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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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

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2022 PCAOB Large Firm Inspection Reports

On February 28, the PCAOB released the 2022 inspection reports for the U.S. affiliates of the six global network audit firms. (The version of KPMG's 2022 report that the PCAOB released was not complete in that the Board redacted the discussion of one KPMG engagement.) Overall, the inspection results for these six large firms declined in 2022, compared to 2021 and 2020. While the upward trend in deficiencies is concerning, the 2022 results are not dramatically out of line with the six firms' past performance. Nonetheless, the firms need to consider and address the root causes of the increasing number of inspection deficiencies. The persistent and growing gap between the performance of the firms with the best and worst inspection records is also a troubling aspect of the 2022 reports.

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This post analyzes the 2022 inspection reports of the six global network affiliate firms, compares them to last year's results and to each other, and offers some observations based on the 2022 reports. Audit committees should review their audit firm's inspection report and discuss it with the engagement partner.

Overview of 2022 Results

In 30 percent of the engagements it inspected for these six firms, the PCAOB found one or more Part I.A deficiencies – that is, deficiencies of such significance that it appeared that the firm did not obtain sufficient evidence to support its opinion. (The KPMG redaction does not affect this percentage.) All six firms had a higher percentage of inspected engagements that were deficient than in 2021. For two firms – EY and PwC – the deficiency rate more than doubled from the prior year, although PwC's 2022 deficiency rate remained in the single digits, while almost half of EY's inspected engagements (46 percent) contained a deficiency in 2022. See Tables 1 and 2.

As in the 2020 and 2021 inspection cycles, PwC's results were the best in the group. In 2022, the Board found deficiencies in five out of 54 PwC audits it inspected – 9 percent; in 2021, the Board found deficiencies in two PwC engagements (3 percent) of 56 PwC engagements inspected. Deloitte maintained its second-place position, with nine deficient engagements in its 2022 inspection report (17 percent of 53 engagements inspected). At the other end of the spectrum, BDO, as in 2021, had the highest percentage of deficient engagements – the Board found problems in 19 (66 percent) of the 29 engagements it inspected, up from 53 percent last year.

Another way of looking at a firm's inspection results is to compare the number of auditing standard violations the Board referenced to the number of engagements inspected. See Table 3. Deloitte and PwC were also best-in-class by this metric. For Deloitte, the Board inspected 53 engagements and referenced 16 auditing standards in Part I.A of its report – 0.30 standards per inspected engagement. For PwC, the result was almost the same – 0.35 standards referenced per inspected engagement. In contrast, for BDO and EY the comparable numbers were 4.86 and 2.35 standards per inspected engagement, respectively.

As has been the case for many years, flaws in the audit of internal control over financial reporting (ICFR) were the major cause of deficient audit engagements. Excluding KPMG, inspectors found ICFR audit deficiencies in 28 percent of integrated audits they inspected in 2022, up from 19 percent in the 2021 global network firm inspections. Seventy percent of audit engagements described in Part I.A of the 2022 inspection reports of the five firms for which complete reports were released included an ICFR deficiency. AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements, was the most frequently cited auditing standard by a wide margin. See Table 4.

Inspection reports also include a section (Part I.B) describing instances of non-compliance with PCAOB standards or rules that do not relate directly to the sufficiency or appropriateness of the evidence supporting an audit opinion and a section (Part I.C) describing instances of potential non-compliance with the rules related to auditor independence. The six global network firm 2022 reports include 139 Part I.B deficiencies – a 50 percent increase over 2021. The most common Part I.B finding was the failure of the engagement team to perform procedures to determine whether a matter should have been disclosed in the auditor's report as a critical audit matter (CAM). See Tables 6 and 7. For the six firms as a group, 401 instances of non-compliance with the independence rules were described in Part I.C., of which 392 were firm self-reported. Most of these instances involved a prohibited investment in an audit client, often by someone who was not on the engagement team. In all cases where the firm was the principal auditor, the firm determined that the instance of non-compliance did not impair its objectivity and impartiality. See Tables 8 and 9.

For last year's analysis of the 2021 inspection reports of the six global network member firms, see 2021 PCAOB Large Firm Inspection Reports, January 2023 Update. For the PCAOB staff's summary of all

157 audit firm inspections in 2022, see 2022 PCAOB Inspections Preview Says 40 Percent of Audits Reviewed Had Deficiencies, July 2023 Update.

Impact on Analysis of the KPMG Report Redactions

Because of the redactions from KPMG's report, it is not possible to fully compare its 2022 results to those of the other five firms. However, a fairly complete picture of KPMG's inspection can be deduced from the information available.

Part I.A of the redacted KPMG report describes 15 engagements in which the Board found deficiencies. These 15 engagements are for companies described as Issuer A through Issuer M, Issuer O, and Issuer P. Between the description of Issuer M and the description of Issuer O there is a redaction. It seems clear that the redacted material is the PCAOB's description of the audit of a sixteenth client – Issuer N. The redaction is in the section of the report captioned "Audits With a Single Deficiency." Because the description of Issuer N is omitted, the report also omits a range of information that depends on that description – e.g., the total number of references to specific auditing standards in Part I.A.

Neither the PCAOB nor KPMG have made a public statement concerning the reason for the redactions. However, it seems likely that KPMG has exercised its right under the Sarbanes-Oxley Act to appeal the PCAOB's findings as to Issuer N to the SEC. Under the SEC rule governing appeals of inspection reports, the PCAOB may release the portions of the report that are not subject to the appeal while the appeal is pending. That appears to be what has happened. Presumably, once the appeal is decided, the PCAOB will release a complete KPMG 2022 report that will either include Issuer N and a description of its single deficiency or exclude Issuer N.

If this explanation of the redactions is correct, KPMG's final inspection report will contain either 15 or 16 Part I.A engagements, depending on whether Issuer N is included. Further, since the 15 engagement descriptions in Part I.A of the redacted report contain 41 deficiencies, the final KPMG report will include either 41 or 42 deficiencies. Tables 1 and 3 reflect these alternative possible outcomes.

2022 Firm Inspection Report Synopses

Below is a 2022 inspection report synopsis for each of the six U.S. affiliates of the global network firms:

- BDO USA, LLP. The PCAOB reviewed 29 BDO issuer audits, 19 of which were integrated audits of both the financial statements and ICFR. In 19 of the 29 audits (66 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to BDO's 53 percent deficient engagement rate in 2021. In one of the 19 deficient engagements, the issuer's financial statements were determined to be materially misstated and were subsequently corrected in a restatement. Nine of the 19 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR; nine included only a financial statement audit deficiency; and one included only an ICFR audit deficiency. The PCAOB described 133 audit deficiencies (4.59 deficiencies per inspection) associated with 141 auditing standards (4.86 standards per inspection) in the 19 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 16 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion. In Part I.C., the Board described no instances it had identified of potential non-compliance with independence rules and eight instances that the firm had identified.

- Deloitte & Touche LLP. The PCAOB reviewed 53 Deloitte issuer audits, 37 of which were integrated audits of both the financial statements and ICFR. In nine of the 53 audits (17 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This

compares to D&T's 13 percent deficient engagement rate in 2021. Six of the nine engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR, and three included only a financial statement audit deficiency. The PCAOB described 17 audit deficiencies (0.32 deficiencies per inspection) associated with 16 auditing standards (0.30 standards per inspection) in the nine engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 25 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion. In Part I.C., the Board described no instances it had identified of potential non-compliance with independence rules and 129 instances that the firm had identified.

