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"Audit Quality: Lessons from BF Borgers and Other Recent Developments"

Thursday, November 21, 2024

Course Materials

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Thursday, November 21, 2024

2 to 3 p.m. Eastern [archive and transcript to follow]

2024 has been a busy year for the PCAOB, with audit quality issues front and center. On the heels of the BF Borgers scandal, continuing high levels of audit quality issues identified in PCAOB inspection reports, and renewed Congressional scrutiny of the PCAOB’s performance of its oversight function, the SEC has approved several new PCAOB rules focusing on audit quality, auditors’ responsibilities and liabilities, and the use of AI and other tech tools in the audit process. Our panelists will focus on what corporate attorneys need to know about the latest audit-quality developments to advise their client(s) on financial reporting and corporate governance matters.

Joining us are:

- **William Calder**, Chief Auditor, Deloitte
- **Bob Dow**, Of Counsel, Maynard Nexsen
- **Olga Usvyatsky**, Founder, Nonlinear Analytics

Topics:

1. Recent Challenges for the Accounting and Auditing Professions
    - Trends in Audit Inspection Results
    - Permanent Suspension of BF Borgers & Other PCAOB Sanctions
    - Integration of GenAI in Audits & Financial Reporting
    - Staffing Issues Facing the Profession

2. Overview of Recent PCAOB-related Rulemaking
    - AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*
    - QC 1000, *A Firm’s System of Quality Control*
    - Rule 3502, *Responsibility to Not Knowingly or Recklessly Contribute to Violations*
    - NOCLAR Proposal

3. Lessons for Public Companies and Audit Committees
    - Impact on Public Companies of Recent PCAOB-related Rulemaking
    - NOCLAR-related Concerns
    - The Audit Committee’s Role in Audit Quality
    - Evaluating and Engaging the Independent Auditor

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Course Outline

1. Recent Challenges for the Accounting and Auditing Professions

- Trends in Audit Inspection Results
  - In accordance with the Sarbanes-Oxley Act and PCAOB Rule 4003, the PCAOB conducts a continuing program of inspections of registered public accounting firms to assess a firm's compliance with certain laws, rules and professional standards in connection with its performance of audits, issuance of audit reports and related matters involving public companies and other issuers. A portion of the PCAOB's report is made publicly available.
  - Types of deficiencies:
    - <u>Part I.A:</u> "Deficiencies that were of such significance that [the PCAOB] believes the firm, at the time it issued its audit report(s), had not obtained sufficient appropriate audit evidence to support its opinion(s) on the issuer's financial statements and/or ICFR."
    - <u>Part I.B:</u> "Deficiencies that do not relate directly to the sufficiency or appropriateness of evidence the firm obtained to support its opinion(s) but nevertheless relate to instances of non-compliance with PCAOB standards or rules."
  - Deficiencies identified in audit inspections increased then leveled off in recent years.
  - Common areas of deficiencies:
    - Auditor independence (especially audit committee preapproval requirements)
    - Fraud considerations
    - Critical audit matters

        - Risk assessment
        - Audit documentation
    - More data is available due to the PCAOB's ongoing efforts to increase transparency in inspection data and make it easier for stakeholders to understand and compare inspection results both across firms and over time.

- Permanent Suspension of BF Borgers & Other PCAOB Sanctions
    - In early May, the SEC's Division of Enforcement announced enforcement proceedings against the BF Borgers CPA PC accounting firm and its sole partner, Benjamin Borgers, for alleged "deliberate and systemic failures" to comply with PCAOB standards in audits and reviews incorporated in more than 1,500 SEC filings from January 2021 through June 2023 and imposed a permanent suspension.
        - The firm ranked 8th in overall market share for public company audits last year and ranked 6th in market share for non-SPAC initial public offerings.
        - Corp Fin's Office of the Chief Accountant issued a statement highlighting public company disclosure and reporting obligations. In addition to flagging the Item 4.01 8-K report required in connection with a change in accountants, the statement highlights the impact on companies with respect to their future SEC filings:
            - "Form 10-K filings on or after the date of the Order may not include audit reports from BF Borgers. Each fiscal year presented must be audited by a qualified, independent, PCAOB-registered public accountant that is permitted to appear or practice before the Commission."
            - "Form 10-Q filings on or after the date of the Order may not present financial information that has been

reviewed by BF Borgers. Each quarterly period presented must be reviewed by a qualified, independent, PCAOB-registered public accountant that is permitted to appear or practice before the Commission."

        - "Form 20-F filings on or after the date of the Order may not include audit reports from BF Borgers. Each fiscal year presented must be audited by a qualified, independent, PCAOB-registered public accountant that is permitted to appear or practice before the Commission."

