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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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

In This Update

2023 PCAOB Large Firm Inspection Reports

On August 15, the Public Company Accounting Oversight Board released the 2023 inspection reports for the 14 U.S. annually inspected accounting firms, including the U.S. affiliates of the six global network firms (GNFs). In 34 percent of the engagements it inspected for these six large 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. This compares to a 30 percent deficient engagement rate for the six GNFs in 2022. See 2022 PCAOB Large Firm Inspection Reports -- Updated, May-June 2024 Update. Substantially higher deficiency rates at BDO and Grant were primarily responsible for the increase. For the Big Four firms only, the 2023 deficiency rate was 26 percent – the same as in 2022. For the eight annually inspected firms that are not global network members (non-affiliate firms--NAFs), the deficiency rates ranged from seven percent (Crowe) to 100 percent (B.F. Borgers).

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In the PCAOB press release announcing the publication of the 14 inspection reports, Chair Williams characterized the results as pointing "to some small signs of movement in the right direction." The release notes that the aggregate deficiency rate at the Big Four firms leveled off in 2023 and that there were "improvements in the deficiency rates at several of the other annually inspected firms," although "outliers" influenced the overall averages.

In addition to the inspection reports, the Board made available two new sources of comprehensive information concerning inspection results:

- The Board published on its website charts summarizing and illustrating much of the data in the 14 annually inspected firm reports. This material includes separate presentations regarding the six GNF inspection reports (U.S. Global Network Firms Inspection Data) and the eight NAF inspection reports (Non-Affiliated Firms Inspection Data).

- The Board also released Spotlight: Staff Update on 2023 Inspection Activities, which provides staff observations based on all of its 2023 inspections, including inspections of triennially inspected firms and broker-dealer auditor inspections. See PCAOB Staff Explains the 2023 Inspection Results in this Update.

This post analyzes the 2023 inspection reports of the six global network affiliate firms, compares them to last year's results and each other, and offers some comments. Audit committees should review their audit firm's inspection report and discuss it with their engagement partner.

Overview of 2023 GNF Results

As noted above, in 34 percent of the global network firm audit engagements inspected in 2023, the PCAOB found one or more Part I.A deficiencies. For two firms – BDO and Grant –deficiency rates rose sharply and exceeded 50 percent in 2023. In contrast, for EY and KPMG, the deficiency rates fell (by nine and four percent, respectively), although at both firms the share of inspected engagements that contained a deficiency remained above 25 percent. See Tables 1 and 2.

As in the 2020, 2021, and 2022 inspection cycles, PwC's results were the best in the GNF group, even though PwC's deficiency rate doubled in 2023. The Board found deficiencies in 10 of the 57 PwC audits it inspected (18 percent). In 2022, the Board found deficiencies in five (9 percent) of 54 PwC engagements inspected. Deloitte maintained its second-place position, with 12 deficient engagements (21 percent) in its 2023 inspection report, a modest increase over its 17 percent rate in 2022. At the other end of the spectrum, BDO, as in 2022, had the highest percentage of deficient engagements. The Board found problems in 25 (86 percent) of the 29 BDO audits it inspected, up from 66 percent last year. The 86 percent deficient engagement rate appears to be the highest ever experienced by one of the GNF firms.

Each engagement in Part I.A of an inspection report may contain several auditing standard violations. Therefore, in addition to comparing the number of engagements in Part I.A of the firms' inspection reports, another way of assessing their inspection results is to compare the number of auditing standard violations the Board found. See Table 3. Deloitte was best-in-class by this metric, followed by PwC. For Deloitte, the Board inspected 56 engagements and found 26 auditing standards violations) – 0.46 standards violations per inspected engagement. Each Deloitte Part I.A engagement had on average 2.2 standards violations. In PwC's report, there were 0.54 standards violations per inspection and an average of 3.1 violations per Part I.A engagement. In contrast, for BDO the comparable numbers were 4.62 standards violations per inspection and an average of 5.36 violations per Part I.A engagement.

In 2023, as in past years, the PCAOB found flaws in a substantial number of audits of internal control over financial reporting (ICFR). Inspectors found ICFR audit deficiencies in 27 percent of global network firm integrated audits inspected in 2023, essentially unchanged from 28 percent in the 2022. Similarly, 30 percent of all inspected engagements were found to have a financial statement audit deficiency. Sixty-seven percent of audit engagements described in Part I.A of the 2023 inspection reports of the six large firms included an ICFR deficiency and 88 percent included a financial statement audit 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. "Did not perform sufficient testing related to a significant account or disclosure or to address an identified risk" in the financial statement audit was the most frequently cited audit deficiency. See Table 5.

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 rules related to auditor independence. The six global network firm 2023 reports include 149 Part I.B deficiencies, compared to 139 in 2022. The most common Part I.B finding was the failure of the firm to perform procedures to determine whether all individuals who participated in an audit were in compliance with the independence requirements. See Tables 6 and 7.

For the six firms as a group, 484 instances of potential non-compliance with the independence rules are described in Part I.C, of which 460 were firm self-reported. The most common of these potential independence issues were violations of the audit committee pre-approval requirements, including instances related to services provided to an audit client affiliate by a non-U.S. firm associated with the auditor without obtaining audit committee pre-approval. See Tables 8 and 9. The 2023 increase in firm-reported Part I.C noncompliance was the result of circumstances at a single firm. See paragraph 1.d of the Audit Committee Takeaways below.

Summaries of 2023 GNF Inspection Reports

Below are summaries of the 2023 inspection reports of each of the six U.S. GNF affiliates:

- BDO USA, LLP. The PCAOB reviewed 29 BDO public company audits, 19 of which were integrated audits of both the financial statements and ICFR. In 25 of the 29 audits (86 percent), the PCAOB 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 66 percent deficient engagement rate in 2022. In two of the 25 deficient engagements, the public company's financial statements and/or its report on ICFR effectiveness, and the firm's opinions thereon, were determined to be incorrect and were revised and reissued. Eleven of the 25 engagements in Part I.A included deficiencies related to both the audit of the financial statements and the audit of ICFR; 11 included only a financial statement audit deficiency; and three included only an ICFR audit deficiency. The PCAOB described 134 audit deficiencies (4.62 deficiencies per inspection) associated with 145 auditing standards (5.0 standards per inspection) in the 25 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 32 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 five instances it identified of potential non-compliance with independence rules and one instance the firm identified.

- Deloitte & Touche LLP. The PCAOB reviewed 56 Deloitte public company audits, 50 of which were integrated audits of both the financial statements and ICFR. In 12 of the 56 audits (21 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 Deloitte's 17 percent deficient engagement rate in 2022. Six of the 12 engagements in Part I.A included deficiencies related to both the audit of the financial statements and the audit of ICFR, four included only a financial statement audit deficiency, and two included only an ICFR audit deficiency. The PCAOB described 26 audit deficiencies (0.46 deficiencies per inspection) associated with 29 auditing standards (0.52 standards per inspection) in the 12 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 14 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 identified of potential non-compliance with independence rules and 83 instances that the firm identified.

