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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

Update No. 102
August 2025

This Update summarizes recent developments relating to public company audit committees and their oversight of financial reporting and the company's relationship with its auditor.

In This Update

PCAOB Suggests What Auditors Should Ask Before Accepting an Engagement

The Public Company Accounting Oversight Board has issued Engagement Acceptance, a publication in the Board's Audit Focus series. Engagement Acceptance highlights reminders and considerations

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related to engagement acceptance and suggests questions that an auditor should ask before accepting an engagement. Although the PCAOB prepared Engagement Acceptance as guidance for auditors, particularly those who audit smaller public companies or brokers and dealers, audit committees may also want to review the paper. Audit firms may ask the audit committee to respond to the questions the PCAOB suggests when the company is seeking to engage a new auditor, and the committee should be prepared to respond.

The PCAOB's auditing and quality control standards contain various requirements related to engagement acceptance. The new quality control standard, QC 1000, which will take effect on December 15, 2025, requires the auditor to consider the nature and circumstances of the potential engagement and to make appropriate judgments about the associated risks and the audit firm's ability to perform the engagement under applicable professional and legal requirements. In addition, AS 2610 requires a successor auditor to make certain inquiries of the predecessor auditor. AS 1301, the standard governing communications with audit committees, states that the auditor should discuss with the audit committee any significant issues that the auditor discussed with management in connection with the auditor's appointment. The PCAOB's suggested auditor questions and considerations reflect the requirements of these standards.

Some of the questions that Engagement Acceptance suggests that auditors explore before accepting an engagement involve the potential client's audit committee or might be posed to the audit committee. These include:

- Were there any recent changes in ownership, company management, the board of directors, or the composition of the audit committee related to the prospective engagement? What were the reasons for the changes?

- What are the qualifications of the company's current management team and the audit committee associated with the prospective engagement, and do these qualifications enable them to execute their roles and responsibilities effectively?

- Were there any risk factors that indicate that company management and those charged with governance lack integrity?

- Was the company's management or audit committee aware of any improper activities conducted by the former auditor during interim reviews or annual audits, including activities related to the supervision of the audit or to the engagement quality review?

- Was the company's management or audit committee aware of any illegal acts identified by the predecessor auditor and not reported to the U.S. Securities and Exchange Commission (SEC or "Commission") or any other relevant regulators?

Audit committees should also be aware of the questions that the PCAOB suggests a successor auditor ask of the predecessor auditor. Questions that may bear on the audit committee's role include:

- Is there information that might bear on the integrity of management?

- Did the predecessor auditor have any disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters?

- What communications were made between the predecessor auditor and the audit committee (or others with equivalent authority and responsibility), regarding fraud, illegal acts by clients, and internal-control-related matters?

- What is the predecessor auditor's understanding as to the reason for the change of auditors?

- What is the predecessor auditor's understanding of the nature of the company's relationships and transactions with related parties and significant unusual transactions?

Audit Committee Takeaways

As noted above, Engagement Acceptance is a useful resource for audit committees when selecting a new auditor. Committees naturally tend to focus on the questions that they plan to ask prospective audit firms. It is, however, useful to also reflect on what the auditor candidates may ask the committee and to be prepared with cogent and informative answers.

Audit committees might also find these questions helpful from another perspective. Any sophisticated auditor would likely seek to explore the issues raised in the PCAOB's suggested questions before accepting an engagement. Moreover, the PCAOB's standards require some of the inquiries. If candidates do not ask these or comparable questions, the audit committee may view that as a red flag concerning the auditor's competence.

AFC Reports on the Financial Reporting Fraud Enforcement Landscape

The Anti-Fraud Collaboration (AFC), a group consisting of the Center for Audit Quality, the Financial Executives International, the Institute of Internal Auditors, the National Association of Corporate Directors, and the Association of Certified Fraud Examiners, has released A Comprehensive Analysis of PCAOB and SEC Enforcement Actions: Key Themes and Lessons Learned. The objective of the AFC study is "to shed light on what future enforcement priorities might look like and provide key observations for issuers, auditors, and other stakeholder groups on how to strengthen their compliance and anti-fraud programs and practices in an environment of uncertain and challenging market conditions, and regulatory and political developments." AFC believes that its analysis will be "valuable to members of the financial reporting ecosystem (boards of directors, audit committees, financial management, internal auditors, and external auditors) as well as regulators, anti-fraud professionals, investors, customers, extended enterprises, service organizations, and other stakeholders."

AFC's report, prepared with the assistance of law firm King & Spalding and consulting firm Ankura, analyzes 148 PCAOB settled disciplinary orders and 255 SEC accounting and auditing enforcement actions brought between January 1, 2021, and December 31, 2024. Based on this review, AFC identifies four key enforcement trends and regulatory insights related to the financial reporting environment:

- Revenue recognition continues to be a focus area for regulators due to its significance to investors and susceptibility to fraud. The SEC has consistently demonstrated a commitment to holding public company executives accountable for their role in perpetrating revenue recognition schemes.

