

MEMO# 29179

July 16, 2015

PCAOB Concept Release Seeks Comment on Audit Quality Indicators

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 20-15
INVESTMENT COMPANY DIRECTORS No. 23-15 RE: PCAOB CONCEPT RELEASE SEEKS COMMENT ON AUDIT QUALITY INDICATORS

The Public Company Accounting Oversight Board recently issued a concept release seeking public comment on audit quality indicators (“AQIs”) and their potential uses. [\[1\]](#) The Release describes the AQIs as a potential portfolio of quantitative measures that may provide new insights about how to evaluate the quality of audits. Taken together with qualitative context, the AQIs may inform discussions among those concerned with the financial reporting and auditing process, for example among audit committees and audit firms. The Release seeks comment on the usefulness of the AQIs, users of the AQIs, and how AQIs should be implemented over time.

The PCAOB simultaneously announced a public roundtable on the Release to be held during the fourth quarter of 2015. Comments on the Release are due to the PCAOB by September 29. The Institute and the Independent Directors Council are considering whether to file a comment letter on the Release. If you have any concerns with the Release, please contact Lisa Hamman (202/371-5405, lhamman@ici.org) or Greg Smith (202/326-5851, smith@ici.org) by August 14.

Potential Audit Quality Indicators

The Release describes 28 potential AQIs organized under three topics: (i) audit professionals; (ii) audit process; and (iii) audit results. Each topic has several subtopics. Many of the AQIs would be calculated at both the “engagement level” and at the “firm level.”

Audit Professionals

Auditor Availability

1. Staffing Leverage – The time of experienced senior personnel relative to the volume of work they oversee.

2. Partner Workload – Data about the level of work for which the audit engagement partner is responsible and the number of claims on his or her attention.
3. Manager and Staff Workload – Information about the workload of audit managers and staff.
4. Technical Accounting and Auditing Resources – The level of a firm’s central personnel available to provide engagement teams with advice on complex, unusual, or unfamiliar issues and the extent to which they are used in an audit.
5. Persons with Specialized Skill or Knowledge – The use in an engagement of persons with specialized skill or knowledge other than technical staff resources described under indicator number four.

Competence

6. Experience of Audit Personnel – The level of experience of an engagement team and the weighted average experience of firm personnel generally.
7. Industry Expertise of Audit Personnel – The experience of senior members of the audit team, including specialists, in the industry in which the audited company operates.
8. Turnover of Audit Personnel – Turnover or transfers to other engagements or movement to other firms at the engagement level and at the firm level.
9. Amount of Audit Work Centralized at Service Centers – The Release explains that some audit firms assign lower risk audit work to domestic or foreign service centers established by the audit firm. This indicator measures the degree to which audit work is centralized by the audit firm at service centers.
10. Training Hours per Audit Professional – The hours of relevant training, including industry specific training that engagement and firm personnel have received.

Focus

11. Audit Hours and Risk Areas – The time spent by members of the audit team at all levels on risk areas identified by the firm during audit planning.
12. Allocation of Audit Hours to Phases of the Audit – The effort and staffing the audit devotes to audit planning, interim field work, and audit completion.

Audit Process

Tone at the Top and Leadership

13. Results of Independent Survey of Firm Personnel – Anonymous independent surveys of current and former personnel about tone at the top, quality of supervision and training, and professional skepticism.
14. Quality Ratings and Compensation – Potential correlation between high quality ratings and compensation increases and the comparative relationship between low quality ratings and compensation increases or decreases.
15. Audit Fees, Effort, and Client Risk – The relationship between engagement or firm audit fees and hours, and levels of client risk.

Independence

16. Compliance with Independence Requirements – Elements of a firm’s independence training and monitoring program and the importance it assigns to that program.

Infrastructure

17. Investment in Infrastructure Supporting Quality Audits – The amount the firm invests in people, process, and technology supporting audits.

Monitoring and Remediation

18. Audit Firms’ Internal Quality Review Results – Information about the internal quality reviews conducted by each audit firm.
19. PCAOB Inspection Results – Information about PCAOB inspection results relating to the engagement or audit firm.
20. Technical Competency Testing – The level of technical competence of a firm’s audit personnel and the success of efforts to maintain the level of competence.

Audit Results

Financial Statements

21. Frequency and Impact of Financial Statement Restatements for Errors – Restatements for error of financial statements audited by the firm.
22. Fraud and Other Financial Reporting Misconduct – Fraud and other financial reporting misconduct at both the engagement and audit firm levels.
23. Inferring Audit Quality from Measures of Financial Reporting Quality – Whether measures of financial reporting quality used by investment analysts, academics and regulators can also be used as measures of audit quality.

Internal Control

24. Timely Reporting of Internal Control Weaknesses – The extent to which an audit firm identifies material weaknesses in internal control over financial reporting on a timely basis.

Going Concern

25. Timely Reporting of Going Concern Issues – The timeliness of the auditor’s use of a going concern paragraph in audit opinions.

Communications between Auditors and Audit Committees

26. Results of Independent Surveys of Audit Committee Members – The effectiveness of auditor/audit committee communications measured through use of a survey tool.

Enforcement and Litigation

27. Trends in PCAOB and SEC Enforcement Proceedings – Board and SEC

proceedings against the audit firm.

28. Trends in Private Litigation – The frequency, nature, and results of private litigation against the firm.

Users of Audit Quality Indicators

The Release describes the use of AQIs by audit committees, audit firms, investors, and regulators. For example, the Release indicates that audit committees may use AQIs to: 1) assess reporting risk and audit quality; 2) retain and compensate auditors; and 3) oversee auditors. Audit firms could use AQIs to assess and manage risk. Investors could use AQIs to assess financial reporting risk (*i.e.*, that the company's financial statements are misstated).

Implementation of Audit Quality Indicators

The Release describes a phased approach for implementing AQIs. For example, the Board could initially support voluntary use of AQIs by engagement teams, audit committees, and audit firms. A voluntary approach could give audit committees and auditors time to become comfortable with the indicators and gain experience in using them in decision-making. This approach would also provide time for study of the indicators and their effectiveness. After a period of demonstrated effectiveness, the Board could consider required disclosure of AQIs to audit committees or the public at large.

Investment Companies

The Release asks whether certain industries where the nature, timing, and extent of audit work can differ from the norm should be excluded from the AQI project. The Release indicates that audits of registered investment companies are likely to prove very different from the audits of global manufacturing companies. Would these differences make the comparison of AQIs misleading or unworkable? Alternatively, can comparability problems be addressed by developing industry-specific AQI data?

Gregory M. Smith
Senior Director of Fund Accounting and Compliance

endnotes

[1] Concept Release on Audit Quality Indicators, PCAOB Release No. 2015-005; PCAOB Rulemaking Docket Matter No. 041 (July 1, 2015) *available at*: http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf ("Release").