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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:

2023 PCAOB Inspections Will Prioritize Fraud, Financial Services, and Crypto

The PCAOB's inspection staff has released Spotlight: Staff Priorities for 2023 Inspections (Spotlight), its annual preview of the current inspection cycle. For audit committees, Spotlight provides insight into whether the company's audit might be selected for inspection and into the aspects of the audit that inspectors are likely to review if it is selected. The Spotlight also highlights accounting and auditing challenges to which

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the committee may want to direct its attention. (For last year's inspections outlook, see 2022 PCAOB Inspections Preview, June-July 2022 Update.)

The 2023 PCAOB inspections will primarily review fiscal year 2022 audits. The Board's 2023 inspection plan will consider overall business risks that existed in 2022, including supply chain disruptions; volatility in financial and commodity markets due to such things as inflation, interest rates, and currency fluctuations; deal cancellations and redemptions related to special purpose acquisition companies (SPACs); mergers and acquisitions (M&A) activities, including de-SPAC transactions; and the impact of the remote/hybrid work environment. In the 2023 inspections, the staff will select some audits for inspection based on risk and some randomly. Approximately 90 percent of the audits selected for review will be subject to a "traditional review" which typically looks at two or three financial statement focus areas. The remaining 10 percent will be subject to "tailored review procedures" which generally focus on only one audit aspect.

The Spotlight discusses ten audit areas or audit types that the PCAOB staff will emphasize in 2023 inspections:

- Risk of fraud. Inspections will look at "how the auditors identified and assessed risks of material misstatements due to fraud when planning and performing the audit."

- Auditing and accounting risks. Inspections will focus on financial statement areas that are "material in amount, are complex in nature, require significant judgment, and/or may be particularly susceptible to changes in economic conditions, for both financial reporting and internal controls." See Financial Reporting and Audit Risks below.

- Risk assessment and internal controls. Inspectors will "evaluate the auditor's procedures to (1) design and implement overall responses that address risks of material misstatement, (2) understand, identify, and test relevant controls, and (3) modify the audit approach based on identified control deficiencies."

- Financial services specific considerations. The inspections staff will select audits of financial services companies that are potentially impacted by risks arising from interest rates, inflation, and uncertainty and volatility in the digital assets markets. "For example, ongoing changes in interest rates can have a material effect on a company's liquidity position, future income and expenses, valuation of investments in securities, ability to meet margin requirements, ability to meet long-term debt obligations, and ability to continue as a going concern."

- Broker-dealer specific considerations. In inspections of audits of securities broker-dealers, the staff will consider how the auditor addressed the risk of fraud, including the misappropriation of customer assets, and will "place an emphasis on the audit firm's procedures relating to revenue identified as having a significant risk, internal controls over compliance with the customer protection rules, and review procedures where broker-dealers have filed an exemption report with respect to such rules."

- Digital assets. The inspections staff will focus on audits of public companies and broker-dealers with material digital assets because digital asset activity "presents unique risks, including potential fraud risks due to volatility and lack of regulation."

- M&A, including de-SPAC transactions. For M&A transactions (including de-SPACs), inspectors will evaluate the auditor's work on "(1) valuation and accounting of financial instruments using complex valuation models, (2) business combinations including reverse mergers, (3) internal control over financial reporting, (4) financial statement presentation and disclosure, (5) significant equity or debt restructuring, and (6) the entity's ability to continue as a going concern."

- Use of the work of other auditors. Issues that will be reviewed in inspections of audits in which the lead auditor used the work of other auditors include "(1) how other auditors were used (including, but not limited to, those in Russia, Belarus, and Ukraine), (2) how lead auditors may have modified their audit approach [e.g., in light of a remote work environment, or geopolitical instability], (3) whether the use of other auditors in multi-location audits was modified due to restrictions on travel, and (4) the lead auditor's supervision of the activities of other auditors."

- Quality control. Inspections will assess the audit firm's quality control procedures, including compliance with PCAOB quality control standards and will "place emphasis on the audit firm's hiring challenges (which were affected by the "great resignation") and independence, which is a recurring deficiency."

- Other areas of inspection. Three other areas that inspectors will address in 2023 are critical audit matters (CAMs), cybersecurity, and use of data and technology in the audit. As to cybersecurity, the staff states: "For audits selected for review where a cyber incident has been identified, we will review the audit firm's response, including whether the auditor assessed the likelihood and magnitude of potential misstatement and how it may have modified its audit approach. In addition, we will review any new or modified firm policies and procedures supporting the audit firm's own cybersecurity program."

