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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:

PCAOB Proposes Engagement Metrics and Audit Firm Operational and Financial Reporting

Why Are Accounting Errors Increasing? Glass Lewis Has Answers and a Warning for Audit Committees

PCAOB Discloses Non-Public Portions of 2018 and 2019 KPMG Inspection Reports

Cornerstone: Accounting Class Actions and Enforcement Cases Continue Their Upward Trend

On the Update Radar: Things in Brief

- Unredacted: KPMG's 2022 Inspection Report
- SEC Puts its Climate Disclosure Rules on Hold
- EY Has Q1 Suggestions for Audit Committees
- Who Audits Public Companies? Mostly Ten Firms

The Audit Blog

PCAOB Proposes Engagement Metrics and Audit Firm Operational and Financial Reporting

On April 9, the Public Company Accounting Oversight Board issued for public comment two proposals that would significantly expand the disclosures that accounting firms must make regarding their performance of audit engagements and their operational and financial condition. See Firm and Engagement Metrics and Firm Reporting. In the press release announcing these two proposals, PCAOB Chair Erica Williams stated: "Sound and consistent information bolsters confidence in our capital markets, and can drive audit quality * * *. Informed by extensive study and stakeholder input, today's proposals

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would strengthen PCAOB oversight and equip investors, audit committees, and others with clear, consistent, and actionable dated related to the audit."

Firm and Engagement Metrics Proposal

The firm and engagement metrics proposal would require PCAOB-registered public accounting firms that audit large accelerated filers and accelerated filers to publicly report eleven metrics relating to specific audit engagements or to the firm's overall audit practice. A primary objective of these disclosures would be to aid audit committees in their oversight. The PCAOB's release proposing the new metrics states that "audit committees could benefit from having additional context when deciding whether to select or retain a firm and overseeing the firm's work." In addition, the PCAOB believes that firms themselves would benefit, since "audit firms could use standardized information about themselves and their peers in designing, implementing, monitoring, and remediating their systems of quality control."

Some firms already disclose firm-level performance metrics in their audit quality or transparency reports. See Four Large Firms Report on How They See Their 2023 Audit Quality, January 2024 Update. However, in the PCAOB's view, these existing disclosures are insufficient:

> "[T]he disclosures are inconsistent across firms, and there are no common definitions or calculations allowing for consistent comparisons. Moreover, most of the disclosures are voluntary, so firms are free to revise or discontinue such reporting any time. In our view, the current voluntary reporting regime does not provide consistent, comparable information that stakeholders can rely on to inform their decisions over time." Proposing Release at 3.

The PCAOB has, for several years, sought to identify "audit quality indicators." See PCAOB Adds Audit Quality Indicators to its Short-Term Agenda, May-June 2023 Update. While this proposal is an outgrowth of that effort, the Board has discarded the phrase "audit quality indicators" in favor of "firm and engagement metrics." The Board believes that the new terminology "avoids the potential misimpression that any set of metrics can comprehensively measure audit quality and emphasizes our goal of promoting informed decision making through robust disclosure requirements. Some of the most important elements of a high-quality audit, such as application of due care and professional skepticism, cannot be measured and quantified directly."

The eleven proposed engagement performance metrics are:

1. Partner and Manager Involvement. Hours worked by senior professionals relative to more junior staff across the firm's issuer engagements and on the engagement.

2. Workload. Average weekly hours worked on a quarterly basis by engagement partners and by other partners, managers, and staff, including time attributable to engagements, administrative duties, and all other matters.

3. Audit Resources – Use of Auditor's Specialists and Shared Service Centers. Percentage of issuer engagements that used specialists and shared service centers at the firm level, and hours provided by specialists and shared service centers at the engagement level.

4. Experience of Audit Personnel. Average number of years worked at a public accounting firm (whether or not PCAOB-registered) by senior professionals across the firm and on the engagement.

5. Industry Experience of Audit Personnel. Average years of experience of senior professionals in key industries audited by the firm at the firm level and the audited company's primary industry at the engagement level.

6. Retention and Tenure. Continuity of senior professionals (through departures, reassignments, etc.) across the firm and on the engagement.

7. Audit Hours and Risk Areas (engagement-level only). Hours spent by senior professionals on significant risks, critical accounting policies, and critical accounting estimates relative to total audit hours.

8. Allocation of Audit Hours. Percentage of hours incurred prior to and following an issuer's year-end across the firm's issuer engagements and on the engagement.

9. Quality Performance Ratings and Compensation (firm-level only). Relative changes in partner compensation (as a percentage of adjustment for the highest rated group) between groups of partners based on internal quality performance ratings.

10. Audit Firms' Internal Monitoring. Percentage of issuer engagements subject to internal monitoring and the percentage with engagement deficiencies at the firm level; whether the engagement was selected for monitoring and, if so, whether there were engagement deficiencies and the nature of such engagement deficiencies at the engagement level.

11. Restatement History (firm-level only). Restatements of financial statements and management reports on ICFR that were audited by the firm over the past five years.

The proposal would require firms that serve as the lead auditor for at least one accelerated filer or large accelerated filer to report the firm-level metrics annually on a new Form FM. (In general, accelerated filers are companies with a public float between $75 and $700 million, while large accelerated filers are companies with a public float of $700 million or more.) For individual accelerated filer and large accelerated filer engagements, the engagement-level metrics would be included in a revised version of Form AP which must already be filed for each public company engagement. Form AP would be renamed "Audit Participants and Metrics." The proposal would allow limited narrative disclosures on both Form FM and Form AP to permit firms to provide context and explanation for the required metrics.

