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AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

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

In This Update

PCAOB Outlines 2025 Inspection Priorities and What Audit Committees Should Ask Their Auditor

The Public Company Accounting Oversight Board's inspection staff describes its priorities for 2025 in Spotlight: Staff Priorities for 2025 Inspections and Interactions With Audit Committees (2025 Priorities Report). An accompanying PCAOB press release states that the 2025 Priorities Report "highlights risks and other considerations the staff believes auditors should consider when planning and performing their current and upcoming audits, as well as sectors and industries that PCAOB inspection staff will prioritize." The report also includes suggested questions for audit committees to consider in their auditor oversight role. For a discussion of last year's inspection priorities, see PCAOB 2024 Inspection Priorities: More Inspections and a Focus on Firm Culture, January 2024 Update.

Dan Goelzer is a retired partner of Baker McKenzie, a major international law firm. He chairs a Big Four accounting firm's Audit Quality Advisory Council. From 2017 to July 2022, Dan was a Sustainability Accounting Standards Board member. The SEC appointed him to the Public Company Accounting Oversight Board as one of its founding members, and he served on the PCAOB from 2002 to 2012, including as Acting Chair from 2009 to 2011. Dan was on the Securities and Exchange Commission's staff for 16 years and served as SEC General Counsel from 1983 to 1990.

Selections and Prioritized Sectors/Industries

In 2025, the staff will select audits for inspection in industries and sectors (1) with specialized accounting or that may be negatively impacted by uncertainties and volatility in the economic and geopolitical environment, (2) where the Board has previously found a higher number of deficiencies, or (3) where public companies are more likely to have a going concern risk. Inspectors will prioritize audits of companies in three sectors: Financial, Real estate, and Information technology.

In addition to these industry considerations, the inspection staff will emphasize the selection of --

- Audits of public companies engaging in merger and acquisition activities or business combinations due to the typical complexities of the accounting and related audit procedures.

- Audits of broker-dealers that file compliance reports and others that provide customers with various investment opportunities, such as introducing brokers.

- Audits of public companies that have changed their supply chain or logistics. Such changes can increase audit risk due to related changes in internal controls, complexities unique to operating in new locations, and challenges associated with the valuation of inventory and the impairment of existing facilities.

2025 Inspection Considerations

In engagements selected for inspection, the staff plans to focus on audit areas that pose a heightened risk to audit quality. The 2025 Priorities Report describes seven such audit areas:

- Audit Execution Challenges. Execution challenges include efforts to decrease audit hours, such as "determining a more aggressive, or higher, materiality level * * * and scoping of multi-location audits." The staff will also "inquire about the use of technology in audit procedures, particularly focusing on instances where technology is used in procedures to respond to identified risks of material misstatement."

- New Auditing Standards. Several new or amended PCAOB standards will be effective for audits performed in 2025, and, in the staff's view, this "presents an enhanced risk that firms will not properly apply those standards." These new or amended standards include AS 1201, Supervision of the Audit Engagement, AS 2101, Audit Planning, and AS 1206, Dividing Responsibility for the Audit with Another Accounting Firm. In addition, AS 2310, The Auditor's Use of Confirmation is effective for audits of fiscal years ending on or after June 15, 2025.

- Critical Audit Matters. The PCAOB is seeking to understand why the number of critical audit matters (CAMs) included in audit reports has declined. Accordingly, the staff will select for inspection some audits where the auditor reported a single CAM or no CAMs.

- Use of Technology by Public Companies. The inspection staff will focus on audits of public companies that have experienced cybersecurity incidents and review how the auditor may have modified its audit approach in response. Inspectors "will also review the disclosures made by the public company or broker-dealer in compliance with the SEC cybersecurity incident disclosure requirements and other information regarding the public company's cybersecurity risk management." The staff also believes that the use of artificial intelligence in operational or financial reporting processes could create new risks and will "be alert broadly for public companies that disclose significant investment in AI."

- Crypto Assets. The inspection staff will focus on audits of public companies and broker-dealers with material crypto asset holdings or significant transactions related to crypto assets. Audit risks associated with crypto include challenges in testing the existence of and rights to crypto assets, testing controls, and considering the risk of fraud and other illegal acts.

- Quality Control. As in prior years, 2025 inspections will include procedures to test audit firm compliance with the PCAOB's quality control standards. In 2024, the PCAOB adopted a new quality control standard, QC 1000. While QC 1000 does not take effect until December 15, 2025, inspection teams will review firms' preparations for the new QC standard. See PCAOB Adopts Enhanced Quality Control Standard for Audit Firms, May-June 2024 Update.

- Culture at Audit Firms. Since 2023, the inspection program has included a team that evaluates the culture at the six largest U.S. firms. This initiative will continue in 2025. For a report on the findings of the culture initiative, see PCAOB Reports on the Link Between Audit Firm Culture and Audit Quality in this Update.