Financial Reporting and Audit Risks

As to audit areas that present heightened risk, the Spotlight lists nine factors that may increase the risk of inaccurate, incomplete, or untimely financial information and may therefore require changes to the audit procedures:

- Unreasonable assumptions and models used to value complex financial instruments and accounting estimates (e.g., derivatives).

- Increased volatility in financial and commodity markets due to fluctuations in interest rates and inflationary trends.

- Unreasonable assumptions in future financial projections used to account for estimates in business combinations; asset impairment; impairment of goodwill and intangible assets; loss contingencies and valuation allowances; and revenue.

- Unreasonable assumptions affecting the timing and amount of revenue recognition due to supply chain disruptions, negative effects of COVID-19, and geopolitical conflicts.

- Complexities regarding existence and valuation of inventory due to challenges with inventory build-up and obsolescence.

- Challenges with accounting for foreign currency and the effects of foreign currency transaction and translation adjustments on the financial statements, including the statement of cash flows, due to the rising value of the U.S. dollar at public companies with significant foreign operations.

- Financial, economic, and business uncertainties that impact the auditor's evaluation of the public company's ability to continue as a going concern, such as the public company's inability to access funds through borrowings due to violation of debt covenants or deal cancellations.

- Economic conditions that could adversely affect a public company's ability to meet certain criteria and/or assumptions, such as whether a public company has the ability and intent to not sell investment securities it has designated as "held-to-maturity."

- Complexities in the public company's activities that may impact disclosures regarding (1) contingent liabilities, (2) changes in classification of financial instruments between level 2 and level 3, (3) concentrations of credit risk, and (4) related party transactions that may result in omitted, incomplete, or inaccurate disclosures.

Target Teams

PCAOB inspections include the use of "target teams" which review specific issues across many audit firms. During 2023, the target team will focus on public company audits that include risks related to digital assets, first year audits, multi-location audits, and significant or unusual events or transactions.

Comment: The Spotlight provides audit committees with insight into why a company's engagement may be selected for review this year and why, if selected, the inspectors may concentrate on some aspects of the audit and ignore others. In addition, the Spotlight may be helpful to the audit committee in understanding their auditor's work plan since areas of PCAOB inspection emphasis this year may also be scrutinized in subsequent inspections. Finally, since the Spotlight reflects the PCAOB's assessment of enhanced audit and financial reporting risks, it may also aid committees in their oversight of the company's financial reporting by providing a catalog of accounting and reporting issues that are challenging in the current environment.

PCAOB Proposes to Expand Auditor Responsibility for Financial Statement Fairness and for Legal Compliance

The Public Company Accounting Oversight Board has issued two sets of proposed revisions to the public company auditing standards. These proposals, if adopted, could significantly affect the scope of the auditor's work, the range of issues auditors raise with audit committees, and the cost of public company audits.

General Responsibilities of the Auditor

On March 28, the Public Company Accounting Oversight Board issued for public comment General Responsibilities of the Auditor in Conducting an Audit, a release that proposes a new auditing standard, AS 1000. If adopted, AS 1000 would reorganize and consolidate existing PCAOB standards that address the core principles and responsibilities of the auditor, such as reasonable assurance, professional judgment, due professional care, and professional skepticism. According to the PCAOB release announcing the proposal, AS 1000 and the related amendments "are designed to streamline and clarify general principles and responsibilities of auditors and provide a more logical presentation, which would enhance the useability of the standards by making them easier to read, understand, and apply." The public comment period on the proposal ended May 30, 2023.

In the PCAOB's view, proposed AS 1000 would not make fundamental changes in the auditor's responsibilities. However, it appears that, in at least one respect, the proposal could change the issues an auditor must consider in determining whether to issue a clean audit opinion and could lead to disagreements with management and discussion with the audit committee concerning financial statement presentation.