- There has been an increasing trend for PCAOB enforcement actions to arise from inconsistent accounting practices after merger and acquisition activity. In contrast, SEC enforcement actions arising from post-M&A accounting issues have decreased.

- Both the PCAOB and SEC have brought enforcement actions against audit firms and auditors based on matters related to professional integrity. Both agencies have imposed heavy monetary fines in these types of cases.

- The PCAOB and SEC have increased the use of sweeps to bring compliance-oriented enforcement actions. The AFC defines a sweep as a coordinated effort "to investigate multiple targets regarding a specific area of concern or violation." Sweeps have been employed for such matters as audit committee communication violations and violations of PCAOB disclosure and filing requirements.

Overview of PCAOB and SEC Enforcement Actions

By most of the measures AFC tracked, SEC and PCAOB financial reporting enforcement increased between 2021 and 2024. For example, in 2021, the SEC and PCAOB brought a combined 67 actions involving financial reporting or auditor-related issues. In 2024, the combined total was 99 such actions – almost a 50 percent increase. The PCAOB accounted for most of this growth – total PCAOB enforcement actions rose from 19 in 2021 to 48 in 2024.

While PCAOB enforcement actions increased steadily over the four years AFC studied, the SEC's record was lumpier. In 2021, the SEC alleged 21 financial reporting violations--eleven cases in which it charged revenue recognition violations, nine cases in which it charged financial reporting disclosure violations, and one case involving an impairment issue. In 2022, total SEC actions rose to 43 (24 revenue recognition charges, 14 disclosure violations, four impairment cases, and one non-GAAP reporting violation). But, in 2024, SEC financial reporting cases were back to nearly the same level as in 2021 – 23 total cases (revenue recognition -- 11, disclosure – 10, and impairment – 2). (In these figures, a single enforcement action may include more than one violation category.)

The PCAOB can only bring cases against audit firms and individuals associated with those firms. In contrast, the SEC can charge public companies and their executives, as well as audit firms and auditors. AFC's analysis shows that the SEC has used its authority to charge executives in financial reporting cases aggressively. Between 2021 and 2024, the SEC charged a total of 159 executives in these types of actions. It also charged 137 public companies, 24 accounting firms, and 51 individual auditors. Regarding company officials, AFC observes:

> "In SEC enforcement actions, violations often involve someone at a company (e.g., management) directing misconduct, being aware of misconduct but not doing anything to resolve it, or being unaware of misconduct they should have known about. * * * . For example, if the Chief Executive Officer (CEO) of a company directs its employees to engage in misconduct that results in an enforcement action, the CEO is likely to be charged individually or along with the issuer. Separately, Chief Financial Officers (CFOs) often appear to have a crucial role in enforcement actions as well because they are responsible for certifying the company's financial statements: that is, if they are aware of any potential misconduct or should have been aware of it, they may also be found liable."

Revenue Recognition and Executive Accountability

Actions involving revenue recognition violations were a major part of the SEC and PCAOB enforcement agendas during the years AFC reviewed. Of the 148 settled PCAOB disciplinary orders between January 1, 2021, and December 31, 2024, approximately 27 percent of respondents allegedly violated auditing standards related to improper accounting for revenue and related accounts. Of the 255 SEC enforcement cases involving public companies, executives, audit firms, and auditors during the period, approximately 33 percent of the actions against auditors involved revenue recognition.

Consistent with its general focus on individual culpability in financial reporting cases, the SEC frequently held executives accountable for their role in revenue recognition violations. During the review period, more than 50 enforcement actions involved executive liability for revenue recognition schemes.

Merger and Acquisition Activity

During the past four years, PCAOB cases arising from post-M&A accounting practices (e.g., goodwill, intangibles, and business combinations) have increased. In contrast, after peaking in 2022, SEC M&A-related financial reporting cases declined.

Between January 1, 2021, and December 31, 2024, the PCAOB published 16 settled orders related to violations involving audit procedures over M&A activity (2021 – 4 cases, 2022 – 2 cases, 2023 – 4 cases, 2024 – 6 cases). Twelve of the cases are related to acquisition accounting and four to goodwill/intangible valuations. AFC states: “These orders demonstrate that the PCAOB is increasingly focused on inadequate audit of management’s accounting for an acquisition or other strategic transaction, and/or insufficient audit procedures with a lack of audit evidence to support valuations.”

From 2021 to 2024, the SEC brought 43 financial reporting cases arising from M&A activity (2021 – 9 cases, 2022 – 18 cases, 2023 – 11 cases, 2024 – 5 cases). These cases addressed such matters as internal control deficiencies and improper goodwill valuations uncovered after an M&A transaction and false or misleading statements in connection with business combinations.

