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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:

2021 PCAOB Large Firm Inspection Reports

On December 19, the PCAOB released the 2021 inspection reports for the U.S. affiliates of the six global network audit firms. The overall percentage of these firms' inspected audits that the PCAOB found deficient was 21 percent. Four of the six firms had a higher percentage than in 2020 of inspected engagements that were deficient; the other two firms – KPMG and BDO – had essentially unchanged deficient rates.

As was the case last year, PwC's inspection results were the best in the group. In 2021, the Board found deficiencies in two out of 56 PwC audits it inspected – a deficiency rate of 3.6 percent; in 2020, the Board found only one deficient audit (2 percent) out of 52 PwC engagements inspected – an all-time record low for any Big Six firm. Deloitte maintained its second-place position, with seven engagements in Part I.A of its

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2021 inspection report (13 percent of 54 engagements inspected). At the other end of the spectrum, BDO, as in 2020, had the highest percentage of deficient engagements – the Board found problems in 53 percent of the 30 engagements it inspected, down slightly from 54 percent last year. KPMG had the second-highest rate with 26 percent of inspected engagements cited for deficiencies.

From a big picture standpoint, the large firm 2021 inspection results were less favorable than in 2020, although the five-year trend for the six firms as a group is still positive. The percentage of engagements that inspectors found to include at least one deficiency in 2021 rose five percent (from 16 percent in 2020). The number of deficiencies per inspected engagement also rose from 0.64 deficiencies per inspection in 2020 to 0.77 in 2021. As in 2020, more than half of all deficiencies described in Part I.A of the six large firm reports related to the audit of internal control over financial reporting (ICFR). Seventy-two percent of engagements in Part I.A of the six inspection reports included at least one ICFR audit deficiency. (Regarding the five-year trend, see Comment 1, below.)

For last year's analysis of the 2020 inspection reports of the six global network member firms, see 2020 PCAOB Large Firm Inspection Reports, November-December 2021 Update. For the PCAOB staff's summary of all 141 of the 2021 audit firm inspection reports, see PCAOB Staff 2021 Inspections Preview Reports Rising Audit Deficiencies in this Update.

2021 Inspection Cycle Report Synopses

Part I.A of a firm's inspection report describes audit deficiencies of such significance that it appeared to the PCAOB that the firm had not obtained sufficient appropriate audit evidence to support its opinion on the financial statements and/or ICFR of the public company under audit at the time the opinion was released. Part I.B of an inspection report describes instances of non-compliance with PCAOB standards or rules that do not relate directly to the sufficiency or appropriateness of the evidence supporting an audit opinion. Below is a synopsis of Part I.A and Part I.B the 2021 inspection reports for the six U.S. affiliates of the global network firms:

- BDO USA, LLP. The PCAOB reviewed 30 BDO issuer audits, 15 of which were integrated audits of both the financial statements and ICFR. In 16 of the 30 audits (53 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to BDO's 54 percent deficient engagement rate in 2020. Six of the 16 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; nine included only a financial statement audit deficiency; and one included only an ICFR audit deficiency. The PCAOB described 56 audit deficiencies (1.87 deficiencies per inspection) associated with 64 auditing standards in the 16 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified nine instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion.

- Deloitte & Touche LLP. The PCAOB reviewed 54 Deloitte issuer audits, 43 of which were integrated audits of both the financial statements and ICFR. In seven of the 54 audits (7 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to D&T's 4 percent deficient engagement rate in 2020. One of the seven engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; two included only a financial statement audit deficiency; and four included only an ICFR audit deficiency. The PCAOB described eleven audit deficiencies (0.20 deficiencies per inspection) associated with eleven auditing standards in the seven engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified eight instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion.

- Ernst & Young LLP. The PCAOB reviewed 56 EY issuer audits, 48 of which were integrated audits of both the financial statements and ICFR. In twelve of the 56 audits (21 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to EY's 15 percent deficient engagement rate in 2020. Nine of the twelve engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; one included only a financial statement audit deficiency; and two included only an ICFR audit deficiency. The PCAOB described 64 audit deficiencies (1.14 deficiencies per inspection) associated with 70 auditing standards in the twelve engagements in Part I.A. (One of these engagements, Issuer A, contained 24 of the 64 total deficiencies.) In Part I.B of the inspection report, the PCAOB identified 27 instances of non-compliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion.

- Grant Thornton LLP. The PCAOB reviewed 31 Grant issuer audits, 22 of which were integrated audits of both the financial statements and ICFR. In seven of the 31 audits (23 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to Grant's 17 percent deficient engagement rate in 2020. Five of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; one included only a financial statement audit deficiency; and one included only an ICFR audit deficiency. The PCAOB described 29 audit deficiencies (0.94 deficiencies per inspection) associated with 30 auditing standards in the seven engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 23 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion.

- KPMG LLP. The PCAOB reviewed 54 KPMG issuer audits, 45 of which were integrated audits of both the financial statements and ICFR. In 14 of the 54 audits (26 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. KPMG's deficient engagement rate was also 26 percent in 2020. Eight of the 14 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; two included only a financial statement audit deficiency; and four included only an ICFR audit deficiency. The PCAOB described 51 audit deficiencies (0.94 deficiencies per inspection) associated with 58 auditing standards in the 14 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 13 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion.

- PricewaterhouseCoopers LLP. The PCAOB reviewed 56 PwC issuer audits, 47 of which were integrated audits of both the financial statements and ICFR. In two of the 56 audits (4 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to PwC's 2 percent deficient engagement rate in 2020. One of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR, and one included only a financial statement audit deficiency. The PCAOB described six audit deficiencies (0.11 deficiencies per inspection) associated with three auditing standards in the two engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 13 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion.

Comparisons of Firm Part I.A Results

Table 1 compares the results of the 2021 inspections of the six firms. Table 2, which appeared in 2020 PCAOB Large Firm Inspection Reports, November-December 2021 Update, comparing the results of the 2020 inspections, follows the 2021 table.