- Ernst & Young LLP. The PCAOB reviewed 54 EY issuer audits, 47 of which were integrated audits of both the financial statements and ICFR. In 25 of the 54 audits (46 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to EY's 21 percent deficient engagement rate in 2021. Twenty of the 25 engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR, and five included only a financial statement audit deficiency. The PCAOB described 108 audit deficiencies (2.00 deficiencies per inspection) associated with 127 auditing standards (2.35 standards per inspection) in the 25 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 30 instances of non-compliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion. In Part I.C., the Board described no instances it had identified of potential non-compliance with independence rules and 93 instances that the firm had identified.

- Grant Thornton LLP. The PCAOB reviewed 26 Grant issuer audits, 14 of which were integrated audits of both the financial statements and ICFR. In eight of the 26 audits (31 percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to Grant's 23 percent deficient engagement rate in 2021. Five of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR, and three included only a financial statement audit deficiency. The PCAOB described 44 audit deficiencies (1.69 deficiencies per inspection) associated with 46 auditing standards (1.77 standards per inspection) in in the eight engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 38 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion. In Part I.C., the Board described no instances it had identified of potential non-compliance with independence rules and nine instances that the firm had identified.

- KPMG LLP (redacted). The PCAOB reviewed 54 KPMG issuer audits, 43 of which were integrated audits of both the financial statements and ICFR. The number of audits in which the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion is redacted. However, it appears that the final number of Part I.A engagements will be either 15 or 16, representing respectively either 28 percent or 30 percent of the 54 inspected engagements. KPMG's deficient engagement rate in 2021 was 26 percent. In one of the deficient engagements, the issuer's financial statements were determined to be materially misstated and were subsequently corrected in a restatement; the issuer also disclosed material weaknesses in its ICFR. Information concerning the number of engagements in Part I.A related to both the audit of the financial statements and of ICFR, to only the financial statement audit, and to only the ICFR audit is redacted. Because of the redactions, it is also not possible to determine the total number of audit deficiencies or of auditing standards associated with the engagements in Part I.A. However, as explained above, it appears that the final number of Part I.A deficiencies will be either 41 or 42, reflecting either 0.76 or 0.78 deficiencies per inspected engagement. In Part I.B of the inspection report, the PCAOB

identified 23 instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion. In Part I.C., the Board described eight instances it had identified of potential non-compliance with independence rules and 24 instances that the firm had identified.

- PricewaterhouseCoopers LLP. The PCAOB reviewed 54 PwC issuer audits, 47 of which were integrated audits of both the financial statements and ICFR. In five of the 54 audits (nine percent), the PCAOB staff identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. This compares to PwC's four percent deficient engagement rate in 2021. Four of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and of ICFR, and one included only an ICFR audit deficiency. The PCAOB described 19 audit deficiencies (0.35 deficiencies per inspection) associated with 19 auditing standards (0.35 standards per inspection) in the five engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified seven instances of noncompliance with PCAOB standards or rules that did not relate directly to the evidence the firm obtained to support an opinion. In Part I.C., the Board described one instance it had identified of potential non-compliance with independence rules and 129 instances that the firm had identified.

Comparisons of Firm Part I.A Results

Part I.A of a firm's inspection report describes audit deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion on the financial statements and/or ICFR of the public company under audit at the time the opinion was released. Table 1 compares the results of the 2022 inspections of the U.S. affiliates of the six global network firms. Table 2, which appeared in 2021 PCAOB Large Firm Inspection Reports, January 2023 Update, compares the results of the 2021 inspections of the six global network firms.

TABLE 1

2022 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(Reports are dated between November 7, 2023, and December 20, 2023, and were released on February 28, 2023)

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

TABLE 2

2021 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(Reports are dated November 4, 2022, except EY, which is dated November 21, 2022, and were released on December 19, 2022)

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	30	16	53%
Deloitte & Touche	54	7	13%
Ernst & Young	56	12	21%
Grant Thornton	31	7	23%
KPMG	54	14	26%
PwC	56	2	4%
Global Network Firm Totals	281	58	
Global Network Firm Averages	47	10	21%

Tables 1 and 2 focus on the percentage of inspected engagements that have at least one audit deficiency. Other indicators of the relative performance of the six firms are the number individual audit deficiencies in each report and the number of citations to auditing standards associated with those deficiencies. These metrics differ from the percentage-of-deficient engagements measure because an engagement included in Part I.A may involve more than one deficiency and a deficiency may be associated with more than one auditing standard. Table 3 compares the performance of the six firms based on the number of audit deficiencies in each inspection report and the number of auditing standards associated with those deficiencies. Because of the redactions in KPMG's 2022 inspection report, it is not possible to determine the aggregate number of auditing standards associated with the Part I.A deficiencies. In some cases, there is an element of judgment in determining the number of deficiencies in a Part I.A engagement description.

TABLE 3

DEFICIENCIES AND ASSOCIATED AUDITING STANDARDS IN PART I.A
OF GLOBAL NETWORK FIRM 2022 INSPECTION REPORTS

Firm	Engagements Inspected	Deficient Engagements	Total Deficiencies	Standards Referenced	Deficiencies Per Inspected Engagement	Standards Referenced Per Inspected Engagement
BDO	29	19	133	141	4.59	4.86
Deloitte & Touche	53	9	17	16	0.32	0.30
Ernst & Young	54	25	108	127	2.00	2.35
Grant Thornton	26	8	44	46	1.69	1.77
KPMG	54	NA	NA	NA	NA	NA
PwC	54	5	19	19	0.35	0.35
Global Network Firm Totals	270	NA	NA	NA		
Global Network Firm Averages	45	NA	NA	NA	NA	NA

Aggregate Part I.A Data on Auditing Standards, Deficiency Descriptions, and Audit Areas

Auditing standards cited in deficiencies. Table 4 lists the auditing standards most frequently cited as the basis for audit deficiencies in Part I.A of the 2022 inspection reports. Table 4 also shows the percentage of all deficiencies that were based on each auditing standard. The same auditing standard may have been cited multiple times in an engagement described in Part I.A. Only standards cited more than once are included in Table 4. Since the PCAOB redacted total auditing standard reference information from KPMG's report, Table 4 only reflects the inspection reports of the other five global network firms.

TABLE 4

AUDITING STANDARDS REFERENCED IN FIVE GLOBAL NETWORK FIRM 2022 PART I.A DEFICIENCY FINDINGS

PCAOB Auditing Standard	Number of Times Standard Cited as Deficiency Basis	Percentage of Total Deficiencies Citing Standard
AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements	152	43.6%
AS 1105, Audit Evidence	63	18.1%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	48	13.8%
AS 2501, Auditing Accounting Estimates	29	8.3%
AS 2315, Audit Sampling	21	6.0%
AS 2810, Evaluating Audit Results	15	4.3%
AS 2305, Substantive Analytical Procedures	9	2.6%
AS 2101, Audit Planning	4	1.1%
AS 1201, Supervision of the Audit Engagement	2	0.6%
AS 2510, Auditing Inventories	2	0.6%

Audit deficiencies. In each inspection report, the PCAOB lists the most frequently identified audit deficiencies, divided between the most frequent deficiencies in financial statement (FS) audits and the most frequent deficiencies in ICFR audits. Table 5 aggregates these frequent deficiencies lists for the six firms. Table 5 also indicates what percentage of the engagements in Part I of the six reports included these deficiencies.

