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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 Isn't Happy with EQR and Has Questions for Audit Committees to Ask

The Public Company Accounting Oversight Board has issued a staff report on engagement quality reviews (EQRs). An EQR is an evaluation by a competent individual not otherwise involved in the audit of significant judgments made by the engagement team. The PCAOB's standards require EQRs in public company audits and certain other engagements performed under its standards. The staff report,

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Spotlight: Inspection Observations Related to Engagement Quality Reviews (EQR Report), finds that 42 percent of the audit firms the PCAOB inspected in 2022 received a quality control criticism related to engagement quality review, up from 37 percent in 2020. Three of the six large U.S. global network firms had at least one EQR deficiency, up from only one of the six having such a deficiency in the 2021 and 2020 inspection cycles. PCAOB Chair Erica Williams said in a statement: "Engagement quality reviews are an important investor safeguard during the audit process. Unfortunately, audit firms are increasingly falling short when performing this function. We urge audit firms and audit committees to read our EQR report so they can fully live up to their responsibility to protect investors against insufficiently supported audits."

Under the PCAOB's standards, the objective of the EQR reviewer is to perform an evaluation of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement. The EQR Report states that the PCAOB adopted the review requirement to increase the likelihood auditors will identify significant audit deficiencies before issuing their audit or attestation report. To evaluate the engagement team's judgments and conclusions, the EQR reviewer should hold discussions with the engagement partner and other members of the team and review the audit documentation. An EQR, including the EQR reviewer's concurring approval of issuance of the engagement report, is required for audit engagements performed under the PCAOB's standards, reviews of interim financial information, and attestation engagements related to securities broker-dealer compliance with certain SEC requirements.

The EQR Report discusses deficiencies identified in 2021 and 2022 PCAOB comment forms issued to audit firms related to the EQR process or the EQR reviewer. (A comment form is the PCAOB inspection staff's initial communication to an audit firm of a deficiency observed in an inspection.) Common EQR deficiencies, and the proportion each represented of total EQR comment forms, were:

- Failing To Identify Certain Engagement Level Performance Deficiencies in the Audit (82 percent of EQR comment forms). In these instances, the EQR reviewer did not identify deficiencies in audit responses to areas of significant risks, including fraud risks, which were subsequently identified by the PCAOB inspection staff.

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- Failing To Provide Competent, Knowledgeable EQR Reviewer (6 percent EQR comment forms). The firm failed to ensure that the EQR reviewer possessed the level of knowledge and competence in accounting, auditing, and financial reporting required to serve as an EQR reviewer or failed to appropriately address the objectivity of the EQR reviewer. This deficiency category also includes situations in which the audit firm failed to ensure that the EQR reviewer had not served as the engagement partner during either of the two audits preceding the audit subject to the EQR, as required by the PCAOB's standards.

- Failing To Properly Document the EQR (6 percent of EQR comment forms). These comments cited inadequacies in the documentation of the EQR reviewer's procedures. For example, the work papers may not have indicated that the EQR reviewer evaluated or reviewed judgments about materiality and the effect of those judgments on engagement strategy.

- Failing To Provide Concurring Approval (6 percent of EQR comment forms). These comments reflect instances in which an audit firm did not obtain concurring approval from an EQR reviewer prior to issuance of an engagement report.

- Failing To Provide an EQR (5 percent of EQR comment forms). In these situations, the audit firm did not have an EQR reviewer perform an EQR on an audit or attestation engagement.

Consistent with Chair Williams's recommendation that audit committees read the EQR Report, the Report states that audit committees and management may find it "useful for engaging their auditors in meaningful discussions about EQRs, which are vital to high-quality audits." The EQR Report includes four questions

that “may be of interest to audit committees to consider amongst themselves or in discussions with their independent auditors.” These questions are:

- What policies and procedures does the audit firm have in place to provide reasonable assurance that the EQR reviewer has sufficient competence, independence, integrity, and objectivity to perform the EQR in accordance with the standards of the PCAOB?

- Does the audit firm have individuals with experience in their specific industry that have not served as the engagement partner during either of the two audits preceding the current audit, who can serve as the EQR reviewer? If not, will the auditor go outside of the audit firm to fill this role?

- Were there any significant judgments discussed or challenged by the EQR reviewer? What was the outcome of those discussions?

- Has the auditor obtained concurring approval of issuance from the EQR reviewer prior to the issuance of the engagement report (or communicating its conclusion if no report is issued)?

Comment: The third PCAOB question, relating to significant judgments discussed or challenged by the EQR reviewer, could be particularly useful for audit committees to ask their engagement partner as an additional way of gaining insight into the most difficult aspects of the audit. Further, in many cases, some issues evaluated by the EQR would likely parallel those discussed in the auditor’s report as critical audit matters.

CAQ Reports on Ten Years of Increasing Audit Committee Transparency

On November 30, the Center for Audit Quality (CAQ) and research firm Ideagen Audit Analytics (AA) released 2023 Audit Committee Transparency Barometer (Barometer), the tenth edition of their annual assessment of S&P Composite 1500 proxy statement disclosures concerning the work of the audit committee. According to the accompanying press release, audit committees “continue the trend of increasing disclosures in key areas of traditional financial oversight, as well as in emerging areas of responsibility” although “room for improvement remains.”