- Ernst & Young LLP. The PCAOB reviewed 59 EY public company audits, 51 of which were integrated audits of both the financial statements and ICFR. In 22 of the 59 audits (37 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 46 percent deficient engagement rate in 2022. In two of the 22 deficient engagements, the firm's opinion and the public company's report on ICFR effectiveness were determined to be incorrect and were revised and reissued. Twelve of the 22 engagements in Part I.A included deficiencies related to both the audit of the financial statements and the audit of ICFR, eight included only a financial statement audit deficiency, and two included only a deficiency in the ICFR audit. The PCAOB described 91 audit deficiencies (2.54 deficiencies per inspection) associated with 96 auditing standards (1.63 standards per inspection) in the 22 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 22 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 identified of potential non-compliance with independence rules and 66 instances that the firm identified.

- Grant Thornton LLP. The PCAOB reviewed 28 Grant public company audits, 20 of which were integrated audits of both the financial statements and ICFR. In 15 of the 28 audits (54 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 31 percent deficient engagement rate in 2022. Five of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and the audit of ICFR, eight included only a financial statement audit deficiency, and two included only an ICFR audit deficiency. The PCAOB described 52 audit deficiencies (1.86 deficiencies per inspection) associated with 59 auditing standards (2.11 standards per inspection) in the 15 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 30 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 19 instances it identified of potential non-compliance with independence rules and 16 instances that the firm identified.

- KPMG LLP. The PCAOB reviewed 58 KPMG public company audits, 52 of which were integrated audits of both the financial statements and ICFR. In 15 of the 58 audits (26 percent), the PCAOB identified deficiencies of such significance that it appeared that the firm had not obtained sufficient appropriate audit evidence to support its opinion. KPMG's deficient engagement rate in 2022 was 30 percent. All 15 of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and the audit of ICFR. The PCAOB described 74 audit deficiencies (1.28 deficiencies per inspection) associated with 79 auditing standards (1.36 standards per inspection) in the 15 engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 36 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 identified of potential non-compliance with independence rules and 219 instances that the firm identified.

- PricewaterhouseCoopers LLP. The PCAOB reviewed 57 PwC public company audits, 50 of which were integrated audits of both the financial statements and ICFR. In ten of the 57 audits (18 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 nine percent deficient engagement rate in 2022. In one of the ten deficient engagements, the firm's opinion and the public company's report on ICFR effectiveness were determined to be incorrect and were revised and reissued. Five of the engagements in Part I.A included deficiencies related to both the audit of the financial statements and the audit of ICFR, two included only a financial statement audit deficiency, and three included only an ICFR audit deficiency. The PCAOB described 31 audit deficiencies (0.54 deficiencies per inspection) associated with 33 auditing standards (0.58 standards per inspection) in the ten engagements in Part I.A. In Part I.B of the inspection report, the PCAOB identified 15 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 instance it identified of potential non-compliance with independence rules and 75 instances that the firm identified.

Comparison of Firm Part I.A Results

Table 1 compares the results of the 2023 inspections of the U.S. affiliates of the six global network firms. Table 2, which appeared in 2022 PCAOB Large Firm Inspection Reports--Updated, May-June 2024 Update, compares the results of the 2022 inspections of the six global network firms.

TABLE 1

2023 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(Reports are dated between May 23, 2024, and June 20, 2024, and were released on August 15, 2024)

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	29	25	86%
Deloitte & Touche	56	12	21%
Ernst & Young	59	22	37%
Grant Thornton	28	15	54%
KPMG	58	15	26%
PwC	57	10	18%
Global Network Firm Totals	287	99	
Global Network Firm Averages	48	17	34%

TABLE 2

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, 2024; unredacted KPMG report released on April 26, 2024)

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	16	30%
PwC	54	5	9%
Global Network Firm Totals	270	82	
Global Network Firm Averages	45	14	30%

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. 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. 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 2023 INSPECTION REPORTS

Firm	Engagements Inspected	Deficient Engagements	Total Deficiencies	Standards Referenced	Deficiencies Per Inspected Engagement	Standards Referenced Per Inspected Engagement
BDO	29	25	134	145	4.62	5.00
Deloitte & Touche	56	12	26	29	0.46	0.52
Ernst & Young	59	22	91	96	2.54	1.63
Grant Thornton	28	15	52	59	1.86	2.11
KPMG	58	15	74	79	1.28	1.36
PwC	57	10	31	33	0.54	0.58
Global Network Firm Totals	287	99	408	441		
Global Network Firm Averages	48	17	68	74	1.42	1.54

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 2023 GNF 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. Table 4 only includes standards cited more than once.

TABLE 4

AUDITING STANDARDS REFERENCED IN FIVE GLOBAL NETWORK FIRM 2023 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	192	43.5%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	88	20.0%
AS 1105, Audit Evidence	57	18.9%
AS 2501, Auditing Accounting Estimates	29	6.6%
AS 2315, Audit Sampling	27	6.1%
AS 2810, Evaluating Audit Results	19	4.3%
AS 1201, Supervision of the Audit Engagement	6	1.4%
AS 2305, Substantive Analytical Procedures	6	1.4%
AS 2510, Auditing Inventories	5	1.1%
AS 2310, The Confirmation Process	4	0.9%
AS 2415, Consideration of an Entity's Ability to Continue as a Going Concern	3	0.7%
AS 2101, Audit Planning	2	0.5%

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 GNF 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 2023 SIX GLOBAL NETWORK FIRM INSPECTION REPORTS

Deficiency Description	Number of Times Deficiency Was Identified	Audit Affected	Share of All Most Frequent Deficiencies
Did not perform sufficient testing related to a significant account or disclosure or to address an identified risk.	50	FS	22.5%
Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing.	40	ICFR	18.0%
Did not identify and test any controls that addressed the risks related to a significant account or relevant assertion.	37	ICFR	16.7%
Did not perform sufficient testing of data or reports used in the firm's substantive testing.	32	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.	31	ICFR	14.0%
Did not sufficiently test an estimate.	17	FS	7.7%
Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.	8	FS	3.6%
Did not appropriately evaluate control deficiencies.	2	ICFR	0.9%
Did not perform sufficient, appropriate analytical procedures when analytical procedures were intended to provide substantive evidence (or when used to address an identified risk).	2	FS	0.9%

Audit/financial statement areas. For each inspection report, the PCAOB lists the audit areas with frequent Part I.A deficiencies. For the six firms, on an aggregate basis, these areas (excluding those cited only once) are:

- Revenue and related accounts – 45 deficiencies.
- Inventory – 19 deficiencies.
- Business combinations – 12 deficiencies.
- Investment securities -- 9 deficiencies.

- Goodwill and intangible assets – 6 deficiencies.
- Allowance for credit losses/Allowance for loan losses – 4 deficiencies.
- Going concern – 3 deficiencies.
- Long-lived assets – 2 deficiencies.
- Insurance-related assets and liabilities, including insurance reserves – 2 deficiencies.

Other Instances of Non-Compliance: Comparison of 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 2023, the PCAOB found an aggregate of 149 such deficiencies, compared to 139 in 2022. Table 6 presents the number of Part I.B deficiencies for each of the six firms and compares each firm's 2023 Part I.B results to its 2022 report.

