted. See ISSB Prioritizes Climate Reporting and Defers Other Disclosures, April 2023 Update.

IFRS S1 is a general standard. It requires an entity to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows and its access to finance or cost of capital over the short, medium, or long term. These disclosures are collectively referred to as "sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects." IFRS S1 sets out general requirements for the content and presentation of sustainability disclosures so that the information disclosed is useful in making decisions relating to providing resources to the entity. In particular, IFRS S1 requires an entity to provide disclosures about –

1. Governance. The governance processes, controls, and procedures the entity uses to monitor, manage, and oversee sustainability-related risks and opportunities.

2. Strategy. The entity's strategy for managing sustainability-related risks and opportunities.

3. Risk Management. The processes the entity uses to identify, assess, prioritize, and monitor sustainability-related risks and opportunities.

4. Metrics and Targets. The entity's performance in relation to sustainability-related risks and opportunities, including progress towards any targets the entity has set or is required to meet by law or regulation.

IFRS S2 specifically addresses climate disclosures. It requires an entity to disclose information about climate-related risks and opportunities that could reasonably be expected to affect the entity's prospects. IFRS S2 applies to climate-related risks to which the entity is exposed which are either (i) climate-related physical risks or (ii) climate-related transition risks, and to climate-related opportunities available to the entity. IFRS S2 sets out the requirements for disclosing information about an entity's climate-related risks and opportunities under the four categories described in IFRS S1 (i.e., governance, strategy, risk management, and metrics and targets.) IFRS S2 seeks to generate comparable climate-related disclosures, consistent with existing standards and frameworks, and particularly with the recommendations of the Task Force on Climate-Related Financial Disclosures. IFRS S2 also includes as illustrative guidance industry-specific climate metrics based on the standards of the Sustainability Accounting Standards Board.

SEC Approves Claw Back Listing Standards. On June 9, the SEC approved New York Stock Exchange and Nasdaq Stock Market listing standards requiring listed companies to have a policy regarding the recovery of executive compensation that was erroneously awarded based on financial reporting that was subsequently restated. These new listing standards will become effective on October 2, 2023. Under the new standards, listed companies must have a claw back policy in place by December 1, 2023.

SEC Rule 10D-1 requires the exchanges to adopt these listing standards. The Commission promulgated Rule 10D-1 in accordance with Section 954 of the Dodd-Frank Wall Street Reform and

Consumer Protection Act. The Commission also issued new disclosure requirements to complement the compensation recovery policy. For additional background on the claw back requirement, see Restatements Will Trigger Compensation Claw Backs Under New SEC Rule, November-December 2022 Update. As noted in that item, the new rule potentially affects the work of the audit committees by changing the stakes of a decision to restate. As the disincentives to restate increase, audit committees will need to become more vigilant in making sure that they are fully and evenhandedly informed in situations in which a restatement is a possibility.

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. Recent blog posts include –

- NOCLAR: The PCAOB Proposes to Broaden the Auditor's Role (Dan Goelzer, July 12, 2023)

The blog is available here. You can follow @BlogAuditor on twitter or @the-audit-blog on medium.com.

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Updates issued after June 1, 2020, are available here. Updates issued between January 1, 2019, and May 31, 2020, are available here. An index to titles and topics in the Update beginning with No. 39 (July 2017) is available here.