The Barometer reports that the most common audit committee disclosure in 2023 was how non-audit services may impact auditor independence (85 percent of the S&P 500 make this type if disclosure). The report also notes that there has been a significant increase in disclosure that the audit committee is responsible for ESG oversight (29 percent of the S&P 500 disclosed audit committee ESG responsibility in 2023, compared to 18 percent in 2022). On the other hand, the Barometer asserts that areas with “room for improved disclosures” include how the audit committee considers the length of the external auditor’s tenure, how the audit committee is involved in selecting the engagement partner, and the audit committee’s view of the appropriateness of the audit fee. On these three topics, only 11 percent, 16 percent, and 6 percent, respectively, of the S&P 500 made any disclosure in 2023. (For discussion of the 2022 Barometer, see Audit Committee Transparency Inches Ahead, November-December 2022 Update.)

Frequent Audit Committee Disclosures

The Barometer tracks audit committee disclosures on twelve topics, two of which include subtopics, and breaks down S&P 1500 disclosures between the S&P 500 (i.e., large-cap companies), the S&P MidCap 400, and the S&P SmallCap 600. Of the disclosure topics surveyed, the three that are most frequently disclosed did not change between 2022 and 2023. These top three disclosures are:

- Disclosure related to a discussion of how non-audit services may impact independence. In 2023, 85 percent of the S&P 500, 82 percent of the S&P MidCap 400, and 75 percent of the SmallCap 600 made this type of disclosure.

- Disclosure of the length of time the auditor has been engaged. Seventy-three percent of the S&P 500, 60 percent of the S&P MidCap 400, and 55 percent of the SmallCap 600 disclose auditor tenure.

- Disclosure that the audit committee is responsible for cybersecurity risk oversight. Fifty-nine percent of the S&P 500, 50 percent of the S&P MidCap 400, and 40 percent of the SmallCap 600 disclosed that the audit committee had cybersecurity risk oversight responsibility. By comparison, in 2016 only 11 percent of the S&P 500 (and 5 percent of Mid-Caps and 4 percent of SmallCaps) discussed audit committee oversight of cybersecurity risk.

Two other topics that have grown in disclosure frequency over the last several years are whether the board includes a cybersecurity expert and whether the audit committee is responsible for ESG oversight. As to board cybersecurity expertise, in 2023 51 percent of the S&P 500 disclosed having a cybersecurity expert on the board, as did 36 percent of the MidCap 400 and 28 percent of the SmallCap 600. In 2016, only 7 percent of the S&P 500, 4 percent of Mid-Caps, and 3 percent of SmallCaps disclosed having such an expert.

Disclosure that the audit committee is responsible for ESG oversight has also increased, although at a slower pace than cybersecurity responsibility disclosure, likely because ESG oversight is often assigned to other committees or to the full board. In 2023, 29 percent of the S&P 500 disclosed that the audit committee is responsible for ESG oversight, as did 17 percent of the S&P MidCap 400, and 12 percent of the S&P Small Cap 600. In 2022, the first year in which the Barometer tracked this issue, the comparable figures were 18 percent, 10 percent, and 7 percent, respectively.

"Room for Improvement" Disclosures

The three areas that the Barometer identifies as having room for improvement had relatively low levels of 2023 disclosure and are not increasing significantly over time. For example:

- Discussion about how the audit committee considers length of auditor tenure. In 2023, 11 percent of the S&P 500, 6 percent of the S&P MidCap 400, and 3 percent of the SmallCap 600 explained how the audit committee considers tenure. In 2022, the frequency of this disclosure was only slightly lower.

- Discussion of how the audit committee is involved in selection of the audit engagement partner. In 2023, 16 percent of the S&P 500, 9 percent of the S&P MidCap 400, and 5 percent of the SmallCap 600 disclosed specifics of the audit committee's involvement in engagement partner selection. As in the case of tenure consideration, the 2022 disclosure rates for this issue were almost the same as in 2023.

The Barometer asserts that more transparency on these two issues would benefit investors and other users of corporate disclosure:

> "[I]t can be helpful for stakeholders to understand how the audit committee considered both positive and negative factors associated with the auditor's tenure. Similarly, stakeholders will likely be interested in the audit committee's process and key considerations in selecting a new audit engagement partner * * *. Auditor tenure and the audit partner leading the engagement impact audit quality. Disclosing how the audit committee carefully considered such matters provides useful information to stakeholders and demonstrates the audit committee's commitment to promoting audit quality."

As to audit fees, the third "room for improvement" disclosure, companies currently provide even less information. Only 6 percent of the S&P 500 made a disclosure related to the connection between audit fees and audit quality. For the MidCap 400 and the SmallCap 600, the disclosure percentages were 3

percent and 1 percent, respectively. This type of disclosure has declined over time. In 2014, the first year in which the Barometer tracked this disclosure, 13 percent of the S&P 500, 4 percent of the MidCap 400, and 1 percent of the SmallCap 600 discussed the audit fee/audit quality nexus. The Barometer explains why it recommends that more audit committees provide insight on this issue:

> "Audit fees can be an indicator of audit quality for stakeholders because abnormally low fees may indicate that not enough time or resources are spent on the audit engagement, which could contribute to low audit quality. On the other hand, abnormally high audit fees could indicate inefficiencies, which may also be a red flag for stakeholders. * * * Describing the audit committee's views on the audit fee's appropriateness can help stakeholders understand what contributes to the audit fee and can provide stakeholders further insights into how the audit committee considers audit quality throughout its engagement with the external auditor."