2025 Target Team

Since 2016, the annual inspections program has included a "target team" -- a group of inspectors that conducts reviews across many audit firms focusing on emerging audit risks. In 2025, the target team will review (1) audits that use shared service centers, (2) engagements where work is referred into the U.S. by other auditors, and (3) use of software audit tools. For the most recent report on the work of the target team, see 2023 PCAOB Target Team Report: Crypto, Multi-Location Audits, and Significant Transactions, September-October 2024 Update.

Interactions with Audit Committees

The 2025 Priorities Report states that the staff "plan[s] to continue to seek opportunities to interact with the audit committee chairs on some public company audits selected for review." (This appears to be a step back from prior practice. Last year, the staff stated that it would invite the audit committee chairs of inspected public companies whose audits are performed by a large audit firm to engage in a dialogue with the inspection staff and would afford a similar opportunity to audit committee chairs of a sample of companies that smaller firms audit.) For a discussion of the PCAOB's most recent report on staff conversations with audit committee chairs, see In 2023 PCAOB Conversations with Audit Committee Chairs, the Economic and Audit Environments Were Top of Mind, July 2024 Update.

Questions for Audit Committees

The 2025 Priorities Report includes suggested questions that the staff believes audit committee members may want to consider and discuss with their auditor.

1. Beyond what auditors are required to communicate to the audit committee, are there any aspects of the company's internal control over financial reporting that management could enhance or strengthen to ensure management overrides relate to appropriate exceptions or atypical transactions are appropriately recorded and appropriately communicated?

2. Which audit issues that were especially challenging were not disclosed as CAMs? What consideration was given to disclosing these issues CAMs?

3. Did the company have any transactions or business risks that the auditor scoped out of the audit based on planned materiality? If so, what were they?

4. Are there any areas of the audit where the company can facilitate, or further facilitate, the audit team's use of technology to streamline testing or to improve the efficacy of the testing?

5. Do the audit workpapers contain any personal or confidential information that is unnecessary to retain as audit evidence or that can be removed prior to finalizing the audit documentation?

6. It is important for auditors to understand the company so they can perform their assignments well and, as such, we appreciate retention within the audit team where appropriate and possible so that knowledge grows and deepens. Are there any members of the audit team that did not return this year? If so, why did they not return? What is the experience of any new staff assigned to the engagement? Are they new to the audit firm? What parts of the audit did they work on? What assistance and supervision are in place for new team members?

Audit Committee Takeaways

The 2025 Priorities Report may be useful to audit committees in several ways:

- It provides audit committees with insight into how the PCAOB selects audits for review and why, if selected, inspectors concentrate on certain aspects of the audit.
- The report may help the audit committee understand their auditor's work plan since auditors are likely to devote special attention to areas of PCAOB inspection emphasis.
- Because the 2025 Priorities Report reflects the PCAOB's assessment of enhanced audit and financial reporting risks, it may also aid audit committees in identifying challenging company accounting and reporting issues.
- The suggested audit committee questions provide a useful basis for dialogue with the company's auditor.

SEC Enforcement in 2024: Fewer Cases But More in Penalties

The total number of SEC enforcement actions of all types fell 26 percent in FY 2024, but the financial remedies ordered rose to an all-time high. Similarly, the Commission brought 80 enforcement actions against public companies and subsidiaries in 2024, a 12 percent decrease from FY 2023. However, total monetary settlements in public company cases grew to $1.5 billion (up from $1.3 billion in 2023), although the median settlement amount declined.

These are the headline findings of two annual reports on SEC enforcement activity – the SEC Division of Enforcement's summary of its 2024 cases and the Cornerstone Research/NYU Pollack Center analysis of 2024 SEC enforcement actions against public companies and their subsidiaries. The prior editions of these two reports were discussed in SEC Enforcement Targets Individuals but Rewards Company Cooperation, November-December 2023 Update.

SEC Division of Enforcement Press Release

On November 22, the SEC's Division of Enforcement issued its annual press release describing the results of its enforcement program. See SEC Announces Enforcement Results for Fiscal Year 2024. An addendum to the press release contains detailed statistics.

The SEC's 2024 enforcement activities are the mirror image of its 2023 results. In 2023, the number of actions filed increased sharply over 2022, but the total amount of monetary relief fell. In contrast, during FY 2024 (which ended on September 30), the SEC filed 583 enforcement actions, a 26 percent decrease from the 784 actions brought in FY 2023. But monetary payments ordered in SEC actions (i.e., civil penalties, disgorgement, and pre-judgment interest) totaled $8.2 billion, the highest amount ever awarded in a single year and roughly two-thirds more than the $4.9 billion in 2023.