TABLE 5

MOST FREQUENTLY IDENTIFIED AUDIT DEFICIENCIES
IN 2022 SIX GLOBAL NETWORK FIRM INSPECTION REPORTS

Deficiency Description	Number of Times Deficiency Was Identified	Audit Affected	Percentage of All Deficiencies
Did not perform sufficient testing related to a significant account or disclosure or to address an identified risk.	39	FS	20.1%
Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing.	33	ICFR	17.0%
Did not identify and test any controls that addressed the risks related to a significant account or relevant assertion.	30	ICFR	15.5%
Did not perform sufficient testing of data or reports used in the firm's substantive testing.	28	FS	14.4%
Did not identify and/or sufficiently test controls over accuracy and completeness of data or reports that the issuer used in the operation of controls.	26	ICFR	13.4%
Did not obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls).	16	FS	8.2%
Did not sufficiently test an estimate.	14	FS	7.2%
Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.	3	FS	1.5%
Did not sufficiently evaluate significant assumptions that the issuer used in developing an estimate.	3	FS	1.5%
Did not appropriately evaluate control deficiencies.	2	ICFR	1.0%

Audit/financial statement areas. For each firm, the PCAOB lists the audit areas with frequent Part I.A deficiencies in the inspection report. This information was not redacted from the KPMG report. For the six firms, on an aggregate basis, these areas (excluding those cited only once) are listed below:

- Revenue and related accounts – 44 deficiencies.
- Inventory – 12 deficiencies.
- Business combinations – 11 deficiencies.
- Long-Lived Assets – 4 deficiencies.

- Allowance for credit losses/Allowance for loan losses – 3 deficiencies.
- Goodwill and intangible assets – 3 deficiencies.
- Deposit liabilities – 2 deficiencies.

Other Instances of Non-Compliance: Six Firm Part I.B Results

Part I.B of an inspection report describes instances of non-compliance with PCAOB standards or rules that do not relate directly to the sufficiency or appropriateness of the evidence supporting an audit opinion. In 2022, the PCAOB found an aggregate of 139 such deficiencies, compared to 93 in 2021. Table 6 presents the number of Part I.B deficiencies for each of the six firms and shows how each firm's 2022 Part I.B results compare to its 2021 report. Year-to-year comparisons may provide general insight into Part I.B trends but should be interpreted with caution. It appears that the PCAOB does not review all inspected engagements for every type of Part I.B deficiency. Therefore, the number of Part I.B deficiencies in a firm's inspection report may not be directly comparable to the number in other firms' reports or to the number reported in prior years.

TABLE 6

PART I.B DEFICIENCIES: 2022 and 2021 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORK FIRMS

Firm	2022 Part I.B Deficiencies	2021 Part I.B Deficiencies	Net Change in Part I.B Deficiencies 2021 to 2022
BDO	16	9	+7
Deloitte & Touche	25	8	+17
Ernst & Young	30	27	+3
Grant Thornton	38	23	+15
KPMG	23	13	+10
PwC	7	13	-6
Global Network Firm Totals	139	93	+46
Global Network Firm Averages	23.2	15.5	+7.7

Table 7 lists the most frequent Part I.B deficiencies in the six reports. Only deficiencies cited more than once are included.

TABLE 7

MOST FREQUENTLY CITED PART I.B DEFICIENCIES
IN 2022 SIX FIRM INSPECTION REPORTS

Deficiency Description/Auditing Standard	Number of Times Deficiency Cited
Engagement team performed procedures to determine whether matters were critical audit matters but did not include one or more matters that were communicated to the audit committee and that related to accounts or disclosures that were material to the financial statements. AS 3101, The Auditor's Report on an Audit of Financial Statements.	38
Firm's report on Form AP contained inaccurate information or omitted information related to the participation in the audit of certain other accounting firms. PCAOB Rule 3211, Auditor Reporting of Certain Audit Participants.	23
Firm did not include all relevant workpapers in the final set of audit documentation it was required to assemble. AS 1215, Audit Documentation.	13
Firm did not make (or did not make on a timely basis) certain required communications to the audit committee related to the names, locations, and/or planned responsibilities of other accounting firms and/or persons not employed by the firm that performed audit procedures. AS 1301, Communications with Audit Committees.	12
Firm did not identify and assess risks of material misstatement (RMM) related to a significant account, evaluate factors related to absence of RMM, or evaluate changes in factors relevant to RMM. AS2110, Identifying and Assessing Risks of Material Misstatement.	12
Firm's communication of a critical audit matter in the audit report included language that was inconsistent with information in the firm's audit documentation or did not refer to the relevant financial statement accounts or disclosures related to the critical audit matter. AS 3101, The Auditor's Report on an Audit of Financial Statements.	6
Firm did not make required communications to the issuer's audit committee (e.g., related to critical accounting estimates, audit strategy, or audit risk). AS 1301, Communications with Audit Committees.	6
Audit report incorrectly communicated certain matters as CAMs or did not identify a financial statement or related schedule that had been audited. AS 3101, The Auditor's Report on an	5
When testing journal entries for evidence of possible material misstatement due to fraud, firm did not have an appropriate rationale for limiting its testing to certain entries. AS 2401, Consideration of Fraud in a Financial Statement Audit.	5
Year the firm began serving consecutively as the company's auditor included in the firm's audit report was incorrect. AS 3101, The Auditor's Report on an Audit of Financial Statements.	4
Firm did not communicate to management all control deficiencies identified during the audit or did not communicate in audit report an exclusion from the scope of the ICFR audit. AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.	4
Firm did not communicate certain relevant matters to the audit committee in connect with pre-approval of permissible tax services or failed to properly document discussion. PCAOB Rule 3524, Audit Committee Pre-Approval of Certain Tax Services.	3
Firm did not make a required communication to management related to one or more identified misstatements. AS 2810, Evaluation of Audit Results.	3

Independence: Comparison of Firm Part I.C Results

The 2022 inspection reports contain a new section – Part I.C. Part I.C discusses instances of potential non-compliance with SEC or PCAOB rules related to maintaining auditor independence. Part I.C describes both instances of potential noncompliance that the PCAOB identified and instances that the firm self-reported to the Board during the inspection. Across the six global network firms, the Board identified nine instances of independence rule noncompliance and the firms reported 392.

As the Board points out, disclosure in Part I.C of an instance of potential non-compliance with the independence rules does not necessarily mean that the Board (or the firm) has concluded the firm was not objective and impartial throughout the audit and professional engagement period. In all 392 firm-reported cases, if the firm involved was the principal auditor, it evaluated the potential non-compliance and determined that its objectivity and impartiality were not impaired.

Table 8 presents the Part I.C instances of potential non-compliance with the independence rules for each of the six firms. However, each inspection report contains the following warning:

> "While we have not evaluated the underlying reasons for the instances of potential non-compliance, the number, large or small, of firm-identified instances of potential non-compliance may be reflective of the size of the firm, including the number of non-U.S. associated firms in the global network; the design and effectiveness of the firm's independence monitoring activities; and the size and/or complexity of the issuers it audits, including the number of affiliates of the issuer. Therefore, we caution against making any comparison of these firm-identified instances of potential non-compliance across firms."