Explanations of changes in the fees paid to the external auditor have also become less common over the past decade. In 2023, 25 percent of the S&P 500, 25 percent of the MidCap 400, and 28 percent of the SmallCap 600 provided and explanation of fee changes. In 2014, the comparable percentages were 28 percent, 30 percent, and 24 percent, respectively. On this issue, the Barometer states:

> "For audit committees to enhance their disclosures, they should provide more robust disclosures about how the audit committee considers the appropriateness of the audit fee, including key factors affecting changes to the audit fee year over year. For example, it may be helpful for stakeholders to understand efficiencies achieved, such as the auditor's use of new technologies, or changes in the scope, such as a major transaction during the year, that could lead to changes in the audit fee."

Disclosure Examples and Audit Committee Questions

An appendix to the Barometer includes examples of effective disclosure from specific audit committee reports for each type of disclosure tracked in the annual analysis. Another appendix contains a detailed pro forma description of an audit committee and its responsibilities, along with a model audit committee report. A final appendix, "Questions to Consider When Preparing Audit Committee Disclosures," lists questions to aid in drafting disclosure concerning the work of the audit committee. These questions are arranged under the twelve disclosure issues tracked in the Barometer report.

Comment: The 2023 Barometer report points out that investors and other stakeholders use audit committee reports and other proxy statement disclosures about the committee's work to understand how the audit committee is exercising oversight. The CAQ believes that the "challenges of the current environment," which include "economic uncertainty, geopolitical crises, and new ways of working" make it an appropriate time for audit committees "to revisit their disclosures to ensure that they are up to date and tailored to the specific events and circumstances that the audit committee currently faces."

Audit committees should consider expanding their audit committee reports, particularly in the areas that the Barometer flags for improvement. The kinds of disclosures the Barometer identifies as common among S&P 1500 companies are not controversial and would rarely involve disclosing confidential information or exposing the audit committee to increased litigation risk. As the Barometer states, "Every year, each audit committee has a unique story to tell, and detailed disclosures in the proxy statement relay the extent of engagement of the audit committee, which contributes to audit quality."

After a SPAC-Driven Surge, Restatements Are Returning to "Normal"

Ideagen Audit Analytics (AA) has released its annual report on public company restatements, Financial Restatements: A 20-Year Review 2003-2022. AA found that SEC filers disclosed 454 restatements in 2022, down 69 percent from 1,467 restatements in 2021. The 2022 restatements were filed by 421 companies (5.1 percent of SEC registrants), compared to 1,040 companies (12.8 percent of registrants) that restated in 2021. Restatement frequency in 2022 was roughly similar to 2020 and 2019. In 2020,

4.9 percent of companies restated (374 total restatements), and, in 2019, 5.7 percent of companies restated (460 total restatements). 2021 was an outlier because of the large number of restatements filed that year by special purpose acquisition companies (SPACs). In 2021, there were 754 SPAC restatements; SPAC restatements fell 91 percent (to 71) in 2022. (For an analysis of AA's prior restatement report, see Fueled by SPACs, Restatements Surge, June-July 2022 Update. Note that some figures previously reported for 2021 and prior years appear to have been revised in AA's current report.)

Big R and Little R Restatements

As explained in the introduction to AA's report (and in Restatements Hit Another New Low, and SOX Could Be the Reason, July 2017 Update), companies have three methods for correcting errors and misstatements in previously-issued financial statements – a reissuance restatement, a revision restatement, or an out-of-period adjustment.

- When a company determines that financial statement users can no longer rely on previously issued financial statements due to a material error, it must disclose that determination by filing SEC Form 8-K within four business days. The company then files restated financial statements after it has had the opportunity to analyze and correct the error. This type of restatement is a "reissuance" or "Big R" restatement.

- When a company determines that previously issued financial statements contain immaterial errors, and that, despite the errors, users can continue to rely on the prior financial statements, the company may simply include corrected financial statements in a subsequent SEC periodic filing. In that filing, the restatement must be disclosed in the footnotes to the current financial statements. These less significant restatements are "revision" or "little r" restatements. Revision restatements do not require a Form 8-K filing and typically attract less public attention and market reaction than reissuance restatements.

- Out-of-period adjustments (OPAs) are also a method of correcting immaterial errors in prior financial statements. OPAs correct the prior period error by making an adjustment in the current period financial statements. OPAs are not restatements because they do not affect previous financial statements. An OPA is only appropriate when the correcting adjustment does not have a material effect on the current period financial statements. (Since they are not restatements, AA's annual reports do not include OPAs.)

SPAC Restatements

The 2021 SPAC restatement surge was primarily in response to an SEC staff statement issued in April 2021. See Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"). This statement urged SPACs to reconsider the accounting treatment of redeemable shares and warrants. Most SPACs recorded shares that included a redeemable feature as permanent equity. The SEC objected and requested the shares be recorded as temporary equity. In addition, the SEC staff asked SPACs and companies that had gone public via a SPAC merger to consider whether warrants recorded as equity should instead be treated as liabilities, subject to fair market value adjustments. As a result, 452 SPACs filed 754 restatements in 2021. While SPAC restatements were down sharply in 2022, SPACs continued to restate at a higher rate than the general SEC filer population.

2022 Restatement Report Highlights

Highlights of AA's current restatement report include:

- Little r restatements continue to predominate, although the long-term trend may be changing. There were 190 domestic filer reissuance (or Big R) restatements (44 percent of the total) in 2022. This represents a decline from 63 percent in 2021; SPAC reissuance restatements inflated

the 2021 figure. Until 2021, domestic filer reissuance restatements had declined as a percentage of the total every year AA measured. However, ignoring 2021, the 44 percent reissuance restatement percentage in 2022 is higher than in any year since 2011.

