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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.

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PCAOB 2024 Inspection Priorities: More Inspections and a Focus on Firm Culture

The Public Company Accounting Oversight Board's inspection staff outlined its 2024 inspections priorities and its plans for interactions with audit committees in Spotlight: Staff Priorities for 2024 Inspections and Interactions With Audit Committees. In a December 20 press release, the Board explains that the staff report "highlights key risks, like high interest rates, and other considerations, like audit areas with recurring deficiencies, that auditors should be focused on when planning and performing audit procedures." The report also suggests eleven questions audit committees should ask "to hold firms accountable to high standards when hiring and overseeing the audit process." (For a discussion of the Board's 2023 inspection priorities, see 2023 PCAOB Inspections Will Prioritize Fraud, Financial Services, and Crypto, May-June 2023 Update.)

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Key Features of the 2024 Inspection Program

The PCAOB's 2024 inspections will primarily review fiscal year 2023 audits; for calendar year companies, these audits will generally have been completed during the first quarter of 2024. In the 2024 inspection cycle, the PCAOB plans to increase the number of engagements selected for review at the ten largest audit firms – those that have more than 100 public company audit clients and are required to be inspected annually. (For comparison, in the 2021 inspections – the most recent year for which the PCAOB has released reports – the Board inspected an average of 55 engagements at the four largest U.S. firms.)

As in prior years, the inspection staff will select some engagements for review based on the perceived risk associated with the audit, while some engagements will be selected randomly. Among other considerations, inspectors will emphasize selecting audits of companies that have engaged in mergers and acquisitions or business combinations. In addition, the selection process will prioritize audits of companies in three sectors:

- Financials**.** The staff offers this reason for focusing on the Financials sector: **"**Regional banks experienced significant disruption in 2023 due to certain high-profile bank failures. The failure of an auditor to properly understand the business and management's strategy degrades the ability to appropriately and diligently exercise professional skepticism and professional judgment."

- Information technology. Companies in this sector include technology, hardware, and the semi-conductor industry. The report states that these companies "have financial statement accounts, disclosures, and related internal controls that tend to be complex due to revenue recognition, other significant judgments, and contractual arrangements with customers." In addition, "the risk of fraud due to management override, although not unique to this sector, is often heightened given earnings pressures. Disruptions to the supply chain can also impact revenue recognition."

- Sectors that apply industry-specific or sector-specific accounting. Inspectors will also focus on companies in sectors that apply sector-specific accounting and in sectors that "hold assets that may have declined in value, such as collateralized commercial real estate debt."

2024 Inspection Considerations

Once a company's audit is selected for inspection, inspectors will review audit areas that present risks or other considerations that should be important when the auditor is planning and performing audit procedures. The report lists seven such topics and warns auditors that they "may want to consider additional focus in these areas as they plan their audit procedures."

- Broker-dealer audit challenges. In addition to inspecting public company audits, the Board inspects audits of securities broker-dealers that are registered with the SEC. In 2024, the broker-dealer inspection program will focus on challenges and deficiencies identified in prior broker-dealer audit inspections. These are discussed in Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers (August 10, 2023).

- Recurring deficiencies. Inspectors will consider audit areas in which they have frequently found deficiencies in past inspections. These areas include audit work related to revenue and related accounts; accounts affected by business combinations; inventory; long-lived assets, including goodwill and intangible assets; equity and equity-related transactions; and testing controls with a review element. The Board's most recent statement describing recurring inspection deficiencies is discussed in 2022 PCAOB Inspections Preview Says 40 Percent of Audits Reviewed Had Deficiencies, July 2023 Update.

- Evaluating audit evidence. Inspectors will consider whether the auditor exercised professional skepticism in evaluating audit evidence. "Professional skepticism is an attitude that includes a

questioning mind and a critical assessment of audit evidence. * * * Gathering and objectively evaluating audit evidence requires the auditor to consider the sufficiency and appropriateness of the evidence."

- Understanding the company and Its environment. The report states: "We plan to continue assessing how the auditor's understanding of the public company and the auditor's evaluation of significant changes in the public company from prior periods, including changes in the public company's internal control over financial reporting, affect the risks of material misstatement."

- Use of other auditors. In engagements where audit firms in addition to the principal auditor had significant involvement, the inspection staff will review the principal auditor's review and supervision of the work of the other firms.

- Going concern. The auditor is required to evaluate the ability of the company to continue as a going concern. In cases where there were potential challenges in making this determination, PCAOB inspectors will review the going concern evaluation.