TABLE 8

INSTANCES OF POTENTIAL NON-COMPLIANCE WITH INDEPENDENCE RULES IN PART I.C OF GLOBAL NETWORK FIRM 2022 INSPECTION REPORTS

Firm	PCAOB-Identified Instances	Firm-Identified Instances	Issuers Affected Firm-Identified Instances	Affected Firm-Id Issuers As Percent of All Issuers	Non-U.S. Affiliate Percent of Firm-Identified Instances
BDO	0	8	6	2%	50%
Deloitte & Touche	0	129	78	3%	23%
Ernst & Young	0	93	62	3%	35%
Grant Thornton	0	9	5	1%	89%
KPMG	8	24	19	2%	33%
PwC	1	129	74	4%	22%
Global Network Firm Totals	9	392	244		
Global Network Firm Averages	1.5	65	41		

Each inspection report describes the most common instances of potential independence non-compliance in the firm-reported cases. Table 9 lists these independence issues on an aggregate basis. Because the descriptions in each inspection report include only the most common instances, Table 9 does not reflect all 392 firm-reported potential non-compliance instances.

TABLE 9

COMMON INSTANCES OF POTENTIAL NON-COMPLIANCE WITH INDEPENDENCE RULES IN PART I.C OF 2022 SIX FIRM INSPECTION REPORTS

Potential Non-compliance	Number of Times Potential Non-compliance Cited
Financial relationships, including investments in or other financial relationships with audit clients (e.g., instances where either a partner in the same office as the engagement partner or an individual who provided 10 or more hours of non-audit services to the client had a financial relationship with the client).	235
Non-audit services, including instances related to services provided by the firm or by a non-U.S. associated firm, such as performing management functions for an affiliate of the client.	41
Employment relationships, including instances in which a former employee of the firm was employed at an audit client in an accounting or financial reporting oversight role or a staff-level employee of the firm was also employed by the audit client.	32
Audit committee pre-approval, including instances related to services provided by non-U.S. firms associated with the auditor without obtaining audit committee pre-approval.	28
Business relationships, including instances of relationships between non-U.S. associated firms and affiliates of the audit client.	4
Indemnification clauses, including agreements under which the audit client agreed to indemnify the auditor with respect to certain liabilities arising from the audit.	2

Comments on 2022 Global Network Firm U.S. Affiliate Inspections

The PCAOB cautions that inspection results are not necessarily comparable over time or among firms because of variations in the inspection process. While that caveat should be kept in mind, below are seven observations based on the 2022 reports.

1. Overall, large firm audit quality appears to have declined in 2022. Both the Chair of the PCAOB and the Chief Accountant of the SEC have expressed concern about the increase in inspection findings. See SEC Chief Accountant Calls on Auditors to Improve and on Audit Committees to Be Proactive, February 2024 Update and 2022 PCAOB Inspections Preview Says 40 Percent of Audits Reviewed Had Deficiencies, July 2023 Update. The 2022 inspection reports are consistent with those concerns. For the global network firm affiliates as a group, the 2022 overall deficient engagement rate was 30 percent, compared to 21 percent last year. In particular, EY's engagement deficiency rate increased from 22 percent to 46 percent, which had a significant effect on the overall average. In addition, inspectors found 1.34 deficiencies for each engagement they inspected at the six firms in 2022, compared to 0.77 deficiencies per inspection in 2021.

   While concerning, these results are not dramatically out of line with past performance. For example, the 2022 averages are similar to those in 2017, when the Big Four deficiency rate was 30 percent. In context, the 2022 inspections do not suggest that there is a crisis or structural deterioration in auditing. In part, the 2022 results likely reflect the impact of the pandemic on

recruiting, training, and the work environment in late 2021 and early 2022 when these audits were performed. Nonetheless, the upward trend in deficiencies over the last few years needs to be addressed.

2. There continue to be pronounced differences between the inspection results of the large firms The gap between the firm with the lowest percent of inspected engagements that were deficient (PwC – 9 percent) and the firm with the highest percentage (BDO – 66 percent) was 57 percentage points. In 2021, that gap was 49 percent (4 percent for PwC versus 53 percent for BDO). Looking only at the Big Four, EY's deficiency rate of 46 percent is more than five times PwC's rate; hopefully, 2022 will prove to be an outlier year for EY.

   There is also wide dispersion between the firms based on the number of individual audit deficiencies and of auditing standards cited in Part I.A of each report. In the 2022 PwC inspection, the inspectors found 19 audit deficiencies associated with 19 auditing standards in five Part I.A engagements out of 54 engagements inspected – an average of 0.35 audit deficiencies and 0.35 standards citations per inspected engagement. At Deloitte, 53 inspections resulted in 17 deficiencies associated with 16 auditing standards in nine Part I.A engagements or 0.32 deficiencies and 0.30 standards citations per inspected engagement. At the other end of the spectrum, in 29 BDO engagements inspected, the PCAOB staff found 133 deficiencies and cited 141 standards, an average of 4.59 audit deficiencies and 4.86 standards citations per inspected engagement. In between these extremes, EY and Grant had deficiency-per-inspection rates of 2.00 and 1.69, respectively. KPMG's rate will likely be either 0.76 or 0.78 deficiencies per inspected engagement – a slight improvement over 0.94 last year.

3. The share of engagements selected for inspection on a random basis decreased in 2022, which may have impacted inspection findings. The PCAOB has been increasing the percentage of inspected engagements selected at random, rather than based on risk. In 2021, random selections rose to 44 percent – almost half of all inspected engagements for the six global network firms. The PCAOB appears to have changed course in 2022. Only 24 percent of the 2022 inspections for these firms were random selections.

   It is possible that the increase in 2022 Part I.A engagement deficiencies is partly the result of this change in the mix of engagement selections. Deficiencies are presumably less likely to be found in engagements selected at random than in those selected based on an assessment of the engagement's inherent risk. In fact, in its July 2023 preview of the 2022 inspection results, the PCAOB staff noted that, for all 2022 inspections, 26 percent of randomly selected engagements were included in Part I.A, while 42 percent of risk-based selected were included in Part I.A. See 2022 PCAOB Inspections Preview Says 40 Percent of Audits Reviewed Had Deficiencies, July 2023 Update.

4. ICFR audit deficiencies continue to drive inspection results, but the focus on financial statement issues is increasing. Excluding KPMG, inspectors found ICFR audit deficiencies in 28 percent of integrated audits inspected in 2022, up from 19 percent in the 2021 global network firm inspections. Seventy percent of audit engagements described in Part I.A of the 2022 inspection reports of the five firms for which complete reports were released included an ICFR deficiency. However, despite the overall frequency of ICFR audit deficiencies, the most common deficiency identified in the 2022 inspections related to financial statement audits, not ICFR audits: Twenty percent of all deficiencies in Part I.A of the six reports was "Did not perform sufficient testing related to a significant account or disclosure or to address an identified risk" in the financial statement audit. The second and third most frequent deficiencies were ICFR audit related: "Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing" (17 percent of all deficiencies) and "Did not identify and test any controls that addressed the risks related to a significant account or relevant assertion" (16 percent of all deficiencies).
   .