TABLE 6

PART I.B DEFICIENCIES: 2023 and 2022 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORK FIRMS

Firm	2023 Part I.B Deficiencies	2022 Part I.B Deficiencies	Net Change in Part I.B Deficiencies 2022 to 2023
BDO	32	16	+16
Deloitte & Touche	14	25	- 11
Ernst & Young	22	30	-8
Grant Thornton	30	38	-8
KPMG	36	23	+13
PwC	15	7	+8
Global Network Firm Totals	149	139	+10
Global Network Firm Averages	24.8	23.2	+1.7

Note: 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 7 lists the most frequent Part I.B deficiencies in the six reports. Table 7 only includes deficiencies cited at least four times.

TABLE 7

MOST FREQUENTLY CITED PART I.B DEFICIENCIES
IN 2023 SIX FIRM INSPECTION REPORTS

Deficiency Description/Auditing Standard	Number of Times Deficiency Cited
Firm did not perform procedures to determine whether all individuals who participated in the audit were in compliance with independence requirements. AS2101, Audit Planning.	22
Firm did not include all relevant work papers in the final set of audit documentation it was required to assemble. AS 1215. Audit Documentation.	19
Firm did not evaluate certain factors when determining that there were no risks of material misstatement related to certain significant accounts and/or disclosures. AS 2110, Identifying and Assessing Risks of Material Misstatement.	14
Firm when testing journal entries for evidence of possible material misstatement due to fraud, did not have an appropriate rationale for limiting its testing of entries it identified as having certain fraud risk characteristics to certain entries. AS 2401, Consideration of Fraud in a Financial Statement Audit.	13
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.	11
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. AS 3101, The Auditor's Report on an Audit of Financial Statements.	9
Firm's report on Form AP omitted information or included inaccurate information related to the participation in the audit by another accounting firm or firms. PCAOB Rule 3211, Auditor Reporting of Certain Audit Participants.	9
Firm, when testing journal entries for evidence of possible material misstatement due to fraud, did not appropriately consider the characteristics of potentially fraudulent journal entries in determining the criteria it used to identify and select journal entries for testing. AS 2401, Consideration of Fraud in a Financial Statement Audit.	7
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.	6
Firm did not make a required communication to management related to one or more identified misstatements. AS 2810, Evaluation of Audit Results.	4
Firm did not communicate to management, in writing, all control deficiencies identified during the audit or did not inform the audit committee when such communications had been made prior to the issuance of the auditor's report. AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.	4

Independence: Comparison of Firm Part I.C Results

Part I.C of an inspection report discusses instances of potential non-compliance with SEC or PCAOB auditor independence rules. 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 24 instances of potential independence rule noncompliance, 19 of which were at Grant. The six firms self-reported 416 such instances, 215 of which were at KPMG. See paragraph 1.d of the Audit Committee Takeaways below.

Table 8 presents the Part I.C instances of potential non-compliance with the independence rules for each of the six firms. In reviewing Table 8, readers should be aware that 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."

As the Board also 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 416 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

INSTANCES OF POTENTIAL NON-COMPLIANCE WITH INDEPENDENCE RULES
IN PART I.C OF GLOBAL NETWORK FIRM 2023 INSPECTION REPORTS

Firm	PCAOB-Identified Instances	Firm-Identified Instances	Issuers Affected Firm-Identified Instances	Affected Firm-Id'ified Issuers As Percent of All Issuers	Non-U.S. Affiliate Percent of Firm-Identified Instances
BDO	5	1	1	Less than 1%	0%
Deloitte & Touche	0	83	50	2%	30%
Ernst & Young	0	66	45	3%	29%
Grant Thornton	19	16	8	1%	75%
KPMG	0	219	97	9%	94%
PwC	0	75	51	3%	28%
Global Network Firm Totals	24	460	252		
Global Network Firm Averages	4	76.7	42		

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 416 firm-reported potential non-compliance instances.

TABLE 9

COMMON INSTANCES OF POTENTIAL NON-COMPLIANCE WITH INDEPENDENCE RULES IN PART I.C OF 2023 SIX FIRM INSPECTION REPORTS

Potential Non-compliance	Number of Times Potential Non-compliance Cited
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. SEC Regulation S-X, Rule 2-01(c)(7).	216
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). SEC Regulation S-X, Rule 2-01(c)(1).	144
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. SEC Regulation S-X, Rule 2-01(c)(2).	31
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. SEC Regulation S-X, Rule 2-01(c)(4).	12
Tax services, including instances in which a non-U.S. associated firm provided a prohibited tax service to a person in a financial reporting oversight role at an affiliate of an audit client. PCAOB Rule 3523.	10
Non-compliance with the SEC's partner rotation requirement. SEC Regulation S-X, Rule 2-01(c)(6) of SEC.	2
Indemnification clauses, including agreements under which the audit client agreed to indemnify the auditor with respect to certain liabilities arising from the audit. Regulation S-X, Rule 2-01(b).	1

Audit Committee Takeaways

1. Audit committees seeking to understand their audit firm's inspection results and how they fit into the overall context of the 2023 inspections may want to review Spotlight: Staff Update on 2023 Inspection Activities, discussed in PCAOB Staff Explains the 2023 Inspection Results in this Update. Audit committees may also want to consider several points:

   a. Audit quality is steady or improving at the four largest firms as a group.

While the overall Part I.A deficiency rate for the six GNFs rose from 30 percent in 2022 to 34 percent in 2023, at the Big Four – Deloitte, EY, PwC, and KPMG – the rate was constant at 26 percent in both years. To some extent, this reflects convergence among the Big Four – the two firms with the best records (Deloitte and PwC) experienced some deterioration in their Part I.A deficiency rates, while the other two firms (EY and KPMG) improved their deficiency rates somewhat. The PCAOB staff also points out in the Spotlight report cited above that the percentage of Big Four audits reviewed with multiple Part I.A deficiencies was 20 percent in 2023, essentially the same as the 21 percent rate in 2021, and that these firms' deficiencies tended to be "more isolated incidents than in the past" rather than part of a pattern of deficiencies affecting multiple audits.

b. The disparity between the six global network firms is increasing.

While the Big Four may be converging, the other GNFs are not. In 2023, the gap between the GNF firm with the lowest percent of inspected engagements that were deficient (PwC – 18 percent) and the firm with the highest percentage (BDO – 86 percent) was 68 percentage points. This gap has widened over the last three years. In 2022, it was 57 percent, and in 2021 it was 49 percent. Similarly, the PCAOB found 0.46 deficiencies for every Deloitte audit it inspected and 4.62 deficiencies – ten times more -- for every BDO audit. The PCAOB staff observes that, for the GNFs as a group, "outliers are substantially affecting the aggregate deficiency rate."

c. Part I.B deficiencies increased modestly.