Integrity and Answer Sharing Cases

Both the PCAOB and SEC brought a series of enforcement actions against audit firms and auditors in matters related to inappropriate answer sharing on internal training or other exams. These professional integrity-related matters resulted in substantial fines. For example, in 2022, the SEC imposed a $100 million fine against the U.S. member of a global network firm based on allegations that audit professionals had cheated on the ethics section of the CPA exam and on continuing professional education courses required for maintaining their CPA licenses. AFC observes: “Both regulatory agencies’ enforcement actions underscore their commitment to focusing on audit firms’ overall culture and quality control systems when auditors and audit firms do not meet regulatory expectations. By addressing misconduct that extends beyond the scope of audit work, these agencies have emphasized the expectation that auditors consistently uphold the highest standards of integrity.”

Sweeps and Other Compliance Matters

The PCAOB and SEC have increased their use of sweeps – “coordinated efforts by regulatory agencies to investigate multiple targets regarding a specific area of concern or violation, to bring compliance-oriented enforcement actions.” For example, the PCAOB has employed sweeps to detect and prosecute audit firm failures to make required audit committee communications. During the review period, actions charging violations of the PCAOB’s audit committee communications requirements increased each year from two in 2021 to 15 in 2024.

With the change in SEC leadership and impending changes at the PCAOB, sweeps may become rarer. AFC predicts that “the regulatory environment will revert to relying on the inspection processes in addressing cases of noncompliance that do not directly affect financial reporting.”

Other Matters on the Horizon

AFC also discusses four matters that could impact financial reporting enforcement in the future:

- Continued rise in the merger and acquisition of accounting firms. Private equity investment in small and mid-sized accounting firms is becoming commonplace. “[A]udit firms looking to consolidate through mergers or acquisitions in the coming years should continue to focus on applying appropriate safeguards to ensure audit quality is not negatively affected through this process.”

- New and updated auditing standards. The PCAOB has “exponentially updated its standards” since 2021. Some of these changes significantly affect audit firms on a business and an engagement team level. For example, the Board’s new quality control standard, QC 1000, expands both firm and individual responsibilities for quality control and supervision. The PCAOB also lowered the standard for individual liability for contributing to a violation from recklessness to negligence.

- Imposition of new tariffs. New tariffs are causing significant market volatility, and companies may respond by seeking to reduce costs, including by changes in their supply chain or logistics agreements. Such measures heighten audit risk.

- Legal challenges. There are ongoing challenges to the nature and scope of the SEC's and the PCAOB's enforcement authority. The resolution of these matters may affect future enforcement responses to accounting and auditing violations.

Audit Committee Takeaways

AFC's analysis provides insight into how the SEC and PCAOB approached their financial reporting enforcement responsibilities during the past four years. However, within the last few months, both SEC and PCAOB leadership have changed. (See SEC Begins to Shakeup the PCAOB in this Update and Paul Atkins Takes the Wheel at the SEC, May 2025 Update).

As the Update observed in SEC Accounting and Auditing Enforcement Slumped in 2024, While PCAOB Enforcement Hit a New High, March-April 2025 Update, audit committees should not assume that a more business-friendly regulatory climate and a less aggressive enforcement philosophy at the SEC and PCAOB will result in reduced scrutiny of public company financial reporting. Despite year-to-year fluctuations, accounting and auditing enforcement are perennial SEC priorities. That focus may increase under the new SEC administration, since a back-to-basics approach to enforcement is likely to result in more, not fewer, accounting and financial disclosure cases. The same may be true of PCAOB actions against auditors, although the future direction of PCAOB enforcement is harder to predict because of uncertainty concerning both who will be leading the Board and because of the constitutional questions that overhang the PCAOB's enforcement program.

A significant finding of the AFC study is the emphasis that the regulators place on individual culpability in financial reporting cases. The theme of individual responsibility tends to be constant across SEC administrations. The risk that restatements, internal control material weaknesses, and other accounting-related problems will result in SEC enforcement action against the individuals involved, along with or instead of the reporting company, is likely to remain elevated.

PwC Offers Ideas for Audit Committee Priorities

Q2 Audit Committee Guide, a new publication from PwC's Governance Insights Center, discusses nine topics that audit committees should consider as they prepare their agendas for the balance of 2025. PwC describes this paper as "[e}verything you need to walk into your next audit committee meeting with confidence" and as a guide to help "streamline meeting prep, prioritize agenda items, and plan for the future." For each of the nine topics covered, PwC discusses what the audit committee needs to know, why the topic is relevant to the audit committee, and what questions the audit committee should ask. Below is an overview of each topic, along with an example of a suggested question related to that topic.

1. US Tax Policy – H.R. 1: "One Big Beautiful Bill Act".

Companies will face accounting and financial reporting challenges because of tax law changes. Examples include changes to deferred tax assets and liabilities, changes to projected tax payments, changes to valuation allowances, and disclosure of the estimated impact of proposed tax legislation. The audit committee should confirm that management has processes to monitor tax developments and is prepared to account for the impact of tax law changes appropriately.

Sample question: What is management's process for assessing resource needs, including specialist knowledge and adequacy of the technology, to support the finance and tax teams' data and reporting needs?