5. Failure to test information provided by the entity, overreliance on controls, and insufficient testing of estimates were frequent issues in financial statement audits. Excluding KPMG, 97 percent of global network firm Part I.A engagements included a financial statement audit deficiency, compared to 79 percent of Part I.A engagements in 2021. As noted above, the most frequent 2022 Part I.A deficiency affecting the financial statement audit was insufficient testing related to a significant account, disclosure, or risk. The other top financial statement audit deficiencies were "Did not perform sufficient testing of data or reports used in the firm's substantive testing" (14 percent of Part I.A deficiencies), "Did not obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls)" (13 percent), and "Did not sufficiently test an estimate" (7 percent).

6. Part I.B deficiencies continue to increase. Part I.B deficiencies increased sharply in 2022. The six 2022 reports include 139 Part I.B deficiencies – a 50 percent increase from 93 Part I.B deficiencies in 2021 and more than twice the 63 in 2020. It is not clear whether these increases reflect more underlying deficiencies or more PCAOB inspection focus on Part I.B issues.

   As in 2021, the Part I.B issue with by far the most findings in 2022 was failure of the engagement team to perform procedures to determine whether particular matters related to material accounts that were communicated to the audit committee should have been disclosed as CAMs in the auditor's report. The second most frequent Part I.B deficiency was inaccurate or incomplete reporting on Form AP regarding the participation of other accounting firms or individuals in the audit. The PCAOB has brought several recent enforcement actions based on Form AP violations and this seems to be an area of current emphasis. Failure to make various types of required audit committee communications was also a frequent Part I.B deficiency.

7. Independence violations are surprisingly frequent but, in the view of the firms, seldom impair objectivity. The six global network firms self-reported an aggregate of 392 instances of non-compliance with the independence rules, and the PCAOB uncovered 9 more instances. The great majority of these involved a prohibited financial interest in a client, including investment by another partner in the same office as the engagement partner in the audit client, sometimes through what the reports describe as investments in broad-based funds. In all instances of non-compliance described in Part I.C where the firm was the principal auditor, it determined that its objectivity and impartiality were not impaired. The independence rules are complex, and, while any violation should be taken seriously, the large number of instances of non-compliance described in the 2022 reports may be more an illustration of the difficulty in administering the rules across a large organization than of a pattern of lack of independence.

* * *

Audit committees should discuss their audit firm's inspection report with the engagement partner. As noted in past Updates, the audit deficiency descriptions and auditing standard deficiency tables could serve as a discussion topic checklist. Audit committees may also want to understand how the auditor addressed, or plans to address, engagement deficiencies highlighted in its report and whether the report will result in any changes in audit procedures that could affect the company's audit. Of course, if the company's engagement was the basis for an inspection finding, the audit committee should understand in depth the cause of the deficiency and how the auditor plans to remedy it and prevent a recurrence. As noted in the 2022 PCAOB Inspections Preview, above, the Board has also urged audit committees to ask their auditor what the firm is doing to address the overall increase in 2022 inspections findings.

SEC Adopts Landmark Climate Change Disclosure Rules

On March 6 – almost two years after publishing its initial proposal – the SEC adopted final rules requiring public companies to make extensive disclosures concerning climate change. The Commission did, however, step back in some respects from the most controversial aspects of its 2022 proposals. According to the Commission's press announcement, "The final rules reflect the Commission's efforts to

respond to investors' demand for more consistent, comparable, and reliable information about the financial effects of climate-related risks on a registrant's operations and how it manages those risks while balancing concerns about mitigating the associated costs of the rules." For a discussion of the Commission's 2022 climate-related disclosure proposals, see SEC Unveils its Climate Disclosure Proposals, March 2022 Update.

The SEC Commissioners approved the climate rules by a 3-2 vote. In her dissenting statement, Commissioner Peirce predicted that the rules would result in a "flood of climate-related disclosures [that] will overwhelm investors, not inform them." Legal challenges to the new rules have already been filed, and the courts will have to determine whether these landmark requirements exceed the Commission's authority.

For most companies, implementing the SEC's climate disclosure rules will require significant changes to information-gathering processes, internal controls, and disclosure review. Because of new financial statement disclosures and greenhouse gas (GHG) emission attestation requirements, the work of the company's auditor or other external assurance providers will also be affected. Audit committees should begin to prepare now for the impact these changes will have on the committee's work and to oversee management's compliance plans. As explained below, the climate disclosure rules will be phased in over time, beginning for the largest public companies in 2026 with their annual reports for fiscal years ending on or after December 31, 2025.

Key Requirements of the Climate-Related Disclosure Rules

The new rules require quantitative disclosure regarding the financial statement effects of severe weather and other natural events and material Scope 1 and Scope 2 GHG emissions. In addition, the rules require companies to make qualitative – narrative – disclosures regarding a range of climate-related issues, including climate risks and risk management strategies, governance practices, and targets and goals. Below is an overview of the main features of the rules.

1. Financial Statement Effects Disclosure

The final rules require financial statements filed with the SEC to include footnote disclosure of the impact on the statements of severe weather events and other natural conditions (such as to hurricanes, tornados, flooding, drought, wildfires, extreme temperatures, and sea level rise). The financial statements will also need to disclose the impact of such events, and of the company's climate-related goals and plans, on accounting estimates and assumptions. Specifically:

- Financial statement impacts. The financial statements must disclose aggregate expenditures incurred and losses recognized in the income statement as a result of severe weather events and other natural conditions, subject to a threshold of the greater of 1 percent of pretax income (or loss) or $100,000. In addition, the financial statements must disclose aggregate capitalized costs and charges reflected on the balance sheet because of severe weather events and other natural conditions, subject to a threshold of the greater of 1 percent of the absolute value of stockholders' equity (or deficit) or $500,000. Disclosure is required when the weather event or natural condition is a "significant contributing factor" to the cost, expenditure, charge, loss, or recovery.

- Carbon offsets and renewal energy credits. If carbon offsets and renewable energy credits (RECs) are material to the company's plans to achieve climate-related targets or goals, the financial statements must disclose information concerning the beginning and ending balances of these offsets and RECs, including the amounts expensed and capitalized during the period. The financial statements must also disclose which line items are affected by offsets and RECs and the applicable accounting policy.

- Financial statement estimates and assumptions. Footnote disclosure is required of whether and, if so, how, severe weather events and other natural conditions, or any climate-related targets,

goals, or transition plans, materially impacted estimates and assumptions used to produce the financial statements.

These disclosures, like other financial statement disclosures, will be within the scope of the company's external audit. In addition, the company's internal control over financial reporting (ICFR) will need to encompass these new disclosures, and both the management assessment of ICFR effectiveness and the auditor's opinion on ICFR (when required) will include these controls.

2. GHG Emissions Disclosure

a. Disclosure

The climate rules require disclosure of Scope 1 GHG emissions (those from the company's owned or controlled operations) and Scope 2 GHG emissions (those from power, such as electricity or steam, purchased by the company), if such emissions are material. This requirement will only apply to larger companies – accelerated filers and large accelerated filers, generally, companies with market capitalizations of at least $75 million or $700 million, respectively. GHG emissions disclosure will not apply to companies that meet the SEC's definitions of an emerging growth company or a smaller reporting company.

The Commission offers guidance as to the meaning of materiality in this context. It states that companies should "apply traditional notions of materiality under the Federal securities laws" and that the materiality of GHG emissions "is not determined merely by the amount of these emissions."