- Debt/equity accounting is still the issue most frequently involved in restatements. Debt/equity accounting – typically the issue involved in SPAC restatements -- was the most-frequently cited restatement issue in both 2021 and 2022; in 2022, the percentage of total restatements disclosing debt/equity errors was 22 percent. The other top five issues in 2022 were revenue recognition (12 percent), liabilities (11 percent), expenses (9 percent), and deferred, stock, executive compensation (9 percent).

- The smallest companies file the most restatements. As has been the case in every year AA has studied, most restatements come from smaller public companies. In 2022, 245 restatements (54 percent of total restatements) were filed by nonaccelerated filers. (Since SPACs are typically nonaccelerated filers, these figures include SPAC restatements.) At the other end of the size spectrum, large accelerated filers accounted for 95 restatements (21 percent of the total). Accelerated filers (the size tier between non-accelerated filers and large accelerated filers) submitted 51 restatements (11 percent of the total). AA does not explain the source of the remaining 14 percent of restatements, although these were presumably from foreign companies.

- The average number of days restated rose over 2021 but fell compared to 2020. The restatement period (the number of days encompassed by the restatement) is a measure of restatement severity. In 2022, the average restatement period was 391 days. This compares to 447 days in 2020, prior to the SPAC surge. In 2021, the average restatement period was 287 days, although this (relatively) shorter period reflects the fact that, on average, SPACs had less than a year (201 days) of financials to restate.

- Restatements that impact income tend to correct errors that erroneously increased net income. Overall, 30 percent of total restatements had an impact on the company's net income. Of these, 32 percent had a positive impact, while 68 percent reduced net income. (Stated differently, 68 percent of the income-affecting errors that were corrected by restatement had improperly increased net income.) By comparison, in 2021 32 percent of restatements had an income effect; 20 percent of those restatements had a positive net income impact, while 80 percent were negative. In 2022, the average negative restatement impact on net income was minus $11.6 million, the smallest average negative impact on net income since 2009. The average positive net income effect in 2022 was $10.5 million.

Comment: As the Update has previously observed, the overall trend in restatements is down. Since 2006, restatements (ex-SPACs) have declined substantially. The investments that companies have made in strengthening their internal control over financial reporting in the wake of the implementation of the Sarbanes-Oxley Act seems to have paid off in less frequent material financial statement errors.

Audit committees should however also bear in mind that some of the decline in restatements may be the result of a change in restatement "culture" – and that the culture may be resetting. SEC Chief Accountant Paul Munter has signaled that the SEC staff believes companies and their advisors have been taking an unduly narrow view of materiality and that many errors treated as immaterial should have triggered a reissuance restatement. See SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions, March 2022 Update. Audit committees confronted with errors in prior financial reporting and questions concerning whether and how to restate should make sure they fully understand the reasons for management's proposed choice between a reissuance or revision restatement. The SEC may inquire into the audit committee's role in cases where it disagrees with a company's determination regarding the handling of a financial statement error, and committees should be prepared to show that they provided active oversight.

SEC Enforcement Targets Individuals but Rewards Company Cooperation

In fiscal year 2023, Securities and Exchange Commission enforcement actions against public companies and their subsidiaries rose 34 percent and the Commission barred 133 individuals from serving as officers or directors of public companies. However, while the focus on individual corporate officials increased, monetary settlements in public company enforcement cases were the lowest in the last 8 fiscal years. At least in part, the lower monetary penalties may have resulted from the Commission's policy of "rewarding" companies that cooperate in an investigation. Sixty-nine percent of public company or subsidiary defendants that settled with the Commission cooperated in the investigation, and 13 percent of cooperators were able to settle without any monetary penalty.

These are some of the findings of two annual reports on SEC enforcement activity – the SEC Division of Enforcement summary of its 2023 cases and the Cornerstone Research/NYU Pollack Center analysis of 2023 SEC enforcement actions against public companies and their subsidiaries. Together, they paint a picture of an active and aggressive enforcement program that is focused – along with other priorities -- on public company disclosure and on the culpability of individuals for corporate violations. The prior editions of these two reports were discussed in SEC Disclosure Enforcement is in High Gear, November-December 2022 Update.

SEC Division of Enforcement Press Release

On November 14, the SEC issued a detailed press release announcing the fiscal year 2023 results of its enforcement program. An addendum to the press release containing underlying enforcement statistics is also available.

During FY 2023 (ended September 30, 2023), the SEC filed 784 enforcement actions, a 3 percent increase over the prior year. Monetary payments ordered in SEC actions (i.e., civil penalties, disgorgement, and pre-judgment interest) totaled $4.949 billion, the second-highest annual amount in SEC history, but down from the record-setting $6.439 billion in fiscal year 2022. The 2023 total includes $1.580 billion in civil penalties (compared to the all-time high of $4.19 billion in 2022) and $3.369 billion in disgorgement of illegally obtained gains and prejudgment interest (compared to $2.25 billion in 2022).

The SEC's announcement makes several points related to cases involving public company disclosure and actions against public company officers and auditors:

- Public company disclosure. The SEC's release states that "[a]ccurate disclosures by public companies are foundational to the securities markets." Fiscal 2023 SEC disclosure cases involved, among other things, fraud, accounting misstatements, and deficient controls. The release cites examples of these cases, including charges against Fluor Corporation for accounting errors that caused it to materially overstate its earnings; against Newell Brands Inc. for misleading investors about its core sales growth, and against four electric vehicle companies for materially misleading statements regarding revenue projections, sales, or product launches.

