GIBSON DUNN

Accounting Firm Quarterly Update

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2023: The Audit Enforcement Year in Review

In this issue, we look back on 2023, another year of aggressive audit enforcement, with a view toward understanding the trends that shaped the year and suggest a possible outlook for 2024. The PCAOB's recent enforcement results are also captured in the Appendix to this Update.

1. Looking Back at 2023

When Erica Williams became Chair of the PCAOB in January 2022, it was immediately obvious that the PCAOB was intent on changing the way it did business—including, among other things, reinvigorating an enforcement program whose output had fallen from the number of cases reported in the mid to late 2010s. The PCAOB accomplished that in 2022, bringing 41 settled enforcement actions as compared to 21 in 2021. That trend continued in 2023, with the number of settled actions increasing to 44. Taken together, 2022 and 2023 provide a coherent picture of the state of the PCAOB enforcement program, whose most prominent features include the following:

PCAOB enforcement focuses to a significant extent on form, filing, and audit committee communication matters, as well as audit-related matters against smaller firms and personnel. While it is clear that PCAOB enforcement has grown more aggressive across the board under Chair Williams, including with respect to audit failure matters, it has continued to bring a large number of actions against firms for violations related to form filings and related matters (including, increasingly, Form AP matters), in addition to actions against smaller firms.

The PCAOB's focus on audit failure by smaller firms has been a consistent feature of its enforcement program from the start. While smaller firms have featured in some of the PCAOB's form and filing cases, they also represent a significant share of the enforcement actions alleging a failure to obtain sufficient evidence to issue an audit report or otherwise to adhere to PCAOB auditing standards.

Sweep investigations increasingly represent an additional pillar that seems to drive an increase in PCAOB enforcement numbers. Form and filing cases have been brought in bundles or as part of larger sweeps for several years, but under Chair Williams, their prominence has grown. Recent matters have included not only follow-on reviews of problems identified at a particular firm, such as the sharing of exam answers by firm personnel, but also broader reviews of PCAOB rules compliance beyond the traditional form and filing cases, such as the review of the use of non-registered firms to play a substantial role in issuer audits. Chair Williams has touted the use of sweep investigations in multiple settings, and it is clear that the PCAOB views them as valuable both because they generate significant enforcement numbers at a lower average cost and because they raise the prospect that firms will receive (and have to respond to) a PCAOB request even absent an event calling the PCAOB's attention to that firm specifically, which may create an additional deterrent.

The PCAOB is increasingly aggressive in the legal theories it is willing to advance. Under Chair Williams, the PCAOB has not merely brought more of the same type of cases and more aggressively pursued established theories; it has also dusted off corners of its rules and standards that were not previously the subject of PCAOB enforcement actions. Two prominent examples since the beginning of 2022 have been (i) cases alleging a failure to supervise, which had never before been the subject of an enforcement action but featured in multiple settled orders that year; and (ii) cases alleging that a registered firm has an obligation under existing quality control standards to ensure that its PCAOB filings are accurate. We note these latter cases appear to be somewhat in tension with the PCAOB's acknowledgement in its 2019 Concept Release related to quality control that existing standards did not "expressly" cover PCAOB filings such as Form AP and Form 2.

Increased PCAOB enforcement is occurring in parallel with, not in lieu of, continued aggressiveness by the SEC. The SEC continued in 2023 to join the PCAOB in seeking out headline cases against gatekeeper respondents to drive home a double-barreled enforcement message. In keeping with the PCAOB's theme of quality controls, the SEC's headline audit enforcement action in 2023 was likely its settled order against Marcum LLP for alleged quality control violations in connection with SPAC audits. The SEC's $10 million penalty in that matter demonstrates that it continues to impose significant financial sanctions on gatekeepers.