At present, and under the proposal, the auditor expresses an opinion on whether the financial statements "present fairly" in all material respects the company's financial position and results of operations "in conformity with the applicable financial reporting framework." Under the existing standards, the auditor's judgment concerning fair presentation is made in the context of generally accepted accounting principles -- GAAP. Under the proposal, the auditor would be required to evaluate, in addition to GAAP conformity, whether "the information in the financial statements is presented and classified appropriately and in a manner that would be informative and not misleading to a reasonable investor" and whether "transactions and relevant events and conditions are appropriately recognized, measured, and disclosed in the financial statements." The PCAOB's release explains that these amendments would "clarify" that the auditor's determination of fairness “goes beyond” evaluation of whether the financial statements are presented in “mere technical compliance” with the applicable financial reporting framework.

By decoupling the concept of fair presentation from GAAP compliance and introducing judgmental issues like what would be “informative and not misleading” and “appropriate,” the proposal seems to open potential areas for disagreement between auditors and management concerning financial statement presentation, notwithstanding that there is no dispute that the statements are in accordance with GAAP. Even if the auditor issues a clean audit opinion, these kinds of judgmental questions are likely to be brought to the audit committee and may become the basis for public disclosure in the auditor’s report as critical audit matters. (This and other issues raised by the PCAOB’s General Requirements proposal are discussed in my post on The Audit Blog, The PCAOB’s “Modest Proposal” to Modernize the Foundations of Auditing.)

NOCLAR

On June 6, the Board, by a 3-2 vote, issued for public comment Amendments to PCAOB Auditing Standards related to a Company’s Noncompliance with Laws and Regulations. This proposal would amend the auditing standards related to the auditor’s responsibility for considering a company’s noncompliance with laws and regulations (NOCLAR). In her public meeting statement explaining the proposal, PCAOB Chair Erica Williams observed that a “company’s noncompliance with laws and regulations, including fraud, can have devastating consequences for investors. When sanctions, fines, and civil settlements directly affect a company’s bottom line, or reputational damage causes a company’s stock value to decline, innocent investors pay a price. * * * [W]e’ve seen far too many examples of investors getting hurt due to noncompliance with laws and regulations.”

Current PCAOB standards require the auditor to perform procedures designed to provide reasonable assurance of detecting illegal acts that would have “a direct and material effect” on the determination of financial statement amounts. However, the auditor is not required to include audit procedures designed to detect illegal acts with an “indirect effect” on the financial statements. The PCAOB’s proposal would discard the distinction between direct and indirect effects of illegal acts on the financial statements and instead broadly require auditors to identify and evaluate information indicating that noncompliance with laws and regulations, including fraud, has or may have occurred and to communicate such information to management and the audit committee.

The NOCLAR proposal would replace current PCAOB auditing standard AS 2405, Illegal Acts by Clients, with a new standard, AS 2405, A Company’s Noncompliance with Laws and Regulations. Among other things, the new standard would delete the term “illegal acts” and instead refer to “noncompliance with laws and regulations.” The new standard would expand the auditor’s obligation to plan and perform audit procedures to (1) identify laws and regulations with which noncompliance could reasonably have a material effect on the financial statements; (2) assess and respond to risks of material misstatement of the financial statements due to noncompliance with those laws and regulations; and (3) identify whether there is information indicating such noncompliance with those laws and regulations has or may have occurred. Auditors would also have enhanced obligations to evaluate of information related to noncompliance, including evaluating the timeliness and appropriateness of management’s remedial actions, and to communicate information indicating noncompliance has or may have occurred to management and the audit committee.

According to the PCAOB press release announcing the NOCLAR proposal, it would strengthen and enhance auditor obligations related to noncompliance with laws and regulations in three respects:

- Identify – The proposal would establish specific requirements for auditors to proactively identify – through inquiry and other procedures – laws and regulations that are applicable to the company and that could have a material effect on the financial statements, if not complied with. The proposal also makes explicit that financial statement fraud is a type of noncompliance with laws and regulations.

- Evaluate – The proposal would strengthen requirements related to the auditor's evaluation of whether noncompliance with laws and regulations has occurred, and if so, the possible effects on the financial statements and other aspects of the audit. For example, the proposed standard would require the auditor to consider whether specialized skill or knowledge is needed to assist the auditor in evaluating information indicating noncompliance has or may have occurred.

- Communicate – The proposal would make it clear that the auditor is required to communicate to the appropriate level of management and the audit committee as soon as they [i.e., auditors] are made aware that noncompliance with laws or regulations has or may have occurred. Additionally, the proposal would create a new requirement that the auditor must communicate to management and the audit committee the results of the auditor's evaluation of such information. Specifically, this communication would address which matters are likely noncompliance and the effect on the financial statements.