The five-member PCAOB voted unanimously to issue the firm and engagement metrics proposal for public comment. However, Christina Ho, one of the two CPA Board members, stated that she did so "cautiously." Her statement raises a variety of issues concerning the costs and utility of the proposed metrics. She encourages public comments on "the usefulness and feasibility of these proposed metrics as proxies to audit quality." She also expresses interest "in hearing from shareholders and audit committees to what extent these metrics would be helpful or harmful to investors" and on "the impact on small and medium firms."

Firm Reporting Proposal

The PCAOB has also proposed expanding the information that accounting firms registered with the Board must provide in their public annual reports (PCAOB Form 2) and in special reports (PCAOB Form 3) that must be filed on the occurrence of certain events. The Board's April 9 press release states that this proposal seeks "to facilitate more public disclosure that would be informative and useful to investors, audit committees, and other stakeholders" and that "[e]nhanced reporting requirements also have the potential to facilitate the PCAOB's oversight functions and its ability to protect investors."

The key reporting changes are:

1. Financial Information. All registered firms would report additional fee information in their annual report on Form 2. For example, firms would be required to report the dollar amount (not merely percentages, as currently required) of the fees earned from audit services, other accounting services, tax services, and non-audit services. The largest registered firms would also be required to confidentially submit financial statements to the PCAOB.

2. Governance Information. All registered firms would report additional information regarding their leadership, legal structure, ownership, and other governance information in their annual report on Form 2. For example, firms would be required to report the names of their principal executive officer and all direct reports to that officer, of the individuals responsible for various components of the firm's system of quality control, and of the members of the governing board or management committees.

3. Network Information. The public annual report would also be required to include a detailed description of any network arrangement to which a registered firm is subject, including the legal and ownership structure of the network, network-related financial obligations, information-sharing arrangements between the network and registered firm, and network governing boards or individuals to which the registered firm is accountable.

4. Special Reporting. The proposal would shorten the time for filing special reports on Form 3 from 30 days to 14 days (or more promptly as warranted). Form 3 must be filed when certain events occur, such as a change in the firm's name or criminal or regulatory proceedings against a partner or principal. The proposal would also create a new confidential special reporting requirement for events material to a firm's organization, operations, liquidity or financial resources, or provision of audit services. Examples of such events include (l) a determination that there is substantial doubt about the firm's ability to continue as a going concern; (2) a planned or anticipated acquisition of the firm, change in control, or restructuring, including external investment and planned acquisition or disposition of assets or of an interest in an associated entity; or (3) entering into or disposing of a material financial arrangement that would affect the firm's liquidity or financial resources.

5. Cybersecurity. The proposal would require confidential reporting on Form 3 of significant cybersecurity events within five business days and periodic public reporting of a brief description of the firm's policies and procedures, if any, to identify and manage cybersecurity risks.

In addition, the proposal would require firms to report changes to their systems of quality control made in response to the Board's proposal to expand and enhance its quality control requirements, if that proposal is adopted and approved by the SEC. See PCAOB QC Proposal Could Impact Auditor/Audit Committee Relationship, November-December 2022 Update. The release proposing the firm reporting rules states: "We believe it is important that firms update the statement regarding their quality control policies and procedures, originally made in connection with their registration application, to reflect the changes to their policies and procedures made in response to the new quality control standard."

The Board vote to issue the firm reporting proposal was 4-1. In opposing this proposal, Board Member Ho stated:

> "I am profoundly worried that the Board's apparent zeal to impose, in each new proposed standard or rule, new burdens on firms, without sufficient tailoring and without quantifying the estimated burdens, may end up breaking the public company auditing profession's back, particularly for small firms. If we 'break' the profession in the name of investor protection, are we really protecting investors?"

Comment: As the two PCAOB releases proposing these extensive new reporting requirements make clear, they are in part intended to benefit audit committees by providing them with additional information to support their oversight of the company's auditor. For example, engagement metrics that assist audit committees in evaluating the work of their auditor, and in comparing the performance of other firms, would unquestionably be a valuable tool. At the same time, as Board Member Ho points out in her statement, most metrics are only meaningful if the user has a sophisticated understanding of the full context of the audit and how particular metrics relate to that audit. Applying metrics to a specific audit would be a complex task, and there is a risk that the PCAOB's proposal would end up creating more confusion and misunderstanding about audit quality, rather than less.

Audit committees should consider whether they would find the engagement performance metrics and firm information that the PCAOB is proposing to require useful in their work. They should also consider whether the benefits would outweigh the costs of collecting and reporting this new data. These costs would inevitably be borne by audit clients and their investors. The comment period on both proposals runs until June 7, 2024.

Why Are Accounting Errors Increasing? Glass Lewis Has Answers and a Warning for Audit Committees

Accounting-related class actions and regulatory enforcement cases increased in 2023 (see Cornerstone: Accounting Class Actions and Enforcement Cases Continue Their Upward Trend in this Update). This seems to suggest that accounting errors are becoming more common. In a recent blog post, Why Are Accounting Errors on the Rise at U.S. Public Companies?, proxy and corporate governance advisory firm Glass Lewis offers some reasons for financial reporting problems. Overburdened audit committees are one of the factors it identifies. The firm also makes clear that, despite the burdens and challenges audit committees face, it is prepared to recommend proxy votes against audit committee members who are not fulfilling their core duties.