- Critical audit matters (CAMs). Compliance with the CAM requirements will be a 2024 inspection priority because the average number of CAMs discussed in audit reports has decreased and the number of reports that include only one CAM has increased. In addition, the inspection staff has found deficiencies in CAM disclosure and evaluation.

Technology-Related Considerations

The report states that a challenge arising from new technologies is "ensuring that auditors have the appropriate knowledge and skills to efficiently and, perhaps more importantly, effectively incorporate or address these new technologies in their audit." Accordingly, inspections will focus on three technology-related areas -- digital assets, cybersecurity, and use of data and technology in the audit.

As to digital assets, inspectors will prioritize selecting for review audits of companies that have material digital asset holdings and transactions. Audits of such companies require "(1) an appropriate risk assessment, (2) understanding of the control environment, including information technology controls, (3) an understanding of the controls over the existence and ownership of the digital assets, including ongoing safeguarding of private keys, and (4) an appropriately planned audit response." See Spotlight, Inspection Observations Related to Public Company Audits Involving Crypto Assets (June 2023).

For all inspected engagements, the PCAOB staff will ask the audit firm to explain how cybersecurity risk was considered and incorporated into the audit. In the case of inspections of audits of companies that experienced a cyber incident, inspectors will review how the auditor evaluated the company's response, any resulting modifications to the audit, and the company's cyber incident disclosures.

Auditors are expanding their use of technology in performing audits. Accordingly, the PCAOB's inspectors "will evaluate the use of technology related to audit procedures, particularly focusing on instances where technology is used in procedures to respond to identified risks of material misstatement" in all inspections.

Review of Large Firm Culture

In its 2024 inspections, the Board will deploy a team to evaluate culture at the six large global network firms (BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC). Culture refers to a firm's "tone at the top" – whether senior leadership promotes and embraces "a culture of integrity and audit quality." This undertaking will involve interviewing firm personnel and evaluating documents. The report describes the reason for the new initiative as follows:

> "Audit firms continue to face challenges delivering quality audits as evidenced by (1) the increasing trend of audit deficiencies in recent years and (2) deficiencies identified that have recurred for

numerous years. We are interested in why these deficiency trends are not improving and whether audit firms' cultures are playing a role in this failure to improve."

Interactions with Audit Committees

During its 2024 inspections, the PCAOB staff will, as in past years, invite the audit committee chairs of public companies whose audits are selected for review, and are performed by a large, annually inspected firm, to engage in a dialogue with the inspections staff. The inspections staff will afford a similar opportunity to audit committee chairs of a sample of companies that are audited by smaller, triennially inspected, firms. For a discussion of the PCAOB's most recent report on staff conversations with audit committee chairs, see No Surprises, Please. 2022 PCAOB Conversations with Audit Committee Chairs, October 2023 Update.

Audit Committee Questions

The 2024 staff priorities report suggests eleven inspection-related questions that audit committee members may want to consider or discuss with their auditor. According to December 20 press release, the questions "are designed principally to further two-way communication on topics such as auditor understanding of the business, fraud, going concern, other auditors, CAMs, and the company's use of technology." Example of these questions include:

- How does the audit firm ensure that audit engagement team members have the appropriate understanding of our business so they can effectively perform their assignments?

- How would you, the auditor, commit fraud in our organization, and if you were an employee or member of management, what would you do to prevent it?

- If portions of the audit were outsourced to a shared service center, how did the auditor determine that service center personnel executed the procedures appropriately?

- What is the audit firm's use of technology? What was applied during the audit?

- What is the auditor's candid impression of the audit committee's oversight of the internal audit function and how the internal audit plan addresses the company's significant risks?

Comment: The 2024 inspections priorities Spotlight provides audit committees with insight into why the PCAOB selected the company's engagement for review and why, if selected, inspectors concentrated on some aspects of the audit and ignored others. In addition, the Spotlight may help the audit committee in understanding their auditor's work plan, since auditors are likely to devote special attention to areas of PCAOB inspection emphasis. Indeed, as noted above, the Spotlight explicitly advises auditors "to consider additional focus" in areas that are 2024 inspection priorities. Similarly, 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. Finally, the eleven suggested audit committee questions could provide a useful basis for dialogue with the company's auditor.