Part I.B deficiencies increased modestly from 139 in 2022 to 149 2023. As in the past, it is not clear whether this increase reflects more underlying deficiencies or more PCAOB inspection focus on Part I.B issues. The most frequent Part I.B issue in 2023 was "Firm did not perform procedures to determine whether all individuals who participated in the audit were in compliance with independence requirements" which was cited in inspection reports 22 times. The frequency of this violation was primarily driven by 16 instances in KPMG audits. The second most frequent Part I.B violation was "Firm did not include all relevant work papers in the final set of audit documentation it was required to assemble." The PCAOB identified 19 instances of this deficiency, nine of which occurred at Grant. The most common Part I.B deficiency in 2022 and 2021, "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" fell to fifth place in 2023.

d. Part I.C independence violations increased, but the increase resulted from one mistake.

In 2023, the six global network firms self-reported 460 instances of potential non-compliance with the independence rules, and the PCAOB uncovered 24 more instances. This compares to 392 self-reported and nine PCAOB-identified incidences in 2022. 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.

More than half of the firm-identified events – 216 instances -- involved noncompliance with the requirement for audit committee pre-approval of services. The vast majority of those instances arose at KPMG. KPMG's inspection report contains the following explanation:

> "The firm reported 202 instances of potential non-compliance with Rule 2-01(c)(7) of Regulation S-X regarding audit committee pre-approval. In the current year, the firm identified that certain non-U.S. associated firms requested that the firm obtain pre-approval for those firms to perform statutory audits but did not report to the firm certain other services that also required preapproval that those firms provided in connection with those statutory audits. As a result, the firm obtained pre-approval for the statutory audits but did not obtain pre-approval for the additional services provided. In response to this, the firm surveyed all non-U.S. associated firms that provided statutory audits associated with the firm's issuer audit clients in the past three years and identified 192 total instances in which additional services were provided by non-U.S. associated firms that were not pre-approved."

But for these 202 instances of noncompliance with the pre-approval rule, the total number of firm-identified potential independence violations in 2023 would have substantially declined compared to 2022.

All 24 of the PCAOB-identified instances of potential non-compliance with the independence rules also involved noncompliance with the requirement for audit committee pre-approval. Nineteen of these instances occurred at Grant and five at BDO. The inspection report does not provide any detail concerning those lapses.

2. Audit committees should discuss their audit firm's inspection report with the engagement partner. In last year's Spotlight: Staff Update and Preview of 2022 Inspection Observations, the staff suggested that, in light of increased inspection findings, audit committees may want to consider asking these four questions in discussions with their independent auditors:

- Has our audit engagement been inspected, and, if so, would you share the results? Were there any audit areas that required significant discussions with the PCAOB that did not result in a comment form?

- Has the engagement partner been inspected on other engagements? If so, what were the results of that inspection?

- What is the audit firm doing to address overall increased inspection findings?

- Are there any audit procedures that are unnecessarily complicated or not "straight-forward" because management is not providing clear, supportable information? (While not related to inspection reporting, the staff believes that this question "may encourage effective two-way communication to assist in understanding matters relevant to the audit.")

3. 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, the impact on the audit as a whole, and how the auditor plans to remedy it and prevent a recurrence.

PCAOB Staff Explains the 2023 Inspection Results

The Public Company Accounting Oversight Board has released Spotlight: Staff Update on 2023 Inspection Activities (2023 Inspections Spotlight). This publication presents the results of the 2023 inspection program and provides staff observations on those results. The 2023 Inspections Spotlight is generally similar to the inspection "preview reports" the Board has released in prior years. See 2022 PCAOB Inspections Preview Says 40 Percent of Audits Reviewed Had Deficiencies, July 2023 Update. However, the 2023 Inspections Spotlight is more comprehensive than the prior reports and includes new information to facilitate comparisons between categories of inspected firms and an understanding of inspection findings.

The 2023 Inspections Spotlights begins with a discussion of trends and key findings. Following that discussion, the report consists of five sections – 2023 Inspections Approach; Common Deficiencies Found by 2023 Inspections; Observations Related to Quality Control Systems; Trends in Areas with Recurring Deficiencies, 2021 to 2023 Inspections; and Good Practices and Important Reminders.

Trends and Key Findings

In 2023, the PCAOB inspected 227 registered public accounting firms and reviewed portions of 793 public company audits and 103 securities broker-dealer audits. Forty-six percent of the public company audits reviewed in 2023 had at least one Part I.A deficiency, up from 40 percent in 2022. (A Part I.A deficiency is an audit deficiency of such significance that it appeared to the PCAOB that the firm did not obtain sufficient evidence to support its opinion.) Regarding the increase in Part I.A deficiencies in recent years, the 2023 Inspections Spotlight offers several observations:

- Although the overall negative trend in deficiencies continued in 2023, the staff states that it has "begun to see the aggregate deficiency rate at the Big Four firms level off, as well as improvements in the deficiency rates at several of the other annually inspected firms."

- Audit firms have told the PCAOB staff that remote work and the lack of in-person training for new hires during the pandemic "negatively affected audit quality and resulted in a surge of inspection deficiencies in 2021 and 2022."

- Some firms have suggested other factors contributed to rising deficiencies, including challenges with firm technology; over-reliance on prior year results; ineffective timing and project management; and insufficient testing of significant transactions.

The 2023 Inspections Spotlight also identifies and discusses ten "key findings" arising from the 2023 inspections:

- Signs of "Leveling Off" at the Largest Firms. For the U.S. Big Four firms as a group, the Part I.A deficiency rate was unchanged at 26 percent of inspected engagements in 2023 after increasing from 12 percent in 2020 to 16 percent in 2021 and to 26 percent in 2022. Similarly, the percentage of these four firms' audits reviewed by the PCAOB that had more than one audit deficiency was nearly flat at 20 percent in 2023, after rising from 9 percent in 2020 to 13 percent in 2021 and to 21 percent in 2022. (Each engagement in Part I.A of an inspection report may have one or more audit deficiencies.) In addition, aggregate Part II criticisms in Big Four inspection reports fell in 2023 for the first time in three years. (Part II of an inspection report includes PCAOB criticisms of the inspected firm's system of quality control.)

- Outliers Heavily Influence Averages. For the six U.S. firms that are affiliates of global networks (including the Big Four), the aggregate Part I.A deficiency rate was 34 percent. The staff states that this rate was substantially affected by two "outliers." The two global network firms with the highest Part I.A deficiency rates were BDO (86 percent) and Grant (54 percent).

- Audit Quality at Triennially Inspected Firms Is Not Improving Quickly Enough. Over half of the triennially inspected firms (i.e., those with 100 or fewer public company audit clients) had no notable changes in their Part I.A deficiency rate compared to prior inspections.

- First-Time Firm Inspections Typically Have Higher Deficiency Rates. An increase in the share of firms inspected for the first time in 2023 was a factor in the increase in Part I.A deficiencies.

- Different Engagement Selection Criteria Produce Similar Results. Although most engagements are selected for inspection based on the PCAOB's perception that the audit involved elevated risk, in 2023, 39 percent of engagements in Part I.A were randomly selected, an increase from 26 percent in 2022 and 19 percent in 2021. The PCAOB staff states that this "demonstrates that the risk-based selection of engagements for review is not the sole factor driving" the increase in deficiency rates. All other things being equally, one would expect that randomly selected engagements would be less likely to result in Pat I.A deficiencies, compared to engagements selected based on risk.