The $8.2 billion in financial remedies consisted of $6.1 billion in disgorgement and prejudgment interest (also an all-time high) and $2.1 billion in civil penalties. However, 56 percent of the $8.2 billion is attributable to the monetary judgment in a single case – the Commission's cryptocurrency fraud action against Terraform Labs and its founder Do Kwon. Following a jury verdict in favor of the SEC, the defendants agreed to pay $4.5 billion in disgorgement, prejudgment interest, and civil penalties. (The $8.2 billion in financial remedies represents the aggregate amount that defendants and respondents in Commission actions were ordered to pay, not necessarily the amount the Commission collected. For example, the Terraform Labs judgment is subject to offsets for payments to defrauded investors, and it is unclear how much the SEC will collect.)

The SEC's announcement makes several points related to cases involving public company disclosure and actions against public company officers and auditors:

- Crediting Market Participants Who Practice Proactive Compliance. The Division states that "market participants including public companies * * * self-reported or remediated securities law violations or otherwise cooperated meaningfully with the Division's investigations, answering the Division's call to practice a culture of proactive compliance." This cooperation resulted in reduced penalties or no penalties, "including in cases involving very large firms."

- Cybersecurity. The SEC brought several actions relating to cybersecurity incidents, including a case against R.R. Donnelley & Sons for disclosure and internal control failures relating to cybersecurity incidents. See Shoot the Wounded! SEC Charges that Inadequate Cybersecurity is an Internal Accounting Control Violation, July 2024 Update.

- Gatekeepers. In fiscal year 2024, the Division investigated a wide range of "gatekeeper" violations. The two examples cited in the press release are charges against audit firm BF Borgers for failure to comply with PCAOB standards in audits and reviews involving several hundred public company clients and charges against audit firm Prager Metis for failing to comply with generally accepted auditing standards in its audit of crypto trading platform FTX and for auditor independence violations in connection with numerous public company clients.

- Public Company Misstatements. The press release states that it is "foundational to the proper operation of the securities markets that public companies provide materially accurate information to investors" and that "the Division investigated misstatements by public companies leading to a number of enforcement actions" during 2024. Examples cited include cases against Cassava Sciences (misleading statements about the results of a Phase 2 clinical trial for an Alzheimer's disease treatment); Ideanomics (misleading statements about financial performance); and former executives of Kubient (involvement in a scheme to overstate and misrepresent revenue in connection with public stock offerings – see SEC Charges Audit Committee Chair with Fraud, September-October 2024 Update).

Cornerstone Research/NYU Pollack Center Report

On November 21, Cornerstone Research and the New York University Pollack Center for Law & Business released SEC Enforcement Activity: Public Companies and Subsidiaries—Fiscal Year 2024 Update, their annual report on SEC enforcement actions against public companies and their subsidiaries. Cornerstone and the Pollack Center also issued a press release summarizing the report. Cornerstone uses the Securities Enforcement Empirical Database (SEED), which it created in conjunction with the Pollack Center, to analyze trends in SEC enforcement.

The Cornerstone/Pollack Center report finds that the SEC filed 80 actions against public companies and their subsidiaries in fiscal 2024 – a 12 percent decrease from the 91 actions in 2023. However, despite the drop in cases, monetary settlements in public company and subsidiary actions grew to $1.5 billion, up from $1.3 billion in 2023. (The 2023 total was the lowest in the last nine fiscal years.) The average monetary settlement in these cases in FY 2024 was $19.8 million—significantly higher than the $15 million average in FY 2023. However, the median monetary settlement decreased to $3.2 million in FY 2024, down from $4.0 million in FY 2023. The report attributes the lower median to "more cases with monetary settlements under $100,000 and the top 10 actions making up a higher percentage of total monetary settlements than in FY 2023."

The average penalty level was also influenced by the tendency for public companies to cooperate with SEC investigations. The defendant or respondent cooperated in 75 percent of settled actions involving public company and subsidiary defendants, including five percent of defendants who cooperated and were not required to make any monetary payment. NYU Law School Professor Stephen Choi, a coauthor of the report, observed that the SEC focused "on cooperation and non-monetary settlements, as the agency prioritized efficiency and cooperation in its enforcement approach."

"Issuer Reporting and Disclosure" was the most common type of allegation against public companies in FY 2024; 45 percent of the 80 actions filed involved reporting/disclosure violations. Broker-dealer allegations were the second most common type of charge (29 percent). The Commission charged Foreign Corrupt Practices Act violations in only three percent of cases against public companies, down from 12 percent in 2023, and the lowest annual FCPA case percentage in SEED, which began in 2015.

Typically, the defendant neither admits nor denies guilt in settling an SEC enforcement action. However, according to the report, the current SEC administration "has taken a strong stance on admissions of guilt as a key accountability measure." In FY 2024, 34 public company and subsidiary defendants admitted guilt in settlement agreements, up from 16 such admissions in 2022 and 2023 and none in 2021.

