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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 Adopts Enhanced Quality Control Standard for Audit Firms

PCAOB Reworks the Foundations of Auditing

Deloitte on How the Audit Committee Can Leverage the Disclosure Committee

KPMG-U.K. Has Audit Committee Agenda Suggestions

Update to the Update

- Revised 2022 PCAOB Large Firm Inspection Reports Analysis

On the Update Radar: Things in Brief

- PCAOB Updates its Agenda and Sets its Sites on Internal Audit
- Read Any Good CAMs Lately? The PCAOB's Investor Advisory Group Wants to Know
- PwC Explains Audit Committee Responsibilities under the EU's CSRD
- Sustainability Assurance is the New Expectations Gap

The Audit Blog

PCAOB Adopts Enhanced Quality Control Standard for Audit Firms

The Public Company Accounting Oversight Board has adopted a new standard, QC 1000, governing the quality control (QC) systems of public accounting firms. In her statement on QC 1000, PCAOB Chair Erica Williams said: "Because QC systems are fundamental to conducting quality audits, these new requirements directly align with our mission to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports." The Board proposed the new QC standard in late 2022. See PCAOB QC Proposal Could Impact Auditor/Audit Committee Relationship,

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November-December 2022 Update. Subject to SEC approval, QC 1000, and related amendments to the PCAOB's auditing standards, will take effect on December 15, 2025.

Most audit committees are unlikely to see specific changes in their auditor's procedures due to QC 1000, although, to the extent that it improves compliance with professional standards, some companies could face requests for more extensive audit evidence. In addition, related changes to other auditing standards may afford audit committees greater visibility into the impact of inspection deficiencies. QC 1000 will involve internal implementation costs for audit firms, and audit committees may encounter audit fee increases as a result. QC 1000 could also cause some audit firms to drop their PCAOB registration, which would reduce competition in the audit market for smaller public companies.

Overview of the QC 1000

The press release announcing the adoption of QC 1000 states that the objective of the new standard is to "require all PCAOB registered firms to identify their specific risks and design a QC system that includes policies and procedures to guard against those risks." The release adopting the new standard adds that it "mandates quality objectives and key processes for all firms' QC systems, with a focus on accountability and continuous improvement" and "will lead firms to better serve investors by more consistently complying with the professional and legal requirements that apply to PCAOB engagements."

Key features of the QC standard include:

- QC system design and operation. QC systems must have two "process components" – risk assessment, and monitoring and remediation. In addition, QC systems must have components that address six aspects of the firm's organization and operations -- Governance and leadership, Ethics and independence, Acceptance and continuance of engagements, Engagement performance, Resources, and Information and communication. QC 1000 also requires individual accountability. The firm's principal executive officer is ultimately responsible and accountable for the system, including its design, implementation, operation, and annual evaluation. In addition, specific individuals must have operational responsibility and accountability for the system and for the firm's compliance with particular system components.

- Scalability/impact on inactive firms. All PCAOB-registered firms will be required to design a QC system that meets the requirements of QC 1000. However, firms that do not perform audits of public companies or SEC-registered broker-dealers will not be required to implement the system unless and until they lead an engagement under PCAOB standards, play a substantial role in the preparation or furnishing of an audit report under the PCAOB's jurisdiction, or otherwise assume responsibilities regarding any such engagement. The release adopting QC 1000 states: "This approach reflects our view that all firms that register with the PCAOB should be appropriately prepared to perform a PCAOB engagement, regardless of whether they are currently subject to requirements with respect to one, while limiting the costs of compliance in circumstances where the risk to investor protection is minimal."

- Evaluation and reporting on QC effectiveness. Firms will be required to annually evaluate the effectiveness of their QC system and to determine, as of September 30 of each year, whether the system (1) is effective with no unremediated QC deficiencies; (2) is effective except for one or more unremediated quality control deficiencies that are not major quality control deficiencies; or (3) is not effective (i.e., one or more major quality control deficiencies exists). Firms will be required to file a report with the PCAOB by November 30 stating their QC system effectiveness conclusion and, where applicable, describing any deficiencies. This report will be nonpublic.

- No mandatory audit committee reporting. In a significant change from the 2022 proposal, the final QC standard does not require firms to report the results of their annual evaluation of the firm's QC system to client audit committees. The Board stated that it deleted the audit committee reporting requirement because "legal constraints" limit its ability to require public disclosures

about the effectiveness of firms' QC systems. This change reduces the risk that audit committees will need to make judgments about the significance of firm quality control deficiencies. Audit committees remain free to ask their audit firm questions about its system.

- External quality control function (EQCF). Firms that annually issue more than 100 public company audit reports must establish an independent QC oversight function. The EQCF must be composed of one or more persons who are not principals or employees of the firm and do not have a relationship with the firm that would interfere with the exercise of independent judgment. The responsibilities of the EQCF must include evaluating the significant judgments made and the conclusions reached in the firm's annual QC system effectiveness evaluation.

Other Auditing Standard Changes

In addition to adopting QC 1000, the PCAOB amended two other auditing standards related to audit quality control.