TABLE 1

2021 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(Reports are dated November 4, 2022, except EY, which is dated November 21, 2022, and were released on December 19, 2022)

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	30	16	53%
Deloitte & Touche	54	7	13%
Ernst & Young	56	12	21%
Grant Thornton	31	7	23%
KPMG	54	14	26%
PwC	56	2	4%
2021 Global Network Firm Totals	281	58	
2021 Global Network Firm Average	47	10	21%

TABLE 2

2020 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(Reports are dated September 30, 2021, and were released on November 1, 2021

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	24	13	54%
Deloitte & Touche	53	2	4%
Ernst & Young	52	8	15%
Grant Thornton	29	5	17%
KPMG	53	14	26%
PwC	52	1	2%
2020 Global Network Firm Totals	263	43	
2020 Global Network Firm Average	44	7	16%

Tables 1 and 2 focus on the percentage of inspected engagements found to have at least one audit deficiency. Other indicators of the relative performance of the six firms are the number individual audit deficiencies in each report and the number of auditing standards associated with those deficiencies. These metrics differ from the percentage-of-deficient engagements measure because an engagement included in Part I.A may involve more than one deficiency and a deficiency may be associated with more than one auditing standard. Table 3 compares the performance of the six firms based on the number of audit deficiencies in each inspection report and the number of auditing standards associated with those deficiencies. (In some cases, there is an element of judgment in determining the number of deficiencies in a Part I.A engagement description.)

TABLE 3

DEFICIENCIES AND ASSOCIATED AUDITING STANDARDS IN PART I.A OF SIX FIRM 2021 INSPECTION REPORTS

Firm	Engagements Inspected	Deficient Engagements	Total Deficiencies	Standards Referenced	Average Per Inspected Engagement: Deficiencies	Average Per Inspected Engagement: Standards Referenced
BDO	30	16	56	64	1.87	2.13
Deloitte & Touche	54	7	11	11	0.20	0.20
Ernst & Young	56	12	64	70	1.14	1.25
Grant Thornton	31	7	29	30	0.94	0.97
KPMG	54	14	51	58	0.94	1.07
PwC	56	2	6	5	0.11	0.09
2021 Global Net Firm Totals	281	58	217	238		
2021 Global Net Firm Average	47	10	36	40	0.77	0.85

Aggregate Part I.A Data on Deficiencies, Standards, and Financial Statement/Audit Areas

The auditing standards most frequently cited as the basis for audit deficiencies in Part I.A of the 2021 inspection reports of the six firms are listed in Table 4. Table 4 also shows the percentage of all deficiencies in the six reports that were based on each auditing standard. The same auditing standard may have been cited multiple times in an engagement described in Part I.A. Only standards that were cited more than once in the six reports are included in Table 4.

TABLE 4

AUDITING STANDARDS REFERENCED IN SIX FIRM 2021 PART I.A DEFICIENCY FINDINGS

PCAOB Auditing Standard	Number of Times Standard Cited as Deficiency Basis	Percentage of Total Deficiencies Citing Standard
AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements	105	49.1%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	34	14.3%
AS 1105, Audit Evidence	32	13.4%
AS 2810, Evaluating Audit Results	21	8.8%
AS 2315, Audit Sampling	16	6.7%
AS 2305, Substantive Analytical Procedures	11	4.6%
AS 2501, Auditing Accounting Estimates	8	3.4%
AS 2310, The Confirmation Process	2	0.8%
AS 2503, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities	2	0.8%
AS 2415, Consideration of an Entity's Ability to Continue as a Going Concern	2	0.8%

In each inspection report, the PCAOB lists the most frequently identified audit deficiencies, divided between the most frequent deficiencies in financial statement (FS) audits and the most frequent deficiencies in ICFR audits. Table 5 aggregates these frequent deficiencies lists for the six firms. Table 5 also indicates what percentage of the engagements in Part I of the six reports included these deficiencies.

TABLE 5

MOST FREQUENTLY IDENTIFIED AUDIT DEFICIENCIES
IN 2021 SIX FIRM INSPECTION REPORTS

Deficiency Description	Number of Times Deficiency Was Identified	Audit Affected	Percentage of All Deficiencies
Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing.	29	ICFR	23.0%
Did not identify and test any controls that addressed the risks related to a significant account or relevant assertion.	20	ICFR	15.9%
Did not identify and/or sufficiently test controls over accuracy and completeness of data and reports issuer used in the operation of controls.	16	ICFR	12.7%
Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.	15	FS	11.9%
Did not perform substantive procedures to obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls).	14	FS	11.1%
Did not perform sufficient testing of the accuracy and completeness of data and or reports used in the firm's substantive testing.	10	FS	7.9%
Did not perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	9	FS	7.1%
Did not test the accuracy and/or completeness of information that the Firm used to make selections for testing the operating effectiveness of a control	4	ICFR	3.2%
Did not perform sufficient, appropriate analytical procedures when analytical procedures were intended to provide substantive evidence.	4	FS	3.6%
Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate.	3	FS	2.4%
Did not perform sufficient procedures to address a going concern issue.	1	FS	0.8%

For each firm, the PCAOB lists the financial statement accounts or audit areas most frequently cited in Part I.A deficiencies in the inspection report. For the six firms, on an aggregate basis, these areas were:

- Revenue and related accounts – 25 deficiencies
- Inventory – 7 deficiencies
- Allowance for credit losses/Allowance for loan losses – 4 deficiencies
- Expenses – 4 deficiencies
- Long-Lived Assets – 3 deficiencies
- Equity and equity-related transactions – 3 deficiencies
- Business combinations – 2 deficiencies
- Going concern – 2 deficiencies
- Investment securities – 1 deficiency

Comparison of Firm Part I.B Results

Part I.B of an inspection report describes deficiencies discovered in the inspection that did not directly affect the auditor's opinion. In 2021, the PCAOB found an aggregate of 93 such deficiencies, compared to 64 in 2021. Table 6 presents the number of Part I.B deficiencies for each of the six firms and shows how each firm's 2021 Part I.B results compare to its 2020 report. Firm-to-firm and year-to-year comparisons may provide insight into Part I.B trends but should be interpreted with caution. It appears that the PCAOB does not review all inspected engagements for every type of Part I.B deficiency. Therefore, the number of Part I.B deficiencies in a firm's inspection report may not be directly comparable to the number in other firms' reports or to the number reported in prior years.

TABLE 6

PART I.B DEFICIENCIES: 2021 and 2020 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORK FIRMS

Firm	2021 Part I.B Deficiencies	2020 Part I.B Deficiencies	Net Change in Part I.B Deficiencies 2020 to 2021
BDO	9	16	-7
Deloitte & Touche	8	19	-11
Ernst & Young	27	2	+25
Grant Thornton	23	3	+20
KPMG	13	6	+7
PwC	13	18	-5
Global Network Firm Totals	93	64	+29
Global Network Firm Average	15.5	10.7	+3.2

Aggregate Part I.B Deficiency Data

Table 7 lists the most frequent Part I.B deficiencies in the six reports. Only deficiencies that were cited more than once are included.