- Individual accountability. Individual – as opposed to solely corporate – responsibility for disclosure and other types of company violations has been an SEC enforcement theme for several years. The SEC's release notes that approximately two-thirds of the SEC's 2023 cases involved charges against one or more individuals and that the SEC obtained 133 orders barring individuals from serving as officers or directors of public companies. Examples in the release of conduct that resulted in officer/director bars are: (1) a former Wells Fargo executive was barred as part of a settlement of fraud charges for misleading investors about the success of Wells Fargo's core business; (2) the former CEO of McDonald's was barred for five years for making false and misleading statements about the circumstances leading to his termination from McDonald's; and (3) telecommunications company Pareteum Corp.'s former controller was

barred (and also denied the privilege of appearing or practicing before the Commission as an accountant) as part of a settlement in a matter relating to his role in an allegedly fraudulent revenue recognition scheme.

- Gatekeepers. Another longstanding SEC enforcement theme is that "gatekeepers," such as accountants, auditors, and other professionals, have investor protection responsibilities and will be held accountable when they fail to fulfil their obligations, The SEC release describes enforcing these responsibilities as "a critical part of the Division's mission" and describes three 2023 examples, all involving accounting firms: (1) Marcum LLP was charged with systemic quality control failures and violations of audit standards in connection with its audit work for special purpose acquisition company (SPAC) clients; (2) Prager Metis was charged for allegedly violating auditor independence rules and aiding and abetting its clients' violations of federal securities laws; and (3) Crowe U.K. LLP, its CEO, and a senior audit partner were charged in connection with the firm's allegedly deficient audit of a SPAC merger target.

- Cooperation. The SEC rewards companies that bring securities law violations to its attention or otherwise cooperate in enforcement investigations. This seems to have been particularly important in fiscal 2023 (and may be one reason for the decline in fines and penalties). As the SEC press release notes, "Rewarding parties that cooperate encourages other firms to proactively self-police, self-report, and remediate potential securities law violations and to provide meaningful cooperation with the Division's investigations." Public companies that settled cases involving disclosure violations but avoided monetary penalties due to their cooperation included:

  - GTT Communications, Inc. (charged with failing to disclose material information about unsupported adjustments that increased GTT's reported operating income by at least 15 percent). The SEC "credited GTT with promptly self-reporting, undertaking affirmative remedial measures, and providing substantial cooperation to the SEC."

  - View, Inc. (charged with failing to disclose $28 million in warranty-related liabilities). "[A]fter self-reporting the conduct, View provided assistance to Division staff by, among other things, providing detailed financial analyses and explanations and summaries of factual issues; proactively identifying key documents and witnesses; and following up on several requests from the staff without requiring subpoenas." See SEC Accounting Enforcement Continues Apace, July 2023 Update.

- Environmental, social, and governance cases. The SEC release states that "ESG issues are increasingly important to investors, resulting in a growth of ESG-branded investment products and an increased focus on ESG by public companies." The examples provided of 2023 public company ESG disclosure cases include the SEC's charges against Activision Blizzard Inc. for failing to maintain disclosure controls and procedures to collect and analyze employee complaints of workplace misconduct. See ESG Meets Disclosure Controls in an SEC Enforcement Action, February-March 2023 Update.

Cornerstone Research/NYU Pollack Center Report

On November 15, Cornerstone Research and the New York University Pollack Center for Law & Business released SEC Enforcement Activity: Public Companies and Subsidiaries—Fiscal Year 2023 Update, their annual report on SEC enforcement actions against public companies and their subsidiaries. Cornerstone and the Pollack Center also issued a press release summarizing their report.

The Cornerstone/Pollack Center report finds that the SEC filed 91 enforcement actions public companies and their subsidiaries in fiscal 2023 – a 34 percent increase over 2022. However, despite the increase in cases, monetary settlements in public company and subsidiary actions decreased 50 percent, to $1.3 billion, the lowest total in the last eight fiscal years. The decrease in penalties appears in part to be the result of the increased tendency for public companies to cooperate with SEC investigations – 13 percent

of public company defendants/respondents that cooperated were able to settle without a monetary penalty, more than triple the average no-penalty rate from 2014 to 2022.

As in prior years, "Issuer Reporting and Disclosure" was the most common category of allegation against public companies in FY 2023. The 41 reporting/disclosure cases (45 percent of all actions filed) was the highest yearly number in the database, which began in 2009. Allegations in the Broker Dealer classification were the second most common type of charge (19 percent). (Presumably, a number of the cases tracked by Cornerstone/Pollack Center involve the securities broker-dealer subsidiary of a public holding company.) Foreign Corrupt Practices Act charges were involved in 12 percent of cases against public companies.

The Cornerstone/Pollack Center report sheds light on the role that cooperation has come to play in the SEC's enforcement program. The SEC noted cooperation in its investigation by 69 percent of public company and subsidiary defendants that settled in fiscal 2023 – higher than the FY2014-2022 average of 61 percent. Moreover, 16 public company or subsidiary defendants admitted guilt, tying 2022 for the highest number of such admissions; 15 of these admissions were in broker-dealer cases. (Defendants generally settle without admitting or denying the Commission's allegations although, over the past decade, the Commission has become more insistent on admissions in certain cases.) As to the rewards for cooperation, 87 percent of the settlements of cooperating defendants included a monetary amount, compared to 94 percent for noncooperators – i.e., 13 percent of cooperators avoided any monetary sanction.