Under the existing auditing standards, the auditor must communicate with the audit committee after an illegal act has come to the auditor's attention. The proposal would create more detailed and specific communications requirements, potentially including three types of communications with the audit committee or full board regarding noncompliance with laws or regulations.

- The auditor would to be required to communicate with management and the audit committee "as soon as practicable" upon becoming aware of information suggesting that legal noncompliance "has or may have occurred." Thus, the audit committee would have to be informed even in cases where the auditor suspects – but has not actually determined – that some type of noncompliance has, or is likely to have, occurred and regardless of any financial statement impact.

- A second audit committee communication would be required after the auditor has evaluated the information indicating that noncompliance may have occurred. The auditor would be required to communicate to management and, unless the matter is clearly inconsequential, to the audit committee the results of the auditor's evaluation. This second communication would be required to identify likely instances of noncompliance and whether there is a material effect on the financial statements.

- The auditor would also be required to communicate to the full board of directors when the auditor concludes (a) the likely noncompliance has a material effect on the financial statements; (b) senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial action with respect to the likely noncompliance; and (c) the failure to take remedial action is reasonably expected to warrant departure from an unqualified opinion or resignation from the audit engagement.

The two CPA members of the PCAOB dissented from issuance of the NOCLAR proposal. In her statement, at the meeting during which the NOCLAR proposal was approved, Board Member Christina Ho characterized the proposal as "a breathtaking expansion of the auditors' responsibilities, which I believe will hurt investors." She pointed specifically to the effort that would be necessary for auditors to identify all laws and regulations applicable to the public company under audit and to the fact that such an undertaking would transform the auditor's role "from one of providing reasonable assurance to one of performing a management function." She also predicted that the proposal would "significantly expand auditors' need for expertise from lawyers, legal experts, and possibly other specialists, resulting in a substantial increase in audit fees."

Board Member DesParte's statement raised similar objections. In particular, he emphasized that the proposal would require auditors "to identify any and all information that might indicate instances of noncompliance of any law or regulation across the company's entire operations, without regard to materiality. * * * This is well beyond both the scope of the financial statement audit and the auditor's core competency; and will trigger the need—at great cost-- to significantly increase the use of lawyers and others as specialists on many, if not all PCAOB audit engagements on a recurring basis." As to the proposed audit committee communications requirements, he stated:

> "It is questionable whether it would be useful or a distraction to the Audit Committee for the auditor to communicate information indicating potential noncompliance prior to the auditor's evaluation of whether the noncompliance has likely occurred or of any financial statement impacts (vs. only reporting matters deemed likely to have occurred and/or to have material financial statement implications)."

The public comment period on the NOCLAR proposal is open until August 7, 2023.

Comment: As discussed above, both PCAOB proposals could, if adopted, affect audit committees by expanding the scope and nature of financial reporting and legal compliance issues that auditors would be required to bring to the committee's attention. In some ways, audit committees might benefit from this wider range of input and insight from the auditor. For example, while it may be difficult for auditors to reach conclusions as to whether GAAP financial statements are "appropriate" and optimally informative, these are the kinds of questions that audit committees (and of course management) should consider. On the other hand, as Board Member DesParte's comments suggest, the NOCLAR proposal seems to have the potential to flood audit committees with a mass of information concerning possible legal violations that may or may not have occurred and that may or may not be significant from a financial reporting perspective. Shifting through these types of matters – which would likely be necessary once the committee is on notice of them – does not seem like an effective use of audit committee time and resources.

Because of their potential impact, audit committees may wish to ask their auditor or legal counsel to keep the committee informed of the progress of these two PCAOB initiatives.

Accounting Class Actions are Increasing Slowly While SEC Accounting Cases are Skyrocketing

Cornerstone Research has issued two reports on litigation involving accounting and auditing violations. In its annual report on accounting-related class actions, Accounting Class Action Filings and Settlements—2022 Review and Analysis, Cornerstone finds that class action filings against public companies for alleged accounting violations increased slightly last year but remain low by historical measures. On the other hand, the dollar value of accounting class action settlements rose 67 percent, compared to 2021. (For a summary of Cornerstone's report on 2021 accounting class actions, see Cornerstone: Accounting Class Actions Fell Sharply Last Year, April-May 2022 Update.)