- Signs of Potential Improvements in Quality Control Findings. Big Four firm 2023 Part I.A audit deficiencies "appear to represent more isolated incidents than in the past, where we often saw the same or related types of deficiencies on multiple audits. The more isolated nature of the incidents in 2023 means the deficiencies are less likely to indicate QC system concerns." The staff also states that it is "hopeful" that the isolated nature of 2023 deficiencies and the decrease in the number of Part II quality control system criticisms "signals improvement in [the Big Four] firms' QC systems, which in turn could lead to declines in their audit deficiencies going forward."

- Market Volatility and Iterative Risk Assessment. Macroeconomic events, such as inflation and interest rates, affected the nature of deficiencies, particularly those related to auditing estimates.

- Recurring and Pervasive Deficiencies Continue. Many 2023 Part I.A deficiencies are similar to those in prior inspections. Two common recurring deficiencies are (1) insufficient testing of estimates or of data and reports used to support audit conclusions, and (2) insufficient testing of controls that include a review element, specifically insufficient testing of whether such controls operated at a level of precision sufficient to prevent or detect material misstatements.

- Noncompliance With Other Rules and Standards Increased. The 2023 Inspections Spotlight does not provide specific information concerning the rate of noncompliance with other rules and standards, but states that the staff "remain[s] concerned" about compliance with PCAOB standards and rules other than those that affect audit evidence. The Spotlight cites fraud risk, audit transparency (audit committee communications and Form AP), and independence as examples.

- Overall, Firms Need To Do Better. "We continue to be concerned about audit quality as reflected in the overall deficiency rates."

2023 Inspections Approach

This section discusses how the Board selects firms for inspection and how it selects engagements for review. It also provides additional insight regarding the impact of random selections on deficiency rates:

> "In 2023, 60% of the randomly selected public company audit engagements resulted in at least one deficiency, and we expect approximately 39% of those randomly selected engagements will be included in Part I.A. In comparison, 62% of our risk-based selections resulted in at least one deficiency, and we expect approximately 47% of those risk-based selections will be included in Part I.A."

The 2023 Inspection Spotlight includes detailed information concerning the profile of firms inspected in 2023 and of the engagements reviewed (e.g., their industry sectors). Financials was the industry sector that accounted for the highest percentage of inspections in 2023 (19 percent) while the Real Estate sector was the lowest (1 percent).

Common Deficiencies Found by 2023 Inspections

This section discusses examples of common deficiencies in ICFR and financial statement auditing and in complying with other PCAOB standards and rules.

- With respect to ICFR, examples include deficiencies in risk assessment, testing of the design effectiveness of controls, testing of management review controls, and consideration of the impact of information technology on controls.

- The top five financial statement areas in which inspectors have found deficiencies are revenue and related accounts; inventory; accounts impacted by business combinations; investment securities; and long-lived assets, goodwill, and intangible assets. The 2023 Inspections Spotlight discusses examples of deficiencies in each of these areas, along with examples involving digital asset transactions, allowance for credit losses, and cybersecurity.

- The most common Part I.B deficiencies related to fraud, critical audit matters, auditor tenure, and audit committee communications. The 2023 Inspections Spotlight discusses these types of noncompliance, along with an overview of findings regarding Form AP.

Observations Related To Quality Control Systems

Inspections include an assessment of the firm's system of quality control, including an evaluation of whether audit deficiencies indicate a defect in quality controls. The 2023 Inspections Spotlight discusses three quality control areas in which deficiencies are commonly identified: compliance with SEC or

PCAOB independence rules, engagement quality review (EQR -- concurring approval of an audit report by a reviewer not involved in conducting the audit), and monitoring (i.e., ongoing consideration and evaluation of the quality control system).

Quality control criticisms appear in Part II of a firm's inspection report and are nonpublic when the report is issued. If the firm fails to satisfactorily remediate the deficiency within one year of the report's issuance, the Board makes the criticism public. In 2023, the Board made remediation determinations related to 92 firm inspection reports and reached a satisfactory determination for approximately 60 percent. Quality control areas with an unsatisfactory determination most frequently related to testing controls, EQR, policies for personal independence compliance testing, and testing revenue.

Trends In Areas With Recurring Deficiencies, 2021 To 2023 Inspections

The 2023 Inspections Spotlight presents three years of data on the ICFR audit and financial statement audit areas with recurring deficiencies. The most frequent ICFR deficiencies during the past three years were "testing controls with a review element" and "identifying and selecting controls to test." For 2023, the most common financial statement deficiency areas were Other Investments, Loans and Related Accounts, and Leases.

Good Practices And Important Reminders

The 2023 Inspections Spotlight discusses in detail good audit practices that inspectors have observed with respect to three audit areas – Long-lived assets, consideration of fraud, and revenue.

Audit Committee Takeaways

1. As noted in 2023 PCAOB Large Firm Inspection Reports in this Update, the 2023 Inspections Spotlight provides good background information for audit committees seeking to understand their audit firm's inspection results and how they fit into the overall context of the 2023 inspections. Committees may want to review the Spotlight in conjunction with their auditor's inspection report and as part of their preparation for discussion of the inspection with their engagement partner.

2. The 2023 Inspections Spotlight suggests five questions audit committee members may want to consider discussing with their auditor:

- What are the pros and cons of audit tenure?
- How does the firm ensure non-U.S.affiliate personnel, staff from other areas of the firm, and/or other auditors used on the engagement maintain their independence?
- How does the firm ensure affiliates outside the U.S. follow PCAOB standards and rules, when required, on referred work related to the group audit?
- What were the results of your most recent remediation efforts with the PCAOB?
- Does the firm have any new initiatives related to improving audit quality?

While these are not a complete list of the relevant questions regarding an audit firm's inspection, they would be a useful component of the discussion with the engagement partner. Four additional, more foundational, inspection-related questions that the PCAOB staff has previously suggested are listed in 2023 PCAOB Large Firm Inspection Reports in this Update. See also So Many Questions: PCAOB Suggests Questions Audit Committees Should Ask, July 2023 Update.

3. The 2023 Inspections Spotlight may also provide insight into issues the PCAOB is likely to focus on in future inspections and into the audit areas most likely to generate deficiencies. Audit committees

may want to discuss with their auditor how it plans to address these areas. The Spotlight may also aid audit committees in understanding their auditor's risk assessment and resource allocation decisions.

A Shift in the Winds: Court Rejects SEC's Use of Internal Control Authority to Police Cybersecurity

On July 18, the Securities and Exchange Commission's efforts to use the internal accounting control requirement in the Securities Exchange Act of 1934 as a lever to regulate public company cybersecurity practices suffered a setback.   In SEC v. SolarWinds Corp., a federal district court judge held that the provision in Section 13(b)(2)(B) of the Exchange Act requiring companies to devise and maintain "a system of internal accounting controls sufficient to provide reasonable assurances that * * * access to assets is permitted only in accordance with management's general or specific authorization" does not apply to cybersecurity controls. This decision is contrary to the position that the SEC took in its recent settlement with R.R. Donnelley & Sons. See Shoot the Wounded! SEC Charges that Inadequate Cybersecurity is an Internal Accounting Control Violation, July 2024 Update.