Comment: The risk of SEC enforcement is rising with respect to disclosures that the SEC views as inaccurate, incomplete, or misleading. Audit committees should keep this risk in mind, especially when confronted with what appear to be accounting "close calls" or management efforts to omit or downplay unfavorable information. For companies embroiled in an SEC investigation, the Commission's record of rewarding cooperation should be a consideration in deciding how to respond.

G&AI: Nine Out of Ten Russell 1000 Companies Publish a Sustainability Report

The Governance & Accountability Institute (G&AI) has released 2023 Sustainability Reporting in Focus, the twelfth annual edition of its series tracking sustainability reporting trends. G&AI's research analyzes sustainability reporting by companies in the S&P 500 index and the Russell 1000 index. G&AI observes in the 2023 report that "annual sustainability reporting is now firmly established as not only a best practice, but as essential for large- and mid-cap U.S. publicly traded companies alike. As a result, U.S. companies are better positioned than ever before for expected new regulations on climate reporting."

G&AI first published an analysis of S&P 500 company sustainability reporting in 2012. Since that time, sustainability reporting has gone from relatively rare to almost universal; G&AI's initial report found that just 20 percent of S&P 500 companies published sustainability reports or disclosures in 2011. In 2019, G&AI expanded its research to include all companies in the Russell 1000 Index and reported that 60 percent of Russell 1000 companies published sustainability reports in 2018. For a discussion of last year's G&AI report, see Sustainability Reporting Reaches an All-Time High, But Investors Have Qualms About the Content, November-December 2022 Update.

The press release accompanying the 2023 G&AI report notes that it reflects "substantial increases in sustainability reporting for both large-cap and mid-cap U.S. public companies." For the S&P 500, almost all companies now engage in sustainability reporting. And the gap between large- and mid-cap company reporting has narrowed. Eighty-two percent of the smallest half of the Russell 1000 published sustainability reports in 2022.

Other key findings of the 2023 report (which covers the 2022 publication year), include:

- Sustainability reporting is ubiquitous. Ninety percent of Russell 1000 companies published a sustainability report in 2022, an increase from 81 percent in 2021 and 70 percent in 2020. Companies in the largest half by market cap of the Russell 1000 are nearly all sustainability reporters – 98 percent published a report in 2022, up from 96 percent in 2021 (and 92 percent in 2020). The smallest half of the Russell 1000 (companies with approximately $2 billion to $4 billion in market cap) had the largest increase in reporting, jumping to 82 percent publishing a report in 2022, compared to 68 percent in 2021 and 49 percent in 2020.

- Use of ESG disclosure frameworks. For the second year, the sustainability disclosure standards issued by the Sustainability Accounting Standards Board (SASB) were the most-widely used disclosure framework among the Russell 1000. Seventy-eight percent of Russell 1000 reporters utilized SASB standards in 2022, an eleven-point increase from 67 percent last year. Alignment with the recommendations of the Task Force on Climate-Related Financial Disclosure (TCFD) also grew; half of Russell 1000 reporters utilized TCFD in 2022, compared to 34 percent in 2021, 17 percent in 2020, and 4 percent in 2019. Russell 1000 use of Global Reporting Initiative (GRI) disclosures was unchanged at 54 percent.

- Industry sectors and sustainability reporting. In two of the eleven Russell 1000 industry sectors – Energy and Utilities -- all companies issued sustainability reports in 2022. The sector with the lowest percentage of sustainability reporters was Communications, with 40 percent of companies failing to issue a sustainability report (17 non-reporters out of the 43 companies in the sector). Communications was also in last place in 2021, although two more companies reported in 2022 than in 2021. Second-from-the-bottom was Financials with 14 percent of the sector not reporting (20 non-reporters in the 142-company sector). Health Care was third lowest with 12 percent of the 117 sector companies not reporting. However, Health Care also had the highest percentage growth in reporting companies – with 24 new reporters in 2022 (21 percent of the sector's members).

- External assurance on sustainability reporting. The number of companies that obtain external assurance from an auditor or other professional on their ESG disclosures is increasing. In 2022, 40 percent of Russell 1000 reporters obtained external assurance on their non-financial ESG disclosures, up 36 percent from 2021. Fifty-seven percent of the companies in the largest half of the index (the S&P 500) obtained assurance, compared to 49 percent in 2021. Twenty-one percent of companies in the smallest half of the Russell 1000 obtained such assurance, an increase from 18 percent in 2021.

  External assurance on sustainability reporting varies in scope, level, and provider. For example, for all Russell 1000 companies that obtained external assurance, only three percent obtained assurance over their entire sustainability report, and 58 percent obtained assurance over only GHG emissions data. Further, only five percent of assurance reports provided a reasonable or a high level of assurance; 92 percent provided limited or moderate assurance. Engineering firms were the assurance provider in 68 percent of Russell 1000 assurance engagements, while accountants provided the assurance report in 17 percent of Russell 1000 assurance engagements and consulting firms were the provider in 15 percent.