The findings of Cornerstone's annual report on Securities and Exchange Commission accounting and auditing enforcement actions are almost a mirror image of those in the class action report: SEC accounting and auditing enforcement activity increased sharply in fiscal 2022, while monetary settlements dropped substantially. SEC Accounting and Auditing Enforcement Activity—Year in Review: FY 2022 found that, in 2022, the SEC announced 68t accounting and auditing enforcement actions, a 55 percent increase from fiscal 2021. However, monetary settlements in SEC accounting and auditing cases totaled $625 million, down over 60 percent from 2021. (For a summary of Cornerstone's report on 2021 SEC accounting and auditing cases, see Accounting and Auditing Enforcement was Down in 2021, But May Now be on the Upswing, March 2022 Update.)

Accounting Class Action Filings and Settlements

Cornerstone found that, in 2022, plaintiffs filed 51 new class actions against public companies alleging accounting violations, an 11 percent increase from the 46 filings in 2021. While an uptick from 2021, the 51 cases brought in 2022 were significantly below the 2013-2021 average of 62 new filings per year. Moreover, 24 percent of 2022 federal securities law class actions involved special purpose acquisition companies (SPACs), up from 20 percent in 2021.

There were 43 accounting case settlements in 2022, inline with the average of 42 during 2013-2021. The value of these accounting-related settlements increased to $1.4 billion, up from $817 million in 2021. However, the total value of accounting-related settlements, as a percentage of the value of all securities class action settlements, declined from 42 percent in 2021 to 36 percent in 2022.

Other key take-aways from the 2022 Cornerstone report include:

- Almost half of accounting class action cases settle, but it takes time. From 2013 through 2021, 40 percent of accounting case filings were settled, 43 percent were dismissed, one percent were remanded, and 16 percent are continuing. In 2022, the average time to settlement was 3.7 years, compared to 3.2 years in 2021.

- Plaintiffs are bringing cases against smaller companies but settling with larger companies. The median pre-disclosure market capitalization of issuer defendants in 2022 accounting class actions was $1.1 billion, 12 percent less than the 2013 to 2021 average. This was the smallest defendant market capitalization since 2017. At the same time, the median pre-disclosure market capitalization of issuer defendants in cases that settled in 2022 increased by over 110 percent from 2021 and was nearly three times the average annual median for 2013 to 2021.

- The industries that attracted the most 2022 filing were Consumer Non-Cyclicals and Consumer Cyclicals. Accounting cases against companies in the Consumer Non-Cyclical and Consumer Cyclical sectors together were almost half of total 2022 filings. The third most-sued industry was Technology, with 18 percent of cases. By comparison, in 2021 the greatest number of cases were filed against companies in the Technology, Consumer Non-Cyclical, and the Financial sectors. In 2022, case filings against companies in the Financial sector dropped to their lowest level in the last 10 years. For the first time in the last 10 years, plaintiffs filed no accounting class actions against companies in the Communications sector.

- Restatements were involved in one-third of new accounting class actions. Seventeen (33 percent) of the 51 accounting cases filed in 2022 involved restatements. This was the highest percentage of restatement cases since 2014 and a sharp increase from the five restatement cases filed in 2021. (The average number of restatement cases filed per year during 2013 to 2021 was 16.) In 2022, 82 percent of the accounting case filings involving a restatement also included allegations of internal control weaknesses.

- Internal control weakness allegations regained some of their popularity. The number of accounting case filings containing allegations of internal control weaknesses increased from 18 to 25 (49 percent of all cases) but was at the second-lowest level in the last 10 years. For the second consecutive year, less than half of new accounting cases alleged internal control weaknesses. Accounting cases filed in 2022 containing allegations of internal control weaknesses involved the smallest defendant firms, as measured by pre-disclosure market capitalization, since 2015.

- Revenue recognition is the most common GAAP allegation, although internal control weaknesses have partly displaced GAAP as a basis for litigation. In 2022, 35 percent of accounting case filings involved allegations of improper revenue recognition. Eighty-four percent of accounting case settlements involved GAAP allegations, compared to 100 percent in 2016.

SEC Accounting and Auditing Enforcement

As noted above, Cornerstone's study of fiscal 2022 SEC enforcement found that the Commission filed 68 accounting and auditing actions, a 55 percent increase from fiscal 2021. While this level of SEC accounting enforcement reflected a 55 percent increase over 2021, it was exactly in line with the average of 68 yearly accounting and auditing filings during fiscal years 2017 through 2022 and significantly below the 93 cases brought in 2019. The SEC brought 51 of the 2022 cases as administrative proceedings and 17 as civil actions filed in federal court. Very few SEC accounting cases are litigated; settlements were announced in 66 of the 68-eight actions simultaneously with the filing of the case.