TABLE 7

MOST FREQUENTLY CITED PART I.B DEFICIENCIES
IN 2021 SIX FIRM INSPECTION REPORTS

Deficiency Description/Auditing Standard	Number of Times Deficiency Cited
Engagement team performed procedures to determine whether or not matters were critical audit matters but did not include in those procedures one or more matters that were communicated to the issuer's audit committee and that related to accounts or disclosures that were material to the financial statements. (AS 3101)	29
Firm did not make certain required communications to the issuer's audit committee related to the names, locations, and/or planned responsibilities of other accounting firms and/or other persons not employed by the firm that performed audit procedures in the audit. (AS 1301)	22
Firm did not include all relevant workpapers in the final set of audit documentation it was required to assemble. (AS 1215)	14
Firm's communication of a critical audit matter in the audit report included language that was inconsistent with information in the firm's audit documentation or did not refer to the relevant financial statement accounts or disclosures related to the critical audit matter. (AS 3101)	6
Firm's report on Form AP contained inaccurate information or omitted information related to the participation in the audit by certain other accounting firms. (AS 3211)	5
Firm did not communicate to management, in writing, all control deficiencies identified during the audit. (AS 2201)	4
Firm's foreign affiliates had obtained letters of representation from management for certain of the issuer's non-U.S. components, but the firm, as the principal auditor, did not review and/or retain one or more of these letters. (AS 1205)	2
Firm did not make certain required communications to the issuer's audit committee related committee related to uncorrected and corrected misstatements. (AS 1301)	2
Firm's audit report on the issuer's financial statements included incorrect language related to the audit of the issuer's ICFR or was dated earlier than the date on which the firm had obtained sufficient appropriate evidence to support its opinion. (AS 2201)	2

Comments: The PCAOB cautions that inspection results are not necessarily comparable over time or among firms because of variations in the inspection process. While that caveat should be kept in mind, below are some observations based on the 2021 reports.

1. Overall, large firm audit quality appears to have marginally declined in 2021, but the longer-term trend is still positive (See Tables 1, 2, and 3). Audit quality seems to have fallen somewhat

compared to last year. For the six global network firm affiliates as a group, the overall deficient engagement rate rose by one-third -- from 16 percent of inspected engagements in 2020 to 21 percent in 2021. For the Big Four, the deficient engagement rate rose from 12 percent in the 2020 reports to 16 percent in 2021. In addition, the inspectors found 0.77 deficiencies and referenced 0.85 auditing standards for each Big Six engagement they inspected in 2021, compared to 0.64 deficiencies per inspection in 2020.

However, in the context of the past five years, the 2021 inspection results are less troubling. The six firms' aggregate 2021 deficiency percentage rate of 21 percent was lower than in any of the three years prior to 2020: 24 percent in the 2019 reports, 27 percent in the 2018 reports, and 30 percent in 2017 reports. Similarly, the Big Four's 2021 performance was better than during 2017-2019: Twenty-two percent of the Big Four engagements inspected in 2019 contained deficiencies, as did 25 percent in 2018 and 31 percent in 2017. As to deficiencies per inspected engagement, most of the increase was attributable to a single firm – EY – and more than half of EY's increase was attributable to a single engagement (Issuer A in its 2021 report).

2. <u>There continue to be pronounced differences between the inspection results of the six large firms</u> (See Tables 1, 2, and 3). This year, the gap between the firm with the lowest percent of inspected engagements that were deficient (PwC – 4 percent) and the firm with the highest percentage (BDO – 53 percent) was 49 percentage points. In 2020, the gap was 52 percent (2 percent for PwC versus 54 percent for BDO). While the difference narrowed slightly this year, the gap in inspection performance remains substantial.

   As noted earlier, four of the six firms had higher Part I.A deficient rates in 2021, while BDO and KPMG, were basically unchanged. However, BDO and KPMG also continued to have the highest Part I.A deficiency rates in the group. Essentially, these two firms did not significantly improve, while the other four experienced modest decreases in their inspection results. Of course, the decline in PwC's performance was relative to the record-setting one deficiency in its 2020 report; the two deficient PwC engagements in 2021 is still a very positive result, relative to the historical record.

   There is also wide dispersion between firms based on the numbers of individual audit deficiencies and auditing standards cited in Part I.A of each report. In the 2021 PwC inspection, the inspectors found six audit deficiencies associated with five auditing standards in two Part I.A engagements out of 56 engagements inspected – an average of 0.11 audit deficiencies and 0.09 standards citations per inspected engagement. At Deloitte, 54 inspections revealed eleven deficiencies associated with eleven auditing standards in seven Part I.A engagements or 0.20 deficiencies and 0.20 standards citations per inspected engagement. At the other end of the spectrum, in 30 BDO engagements inspected, the staff found 56 deficiencies and cited 64 standards, an average of 1.87 audit deficiencies and 2.12 standards citations per inspected engagement – 17 times more deficiencies and 23 times more standards citations per inspected engagement than at PwC. In between these extremes, EY, Grant, and KPMG had deficiency-per-inspection rates of 1.14, 0.94, and 0.94, respectively.

3. <u>Although the share of engagements selected for inspection on a random basis increased in 2021, the impact on inspection findings, if any, is unclear</u>. As discussed in last year's inspection summary (see [2020 PCAOB Large Firm Inspection Reports](), [November-December 2021 Update]()), during the last several years the PCAOB has increased the percentage of inspected engagements selected for inspection at random, rather than based on risk. This appears to be the case for both the six large firms and for the inspection universe as a whole. See [Staff Update and Preview of 2021 Inspection Observations](), cited above. In 2018, 18.7 percent of the six firm inspection selections were random. In 2019, that figure grew to 23.7 percent, and in 2020, 24.7 percent were random selections. In 2021, random selections rose sharply to 44.1 percent – almost half of all Big Six inspected engagements. The PCAOB argues that random selection makes it harder for firms to predict which audits will be reviewed.

Deficiencies are presumably less likely to be found in engagements selected at random than in those selected based on an assessment of the engagement's inherent difficulty or risk. Therefore, one would expect the percentage of deficient engagements to decline as the share of inspections that are random increases. However, in 2021 that does not appear to have been the case, since the percentage of deficient engagements rose, despite the increase in random selections. Of course, it is possible that audit quality declined sharply in 2021 and that the shift to more random selections masked that decline. It is also possible the risk of audit deficiencies is spread fairly equally across the audit universe, and random selections are no more or less likely to uncover problems than are risk-based selections. Several more years of data will probably be necessary to draw conclusions on this point.