2. The Outlook for 2024

The easiest prediction to make in any field is that the coming year will bring "more of the same." As a result, we focus here on the ways in which 2024 might not represent merely a further extension of 2023 in the field of audit enforcement. We are watching the following spaces, among others, for potentially significant developments:

Pending litigation concerning the structure of the SEC enforcement program. On November 29, 2023, the Supreme Court heard oral arguments in *SEC v. Jarkesy*, in which an SEC respondent argues that the SEC's administrative proceedings violate his Seventh Amendment jury trial rights, among other claims; a decision is expected by June. At oral argument, several Justices appeared to express skepticism as to the structure of SEC administrative proceedings, and thus there seems a distinct possibility that the Court could rule that those proceedings, as they currently operate, violate the Constitution. The basis of the ruling and any statements by the Court indicating the retroactive effect of its ruling will determine how the SEC responds and whether the ruling has any implications for the PCAOB as well.

The tumultuous 2024 political landscape and what it portends for 2025. The question of who will occupy the White House in 2025 will likely take on increased importance at the SEC and PCAOB as 2024 progresses. A potential Trump presidency could portend a significant shift in the SEC's and PCAOB's approaches in 2025 and beyond, and in 2024 could very well lead the current leadership of the SEC and PCAOB to "clear the decks" of some of their pending enforcement matters to avoid those matters being subject to any change in approach under a new administration, while at the same time some of that leadership may look to depart.

The SEC's pending rulemaking concerning disclosure of, and attestation reports regarding, greenhouse gas emissions. As noted in our very first Update, the SEC issued its proposed rule on greenhouse gas emissions disclosures in March 2022, and according to the Biden Administration's Fall 2023 Unified Agenda of Regulatory and Deregulatory Actions, a final rule is expected in April 2024. Assuming that the final rule preserves the proposed rule's requirement that certain climate disclosures be subject to external attestation, we expect that the implementation of that new regime could occupy significant attention for the remainder of 2024, in addition to shaping how the SEC and PCAOB focus their efforts in later 2024 and into 2025 in preparation for the effective date of the requirements.

As a prelude to that development, on January 12, 2024, a coalition of consumer and environmental groups published an open letter calling for the PCAOB to develop attestation standards related to climate change disclosures, to address climate disclosure rules that take effect in California in 2027.

Will there be more sweeps? As noted above, sweep investigations are becoming an ever more important aspect of the PCAOB enforcement program. Because the PCAOB's sweeps have generally followed the identification of compliance violations at particular firms, the institution of new sweeps might be dependent on a novel, serious issue emerging in SEC or PCAOB enforcement actions against a particular firm.

PCAOB Publishes Enforcement Orders Against China-Based Firms, Even as Congress Contemplates Further Action

On November 30, 2023, the PCAOB announced enforcement orders against three China-based accounting firms, totaling $7.9 million in fines. These orders represented the first enforcement settlements with China-based firms since the PCAOB secured access to inspect firms in China following the passage of the Holding Foreign Companies Accountable Act (HFCAA). The sanctions were against three firms: PwC China, PwC Hong Kong, and Shandong Haoxin (as well as four of its individual auditors). PwC China and PwC Hong Kong were sanctioned for violating the PCAOB's quality control standards by failing to detect or prevent widespread answer sharing on internal training courses, with penalties of $3 million and $4 million, respectively. Shandong Haoxin and its personnel were collectively penalized $940,000 for falsifying an audit report and improperly adopting the work of another firm, as well as for independence violations. Shandong Haoxin was also required to retain an independent monitor.

In her statement following the announcement of the settled orders, Chair Williams thanked Congress for passing the HFCAA and for its "ongoing work to hold China accountable and their ongoing support of the PCAOB's efforts in China." Chair Williams reiterated this sentiment during December 12, 2023 testimony before the House Committee on Financial Services, expressing appreciation for the Committee's "commitment to holding China accountable." Multiple bills have been introduced in Congress to further strengthen the HFCAA, including Senate Bill 3494, Trusted Foreign Auditing Act of 2023, introduced by U.S. Senator Marco Rubio on December 13, 2023, which would bolster the HFCAA by requiring companies to retain auditors not under the jurisdiction, control, or material influence of the Chinese government or Communist Party. Rep. Elise Stefanik has introduced a companion bill to S. 3494 in the House.