Scope of the Problem

Glass Lewis notes that, since 2021, SEC enforcement actions related to issuer reporting, auditing, and accounting have increased from 70 cases in 2021 to more than 100 in 2023. Further, in the 2023 proxy season, financial reporting concerns, particularly those relating to material weaknesses and restatements, led Glass Lewis to make adverse proxy voting recommendations 2.5 times more frequently than in the 2022 season. Glass Lewis states that the increase in adverse voting recommendations based on financial reporting issues "reflects a market environment in which less established issuers are still developing strong internal controls – however, these errors are not only affecting less established issuers." The blog post also notes that, in announcing its 2023 enforcement results, "the SEC highlighted a wide range of alleged misconduct at a wide range of issuers, including many companies that only recently went public by way of SPAC mergers * * * as well as many more established companies * * * ."

Drivers of Financial Reporting Issues

Glass Lewis cites three causes for increasing financial reporting problems.

- SPAC and IPO Boom. During 2020 and 2021, there was an explosion in new listings stemming from the popularity of special purpose acquisition companies (SPACs) and initial public offerings (IPOs). According to Glass Lewis, "Many of these less established public companies may have less experience dealing with the rigor of public company financial reporting, even compared to typical newly-public issuers, since the SPAC process allows companies to bypass some of the regulatory obstacles involved in an IPO." Moreover, in April 2021, the SEC staff issued guidance concerning accounting for SPAC warrants. This guidance resulted in many restatements.

- Lack of Qualified Accountants. Glass Lewis also points to a shortage of qualified accounting personnel. As discussed in the blog post, some companies have publicly attributed material weaknesses to their inability to hire sufficient qualified staff. This problem may not be solved rapidly.

  > "In general, companies looking to fill vacant accounting positions must face a difficult labor market where qualified candidates are increasingly scarce. The Wall Street Journal reported that some universities are reporting 'double-digit' percentage declines in accounting degree enrollments, with U.S. Census Bureau data suggesting that accountant salaries have failed to

outpace inflation in recent years. Perhaps not unrelatedly, hundreds of thousands of existing accountants have sought career changes in more lucrative sectors."

(Regarding the relationship between material weaknesses and the accountant shortage, see Material Weaknesses are Increasing and an Accountant Shortage May Be to Blame, August-September 2023 Update.)

- Increasing Audit Committee Oversight Responsibilities. Glass Lewis also suggests that the growing scope of the audit committee's responsibilities may be compromising the ability of audit committees to perform their core financial reporting oversight responsibilities. Cybersecurity and ESG disclosure and reporting are examples of complex new challenges that are in many cases under audit committee oversight. Glass Lewis observes that this "trend is understandable – the audit committee's role in overseeing risk factors lends to its ability to manage cybersecurity and ESG." However, broadened audit committee mandates may come at a price, and "boards and investors should be mindful that, absent additional resources commensurate with the increased scope, these new areas of oversight might also divert audit committee members' attention from their core responsibilities."

  Glass Lewis notes that the PCAOB's NOCLAR proposal could exacerbate this problem. That proposal would expand the auditor's responsibility to detect and report non-compliance with a wide range of laws and regulations. See PCAOB Proposes to Expand Auditor Responsibility for Financial Statement Fairness and for Legal Compliance, May-June 2023 Update. "The expanded definition [of the auditor's responsibility to report non-compliance to the audit committee] included in the amendments might also place further strain on audit committees in their role of evaluating, selecting and rotating company auditors, and reshape the relationship between auditors and audit committees."

Impact on Proxy Voting Recommendations

Glass Lewis does not foresee a quick end to the increase in accounting and related reporting issues: "We anticipate that present developments in corporate accounting, including de-SPAC companies, accounting personnel shortages and expanding audit committee responsibilities, will continue to influence the volume of financial reporting related concerns we review in our research." When financial reporting errors or material weaknesses in internal control over financial reporting (ICFR) occur, Glass Lewis's Benchmark Policy on proxy voting focuses on how the audit committee responds.

- As to material ICFR weaknesses, "the policy focuses on audit committees that fail to provide material updates to their remediation plans when a material weakness has been ongoing for more than one year, and will consider recommending against audit committee members in cases where this disclosure has not been provided or the material weakness has not been remediated on a timely basis."

- As to restatements, the policy focuses on the materiality of the changes in key financial statement line items. "Where such adjustments exceed relevant thresholds, or where fraud or insider manipulation is involved, the Benchmark Policy will also consider recommending against audit committee members."

Comment: The Glass Lewis post is a reminder that audit committees need to be careful that new responsibilities like ESG and cybersecurity oversight don't distract them from their core mission of financial reporting oversight. Glass Lewis recognizes that the full board and management have a responsibility to protect the audit committee from being overwhelmed. It makes this recommendation:

> "It may be useful for all public companies, regardless of how well established, to review their board's structure and the breakdown of responsibilities assigned to different committees. In particular, boards need to meet increasing investor expectations regarding the oversight of subjects such as

cybersecurity and ESG, without undermining their effectiveness in more traditional areas of oversight. With a range of tools at their disposal, including increases in board size, formation of new committees, or more frequent hiring of specialized consultants, we will continue to closely monitor how companies approach this challenge — and how investors respond."

Audit committees should reflect on whether they are able to discharge all the responsibilities that have been assigned to them without compromising their primary financial reporting oversight function and be prepared to have candid discussions with the full board about steps that can be taken to maintain their effectiveness.

