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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

Update No. 92
July 2024

Summary

Shoot the Wounded! SEC Charges that Inadequate Cybersecurity is an Internal Accounting Control Violation. The SEC has charged R.R. Donnelley & Sons Co., a global provider of business communication and marketing services, with internal accounting control and disclosure control violations stemming from a 2021 ransomware attack on the company. According to the Commission's administrative order, RRD failed to devise and maintain "cybersecurity-related internal accounting controls" sufficient to provide reasonable assurance that access to RRD's assets (i.e., its information technology systems and networks) was permitted only in accordance with management authorization. Applying the Foreign Corrupt Practices Act requirement that companies maintain internal accounting controls to cybersecurity practices is novel, and two Commissioners issued a statement asserting that the Commission was "stretch[ing] the law to punish a company that was the victim of a cyberattack" and "distorting a statutory provision." Audit committees (particularly those with responsibility for cybersecurity oversight) may want to use the RRD case as an opportunity to discuss with the Chief Information Security Officer or other relevant members of management whether the company's cybersecurity procedures could be viewed as having any of the same flaws as the SEC identified at RRD. (more)

In 2023 PCAOB Conversations with Audit Committee Chairs, the Economic and Audit Environments Were Top of Mind. Each year, the PCAOB's inspection staff invites audit committee chairs of companies selected for inspection to participate in "candid conversations in an informal setting." In 2023, 230 audit committee chairs accepted this invitation. Spotlight: 2023 Conversations With Audit Committee Chairs presents the staff's "high-level observations and takeaways from those conversations." Among other things, audit committee chairs stated that they had discussed economic and geopolitical events with their auditor, focusing on the risks that these issues presented in the audit and how the audit team was addressing them. The PCAOB also reports that the chairs were "pleased with their auditors' ability to retain a skilled workforce and with their use of technology," although some voiced concerns about the impact of remote and hybrid work environments on audit quality. Interviewees said that they monitor the quality control systems of their auditor through discussion of the firm's PCAOB inspection report, including how the firm is remediating deficiencies, although the PCAOB notes that "some audit committees did not appear to spend the same amount of time on this review."

Audit committees may want to use the report as an indicator of the issues that their peers are raising with their auditor. In addition, an audit committee chair contacted by the PCAOB staff as part of an inspection may want to review the reports on these dialogues to prepare for the interview. (more)

Two Studies Find that Restatements Rates Remain Low, Although Big R Restatements Have Begun to Increase. During June, Ideagen Audit Analytics and the Center of Audit Quality each released studies of public company financial statement restatements. Financial Restatements, which covers 2004 to 2023, is the 2024 version of IAA's annual report on restatement trends. The CAQ's Financial Restatement Trends in the United States: 2013 – 2022 focuses on restatements announced from January 1, 2013, through December 31, 2022. Both studies show that the number of restatements filed annually by SEC-reporting companies is at or near historic lows and broadly indicate that financial reporting quality, as measured by restatements, is high. However, the studies also suggest a note of caution. Both find that the share of Big R or reissuance restatements has recently risen. Also, the CAQ (which employed a different methodology than IAA to count restatements) finds that the total number of restatements has begun to increase. Audit committees confronted with errors in prior financial reporting and questions concerning whether and how to restate should be sure they fully understand management's materiality analysis and the reasons for its choice of restatement methodology. (more)

CAQ's Annual Analysis Finds that More Companies are Using Their Auditor for ESG Assurance. The Center for Audit Quality has posted on its website S&P 500 ESG Reporting and Assurance Analysis, the annual update of its study of S&P 500 company environmental, social, and governance disclosures. The CAQ found that 98 percent of S&P 500 companies publicly disclosed detailed ESG information in 2022, essentially unchanged from 99 percent in 2021. Seventy percent of S&P 500 companies that reported 2022 ESG information also obtained third-party assurance or verification over at least some of the information, compared to 65 percent of ESG reporters that obtained assurance or verification in 2021. About one-fifth (21 percent) of the companies that obtained assurance in 2022 retained a public company auditor – usually the same firm that audited their financial statements -- to provide ESG assurance, up from 18 percent in 2021. Regardless of the type of provider, most assurance reports on ESG metrics provided limited, rather than reasonable, assurance. Audit committees should consider the benefits of obtaining reasonable assurance over the company's ESG disclosures. Committees that opt for limited assurance should ensure that the disclosure clearly explains to users the meaning of that assurance level. (more)