2. Accounting for market/geopolitical uncertainty.

Macroeconomic and geopolitical uncertainty and volatility characterize the current environment. Audit committees need to understand how these factors impact accounting estimates, internal controls, and financial disclosures.

Sample question: What is management’s process for evaluating how market uncertainties might affect inventory valuation? Are there risks of inventory obsolescence or write-downs due to increased costs?

3. Audit committee oversight of artificial intelligence.

“As companies begin to evaluate and use AI in the financial reporting process, audit committees will want to understand where, why and how management is using it and verify that appropriate controls and processes are in place to manage unique AI-related risks.”

Sample question: How are AI models tested for accuracy, completeness, reliability, data bias, and other risks prior to and after deployment?

4. Adding special topics and deep dives to the agenda.

PwC suggests that audit committees consider “deep-dive sessions” at which management provides a comprehensive update on a key oversight area. Deep dives may also include presentations from external experts or experiential sessions, like tabletop exercises. Areas that PwC suggests for these sessions include internal controls and risk management, tax matters, regulatory and compliance matters, fraud risk and ethics compliance, litigation and legal matters, vendor management, and technology transformation.

Sample question: What is management’s process for identifying and addressing cybersecurity threats?

5. Earnings guidance in an uncertain environment.

“Overseeing earnings guidance is integral to the audit committee’s role in supporting the integrity of financial reporting and safeguarding shareholder value. Therefore, it is essential for audit committees to be aware of how market conditions affect the company’s earnings outlook and the rationale behind any changes to guidance.”

Sample question: What is management’s process for stress-testing financial forecasts against various geopolitical and economic scenarios?

6. Evolving enterprise risk management.

Oversight of the company’s ERM process is typically an audit committee responsibility. ERM is also linked to the committee’s oversight of financial reporting and of internal controls. The audit committee should have a deep understanding of the company’s risk landscape and confirm that the ERM framework is “robust, strategic, and aligned with the company’s goals.”

Sample question: What is management’s process for identifying the company’s top risks, prioritizing them, and developing strategies to mitigate them?

7. Mid-year considerations for internal audit oversight.

Audit committee oversight of internal audit is essential to effective governance. “As companies navigate current economic uncertainties and market volatility, the role of internal audit in providing assurance over areas such as financial reporting and aspects of operations involving important business risks, among others, becomes increasingly critical.”

Sample question: What is the CAE’s process for aligning internal audit’s activities with the organization’s strategic objectives and risk profile?

8. Finance transformation oversight.

Digital technologies, regulatory complexity, and heightened stakeholder expectations are leading to the restructuring of finance functions. “Audit committees are uniquely positioned to guide and oversee these transformation efforts, supporting alignment with strategic objectives and adherence to regulatory requirements as well as making sure the initiative is implemented effectively and responsibly, while safeguarding against potential risks such as data breaches and financial inaccuracies.”

Sample question: How will the transformation impact the company’s compliance with existing and emerging regulatory requirements, and what measures are being contemplated to support ongoing compliance?

9. Recurring items for the audit committee agenda.

PwC recommends that audit committees regularly discuss hotline complaints and code of conduct violations, changes in the regulatory environment, related-party transactions, and internal and external audit plans. In addition, audit committees should hold discussions with the chief information officer, chief information security officer, and general counsel as needed.

Audit Committee Takeaways

PwC’s paper is a good overview of current issues that most audit committees are facing. Committees may want to review and consider PwC’s suggestions to make sure they focus on the relevant issues. Along with its suggested questions, PwC’s discussion of why the various topics listed are important to audit committees may provide useful insight for committees that are structuring their agendas for the balance of 2025.

KPMG: What Audit Committees Should Know About Tariffs and Financial Reporting

KPMG has released Tariffs Uncertainty: Ask the right financial reporting questions. The paper, which KPMG describes as “a briefing prepared for audit committee members,” includes summaries of key areas of financial reporting that tariffs may affect and questions related to each area. In KPMG’s view, “The financial reporting, accounting, and disclosure obligations posed by the current geopolitical, macro-economic and risk landscape -- including tariffs uncertainty -- are a top priority and major undertaking for audit committees in 2025.”

The paper begins by emphasizing the pervasive impact of tariffs on financial reporting:

> “Both revenue and cost of goods sold may be affected, and contract modifications can involve either suppliers or customers. Assets may be impaired, debt arrangements may be modified and covenant relief may be sought. In some cases, there may be doubt about a company's ability to continue as a going concern. And strategic decisions may give rise to restructuring and asset disposals.”

KPMG also observes that “Every business implication of tariffs uncertainty – throughout the value chain – has a ripple effect on the company’s financial reporting.”

KPMG’s discussion focuses on nine areas in which tariffs may have financial reporting impacts. For each area, KPMG discusses the potential financial reporting issues and the related business considerations. Below are these nine areas, along with a summary of the financial reporting implications KPMG describes in each area and a sample of the questions that KPMG recommends audit committees consider.