Four Large Firms Report on How They See Their 2023 Audit Quality

Each year, the U.S. members of the six large global network accounting firms issue audit quality reports. These reports describe the firm's commitment to audit quality, its performance on various self-selected audit quality-related metrics, and its plans to maintain and enhance the caliber of its audit performance. See CAQ's Guide to Audit Quality Reports, April 2023 Update. These reports seldom attract public attention. However, while each firm undoubtedly prepares its report with a view to putting the firm's performance and commitment to audit quality in the best light, these reports provide useful information

and insight into how the firms view audit quality. Because of their responsibility for the selection, evaluation, and retention of audit firms, audit committees are a key target audience for these reports.

During the past several months, four global network firms have issued their 2023 audit quality reports.

- Deloitte: 2023 Audit Quality Report: Setting the standard of excellence (December 2023)

- Ernst & Young: Our commitment to audit quality (November 2023)

- KPMG: FY23 Audit Quality Report (undated, released in January 2024)

- PwC: Our focus on audit quality: 2023 Audit Quality Report (undated, released in September 2023)

The other two global network firms, BDO and Grant Thornton, have not yet issued their 2023 audit quality reports. The 2022 reports for these firms (and a preview of the 2023 BDO report) are however available:

- BDO: 2022/2021 BDO Audit Quality Report: Preserving Trust Through Agility and Innovation and BDO USA's Audit Quality Journey: Preview of Our 2023 Audit Quality Report

- Grant Thornton: Audit quality & transparency report 2022 (released August 7, 2023)

Report Content

Each report is primarily a narrative discussion of the firm's commitment to audit quality and of how it seeks to achieve its quality objectives. The topics discussed in the 2023 reports vary from firm to firm, but include such matters as –

- A message from leadership regarding the firm's commitment to audit quality.

- A statement of the firm's culture and values, including the firm's commitment to ethics, and compliance with independence requirements.

- Discussion of how the firm defines audit quality and the ways in which it emphasizes quality in the performance of audit engagements.

- Description of how the firm monitors audit quality and the results of internal and external inspections.

- Recruiting, retention, and training of audit personnel, including commitment to workforce diversity.

- The role of technology in auditing, including the use of artificial intelligence.

- The firm's view of future auditing challenges and how it intends to address them.

- How the firm seeks to understand and incorporate into its practice the needs and interests of stakeholders, including whether and how the firm obtains independent input on governance or audit quality issues.

- The firm's governance structure, including identification of senior audit practice leadership.

Audit Quality Metrics

Each report also contains metrics -- quantitative data relevant to audit quality performance. Since the reports are not subject to any common standard or content requirements, and since audit quality is not a

defined concept, these metrics are not consistent across firms. However, some measures are common to most of the reports.

Below is an overview of eight of these common metrics, as presented in the 2023 audit quality reports of the four large firms that have released 2023 reports. Unless otherwise stated, all figures below are for 2023, although in most cases firms also present metrics for prior years to permit comparison and trend analysis. The reports do not describe in detail how particular metrics were computed; therefore, measures with similar names may not necessarily be comparable across firms.

1. PCAOB Inspection Results

PCAOB inspection results are publicly available on the PCAOB's website. See 2021 PCAOB Large Firm Inspection Reports, January 2023 Update. Each of the firms includes as a metric the number (or percent) of audits in Part I.A. of their 2021 PCAOB inspection report. (Part I.A. describes engagements that the PCAOB found to have one or more deficiencies of such significance that the firm had not obtained sufficient appropriate evidence to support the audit opinion). While 2022 PCAOB inspection reports had not yet been issued at the time that the 2023 audit quality reports were published, two firms also state the number of Part I.A. engagements that will be in their 2022 inspection report.

- Deloitte: In 2021 inspections, the PCAOB found Part I.A. deficiencies in 13 percent of 54 audits inspected. In 2022 inspections, the PCAOB found Part I.A. deficiencies in 17 percent of 53 audits inspected.

- Ernst & Young: In 2021 inspections, the PCAOB found Part I.A. deficiencies in 12 (21 percent) of 56 audits inspected. In 2022 inspection, the PCAOB found Part I.A. deficiencies in 25 (46 percent) of 54 audits inspected.

- KPMG: In 2021, the PCAOB found Part I.A. deficiencies in 14 of 54 audits audit inspected.

- PwC: In 2021 inspections, the PCAOB found Part I.A. deficiencies in two of 56 audits inspected.

2. Use of Specialists

To address challenging or complex audit areas, firms typically assign personnel with specialized skills and knowledge to assist in assessing risk and designing and performing audit procedures.

- Deloitte: Specialists represented 17 percent of total public company audit hours. IT specialists (10.7 percent of total audit hours) were the largest contributors.