Audit Committee Takeaways

SEC Chair Gensler has announced that he will depart on January 20, and President-Elect Trump has indicated they he will nominate former SEC Commissioner Paul Atkins as SEC Chair. As a result, the SEC's enforcement priorities and settlement philosophy will likely change in 2025. Companies involved in SEC investigations and their audit committees may face a different approach to enforcement decision-making under the new SEC administration.

Nonetheless, companies embroiled in an SEC investigation should consider the Commission's record of rewarding cooperation in deciding how to respond. The 2024 enforcement results indicate that more companies are choosing to cooperate, and that cooperation can have tangible benefits in terms of reducing the monetary penalties to which the company must agree to settle a matter. On the other hand, the benefits of cooperation are uncertain at the beginning of an investigation, the costs in terms of the exposure of company executives to sanctions can be high, and what the staff will view as reward-worthy is not always clear. Also, admitting guilt as part of a settlement, while pleasing to the SEC, may open the door to liability in private civil litigation based on the same matters as addressed in the SEC investigation. Despite these factors, cooperation is likely to be cheaper in the long run than resisting an SEC inquiry.

PCAOB Reports on the Link Between Audit Firm Culture and Audit Quality

In September 2023, the Public Company Accounting Oversight Board's inspection staff launched an initiative to examine whether audit firm culture and audit deficiency levels were linked. This initiative included interviews, analysis of inspection results, and review of materials related to firm quality control systems at the six large global network audit firms. See PCAOB Staff Report on Audit Firm Culture Offers Considerations for Firms Looking to Improve Audit Quality (PCAOB Press Release, December 5, 2024). Although the initiative is continuing (see PCAOB Outlines 2025 Inspection Priorities and Questions Audit Committees Should Ask Their Auditor in this Update), the staff has published a report on the findings of the culture study. Spotlight: Insights on Culture and Audit Quality (Culture Report) discusses the impact of centralization, remote work, messaging from audit firm leaders, and other cultural factors on audit quality.

Audit committees may find the Culture Report useful as background in evaluating their audit firm's commitment to audit quality. The report could serve as a source of discussion topics to raise with the company's engagement partner or with candidates when considering retention of a new audit firm. Below is a synopsis of some of the main themes in the Culture Report.

Why Culture Is Important for Audit Firms

The Culture Report defines "culture" as a set of shared attitudes, values, goals, and practices that characterize an organization." Culture influences an organization's reputation, team management, and productivity. "Healthy cultures enable an organization to thrive, while unhealthy cultures can lead to underperformance or worse." Audit firm leaders are responsible for ensuring that their professionals maintain independence, integrity, and professional skepticism while pursuing growth and profitability. An audit firm's culture contributes to its ability to deliver quality audits, and misalignment between leadership's words and actions can detract from audit quality.

Aspects of Quality Control That May Affect Audit Firm Culture

An audit firm's quality control (QC) system is critical for maintaining audit quality. QC systems encompass the audit firm's organizational structure, policies, and procedures to ensure compliance with professional standards. The Culture Report identifies four key QC topics that affect audit firm culture -- governance and leadership, resources, engagement performance, and information and communication.

1. Governance and Leadership.

Governance and leadership are foundational for a QC system. Audit leadership shapes firm culture and sets the overall tone. Leaders must exemplify the desired culture through their actions. Effective governance and leadership involve establishing core values related to integrity and audit quality, emphasizing these values in communications, using employee surveys to gather feedback, and holding professionals accountable for audit quality.

- Focus on Leadership's Commitment to Integrity and Audit Quality. If less experienced personnel see managers taking shortcuts or making exceptions, they may believe this is the way to advance. Conversely, firm personnel trained to act with integrity and uphold ethical standards reinforce each other. Audit leaders who fail to demonstrate professional conduct or fail to support firm personnel in making tough decisions will fail as gatekeepers. In general, audit firm leaders have increased their communications with firm personnel and have emphasized the importance of "performing quality audits, exercising professional skepticism, upholding audit firm values, and acting with integrity."

- Focus on Professional Skepticism. Establishing the right tone at the top is essential for fostering professional skepticism, which involves a questioning mind and critical assessment of audit evidence. Leadership must empower less experienced personnel to exercise skepticism. Audit firms should emphasize professional skepticism in communications, provide practical guidance, offer training, and consider professional skepticism in performance management.

- Focus on Strategic Decisions and Actions. An audit firm's operating strategy, including investments in people and technology, organizational structure, and globalization, affect audit quality. Audit firms should have strategic plans that emphasize audit quality. Investments in audit platforms, software, technology, and standardization of templates and workpapers are common strategies to drive improved audit quality.

2. Resources.

Audit leadership should prioritize audit quality in hiring, retention, and promotion. Audit firms should ensure that candidates for advancement have the necessary qualifications and that performance evaluations consider audit quality.