4. <u>ICFR audit deficiencies still feature prominently in inspection reports but may have plateaued</u> (See Tables 4 and 5). The inspectors found ICFR audit deficiencies in 19 percent of integrated audits they inspected, up from 14 percent in 2020, but down from 23 percent in 2019 and 26 percent in 2018. This year, 72 percent of all audit engagements in Part I.A of the Big Six reports included an ICFR deficiency. In 2020 and 2019, 77 percent and 81 percent, respectively, of Part I.A engagements included an ICFR deficiency. In 2020, 50 percent of the most frequently cited deficiencies affected the ICFR audit. In 2021, frequent deficiencies affecting the ICFR audit rose to 56 percent, essentially the same as in 2019. As in past years, AS 2201, <u>An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements</u>, was the most frequently cited auditing standard in the six inspection reports by a wide margin.

5. <u>Failure to evaluate accounting and disclosure and overreliance on controls were the most frequent issues in financial statement audits</u> (See Tables 4 and 5). The PCAOB found deficiencies in the financial statement audits of 16 percent of the Big Six engagements it inspected in 2021, and 79 percent of Part I.A engagements included a financial statement audit deficiency. In 2020, 14 percent of inspected engagements had a financial statement audit deficiency, and 86 percent of engagements in Part I.A included a financial statement audit deficiency. The most frequent 2021 Part I.A deficiency affecting the financial statement audit was "Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts." The most common financial statement audit deficiency in 2020 was the second most common in 2021: "Did not perform substantive procedures to obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls)."

6. <u>Critical audit matters (CAM)s and audit committee communications drove a sharp increase in Part I.B deficiencies</u> (see Tables 6 and 7). A striking feature of the 2021 reports is the increase in the number of Part I.B deficiencies. In 2020, there were a total of 64 Part I.B deficiencies in the six large firm reports – 10.7 deficiencies per firm. In 2021, the total number of Part I.B deficiencies rose by almost 50 percent to 93 or 15.5 deficiencies per firm. It is not clear whether the increase reflects more underlying deficiencies or simply more PCAOB focus on Part I.B issues. Either way, however, issues like CAM reporting, audit committee communications, and completeness of work papers are likely to draw PCAOB attention in 2023.

   The Part I.B issue with the most findings in 2021 was the failure of the engagement team to perform procedures to determine whether particular matters related to material accounts that were communicated to the audit committee should have been disclosed as CAMs in the auditor's report. The second most frequent Part I.B deficiency was the failure to make required communications to the audit committee related to the names, locations, and responsibilities of other accounting firms or persons that performed audit procedures. Since both of these issues touch on the auditor's relationship with the audit committee, committees may be particularly interested in exploring breakdowns in these areas with their auditor.

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Audit committees should discuss their audit firm's inspection report with the engagement partner. As noted in past years, the audit deficiency descriptions and auditing standard deficiency tables could be used as a discussion topic checklist. Audit committees may also want to understand how the auditor addressed, or plans to address, engagement deficiencies highlighted in its report and whether the report will result in any changes in audit procedures that could affect the company's audit. Of course, if the company's engagement was the basis for a Part I.A or Part I.B finding, the audit committee should understand in depth the cause of the deficiency and how the auditor plans to remedy it and prevent a recurrence.

PCAOB Staff 2021 Inspections Preview Reports Rising Deficiencies

The PCAOB has issued Spotlight: Staff Update and Preview of 2021 Inspection Observations (Preview Report), a staff summary of the Board's 2021 inspections. These "aggregate observations" on the results of the 141 audit firm inspections (encompassing 690 public company audits) performed during the 2021 inspection cycle are a preview of the 2021 inspection reports, many of which have not yet been publicly released. The Preview Report is intended for investors, auditors, and financial reporting stakeholders generally, and, in the staff's view, "audit committees may also benefit from the use of this publication as a reference point when speaking with and evaluating their auditors."

Overall Findings

In contrast to last year (see PCAOB Staff Summary of 2020 Inspections: Fewer Findings, But Still Room for Improvement, September-October 2021 Update), the results of the 2021 inspections suggest that deficiencies are increasing:

- The staff expects that approximately 33 percent of inspected engagements will have one or more deficiencies that will be discussed in Part I.A of the individual audit firm's inspection report, up from 29 percent in 2020. (Part I.A of an inspection report discusses deficiencies that were of such significance that, in the PCAOB's view, the audit firm did not obtain sufficient appropriate audit evidence to support its opinion on the financial statements and/or internal control over financial reporting.) PCAOB Chair Erica Williams described this increase in Part I.A deficiencies as "a warning signal that the audit profession needs to sharpen its focus on improving audit quality and protecting investors."

- Part I.B deficiencies also increased in 2021. The staff expects that approximately 40 percent of the 691 audits reviewed will have one or more deficiencies discussed in Part I.B of the inspected firm's inspection report, up from 26 percent in 2020. (Part I.B describes instances of noncompliance with PCAOB standards or rules that do not relate directly to the sufficiency or appropriate-ness of evidence the audit firm obtained to support its opinions.) A significant portion of the increase in Part I.B deficiencies was driven by an increase in deficiencies related to critical audit matters (CAMs), particularly among triennially inspected audit firms (those with fewer than 100 public company audit clients). Most of these CAMs-related deficiencies involved failures to include in the work papers every matter that should have been analyzed as a potential CAM and do not necessarily mean that additional CAMs should have been communicated in the auditor's report.

- Many inspection reports will include both Part I.A and Part I.B deficiencies. More than half -- approximately 55 percent -- of the audits the PCAOB reviewed in 2021 will have one or more Part I.A and/or Part I.B deficiencies, up from 44 percent in 2020.

2021 Inspections Objectives and Approach

The PCAOB's 2021 inspections -- all of which were conducted remotely -- had two main objectives, responding to the financial reporting and audit risks arising from the COVID-19 pandemic and increasing the overall unpredictability of inspections by including a higher percentage of random selections and non-traditional focus areas. As to the later objective, 39 percent of annual firm engagement selections were random, up from 23 percent in 2020. Nontraditional focus areas included cash and cash equivalents, deposit liabilities, debts, accruals, and foreign currency translations.

The 2021 inspections made use of a target team – inspectors who reviewed emerging audit risks and topics across inspected firms. The 2021 target team's focus included audit firms' procedures concerning fraud, cash and cash equivalents, special purpose acquisition companies (SPACs) and de-SPAC transactions, and financial reporting and audit risks arising from the pandemic. See PCAOB Reports 2021 Target Team Observations, September-October 2022 Update.