- Ernst & Young: U.S. specialists generated 18.7 percent of U.S. public company audit hours. IT specialists (12.5 percent of total audit hours) were the largest contributors.

- KPMG: Information on utilization of specialists not provided.

- PwC: Specialists provided 17.1 percent of audit hours. (This includes hours incurred by acceleration center audit team members that performed work under the direct supervision of the specialist. The report states that acceleration centers, which are in the US, India, Argentina, Mexico, Malaysia, and the Philippines, "represent a global talent pool of people who work seamlessly with other team members to complete audit procedures for both public and non-public audits.")

3. Restatements

A measure of audit quality is the frequency with which financial statements on which the firm has expressed an opinion are subsequently restated. Firms may present this metric as the percentage of audited financial statements that were not restated.

- Deloitte: Percentage of issuer audit clients' (SEC registrants and registered investment companies) annual financial statements that were not restated was 99.9.

- Ernst & Young: Twelve issuers (0.8 percent) disclosed restatements and reissued their financial statements (based on the number of SEC registrants and mutual fund issuers audited).

- KPMG: Information on public company audit client restatements not provided.

- PwC: 99.1 percent of reports on ICFR were not reissued or withdrawn. 99.6 percent of issuer audit client financial statements were not restated.

4. Number of Audit Professionals

In their audit quality reports, firms present a wide range of statistics on workforce size and composition, usually with a particular emphasis on diversity. The number of employees in the audit practice is a basic measure of audit practice size.

- Deloitte: Information not provided on size of audit workforce.

- Ernst & Young: 11,270 U.S. audit professionals (1,187 partners and managing directors, 2,555 senior managers and mangers, and 7,528 seniors and staff).

- KPMG: 9,712 total personnel (1,276 partners/managing directors, 2,396 managers, and 6,040 associates).

- PwC: 14,923 audit team members (1,121 partners/managing directors, 2,470 directors/managers, 2,635 senior associates, and 3,591 acceleration center full-time equivalents; see Use of Specialists, above, for a description of PwC acceleration centers.)

5. Leverage Ratio

The ratio of partners to staff is a measure of the availability of experienced, senior audit talent. It is also a determinant of firm profitability.

- Deloitte: The ratio of partners, principals, and managing directors to all other Audit & Assurance professionals was 1 to 12.3. The ratio of partners, principals, managing directors, senior managers, and managers to seniors and staff was 1 to 2.4.

- Ernst & Young: The ratio of partners and managing directors to staff through senior managers was 1 to 8.5. The ratio of senior managers and managers to seniors and staff was 1 to 2.9.

- KPMG: Information on ratio of partners to staff not provided.

- PwC: The ratio of partners/managing directors to all other audit team members (including acceleration centers) was 1 to 12.5; excluding acceleration centers, the ratio was 1 to 7.9. (See Use of Specialists, above, for a description of PwC acceleration centers.)

6. Partners and Managing Directors Involved in Quality or Audit Oversight

Each firm assigns some partners and other senior personnel to provide oversight and guidance on issues relating to audit quality.   The ratio of these professional practice or quality management partners to the total audit partner population is a data point regarding the firm's audit quality resources.

- Deloitte: The ratio of partners, principals, and managing directors (PPMDs) in “technical roles” as part of the Quality & Professional Practice Network to total PPMDs was 1 to 10.4.

- Ernst & Young: The ratio of “Quality Network and Professional Practice” partners and managing directors to all audit partners and managing directors was 1 to 6.

- KPMG: Information on number of partners involved in audit quality oversight not provided.

- PwC: The ratio of partner/managing directors serving in technical support roles to total partners/managing directors was 1 to 6.0.

7. Audit Staff Turnover

Audit firms typically experience turnover as personnel take advantage of the training and expertise gained in auditing to move to employment opportunities in other aspects of business and finance. Turnover can be an issue for audit quality since new hires require training and experience time to become familiar with the business of the clients to which they are assigned.

- Deloitte: The voluntary turnover rate was 11 percent. The average tenure by rank level was 22.5 years for partners/managing directors, 10.6 years for senior managers, 5.6 years for managers, 3.1 years for seniors, and 1.2 years for staff.

- Ernst & Young: The retention rate for senior managers and managers was 82 percent. The retention rate for seniors and staff was 78 percent. The retention rate for all ranks below partner (including managing directors) was 80 percent. (While not discussed in the EY report, presumably the turnover rate would be determined by subtracting the retention rate from 100.)

- KPMG: The voluntary attrition rate was 10 percent for managers and 19 percent for staff.