> "A registrant's Scopes 1 and/or 2 emissions may be material because their calculation and disclosure are necessary to allow investors to understand whether those emissions are significant enough to subject the registrant to a transition risk that will or is reasonably likely to materially impact its business, results of operations, or financial condition in the short- or long-term. For example, where a registrant faces a material transition risk that has manifested as a result of a requirement to report its GHG emissions metrics under foreign or state law because such emissions are currently or are reasonably likely to be subject to additional regulatory burdens through increased taxes or financial penalties, the registrant should consider whether such emissions metrics are material under the final rules." (footnote omitted)

b. Attestation

Companies that must disclose material Scope 1 and Scope 2 GHG emissions will also be required to obtain attestation -- the opinion of an independent third-party regarding those disclosures. The attestation provider could be the financial statement auditor or another professional, although the provider will have to be an expert in GHG emissions that is independent of the company and its affiliates. The attestation report must be provided pursuant to standards that are publicly available and that are established by a body that has followed due process procedures – such as the Public Company Accounting Oversight Board, American Institute of Certified Public Accountants, or International Auditing and Assurance Standards Board.

Under the SEC's phase-in schedule for the climate rules, the attestation will initially only have to provide limited or negative assurance regarding GHG emission disclosures. A limited assurance report would typically state that, based on performing described procedures, the provider has no reason to believe that the GHG disclosures are materially misleading. However, the largest companies – large accelerated filers – will eventually have to obtain reports that provide reasonable assurance, the same level of assurance that must be provided with respect to the financial statements. In a reasonable assurance opinion, the provider states that, based on the procedures performed, it has reasonable grounds to believe the disclosures are materially correct. The rules require large accelerated filers to obtain reasonable assurance over their Scope 1 and 2 GHG disclosures beginning in 2033.

3. Climate-Related Risks Disclosure

The climate rules require companies to disclose any climate-related risks that have materially impacted, or are reasonably likely to materially impact, the company, including impacts on its business strategy, results of operations, or financial condition. The company should describe separately risks that are reasonably likely to have a short-term (the next 12 months) and a long-term (beyond the next 12 months) impact.

4. Disclosure of Impacts of Climate-Related Risks on Strategy, Business Model, and Outlook

With respect to its climate-related risks, the rules require a company to disclose –

- The actual and potential material impacts of such risks on the company's strategy, business model, and outlook.

- Any transition plan to manage a material transition risk. A "transition plan" means a strategy and implementation plan to reduce climate-related risks, including a plan to reduce GHG emissions. However, if the company does not have a plan, no disclosure is required.

- Use of scenario analysis, if the company uses scenario analysis to assess the impact of climate-related risks that are reasonably likely to have a material impact.

- Information about its internal carbon price, if the company's use of an internal carbon price is material to how it evaluates and manages a climate-related risk.

5. Risk Management Disclosure

Companies will be required to describe any processes for identifying, assessing, and managing climate-related risks. This disclosure should include how the company identifies whether it has incurred or is reasonably likely to incur a material physical or transition risk; how it decides whether to mitigate, accept, or adapt to the particular risk; and how it prioritizes whether to address the climate-related risk. In addition, disclosure must include whether and how climate risk management has been integrated into the company's overall risk management system.

6. Governance Disclosure

The rules require companies to describe the board's oversight of climate-related risks, including board committees responsible for such risks. This disclosure includes whether and how the board considers climate-related risks as part of its business strategy, risk management, and financial oversight and whether and how the board sets and oversees climate-related targets or goals.

Companies will also be required to describe management's role in assessing and managing climate-related risks. This disclosure includes which management positions or committees are responsible for climate-related risks; the expertise of the individuals occupying these positions; the processes by which they assess and manage climate-related risks; and whether these managers or committees report to the board about climate risks.

7. Targets and Goals Disclosure

The climate rules require companies to disclose any climate-related target or goal that has materially affected, or is reasonably likely to materially affect, the company's business, results of operations, or financial condition. Among other things, this disclosure includes the activities subject to the target or goal, the time horizon over which the target or goal will be achieved, and the baseline against which the company will measure progress. The rules also require disclosure of how the company intends to meet its climate-related targets or goals. Disclosure concerning progress must be updated annually.

Significant Changes from the 2022 Proposals

While the rules the Commission has adopted are far-reaching, they are not as extensive as those originally proposed in 2022. Significant changes from the proposals include:

- The proposed requirement that all SEC registered companies disclose Scope 1 and Scope 2 GHG emissions has been narrowed. The final rules only require large accelerated filers and accelerated filers that are not emerging growth companies or smaller reporting companies to disclose Scope 1 and Scope 2 emissions. Further, disclosure is only required of material GHG emissions.

- The final rules do not require any SEC reporting of Scope 3 GHG emissions (emissions in the company's supply change or from customer use of its products). The proposed Scope 3 emissions disclosure requirement was the most controversial aspect of the proposal, particularly because of its potential indirect impact on non-SEC registrants that are suppliers to public companies (e.g., farmers).

- Unlike the proposal, the final rules do not require line-by-line analysis of the financial statement impact of severe weather events and climate transition activities. The requirement to discuss the impact of severe weather and natural conditions is on an aggregate basis and subject to a higher threshold (one percent of net income or stockholders' equity). The impact of transition activities is no longer part of the financial statement disclosure requirements.

- The final rules do not include the proposed requirement to disclose board members' climate expertise.

- Many of the climate-related disclosures are qualified by materiality (e.g., Scope 1 and Scope 2 GHG emissions, impacts of climate-related risks, and use of scenario analysis).

- The final rules include more lengthy phase-in periods. For example, smaller reporting companies will not need to beginning making any disclosure under the climate rules until 2027, and large accelerated filers will not be required to obtain reasonable assurance reports on their material Scope 1 and Scope 2 GHG emissions until 2033.

Implementation Schedule

The climate rules will be phased, with the compliance date for a particular company dependent on its status as a large accelerated filer (LAF), accelerated filer (AF), emerging growth company (EGC), smaller reporting company (SRC), or non-accelerated filer (NAF). In addition, qualitative disclosures and financial statement effect disclosures, financial expenditure disclosures, GHG emissions disclosures, and attestation requirements have separate phase-in schedules. (Financial expenditure disclosures include material expenditures that result from mitigation of or adaptation to climate-related risks, of transition plans, or of actions to achieve targets or goals.)

- LAFs with must comply (1) with the qualitative disclosures and financial statement effect disclosure for fiscal years beginning in 2025, (2) with the GHG emissions disclosure and financial expenditure disclosures for fiscal years beginning in 2026, (3) with the GHG emissions limited assurance attestation requirement for fiscal years beginning in 2029, and (4) with the GHG emissions reasonable assurance attestation requirement for fiscal years beginning in 2033.

- AFs (other than SRCs and EGCs) with must comply (1) with the qualitative disclosures and financial statement effect disclosure for fiscal years beginning in 2026, (2) with the financial expenditure disclosures for fiscal years beginning in 2027, (3) with the GHG disclosures for fiscal

years beginning in 2028, and (4) with the GHG emissions limited assurance attestation requirement for fiscal years beginning in 2031.

- NAFs, SRCs and EGCs with must comply (1) with the qualitative disclosures and financial statement effect disclosure for fiscal years beginning in 2027 and (2) with the financial expenditure disclosures for fiscal years beginning in 2028.

Below is an SEC-prepared table which summaries the phase-in schedule.