Inventory costs and impairment risk.

Tariffs incurred to import an inventory asset increase the item’s cost basis. Inventory is impaired if its cost (including tariff costs) exceeds its realizable value or market value.

- What are the judgments and risks involved in the tariff positions and strategies taken by the company?
- How will product margins be affected by tariffs?
- Can and will selling prices be raised on affected products?
- Does the company have firm purchase commitments?

The myriad effects on revenue.

Tariff-related increases in sales prices increase revenue, while the tariffs increase cost of sales. Tariffs cannot be netted against revenue, even if shown on the customer’s invoice. Increased selling prices, as well as the overall macroeconomic environment, may increase collection risk, which may in turn affect the amount and timing of revenue recognition.

- Does the company have an enforceable right to pass along the cost of tariffs to customers?
- Is there price concession or collectability risk?
- What are the effects of tariffs on over-time or long-term revenue contracts?
- Is accounting for new contracts appropriately considering the changes to selling prices, costs, and customer behavior?

Contract modifications as a response.

A contractual modification to increase customer prices “generally results in prospective revenue recognition if the future goods are 'distinct' - even if the contract states that the customer is paying for previously incurred tariffs.” If the future goods are not distinct, a contractual modification that increases the customer's price may be recognized “on a cumulative catch-up basis.”

- Is legal counsel involved in evaluating the contractual rights related to price changes?
- Has the company recognized the benefits of price changes based on estimates before there is an enforceable right?
- Has the company allocated the benefits to the appropriate sales/purchases?

Projected financial information sensitivity.

Projected cash flows are critical to many accounting models. Two areas that rely on cash flow projections to determine market-based valuation are nonfinancial asset impairment testing and going concern assessment.

- Have secondary impacts on the company’s planned tariffs response been considered?
- Has a sensitivity analysis been performed to assess the range of possible outcomes?
- What is the level of documentation of assumptions and significant judgments?

Impairment testing essentials.

If tariffs significantly reduce the expected cash flows of a reporting unit, such as because of decreased demand or margin compression, goodwill may be impaired. Intangible assets like customer relationships and trade names may lose value if management expects growth prospects or financial results to decline.

- Are tariff policies disrupting supply or demand for products?
- How have tariffs impacted the company’s suppliers and customers?
- Is financial performance declining or expected to decline?
- Does the company have any development projects impacted by tariffs?

Financing implications.

Debt is modifications, or exchanges for new debt with the same lender, raise accounting complexities. Different accounting models apply to a troubled debt restructuring versus other debt modifications.

- Are debt agreements expected to be modified?
- Has debt covenant compliance been projected under revised forecasts?
- Is additional borrowing or refinancing required to support near-term liquidity?
- Has a sensitivity analysis been performed to assess the level of risk of a going concern issue?

Consequential operational changes.

“Restructuring efforts may give rise to severance obligations, contract termination costs. relocation expenses and other restructuring charges. There are separate accounting requirements for lease reassessments, modifications, and terminations -- as well as specific impairment testing requirements. Some of these requirements may result in a loss being recognized.”

- Are agreements being terminated early?
- Have plans been made to abandon assets?
- Will changes be made to the company’s workforce?
- Are any assets or businesses being disposed of?

Disclosure matters.

KPMG reports that 94 percent of Form 10-Q filings analyzed between April 1 and June 2 discussed tariff-related matters. These disclosures appeared in MD&A (69 percent), Risk factors (18 percent), Notes to the financial statements (7 percent), and elsewhere in the filing (6 percent).

- Are disclosures about estimation uncertainties and the underlying basis for critical judgments adequate?
- Are disclosures company-specific rather than boilerplate?
- Are there certain risks, which may have previously been discussed hypothetically, that should be framed differently amid tariffs uncertainty?

Risk assessment reminders.

Both management and the auditor need to understand how risks and uncertainties impact the financial reporting process.

- Which executives are responsible for identifying material financial, liquidity, and operating risks?
- How is management identifying and mitigating these risks?
- Does management have an incident response plan?

Audit Committee Takeaways

As KPMG notes, the financial reporting, accounting, and disclosure issues arising from uncertainty regarding tariffs is a top priority for many audit committees. KPMG's paper provides a comprehensive overview of the issues audit committees may need to grapple with in the rapidly changing tariff environment. KPMG's suggested questions would be a good starting point for exploring these issues with management. Audit committees with an interest in this topic may also want to review BDO's discussion of tariff-related reporting and disclosure issues and suggested questions. See BDO on Financial Reporting Implications of Tariffs and Questions Audit Committees Should Ask, March-April 2025 Update.

On the Update Radar: Things in Brief

The SEC Begins to Shake Up the PCAOB. As discussed in The PCAOB Dodges the Bullet, June-July 2025 Update, legislation to merge the PCAOB into the SEC as part of the 2025 federal budget reconciliation bill failed when the Senate Parliamentarian ruled that abolishing the PCAOB was not a proper subject for budget reconciliation under the Senate's rules. With a merger off the table for now, the SEC has begun to take steps to remake the PCAOB.