In 2023, the SEC brought an enforcement action against SolarWinds Corp. and its Chief Information Security Officer. SolarWinds markets Orion, an IT monitoring and management software platform. The case arises from a cyberattack, known as SUNBURST, in which Russian hackers surreptitiously inserted a vulnerability into Orion thereby making the IT systems of SolarWinds' customers susceptible to exploitation by the hackers. The SEC's case against SolarWinds includes four claims:

- Prior to the SUNBURST attack, SolarWinds misled investors by overstating its cybersecurity practices and downplaying risks associated with Orion. This claim is based primarily on the content of a Security Statement, directed at customers, posted on the company's website.

- Following the SUNBURST attack, SolarWinds misled investors by minimizing the scope and impact of the breach, including by omitting to disclose that customers had previously reported malicious activity involving Orion.

- Solar Winds violated the Exchange Act requirement to devise and maintain a system of internal accounting controls. This claim is based on the contention that the company's source code, databases, and products were its most vital assets, but that, because of poor access controls, weak internal password policies, and VPN security gaps, SolarWinds failed to limit access to those assets "only in accordance with management's general or specific authorization" as required by Section 13(b)(2).

- SolarWinds violated Exchange Act Rule 13a-15(a) which requires companies to maintain disclosure controls and procedures designed to ensure that information required to be disclosed in SEC filings is "recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms." The SEC contends that senior management failed to evaluate the need to disclose two cyber incidents because the seriousness of those incidents was misclassified under the company's disclosure procedures.

The court dismissed all the Commission's claims except those related to the Security Statement. Concerning the internal accounting controls claim, the court stated:

> "[T]he statutory requirement that a public issuer 'devise and maintain a system of internal accounting controls' is properly read to require that issuer to accurately report, record, and reconcile *financial* transactions and events. A cybersecurity control does not naturally fit within this term, as a failure to detect a cybersecurity deficiency (*e.g.*, poorly chosen passwords) cannot reasonably be termed an accounting problem. Cybersecurity controls are undeniably vitally important, and their failures can have systemically damaging consequences. But these controls cannot fairly be said to be in place to 'prevent and detect errors and irregularities that arise in the accounting systems of the company.'"

* * *

> "[T]he the internal accounting controls identified in Section 13(b)(2)(B) thus are intended to provide extra assurance of the accuracy and completeness of the financial information on which the issuer's annual and quarterly reports rely. To state the obvious, cybersecurity controls are not--and could not have been expected to be--part of the apparatus necessary to the production of accurate such reports." [emphasis added, citation omitted]

With respect to the disclosure controls claim, the Court held that the SEC's complaint recognized that SolarWinds had a system of controls in place to facilitate the disclosure of potentially material cybersecurity risks and incidents. The fact that the system misclassified two cybersecurity incidents and therefore failed to trigger management consideration of the need to disclose them did not render the system insufficient. "[E]rrors happen without systemic deficiencies. Without more, the existence of two misclassified incidents is an inadequate basis on which to plead deficient disclosure controls."

Audit Committee Takeaways

The SolarWinds decision should put the brakes on the SEC's efforts to use the internal accounting control provisions of the Exchange Act to regulate cybersecurity (and other) corporate administrative and managerial practices that are not directly related to financial reporting. The Commission could either appeal the decision or continue to press its broad reading the internal accounting control provisions in other courts and in its in-house administrative proceedings. However, the reasoning of the opinion seems compelling and is likely to be persuasive to other judges.

Nonetheless, from an audit committee perspective, the SEC's loss in SolarWinds may not have much practical impact. With or without internal accounting controls as one of its theories, the Commission is likely to remain aggressive in pursuing cybersecurity disclosure cases, especially where, after a breach has occurred, pre-breach disclosures appear in hindsight to have been overly optimistic about the company's cybersecurity posture.

Audit committees might want to take this decision as a reminder that –

- Disclosure concerning cybersecurity and cyber breaches is a top SEC enforcement priority.

- The Commission is increasingly willing to use the disclosure controls requirement in Rule 13a-15 to bring enforcement actions and is likely to make liberal use of the rule in cases involving cybersecurity disclosure issues. While the two misclassifications in this case did not indicate a lack of controls and procedures, more pervasive failures to consider cyber incidents (or other events) for disclosure may result in SEC charges under Rule 13a-15. See The SEC is Zeroing in on Disclosure Controls, April 2023 Update.

- The Commission will likely be aggressive in enforcing its new cybersecurity disclosure rules with respect to future cybersecurity incidents. See SEC Adopts Cybersecurity Disclosure Rules, August-September 2023 Update. The SolarWinds case arose prior to the adoption of those rules.

- The SEC may scrutinize statements about cybersecurity practices that are outside of SEC filings and that aimed at audiences other than investors. Any company public statement that the SEC deems to be materially false or misleading can be the basis for SEC enforcement, regardless of where the company makes the statement or who it intends to influence. (The Security Statement in SolarWinds appeared on the company's website and targeted customers, not investors.)

For these reasons, oversight of cybersecurity disclosures should be an audit committee priority.

CAQ Releases a Resource for Audit Committees on Generative AI Oversight

The Center for Audit Quality (CAQ) has published Audit Committee Oversight in the Age of Generative AI, a resource for audit committee members that provides an overview of the use of generative AI (genAI) in financial reporting processes and internal control over financial reporting (ICFR). The paper includes questions audit committees can ask to understand management's approach to using genAI in financial reporting and the related risks. The CAQ notes that "As the use of genAI in financial reporting processes and ICFR presents new risks and considerations for companies, audit committees will have an important oversight role to play."

The CAQ's publication discusses three topics – an overview of genAI, the impact of genAI on financial reporting and ICFR, and the AI regulatory environment.

Overview of GenAI

GenAI is one category of the broader field of artificial intelligence. The CAQ provides this taxonomy:

- Artificial intelligence (AI) broadly refers to machines that mimic human cognitive abilities. AI includes capabilities such as natural language processing, problem-solving, pattern recognition, anomaly identification, and decision-making.

- Machine learning is a subset of AI that uses algorithms to learn from, and make predictions or decisions based on, data. Machine learning algorithms are designed to learn and improve from experience.

- Deep learning is a subset of machine learning that uses algorithms that roughly approximate the structure and capabilities of the human brain and enable the technology to handle complex tasks.

- GenAI refers to a subset of deep learning based on probabilistic technology that can create content, including text, images, audio, or video, when prompted by a user. GenAI creates responses using algorithms that are often trained on open-source information, such as text and images from the internet.

Other points in the CAQ's explanation of genAI Include:

- Predictive technology: Gen AI technologies are trained on large datasets and learn patterns, structures, and representations from the training data. GenAI technologies make "predictions of the next character, word, phrase, pixel, etc. to formulate a probable response to the user prompt." Asking genAI the same question several times may produce different answers.