- Response to audit engagement deficiencies. The Board amended AS 2901, Consideration of Omitted Procedures After the Report Date, to require auditors to address all engagement deficiencies that come to their attention after the completion of an audit. An engagement deficiency is "an instance of noncompliance with applicable professional or legal requirements." (PCAOB inspection findings are an example of engagement deficiencies.) The current standard affords the auditor latitude in deciding whether any action is necessary in response to an engagement deficiency. Under revised AS 2901, in cases where, because of the deficiency, the auditor did not obtain sufficient appropriate audit evidence to support the opinion, the auditor must either perform procedures to obtain additional evidence or prevent future reliance on the opinion. For engagement deficiencies that do not affect the sufficiency of the audit evidence, the auditor must either correct the deficiency or take action to prevent a recurrence.

- Integrity and ethics standard. The Board rescinded its existing ethics and independence standard and replaced it with a new standard, EI 1000, Integrity and Objectivity. Among other things, this new standard would address the situation in which a person associated with a registered accounting firm has a disagreement with his or her supervisor over compliance with professional or legal requirements. EI 1000 provides that, if, in the view of the associated person, the firm does not take appropriate action, he or she should consider notifying third parties of the matter, including regulatory authorities and audit committees.

Impact on Competition: Commissioner Ho's Dissent

The Board adopted the new QC standard by a 4-1 vote. In her statement, dissenting Board member Christina Ho focused on the burdens that QC 1000 imposes on accounting firms that do not currently audit public companies or broker-dealers. About half of the PCAOB-registered firm population does not engage in PCAOB-regulated activity. As explained above, the standard requires these firms to design a system that complies with QC 1000 but does not require the firm to implement the system unless it becomes involved in an engagement subject to the PCAOB's jurisdiction. Board Member Ho stated:

> "I believe that the adopting release's design-only requirement for firms that do not issue public company audit reports: (1) appears inconsistent with the statutory text of the Sarbanes-Oxley Act of 2002 (SOX); (2) appears inconsistent with what the PCAOB told Congress in 2023; and (3) imposes undue burdens on competition that will hurt smaller public companies (including emerging growth companies), investors, and the competitiveness of audit marketplace.
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> "I want to encourage competition in the audit marketplace and induce inactive firms not to deregister but rather to become active, because competition will result in lower audit fees which will allow

smaller issuers and emerging growth companies to dedicate more of their scarce capital to research and development and job creation. Our capital markets depend on a robust and resilient public company auditing profession, and this proposal seeks to dismantle the profession by creating unnecessary, inappropriate, and I believe unlawful barriers to entry, which I predict will adversely affect competition in the audit marketplace."

Comments:

1. Strong quality controls are a key component of a firm's ability to deliver a quality audit. Audit committees should of course support that goal. If QC 1000 is effective, audit committees should see the benefits of stronger firm QC in the performance of the company's audit.

2. At the same time, audit firms will incur costs in complying with the complex requirements of QC 1000, and those costs will likely be reflected in higher audit fees. Audit clients may be affected in other ways as well. The economic analysis in the release adopting QC 1000 repeats the same observation regarding costs that appeared in the 2022 proposing release:

> "Firms may pass on part of any increased costs they incur at the firm or engagement level by raising the fees they charge their clients. In addition, to the extent that the requirements improve compliance with applicable professional and legal requirements, some audited companies could face additional costs to respond to their auditors' requests for additional or more extensive audit evidence. Audited companies may incur other costs due to changes in audit firm QC policies and procedures. For example, if QC 1000 results in changes to firms' client acceptance and continuance practices, firms may require greater fees or refuse to accept or retain high-risk clients."

3. Board Member Ho raises serious concerns about the impact of the new QC standard on smaller firms. Further, this standard is only one of a series of new standards the Board is considering that may make public company auditing less attractive for firms that do not have a large public company clientele. Some of these firms may decide to de-register and concentrate on private company auditing. The result, Ms. Ho fears, might be that smaller public companies and their audit committees will have fewer auditor choices. Reduced auditor competition is likely to lead to higher audit fees for small public companies.

4. The new AS 2901 requirement that firms take action to address all engagement deficiencies could have the effect of making the consequences of deficiencies uncovered in PCAOB inspections or firm internal reviews more visible to audit committees. The new version of this standard will require the auditor to perform further audit work, regardless of whether the deficiency has any impact on the original audit opinion. The need to perform additional work may highlight for audit committees the nature of the deficiency and the extent of the effort necessary to correct it.

5. The deletion of the requirement to report the results of the auditor's annual QC evaluation to the audit committee is a positive development for audit committees since spares them from mandatory receipt of information about a topic that may be hard to evaluate. At the same time, audit committees will be free to ask their auditor for information about its QC system. In this regard, the Board stated in its release, "such inquiries could include requesting the firm to keep the audit committee apprised of the status of the quality control remediation process (including whether the firm made a submission to the Board responding to inspection report quality control criticisms by the 12-month deadline) and whether the Board has made a final remediation determination (including a negative determination that has not yet become public)."