- Focus on Resource Management. Audit firm resource management includes policies and procedures for advancement, evaluation, and addressing audit quality events. Audit firms should have documented competencies, evaluate performance regularly, and consider audit quality in performance ratings. Negative audit quality events should be assessed, and action plans should be implemented and monitored.

- Focus on Hiring and Retention. Audit firms should have policies and procedures to ensure new hires possess the appropriate characteristics to perform competently. Recognition and rewards programs should be designed to address increased turnover and retain talent. Audit firms should consider the impact of acquisitions and hiring from other firms on culture and audit quality. "Based on information gathered during our interviews, we recognized that the audit firms with the highest percentage of respondents that started their careers in the respective audit firm had the lowest deficiency rates over the last three years. In contrast, the audit firms with the lowest percentage of respondents that started their careers in the respective audit firm had the highest deficiency rates over the last three years."

3. Engagement Performance.

An audit firm's culture depends on policies and procedures that provide reasonable assurance that work performed by firm personnel meets professional standards. This includes all phases of engagement design and execution, as well as engagement quality reviews.

- Focus on Responsibility and Accountability. Audit firms should have processes to assess responsibility for inspection findings. This includes reviewing documentation, interviewing engagement team members, and implementing consequences for those responsible. Lack of accountability can result in repeated deficiencies. "[W]hen audit firms disagree with PCAOB findings, it often results in a lack of accountability for that finding and remedial processes to ensure it is not repeated."

- Focus on Centralization and Standardization. Centralized and standardized processes, tools, and templates help ensure consistent audit quality. Audit firms should implement tools for client acceptance, reviews of audit work, and other key areas. Consistent use of these tools and templates is crucial for maintaining audit quality. "We noted during the culture initiative that the degree of centralized and standardized processes, tools, and templates at the audit firms is important to ensuring consistent application and promotion of audit quality."

- Focus on Use of Shared Service Centers. Shared service centers (SSCs) provide resources and services to engagement teams, typically for standardized audit procedures. While SSCs can improve efficiency and standardization, there are concerns that the use of SSCs deprives newer personnel of opportunities to develop foundational skills. Audit firms should balance the use of SSCs with the need to develop the skills of firm personnel.

4. Information and Communication.

Inspection procedures examined firm policies and procedures related to the identification, capture, processing, and maintenance of information to support the operation of the firm's QC system and the performance of its engagements in accordance with applicable professional and legal requirements.

- Focus on Communications. Audit firms should communicate their policies and procedures to firm personnel and external parties. Consistent messaging from audit leadership and engagement partners is essential for promoting audit quality.

- Focus on Work Environment. The remote and hybrid work environment has impacted audit firm culture and the apprenticeship model. "Respondents also noted that remote and hybrid work at the audit firms led to potential learning challenges among entry-level firm personnel. In addition, many respondents cited learning challenges and a decrease in readiness of firm personnel on engagements due to not working in-person as often as before the pandemic, leading to a loss in the apprenticeship culture at the audit firms."

Key Insights on Audit Firm Culture

Based on the staff's work, the Culture Report offers six "key insights" into the relationship between firm culture and audit quality.

1. Audit firm culture can drive audit quality – positively or negatively.

The staff's study "support[s] the idea that audit firm culture can impact audit quality, for better or worse * * * [and] that an audit firm's personnel are the backbone of an audit firm's culture." Turnover can influence audit quality. Firms with "the highest percentage of respondents that started their careers in the respective audit firm had the lowest deficiency rates over the last three years."

2. Centralization and standardization may be correlated with audit quality.

Audit firms with more centralization and standardization of audit processes, tools, and templates appear to have fewer deviations in their procedures and fewer PCAOB inspection deficiencies.

3. The remote/hybrid work environment affects audit firm culture.

The pandemic and the remote/hybrid work environment adversely impacted the apprenticeship training model, dissemination of culture, and the development of professional skepticism.

4. Audit firms need to promote a culture of accountability to support audit quality.

Audit firms "have room to improve" their cultures of accountability.

> "We observed, for example, that negative audit quality events (e.g., internal and external inspection results, restatements, independence violations) at some audit firms are not sufficiently evaluated or attributed to firm personnel. Rather than accepting responsibility for negative audit quality events, respondents from all six audit firms pointed to the complexity of their audit clients as a reason for the increase in audit findings. A minority of respondents from five out of the six audit firms also pointed to external factors for the increase in audit findings – such as PCAOB inspections getting more difficult, despite, the fact that the PCAOB has historically inspected against our standards and continues to do so."

5. Certain firm personnel may lack foundational skills.

Some interview respondents expressed concern about personnel competency and the appropriateness of engagement staffing. Some were also concerned that the use of SSCs undermines the ability of personnel to develop foundational skills. "This lack of experience in basic audit skills could lead to additional difficulties as those individuals progress in their careers."