Other interesting features of Cornerstone's SEC accounting enforcement analysis include:

- Announcements of restatements or material control weaknesses are frequently the basis for SEC enforcement. Of the 68 enforcement actions, 36 referred to announced restatements of financial statements and 23 referred to announced material weaknesses in internal control over financial reporting. Five referred only to a material weaknesses announcement, 18 to only a restatement announcement, and 18 referred to both.

- Revenue recognition, compensation claw backs, and auditor independence were popular topics. Twenty-five of the 36 actions that referred to restatements alleged improper revenue recognition. Nine of the 68 cases brought in 2022 were based on the Sarbanes-Oxley Act provision that authorizes the SEC to claw back executive compensation following a restatement. Five cases charged violations of the auditor independence rules.

- SEC enforcement is focusing on individuals. The SEC named one or more individuals as defendants or respondents in 49 (72 percent) of the 68 cases it filed in 2022. Fifty-three percent of actions (36 cases) involved individual respondents only, a sharp increase from the FY 2017 to 2021 average of 37 percent. In total, the SEC charged 66 individuals in accounting or auditing cases in 2022, up from 38 individuals last year, but in line with the 2017-2021 average of 65 individual defendants/respondents per year.

- The spotlight is on auditors. The SEC filed charges against 28 individual public company auditors and audit firms, representing 27 percent of the 103 defendants/respondents in the 68 cases brought in 2022. The number of auditor/audit firm defendants/respondents was almost double the number in 2021 and almost triple 2020.

- The monetary cost of settling with the SEC declined. In fiscal 2022, 90 respondents/defendants settled with the SEC. In those settlements, 65 of the settling parties were required to make a monetary payment. These payments totaled $625 million, down from $1.627 billion in 2021. Civil penalties accounted for 67 percent of the $625 million, while the remaining 33 percent was disgorgement of illegally obtained funds (31 percent) and prejudgment interest (2 percent).

Comment: While the frequency of both class action and SEC enforcement accounting cases is somewhat low compared to historical norms, this type of litigation is increasing and remains a real possibility for many public companies. Moreover, the cost of settling class action cases, and the time required to do so, also seem to be increasing. As stated in several prior Updates, accounting issues are a significant line of attack for the plaintiff's bar, and restatements and disclosure of internal control weaknesses are likely to attract litigation, if they coincide with a significant drop in stock price. Investing in strong internal controls, along with audit committee care and diligence in overseeing the company's financial reporting, are a small price to pay to reduce the risk that the company will be exposed to the cost and distraction of litigation over accounting matters.

Another significant Cornerstone finding that audit committees and financial reporting management should keep in mind is the SEC's stepped-up focus on individual culpability. As noted above, over half of 2022 accounting cases involved only individual defendants/respondents, well above the historical average. Cornerstone attributes this shift to SEC Chair Gensler's commitment to make holding individuals accountable a key priority of the enforcement program. The risk that restatements, internal control material weaknesses, and other accounting-related problems will result in SEC enforcement action against the individuals involved, along with or instead of the reporting company, is likely to remain elevated for the foreseeable future.

On the Update Radar: Things in Brief

Commissioner Uyeda Discusses the SEC's Focus on Accounting. In a recent speech, SEC Commissioner Mark T. Uyeda discussed the SEC's focus on accounting violations. See Remarks at ICAEW Event – World-Class Regulation: Building Trust and Transparency in International Markets (May 12, 2023). His remarks underscore that the Commission is ramping up enforcement activity involving accounting and auditing -- the same point illustrated in Cornerstone's report on 2022 SEC accounting and auditing enforcement. See Accounting Class Actions are Increasing Slowly While SEC Accounting Cases are Skyrocketing in this Update. Commissioner Uyeda also emphasized the importance of a strong audit committee as a means of lowering the likelihood that a company will become the target of SEC financial reporting enforcement.