SEC Cybersecurity Disclosure Rules Go into Effect

On July 26, 2023, the SEC adopted a final rule requiring public companies to disclose material cybersecurity incidents and to make annual disclosures relating to cybersecurity risk management, strategy, and governance. With some of the rule's requirements taking effect in December 2023, including that public companies comply with the Form 8-K incident disclosure requirements for material cybersecurity incidents, Erik Gerding, Director of the Division of Corporation Finance, issued a statement highlighting the rationale behind the rule and attempting proactively to "clear up potential misconceptions" regarding its implications.

Gerding reaffirmed that the four-day deadline to disclose a cybersecurity incident is triggered by the date on which the company determines that the incident was material, not the date on which the incident actually occurred. He also noted that disclosure should focus on material impacts of an incident, not specific information regarding the company's planned response.

Gerding added that a company's consulting DOJ regarding the applicability of the national security and public safety delay exception does not necessarily mean that an incident is material such that it must be disclosed. Finally, Gerding stated that the risk management, strategy, and governance disclosure provisions are meant to provide more detailed disclosure regarding management's steps to manage cybersecurity risks while also providing investors with a higher-level understanding of how a company's board oversees the management of such risks.

Underscoring the SEC's focus on cybersecurity disclosures, on October 30, 2023, the Commission brought charges against SolarWinds and its Chief Information Security Officer, alleging the company was aware that it had faced a major cyberattack from 2018 through 2020 but made only generic and hypothetical disclosures to investors regarding cybersecurity risks during that period.

SEC Approves 2024 PCAOB Budget

On December 13, 2023, the SEC approved the PCAOB's budget for 2024, along with the related annual account support fee, which were $384.7 million and $358.8 million, respectively. SEC Chair Gary Gensler noted in a statement that the PCAOB budget supported a two percent increase in headcount at the PCAOB.

Board member Christina Ho criticized the decision to approve the budget, noting "the PCAOB's double digit year-over-year budget increases appear strikingly out of touch with the broader fiscal environment and are unsustainable over the years to come."

SEC Chief Accountant Issues Statements on Cash Flow Reporting and Professional Skepticism

In a statement issued on December 4, 2023, SEC Chief Accountant Paul Munter highlighted the importance of cash flow reporting for issuers. Munter observed that the statement of cash flows is a consistently leading area of financial statement restatements and that the OCA has observed material weaknesses in internal controls around the preparation and presentation of the statement of cash flows.

Specifically, OCA has noted, and not found persuasive, analyses concluding that an error in the statement of cash flows is not material because it is a mere error in classification. On the contrary, Munter commented, understanding whether cash flows are related to operating, investing, or financing activities is critical to investors' understanding of an issuer, and issuers and auditors should consider all relevant facts and circumstances in determining whether classification errors are material to a reasonable investor. These are important statements, particularly against the backdrop of the clawback rules.

Munter also stressed the importance of direct controls to facilitate risk identification, analysis, and response related to the statement of cash flows, including controls relating to the classification of cash flows and the disclosure of non-cash items. Because of the unique risks of material misstatement related to the statement of cash flows, OCA "expect[s] auditors to design and implement audit procedures that are specifically responsive to those risks in the statement of cash flows," rather than simply reconciling the statement of cash flows to the balance sheet or income statement. These comments likely could spur additional focus on this area during the course of PCAOB inspections.

Then, in a statement issued on February 5, 2024, Munter noted the "troubling trendline" of PCAOB inspection results and discussed certain factors touching on audit quality. For example, Munter stated that dynamic conditions can change or increase financial reporting risks, including fraud risks. In light of those risks, the "proper exercise of professional skepticism" may require "more persuasive evidence to corroborate management's assertions." Munter identified engagement with the audit committee, effective use of specialists, bias training, and empowerment of the engagement team as practices supporting the exercise of professional skepticism.

Munter also highlighted the "critical" gatekeeping role played by audit committees in their oversight of the external audit. He encouraged audit committees to select auditors based on audit quality metrics, including PCAOB inspection results and the engagement team's staffing and hours. Munter also urged audit committees to develop strong relationships with the audit engagement team and to evaluate the team's interactions with management.