6. Audit leadership sends mixed messages.

Some respondents indicated that audit firm leaders send mixed messages about incentives and penalties for positive and negative audit quality events. Firms need to align factors that drive compensation adjustments with behavior that promotes audit quality and communicate that alignment to firm personnel.

* * *

The PCAOB inspections staff plans to continue exploring the impact of audit firm culture on audit quality. Future steps include exploring such issues as—

- Who is responsible for audit firm culture, and when does that responsibility begin?

- Do recent scandals in the accounting or financial sectors deter future students from entering the profession?

- Has there been more progress on resolving the accounting pipeline issues, including entry-level salaries?

- How does audit firm growth, including a potential focus on selling and/or delivering non-audit services, influence the culture of the firm?

<u>Audit Committee Takeaways</u>

Most aspects of firm culture that the PCAOB staff identifies as affecting audit quality are not directly visible to audit committees. Engagement partners may, however, discuss some of these culture issues with the committee as part of describing the audit plan. For example, the use of SSCs to perform certain aspects of an audit is common at the largest firms. While SSCs contribute to efficiency, consistency, and audit quality, it might be interesting to explore with the engagement partner how he or she views their impact on the development of new staff members.

More generally, audit committees may want to consider using the <u>Culture Report</u> as a source for questions and discussion with their engagement partner as part of their annual evaluation of the firm. An understanding of how the firm views these topics could provide useful insight into how the firm addresses the relationship between its culture and its commitment to audit quality. As noted above, the <u>Culture Report</u> could also be useful when an audit committee is interviewing candidates in connection with a change in audit firms.

What Should be on the Audit Committee's 2025 Agenda?

At the end of each year, many accounting and consulting firms present their views on the issues on which audit committees should focus during the coming 12 months. Below are four of these papers.

- EY Center for Board Matters, What audit committees should prioritize in 2025.

- KPMG Board Leadership Center, On the 2025 audit committee agenda.

- Protiviti, Setting the 2025 Audit Committee Agenda.

- PwC Governance Insights Center, Approaching the 2024 year-end financial reporting season.

For last year's audit committee agenda suggestions, see What Should be on the Audit Committee's 2024 Agenda?, January 2024 Update.

These papers approach how audit committees should set their agendas at various levels of generality, and each firm has a unique perspective on how audit committees should direct their time and attention. However, there are many common themes. Some frequently mentioned 2025 audit committee agenda topics, along with examples of suggestions, include:

<u>Cybersecurity trends and related governance</u>. (EY, KPMG, Protiviti)

- Protiviti: "Audit committees should receive regular updates from those responsible for managing what has become many organizations' perennial top risk – cybersecurity. * * * Typically, effective governance would entail setting expectations of the internal audit function to provide independent assurance regarding the effectiveness of the people, processes and technology that have been put into place to manage cybersecurity risks."

<u>Company use of generative artificial intelligence</u>. (EY, KPMG, Protiviti)

- EY: "Audit committees should assess whether training, governance and operational strategies are evolving to address the complexities of AI — including considerations around responsible use of AI and robust data protection. Given the dynamic cybersecurity landscape, audit committees should stay attuned to evolving oversight practices, disclosures, reporting structures and metrics and understand implications of how the company is staying in compliance with requirements."

- Protiviti: "There are numerous data privacy and security-related concerns to navigate with AI usage, and regulatory scrutiny will catch up eventually. The committee must act to understand the organization's investments and adoption levels while considering the effectiveness of corresponding risk management activities to ensure responsible AIU deployment. "

<u>Climate reporting and other sustainability disclosures</u>. (EY, KPMG, Protiviti)

- EY: "US companies with operations in the EU should continue to consider their obligations under the EU Corporate Sustainability Reporting Directive (CSRD) and EU Corporate Due Diligence Directive (CS3D). * * * [A]udit committees should understand how management teams are planning to comply, including whether adequate processes, controls and technologies are in place to provide quality reporting."

- KPMG: "Given these near-term demands and growing consensus around common, comparable reporting standards—likely in accordance with the standards of the International Sustainability Standards Board, which incorporate the Task Force on Climate-related Financial Disclosures standards and Greenhouse Gas (GHG) Protocol – audit committees should closely monitor the state of management's preparations for new climate reporting frameworks/standards."

<u>Internal audit areas of focus</u>. (EY, KPMG, Protiviti, PWC)

- KPMG: "At a time when audit committees are wrestling with heavy agendas and issues like GenAI, ESG, supply chain disruptions, cybersecurity, data governance, and global compliance [is] putting risk management to the test, internal audit should be a valuable resource of the audit committee and a crucial voice on risk and control matters."