- PwC: The overall average annual voluntary turnover rate was 16.5 percent. By rank, the voluntary turnover rate was 15.6 percent for managing directors/directors/mangers, 21.1 percent for senior associations, and 13.4 percent for associates.

8. Continuing Professional Education

Since both accounting and auditing are constantly evolving, continuous professional education for audit staff personnel is an essential aspect of audit quality.

- Deloitte: Average mandatory learning hours per person were 71.

- Ernst & Young: Average hours of continuing professional education were 97.

- KPMG: Average hours of continuing professional education by rank were: Partner/principal – 52 hours; Managing director – 51 hours; Senior manager/director – 46 hours; Manager – 52 hours; Senior associate – 43 hours; Associate – 51 hours.

- PwC: Each audit professional completed an average of 87 training hours.

Comment: Audit committees should review their audit firm’s audit quality report as part of their evaluation of the firm’s performance and consideration of whether to continue to engage the firm. The reports may also serve as a basis for discussion among committee members and with the engagement partner regarding how the firm views audit quality and how its efforts to enhance quality may affect the company’s audit.

Similarly, audit committees that are considering retaining a new auditor should review the quality reports of the competing firms. While these reports contain a large amount of useful information, they are less

useful as vehicles for comparing firms because the content is not the same across firms and metrics may be computed using differing methodologies. As discussed in PCAOB Adds Audit Quality Indicators to its Short-Term Agenda, May-June 2023 Update, the PCAOB is considering the feasibility of developing key indicators of audit quality and effectiveness. Such indicators could improve the comparability of firm quality reporting.

PCAOB Target Team Zeroed in on First-time Audits, Shared Service Centers, and Climate

The Public Company Accounting Oversight Board's annual inspections program includes a "target team" which examines how auditors handled specific issues on a cross-firm basis. The target team inspectors focus on emerging audit risks and topics that the PCAOB staff believes could have important implications for audits. The Board has stated that the target team "executes in-depth reviews across audit firms using information-gathering inspection procedures that extend beyond traditional inspection procedures." In a new publication, Spotlight: Observations From the Target Team's 2022 Inspections, the PCAOB staff summarizes the target team's work in 2022, including deficiencies observed, good practices identified, and key insights.

The 2022 target team looked at three areas – first post-initial public offering (IPO) audits, including both companies that engaged in traditional IPOs and those that became public via a merger with a special purpose acquisition company (SPAC); audit firm use of shared service centers (SSCs); and climate-related matters that impacted financial reporting. (For a discussion of the PCAOB's report on the findings of its 2021 target team, see PCAOB Reports 2021 Target Team Observations, September-October 2022 Update.)

Traditional IPOs and De-SPAC Transactions

The 2022 target team reviewed 20 post-IPO audit engagements. Sixteen of these companies became public as the result of a de-SPAC transaction (i.e., a merger with a SPAC), while four were the product of traditional IPOs. One of the six largest U.S. global network firms (BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC) performed each of the 20 audit engagements.

The target team identified deficiencies in four (20 percent) of the de-SPAC transaction audits. All deficiencies related to revenue. These deficiencies involved the auditor's failure to –

- Identify a departure from GAAP in the presentation of deferred revenue.
- Perform procedures to test, or test controls over, the accuracy and completeness of labor hours used as an input to record revenue.
- Perform sufficient substantive procedures to test the reasonableness of the percentage of completion used by the public company to estimate revenue.
- Identify and evaluate the significance of an inconsistency in the description of a transaction in a note disclosure and the description of the transaction in Part I of the public company's annual report filed on Form 10-K.
- Evaluate the specific review procedures that control owners performed to assess the reasonableness of forecasted hours used as an input to record revenue.
- Sufficiently evaluate the severity of a control deficiency to determine whether the deficiency, individually or in combination with other deficiencies, was a material weakness.
- Identify and test controls over the reconciliation of time-and-materials data with the general ledger.

- Identify and test controls over the presentation of deferred revenue.

In reviewing the post-IPO audits, the target team also observed certain "good practices" – features of particular audits that, in the target team's view, enhanced audit quality. These good practices included the use of valuation specialists in situations where a specialist was not required under firm policy; consultation with the firm's professional practice group on particular accounting and auditing issues, including where the firm's audit methodology did not require consultation; use of technology-based tools, such as data analytics; and voluntarily adding a partner with relevant industry experience to the engagement team in order to assist in reviewing fraud risks.