Second Circuit Limits SEC's Ability to Seek Disgorgement

In a case with potentially far-reaching implications for the SEC's enforcement program, the Second Circuit held on October 31, 2023, in *SEC v. Govil* that the SEC is not entitled to disgorgement unless it can show the allegedly defrauded investors suffered pecuniary harm.

Applying the Supreme Court's ruling in *Liu* that disgorgement "is permissible" as equitable relief only where it "is awarded for victims," the Second Circuit held that disgorgement under both Section 21(d)(5) and Section 21(d)(7) of the Exchange Act requires a finding that victims suffered some financial loss. Noting that *Liu* "did not explain straightforwardly what a 'victim' is for the purpose of awarding 'equitable relief,'" the Second Circuit held that a victim is "one who suffers pecuniary harm from the securities fraud" because allowing disgorgement to benefit investors who had not suffered any damages "would be conferring a windfall on those who received the benefit of the[ir] bargain" rather than "restoring the status quo for those investors." In doing so, the court expressly rejected a presumption that investors have "suffered economic harm by definition when capital they invested in the company for corporate purposes [is] looted," explaining that determining whether investors "actually suffered pecuniary harm" requires an analysis of "the type of securities held, the terms of those securities, and when those securities were sold" because defrauded investors might earn a profit on their investment notwithstanding a defendant's wrongdoing. As the Second Circuit reasoned, Liu "emphasized" that disgorgement as "an equitable remedy is about 'returning the funds to victims,'" which necessarily "presupposes pecuniary harm" as funds "cannot be returned if there was no deprivation in the first place."

Should *Govil* prevail as controlling law, limiting disgorgement and more closely aligning it with the relief available in private securities fraud actions in which economic loss must be proven, the SEC will be forced to more clearly identify and prove the harm suffered by alleged "victims" in many of its enforcement actions in order to preserve disgorgement as a remedy.

For more detailed analysis and background information on this case, please see Gibson Dunn's client alert on this matter.

Canadian Public Accountability Board Provides Insights on 2023 Audit Quality Assessment Results

The Canadian Public Accountability Board (CPAB) released its interim inspections results report in October 2023. The report noted a slight year-over-year rise in files with significant findings at the four largest accounting firms. The report noted that several common themes emerged from its inspection findings, including missteps around auditors' identification and assessment of the risks of material misstatement in financial statements, services provided by a service organization, perpetual inventory systems, and audit documentation, supervision, and review. CPAB published five public censures in 2023. The report also noted an increased need for engagement teams to consider climate-related risks in their audits.

UK Economic Crime and Corporate Transparency Act 2023 Goes into Effect While FRC Revises Corporate Governance Code

A UK law expanding corporate criminal liability went into effect on December 26, 2023. The Economic Crime and Corporate Transparency Act 2023 contains a number of key provisions. For example, with respect to certain economic crimes it replaces the "identification doctrine"—which permitted corporate liability only in cases where an individual criminal actor was "the directing mind and will of the corporation"—with a rule allowing corporations to be held criminally liable based on the conduct of a "senior manager," a broader term. Additionally, it permits the UK government in certain cases to prosecute criminal conduct with a more tenuous connection to the UK than was previously allowed. Corporations based in or doing business in the UK can consult Gibson Dunn's client alert for more information.

Meanwhile, on January 22, 2024, the UK Financial Reporting Council issued a revised UK Corporate Governance Code, which takes effect in 2025. The revised version replaces an initial proposal that would have required more widespread governance changes, and in touting its revision the FRC emphasized that it "takes a targeted approach, focusing on a limited number of changes to ensure the right balance is struck between UK competitiveness and positive outcomes for companies, investors and the wider public."

PCAOB Makes Personnel Changes

On October 25, 2023, George R. Botic, CPA, was sworn in as the newest Board member of the PCAOB. Botic replaced Board member Duane S. DesParte following the end of DesParte's second term. Prior to becoming a member of the Board, Botic served as Director of the PCAOB's Division of Registration and Inspections (DRI) and has been with the PCAOB since 2003. Replacing Botic as Acting Director of DRI is Christine Gunia, CPA, who was previously DRI's Deputy Director, Global Network Firm Inspection Program. Gunia has been with the PCAOB since 2004.