Compliance Dates under the Final Rules[1]						
Registrant Type	**Disclosure and Financial Statement Effects Audit**		**GHG Emissions/Assurance**			**Electronic Tagging**
	All Reg. S-K and S-X disclosures, other than as noted in this table	*Item 1502(d)(2), Item 1502(e)(2), and Item 1504(c)(2)*	*Item 1505 (Scopes 1 and 2 GHG emissions)*	*Item 1506 - Limited Assurance*	*Item 1506 - Reasonabl e Assurance*	*Item 1508 - Inline XBRL tagging for subpart 1500[2]*
LAFs	FYB 2025	FYB 2026	FYB 2026	FYB 2029	FYB 2033	FYB 2026
AFs (other than SRCs and EGCs)	FYB 2026	FYB 2027	FYB 2028	FYB 2031	N/A	FYB 2026
SRCs, EGCs, and NAFs	FYB 2027	FYB 2028	N/A	N/A	N/A	FYB 2027
	1 As used in this chart, "FYB" refers to any fiscal year beginning in the calendar year listed. 2 Financial statement disclosures under Article 14 will be required to be tagged in accordance with existing rules pertaining to the tagging of financial statements. *See* Rule 405(b)(1)(i) of Regulation S-T.					

Source: [SEC Fact Sheet, The Enhancement and Standardization of Climate-Related Disclosures: Final Rules]

Comments: While pared back from the SEC's 2022 proposals, the final climate rules create an extensive and detailed body of new disclosures -- arguably the most far-reaching changes to the SEC disclosure requirements in many decades. The audit committee's oversight of the company's information gathering, controls, disclosure, and reporting processes will be significantly affected by these new requirements. While the implementation schedule is not as tight as in the original proposals, and delays arising from the legal challenges to the rules are possible, management, the audit committee, and the full board should begin considering now what steps the company will need to take to comply.

Questions that audit committees might ask as part of their oversight of the implementation of the SEC's climate-related disclosure regime include:

- What climate-risk related information does the company currently collect? What information does it disclose? What gaps are there between the information currently available and the disclosures required under the new rules? How do the requirements of the SEC's new rules compare to any other climate-related reporting requirements to which the company is subject (e.g., California or EU requirements)?

- How will the company's information-gathering processes, internal control over financial reporting, and disclosure controls and procedures need to change in order to implement the new rules?

- Are the company's Scope 1 and 2 GHG emissions material under the test outlined in the SEC's release? If so, when would GHG disclosure phase in for the company? Is Scope 1 and Scope 2 GHG emissions information currently available to the company?

- If the company will be required to disclosure GHG emissions, when will attestation be required? How will the company determine who should provide the required attestation?

- Which company personnel.(e.g., finance, legal, investor relations, internal audit) will be involved in compliance with the new rules? Are they aware of and prepared for the demands that will be placed on them? Would their position descriptions, functional responsibilities, charters, and policies and procedures need to be revised? Does management responsible for SEC reporting currently possess the necessary skills and expertise regarding climate-related disclosure? How will any gaps in these skills be addressed?

- Does the audit committee currently possess expertise regarding climate-related disclosure? Would the committee benefit from education (or a membership change) to enhance its understanding of this field?

Cybersecurity and ERM Are Top Audit Committee Priorities. ESG, Not So Much

The Center for Quality (CAQ) and the Deloitte Center for Board Effectiveness have released their third annual survey of audit committee practices and priorities, Audit Committee Practices Report: Common Threads Across Audit Committees (2024 Practices Report). As was the case last year, cybersecurity and enterprise risk management (ERM) topped the list of audit committee concerns. Finance and internal audit talent was third, while environmental, social, and governance (ESG) reporting, the third-highest concern last year, fell to sixth place. In terms of ways of improving audit committee practices and effectiveness, "increased discussion and/or engagement from members during meetings" and "improved quality of pre-read materials" were the two most frequent suggestions. Many survey respondents also thought their committee would benefit from additional cybersecurity expertise. For a discussion of last year's survey results, see Scope Creep is Affecting Audit Committee Composition and Focus, January 2023 Update.

Audit Committee 2024 Priorities

The CAQ and Deloitte surveyed 226 audit committee members, 74 percent of whom served on the board of a U.S. company. Eighty-one percent of respondents' companies had a market capitalization of $700 million or more. Respondents were asked to identify the three most important topics, risks, or issues for their audit committee in the next 12 months (apart from financial reporting and internal control.) The top five responses were:

- Cybersecurity. Sixty-nine percent of respondents indicated that cybersecurity will be one of the three highest priority areas for the audit committee in the next 12 months, up from 63 percent last year. Thirty percent ranked cybersecurity as the committee's number one priority. Most companies assign cybersecurity oversight to the audit committee: Fifty-eight percent of respondents said their board delegates cybersecurity oversight to the audit committee (up from 53 percent last year), while 25 percent said cybersecurity is a full board responsibility, and 11 percent said it is assigned to the risk committee. However, only about a quarter (24 percent) believe their audit committee members have appropriate cybersecurity expertise, down sharply from 41 percent in the prior survey. Cybersecurity was the skill most frequently cited as having the potential to improve audit committee effectiveness. The 2024 Practices Report observes, "Given the importance of this topic, it's also worth considering whether directors might benefit from external advisers or educational programs."

- Enterprise risk management. Forty-eight percent of respondents indicated that ERM will be a top priority in the next 12 months, up from 45 percent last year. Forty-seven percent said that the audit committee was responsible for oversight of ERM, while 35 percent cited the full board, and 15 percent the risk committee. Financial services companies are less likely to assign ERM

oversight to the audit committees; 43 percent of financial services respondents stated that the risk committee had ERM responsibility. However, in contrast to cybersecurity, audit committees seem generally to believe they have adequate ERM expertise. Eighty-five percent reported some level of enterprise risk experience/expertise on the committee. The 2024 Practices Report advises directors to "encourage management to assess risks on a continuous basis, instead of relying on the outdated approach of conducting a risk assessment on an annual basis and setting it aside until the next year."

- Finance and internal audit talent. Thirty-seven percent of respondents believed that finance and internal audit talent will be a priority for their committees in the coming year, although only 9 percent see it as the top issue. Forty-six percent noted that their audit committee addressed the topic of talent quarterly last year, and 23 percent discussed it once. Most respondents view the internal audit function as both effective and adding value, and 89 percent agree or strongly agree that internal audit demonstrates a high level of understanding of the company's operations. However, almost 80 percent of respondents agreed or strongly agreed that there is opportunity for internal audit to add still more value.

- Compliance with laws and regulations. Thirty-six percent of respondents cited compliance with laws and regulations as one of the top three audit committee priorities in the next 12 months, and 17 percent thought it would be the top issue. Forty-five percent of respondents indicated their company placed legal compliance oversight with the audit committee (37 percent cited the full board and 5 percent to the risk committee). The 2024 Practices Report notes that "heightened complexity of the regulatory environment may account for the increased priority assigned to this area this year."

- Finance transformation. Thirty-three percent of respondents indicated that finance transformation will be one of the three top priorities for their audit committee in the next 12 months, and 15 percent selected it as the top issue. The implications of the rapid development of artificial intelligence are intertwined with questions about the future of the finance function, and two-thirds of respondents indicated their audit committee spent insufficient time last year discussing AI governance. The 2024 Practices Report states: "Audit committees should understand emerging finance technologies and how they are being considered and implemented within the organization. Absent any immediate adoption of technologies such as generative AI, management should work with the board to outline governance structures and controls for new technologies."