    - In late May, the SEC announced an exemptive order providing an extension to certain companies affected by the suspension. The order provided that, for any reporting company that notified the Commission between May 3 and May 16 pursuant to Rule 12b-25 of its inability to timely file a quarterly or transition report on Form 10-Q due to the BF Borgers suspension order, the Form 10-Q will be deemed to be filed on its prescribed due date as long as it is filed no later than the 30th calendar day (instead of the 5th calendar day) following the due date.

  - More recently, in October, the PCAOB announced a settled disciplinary order sanctioning Yusufali & Associates, LLC, and its sole owner and partner, for violations of multiple PCAOB rules and standards in connection with four audits of two issuer clients, and for violations of PCAOB quality control standards. The PCAOB revoked the firm's registration and barred the partner.

- Integration of GenAI in Audits & Financial Reporting

  - A July 2024 PCAOB Spotlight reported observations related to GenAI integration in audits and financial reporting and found that auditors' current use of GenAI is focused on administrative and research activities, while financial statement preparers have been more focused on integrating GenAI in operational and customer-facing areas than on accounting and financial reporting.

- Most audit firms also reported investing in GenAI-enabled tools to expand their use case, but cited data privacy and security, plus the lack of auditability of the underlying source data, as limiting factors for using GenAI for audit or attest procedures.

- Staffing Issues Facing the Profession
  - In July, Thomson Reuters reported that 58% of auditor survey respondents reported that staffing issues were a top challenge.
  - This is an issue for the accounting and financial reporting team at public companies as well, and resulting skill gaps can cause accounting errors, material weaknesses or significant deficiencies in internal controls and/or challenges with filing reports on time (*see, e.g.*, this Form 12b-25 by Advance Auto Parts)

2. Overview of Recent PCAOB-related Rulemaking

- QC 1000, *A Firm's System of Quality Control*
  - In early September, by a divided vote at an open meeting, the SEC approved the PCAOB's new quality control standard, QC 1000 — *A Firm's System of Quality Control* — and related amendments. The new requirements will go into effect in December 2025. QC 1000 replaces the existing AICPA standard that pre-dated the creation of the PCAOB. The SEC's press release says:

    > QC 1000, *A Firm's System of Quality Control*, establishes an integrated, risk-based quality control standard that will require all registered public accounting firms to identify specific risks to their practice and design a quality control system that includes appropriate responses to guard against those risks. Registered firms that perform engagements under PCAOB standards will be required to implement and operate the QC system. The new quality control standard focuses on an audit firm's accountability and continuous improvement of its audit practice and will

> require an annual evaluation of the firm's QC system and related reporting to the PCAOB, certified by key firm personnel. In addition, firms that annually issue audit reports for more than 100 issuers will be required to establish an external quality control function (EQCF) composed of one or more persons who can exercise independent judgment related to the firm's QC system.

- Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*; AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*; AS 1105, *Audit Evidence*; and AS 2301, *Auditor's Response to the Risks of Material Misstatement*
    - In August, the SEC approved several rule changes proposed by the PCAOB. The changes address auditors' general responsibilities in conducting an audit, the use of technology assisted data analysis in audits and auditor liability. This excerpt from the SEC's press release summarizes the new rules:

      > The Commission approved the PCAOB's new AS 1000, *General Responsibilities of the Auditor in Conducting an Audit*, along with related amendments to other PCAOB standards, to reaffirm, consolidate, and modernize the general principles and responsibilities of the auditor when conducting an audit. These standards cover such foundational topics as affirming the auditor's duty to protect investors through the preparation and issuance of informative, accurate, and independent auditor's reports; the exercise of due professional care, professional skepticism, and professional judgment when performing audits; and compliance with ethics and independence rules.
      >
      > In addition, the Commission approved the PCAOB's amendments to AS 1105, *Audit Evidence*, and AS 2301, *The Auditor's Response to the Risks of Material Misstatement*, and conforming amendments, to

address the use of technology-assisted data analysis in audit procedures. The amendments specify and clarify auditors' responsibilities when the auditor uses such analytical tools in conducting audits.

Finally, the Commission approved the PCAOB's amendment to Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*, governing the liability of an associated person of a registered public accounting firm who directly and substantially contributes to that firm's violations of the laws, rules, and standards that the PCAOB enforces. The amendments to Rule 3502 revise from recklessness to negligence the standard for an associated person's contributory liability, while maintaining the requirement that to be held liable, an associated person must have contributed to the firm's violation "directly and substantially."

- NOCLAR Proposal
    - In June 2023, at an open meeting, the PCAOB issued its long-awaited "NOCLAR" proposal — which stands for "Noncompliance with Laws or Regulations." Here is the PCAOB's page that tracks the status of this project. The proposal is a big deal, because it would enhance the responsibility of auditors to consider corporate noncompliance with laws and regulations, including financial statement fraud. The PCAOB's press release summarizes the key points:

        Broadly, the proposal seeks to strengthen and enhance auditor obligations related to a company's noncompliance with laws and regulations in three key respects:

        - **Identify** – The proposal would establish specific requirements for auditors to proactively identify — through inquiry and other procedures — laws and regulations that are applicable to the company and that could have a material effect on the financial statements, if not complied with. The proposal also makes explicit that financial statement fraud is a type of noncompliance with laws and regulations.