PCAOB Reworks the Foundations of Auditing

The Public Company Accounting Oversight Board has adopted a new auditing standard, AS 1000, General Responsibilities of the Auditor in Conducting an Audit, and related amendments to other auditing standards, to "modernize, clarify, and streamline" the foundational concepts of auditing. AS 1000

consolidates into one standard the general principles and responsibilities of the auditor, such as due professional care, professional skepticism, competence, and professional judgment. The press release announcing the adoption of AS 1000 describes the new standard as "enhance[ng] investor protection by reaffirming the general principles and responsibilities of the auditor and solidifying the foundation of every audit." In his statement, Board Member George Botic described AS 1000 as "an evolutionary change that should not be considered trivial."

Subject to SEC approval, AS 1000 and related amendments will take effect for audits of financial statements for fiscal years beginning on or after December 15, 2024. A change in the documentation completion date – the date by which the auditor must finalize the work papers following issuance of the audit report – will be phased such that smaller audit firms will not be required to comply until performing audits of financial statements for fiscal years beginning on or after December 15, 2025.

The Board proposed AS 1000 for comment in March 2023. See PCAOB Proposes to Expand Auditor Responsibility for Financial Statement Fairness and for Legal Compliance, May-June 2023 Update. The final standard is substantially similar to the proposal. One significant change is that the Board has clarified that the auditor's opinion on whether the financial statements "present fairly" in all material respects the company's financial position and results of operations is grounded in the applicable financial reporting framework (e.g., GAAP). The proposal would have required the auditor to also consider broader securities law concepts, such as the SEC rule governing the completeness of company filings.

Key provisions of the AS 1000 and related amendments include:

- The auditor's obligation to protect investors. The first paragraph of AS 1000 introduces the proposition that the auditor "has a fundamental obligation to protect investors through the preparation and issuance of informative, accurate, and independent auditor's reports." The Board's release adopting AS 1000 stresses that this provision "does not alter any existing regulatory or legal requirements or obligations between auditors and investors" and "does not establish a novel duty or new form of legal obligation." Based on suggestions from some commenters, this paragraph also states that the auditor's responsibility to investors "transcends an auditor's relationship with management and the audit committee of the company under audit, providing the foundation for an objective and independent audit." The release explains that this statement "expresses a longstanding principle of public accounting."

- The auditor's responsibility to evaluate whether the financial statements are "presented fairly." AS 2810, Evaluating Audit Results, currently requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, such as GAAP. The proposal would have amended AS 2810 to "clarify" that the obligation to evaluate the fairness of the financial statements "goes beyond mere technical compliance" with the requirements of the financial reporting framework. Some commenters asserted that this change could create a conflict between the auditor's disclosure judgment and management's and could introduce inconsistency in accounting treatment. Others pointed out that it could force auditors to override the requirements of GAAP if, in the auditor's judgment, the GAAP financial statements did not fairly present the substance of the company's financial results.

  In response to these concerns, the final standard and the adopting release make clear that revised AS 2810 does not change the auditor's existing responsibilities for evaluating whether the financial statements are presented fairly in conformity with the applicable financial reporting framework. The amendments to AS 2810 state that "presents fairly" involves evaluating whether information in the financial statements is presented and classified appropriately and in a manner that is not misleading, within the applicable financial reporting framework. In addition, the amendments acknowledge that financial reporting frameworks recognize that additional company disclosures may be necessary to ensure fair presentation. The Board deleted a proposed reference in AS 2810 to SEC Rule 12b-20, which prohibits the omission from company filings of information necessary to prevent the filing from being materially misleading.

- The engagement partner's due professional care responsibilities. The new standards describe the responsibilities of the engagement partner, which include ensuring that the audit is properly planned and performed, evaluating significant findings or issues that arise during the audit, and ensuring that the conclusions reached are appropriate and supported by sufficient evidence. In response to comments on the proposal, the adopting release clarifies the distinction between the responsibilities applicable to all auditors and those that are incremental for engagement partners. The new standards also clarify that, while an engagement partner may seek assistance on specific tasks from other engagement team members, the engagement partner continues to retain the primary responsibility for supervising, reviewing, and ensuring the quality of the work performed in the audit and that the work of other engagement team members does not replace or reduce the engagement partner's responsibility for the engagement and its performance.

- Acceleration of the documentation completion date. Under the current standards, the auditor must assemble the audit documentation – the work papers – not more than 45 days after release of the audit report; this deadline is the "documentation completion date." Under the new standards, the documentation completion date will be 14 days after release of the audit report. The Board's press release states that the "new documentation completion date will reduce the window of opportunity for improper alteration of audit documentation and also enable the Board to potentially begin the inspection process sooner after completion of an audit." The accelerated period will be phased in. For public accounting firms that, during the calendar year ending December 31, 2024, issued audit reports for more than 100 issuers, the 14-day documentation completion requirement will take effect for audits of financial statements for fiscal years beginning on or after December 15, 2024. For all other firms, the 14-day documentation completion requirement will take effect for audits of financial statements for fiscal years beginning on or after December 15, 2025.