PCAOB Discloses Non-Public Portions of 2018 and 2019 KPMG Inspection Reports

The Public Company Accounting Oversight Board has made public several previously nonpublic portions of KPMG's 2018 and 2019 inspection reports. This action indicates that, in the Board's view, the firm did not satisfactorily address the quality control issue discussed in those portions of the 2018 and 2019 inspection reports within 12 months of the report dates. Criticisms of a firm's quality control system are discussed in Part II of the firm's inspection report. Under the Sarbanes-Oxley Act, Part II is nonpublic when the report is issued. If the firm does not satisfactorily address a quality control criticism within 12 months, the Board makes the criticism public.

The now-public quality control criticisms in the 2018 KPMG PCAOB inspection report relate to three topics:

- Testing Controls. The 2018 report states that KPMG's system of quality control does not provide reasonable assurance that the work performed by the firm's personnel with respect to testing controls will meet the requirements of the Board's auditing standards. This finding is based on deficiencies inspectors identified in the areas of (1) identifying and testing controls that address risks of material misstatement, (2) testing controls that include a review element, and (3) identifying and testing controls over the accuracy and completeness of data or reports. For example, with respect to testing controls that include a review element, the Board found that the firm "did not sufficiently evaluate whether controls that it selected for testing that included a review element operated at a level of precision that would prevent or detect material misstatements because the firm did not evaluate the review procedures the control owners performed, including instances in which the firm did not evaluate (1) the criteria used to identify items for follow up and (2) the resolution of such items."

- Supervision of the Audit. The 2018 inspection report states that KPMG's system of quality control does not provide reasonable assurance that supervisory activities, including engagement partner reviews of audit work, will meet the requirements of the Board's auditing standards. This finding is based on the PCAOB inspection team's identification of deficiencies that the engagement partner should have identified but did not.

- Policies for Financial Holdings Disclosures. The 2018 inspection report also finds that KPMG's system of quality control does not provide reasonable assurance that KPMG personnel will comply with the firm's policies and procedures concerning independence-related regulatory requirements. KPMG, like other large firms, conducts periodic sampling reviews to determine whether firm personnel are complying with internal requirements that they report certain financial relationships to the firm. In the reviews KPMG conducted during 2018, it found that 25 percent of the managers included in its sample had not reported financial relationships that were required to be reported under firm policies. The inspection report states: "This high rate of non-compliance with the firm's policies, which are designed to provide compliance with applicable independence regulatory requirements, provides cause for concern, especially considering that these individuals are required to certify on an annual basis that they have complied with the firm's independence policies and procedures."

The quality control criticisms in KPMG's 2019 PCAOB inspection report are largely the same as those in the 2018 report. The main difference between the portions of the 2019 and 2018 reports that have been made public is that, unlike the 2018 report, the Testing Controls section of the 2019 report does not include criticism of KPMG's testing of controls over the accuracy and completeness of data or reports.

The 2018 KPMG inspection report is dated April 28, 2020. Therefore, the release of these portions of the 2018 report indicates that KPMG failed to persuade the PCAOB that, as of April 28, 2021, it had satisfactorily remediated the quality control deficiencies. The 2019 KPMG inspection report is dated December 17, 2020. Therefore, the release of the previously nonpublic criticisms in that report indicates that KPMG failed to persuade the PCAOB that, as of December 20, 2021, it had satisfactorily remediated the quality control deficiencies in that report.

Comment: Disclosure of a portion of Part II of a major firm's inspection report is unusual, but not unprecedented. The Board has taken such action concerning each of the Big Four firms and many other firms as well. In 2022 and 2023, the PCAOB made public portions of EY's and Deloitte's 2018 inspection reports that are similar to the "Policies for Financial Holdings Disclosures" portion of KPMG's 2018 and 2019 reports. See PCAOB Gives EY a Partial Fail on 2018 Remediation, September-October 2022 Update and PCAOB Makes Public a 2018 Criticism of D&T's Quality Control, February-March 2023 Update.

However, the portions of the 2018 and 2019 KPMG inspection reports that the PCAOB has released raise somewhat different issues than the EY and Deloitte reports. In particular, the criticisms of control testing and audit supervision address matters that could potentially directly affect many audits. Audit committees of KPMG clients may want to discuss with their engagement partner how the firm is addressing these matters, what changes have been made since the PCAOB's determination that the deficiencies had not been remediated, and how the company's audit might be affected.

Cornerstone: Accounting Class Actions and Enforcement Cases Continue Their Upward Trend

Cornerstone Research has issued three reports on litigation involving accounting and auditing violations. Together, these reports indicate that these cases are increasing, as are the costs of resolving them.

In its annual report on accounting-related class actions, Accounting Class Action Filings and Settlements—2023 Review and Analysis, Cornerstone finds that the number of class action filings against public companies for alleged accounting violations increased 10 percent last year compared to 2022. The dollar value of accounting class action settlements rose 11 percent, even though the number of settlements fell. Cornerstone's annual analysis of Securities and Exchange Commission accounting and auditing enforcement cases, SEC Accounting and Auditing Enforcement Activity—Year in Review: FY 2023, reports that the SEC brought 83 accounting and auditing enforcement actions in FY 2023, a 22 percent increase over FY 2022 and the highest number of actions initiated since FY 2019. Cornerstone also reports that, in FY 2023, the Public Company Accounting Oversight Board expanded its auditing enforcement activity to the highest level since 2017 and that PCAOB monetary penalties set a record. See PCAOB Enforcement Activity—2023 Year in Review. (For a summary of last year's Cornerstone reports on accounting class actions and SEC accounting enforcement, see Accounting Class Actions are Increasing Slowly While SEC Accounting Cases are Skyrocketing, May-June 2023 Update.)