On January 11, 2024, the PCAOB elevated Acting General Counsel James Cappoli to the General Counsel position.

PCAOB Announces Staff Priorities for 2024 Inspections and Interactions with Audit Committees

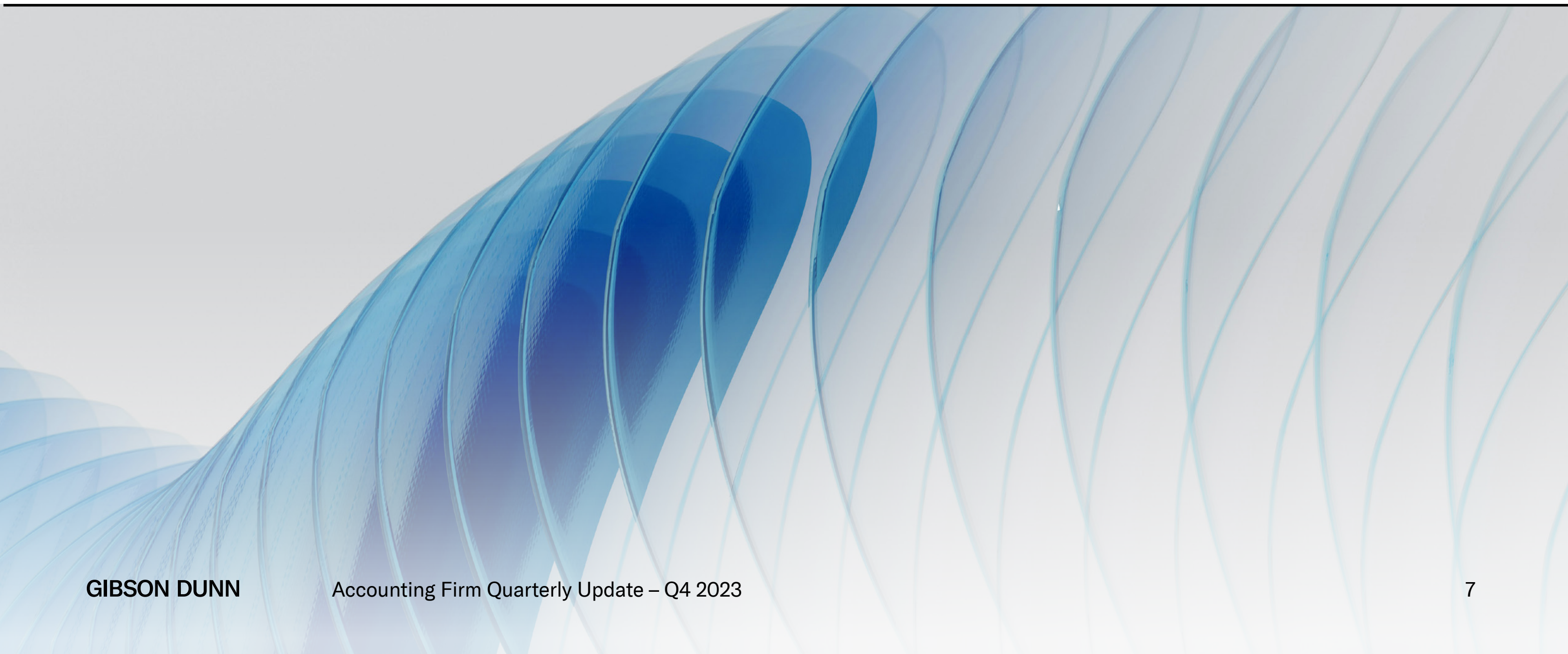
The PCAOB published its priorities for inspections heading into 2024. The Board indicated that it intends to increase the number of engagements that it will review and, in addition to random inspections and areas of previous focus, will increase the number of inspections for regional banks, information technology companies, and industries that apply industry-specific accounting. The Board also noted that it will focus on public companies with material digital asset holdings and major transactions in digital assets. The PCAOB further stated that it will assess audits for their consideration of cybersecurity risks.