In the prior CAQ/Deloitte survey, audit committee members identified ESG reporting as one of their top three priorities. This year, however, ESG reporting fell to sixth place, with only 22 percent of respondents including it among their priorities. Indeed, 11 percent said that their audit committee spent too much time on ESG.

Audit Committee Practices and Effectiveness

In addition to providing their views on audit committee priorities, respondents were asked about ways committees could enhance their practices and effectiveness. Sixty-five percent indicated there was at least one strategy that might improve their committee's effectiveness. For those respondents who believed that there were opportunities for improvement, suggestions (and the percentage of respondents that supported them) included:

- Increased discussion and/or engagement from members during meetings (29%).

- Improved quality of pre-read materials (28%).

- Improved quality of presentations during meetings (26%).

- Improving the level of committee member advanced preparation for meetings (15%).

- Improving management of the agenda during meetings (10%).
- Increasing the length of existing committee meetings (10%).
- Increasing the total number of committee meetings (5%).

Comments: The 2024 Practices Report survey results can serve as a benchmarking resource to aid audit committee members in understanding what their peers are doing and whether there are priorities and practices other audit committees are considering that they may wish to employ.

The high priority respondents assigned to cybersecurity oversight is not surprising, given the increasingly dangerous cyber threat environment and the publicity that surrounds the issue. Also, the SEC's new cybersecurity disclosure requirements are likely to cause many audit committees to become enmeshed in difficult disclosure judgments around cyber breaches. See SEC Adopts Cybersecurity Disclosure Rules, August-September 2023 Update. Committees that believe – as many apparently do – that they lack sufficient expertise in this field might want to consider the suggestion in the 2024 Practices Report that they retain external advisers or participate in educational programs to enhance their knowledge.

Regardless of their views about the inherent importance of the topic to the company's business, audit committees may find that ESG reporting, at least as to climate, will be a more pressing issue in the next 12 months than they currently anticipate. During the past year, there has been something of an ESG backlash, and the drop in the prioritization of the issue revealed in the CAQ/Deloitte survey is understandable. However, the recent adoption of extensive climate-related reporting requirements by the SEC, the state of California, and the EU may force audit committees to spend time on climate disclosure reporting challenges, despite the importance of the other issues competing for committee time and attention. See SEC Adopts Landmark Climate Change Disclosure Rules in this Update and California Outflanks the SEC on Climate Disclosure and E.U. ESG Disclosure Requirements Will Affect Many U.S. Companies, both in the October 2023 Update.

On the Update Radar: Things in Brief

Ceres Advocates Climate Disclosure Reasonable Assurance. Ceres, a nonprofit organization that works with capital market leaders to address sustainability challenges, has released Closing the Gap: Investor Insights into Decision-Useful Climate Data Assurance. The report explores the challenges investors face in obtaining reliable and rigorous climate-related information and highlights the need for independent, third-party assurance to validate and ensure the credibility of corporate sustainability reports. Ceres states:

> "The tools to protect our capital markets are available to investors and companies today—processes and controls, transparency, and high-quality independent assurance. Fortunately, the model of reasonable assurance that is standard for financial reporting can be applied to climate data to support markets that operate on quality decision-useful information."

Ceres suggests steps that companies and assurance providers can take to afford investors greater confidence in climate data disclosures. Several of these suggestions are aimed at audit committees.

Based on the results of a "listening tour" with investors who use climate-related information to make investment decisions, Ceres finds that investors do not currently have access to consistent, comparable, decision-useful climate data. The investors the Ceres team spoke with identified several challenges to using climate data.

- Poor data quality. "High quality data requires accuracy, completeness, reliability, relevance, and timeliness. During the interviews, investors voiced concerns about inadequate data quality, often citing at least one of these characteristics as lacking."

- Limited disclosure. "There are significant gaps in the information that is available for investors. Risks that can crystallize into business issues are not clearly being disclosed, nor are the strategic ways businesses are capitalizing on related opportunities, leaving investors in the dark."

- Lack of connectivity between sustainability reporting and financial reporting. "Investors often cannot see a clear through line between companies' sustainability and climate disclosures, on the one hand, and their financial position and results, on the other."

- Inconsistent assurance quality. "While some companies obtain third-party assurance over certain disclosures, such as GHG emissions, the inconsistencies in approaches to assurance make it difficult for investors to compare and use assurance reports. That is, the variation in the level of assurance, extent of procedures, and form of reporting on results of those procedures is an impediment to meeting capital market needs."

- Weak corporate governance. "Investors expressed concerns that inadequate governance lies at the root of these challenges. Good governance plays a foundational role in the development and disclosure of meaningful and credible disclosure."

The steps that Ceres recommends companies and assurance providers take to address these problems and instill greater investor confidence in climate disclosures include several that fall within the scope of the audit committee's responsibilities. These include:

- "Ensure the audit committee oversees all assurance providers and is involved in determining the type, scope, and procedures of assurance engagements necessary to support investor trust in the company's reporting." Assurance providers should be required to demonstrate "that they have a robust and transparent ethics framework, particularly to demonstrate independence, and a system of quality control over the assurance engagement to ensure procedures and judgments are applied consistently."

- The audit committee should ensure that there is "open and relevant communication" between assurance providers. Companies may engage different assurance providers for different disclosures (e.g., the financial statements and GHG emissions) and the audit committee should make sure that these providers communicate with each other.

- Companies should phase out or reduce the use of limited assurance. A limited assurance engagement results only in a statement that the assurance provider performed certain procedures and that nothing came to the provider's attention that would indicate the disclosure is inaccurate. "Financial statements have long been subject to reasonable assurance, which results in an opinion by the expert third-party as to whether the disclosure is fairly presented in conformity with the relevant disclosure framework and is free of material misstatement. Only such an opinion is a true attestation to the reliability of the disclosure." (In contrast, the SEC's climate rules require only limited assurance over GHG disclosure for many companies. See SEC Adopts Landmark Climate Change Disclosure Rules in this Update.)

- Companies should require sustainability assurance providers to make certain disclosures in their reports. As with the level of assurance, the disclosures in the assurance provider's report would presumably be a matter of negotiation between the audit committee and the provider. Ceres recommends that sustainability assurance providers disclose:

  - The provider's qualifications, team lead and characteristics, quality controls, independence, and compliance with standards.

    - The suitability of measures used in voluntary disclosures. “[I]nvestors told us they would find considerable value in the auditor of sustainability disclosures discussing the results of its evaluation of the reporting criteria the company used (or perhaps developed itself). Bespoke metrics can be useful to measure a company’s progress on a company-specific plan, but they may also be an opportunity for greenwashing.”

    - Critical assurance matters. Under PCAOB and international auditing standards, reports on financial statement audits must include a discussion of key or critical audit matters, i.e., challenging aspects of the audit and how the auditor addressed the challenges. Reports on assurance over sustainability disclosures should include a similar discussion.

- “Audit committees should explain the company’s choices about the scope, level, and approach to obtaining assurance to enhance investor trust and confidence in the company’s disclosures, as well as its selection of assurance providers.” In its annual report, the audit committee should discuss the decisions it made around issues such as the professional selected to provide assurance over climate disclosures, the level of assurance, and other issues Ceres highlights. If the audit committee decides not to use the same provider for financial statement assurance and sustainability assurance, it should explain “how it has ensured fluid communication amongst providers in a way that supports audit quality.”

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.

You can follow @BlogAuditor on twitter or @the-audit-blog on medium.com.

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

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