Accounting Class Action Filings and Settlements

Cornerstone found that, in 2023, plaintiffs filed 56 new class actions against public companies alleging accounting violations, a 10 percent increase from the 51 filings in 2022. While an uptick from 2022, the 56 cases brought in 2023 were significantly below the 2014-2022 average of 62 new filings per year.

Although fewer accounting class actions were settled in 2023, the cost of settlement rose considerably. There were 35 accounting class action case settlements in 2023, down from 43 settlements in 2022 and well below the average of 42 settlements per year during 2014-2022. Despite fewer cases settling, the total value of accounting case settlements increased from $1.4 billion in 2022 to $1.6 billion in 2023, and the average settlement amount rose from $33.3 million to $45.7 million. The total value of accounting-related settlements, as a percentage of the value of all securities class action settlements, rose from 36 percent in 2022 to 41 percent in 2023.

Other key takeaways from the Cornerstone accounting class action report include:

- Most accounting class action cases are eventually dismissed or settled, but it takes time. From 2014 through 2022, 41 percent of accounting case filings were settled, 43 percent were dismissed, 1 percent were remanded, and 15 percent are continuing. In 2023, the median time from filing to settlement was 4.2 years, the longest since Cornerstone began its tracking in 1995.

- Plaintiffs are bringing and settling cases against smaller companies. The median pre-disclosure market capitalization of issuer defendants in 2023 accounting class actions was $719.3 million, 46 percent less than the 2014 to 2022 average and almost 30 percent less than the $1.04 billion median in 2022. 2023 was the first year in which the median market capitalization of issuer defendants in new accounting cases was below $1 billion. The median pre-disclosure market capitalization of issuer defendants in cases that settled in 2023 also fell sharply. In 2023, settling defendants had a market capitalization of $1.34 billion, compared to $2.48 billion in 2022.

- The industry sectors that attracted the most 2023 filings were Financials, Consumer Non-Cyclicals, and Consumer Cyclicals. Accounting cases filed against companies in the Financial sector doubled in 2023 and represented over 15 percent of all filings. Companies in the Consumer Non-Cyclical and Consumer Cyclical sectors together were the defendants in over one-third of 2023 new cases. (In 2022, filings against Consumer Non-Cyclical and Consumer Cyclical companies were nearly half of the total.) While there were no cases against companies in the Communications sector in 2022, in 2023 plaintiffs filed five accounting class actions against Communications companies.

- Class actions involving restatements continued to increase. Twenty-one (38 percent) of the 56 accounting cases filed in 2023 involved restatements. This was the highest percentage of restatement cases since 2014 and a continuation of the upward trend of restatement cases that began in 2022, after hitting a low of 5 cases (11 percent of filings) in 2021. (The average number of restatement cases filed per year from 2014 to 2022 was 16.)

- Internal control weaknesses are growing in popularity as a basis for litigation. The number of accounting case filings alleging internal control weaknesses increased from 25 (49 percent of all cases filed) in 2022 to 35 (62 percent of filings) in 2023. Sixteen percent of new cases alleged only internal control weaknesses, nearly triple the share of internal-control-only cases in 2021.

- Revenue recognition is the most common alleged GAAP violation. In 2023, 38 percent of new case filings alleged only GAAP violations and 46 percent alleged both GAAP violations and internal control weaknesses. The most common alleged GAAP violation continues to be improper revenue recognition, which was involved in 27 percent of 2023 accounting case filings. The other top GAAP violation allegations are asset valuation/impairments (20 percent) and liability/contingent valuation (16 percent).

SEC Accounting and Auditing Enforcement

As noted above, Cornerstone's study of fiscal 2023 SEC enforcement found that the Commission filed 83 accounting and auditing actions, a 22 percent increase from fiscal 2022. This increase in the level of SEC accounting enforcement exceeded the eight percent increase in overall SEC 2023 cases. Although 2023

was a busy year for the SEC's accounting enforcement program, the level of activity remains below the 93 cases brought in 2019. Also, some of the noteworthy features of the SEC's 2022 enforcement efforts – such as the focus on individual defendants and auditors – seem to have moderated in 2023.

Other interesting points in Cornerstone's SEC accounting enforcement analysis include:

- The SEC relies heavily on in-house proceedings, rather than actions in federal court. The Commission brought 71 of the 2023 accounting and auditing cases as administrative proceedings (i.e., before an in-house administrative law judge) and 12 as civil actions in federal court. Sixty-six of the 71 administrative proceedings were settled simultaneously with the filing of the case. The 12 civil cases included 25 defendants; actions against 14 of those defendants remained pending at the end of fiscal 2023.

- Announcements of restatements or material control weaknesses are fertile ground for SEC enforcement. Of the 83 enforcement actions, 35 referred to announced restatements, and 32 referred to announced material weaknesses in internal control. Thirty-one percent of the actions (26 cases) referred to both a restatement and an internal control material weakness, the highest level of such cases during the 2018-2023 period.

- Revenue recognition remained a popular enforcement topic. Like its counterparts in the plaintiff's bar, the SEC enforcement staff relies heavily on revenue recognition cases. Seventeen of the 35 SEC enforcement actions that referred to restatements alleged improper revenue recognition. Twenty-one cases combined allegations of revenue recognition violations with allegations of internal control violations.