Shared Service Centers

In 16 of the 20 post-IPO audits reviewed, the engagement team made use of a firm SSC. The target team report describes an SSC as –

> "an entity – affiliated with one or more audit firms – that mostly provides resources and services remotely to core engagement teams. SSC personnel traditionally serve in staff or senior associate roles of an engagement team. The services provided are typically more traditional standardized audit procedures, such as testing the mathematical accuracy of schedules prepared by the public company. SSCs may be based inside and/or outside the U.S. and may or may not be subsidiaries of the U.S. audit firm."

The target team did not identify any audit deficiencies related to the use of SSCs. Among other things, the target team noted that the U.S. engagement team was ultimately responsible for all audit work that an SSC performed. Observations related to the U.S. engagement team's overall control of the audit included:

- The lead engagement partner determined the scope of audit procedures that the SSC performed.

- Formal communication and reporting lines were established between the SSC and the U.S. audit firm.

- The U.S. engagement team determined and managed the extent of SSC interactions with the audit client. In most cases, the audit firm required a U.S. engagement team member to be involved in such interactions.

- All audit firms restricted SSC personnel from serving as final workpaper reviewers.

Climate-Related Matters

The target team reviewed ten audit engagements, performed by five of the six large firms, focusing on the risk that climate-related matters could materially affect the public company's financial reporting. The ten companies were in four industry sectors – Consumer Discretionary, Energy, Industrials, and Materials. Each of the ten companies had a market capitalization exceeding $800 billion. The target team reviewed how climate-related considerations affected the financial statement audit. The team also reviewed company climate-related disclosures, including disclosures in public sustainability reports.

All ten engagement teams considered the potential impact of climate-related matters as part of audit planning and risk assessment, and the target team did not identify any audit deficiencies related to climate risk. Target team observations with respect to climate risk included:

- All five audit firms issued internal guidance highlighting, among other things, the importance of management's key assumptions and judgments in assessing the impact of climate-related commitments on the preparation of the financial statements, including such issues as potential

impairment of nonfinancial assets, estimated useful lives of property, plant, and equipment, and going concern assessments.

- All five audit firms provided firm specialists to assist engagement teams in conducting risk assessment procedures when the impact of climate-related matters could be material to the financial statements.

- All five audit firms issued external guidance, including educational material, noting the firm's expertise in climate-related matters.

- One engagement team stated that it met frequently with management and the audit committee to discuss climate-related matters. That engagement team noted that climate matters were included as a standing agenda item for upcoming audit committee meetings.

Comment: For audit committees, the most interesting feature of the 2022 target team Spotlight is that it underscores the PCAOB's focus on auditor use of shared service centers and on the impact of climate-related risks on financial reporting and auditing. (The PCAOB is also focused on IPOs and SPACs, but only a small number of audit committees will have been involved in such transactions.) Audit committees should consider asking their engagement partner to describe the role that SSCs played in the company's audit and how climate-related risks affected audit planning and execution. The observations in the Spotlight could be helpful in framing these discussions. More generally, the target team Spotlight could be useful to the audit committee in understanding what aspects of the company's future audits are likely to attract PCAOB inspection staff attention.

On the Update Radar: Things in Brief

What Should be on the Audit Committee's 2024 Agenda? At the beginning of each year, 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 2023 year-end/2024 agenda papers.

- Deloitte Center for Board Effectiveness, On the audit committee's agenda: Looking ahead: The audit committee agenda in 2024.

- EY Center for Board Matters, What audit committees should prioritize in 2024.

- KPMG Board Leadership Center, On the 2024 audit committee agenda.

- Protiviti, Setting the 2024 Audit Committee Agenda.

- PwC Governance Insights Center, Approaching the 2023 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 frequent 2024 audit committee agenda topics (along with references to reports that discuss them) include:

- ESG reporting, including existing and proposed mandatory climate change disclosure requirements (Deloitte, EY, KPMG, Protiviti, PwC).

- Risk and disclosure implications of the use of artificial intelligence (Deloitte, EY, KPMG, Protiviti, PwC).

- Cybersecurity and compliance with SEC cybersecurity disclosure requirements (Deloitte, EY, KPMG, Protiviti).

- Audit committee effectiveness (Deloitte, KPMG, Protiviti, PwC).

- Impact of the PCAOB's proposal to enhance the auditor's responsibility to detect company noncompliance with laws and regulations (NOCLAR) (Deloitte, EY, KPMG).

- Adequacy of company financial reporting and internal audit talent (Deloitte, KPMG, Protiviti).