On July 15, SEC Chair Paul Atkins stated that he had accepted Erica Williams's offer to resign as Chair and as a PCAOB board member, effective July 22. It appears that Chair Atkins requested Ms. Williams's resignation. On July 21, the SEC announced that it had designated George Botic to serve as acting PCAOB chair following Chair Williams's departure. Mr. Botic, a CPA, became a PCAOB Board member on October 25, 2023. Before joining the Board, he served as the Director of the PCAOB's Division of Registration and Inspections.

On July 23, Chair Atkins issued a statement soliciting candidates for all five PCAOB Board positions, including the Chair. In that statement, he signaled that the SEC is likely to cut the Board's budget and that Board member compensation may be reduced:

> "* * * I note that over the last several years, the PCAOB's annual budget has increased at a rate significantly faster than that of the Commission. This increase took place over a period in which the Board's mission did not change materially. Under the Act, the Board's budget is subject to Commission approval. The Commission's review of the PCAOB's annual budget is an important element of the Commission's oversight of the Board, and I expect that an evaluation of Board member compensation will be among the items the Commission considers in connection with its review of the Board's 2026 budget."

Currently, the annual salary of the PCAOB Chair is $672,676, while the other four PCAOB board members earn $546,891. For comparison, the SEC Chair's annual salary is $225,700, and the other four Commissioners receive $207,500.

The request for Chair Williams's resignation and the SEC's intention to replace the remaining PCAOB members is not a surprise. The same sort of Board-level housecleaning occurred in both the first Trump Administration and in the Biden Administration. See [SEC Removes the Chair and Plans to Clean House at the PCAOB](), [May-June 2021 Update](). More unusual is Chair Atkins's warning that new Board members should not necessarily expect to receive the current $540,00-plus annual salaries. Uncertainty about Board member compensation may, of course, affect who decides to apply.

Persons interested in appointment to the PCAOB should submit a letter discussing their qualifications and a resume to the SEC by August 25, 2025.

PCAOB Releases Part II of BDO's 2019 Inspection Report. On July 23, the Public Company Accounting Oversight Board released previously nonpublic portions of BDO USA's 2019 inspection report. Board criticisms of a firm's quality control system appear in Part II of its inspection report, and, under the Sarbanes-Oxley Act, Part II is nonpublic when the report is issued. If the firm does not, in the PCAOB's view, satisfactorily address a quality control criticism within 12 months of the report date, the Board makes the criticism public.

The now-public quality control criticisms in BDO's 2019 inspection report relate to five aspects of the firm's system of quality control:

- Application of Professional Skepticism. The PCAOB states that "the firm's system of quality control does not provide reasonable assurance that the firm's personnel will appropriately exercise the professional skepticism required by PCAOB standards in the performance of issuer audits." In the inspection, the PCAOB staff found deficiencies in five audits that "appeared to have been caused, at least in part, by the firm's personnel not appropriately exercising professional skepticism."

- Testing Controls. The inspection results indicated that BDO's system of quality control does not provide reasonable assurance that the work performed by the firm's personnel with respect to testing controls will meet the requirements of the Board's auditing standards. The inspection team identified deficiencies in the firm's control testing in three areas: Identifying and testing controls that address risks of material misstatement, testing controls that include a review element, and identifying and testing controls over the accuracy and completeness of data or reports.

- Supervision of the Audit. The 2019 inspection results indicated that BDO's quality control system did not provide reasonable assurance that "the supervisory activities, including reviews of audit work, performed by the firm's engagement partners will meet the requirements of AS 1201, Supervision of the Audit Engagement. In nine audits, the inspection team "identified one or more deficiencies that the engagement partner should have identified and appropriately addressed but did not."

- Engagement Quality Review. The inspection results indicated that BDO's system of quality control did not provide reasonable assurance that engagement quality review ("EQR") partners would perform the procedures required by the Board's EQR standard. In six audits, the inspection team identified one or more deficiencies in an area that the standard required the EQR partner to evaluate.

- Policies for Financial Holdings Disclosures. The 2019 inspection report states that BDO's system of quality control did not provide reasonable assurance that firm personnel comply with BDO's policies and procedures concerning independence-related regulatory requirements. BDO conducts periodic audits of a sample of its personnel to monitor compliance with firm independence policies. In reviews BDO conducted during the nine months ending June 30, 2019, the firm found that 35 percent of partners and 26 percent of managers and directors it audited had not reported financial relationships that firm policies required them to report.

The date of BDO's 2019 inspection report is December 17, 2020. Therefore, the PCAOB's disclosure of the above-described portions of the 2019 report indicates that BDO failed to persuade the PCAOB that, as of December 17, 2021, it had satisfactorily remediated the deficiencies.