The Board indicated that it has observed recurring deficiencies in audit work related to revenue and related accounts, accounts affected by mergers and acquisitions, inventory, long-lived assets, equity, and testing controls with a review element. To better understand these deficiencies, the PCAOB stated its intention to analyze how auditors' understanding of companies and their environments impact material misstatements, as well as to continue to analyze firms' use of other auditors. The Board also stated that it will assess whether there is any connection between accounting firm culture and audit quality.

The PCAOB further noted the decline in reporting of critical audit matters and provided guidance for determining if such matters are present. Finally, the Board proposed a number of questions that audit committees should consider asking their auditors, reflecting many of the themes outlined in the publication.

FinCEN Corporate Transparency Reporting Goes into Effect

On January 1, 2024, the Financial Crimes Enforcement Network (FinCEN) began to accept Beneficial Ownership Information reports to implement the Corporate Transparency Act of 2021. The law requires numerous classes of businesses to report beneficial ownership information, though it exempts accounting firm entities that are registered with the PCAOB, as well as certain subsidiaries of exempt entities. More information is available on the FinCEN website, and in Gibson Dunn's recent client alert summarizing the most important AML developments in 2023.



Other Recent SEC and PCAOB Enforcement and Regulatory Developments

Enforcement

- On November 14, 2023, the SEC released fiscal year 2023 enforcement results, announcing another active year for the Division of Enforcement. The SEC filed a total of 784 enforcement actions during the year (a 3% increase over 2022), including 501 standalone actions (8% more than 2022), 162 follow-on administrative proceedings, and 121 actions against issuers for filing delinquencies. Among other things, the Commission touted the growing success of its Whistleblower Program, with nearly $600 million in whistleblower awards. The SEC also celebrated its “numerous charges” against gatekeepers, including its actions against auditors. Looking ahead, the release signaled increasing focus in 2024 by the SEC on ESG issues, cybersecurity, policing crypto asset securities, and imposing more widespread individual accountability.

- On November 15, 2023, the PCAOB announced a settled order with KPMG Japan for quality control violations, alleging that between 2019 and 2021, the firm’s policies and procedures were insufficient to provide reasonable assurance that personnel performing audits would sufficiently test journal entries to comply with applicable auditing standards. The PCAOB also found that KPMG Japan failed to adequately monitor its system of quality control.

- In November 2023, the PCAOB’s enforcement sweeps continued to bear fruit, with the announcement of settled actions relating to internal training programs, Form 3 and Form AP reporting, and audit committee communications.

Rulemaking and Standard-Setting

- In the final quarter of 2023, the PCAOB updated its standard-setting agenda, rounding off a year of more rulemaking and standard setting than any other in the last decade. On November 1, 2023, the PCAOB added two new projects to its agenda, including (a) possible updates to AS 2510, *Auditing Inventories*; and (b) a new project on its research agenda regarding Communication of Critical Audit Matters (CAMs), specifically why there continues to be a decrease in the average number of CAMs reported and whether additional guidance, rulemaking, or other action on the part of the PCAOB is required. The PCAOB’s update also included updated timing for projects previously added to its agenda, including seven projects with proposals expected in 2024. PCAOB Chair Erica Williams reiterated the Board’s plans to continue pursuing its aggressing standard-setting agenda, stating, “Our commitment to modernizing our standards and rules remains stronger than ever as we continue working to get these agendas done and done right for investors.”

Inspections

- In December 2023, the PCAOB issued a Spotlight publication discussing the findings of its target team review in 2022. The target team focused on three areas: audit engagement post-initial public offering; audit firms’ use of shared service centers (SSCs) as part of the audit; and climate-related matters in the context of a public company’s financial statements. Among other things, the publication noted certain best practices for post-IPO audits and the strategies that firms are using to assess climate risks.