- SEC emphasis on disclosure controls and procedures (Deloitte, KPMG).

- Assuring that internal audit focuses on key risks (KPMG, Protiviti).

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

For last year's audit committee agenda suggestions, see What Should be on the Audit Committee's 2023 Agenda?, January 2023 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 to better understand the various suggested topics. Those questions could provide a good starting point for discussion.

AI: Yet Another Audit Committee Responsibility. As noted in several of the 2024 audit committee agenda papers (see What Should be on the Audit Committee's 2024 Agenda?, above), audit committees are beginning to focus on the risks and disclosure implications of business use of artificial intelligence (AI), particularly the rapidly expanding use of generative AI. In Artificial intelligence: An emerging oversight responsibility for audit committees?, Deloitte discusses some of the emerging risks and opportunities that audit committees need to consider as AI becomes more widely integrated with core business processes. The paper also suggests questions for audit committees to consider in overseeing AI strategy and governance. (A somewhat more detailed version of the paper (available here) appears in the National Association of Corporate Directors (NACD) publication, 2024 Governance Outlook.)

The Deloitte paper describes the current state of AI adoption and oversight as "an abstract governance puzzle." For example, based on a 2022 Deloitte survey:

- Twenty-nine percent of respondents reported that AI oversight was not assigned to any committee or the full board; 16 percent said AI oversight was assigned to the audit committee.

- Forty-four percent of respondents reported that AI has not been on the agenda of either the full board or a committee; 37 percent said AI had been discussed on an "ad hoc or as needed basis."

- Sixty-eight percent of respondents did not know (or did not respond) when asked how their company mitigates AI-related risk.

The paper identifies some of the risks that AI poses, such as "shadow IT environments" (use of IT assets without the knowledge or oversight of IT security personnel); "IP ownership and infringement" (e.g., disclosure of confidential company data to third parties or infringement of intellectual property rights); and enhanced company exposure to cybersecurity threats. Generative AI also creates risks stemming from the fact that it can be a "black box" with low transparency of how output is derived and from the possibility of "hallucinations" – plausible, but inaccurate, outputs.

Along with risks, the paper details potential benefits of AI, particularly those related to transaction processing, forecasting and modeling, and financial reporting. The authors note that:

> "One particular set of benefits is squarely in the audit committee's wheelhouse—namely, the potential to streamline and enhance a company's internal audit, financial reporting, and internal control functions. * * * In the shorter term, various subcategories of AI are already capable of improving the quality of financial reporting via reviewing transactions, identifying errors, addressing internal control gaps, and detecting fraud. If AI isn't being used within these areas, the audit committee might ask if the company is exploring potential use cases—and if the company is not, the committee might ask to hear the reasons behind that decision."

Deloitte also points out that, while audit committees typically have a role in risk oversight, some aspects of AI oversight seem more aligned with the audit committee's work than others. For example, the risks associated with the use of AI in such areas as auditing, financial reporting, and internal control functions seem to fall squarely in the scope of the committee's core responsibilities. At the same time, AI is an emerging technology that is likely to change rapidly. Further, there is a likelihood of government regulation that could impact oversight responsibilities. "Thus, determining now that AI, or aspects of AI, should be overseen by another committee or committees may turn out to be premature."

The paper concludes with five potential questions for audit committees to consider:

- What are the company's current and potential future use cases for AI, and do any of them have an impact on financial reporting or other audit committee oversight areas?
- Has management considered opportunities to use AI that may enhance or improve financial reporting processes?
- What processes are, or will be, used to evaluate dependencies that may arise in other areas where the audit committee may have primary oversight, like cybersecurity or data management?
- Are processes for use of AI congruent with the company's risk appetite in terms of level of proactiveness and mitigation strategy?
- Given the speed of AI technology development, are existing processes being assessed and updated with appropriate frequency?

Audit committees that are seeking a basic grounding in the impact of AI risks and opportunities on their work may also be interested in a one-hour video presented by the Center for Audit Quality and the NACD on AI. Artificial Intelligence (AI) 101 For Audit Committees includes discussion of what AI is, examples of how businesses are using AI in financial reporting, and questions boards should ask corporate management. In addition, audit committee members may find a recent KPMG publication, AI Transformation: Audit committees play a crucial role, useful.

What Do Clients Want from Auditors? Is it the Same as What Investors Want?