These quality control deficiencies appear to be chronic challenges for BDO. Except for the criticism regarding financial holding disclosures, the quality control deficiencies that the PCAOB found in its 2019 inspection of BDO and has now made public are similar to deficiencies that the Board identified and discussed in its 2018 and 2017 BDO inspections. The PCAOB has previously made those deficiencies public because BDO failed to remediate them in response to the earlier inspections.

Audit committees of BDO clients may want to discuss with their engagement partner how the firm is addressing these matters, changes it has made since the PCAOB's determination that the firm had not remediated the deficiencies, and whether the deficiencies might have affected the company's audit.

COSO Withdraws its Corporate Governance Framework. On July 16, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) withdrew its draft Corporate Governance Framework (CGF) from public comment. As discussed in COSO Unveils its Corporate Governance Framework, June-July 2025 Update, COSO intended the CGF to provide "principles-based guidance for organizations to establish and strengthen governance practices, starting in the board-room and cascading throughout the enterprise." COSO released the CGF for comment on May 27.

COSO's press release announcing the withdrawal states that the decision to pull the plug on the current version of the CGF was made in collaboration with the National Association of Corporate Directors (NACD) and "comes amid a shifting regulatory and economic landscape for U.S. businesses and follows the recent passage of a wide-ranging federal law that introduces significant changes to corporate reporting and planning requirements." The "wide-ranging federal law" appears to be the 2025 budget reconciliation bill (the One Big Beautiful Bill Act), although that legislation does not directly change corporate reporting requirements. The release adds that, in light of these develop-ments, "COSO and NACD recognize the importance of ensuring that any revised draft framework aligns with the existing requirements and evolving expectations placed on public companies."

The comments COSO received on the CGF are not public, and the press release does not discuss their content, although it implies that many comments were negative. COSO says that it will take the views it received into account in preparing a revised CGF draft: "COSO and NACD will continue to work closely with key constituencies and thank them for their extensive feedback and collaboration. COSO looks forward to reintroducing a refined draft of the Corporate Governance Framework at a future date."

GAO Finds that SOX Costs are Proportionally Higher for Smaller Companies. The Government Accountability Office (GAO) has issued a report on the costs of compliance with Section 404 of the Sarbanes-Oxley Act (SOX). In Sarbanes-Oxley Act: Compliance Costs Are Higher for Larger Companies, GAO found that compliance costs are higher for larger companies but proportionally more burdensome for smaller ones.

SOX Section 404 imposes two requirements on public companies. Section 404(a) requires management to annually assess the effectiveness of internal control over financial reporting (ICFR) and to report their assessment in an SEC filing. Section 404(b) requires the company to obtain and file an annual ICFR assessment from the company's independent auditor. All public companies must comply with the management assessment requirement in Section 404(a). Only companies with a public float (i.e., market value of shares held by public investors) of $700 million or more, or a public float of $75 million or more and $100 million or more in annual revenue, must obtain a Section 404(b) auditor attestation. Emerging growth companies (companies with less than $1.235 billion in annual revenue that also meet certain other criteria) or also exempt from Section 404(b).

GAO prepared the study at the request of the Chair of the Subcommittee on Capital Markets of the House Committee on Financial Services. The Subcommittee asked GAO to review the costs and other effects of SOX, particularly ICFR reporting, as part of Congress's consideration of reforms to stimulate initial public offerings. The study could therefore influence the possibility of legislation making further changes to the scope of the Section 404(b) auditor attestation requirement.

GAO's report examines three issues: (1) compliance costs associated with Section 404, (2) the effects of the exemptions from Section 404(b) auditor ICFR attestation on fraud risks and the reliability of financial information, and (3) other effects of the Section 404(b) exemption on companies and investors.

<u>Compliance Costs</u>

GAO found that larger companies spend more on SOX compliance, but smaller companies spend a higher proportion of their assets on SOX compliance:

> "Larger (nonexempt) companies generally incurred higher overall Sarbanes-Oxley compliance costs, but these costs were proportionally more burdensome for smaller (exempt) companies. Nonexempt companies (generally those with $75 million or more in publicly held shares or companies not qualifying as emerging growth companies) had higher costs (19 percent) than their exempt counterparts, according to GAO's analysis of a nongeneralizable sample of 96 companies."

Moreover, for a company that is exempt from the auditor ICFR attestation requirement, the transition to full Section 404 compliance is expensive:

> "Companies generally experienced increased audit costs when they transitioned from exempt to nonexempt status (became subject to auditor attestation because their public float or revenues grew above exemption thresholds). Audits of nonexempt companies involve more work because the incremental auditing standards that apply to them require more planning, control testing, and quality review. GAO's analysis found a median increase of $219,000 (13 percent) in audit fees in the year a company became nonexempt. Audit fees generally leveled off in the year after transition." (GAO's analysis found a $47,000 median audit fee increase in the year following transition.)