Recurring Deficiencies

The 2021 inspections continued to identify the same audit deficiencies that have been common for many years. The report states that that staff expects "audit firm leadership to address the recurring nature of these deficiencies" and threatens that "recurring deficiencies may warrant action, such as * * * referring firms to the Division of Enforcement and Investigations for potential investigation or disciplinary action for failing to comply with PCAOB standards." These recurring deficiencies include:

- Deficiencies in auditing ICFR. The top ICFR audit deficiencies in 2019 to 2021 inspections comment forms were: Testing controls with a review element (35 percent of total 2021 ICFR audit deficiencies), identifying and selecting controls to test (22 percent of total 2021 ICFR audit deficiencies), and testing controls, other than review controls (15 percent of total 2021 ICFR audit deficiencies).

- Deficiencies in financial statement audits. The top financial statement audit areas with deficiencies in 2019 to 2021 inspections comment forms were revenue and related accounts, (35 percent of total 2021 financial statement audit deficiencies), inventory (9 percent of total 2021 financial statement audit deficiencies), and expected credit losses (9 percent of total 2021 financial statement audit deficiencies).

- Deficiencies that did not directly affect audit evidence. The areas with deficiencies related to compliance with other PCAOB standards and rules (i.e., Part I.B deficiencies) in 2019 to 2021 inspections comment forms were CAMs (31 percent of total 2021 Part I.B deficiencies), audit committee communications (26 percent of total 2021 Part I.B deficiencies), and Form AP (12 percent of total 2021 Part I.B deficiencies).

Common Deficiencies in 2021 Inspections

The Preview Report discusses in detail common deficiencies in 2021 inspection reports. Examples of these include:

- Insufficient evaluation of whether controls with a review element selected for testing operated at a level of precision sufficient to prevent or detect material misstatements. In these instances, the auditors did not evaluate the review procedures that control owners performed, including the procedures to identify items for follow-up and the procedures to determine whether those items were appropriately addressed.

- Deficiencies related to the design and performance of audit procedures to identify and address assessed risks of material misstatement related to revenue. Revenue-related deficiencies included failure to evaluate sufficiently whether contractual performance obligations were satisfied and failure to evaluate the allocation of the transaction price to performance obligations.

- Deficiencies related to the use of such technology-based tools. These deficiencies included the failure, when testing revenue transactions, to sufficiently evaluate the implications of exceptions identified by a technology tool.

- Deficiencies in auditing estimates. For example, in some instances auditors failed to evaluate the reasonableness of significant assumptions used in a financial statement forecast to determine the fair value of acquired assets.

- Failure to identify and/or test any controls over, the accuracy and completeness of company-produced data or reports used in the auditors' substantive procedures. The failure to test controls over information provided to the auditor by the client affected such matters as testing the cost of inventory or evaluating the reasonableness of inventory reserves when the auditor used the entity-provided information as part of its audit procedures.

- Incomplete CAM discussions. In some instances, auditors, when communicating a CAM in their report, did not accurately describe how the CAM was addressed in the audit or the principal considerations that led the auditor to determine that the matter was a CAM.

The Preview Report also identifies deficiencies in auditor communications with the audit committee. Common audit committee communications deficiencies include:

- Auditors did not communicate to the audit committee the names, locations, and planned responsibilities of other accounting firms or other engagement team members, including the use of shared service organizations.

- Auditors did not inform the audit committee of critical accounting policies and practices used by the public company, including the reasons why certain policies and practices were considered critical.

- Auditors did not provide the audit committee with a copy of the management representation letter or of another material written communication between management and the auditor.

Quality control systems

The 2021 inspections included procedures to update the staff's understanding of the design and operating effectiveness of the inspected firm's quality control system. The Preview Report describes quality control deficiencies found as a result of these procedures, including:

- Independence. For a number of triennially inspected audit firms, including many non-U.S. firms, the inspectors identified instances where audit committee pre-approval was not obtained for certain audit-related services, non-audit services, or tax services. Additionally, some audit firms had a high rate of non-compliance by audit firm personnel with respect to reporting their financial relationships into firm monitoring systems.

- Supervision of audits and engagement quality review. The 2021 inspections identified audit deficiencies in areas that the engagement partner should have identified and appropriately addressed, e.g., engagement partner failures to address significant risks identified by the engagement team. Inspectors also found deficiencies related to the engagement quality reviewer's evaluation of the engagement, such as audit documentation that was insufficient to support the review or the failure to obtain a reviewer's approval before issuing the audit report.

- Internal monitoring. In some instances, the inspection staff identified audit deficiencies that were not identified through the firm's internal inspection of the same audit area of the same engagement. In other cases, firms failed to perform internal inspections.

Good practices

The Preview Report also describes "good practices" that the staff observed in various areas. The staff encourages auditors to consider how these practices may apply to their audit engagements and to implement changes “proactively to enhance audit quality in the public interest and to help ensure compliance with PCAOB standards and rules.” Such practices include:

- Use of a “template” to facilitate the engagement team’s testing of the design and operating effectiveness of controls that include a review element.

- Development of tools to track every matter communicated or required to be communicated to the audit committee in order to ensure that all potential CAMs were considered.

- Use of technology-based tools for early detection of potential personal independence violations. Such tools include a tool that compares time charged by firm personnel to financial holdings and a tool that imports information from employee broker-dealer accounts directly into the firm’s tracking mechanisms.

- Establishment of “milestone programs” to track the progress of supervision and review procedures. Such a program captures relevant steps of the audit, tracks compliance, and monitors whether partners and engagement quality reviewers focus on key working papers or audit procedures that addressed significant risks.

Comment: As noted above, the PCAOB staff suggests that audit committees may want to use the Preview Report as a “reference point” when evaluating their auditor. The report also provides insight into issues the PCAOB is likely to focus on in 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. As a corollary, the Preview Report may 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, whether or not they received adverse PCAOB comments on particular recurring audit deficiencies in the past, can be expected to devote attention to these areas in anticipation of possible 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.

Scope Creep is Affecting Audit Committee Composition and Focus

The scope of the audit committee’s responsibilities continues to grow, and many committees are responding by expanding or changing their committee composition. That is one of the key findings of Audit Committee Practices Report: Priorities and Committee Composition (Practices Report), the second annual survey conducted by the Center for Audit Quality and Deloitte’s Center for Board Effectiveness on the oversight practices and current concerns of U.S. public company audit committee members. Survey respondents also reported that, outside of financial reporting and internal control, their top three areas of focus in 2023 would be cybersecurity (63 percent), enterprise risk management (45 percent), and ESG disclosure and reporting (39 percent). However, in a reversal of prior survey findings, only 20 percent of respondents ranked fraud risk as one of their top three focus areas in the next 12 months. For the results of the prior annual survey, see Good News and Bad News: Audit Committee Members Think Audit Quality Held Steady During COVID, But Many See Fraud Risk Rising, January-February 2022 Update.