- **Evaluate** – The proposal would strengthen requirements related to the auditor's evaluation of whether noncompliance with laws and regulations has occurred, and if so, the possible effects on the financial statements and other aspects of the audit. For example, the proposed standard would require the auditor to consider whether specialized skill or knowledge is needed to assist the auditor in evaluating information indicating noncompliance has or may have occurred.

- **Communicate** – The proposal would make it clear that the auditor is required to communicate to the appropriate level of management and the audit committee as soon as they are made aware that noncompliance with laws or regulations has or may have occurred. Additionally, the proposal would create a new requirement that the auditor must communicate to management and the audit committee the results of the auditor's evaluation of such information. Specifically, this communication would address which matters are likely noncompliance and the effect on the financial statements for those matters that are likely noncompliance.

By requiring auditors to identify and communicate noncompliance sooner, the proposed amendments, if adopted, would encourage companies to take more timely remedial actions and thereby reduce investor

> harm caused by legal and regulatory penalties. Another potential benefit would be to lower the likelihood that financial statements are materially misstated due to noncompliance with laws and regulations.

3. Lessons for Public Companies and Audit Committees

- Impact on Public Companies of Recent PCAOB-related Rulemaking
    - Audit quality may improve
    - Audit committees may have more visibility into audit deficiencies and audit firm quality controls
    - Benefits may be accompanied by some fairly significant costs, such as higher audit fees and an increase in "CYA" behavior by auditors
- NOCLAR-related Concerns
    - From the ABA Business Law Section's comment letter:

> [W]e are concerned about the scope and impact of the Proposed Standards, which effectively would impose an affirmative obligation on auditors to detect and evaluate all noncompliance by an audit client with law and regulations that may have a direct or indirect effect on the financial statements, even where untethered to existing accounting standards. Among other concerns, the Proposed Standards (i) place an unworkable responsibility upon accountants to make subjective assessments of often complex and uncertain legal matters, the probability of future events, and the potential impact of those events, all of which are outside the scope of auditors' typical responsibilities, (ii) endanger the confidentiality and protections of client communications that are foundational components of the lawyer-client

relationship and our legal system and which are designed to promote legal compliance, (iii) risk diluting the audit function that is at the core of ensuring the integrity of financial reporting, (iv) would disrupt the separate roles played by the legal and accounting professions that benefit clients, and (v) would do the foregoing by adding costs to the audit process that will far outweigh any limited and speculative perceived benefits.

  - The comment letter contrasts the proposal with the existing auditing standard and the requirements of Section 10A of the Exchange Act and says that those standards "take a balanced approach" that addresses the need to ensure and enhance a public company's compliance with applicable laws and regulations by imposing obligations on auditors when they become aware of illegal acts.

  - The letter argues that the existing requirement that auditors not ignore "red flags" that come to their attention is different from the NOCLAR proposal, which would effectively require auditors to conduct a legal audit of a company's compliance with laws and regulations.

- The Audit Committee's Role in Audit Quality, and Evaluating and Engaging the Independent Auditor

  - In February, the SEC's Office of Chief Accountant Paul Munter released this statement on the recent increase in deficiency rates found in audit inspections and the role of the auditor and audit committee in ensuring high-quality audits.

    - The statement first addresses the role of auditors and suggests that auditors do more of the following:

      - Frequently and proactively engage with the audit committee, including on events that impact financial reporting and red flags arising from management responses;

    - Not agree to truncated or summary presentations with the audit committee regarding concerns with management or management responses;
    - Include specialists and other experts to assist in auditing complex areas or where specialized knowledge is needed to ensure adequate expertise;
    - Ensure engagement teams are trained on biases that affect auditor judgment and decision-making and undermine professional skepticism; and
    - Ensure that audit staff are empowered to exercise professional skepticism and challenge judgments of management by supporting audit staff in exploring areas of heightened risk and red flags, insulating audit staff from pressure to accept less than persuasive audit evidence and refusing management requests to replace audit team members.
- Then, the statement turned to the role of audit committees. First, it describes the importance of the committee's role in assessing auditor performance, and suggests committees evaluate whether and how they consider the following:
    - "results of the auditor's PCAOB inspections, the firm's internal monitoring programs, or other firm audit quality reporting;
    - whether the engagement team has appropriate industry expertise, and whether the engagement partner is sufficiently engaged and provides leadership to the engagement team;
    - the engagement team's total hours and staffing mix (such as, the use of specialists, the composition of experience within the engagement team, or portions

of the engagement performed by other auditors); and

- significant changes (or the lack thereof) in hours or staffing mix from previous audits."

– It also encourages audit committees to build a strong professional relationship with the auditor independent of management and makes suggestions to further that goal.