- The SEC's enforcement focus on individuals abated somewhat, but senior officials are at risk. In 2023, the SEC charged 59 individuals in its accounting/auditing cases. This compares to 66 individuals charged in 2022. The SEC named one or more individuals as defendants or respondents in 49 of the 83 accounting cases it filed (59 percent), and 42 percent of SEC accounting and auditing actions initiated in 2023 involved only individual respondents or defendants. By comparison, in 2022, there were also 49 cases in which one or more individuals were charged, but those cases represented 72 percent of total accounting/auditing actions. In 2022, 53 percent of the cases involved only individuals.

  While there were fewer individual defendants/respondents in 2023, those who were charged tended to hold senior positions. Nearly half (46 percent) were CEO and CFO at the time of the alleged violation. Moreover, of the 45 charged individuals who were associated with SEC registrants, 17 were members of the board of directors (12 of these were also CEOs). Twenty of the 59 defendants/respondents were CPAs.

- Cases involving auditors declined. Twenty-two auditors and audit firms were charged in SEC actions in 2023. This was lower than the FY2018-2022 average of 25 such defendants or respondents. Fourteen of the 59 individuals in SEC 2023 accounting/auditing cases were auditors.

- The monetary cost of settling an accounting case with the SEC declined. In fiscal 2023, 119 respondents/defendants settled with the SEC. In those settlements, 101 of the settling parties were required to make a monetary payment. These payments totaled $583 million, down from $625 million in 2022 and $1.627 billion in 2021. Civil penalties accounted for 33 percent of the $625 million, while the remaining 67 percent was disgorgement of illegally obtained funds (54 percent) and prejudgment interest (13 percent). Interestingly, these figures are the mirror image of 2022 when civil penalties were 67 percent of total monetary settlements and disgorgement and prejudgment interest were 33 percent.

PCAOB Enforcement

Cornerstone's report on 2023 PCAOB enforcement finds that the Board publicly disclosed 46 enforcement actions in 2023. (Board enforcement matters are confidential unless and until settled or otherwise concluded in the Board's favor.) Thirty-seven of those actions involved the performance of an audit (Auditing Actions), a 28 percent increase over 2022; non-auditing actions involved such matters as reporting violations or failure to cooperate with a PCAOB inspection or investigation. The Board assessed monetary penalties of $19.7 million – a record for a single year and nearly double the 2022 amount.

Other highlights of Cornerstone's PCAOB enforcement report include:

- The PCAOB shifted its emphasis from individuals to firms. In 2023, the Board charged 19 individuals and 34 accounting firms in the 37 Auditing Actions it disclosed in 2023. This reflects a significant change in approach. During the period 2018-2022, on average 37 percent of respondents were firms and 63 percent were individuals. In 2023, 22 percent of cases involved a firm and one or more individuals, 11 percent involved individuals only, and 68 percent involved only a firm.

- The PCAOB is focusing on independence and firm quality control. Approximately 25 percent of the 2023 Auditing Actions involved alleged violations of the auditor independence rules. In contrast, none of the Board's 2022 Auditing Actions included independence violations. Fifty-seven percent of the 2023 Audit Actions included alleged violations of the PCAOB's quality control standards, roughly the same as in 2022.

- Individuals charged by the PCAOB are likely to be barred or suspended from auditing public companies or broker-dealers while firms are generally required to undertake remediation. The PCAOB permanently or temporarily barred from auditing public companies or broker-dealers 85 percent of the individuals it charged; an additional five percent were suspended. By comparison, 64 percent of individuals were barred, and 16 percent were suspended in 2022. For firms, 67 percent were required to undertake remedial actions and 15 percent were required to retain an independent consultant. Twenty-one percent of firm respondents had their PCAOB registration (and therefore their ability to audit public companies and broker-dealers) permanently or temporarily revoked. Similarly, in 2022, 24 percent of firms had their registration temporarily or permanently revoked and six percent were suspended.

- The Board is taking monetary penalties to a new level. As noted above, the PCOAB imposed $19.7 million in monetary penalties in 2023, almost double the $10.5 million in 2022 and about 18 times the $1.1 million it assessed in 2021. Monetary penalties imposed on firms were $18.8 million – 95 percent of the total. Two-thirds of the firm penalties were levied against non-U.S. firms. The PCAOB imposed monetary penalties against every respondent in its 2023 cases, although just six respondents paid almost 80 percent of the total monetary penalties.

Comment: While the frequency of both class action and SEC enforcement accounting cases is not at record levels, this type of litigation is increasing and remains a risk for public companies and their senior management. (PCAOB enforcement actions are also increasing, although only accounting firms and their employees are subject to PCAOB enforcement.) Moreover, the cost of settling class action cases, and the time required to do so, is also increasing. As stated in several prior Updates, accounting issues are a significant line of attack for the plaintiff's bar, and restatements and disclosure of internal control weaknesses are likely to attract litigation, if they coincide with a significant drop in stock price. Investing in strong internal controls, along with audit committee care and diligence in overseeing the company's financial reporting, is a small price to pay to reduce the risk that the company will be exposed to the cost and distraction of litigation over accounting matters.

Another significant Cornerstone finding that audit committees and financial reporting management should keep in mind is the SEC's stepped-up focus on individual culpability. As noted above, while the number of

individuals charged in SEC accounting cases fell in 2023, those that the SEC did charge tended to hold senior positions, such as CEO or CFO. SEC Chair Gensler has publicly committed to holding individuals accountable for company violations. The risk that restatements, internal control material weaknesses, and other accounting-related problems will result in SEC enforcement action against the individuals involved, along with or instead of the reporting company, is likely to remain elevated for the foreseeable future.