The Center and the CAQ conducted their survey of audit committee members between August and October 2022. A total of 164 individuals participated, predominantly from U.S. public companies with revenue in excess of $500 million. Participants were asked to respond to 17 questions covering audit committee composition and core and emerging priorities and practices. Some highlights of the report’s findings are described below.

Audit Committee Composition

- Committee membership turnover. Twenty-five percent of survey participants anticipate making changes to the composition of the audit committee in the next 12 months, including increasing its size. Further, 28 percent anticipate that their audit committee will replace the current chair. Forty-two percent anticipate replacing one or more committee members during the coming year; 24 percent of respondents expect to replace audit committee members with current board members, while 18 percent plan to bring in directors who are not presently on the board.

- Committee expertise. The Practices Report opines that much of the anticipated change in audit committee composition is driven by necessity. "It may stem from expanding responsibilities and to combat fatigue and attrition, in addition to filling specific experience and knowledge gaps." Respondents identified cybersecurity and technology as areas of expertise that could enhance their committees' effectiveness. Ninety-three percent of respondents said that their audit committees already had finance and accounting expertise.

- Committee diversity. Fifty-eight percent of respondents said that audit committee tracks the gender of committee members, while 48 percent track ethnicity/race, and 44 percent track age. Thirty-five percent of respondents said their committee did not track any diversity characteristics.

Audit Committee Agenda Issues

As noted above, the top nonfinancial reporting topics that survey participants thought would be areas of audit committee focus during the coming year were cybersecurity, enterprise risk management, and ESG disclosure and reporting.

- Cybersecurity. Fifty-three percent of respondents said their board delegates cybersecurity oversight to the audit committee, while 26 percent said cybersecurity is a full board responsibility, and 11 percent said it is assigned to the risk committee. However, less than half (41 percent) of respondents believe their audit committee members have appropriate cybersecurity expertise, up 6 percent from the 2021 survey. Forty-three percent of respondents met with external cyber-security experts in the last 12 months to gain an outside perspective on the issue. The Practices Report observes, "Regardless of where oversight of cybersecurity risk falls, the escalating threats and attention it demands needs to be overseen with as much discipline as financial risk."

- Enterprise risk management (ERM). Forty-three percent of respondents indicated the audit committee is responsible for oversight of ERM, while 28 percent said ERM oversight was a full board responsibility and 21 percent said responsibility was lodged in the risk committee. Audit committee members have more confidence in their understanding of ERM than in their cybersecurity expertise: 75 percent of respondents believe their audit committee members have appropriate experience/expertise in enterprise risk. Nonetheless, 17 percent met with outside ERM specialists in the last 12 months.

- ESG disclosure and reporting. ESG disclosure has rapidly become an important audit committee agenda topic. When asked who was responsible for oversight of ESG disclosure and reporting, 34 percent of respondents said the audit committee, while 27 percent indicated the board, and 16 percent pointed to the nominating/governance committee. In contrast, last year only 10 percent of survey respondents said that the audit committee had oversight responsibility for ESG disclosure. (These figures differ somewhat from those reported in Deloitte's ESG readiness survey. See Many Large Companies Plan to Invest in ESG Reporting Readiness During 2023 in this Update.) Survey participants have less confidence in their abilities in this area than they do with respect to either cybersecurity or ERM. Just 32 percent of respondents believe their audit committee members have appropriate ESG/sustainability experience and expertise. Approximately 30 percent of respondents said they had met with outside ESG specialists in the last 12 months.

One significant change in audit committee agenda priorities relates to fraud. Only 20 percent of 2022 survey respondents ranked fraud risk as one of their top three focus areas in the next 12 months. Last year, financial reporting and internal controls -- including fraud risk – was the most-cited audit committee priority, and 56 percent said that the audit committee's focus on fraud deterrence and detection had increased.

Further, in 2021, 42 percent of respondents believed that fraud risk rose as a result of the COVID-19 business environment. See Good News and Bad News: Audit Committee Members Think Audit Quality Held Steady During COVID, But Many See Fraud Risk Rising, January-February 2022 Update. It is difficult to believe that the risk of financial reporting fraud has decreased significantly during the past year. Instead, it appears that the need to devote time and attention to new issues like cybersecurity and ESG may have lessened audit committees' ability to focus on core responsibilities like fraud risk.

Comment: The Practices Report survey results can serve as a benchmarking resource to aid audit committee members in understanding what their peers are doing and whether there are practices other audit committees employ that they may wish to copy. Audit committees may also want to reflect on the risks of scope creep and on the possibility that new responsibilities like cybersecurity oversight, ERM, and ESG disclosure are crowding out the committee's ability to perform its core mission of overseeing financial reporting. The CAQ's recent publication, Audit Committee: The Kitchen Sink of the Board offers some suggestions on how audit committees can keep up with an ever-evolving workload. The Kitchen Sink report is described in Audit Committee Transparency Inches Ahead, November-December 2022 Update.

On the Update Radar: Things in Brief

PCAOB Proposes to Modernize Confirmations. On December 20, the PCAOB issued for public comment a proposal to modernize its standard on the use of confirmations in audits. The confirmation process involves obtaining audit evidence about financial statement assertions by sending requests to outside parties asking that they confirm information in the company's records. Confirmation of accounts receivable, which has been presumptively required in the United States since 1939, is the most common example of the use of confirmations in an audit.

According to the PCAOB's release soliciting public comment, the proposed new standard embodies "principles-based requirements that apply to all methods of confirmation, including paper-based and electronic means of communications" and would be integrated with the Board's risk assessment standards. Key provisions of the Board's proposal include:

- Continuation of the existing requirement to confirm accounts receivable. The standard would permit the use of alternative audit procedures instead of confirmation if the auditor determines that the other procedures would provide audit evidence that is at least as persuasive as evidence the auditor might expect to obtain through confirmation. The auditor would be required to inform the audit committee of instances where the auditor determined that the presumption to confirm accounts receivable has been overcome.

- A new requirement to confirm cash held by third parties. The auditor would not necessarily need to confirm every cash account, but "would select individual cash items to confirm following the relevant direction in PCAOB standards, including identifying and assessing the risk of misstatement and developing an audit response." The new proposed standard would not, however, address the possibility of using alternative procedures instead of cash confirmation. The release states that "the Board is not aware of other types of substantive procedures that would provide audit evidence that is as persuasive as audit evidence obtained through confirmation of cash."

- A prohibition against the use of negative confirmations as the sole substantive audit procedure for addressing a financial statement assertion. Negative confirmations are requests that do not call for a response if the confirming party agrees with the information in the confirmation request. Although negative confirmation alone would not provide sufficient appropriate audit evidence, auditors would be allowed to use negative confirmation requests to supplement other substantive audit procedures.