- PWC: "In January 2024, the IIA issued new Global Internal Audit Standards, which will become effective on January 9, 2025. The Standards aim to help internal auditors define and fulfill their mandate and provide a framework of principles, requirements, considerations and examples for the professional practice of internal auditing globally. * * * The audit committee plays a critical role in overseeing the internal audit function and supporting its effectiveness. Understanding the new standards is critical for the audit committee in enhancing its oversight of the internal audit function and to be able to more effectively leverage it."

<u>Compliance and corporate integrity</u>. (EY, KPMG, PWC)

- EY: "[T]he U.S. Department of Justice (DOJ) updated its Evaluation of Corporate Compliance Programs (ECCP) guidance in September 2024. The ECCP can serve as a guide in evaluating whether the company's compliance programs are effective and would hold up under the DOJ's scrutiny. * * * Accordingly, boards and audit committees should understand the implications of these updates, including revisiting the organization's compliance program to verify whether it is designed and functioning effectively."

- PWC: “Audit committees have a critical oversight role in ensuring the integrity of financial reporting and adherence to regulatory standards. With the increasing complexity and scope of regulations, audit committees must confirm that their organizations have robust compliance frameworks in place to understand its requirements, mitigate risks, and avoid potential legal and financial repercussions.”

Tax law changes. (EY, KPMG, PWC)

- KPMG: “Boards and audit committees should prompt deeper conversations with management about how their companies are preparing for a range of possibilities, including by asking management about the type of scenario planning being done; understanding the variable that may be more ‘forecastable’ and looking at impacts on cash flow; and considering how best to monitor state, federal, and global regulatory developments.”

- PWC: “The audit committee will want to confirm management has processes to monitor tax developments (both internationally and domestically) and are prepared to account for the impacts of changes appropriately. The audit committee will also want to understand how management is addressing the benefits and risks of significant tax developments going forward.”

Audit committee composition and effectiveness. (KPMG, Protiviti, PWC)

- KPMG: “The continued expansion of the audit committee’s oversight responsibilities beyond its core oversight responsibilities (financial reporting and related internal controls, and internal and external auditors) has heightened concerns about the committee’s bandwidth and composition and skill sets. Assess whether the committee has the time and the right composition and skill sets to oversee the major risks on its plate.”

- Protiviti: “It is crucial that management – and internal audit – provide high-quality and concise information with the right context, rather than disparate data points, to the audit committee. The role of an effective audit committee demands an enterprise wide, big-picture view rather than reporting from multiple parties and silos to identify potential blind spots. The audit committee should request collaboration from board-facing members of management and internal audit to ensure that the reporting the committee receives is succinct, strategically relevant and actionable.”

Fraud risk exposure. (Protiviti, PWC)

- Protiviti: “Perhaps now more than ever, the time has come for a robust and refreshed view of fraud possibilities within the organization’s virtual and physical walls. Moreover, turning the lens beyond employees to actively consider scenarios that include contractors, vendors or customers may reveal surprising results.”

- PWC: “Since the audit committee is charged with oversight of management’s fraud prevention program, it may want to add focus to this area given the continuing volatile and evolving business environment. Confirming an understanding of the robustness of management’s anti-fraud programs, including its fraud risk assessment process, and how management is using technology to evaluate, measure and mitigate fraud risks should be a keen focus area. The audit committee will also want to understand how management has updated internal controls to address risks associated with suppliers and other third parties.”

FASB’s requirement to disaggregate certain income statement expenses. (EY, PWC)

- EY: “Audit committees should inquire with management teams whether existing systems can capture the data required and/or whether additional processes and controls are necessary to implement this new guidance.”

New PCAOB standards. (EY, KPMG)

- KPMG: "Audit committees should probe the audit firm on its quality control systems that are intended to drive sustainable, improved audit quality- including the firm's implementation and use of new technologies such as AI. * * * Discussions should also include the status of the firm's preparations for the PCAOB's new quality control standard, QC 1000, *A Firm's System of Quality Control,* which the SEC approved in September 2024."

Audit Committee Takeaways

A high-level review of these papers could be helpful to an audit committee as a check that it is not overlooking topics that should be on its agenda. Also, the papers include suggested questions that the audit committee could pursue with management or the auditor to better understand suggested topics. Those questions provide a good starting point for discussion.

On the Update Radar: Things in Brief

PCAOB Describes Common Auditor/Audit Committee Communications Glitches. The Public Company Accounting Oversight Board's staff has issued a publication in the Audit Focus series highlighting auditor responsibilities related to audit committee communications, describing common deficiencies in auditor/audit committee communications, and discussing good practices in this area. Audit Focus is a publication that provides information and guidance to auditors of smaller public companies. Audit committees may find [Audit Focus: Audit Committee Communications]() a useful summary of the kinds of communications they should receive from their auditor and of communication breakdowns that may occur, especially in the smaller public company context.