On the Update Radar: Things in Brief

Unredacted: KPMG's 2022 Inspection Report. On April 26, the Public Company Accounting Oversight Board made public the complete 2022 KPMG PCAOB inspection report. The version of the 2022 KPMG report that the PCAOB released in February was redacted to omit discussion of one of the KPMG engagements the PCAOB inspected in 2022. See 2022 PCAOB Large Firm Inspection Reports, March 2024 Update.

The material redacted from the original version of the 2022 KPMG inspection report was a description of the PCAOB's findings concerning an audit client described in the unredacted report as Issuer N. Issuer N is in the Information Technology sector. The PCAOB inspectors found a deficiency related to income taxes in Issuer N's audit. The unredacted report states that KPMG "did not identify and evaluate a misstatement in a required disclosure under FASB ASC Topic 740, Income Taxes.2 (AS 2810.30 and .31)."

Neither the PCAOB nor KPMG have made any public statements concerning the reason for the original redaction or the subsequent release of the unredacted report. As discussed in the March 2024 Update, the most likely explanation is that KPMG exercised its right under the Sarbanes-Oxley Act to appeal the PCAOB's deficiency finding regarding Issuer N to the SEC. Under the SEC rule governing appeals of inspection reports, the PCAOB may release only the portions of the report that are not subject to appeal while an appeal is pending. Presumably, after the release of the redacted report, the SEC concluded that the PCAOB's finding concerning Issuer N was correct, and the Board has now released the full report, including the description of the Issue N deficiency.

Below is a synopsis of the complete 2022 KPMG inspection report and an updated version of Table 1 in 2022 PCAOB Large Firm Inspection Reports, March 2024 Update.

KPMG LLP. The PCAOB reviewed 54 KPMG issuer audits, 43 of which were integrated audits of both the financial statements and ICFR. In 16 of the 54 audits (30 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 KPMG's 26 percent deficient engagement rate in 2021. Eleven of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and ICFR, four included deficiencies in the financial statement audit only, and one included only an ICFR audit deficiency. In one of the deficient engagements, the issuer's financial statements were determined to be materially misstated and were subsequently corrected in a restatement; that issuer also disclosed material weaknesses in its ICFR. The PCAOB described 42 audit deficiencies (0.78 deficiencies per inspection) associated with 47 auditing standards (0.87 standards per inspection) in the 16 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. In Part I.C., the Board described eight instances it had identified of potential non-compliance with independence rules and 24 instances that the firm had identified.

TABLE 1

2022 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(Reports are dated between November 7, 2023, and December 20, 2023,
and were released on February 28, 2024; unredacted KPMG report released on April 26, 2024)

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	29	19	66%
Deloitte & Touche	53	9	17%
Ernst & Young	54	25	46%
Grant Thornton	26	8	31%
KPMG	54	16	30%
PwC	54	5	9%
Global Network Firm Totals	270	82	
Global Network Firm Averages	45	14	30%

SEC Puts its Climate Disclosure Rules on Hold. The SEC has issued an order staying its rules requiring public companies to disclose certain climate-related information, including material Scope 1 and Scope 2 GHG emissions. (For a discussion of the climate rules, see SEC Adopts Landmark Climate Change Disclosure Rules, March 2024 Update.) The effect of the stay order is to suspend the effectiveness of the new rules pending judicial review of their validity.

The Commission adopted the climate rules on March 6 and was almost immediately sued. Several parties allege that the rules exceed the Commission's authority, while others assert that the rules do not go far enough, particularly in that they do not require companies to disclose Scope 3 GHG emissions (i.e., those from use of the company's product and from its supply chain). The stay order lists nine petitions for review filed in various federal courts of appeal. These cases have been consolidated in the Court of Appeals for the Eighth Circuit and, absent the Commission's voluntary stay, it is likely that the court would have suspended the effectiveness of the rules, pending its decision.

The Commission makes clear in its order that issuance of the stay does not suggest that the agency lacks confidence in the validity of the rules:

> "In issuing a stay, the Commission is not departing from its view that the Final Rules are consistent with applicable law and within the Commission's long-standing authority to require the disclosure of information important to investors in making investment and voting decisions. Thus, the Commission will continue vigorously defending the Final Rules' validity in court and looks forward to expeditious resolution of the litigation. * * * [A] Commission stay will facilitate the orderly judicial resolution of those challenges and allow the court of appeals to focus on deciding the merits. Further, a stay avoids potential regulatory uncertainty if registrants were to become subject to the Final Rules' requirements during the pendency of the challenges to their validity."

The stay has no immediate direct impact. Under the phase-in schedule in the rules, the first climate disclosures would be required in large accelerated filer financial statements for fiscal years beginning in calendar 2025 (which would be filed in 2026). The litigation, including any effort to seek review in the U.S. Supreme Court, is likely to continue for several years and, even if it is victorious, the SEC may need to adjust the phase-in schedule.

Despite the stay, it would be prudent for companies to continue to make plans to implement the new rules. Especially for companies that are currently making limited climate disclosure, the necessary systems and controls will take time and resources to build. It may not be practical to delay that effort until the conclusion of the litigation – or to gamble that the courts will strike down the rules. Also, regardless of the fate of the SEC's climate disclosure regime, many companies will need to comply with similar – or broader – climate disclosure laws, such as those recently adopted in California and the European Union. See California Outflanks the SEC on Climate Disclosure and E.U. ESG Disclosure Requirements Will Affect Many U.S. Companies, both in the October 2023 Update.