- A prohibition against direct participation by the company's internal audit staff in the confirmation process. The release states that internal auditors' involvement in such activities as selecting items to be confirmed or in sending confirmations or receiving responses "would create a risk that information exchanged between the auditor and the confirming party is intercepted and altered." Internal audit personnel could assist in administrative aspects of the confirmation process, such as preparing the confirmation request and researching differences in confirmation responses.

If the proposal is adopted, audit committees may find that auditors will begin to use confirmation procedures more frequently than has been traditional. Apart from the specific situations in which the proposed standard would require the use of confirmations, the release seems to encourage third party confirmation. For example, the release states, "In situations involving fraud risks and significant unusual transactions, audit evidence obtained through the confirmation process generally is more persuasive than audit evidence obtained solely through other procedures." Auditors may interpret this as a directive to use confirmation procedures wherever possible as a tool to address fraud risk.

What Should be on the Audit Committee's 2023 Agenda? At the beginning of each year, many accounting and consulting firms present their views on the issues on which audit committees should focus in connection with the end of the prior year and during the coming 12 months. Below is a list (with hyperlinks to the documents) of five of these 2022 year-end/2023 agenda papers.

- Deloitte Center for Board Effectiveness, On the audit committee's agenda, 2023: The year of the risk-centric agenda.

- EY Center for Board Matters, What audit committees should prioritize in 2023.

- KPMG Board Leadership Center, On the 2023 audit committee agenda.

- Protiviti, Setting the 2023 Audit Committee Agenda.

- PwC Governance Insights Center, Approaching the 2022 year-end financial reporting season.

These papers approach the topic of how audit committees should set their agendas at different levels of generality, and each firm has its own perspective on where audit committees should direct their time and attention. Not surprisingly, however, there are many common themes. Some frequently mentioned 2023 audit committee agenda topics (along with references to examples of reports that discuss them) include:

- Enterprise risk management and enterprise risks that could affect financial reporting (Deloitte, EY, Protiviti).

- Cybersecurity and other technology risks (Deloitte).

- Post-pandemic challenges, including supply chain disruption, workforce shortages, and inflationary pressures (Deloitte, Protiviti, PWC).

- Impact of U.S. and global tax policy changes on financial reporting (EY, KPMG, PWC).

- ESG reporting, including the SEC's climate change disclosure proposals; impact of ESG risks and opportunities on financial reporting (All five reports).

- Role of internal audit; internal audit's innovation and maintenance of relevance and focus on key risks (KPMG, Protiviti).

- Company culture, including company focus on ethics and compliance; warning flags regarding disfunction (KPMG, Protiviti).

- Developments in the crypto assets landscape (PWC).

- Proxy statement disclosure regarding the work of the audit committee (PWC).

- Role of the CFO, including efforts to utilize traditional CFO skills to add value in new ways; talent and leadership in the finance organization (KPMG, Protiviti).

For last year's audit committee agenda suggestions, see What Should be on the Audit Committee's 2022 Agenda?, January-February 2022 Update.

A high-level review of these papers could be helpful to an audit committee as a check that it is not overlooking topics that should be on its agenda. Also, most of these papers include suggested questions that the audit committee could pursue with management in order to better understand the various suggested topics. Those questions could provide a good starting point for discussion.

What Audit Committees Want – and Don't Want -- from CFOs. What audit committees really want from CFOs, an article in the December 15 issue of Deloitte's CFO Insights, lists seven things that audit committees want from CFOs – and five they don't. These dos and don'ts are based on Deloitte's engagement with CFOs in labs and forums, on interviews with audit committee chairs and members, and on client interactions. The suggestions for CFOs may be useful to audit committees as they think about the quality of their relationship with the CFO and how it might be strengthened.

The seven desirable behaviors are:

1. No surprises. "CFOs need to have a strong relationship and trust with the audit committee and clearly communicate in a timely and candid manner so the committee isn't caught off guard."

2. Strong partnering with the CEO and other leaders. "Effective partnering and influence skills with the CEO and other C-suite leaders are critical imperatives for CFOs. In fact, audit chairs and board members often observe CFO-CEO and CFO-peer relationships to gauge how well the leadership team works together to achieve company goals."

3. Confidence in finance organization talent. "A good practice for CFOs is to give the audit committee visibility into their key staff and have candid discussions on how they intend to develop talent. It's also important to convey plans to change staff well ahead of time to forestall misunderstandings with committee members. CFOs and audit committees also should discuss succession planning at least once a year, typically in an executive session."

4. Command of key accounting, finance, and business issues. "CFOs need to have full command of the key technical accounting, financial reporting, tax compliance and planning, control environment, finance, or treasury issues pertinent to their companies—within the C-suite, with the board and audit committee, and with broader stakeholders."

5. Insightful forecasting and earnings guidance. "[B]eyond forecasts and guidance, what many audit committees really want is an insightful CFO—one who can clearly articulate the underlying assumptions and drivers that guide estimates of future performance."

6. Effective risk management. "Some audit committees expect the CFO to take a leading role in managing enterprise and operational risk beyond traditional financial, accounting, and regulatory compliance risks."

7. Clear and concise stakeholder communications. "Audit committees generally expect clear and concise communications from CFOs that put the numbers and risks in context, offering fresh insights. In addition, communications with analysts and investors should demonstrate their mastery over the pertinent business, financial, and accounting issues."

The things CFOs should avoid are:

1. Get exposure for your finance team—but not all at once. "It's important for the audit chair to know who is in attendance, even the folks standing up in back. A crowd is likely to inhibit any candid back-and-forth."

2. Strategic thinking comes packaged in brevity and synthesis. "CFOs may be tempted to share their commanding knowledge of the business or the industry or both. * * * But with minutes at a premium, CFOs can be more useful by, say, boiling their presentation down to three strategic objectives."

3. Look for input, rather than seeking validation. "CFOs should come to the audit committee with a proposed solution, then engage the committee members in helping finalize a decision."

4. Don't recreate three-ring binders. "It's important to make sure that pre-reads contain the right level of information—strategic, with an executive summary of what is included in each section, and clear indications of areas of focus or actions."

5. Accept coaching, whether or not you agree you need it. "If a CFO's presentation comes across as unfocused or tedious, for instance, a supportive committee chair will take steps to offer constructive feedback and coaching."