Comment: AS 1000 and related amendments make many changes in the wording of the foundational auditing standards. While it does not appear that the PCAOB intended these revisions to cause any specific changes in the audit process, it may take some time for the profession to assimilate the new standards and determine their practical effect. Audit committees may want to ask their engagement partner whether he or she envisions any impact on the company's audit. For example, the Board seems to assume that the acceleration of the documentation completion date will not have any significant effects on audits, in part because most auditors maintain work papers in electronic form. Audit committees may want to ask whether their engagement team has the same view.

The Board's repackaging in the final standard of the auditor's obligation to consider whether the financial statements are fairly presented in conformity with the financial reporting framework is a positive development. The original formulation of revised AS 2810 could have embroiled audit committees in disputes between the auditor and management about financial statement presentation, notwithstanding that the statements conformed with GAAP. The Board deserves credit for taking the concerns commenters expressed on this issue seriously.

Deloitte on How the Audit Committee Can Leverage the Disclosure Committee

Disclosure oversight is one of the key responsibilities of audit committees. This responsibility is becoming more challenging because of the volume of new disclosure requirements, the expanding scope of nontraditional disclosures outside the financial statements, and the increase in unregulated, voluntary disclosures. According to a recent publication of the Deloitte Center for Board Effectiveness, one tool that audit committees can use to leverage their oversight of the disclosure landscape is the company's disclosure committee. Aligning the disclosure committee in the era of disclosure, part of the Center's On the audit committee's agenda series, offers some suggestions for how disclosure committees can help to make audit committee disclosure oversight more effective.

What is the disclosure committee?

There is no requirement that a company have a disclosure committee, although the SEC has recommended that companies establish a management-level committee responsible for “considering the materiality of information and determining disclosure obligations” and that the committee report to the CEO and CFO since those officers are responsible for the company’s disclosure controls and procedures. In practice, most large public companies have disclosure committees. Deloitte states that typical disclosure committee objectives are to:

- Review draft SEC filings, recommend edits and provide comments, and confirm that edits have been incorporated before submitting the filing.

- Provide integrity and completeness relating to internal controls over financial reporting (ICFR).

- Support the certification requirements of Sections 302, 404, and 906 of the SOX Act. [These sections require the CEO and CFO to certify, among other things, to the accuracy of company financial reports, and require management to report on the effectiveness of the company’s ICFR.]

Considerations for disclosure committee refresh

Deloitte recommends three steps to formalize and enhance the work of the disclosure committee.

1. Maintain and update a formal disclosure committee charter. Charter topics may include the committee’s purpose or mission statement; the committee’s responsibilities (e.g., reviewing and monitoring disclosure controls and public filings); factors that inform the disclosure committee’s assessment of controls; committee membership and chair; and how often the committee meets and its procedures. The disclosure committee’s charter should align with the audit committee charter, and, as the breadth of audit committee disclosure responsibilities grows in response to regulatory developments, the scope of the disclosure committee’s remit should also expand.

2. Reassess disclosure committee owner(s) and membership. Suggestions relating to disclosure committee leadership and membership include:

   - The disclosure committee charter should designate a chair (or co-chairs), often from the finance or legal departments.

   - As disclosure requirements broaden, disclosure committees should consider expanding their membership to include additional subject-matter experts (e.g., executives/managers in sustainability, cyber, technology, and human resource roles). Committee leadership may want to inventory the disclosures the committee is responsible for and assess whether all relevant data is within the purview of current committee members.

   - Consider onboarding procedures so that new committee members understand its functions.

3. Enhance disclosure committee procedures, particularly those pertaining to memorialization of committee operations. Deloitte suggests that disclosure committees revisit their procedures with a focus on ensuring that each committee meeting agenda includes all relevant topics and adequate documentation of the committee reviews.

Documentation

Documentation of the work of the disclosure committee is important, especially in situations where the adequacy of disclosure controls is questioned. Formal meeting minutes are one tool. Others include:

- Maintaining records of agendas and calendar appointments to evidence that meetings occurred.

- Maintaining records of financial report drafts marked up for the committee meeting to illustrate the nature of the review.

- Maintaining records of checklists utilized by the disclosure committee to demonstrate the scope of review.

- Memorializing in audit committee minutes that the disclosure committee provided a report and any relevant details presented.

Deloitte recommends that disclosure committee leadership consult with counsel to determine the best approach to documentation considering the company's specific risks.

Questions for Audit Committees

Deloitte suggests seven questions audit committees may want to ask to assess the disclosure committee's "readiness for a changing disclosure landscape."

- If we do not have a disclosure committee, should we consider establishing one?

- Does the disclosure committee have a charter, and if so, does it accurately reflect the breadth and depth of disclosures the committee is currently responsible for?

- Is the disclosure committee composed of representatives from all relevant business functions so that all disclosure data is reviewed by an expert?

- Are all disclosure committee members, whether new or experienced, adequately familiar with the committee's role and their responsibility as a member?