PCAOB Discloses Three 2019 Criticisms of EY's Quality Control. On July 11, the PCAOB released portions of the previously nonpublic section of Ernst & Young's 2019 inspection report. This action indicates that, in the Board's view, the firm did not satisfactorily address the quality control issues discussed in those portions of the inspection report within 12 months of the report date. The now-public quality control criticisms in EY's 2019 inspection report relate to the supervision of audits, the firm's internal inspection program, and compliance with the firm's policies for employee financial holdings disclosure. Audit committees of EY 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 deficiencies had not been remediated, and how the company's audit might be affected. (more)

FASB Moves Ahead with Requirement to Disaggregate Expenses. The Financial Accounting Standards Board has voted to require public companies (and other SEC filers) to disaggregate certain income statement expense line items by disclosing their component expense categories, such as inventory purchases, employee compensation, and depreciation. While the face of the income statement will not change, this additional information will be required in financial statement footnotes. Investors have long sought this type of expense breakdown. However, the new disclosures may be costly for companies and may require accounting systems changes. The Board is expected to approve a final Auditing Standard Update on disaggregation in the fourth quarter of 2024. The new requirement will be effective for fiscal years beginning after December 15, 2026, and for interim periods within fiscal years beginning after December 15, 2027. Audit committees may want to discuss with financial reporting management what changes in the company's accounting systems and processes will be necessary to implement the ASU, the cost of making those changes, and the timeline. (more)

The PCAOB Isn't Slowing Down. At its public meeting on June 12, the PCAOB took three significant actions. The Board adopted a previously proposed rule change that exposes an associated person of an accounting firm who negligently contributes to firm violations to PCAOB's enforcement action; previously the Board was required to show that such a person acted recklessly, a higher legal standard. The Board also adopted auditing standards amendments that address the use of technology in audits, including designing and performing audit procedures that involve analyzing information in electronic form with technology-based tools. Finally, the Board issued for public comment a proposal to "strengthen and clarify" the auditor's responsibilities when designing and performing substantive analytical procedures and increase "the likelihood that the auditor will obtain relevant and reliable audit evidence." Audit committees may want to ask their engagement partner whether the auditing standard changes or the proposal will have any impact on the company's audit. (more)

What's in Store for the Rest of 2024? SEC Reg Flex Agenda Update. OMB's Office of Information and Regulatory Affairs has released the federal government's Spring 2024 Unified Agenda of Regulatory and Deregulatory Actions, a list of the rulemaking activities that federal administrative agencies plan to undertake. The SEC's contribution to this list, which is referred to as the agency's Reg Flex Agenda, includes four disclosure-related projects of interest to audit committees: Human capital management disclosure, corporate board diversity disclosure, disclosure of payments by resource extraction issuers, and financial institution incentive-based compensation arrangements. The SEC's "target date" for proposals on human capital management and incentive-based compensation is October 2024. The target date for proposals on the other two matters is April 2025. (more)

Why is Your Audit Fee So High? Perhaps Management is Telling Investors it's Honest. Under A research paper published in the Journal of Business Ethics finds that companies that use "trust words," such as "character," "ethics," and "honest," in their MD&A "have lower information content" in their earnings announcements than firms that do not use trust words. In Can We Trust the Trust Words in 10-Ks?, the authors also report that "firms using trust words are more likely to receive a comment letter from the SEC, pay higher audit fees, and have lower corporate social responsibility scores." In short, the use of trust words in the 10-K is "associated with negative outcomes, and trust words are an inverse measure of trust." In reviewing MD&A and other company disclosures, audit committees may want to be alert to these words and consider whether they describe tangible corporate policies or are simply an attempt to create a favorable impression untethered to reality. (more)

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Update Nos. 89-present (March 2024 to present) and summaries are available here. Update Nos. 76-88 (August 2022 to February 2024) and summaries are available here. Update Nos. 60-75 (June 2020 to July 2022) are available here. Update Nos. 49-59 (January 2019 to May 2020) are available here. Updates prior to No. 49 are available on request.

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