SEC Reg Flex Agenda Update – April May be a Busy Month. On January 4, OMB's Office of Information and Regulatory Affairs released the federal government's Fall 2022 Unified Agenda of Regulatory and Deregulatory Actions, a listing of the rulemaking activities that the various federal administrative agencies plan to undertake in the near and long term. The SEC's contribution to this list, which is referred to as the agency's Reg Flex Agenda, updates the timing for action on several projects of interest to audit committees. See SEC Rulemaking is in Hyperdrive: Spring 2022 Regulatory Agenda, June-July 2022 Update. If the SEC sticks to its updated agenda, the next 12 weeks will be extremely busy. By May 1, there could be significant changes in the public company disclosure landscape.

The Commission anticipates adopting final rules before the end of April 2023 on both climate change disclosure and cybersecurity risk governance disclosure. The far-reaching and controversial climate change disclosure proposals were published for comment in March 2022. See SEC Unveils its Climate Disclosure Proposals, March 2022 Update. Rules to inform investors about cybersecurity risk management, strategy, and governance, and to require disclosure of material cybersecurity incidents, were also proposed in March 2022. See SEC Proposes Cyber Risk Management and Attack Reporting Requirements, March 2022 Update. In addition, the Commission plans to adopt final rules to enhance disclosure regarding special purpose acquisition companies (SPACs) and regarding corporate share repurchases before the end of April. Finally, a proposal to expand human capital management disclosure is scheduled to be published for comment by May 1.

Although the target action dates are not mandatory (and are frequently missed), the Reg Flex Agenda provides insight into the SEC's regulatory priorities. The most significant item on the current agenda is climate change disclosure. While the action deadline has slipped from October 2022 to April 2023, it is clear that completion of this project remains a top SEC priority. Public companies and their audit committees should consider what systems and control changes would be required to implement these new requirements. See Many Large Companies Plan to Invest in ESG Reporting Readiness During 2023 in this Update.

Many Companies Plan to Invest in ESG Reporting During 2023. Deloitte has released Sustainability action report: Survey findings on ESG disclosure and preparedness, a report on the results of a survey and interviews conducted in August and September 2022 of senior finance, accounting, sustainability, and legal executives at companies with at least $500 million in annual revenue concerning their companies' environmental, social, and governance (ESG) strategy and disclosures. This report updates a similar survey conducted in 2021. See Companies are Preparing for Required ESG Disclosure, But Many Have a Lot Left to Do, March 2022 Update.

The 2022 survey found considerable progress on disclosure readiness, along with plans to make further investments in ESG disclosure technology. Sixty-two percent of those surveyed believe their company is "already prepared or currently undertaking extensive preparations" for the expected adoption of SEC climate change disclosure requirements. Nearly all of the companies represented in the survey (99 percent) anticipate investing in new technologies and tools in order to meet stakeholder ESG expectations and future regulatory requirements. About half of respondents (47 percent) said their companies are "very likely" to make such investments in the next 12 months, while 52 percent are "somewhat likely" to invest in the coming year.

Other findings of the 2022 Deloitte survey include:

- Cross-functional ESG strategy councils are becoming standard practice. Fifty-five percent of respondents said their company had a cross-functional ESG council or working group to drive ESG strategic attention, almost triple the 21 percent that had such a group last year. An additional 42 percent are taking steps to establish an ESG group, while the remaining 3 percent are "making plans" to do so. No respondent said their company had no such committee and no plans to create one. Consumer Products and Life Sciences and Health Care are the industries in which cross-functional ESG councils are most common.

- Readiness to disclose greenhouse gas (GHG) emissions is increasing, but Scope 3 remains a major challenge. Sixty-one percent of companies reported being prepared to disclose Scope 1 GHG emissions (i.e., direct emissions from the company's operations), up slightly from 58 percent last year, while 76 percent are prepared to disclose Scope 2 GHG emissions (i.e., emissions from the generation of purchased power), an increase from 47 percent in 2021. However, only 37 percent of respondents are currently prepared to disclose Scope 3 emissions (i.e., emissions from the company's supply chain and from product usage), a modest increase from 31 percent in 2021. The majority of companies (86 percent) reported challenges measuring Scope 3 GHG emissions, with the main challenges being lack of confidence in data received from vendors (51 percent) and lack of data availability (41 percent). The Life Sciences and Health Care industry is most prepared for Scope 3 GHG emissions disclosure.

- TCFD and SASB are the most popular ESG reporting frameworks, but most companies use more than one. The recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) (56 percent) and the standards of the Sustainability Accounting Standards Board (SASB) (55 percent) are the most frequently used ESG disclosure frameworks, followed closely by the Greenhouse Gas Protocol (50 percent), the principles of the International Integrated Reporting Council (48 percent), and the Global Reporting Initiative (47 percent).

- Chief sustainability officers and board ESG committees are becoming more common. A plurality of respondents, 43 percent, said that ESG disclosure management responsibility was lodged with a chief sustainability officer. CFOs came in second at 38 percent. (Respondents could identify more than one person as having ESG disclosure management responsibility.) In contrast, last year 54 percent said that the executive leadership team as a whole was responsible for ESG disclosure management; that percentage declined to 30 percent in 2022. Various board-level bodies were identified as having ESG oversight responsibility: ESG/sustainability committee (55 percent, up from 41 percent in 2021), audit committee (30 percent, down from 39 percent in 2021), nominating and governance committee (37 percent, down from 39 percent in 2021), and full board (30 percent, down from 37 percent in 2021).

- External assurance over ESG disclosure is becoming the norm. Nearly all (96 percent) of survey respondents said that their company plans to seek – or continue to obtain -- external assurance over ESG disclosures for the next reporting cycle. Sixty-one percent have previously obtained external assurance and will continue to do so, while 35 percent will seek external assurance for the first time. The remaining four percent plan to attain external assurance readiness. (Unlike last year's survey, the 2022 survey apparently did not address what ESG disclosures are or will be subject to assurance nor what types of professionals are being utilized to provide assurance.)

- The accuracy of ESG data is a significant concern. Thirty-five percent of survey respondents cited the accuracy and completeness of sustainability data as the top disclosure challenge, up from 25 percent in 2021. Another 25 percent cited access to data as the greatest challenge, a slight decrease from 32 percent in 2021. Companies that are obtaining external assurance over ESG disclosures are more likely to see challenges with data quality than companies that will obtain external assurance for the first time this year (40 percent v. 27 percent). Thirty-seven percent of respondents are starting to apply the COSO internal control framework to their ESG reporting process.

The Audit Blog

I am a co-founder of The Audit Blog and blog on developments in auditing and financial reporting, on auditor oversight and regulation, and on sustainability disclosure. Occasionally, items that appear in the Audit Committee and Auditor Oversight Update also appear on the blog.

The blog is available here. You can follow it @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.