- Does the disclosure committee agenda reflect all relevant topics?

- Is the disclosure committee effectively documenting the completion and quality of its disclosure reviews?

- How does the disclosure committee coordinate with the risk management committee (if applicable) and/or the sustainability committee (if applicable)?

Comment: Audit committees have at least two reasons to pay attention to the effectiveness of the company's disclosure committee. First, as described in Deloitte's paper, both mandatory and voluntary disclosures are increasing, and the "increased demand for disclosure from regulators, investors, and stakeholders is likely to continue, as will the complexity of the data reported, regulatory expectations, and legal risk." Audit committees may find it challenging to stay abreast of this disclosure revolution, and a well-functioning disclosure committee can make the audit committee's job easier.

Second, SEC enforcement is focusing on the adequacy of company disclosure controls. See The SEC is Zeroing in on Disclosure Controls, April 2023 Update and ESG Meets Disclosure Controls in an SEC Enforcement Action, February-March 2023 Update. This underscores the need for the audit committee to monitor the disclosure committee's evaluation of the design and effective operation of the company's disclosure controls.

KPMG-U.K. Has Audit Committee Agenda Suggestions

The Harvard Law School Forum on Corporate Governance has published The 2024 Audit Committee agenda and the questions investors should be asking. The blog post is based on a paper with the same title issued by KPMG-U.K. The paper discusses nine matters audit committees should have on their 2024 agendas and suggests questions that investors may wish to ask the committee about each. While prepared for a U.K. audience, the paper is also relevant to U.S. audit committees. The nine agenda topics and related investor questions are:

1. Financial reporting and related internal control risks.

    - Forecasting and disclosures. Matters likely to require the audit committee's attention include disclosures regarding the impact of the wars in Ukraine and the Middle East, government sanctions, supply chain disruptions, heightened cybersecurity risk, climate change, inflation, interest rates, market volatility, and the risk of a global recession; forward-looking cash-flow estimates and impairment of non-financial assets; and use of non-GAAP metrics.

        Investor question: Ask for details about the significant issues the audit committee considered in relation to the financial statements, what makes an issue "significant," and how have those significant issues been addressed.

    - Internal control over financial reporting (ICOFR) and probing control deficiencies. "[T]he current geopolitical, macroeconomic, and risk environment, as well as changes in the business (such as acquisitions, new lines of business, digital transformations, etc.) * * * will continue to put ICOFR to the test."

        Investor question: Ask about the committee's role with regards to monitoring the effectiveness of internal controls, how the current environment and regulatory mandates (including new climate rules) affect controls and if there have been any significant issues raised by internal or external audits and (if so, how has the committee addressed them).

    - Importance of a comprehensive risk assessment. "Audit committees help ensure that management and auditors are not too narrowly focused on information and risks that directly impact financial reporting while disregarding broader entity-level issues that may also impact financial reporting and internal controls."

        Investor question: Ask about the committee's role in the oversight of management's principal risk disclosures in the annual report and how does the committee take into account other, emerging areas of risk – such as supply chain resilience and geopolitical risks?

    - Committee bandwidth and skillsets. ESG reporting requirements further expand audit committee responsibilities beyond core financial reporting and audit oversight functions. Committees may wish to reassess whether it has "the time and expertise to oversee the major risks on its plate."

        Investor question: Ask about the committee's workload, the measures taken to ensure that committee members have the skillset to oversee emerging risks and how the committee evaluates its own effectiveness.

2. Audit and governance reform agenda. The issues KPMG cites under this heading relate to U.K. regulatory developments. However, comparable issues exist in the U.S. For example, audit committees might want to consider and discuss with their auditor how adoption of the PCAOB's NOCLAR proposal would affect the company's audit and what steps the company should take in

anticipation of NOCLAR. See Audit Committee Members Weigh in on NOCLAR Proposal, August-September 2023 Update.

Investor question: Ask about what actions are being taken to ensure a smooth transition to [new regulatory] * * * expectations, how will the committee oversee any necessary cultural shift and how will technology be leveraged.

3. Cybersecurity and data privacy. Cyber threat issues which the audit committee should explore include whether the company has:

    - Identified the critical information assets which it wishes to protect against cyber attack – the crown jewels of the firm – whether financial data, operational data, employee data, customer data or intellectual property.

    - Intelligence processes in place to understand the threat to the company's assets, including their overseas operations.

    - Controls in place to detect and respond to a cyber attack – including the management of the consequences of a cyber security incident.

    - A means of monitoring the effectiveness of their cyber security controls, including where appropriate, independently testing, reviewing, and assuring such controls.

    Investor question: Ask about the role the committee plays in relation to the company's disclosures about cyber-related risks, do they adequately reflect the company's preparedness and its understanding of the full threat landscape, company vulnerabilities, mitigating actions and their effectiveness.

4. New climate, sustainability, and other ESG disclosures – and the quality and reliability of the underlying data. A key area audit committee focus should be the company's preparedness for new ESG reporting requirements. Among other things, KPMG suggests --

    - Ensuring management has processes in place to review ESG disclosures, including for consistency with the annual report and accounts.