From an audit committee perspective, three points in this speech are of interest:

- Actions Against Individuals. Based on the Cornerstone report, Commissioner Uyeda points out that accounting cases against individuals increased significantly over prior years and explains why the trend of naming more individuals in SEC accounting enforcement cases is likely to continue:

  > "When this [a reporting company accounting violation] happens, a potential cause is the activities of one or more bad actors within the company's management. When bringing enforcement actions in these instances, the SEC should continue to focus on pursuing those individual bad actors and levying appropriate remedies against them. An enforcement program focused solely on charging and imposing monetary penalties on firms, without parallel actions to hold individuals accountable, will mostly harm the firms' current shareholders and will not discourage individuals from becoming bad actors in the future. Accordingly, charges and penalties against individuals serve as the strongest disincentive against people becoming bad actors and engaging in the same activities in the future."

- Compensation Claw Backs Following Restatements. Like Cornerstone, Commissioner Uyeda notes that in several 2022 actions the Commission sought to recover bonuses and profits from executives following a restatement of financial statements under Section 304 of the Sarbanes-Oxley Act. He also notes that in 2022 the Commission adopted a broader claw back rule, based on authority granted in the Dodd-Frank Act. See Restatements Will Trigger Compensation Claw Backs Under New SEC Rule, November-December 2022 Update. Commissioner Uyeda predicted, "Going forward, clawbacks pursuant to this rule may become a significant process that companies will need to go through whenever [they engage] in a restatement."

- Role of the Audit Committee. In Commissioner Uyeda's view, a strong audit committee can lower the likelihood of accounting violations by actively overseeing and understanding the accounting policies, estimates, and judgments made by management. "Carrying out this duty requires insight into whether the controls and procedures related to financial reporting are effective." With respect to the audit committee's oversight of the company's auditor, he emphasized the importance of "determining that the auditor is independent under the myriad of rules that govern independence" of contributing "to a culture of cooperation between management and the auditor, while still ensuring that differing views on important issues are raised to the committee."

PCAOB Adds Audit Quality Indicators to its Short-Term Agenda. On May 16, the Public Company Accounting Oversight Board announced that its staff had posted to the Board's website a revised standard-setting agenda. The Board describes its standard-setting agenda as "primarily focused on enhancing investor protection by prioritizing the areas where improvements to PCAOB standards could have the most significant impact on audit quality and the public interest." From an audit committee perspective, the most significant change from the prior agenda is that a project entitled “Firm and Engagement Performance Metrics” has been added to the short-term agenda. The short-term list consists of those standard-setting projects where a Board action (e.g., proposal or adoption) is anticipated in fewer than 12 months.

The Firm and Engagement Performance Metrics project is based on a 2008 recommendation of the Department of the Treasury’s Advisory Committee on the Auditing Profession that the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness. In 2015, the PCAOB issued a Concept Release on Audit Quality Indicators and sought comment on 28 potential indicators. See PCAOB Publishes Concept Release on Audit Quality Indicators, July 2015 Update. The PCAOB has taken no further action on audit quality indicators since publication of the concept release.

PCAOB audit quality indicators could be useful to audit committees in assessing the performance of their auditor. Audit committees may want to follow the progress of the project as it evolves.

Pointers on the Audit Committee’s Role in Ethics and Compliance Oversight. As part of its “On the audit committee’s agenda” series, the Deloitte Center for Board Effectiveness has released Who’s in charge: The audit committee’s role in ethics and compliance oversight (April 2023). The paper is a high-level discussion of audit committee oversight of ethics and compliance, particularly issues arising from the committee’s statutorily-mandated responsibility for procedures, such as hotlines, for receipt of employee complaints regarding questionable accounting or auditing matters. Themes of the discussion include:

Responsibilities and resources. The audit committee should consider whether it is the proper committee to oversee a particular area of compliance. Some types of risks may be better overseen by other committees “thereby conserving the audit committee’s resources for matters that more directly relate to its key areas of risk management oversight.”

Risk as a starting point. In addressing ethics and compliance, the questions an audit committee should consider asking include “What are the greatest areas of ethical and compliance risks we face?” and “Are we looking at the right risks, and if not, what risks should we be looking at?” Both newly public and long-established companies may benefit from a fresh look at ethics and compliance risks.

Questions for management. Once the relevant risks have been identified, the committee should seek management’s assistance in determining whether the company’s policies, processes, and procedures optimally address those risks. Key questions for management are –

- Do we have the right policies in place? Are there key risks for which we don’t have policies?

- Have existing policies been updated to address recent developments, including changes in the company, in law or regulation, and otherwise?