- Foundation models and customization. Foundation models are large language models that can be adapted to a range of uses. Companies can build their own customizations on top of foundation models, such as by training the model with the company's data.

- The "black box" concept. The process by which genAI derives output is not readily "explainable or interpretable" because of the inherent complexity of AI algorithms and the nonlinearity of the relationships between the underlying data and the outputs. The importance of being able to explain or interpret output depends on the use.

Impact of GenAI on Financial Reporting and ICFR

GenAI can streamline some financial reporting activities, such as those that involve drafting, summarizing data, and working with unstructured data. Further, genAI can identify trends, patterns, and anomalies in data that would be difficult for humans to uncover. While the use of genAI in financial reporting can make employees more efficient, “humans continue to be involved to oversee, understand, and evaluate the relevance and reliability of the outputs from genAI technology”.

The CAQ lists five sources of risk that the audit committee should consider in understanding and overseeing management’s use of genAI in financial reporting. For each risk topic, the CAQ suggests questions the committee may want to discuss with management and the auditor. Below is a summary of each risk and examples of suggested questions.

- <u>Governance</u>. Establishing strong oversight and governance of the use of genAI is foundational to successfully deploying genAI technologies. Oversight/governance questions the audit committee might ask include:

    - For management: Does the company have the requisite expertise to select, develop, deploy, and monitor genAI technologies? Will management need to engage third parties to select, develop, deploy, and monitor genAI technologies? What are the company’s objectives and related success criteria for deploying genAI technologies? Are genAI technologies intended to augment or automate existing processes?

    - For the auditor: What risks has the auditor identified based on how the company has deployed genAI technologies? How will the auditor address such risks in the audit? Has the auditor identified any deficiencies or lack of internal controls to mitigate against risks related to the company’s use of genAI technologies that fall within the scope of the audit?

- <u>Data Privacy and Security</u>. Privacy and security risks depend on how genAI is used. Publicly available genAI may track and save user prompts and user data inputs. These inputs may be used to train the model and could affect the responses provided to other users. GenAI technologies may also be susceptible to cyber-attacks that could impact the reliability of outputs or put confidential company data at risk. Data privacy/security questions the audit committee might ask include:

    - For management: Does the company use a public instance of genAI technologies or a private instance? How does management consider cybersecurity risks when selecting or developing genAI technologies? Has the company performed a cybersecurity risk assessment for genAI technologies to evaluate threats and safeguards?

    - For the auditor: Has the auditor identified any risks related to data privacy or security of genAI technologies that are relevant to the audit?

- <u>Selection and Design of GenAI Technologies</u>. The audit committee should understand where genAI is deployed in the financial reporting process and why management selected those aspects of the process for genAI support. The committee should also understand how management determined whether to build or buy the genAI technologies it is employing and how it determined the technology’s capabilities. Questions the audit committee might ask include:

    - For management: How does management design genAI technologies, including determining which genAI technologies to use (such as selecting an existing genAI technology, using a foundation model with added customizations, or developing the company’s own model) and the data needed for those technologies?

    - For the auditor: How does the company’s use of a foundation model or development of its own model impact the auditor’s risk assessment?

- <u>Deploying and Monitoring GenAI Technologies</u>. The audit committee should understand how management tests genAI technology prior to deployment, how it determines the appropriate level of human involvement, and how management monitors the effectiveness of genAI technologies. Questions the audit committee might ask include:

  - For management: How does the company test genAI technologies prior to deployment to determine that they operate as designed? Does the company measure, track, and communicate performance metrics related to the functioning of the genAI technologies, including the precision of the technology? How has the company trained employees about genAI technologies?

- Fraud. The use of genAI can increase fraud risk. For example, employees could use genAI to create documentation for fraudulent transactions or third parties could use genAI to create deepfake videos or audio files to convince company employees to provide them with money or confidential information. Fraud risk questions the audit committee might ask include:

  - For management: What fraud risks associated with the use of genAI technologies has management identified and how have they been addressed?

  - For the auditor: Has the auditor identified any fraud risks related to the company's use of genAI technologies? How has the auditor addressed such risks in the audit? Has the auditor identified any deficiencies in or lack of internal controls to mitigate against fraud risks arising from the company's use of genAI technologies?

Regulatory Environment

Both existing regulations governing technology and data protection and new regulations to mitigate security and safety risks may apply to the company's use of AI. The audit committee should understand how management monitors, evaluates, and complies with applicable laws and regulations. Questions the audit committee might ask include:

- For management: Has management considered any new compliance or regulatory risks that are introduced by the use of genAI technologies? How has management addressed such risks?

- For the auditor: Has the auditor identified any risks of material misstatement related to noncompliance with laws and regulations related to the use of genAI?

Audit Committee Takeaways

Oversight of the use of genAI in financial reporting processes and ICFR will be a new challenge for many audit committees. The CAQ's paper is an excellent primer on genAI and the risk areas that audit committees should consider. The questions it suggests committees discuss with the management and the auditor would be a good starting point for committees seeking to educate themselves on how genAI will impact financial reporting and on the new risks that will arise as it becomes ubiquitous.

PCAOB Shines a Spotlight on Generative AI in Auditing and Financial Reporting

The Public Company Accounting Oversight Board's staff has conducted "limited outreach" to audit firms and public companies to understand their perspectives on the use of generative artificial intelligence (genAI) in financial reporting and auditing. This effort is part of a project on the Board's research agenda to determine whether there is a need for guidance, changes to PCAOB standards, or other regulatory actions in light of the increased use of technology-based tools in financial statement preparation and auditing. Spotlight: Staff Update on Outreach Activities Related to the Integration of Generative Artificial Intelligence in Audits and Financial Reporting (GenAI Spotlight) summarizes the staff's observations regarding the use of genAI in auditing and financial reporting based on the outreach initiative.

Observations Related to GenAI Integration in Audits

Integration of genAI into auditing focuses primarily on "administrative and research activities." However, most audit firms see the potential for using genAI in audit planning and performance. The firms interviewed do not view PCAOB auditing standards as an impediment to using genAI in audits. Audit firm observations included:

- Current Use of GenAI. Some firms use genAI to prepare administrative documents or initial drafts of memos and presentations related to audits. Some firms have developed genAI-enabled tools to assist staff in researching internal accounting and auditing guidance.

- Investment in GenAI. Most firms are investing in genAI-enabled tools either by developing them internally or by partnering with third parties. Potential uses include "assisting with summarizing accounting policies and legal documents, evaluating the completeness of audit documentation against relevant documentation requirements, performing certain risk assessment procedures, scoping the audit, evaluating the completeness of financial statement disclosures, and comparing amounts in the financial statements or notes to the financial statements with audited amounts."

- Limitations on the Use of GenAI. Data privacy and data security are concerns. Some firms have safeguards that address what information can be uploaded to genAI tools, while some limit or prohibit the use of genAI in audits.

- Supervision and Review of GenAI. An engagement team member who uses a genAI-enabled tool is still responsible for the results and documentation of the work, and supervisors who review such work are expected to apply the same level of diligence as when reviewing work where genAI was not involved.