    - Helping to ensure that ESG disclosure is subject to the same level of rigor as financial information.

    - Encouraging management to identify any gaps in governance and consider how to gather and maintain quality information.

    - Understanding whether appropriate systems are in place or under development to ensure the quality of data that must be assured by third parties.

    Investor question: Ask about the committee's role in relation to the reporting of climate-related risks, to what extent is climate change being incorporated into key accounting assumptions (such as impairments, depreciation, and asset decommissioning), and is the committee satisfied with the level of assurance in the company's ESG disclosures.

5. Audit quality. KPMG recommends that audit committees discuss with the auditor how the company's financial reporting and related internal control risks have changed in light of the geopolitical, macroeconomic, regulatory and risk landscape; set expectations for frequent, open, candid communications between the auditor and the audit committee; probe the audit firm on its quality control systems; and consider the results of auditor regulatory and internal inspections.

Investor question: Ask how the committee measures the effectiveness of the external audit, their role in the planning of the audit, how they challenge the auditor's findings, how the auditor challenges management, and the factors most important to them in selecting an auditor.

6. Internal audit focus on key risks. "As audit committees wrestle with heavy agendas – and risk management is put to the test – internal audit should be a valuable resource for the audit committee and a crucial voice on risk and control matters. This means focusing not just on financial reporting and compliance risks, but also critical operational and technology risks and related controls, as well as ESG risks."

   Investor question: Ask about the committee's role with regards to monitoring the effectiveness of internal audit, how does the committee ensure that the internal audit plan is aligned to the key risks of the business, if there has been any significant issues raised by internal audit and the committee's response, how do they ensure the internal audit function have the right skills and resources to succeed.

7. Leadership and talent in the finance organization. KPMG expects that audit committees will focus particularly on two finance talent/leadership areas: (1) Leadership, talent, skill sets, and other resources necessary to address climate and other ESG reporting; and (2) Opportunities for finance to add greater value to the business by combining strong analytics and strategic capabilities with traditional financial reporting skills.

   Investor question: Ask about the committee's role in overseeing the finance function's climate/sustainability/ESG strategy and digital transformation strategy, how the function is attracting, developing, and retaining the leadership, talent, skill sets and bench strength to execute those strategies, as well as its existing responsibilities.

8. Ethics, compliance, and culture. Audit committees should "closely monitor the tone at the top and culture throughout the organization." with a sharp focus on behaviors (not just results) and yellow flags. Committees should also focus on the effectiveness of the company's whistleblower reporting channels.

   Investor question: Ask how the committee satisfies itself that management has systems in place to detect fraud, to what extent is the committee involved in the oversight of the company's whistleblowing procedures and how do they ensure these are appropriate?

9. Oversight of generative AI. The audit committee may find itself overseeing "compliance with the patchwork of differing laws and regulations governing generative AI, as well as the development and maintenance of related internal controls and disclosure controls and procedures." Generative AI is rapidly evolving, and the audit committee's AI oversight responsibilities may need to be revisited during the year.

   Investor question: Ask about the committee's role with regards to oversight responsibilities for generative AI, including oversight of various aspects of the company's governance structure for the development and use of the technology.

Comment: KPMG-U.K.'s paper provides an excellent catalog and discussion of current issues that most audit committees will have to address in 2024. It has many topics in common with other firms' suggestions concerning audit committee agenda topics (see What Should be on the Audit Committee's 2024 Agenda?, January 2024 Update), and a review of KPMG's paper could be helpful to an audit committee as a check that it is not overlooking topics that should be considering.

Update to the Update

Revised 2022 PCAOB Large Firm Inspection Reports Analysis. A new version of the Update's summary and analysis of the 2022 Public Company Accounting Standards Board's inspection reports for the U.S. affiliates of the six global network audit firms has been posted on www.auditupdate.com, the Update's website. 2022 PCAOB Large Firm Inspection Reports – Updated includes the unredacted KPMG 2022 inspection report.

On February 28, the PCAOB released the 2022 inspection reports for the six global network firms. However, the version of KPMG's 2022 report released in February omitted discussion of one of the 54 KPMG engagements inspected in 2022. The March 2024 Update included a summary and analysis of the 2022 large firm inspection reports, although some aspects of the analysis were incomplete due to the redactions. See 2022 PCAOB Large Firm Inspection Reports, March 2024 Update.

On April 26, the PCAOB made public a complete version of KPMG's 2022 PCAOB inspection report. See Unredacted: KPMG's 2022 Inspection Report, April 2024 Update. 2022 PCAOB Large Firm Inspection Reports – Updated reflects the additional information that became available when the PCAOB released the unredacted KPMG report.