The PCAOB staff describes communications deficiencies it has observed in inspections of smaller public company audits. These deficiencies involve failures to communicate to the audit committee the following six types of information:

- Management representation letters or evidence that management provided the management representation letters to the audit committee.
- The overall audit strategy, including the names, locations, and planned responsibilities of other independent public accounting firms or other persons not employed by the firm, that performed audit procedures.
- Significant deficiencies and material weaknesses identified during the audit.
- The schedule of corrected misstatements identified during the audit.
- The company's critical accounting policies and practices, including the reasons certain policies and practices are considered critical, and how future events might affect whether policies and practices are critical.
- The auditor's evaluation of the company's identification, accounting, and disclosure with respect to relationships and transactions with related parties.

Audit Committee Communications also includes reminders for auditors, such as –

- The PCAOB's standards require the engagement team to disclose to the audit committee the names, locations, and planned responsibilities of other independent public accounting firms or other persons, not employed by the auditor, that perform audit procedures.

- The auditor should communicate an overview of the overall audit strategy and timing and discuss with the audit committee the significant risks identified by the auditor's risk assessment procedures. The auditor should also inform the committee of any significant changes to the audit strategy during the audit.

- The Board's rules require the auditor at least annually to describe to the audit committee in writing all relationships between the audit firm and the audit client (or persons in financial reporting oversight roles at the audit client) that may reasonably be viewed as bearing on the auditor's independence.

Audit Committee Nonfinancial Oversight Responsibilities Continue to Expand. In How board committee responsibilities and structures are changing, the EY Center for Board Matters explores changes in board committee structure and responsibilities at S&P 500 companies from 2021 to 2024. EY found that audit committee responsibility for oversight of nonfinancial matters has increased, particularly in the areas of enterprise risk, cybersecurity, sustainability, and AI.

The EY Center reviewed how committee oversight responsibilities were described in S&P 500 company proxy statements between 2021 and 2024. Key findings regarding changes in the work of audit committees include:

- Enterprise risk. Audit committees are frequently the overseers of risk. In 2024, 44 percent of companies referenced enterprise risk in their proxy statement description of the audit committee's responsibilities, up from 38 percent in 2021.

- Cybersecurity oversight. The audit committee is the primary committee with responsibility to oversee cybersecurity risks. The percentage of S&P 500 companies citing cybersecurity in their audit committee descriptions increased from 25 percent in 2019, to 70 percent in 2021 and 77 percent in 2024. In 67 percent of 2024 proxy disclosures, the audit committee was the only committee described as having cybersecurity oversight responsibility (up from 61 percent in 2021.) Eighteen percent cited only a committee other than audit as having cybersecurity oversight responsible, and 10 percent included cybersecurity in describing the responsibilities of the audit committee and another committee. In 2024, only 5 percent of S&P 500 boards did not disclose a specific committee to which cybersecurity is assigned, down from 15 percent in 2021. The EY Center states: "This change was likely driven by the SEC's new rules on cybersecurity disclosures, under which companies must identify any board committee or subcommittee that oversees cybersecurity risk, if applicable."

- Sustainability oversight. Nominating and governance is the primary board committee that oversees sustainability, but audit committees are catching up. Since 2021, the percentage of S&P 500 companies mentioning ESG or sustainability in their audit committee description increased from 6 percent to 22 percent. Mentions of environment and climate in audit descriptions rose from 7 percent in 2021 to 14 percent in 2024. The EY Center surmises that, in many cases where audit committee descriptions include sustainability-related terms, the committee is "overseeing the reliability and adequacy of ESG disclosures, including related disclosure controls and procedures" although some committees also have substantive responsibility for ESG strategy.

- AI oversight. In 2024, two percent of S&P 500 companies disclosed that AI oversight was an audit committee responsibility. "[D]isclosures vary with some only listing AI among a variety of specific risks, while others provide more in-depth information regarding their AI oversight responsibilities (e.g., oversight of issues emerging from AI's development, including impacts to data privacy, human rights and climate action)."

The EY Center's report also discusses how S&P 500 companies describe the responsibilities of other committees and trends in the formation of new committees, such as technology and sustainability committees. The Center states:

> "Decisions about board committee structure or the division of oversight responsibilities are heavily dependent on company facts and circumstances. Leading practice is for boards to conduct regular and thoughtful reviews of how their oversight responsibilities are allocated, to establish that such allocation remains fit for purpose. Boards should regularly evaluate what works best for them to meet changing priorities and needs."

The report concludes with a list of questions to guide board consideration of whether to modify committee structure or the matters assigned to particular committees.

The Audit Blog

The Audit Blog provides commentary on developments in auditing and financial reporting, auditor oversight and regulation, and sustainability disclosure. The blog is available here. You can follow @BlogAuditor on Twitter or @the-audit-blog on medium.com.

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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.