Comment: ESG disclosure is becoming an important aspect of the audit committee's work. Audit committees that are not already doing so should focus on what ESG disclosures their company makes, how the company collects ESG information, and how the disclosures impact financial reporting. As investors rely more heavily on ESG disclosures in their decision-making, the reputational and liability risks associated with inaccurate disclosure increase. To address these risks, audit committees should explore with management the controls and procedures to which sustainability disclosures are subject. These controls should be as rigorous as those applicable to traditional financial reporting. Management and the audit committee should also consider obtaining third-party assurance over sustainability disclosures.

On the Update Radar: Things in Brief

Audit Committees Should Pay Attention to the Statement of Cash Flows. SEC Chief Accountant Paul Munter has issued The Statement of Cash Flows: Improving the Quality of Cash Flow Information Provided to Investors, as a reminder of the importance of the statement of cash flows. According to Mr. Munter, the "statement of cash flows is integral to a complete set of financial statements, and it should therefore be subject to the same level of due professional care, effective internal controls, and robust, high-quality audit as other financial statements." However, "preparers and auditors may not always apply the same rigor and attention to the statement of cash flows as they do to other financial statements." This failure "may impede high quality financial reporting for the benefit of investors."

Mr. Munter's statement makes several points that audit committees should bear in mind as part of their financial reporting oversight:

- Statements of cash flow are a leading source of restatements. Cash flows statement errors are frequently corrected by "little r" restatements, indicating that the company believes that the misstatement was immaterial. (For a description of little r restatements, see After a SPAC-Driven Surge, Restatements Returned to "Normal" in this Update.) In some instances, the SEC staff disagrees with this conclusion. "We remind issuers, auditors, and others of the importance of performing an objective analysis from the perspective of a reasonable investor when evaluating the materiality of both the financial statement and ICFR impacts of an error in the statement of cash flows." (footnotes omitted) See SEC Acting Chief Accountant Warns Against Bias in Restatement Materiality Decisions, March 2022 Update which discusses Mr. Munter's comments on audit committee oversight of restatement decisions.

- Disclosures related to the statement of cash flows are critical to investors. "We remind issuers that the requirement to disclose significant accounting policies includes those policies that materially affect the determination of cash flow classification."

- Establishing and maintaining effective internal control over financial reporting includes controls to facilitate the preparation and presentation of the statement of cash flows.

- Companies should carefully consider how to best present cash and noncash information and what disclosures facilitate investor understanding of the statement of cash flows and the financial statements as a whole. In particular, companies should consider reporting operating cash flows under the "direct method." The direct method of preparing a statement of cash flows involves presenting the specific cash amounts associated with each item that affects cash flow. In contrast, the more common indirect method involves adjusting net income with changes in balance sheet accounts to arrive at the amount of cash generated by operating activities.

As to additional disclosure and the choice between the direct and indirect methods, Mr. Munter explicitly refers to the audit committee's responsibilities:

> "We encourage audit committees, as part of their important oversight role, to discuss with management and the independent auditor the potential use of the direct method or additional disclosures of gross cash receipts and payments, with an emphasis on investor needs. We also note that independent auditors can use their communications with the audit committee around alternative accounting treatments to facilitate this dialogue."

PCAOB Updates its Agendas and Adds a CAMs Review. On November 1, the PCAOB announced that it had released updated versions of its standard-setting, research, and rulemaking projects agendas. These agendas suggest that 2024 will be a busy year for the PCAOB. Several initiatives it is pursuing could have an impact on audit committees.

From an audit committee perspective, the most significant change from the prior listings is that the PCAOB has added a project entitled "Communication of Critical Audit Matters" to the research projects agenda. According to the Board's website, research projects "focus on whether there is a need for changes to PCAOB standards or other regulatory responses." A research project may graduate to the standard-setting or may result in other actions, such as the issuance of guidance regarding the application of existing PCAOB standards. The research agenda describes the new CAMs project as follows:

> "A critical audit matter (CAM) is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. The project seeks to understand why there continues to be a decrease in the average number of critical audit matters reported in the auditor's report over time and whether there is a need for guidance, changes to PCAOB standards, or other regulatory action to improve such reporting, including the information that is provided as part of the CAM reporting."

In addition to the CAMs research project, at least three of the eight matters on the PCAOB's short-term standard-setting agenda could have a significant impact on the relationship between audit committees and auditors. (Short-term standard-setting projects are those that are under active development and where a Board action, such as a proposal or final adoption of a standard, is anticipated in fewer than 12 months.) The three near-term standard-setting projects of interest to audit committees are:

- Noncompliance with Laws and Regulations. This proposal, which the Board published in June 2023, would substantially expand the auditor's consideration of possible audit client noncompliance with laws and regulations (NOCLAR). See PCAOB Proposes to Expand Auditor Responsibility for Financial Statement Fairness and for Legal Compliance, May-June 2023 Update. As discussed in Audit Committee Members Weigh in on NOCLAR Proposal, August-September 2023 Update, many audit committees filed comments with the PCAOB in opposition to this proposal. The Board anticipates adoption of a final NOCLAR standard in 2024.

- General Responsibilities of the Auditor in Conducting an Audit (AS 1000). These amendments to the existing auditing standards, which the Board proposed in May 2023, are intended to "modernize and clarify principles and responsibilities fundamental to the conduct of an audit." Among other things, the proposals would expand the auditor's responsibilities by "clarifying" that the auditor's determination of fairness "goes beyond" evaluation of whether the financial statements are presented in "mere technical compliance" with the applicable financial reporting framework. See PCAOB Proposes to Expand Auditor Responsibility for Financial Statement Fairness and for Legal Compliance, May-June 2023 Update. The Board anticipates final adoption of these changes to the current standards in 2024.