In What Do Audit Clients Want from Their Auditor?, Brant Christensen (Brigham Young University), Matthew Ege and Nathan Sharp (both of Texas A&M University), and T. Jeffrey Wilks (Brigham Young University) report the results of a survey and interviews with public company executives and directors about what they want from their external auditor. Their findings suggest that executives and audit committee members may value different auditor attributes than those that investors presumably favor.

The participants in the study were chief financial officers, chief accounting officers, and directors of U.S. public companies. The authors received survey responses from 171 executives and 76 directors.

Sixty-one percent of the executives were CFOs or CAOs, and 51 percent of the directors were audit committee members. The authors conducted 14 follow-up interviews five with directors and nine with executives.

The authors describe four “key takeaways” from their research:

- Executives and directors view auditors’ service quality as at least as important as technical competence or compliance with auditing standards. “Both directors and executives emphasize the need for audit firms, partners, and teams to be strong communicators who raise issues in a timely manner to avoid surprises.” As the study notes, a preference for service quality over audit quality “is likely inconsistent with what regulators, investors, and creditors want from auditors.”

- Executives particularly value an audit partner’s willingness to be flexible in areas involving subjective judgment, “such as determining whether a misstatement is material or whether a control deficiency is a material weakness.” Executives also value a partner’s willingness to make decisions without involving the audit firm’s national office. Director respondents placed less weight on these attributes. The authors observe that a preference for partner flexibility and autonomy “might not be in the best interest of investors if that judgment is used to record transactions in ways that do not faithfully represent the underlying economics of the transactions.”

- Approximately 40 percent of respondents are unable to assess audit quality very accurately. For example, there was a “wide range of responses when participants are asked to provide their perception of the level of assurance the typical audit provides.”

- Participants generally prefer the status quo when asked about potential changes to the audit process. In addition, “participants generally report satisfaction with their current auditor and the level of assurance received, in part because switching costs are high and exceed the benefits obtained from audits that are viewed by some as compliance exercises that resemble a commodity.”

The paper’s abstract concludes: “These results raise questions about whether executives’ and directors’ focus on service quality and flexibility aligns with investors’ needs and, separately, whether regulators’ focus on quality and compliance meets executives’ and directors’ needs.” In evaluating auditor performance, audit committees may want to keep the implications of these differences in perspective in mind.

How to Improve Your Audit: Ask Your Auditor to Hire a PCAOB Alum.
Washington is famous for the revolving door – the practice of professionals serving some time in government and then going to work for the industry that they were previously in charge of regulating. But is that a bad thing? A recent academic study presents evidence that former PCAOB employees bring with them expertise that is beneficial for audit quality.

In Does audit firm hiring of former PCAOB personnel improve audit quality?, a paper published in the Review of Accounting Studies, Jagan Krishnan (Temple University), Jayanthi Krishnan (Temple University), and Steven A. Maex (George Mason University) examine whether large audit firm hiring of PCAOB employees firms is associated with subsequent higher audit quality at these firms. They find that adding staff with PCAOB experience reduces the likelihood that the firm will fail to detect material misstatements or will issue an incorrect opinion on internal control over financial reporting:

> “[F]inancial restatements and Big R restatements are negatively associated with regulatory audit quality expertise, consistent with the expectation that the revolving door hires can help identify and address audit deficiencies in areas of high misstatement risk. * * * We find that internal control audit quality improves (i.e., internal control audit opinions become more accurate) as regulatory audit quality expertise increases but only for high misstatement-risk clients. * * * Overall our tests suggest that regulatory audit quality expertise benefits both financial statement and internal control audit quality for clients prone to significant misstatement risk.”

The revolving door between accounting firms and the PCAOB has been controversial, not because of doubts about whether it potentially benefits firm audit quality, but because of the possibility that former PCAOB employees could illicitly provide their new firm with confidential information regarding the Board's inspection program. In 2018, two former PCAOB inspections staff members who had joined KPMG were criminally charged with participation in a scheme to misappropriate and use confidential PCAOB inspection plans to aid KPMG in improving its inspection results.

While the audit committee should certainly take an interest in the professional background of senior members of the engagement team, in practice the presence of PCAOB alumni on an audit firm's staff is not a basis for differentiating between the major firms, since almost all of them engage in such hiring. According to a table in the study, beginning in 2014, nine of the ten largest U.S. accounting firms had at least one ex-PCAOB employee on their staff (the exception was Marcum). By 2016, the last year included in the study, the six global network firms (BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC) each had at least seven former PCAOB employees, while one firm (EY) had 19 alums.

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. The blog is available here.

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An index to titles and topics in the Update beginning with No. 39 (July 2017) is available here.

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