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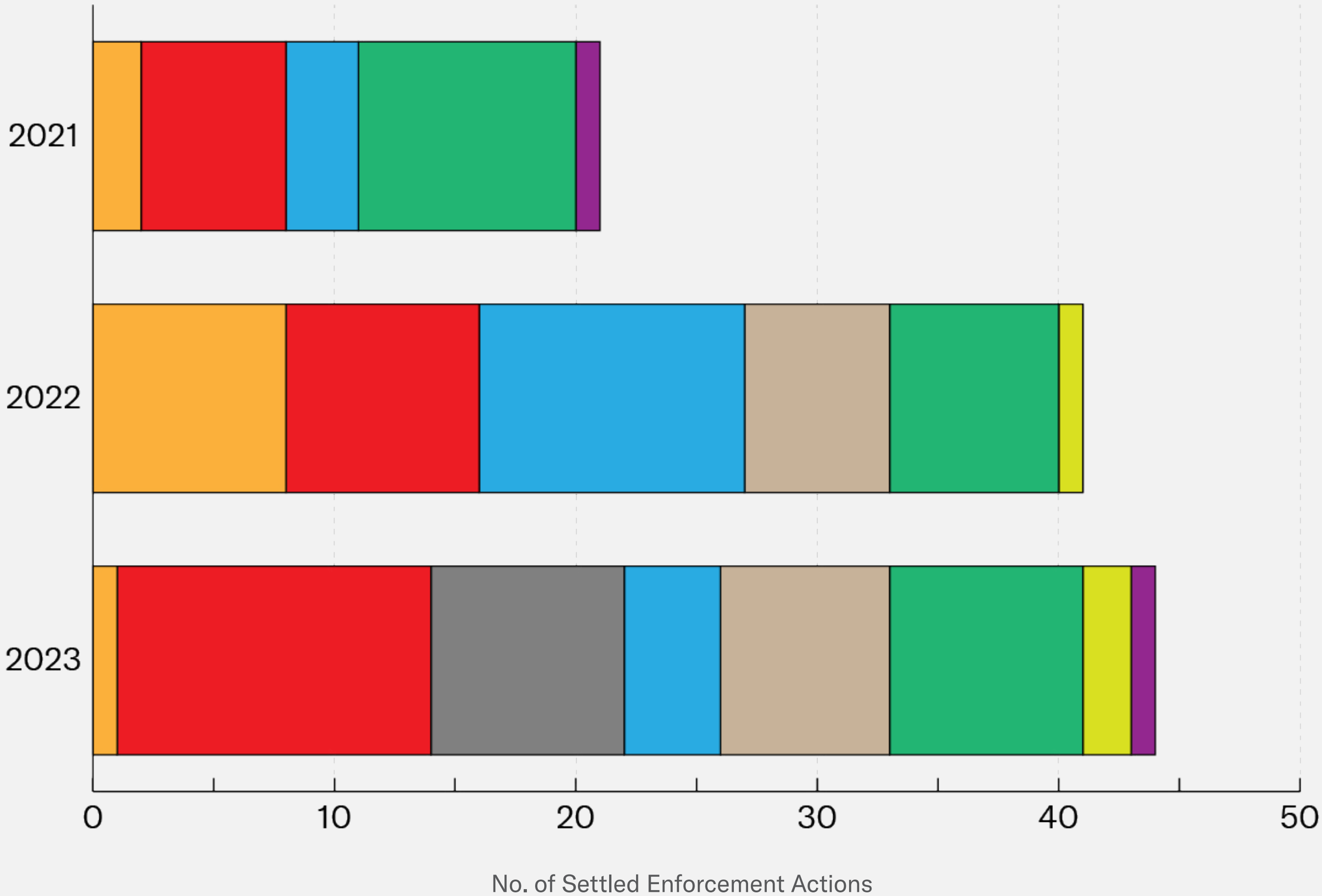
For further information about any of the topics discussed herein, please contact one of the Accounting Firm Advisory and Defense Practice Group Chairs or the Gibson Dunn attorney with whom you regularly work.

Appendix

PCAOB Settled Enforcement Actions
2021-2023



- **Non-Cooperation**
- **Quality Control/Documentation/Independence**
- **Audit Committee**
- **Form AP/Unregistered Firm**
- **Form 2/3**
- **Audit** (NAF)
- **Audit** (GNF, Non-U.S.)
- **Audit** (GNF, U.S.)

Note: Statistics are based on the primary violation in each settled action, which may be a judgmental determination.

“GNF” designates members of the six largest global networks. “NAF” designates all other firms.