On the Update Radar: Things in Brief

PCAOB Updates its Agenda and Sets its Sights on Internal Audit. The staff of the PCAOB has announced updates to the Board's standard-setting, research, and rulemaking agendas. The Board removed two projects completed in May from the standard-setting agenda – Quality Control and General Responsibilities of the Auditor in Conducting an Audit. See PCAOB Adopts Enhanced Quality Control Standards for Audit Firms and PCAOB Reworks the Foundations of Auditing in this Update. A new project on the auditor's consideration and use of a client's internal audit function has been added to the mid-term standard-setting agenda. The updated agendas indicate that the PCAOB intends to move forward with several important initiatives during the second half of 2024, including a final standard on auditor consideration of client noncompliance with laws and regulations The prior version of the PCAOB agendas is discussed in PCAOB Updates its Agendas and Adds a CAMs Review, November-December 2023 Update.

Standard-setting projects that could have an impact on audit committees include:

- Noncompliance with Laws and Regulations (NOCLAR). This proposal, published in June 2023, would expand the auditor's consideration of possible client noncompliance with laws and regulations. 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 committee members filed comments opposing the proposal. On March 6, the Board held a public roundtable on NOCLAR. As noted above, the PCAOB staff anticipates adoption of a final NOCLAR standard before the end of 2024.

- Critical Audit Matters (CAMs). The Board's research agenda includes a project on CAMs. This project "seeks to understand why there continues to be a decrease in the average number of * * * [CAMs] 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." See PCAOB Updates its Agendas and Adds a CAMs Review, above. Projects on the research agenda do not have specific time schedules.

- Firm and Engagement Performance Metrics. On April 9, the PCAOB issued for comment two proposals that would expand the disclosures accounting firms must make regarding their performance of audit engagements and their operational and financial condition. See PCAOB Proposes Engagement Metrics and Audit Firm Operational and Financial Reporting, April 2024 Update. The engagement metrics proposal would require firms that audit large public companies to report eleven metrics relating to specific audit engagements or to the firm's overall audit practice. This project is on the short-term standard-setting agenda, although the next anticipated action is "TBD pending analysis of comment letters."

- Internal Audit. The staff added a new project on internal audit to the mid-term standard-setting agenda. This project will consider updates to AS 2605, Consideration of the Internal Audit Function. AS 2605 provides guidance to auditors on considering the work of internal auditors and on using internal auditors to provide direct assistance in performing an audit. This project has no specific timeline.

Read Any Good CAMs Lately? The PCAOB's Investor Advisory Group Wants to Know. The PCAOB's Investor Advisory Group (IAG) has requested nominations for the most decision-useful critical audit matter (CAM) or key audit matter (KAM) in a public company audit report filed with the SEC as part of a 2023 Form 10-K or Form 20-F. The IAG will select the top three 2023 CAMs/KAMs and discuss them in a public report it will issue later this year.

The PCAOB's auditing standards require audit reports to include a description of any CAMs, defined as matters arising from the financial statement audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. KAMs are required in audit reports prepared under the International Standards on Auditing. KAMs are matters that, in the auditor's professional judgment, were of the most significance in the financial statement audit and were communicated to those charged with governance.

The IAG invites nominations from the "general public, including from public company issuers (management and boards), auditors, financial analysts and investors." Nominations should not exceed 500 words and should explain why the CAM or KAM provides decision-useful information to investors. Nominations should be emailed to allie@cii.org by June 30, 2024.

At the IAG's suggestion, the PCAOB has added a review of CAMs, including whether there is a need for regulatory action to improve CAM reporting, to its research agenda. See PCAOB Updates its Agendas and Adds a CAMs Review, November-December 2023 Update.

PwC Explains Audit Committee Responsibilities under the E.U.'s CSRD. The European Union's Corporate Sustainability Reporting Directive (CSRD) will directly impact many U.S.-based companies. According to The audit committee has specific responsibilities under the EU's CSRD, a publication of PwC's Governance Insights Center, those impacts will include new audit committee responsibilities. For companies subject to its requirements, the CSRD "explicitly puts audit committees of the reporting entities on the spot as it relates to sustainability reporting."

In broad terms, the CSRD will apply to "large" (as defined) non-E.U. companies (including subsidiaries of non-E.U. parents) with securities listed on an E.U.-regulated market and to certain companies based outside of the E.U. that generate "net turnover" in the EU exceeding specified thresholds. See E.U. ESG Disclosure Requirements Will Affect Many U.S. Companies, October 2023 Update. The application of the CSRD to any specific non-E.U. company is likely to be a complex question that management should explore with the assistance of legal counsel.

For those companies that are within its scope, PwC lists several ways in which the CSRD incorporates sustainability into the audit committee's work. Audit committee responsibilities will include informing the board of the outcome of sustainability reporting assurance and explaining how

assurance contributed to the integrity of sustainability reporting. In addition, audit committees will need to monitor the sustainability reporting process, including the identification of information that the company must report, and make recommendations to ensure the integrity of these processes.