- Firm and Engagement Performance Metrics. The objective of this project is to enhance information provided to investors at both the firm and engagement level by developing key indicators of audit quality and effectiveness. See PCAOB Adds Audit Quality Indicators to its Short-Term Agenda, May-June 2023 Update. The Board anticipates issuing a proposed performance metrics standard in 2024.

FERF: Audit Fees Rose 4.6 Percent in 2022. The Financial Executives Research Foundation (FERF), the research affiliate of Financial Executives International (FEI), has released its annual survey of audit fees. The 14th Annual Public Company Audit Fee Report, sponsored by the Center for Audit Quality, is available here for purchase. According to FEI's publicly-available press release, the FERF study finds that average audit fees increased 4.6 percent from 2021 to 2022. By comparison, earlier this year Ideagen Audit Analytics reported that the average audit fee for SEC-

registered public companies increased 11 percent over 2021. See The Average Audit Fee Reached an All-Time High in 2022, August-September 2023 Update.

The FERF report covers fees companies paid to external auditors for auditing and related services between June 2022 and May 2023 and is based on responses from 54 financial executives at public companies and a survey of 116 audit engagement partners. FERF also examined audit fees as reported by approximately 7,060 SEC filers. In addition to the audit fee increase, FEI's press release highlights several other FERF findings:

- Increasing management effort to support the audit. Forty-seven percent of company respondents reported an increase over 2021 in management effort to support the external audit (51 percent reported no change). Twenty-one percent cited acquisitions as the primary driver of the increased management effort; additional reasons noted were changes to internal control over financial reporting and divestitures.

- Auditor use of data analytics. Eighty-nine percent of preparers indicated that their auditor used advanced data and information analysis as part of their audit processes, while 80 percent of audit partners said they used data analytics or other emerging technologies in a 2022 audit. Sixty-four percent of preparers whose auditor employed emerging technologies thought their use improved audit quality, up from 49 percent in the prior survey.

- More in-person auditing and auditor/client interaction. Fifty-five percent of surveyed audit partners expect that their team will spend more than 50 percent of its time together on-site at the client or at the firm office during peak times; less than 25 percent had this expectation in the prior survey. Similarly, 43 percent of preparers expect their finance and accounting teams to spend 50 percent or more of their time on-site supporting the financial statement audit during peak times, compared to less than 15 percent who had this expectation last year.

- Financial reporting will incorporate AI. Thirty-six percent of preparer respondents plan to incorporate artificial intelligence into their financial reporting process within the next five years.

- Rising climate risk disclosure. Seventy percent of preparers indicated that their company disclosed climate-related risks that management considered in the preparation of the most recently filed annual financial statement. Ninety-two percent of S&P 500 companies mentioned climate-related risks in the risk factors disclosure section of their most recent Form 10-K.

Audit committees may want to consider whether any changes in their audit fee, or in management effort to support the audit, parallel those of similar companies and the reasons for any differences.

California Weighs in on Net Zero Disclosure. Two new California laws on climate disclosure have attracted considerable attention because of their potentially far-reaching impact on U.S. public company disclosures and because they seem to put California ahead of the SEC in formulating climate disclosure policy. See California Outflanks the SEC on Climate Disclosure, October 2023 Update. A third, less publicized, new California climate disclosure law also has the potential to affect many U.S. public companies.

AB 1305, Voluntary Carbon Market Disclosures, applies to any entity operating in California that (1) makes claims regarding the achievement of net zero emissions, (2) makes claims that the entity, a related or affiliated entity, or a product is "carbon neutral," or (3) makes other claims implying the entity, related or affiliated entity, or a product does not add net carbon dioxide or greenhouse gases * * * to the climate or has made significant reductions to its carbon dioxide or greenhouse gas emissions" A company that makes any of these claims must disclose on its website:

- "All information documenting how, if at all, a 'carbon neutral,' 'net zero emission,' or other similar claim was determined to be accurate or actually accomplished, and how interim progress toward that goal is being measured." This information may include, "disclosure of

independent third-party verification of all of the entity's greenhouse gas emissions, identification of the entity's science-based targets for its emissions reduction pathway, and disclosure of the relevant sector methodology and third-party verification used for the entity's science-based targets and emissions reduction pathway."

- Whether there is independent third-party verification of the company data and claims.

AB 1305 also contains detailed disclosure requirements applicable to entities that market or sell voluntary carbon offsets in California and to companies operating in California or that purchase voluntary carbon offsets in California.

AB 1305 is effective on January 1, 2024. Companies must update their disclosures annually. The penalty for violations is $2,500 for each day that required information is not available on the entity's website or is inaccurate, with a maximum of $500,000 per violation. AB 1305 applies to all entities that operate in California, make carbon-neutral claims in California, or purchase or sell carbon offsets in California, regardless of where the entity is organized or headquartered. The law does not define the meaning of "in California" for these purposes, and its scope is therefore potentially quite broad.

Companies should not make public statements regarding a commitment to carbon neutrality lightly and without a tangible plan to achieve the promised goal.

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. Recent posts include –

- The PCAOB Takes Aim at Negligent Auditors (Dan Goelzer, October 25, 2023)

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

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Updates Nos. 76-86 (August 2022 to present) are available here. Updates Nos. 60-75 (June 2020 to July 2022) are available here. Updates Nos. 49-59 (January 2019 to May 2020) are available here. Updates prior to No. 49 are available on request.

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

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