<u>Auditor ICFR Attestation Exemption and Fraud Risk</u>

Based on a review of other studies, GAO observes that companies that announced financial statement restatements tended to have weak ICFR or be smaller. GAO's analysis of one hundred restatements in 2022 and 2023 found that 41 of 56 Section 404(b)-exempt companies (73 percent) that restated cited both ineffective ICFR and material weaknesses, compared to 26 of 44 nonexempt companies (59 percent). Weak internal controls are, in turn, also associated with fraud. GAO states, "Our analysis of a sample of 55 SEC enforcement cases involving accounting violations announced in 2022 and 2023 found 47 involved weak or insufficient internal controls, or materially misleading statements. Of those, 37 cases were fraud-related violations."

<u>Other Effects of the Auditor ICFR Attestation Exemption</u>

Apart from the issue of increased restatement risk, GAO found both positive and negative effects of the Section 404(b) exemption from auditor attestation.

- <u>Investment in Business Development and Growth</u>. "Several studies we reviewed identified cost savings from not paying audit fees [for ICFR attestation] as a key measurable benefit of the exemption. For example, one study found that following the passage of the JOBS Act, reduced compliance costs allowed companies to invest more in research and development and innovation. Another study reported that relaxed disclosure requirements helped emerging growth companies save money and other resources that otherwise would be needed to prepare documents. A separate study noted that the exemption freed up management and employee time that otherwise would have been spent with auditors." (footnotes omitted)

- Reduced Investor Confidence in Their Financial Reporting. Auditor ICFR attestation has a positive impact on investor confidence because it is "viewed as providing reasonable assurance about the effectiveness of companies' internal controls and the reliability of their financial reporting, as demonstrated by fewer restatements." Further, "diminished disclosures associated with the exemption" increases information asymmetry between company management and investors, which, in turn, can increase the cost of capital.

- Effect on the Number of IPOs. In 2012, the Jumpstart Our Business Startups Act (JOBS Act) expanded the exemption from auditor ICFR attestation and created the emerging growth company category. GAO concludes that it is unclear whether the JOBS Act had any impact on the number of initial public offerings (IPOs). Some studies indicate the JOBS Act increased IPOs by lowering the costs of going public and operating as a public company. GAO notes, however, that the JOBS Act included other reforms and that the studies GAO reviewed "did not pinpoint which JOBS Act provisions influenced the decision to go public." In addition, non-regulatory factors, such as market volatility, overall economic conditions, and alternative mechanisms for raising capital, can affect a company's decision to go public.

GAO's findings are generally consistent with other studies of Section 404 compliance costs. See Protiviti Reports that SOX Compliance Costs Continue to Rise, June-July 2022 Update. Indeed, much of GAO's report is based on prior studies, such as Protiviti's.

Can You Spell Your Audit Partner's First Name? The Answer May Affect Earnings. An academic study that will appear in a forthcoming issue of Contemporary Accounting Research finds that audit partners with individualistic personalities are more likely to allow their clients flexibility in making accounting choices and that, as a result, the comparability of their clients' earnings is decreased. To measure individuality, the researchers looked at whether the partner had an uncommon first name. In Does Audit Partner Individualism Reduce Client Earnings Comparability? Evidence from the United States, Young Hong Kim (George Mason University), Yinghua Li (Arizona State University), and Dechan Wang (Texas A&M University) conclude:

> "We find that two companies report less comparable earnings when one is audited by a partner with an uncommon name and the other is audited by a partner with a common name relative to two companies each audited by a partner with a common name. This finding suggests that audit partner individualism is associated with lower earnings comparability. In addition, we find that the negative relation between partner individualism and comparability is more salient for more confident audit partners and less salient under stronger regulatory monitoring by the PCAOB and the SEC and for more important clients."

Other researchers have found that uncommon first names are a proxy for individualism because people with uncommon names are more likely to view themselves as independent and self-reliant, and to prefer personal freedom over regulations and social norms. Based on that prior research, Professors Kim, Li, and Wang define an individualistic audit partner as one with a first name outside the national top 50 frequent first names (by gender) in Social Security Administration data from 1950 through 1990. The authors state that individualism "cultivates independence, autonomy, freedom of action, self-fulfillment, and rights over duties" and that partners with uncommon first names are less likely to follow rules and more likely to trust their judgment.

> "Thus, we conjecture that, when interpreting firm-wide policies, individualistic audit partners tend to rely more on their own judgment and expertise rather than seeking consensus or strictly

> adhering to rules. As such, we hypothesize that individualistic audit partners are more likely to prioritize their personal interpretation of GAAP and generally accepted auditing standards (GAAS), leading to deviations from firm-wide internal working rules and lowering the earnings comparability of their clients relative to those of non-individualistic peers."

The study also identified factors that may amplify or mitigate the effects of partner individualism. For example, regulatory monitoring, as measured by PCAOB "inspection intensity" or the receipt of an SEC comment letter, reduces the effect of partner individualism on earnings comparability. In addition, partner individualism has less impact on earnings comparability in audits of important clients, since more audit staff and other partners are likely to be involved, and "individualistic partners are more constrained from deviating from internal working rules."

The Audit Blog

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