- Do we have the right management resources to monitor and enforce compliance with our policies? How are we using technology to monitor and enforce our policies?

Critical importance of employee communications. Effective communications with employees are essential. Communications should attract and retain employees’ attention and result in “sticky” messaging. “The dramatic increase in hybrid and remote work arrangements in the current environment has complicated these challenges at the same time that it may lead to heightened incidence of fraud.”

Avoiding Awkward Silences: FRC Has Conversation Starters for Investor-Audit Committee Dialogue. The UK's Financial Reporting Council (FRC) has announced the launch of a web page "aimed at promoting better engagement between investors and audit committees to facilitate better understanding of companies and their approach to financial reporting and internal control." The FRC said that this new resource is intended to assist investors that wish to engage with audit committees and companies on assurance-related topics. The FRC believes that direct conversations with audit committee chairs could provide investors with insights into the company's approach to regulatory issues and other areas of interest to market participants.

The FRC web page is organized by topic, with an initial broad question followed by more detailed follow-up questions. For example –

> Conversation starter
>
> Please give more detail about the significant issues the committee considered in relation to the financial statements.
>
> Suggested follow-ups

- How does the committee determine what makes an issue "significant"?
- How have the significant issues been addressed?
- How have these significant issues changed since last year? How do you expect them to change in the coming year? Are there any emerging issues which you expect to become significant in the future?
- How did you decide which significant issues to include in the audit committee report?
- What system(s) are in place to ensure the committee is able to monitor the evolution of significant issues and to identify further emerging issues?

While the FRC's web page is written from a UK perspective and includes references to FRC documents as sources of further information, it could be useful to U.S. audit committees in understanding what information concerning the committee's work might be of interest to investors. In addition, some suggested questions, while framed as inquiries that investors might make to an audit committee chair, could be rephrased as questions that committees might want to pose to their auditor or to management.

If You Want Assurance Over Your ESG Disclosures, Hire a CPA. As corporate environment, social, and governance (ESG) disclosures have increased, more companies are seeking third-party assurance over their ESG disclosures. However, unlike financial statement audits, which must be performed by licensed CPAs, in most jurisdictions are there are no regulatory constraints on who can express an opinion on ESG disclosures, and companies often utilize other types of professionals for ESG assurance. In Corporate decision-making: Why choose a CPA for your ESG assurance needs? (April 2023), the Center for Audit Quality and the Association of International Certified Professional Accountants discuss reasons why companies should choose a CPA as their ESG assurance provider.

The paper cites five benefits of engaging a CPA for third party assurance of ESG information:

- Knowledge of a company's business and business processes. "CPAs understand specific industries, market forces, and why certain ESG metrics are important financially as well as from a risk perspective. They have extensive experience in gaining an understanding of a company's business processes and assessing and responding to risk, and they have expertise in evaluating internal systems and processes for collecting, measuring, analyzing, and reporting information."

- Adherence to recognized standards. US accounting firms usually apply the American Institute of Certified Public Accountants' attestation standards. "The AICPA standards have been subjected to due process procedures, a transparent, public and reasoned process. The AICPA attestation standards are also publicly available at no cost, which allows users to evaluate the practitioner's report against the requirements of the attestation standards."

- Commitment to quality control, professional and ethical standards. "CPAs comply with rigorous and widely recognized requirements for independence, firm systems of quality control, and subject matter competency." Non-CPA firms "may not have the same rigorous credentialing, continued education, quality control, and oversight which could potentially impair independence and objectivity at the risk of public protection."

- Use of specialists. Accounting firms have access to specialists "with expertise in a wide variety of ESG information, including climate-related areas such as GHG emissions, and have proven experience incorporating those specialists to deliver seamless services."

- Trusted and valued by users of ESG reporting, including capital market participants. "Investors are increasingly focused on ESG information because they find such information helpful in understanding the resilience of a company's long-term value-creation strategy, and the information enables them to manage their investments based on ESG risks and opportunities."

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 –

- The PCAOB's "Modest Proposal" to Modernize the Foundations of Auditing (Dan Goelzer, May 26, 2023)

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

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The Update's website is www.auditupdate.com.

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The Update seeks to provide general information of interest to audit committees, auditors, and their professional advisors, but it is not a comprehensive analysis of the matters discussed. The Update is not intended as, and should not be relied on as, legal or accounting advice.

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.