- Risks Related to GenAI Input and Output. Some audit firms emphasized the importance of the auditability of both the underlying source data and of genAI-created content when genAI-enabled tools are used. Firms also noted that genAI may generate false or misleading content.

- Other Risks Related to the Use of GenAI. Financial statement preparer use of genAI could amplify existing information technology risks (e.g., risks related to segregation of duties) or create new risks.

- Firm Policies Related to GenAI. Firms emphasized the importance of policies and procedures, internal controls, and training related to the use of genAI.

Observations Related to GenAI Integration in Financial Reporting

Some companies are exploring incorporating genAI in accounting and financial reporting processes. However, integrating genAI into "operational and customer-facing areas" is currently a higher priority. Financial statement preparer observations included:

- Current Use of GenAI. Some company personnel use genAI in creating initial drafts of internal documents, such as "summaries of accounting standards and interpretations, presentations, and benchmarking of company information with publicly available information from competitors)." Some preparers use genAI to assist in "less complex and repetitive processes, such as preparing account reconciliations or to assist with identifying reconciling items."

- Supervision and Review of GenAI. While genAI has the potential to improve efficiency, "human involvement in supervising the use of genAI and reviewing genAI output continues to be important."

- Governance of GenAI. Some preparers said the governance issues around the development and integration of genAI were similar to those for other types of technology, while others are establishing new genAI-specific policies and procedures. Some preparers emphasized the importance of controls over the data used to train genAI models, although this may be difficult when models are developed or trained by third parties.

- Consistency of GenAI Created Content. Preparers noted challenges in the broader use of genAI in financial reporting processes, including the "black box" nature of some genAI tools, the lack of consistent output, and the inability to audit some genAI-created output.

Audit Committee Takeaways

Like the more detailed and audit committee-focused CAQ paper, the GenAI Spotlight introduces some of the oversight issues that audit committees will face as genAI is integrated into financial reporting and auditing. (See CAQ Releases a Resource for Audit Committees on Generative AI Oversight in this Update.) The PCAOB staff is seeking input from stakeholders – including audit committee members – about how genAI may be used in auditing or financial reporting.

On the Update Radar: Things in Brief

PCAOB Discloses a Criticism of Deloitte's Internal Independence Reporting – Again. On July 23, the PCAOB made public a portion of the previously nonpublic section of Deloitte & Touche's 2020 inspection report. This action indicates that, in the Board's view, the firm did not satisfactorily address the quality control issue discussed in that portion of the inspection report within 12 months of the report date. Criticisms of a firm's quality control system appear in Part II of a firm's inspection report, and, under the Sarbanes-Oxley Act, Part II is nonpublic when the report is issued. If the firm does not satisfactorily address a quality control criticism within 12 months, the Board makes the criticism public.

The now-public quality control criticism in Deloitte's 2020 inspection report is that Deloitte's system of quality control did not provide reasonable assurance that Deloitte personnel would comply with the firm's policies and procedures concerning independence-related regulatory requirements. Deloitte conducts periodic audits of a sample of its personnel to monitor compliance with firm policies and procedures with respect to reporting certain financial relationships. In the reviews Deloitte conducted during the 12 months ended August 31, 2020, the firm found that 25 percent of partners and principals and 39 percent of managing directors and managers who were audited had not reported financial relationships that were required to be reported under the firm's policies. The inspection report states:

> "This high rate of non-compliance with the firm's policies, which are designed to provide compliance with applicable independence regulatory requirements, provides cause for concern, especially considering that these individuals are required to certify on a semi-annual basis that they have complied with the firm's independence policies and procedures."

The date of Deloitte's 2020 inspection report is September 30, 2021. Therefore, release of this portion of the 2020 report indicates that Deloitte failed to persuade the PCAOB that, as of September 30, 2022, it had satisfactorily remediated the deficiency related to compliance with the firm's independence-related reporting policies and procedures. 2020 is the third inspection year for which the PCAOB has found that Deloitte failed to remedy this deficiency. On January 24, 2023, the Board made public the same finding in Part II of Deloitte's 2018 inspection report. See PCAOB Makes Public a 2018 Criticism of D&T's Quality Control, February-March 2023 Update. The Board subsequently released the same finding in Part II of Deloitte's 2019 inspection report.

Deloitte is not alone in failing – in the PCAOB's view – to remediate this type of deficiency. During the past year, the Board has made substantially the same finding public with respect to each of the other three largest firms. See PCAOB Discloses Three 2019 Criticisms of EY's Quality Control, July 2024 Update; PCAOB Discloses Non-Public Portions of 2018 and 2019 KPMG Inspection Reports, April 2024 Update; and 2019 Inspection PricewaterhouseCoopers LLP (portion of Part II made public on July 13, 2023). There is no public indication that any of these quality control lapses resulted in violations of the SEC's or PCAOB's independence requirements.

Is AI One of Your Risks? The Rise of Generative AI In SEC Filings, a report issued by Arize AI, a software provider, finds that in 2024 almost two-thirds (323 companies) of the Fortune 500 mention artificial intelligence (AI) in their annual report on Form 10-K and more than half (281 companies) have a risk factor citing AI. These disclosures have mushroomed over the past two years: The number of Fortune 500 companies mentioning AI has increased 250.1 percent and risk factors citing AI have risen 473.5 percent.

As to generative AI (genAI) specifically, about eleven percent of the Fortune 500 mention genAI in their current Form 10-K. Of those 108 companies, 75 refer to genAI only in their risk factors, while nine refer to it only in terms of potential benefits. Twenty-four companies discuss both risks and benefits.

Not surprisingly, the frequency of AI disclosures varies by industry. Media and Entertainment, Financial Services, and Software and Technology companies have the highest percentage of companies disclosing AI risks. The filings of companies in Software and Technology and Financial Services are the most likely to mention genAI.

Arize AI finds that genAI risk factors fall into four categories:

- Competitive Risks. Failing to keep pace with competitors or achieve AI goals.

- General Harms. Physical, reputational, or other harms to the company or its stakeholders from AI, often touching on AI fairness or responsible use of AI.

- Regulatory Risks. Regulation of AI upending data pipelines or business lines relying on machine learning.

- Security Risks. Data leakage or heightened cybersecurity risks.

The Arize AI report includes examples from Fortune 500 filings of each type of risk factor disclosure. The report also includes examples of disclosures discussing the benefits or industry implications of genAI.

Audit committees may want to consider whether there are material risks associated with either the company or its competitors deploying AI, especially genAI, and, if so, whether those risks are appropriately disclosed. This issue may warrant particular attention if the company, as is apparently the case for some Fortune 500 filers, discusses the potential benefits of AI in its Form 10-K or other public documents, but is silent as to risks. While not involving risk factor disclosure, the SEC recently brought its first action against a public company for "AI washing" – overstated, misleading , or false claims about the company's AI capabilities or potential. See SEC press release on SEC v. Ilit Raz. It seems likely that AI disclosure will be a continuing area of SEC focus.

The Audit Blog

I am a co-founder of The Audit Blog and blog on developments in auditing and financial reporting, on auditor oversight and regulation, and on sustainability disclosure. The blog is available here.

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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.