PwC suggests eight questions audit committees should ask as companies prepare for CSRD reporting:

- How does the board's governance structure align sustainability and strategy?
- Does management's presentation and reporting of sustainability-related information allow the board and the audit committee to adequately understand the company's risks and opportunities?
- What framework does management have in place for coordinating sustainability reporting across geographies and business units and for maintaining a holistic view across topics?
- To what extent are the company's finance function, internal audit and other reporting units involved in creating and/or strengthening the control environment for the sustainability disclosures?
- What is the disclosure committee's role, and do the members have the necessary expertise for the new disclosures? Should new members be added?
- How far in advance of the required disclosure date will the audit committee receive draft disclosures? This is usually an iterative process and may need revisions. The sooner the audit committee can review draft disclosures, the better.
- Which sustainability reporting requirements is the company subject to globally? Has the company done a gap analysis to identify where investment is needed to meet the requirements? How is the company collecting data in an accurate, cost-efficient manner that recognizes the limited interoperability?
- How has management assessed the material short, medium, and long-term risks? What methodologies were used to assess those risks?

The PwC paper also lists audit committee action items. The list includes such things as "Develop a plan for new audit committee activities related to sustainability reporting, such as reviewing the materiality assessment periodically and overseeing the sustainability assurance provider;" "Understand the outcome of management's materiality assessment;" and "Update the charter to reflect these new responsibilities."

Audit committees of companies with any level of contact with the E.U. should make sure that management is considering how the CSDR may affect the company. For those companies that will be subject to CSRD reporting, the audit committee should understand how the Directive will affect its responsibilities. PwC's paper provides a good introduction to the CSRD's impact on audit committees.

Sustainability Assurance is the New Expectations Gap. Companies frequently obtain third-party assurance over portions of their sustainability reporting, and sustainability reporting rules typically require assurance. However, assurance reports on sustainability disclosures often provide only limited, rather than reasonable, assurance. See Large Companies Worldwide Continue to Expand Their ESG Disclosure and Assurance, February 2024 Update (95 percent of sustainability assurance reports worldwide provided limited assurance). Similarly, the SEC's climate rules initially require only limited assurance over GHG disclosures, and, for many smaller companies, reasonable assurance will never be required. See SEC Adopts Landmark Climate Change Disclosure Rules, March 2024 Update. In contrast, under PCAOB standards, an auditor's opinion on financial

statements must provide "reasonable assurance" that the statements are fairly presented in conformity with GAAP.

In Managing Expectations: How Assurance Level and Sustainability Reporting Approach Affect Investor and Auditor Confidence, Lori Shefchik Bhaskar (Indiana University), Jeffrey Hales (University of Texas at Austin and a member of the International Sustainability Standards Board), Tamara A. Lambert (Lehigh University), and Roshan K. Sinha (Indiana University) explore how the choice between reasonable and limited assurance) affects nonprofessional investor confidence in sustainability information. They find "significant expectation gaps" and that "investors fail to sufficiently adjust for the lower level of assurance that a limited-assurance engagement provides."

In simplified terms, the approach of the Managing Expectations study was to ask two sets of participants to review an ESG disclosure regarding water management and an independent auditor's report on that disclosure. One group of participants – the proxies for investors – consisted of 117 MBA students. The second group consisted of 110 large firm auditors with ESG experience. The researchers varied the disclosures participants reviewed in two respects. First, they described the company's approach to disclosure as either investor-oriented or broad-stakeholder oriented (i.e., the company's disclosure objective was either to provide information specifically relevant to investors or to provide information relevant to a broader range of stakeholders). Second, the auditor's report on the disclosure provided either reasonable assurance or limited assurance.

The researchers measured the level of confidence participants reported in the various disclosures. They also calculated the difference between the confidence levels reported by experienced auditors – who are presumably familiar with the difference between reasonable assurance and limited assurance engagements – and those reported by the more generalist MBA students.

The core finding of the study is that, while investors understand that there is a difference between reasonable and limited assurance, they overestimate the value of limited assurance:

> "Consistent with our predictions, results reveal investor confidence depends on assurance type, such that investors differentiate limited from reasonable assurance. However, results also reveal significant expectation gaps between investors and auditors, with investor confidence being significantly higher than auditor confidence for sustainability disclosures with limited assurance. Interestingly, the expectation gap is avoided entirely for sustainability disclosures with reasonable assurance. Thus, our results highlight an area of concern related to companies obtaining limited assurance on sustainability disclosures and suggest reasonable assurance as one potential solution. Alternatively, while limited assurance remains a popular choice, and is already mandated for some sustainability disclosures, our study highlights the need to better inform investors about the meaning and limitations of limited assurance."

Ceres and others have argued that the use of limited assurance reports on sustainability disclosures should be curtailed in favor of reasonable assurance. See Ceres Advocates Climate Disclosure Reasonable Assurance, March 2024 Update. Managing Expectations lends support to those arguments:

> "[O]ur finding that the expectation gap can be fully alleviated with reasonable assurance gives credence to investors' and audit firms' calls for reasonable assurance on sustainability disclosures * * *. In the absence of reasonable assurance, our findings highlight the need to better inform investors on how to interpret limited assurance. * * *"

Audit committees may want to consider the findings of this study when discussing with sustainability assurance providers the level of assurance they will provide.

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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