EY Has Q1 Suggestions for Audit Committees. The EY Center for Board Matters (EY Center) has issued How audit committees can prepare for 2024 Q1 reporting. The EY Center's paper provides a summary of key developments related to risk, financial reporting, and regulatory matters of interest to audit committee members. It addresses five topics:

- Risk management. In late 2023, Tapestry Networks, an independent firm supported by EY, convened audit committee chairs to discuss audit committee risk concerns and oversight practices. The audit committee chairs identified seven top risk concerns: (1) Artificial intelligence and other technology-driven risks; (2) Cybersecurity; (3) Political and regulatory uncertainty; (4) Tensions stemming from international conflict; (5) Shifts in global tax policy; (6) Labor challenges; and (7) Unforeseen or "black swan" risks.

  With respect to item (5), global tax policy changes, the paper highlights the OECD's Pillar Two Global Anti-Base Erosion (GloBE) rules, which took effect on January 1, 2024, in many countries. The Center suggests that "[a]udit committees will want to make sure management teams are monitoring developments in the relevant jurisdictions to determine the impact of GloBE rules on financial statements, audits and tax filings."

- Recent changes to internal audit standards. The Institute of Internal Auditors has issued new Global Internal Audit Standards which become effective on January 9, 2025. These standards are designed to guide the professional practice of internal auditing and serve as a basis for evaluating the quality of the internal audit function. While the standards are not mandatory, EY notes that "conformance to them offers boards comfort that Internal Audit (IA) is operating against a trusted framework and delivering on its mandate."

- Accounting and disclosures. The EY Center notes two accounting and disclosure issues -- Financial reporting considerations related to commercial real estate and interim period estimation of the annual effective tax rate.

  With respect to commercial real estate, the Center states: "Entities that own or operate commercial real estate and their lenders will need to consider how their accounting and financial reporting may be affected by current macroeconomic factors such as the increased cost of capital, tighter lending standards, and industry trends, including changes in cash flows and occupancy rates for certain properties." As to tax rate estimation, EY recommends that audit committees "inquire whether forecasts used for estimating income taxes are consistent with those used for other purposes and incorporate the effects of current economic conditions."

- Investor views on risks and other growing areas of focus in 2024. Based on conversations with "investor stewardship leaders," the EY Center identifies several areas of investor focus, including the impact on talent of shifting labor dynamics and emerging technologies; climate change and related environmental issues; and board quality, effectiveness, and engagement.

- SEC rulemaking and other reporting considerations. The Center highlights four SEC developments that impact audit committees:

  (1) Adoption of climate-related disclosure rules. Audit committees should monitor "the company's readiness and implementation efforts to comply once legal challenges are resolved." Audit committees should also "monitor that companies are implementing (and

maintaining) strong disclosure controls and procedures over climate-related data to produce investor-grade and assurance-ready climate disclosures." See SEC Adopts Landmark Climate Change Disclosure Rules, March 2024 Update and SEC Puts its New Climate Disclosure Rules on Hold in this Update.

(2) Adoption of disclosure rules for special purpose acquisition companies.

(3) Chair Gensler's public remarks about the risks and opportunities of artificial intelligence in the capital markets.

(4) SEC Chief Accountant Paul Munter's statement calling for greater auditor attention to professional skepticism and reminding audit committees of their investor protection role. See SEC Chief Accountant Calls on Auditors to Improve and on Audit Committees to Be Proactive, February 2024 Update.

The paper concludes with a series of questions that audit committees should consider asking in their discussions with management, compliance personnel, and internal and external auditors. These questions fall under three headings: Risk management-related inquiries; Accounting, disclosures, and other financial reporting-related inquiries; and Inquiries to auditors.

Who Audits Public Companies? Mostly Ten Firms. Ideagen Audit Analytics (AA) has released its annual analysis of the market for public company auditing. 2024 who audits public companies finds that ten firms audit 68 percent of the total SEC-registered company population (including SPACs), while the four largest firms – EY, Deloitte, PwC, and KPMG – audit 48.4 percent. EY leads the pack at 14.7 percent (971 public company clients). According to AA's blog post on the 2024 report, the majority of the top ten firms reduced their public company audit client count from the prior year, although Deloitte added 13 clients to a total of 900. Overall, 239 firms conducted audits of 6,607 SEC registrants. By comparison, in 2023, 258 firms performed audit engagements for 6,950 SEC registrants.

Not surprisingly, the audit market for the largest public companies -- large accelerated filers (LAFs) -- is highly concentrated. The four largest firms audited 90 percent of these companies, up two percent from last year. As it has for the past eight years, EY also leads in this segment with 577 LAF clients (down from 600 in 2023) or approximately 28 percent of the LAF population. Thirty-one other firms audited the 10 percent of LAFs that were not Big Four clients. Grant Thorton, at 4 percent, performed about 40 percent of those engagements. Since last year's analysis, the total number of LAFs decreased by 3 percent.

At the other end of the public company size spectrum – smaller reporting companies (SRCs) – there is considerably more competition. Altogether, 122 firms audited the 340 SRC registrants. Six firms -- BF Borgers, M&K CPAs, Victor Mokuolo CPA, Assurance Dimensions, RBSM LLP, and JP Centurion – together audited 30 percent of SRCs. The remaining 70 percent of the SRC market is audited by 116 other firms, of which 57 had only one SRC client. The population of SRC filers decreased 9 percent from last year, and the number of firms auditing SRC clients fell from 136 to 122.

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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