May 13, 2013

Mr. Greg Jonas
Director, Office of Research and Analysis
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Dear Mr. Jonas,

The Center for Audit Quality (CAQ) commends the Public Company Accounting Oversight Board (PCAOB) for its recent issuance of the briefing paper "Discussion - Audit Quality Indicators" for review at the May 15-16 PCAOB's Standing Advisory Group (SAG) meeting. We agree that reliable audit quality indicators could be used by both the PCAOB and auditors to enhance audit quality. We also believe audit quality indicators could be used to better inform audit committees and other stakeholders about audit quality, and how it evolves over time. We expect the information presented in the briefing paper, and the feedback the PCAOB receives, will go a long way in furthering the dialogue on this important topic.

Over the past several months, the CAQ has worked to develop perspectives regarding components of an audit quality definition, beneficiaries of the audit, the role others have in impacting audit quality, and how the most relevant audit quality indicators may be identified.

We feel it is appropriate to share these perspectives with the PCAOB, in advance of the upcoming SAG meeting. This letter represents the perspectives of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Components of an Audit Quality Definition

As reflected in the PCAOB’s briefing paper, defining audit quality is challenging due, in part, to differing views of the definition of audit quality among various stakeholders and the judgment involved in evaluating what is considered sufficient appropriate audit evidence to support an audit report. However, we agree with the PCAOB that these challenges also represent important reasons supporting the need for an audit quality definition, as it could serve to provide a better understanding of what audit quality means. A definition could also provide the foundation for the development of audit quality indicators by identifying within the definition those key elements that contribute to audit quality, as well as a more common understanding of the elements of the audit process by all relevant parties and stakeholders.
In developing a definition of audit quality, we believe it is helpful to consider the definition of quality as used in other industries. In the manufacturing industry, for example, definitions of quality are often focused on a product working as intended with a minimum number of faults or failures. Manufacturing-based definitions are typically concerned with engineering and manufacturing practices and use a definition of “conformance to requirements.” In service industries, customer satisfaction is often the primary measure and is typically defined as “meeting or exceeding customer expectations.”

As a result, when contemplating the definition of quality, we believe two overarching concepts should be considered.

1. **Process-driven (system or input-based)** quality is the degree of compliance of a process or its outcome with a predetermined set of criteria, which are presumed essential to the ultimate value it provides. One example would be the proper formulation of a medication.
2. **Outcome-based (output-based)** quality is the level of perceived value reported by the person who benefits from a process or its outcome. Building off of the previous example, an outcome-based measure would be the degree of pain relief provided by the medication.

The CAQ believes that these two notions of quality are reflective of the existence of multiple stakeholders, each with potentially different viewpoints regarding quality. Users of audited financial statements often view quality based on the outcome of the service (i.e., whether the auditor issues the appropriate report and performed the audit in accordance with professional standards to provide reasonable assurance that the financial statements are fairly presented in accordance with the relevant financial reporting framework). Alternatively, other stakeholders with an interest in the delivery or oversight of the service (e.g., audit committees and regulators) are not only interested in the quality of the outcome of the audit, but are also focused on the systems and processes that facilitate the delivery of a quality outcome on a consistent basis. Recognizing these interdependencies, the CAQ believes that an effective definition of audit quality should acknowledge the importance of both the quality of outcomes (outputs), as well as the quality of supporting processes (inputs) to deliver those outcomes.

As such, we believe that the development of a definition of audit quality should:

1. Recognize the role that the audit committee plays in providing oversight of the audit services, and how this oversight contributes to enhanced confidence in the financial statements.
2. Incorporate the following key components, which we believe are critical to audit quality:
   a. Compliance with the applicable regulations and professional standards (input and output-based).
   b. Consideration of the audit firm’s system of quality control, which is designed to consistently deliver quality audits in a dynamic and evolving environment (input-based).
3. Provide linkage to the key elements of an audit quality framework as developed based on the PCAOB’s quality control standards or other professional standards (e.g., value, ethics, and attitude; knowledge, experience, and time; process and execution; and reporting and communications).

**Beneficiaries of the Audit**

In seeking to provide more meaningful information about audit quality, it is important to recognize the beneficiaries of the audit and their information needs. The CAQ believes that shareholders, creditors, and audit committees (who represent the interests of shareholders), are beneficiaries of the audit. The value they place on the assurance provided by the audit is integral to their confidence in an entity’s financial statements.
Stakeholders Contributing to Audit Quality and Financial Reporting Quality

While the responsibility for performing an audit rests with auditors, we believe audit quality is enhanced in an environment where there is support from other stakeholders. Preparers, audit committees, regulators, and accounting and auditing standard-setters all contribute to a well-functioning capital market system, which is dependent on reliable financial statements; although their responsibilities for financial reporting quality and potential impact on audit quality differs depending on the functions they perform. For example, audit committees have a statutory responsibility to oversee the financial reporting process and to appoint, compensate and oversee the auditor. Audit committees contribute to audit quality through their oversight of the work of the auditor by monitoring the execution of the audit plan and reviewing the auditor’s findings. Audit committees can influence the quality of the audit by sharing insights and information about transactions and events, and concerns about other accounting or auditing matters.¹

Preparers are responsible for ensuring that the financial statements are prepared in accordance with the relevant financial reporting framework. Auditors interact extensively with the preparers, ultimately opining on whether the preparer’s financial statements are presented fairly in accordance with the relevant financial reporting framework. Effective two-way communication between the auditor and the preparer helps improve the quality of the audit by ensuring there are no impediments to the auditors’ access to information relevant to the execution of the audit. An open and constructive relationship assists the auditor in identifying, assessing and responding to the risks of material misstatement, particularly with regard to complex or unusual transactions, or matters involving significant judgment or uncertainty.²

The establishment of an effective regime for monitoring audit performance, including effective dialogue between auditors and regulators, is also integral to the successful performance of audits in accordance with applicable professional standards. The promulgation of standards that establish the parameters for audits and set forth performance requirements that clearly communicate expectations and facilitate auditor implementation are also fundamental in impacting audit quality.

Audit quality is enhanced when all the participants are working effectively towards the shared goal of enhancing the reliability of the financial statements.

Audit Quality Indicator's Selection Criteria

Prior to selecting potential audit quality indicators, the CAQ believes that it is important to first establish selection criteria, or guiding principles, to be applied during the process of identifying indicators. Subject to inherent limitations, audit quality indicators may be quantitative, but are likely useful only when supplemented by qualitative narrative that provides insights on how the indicator fits into the larger context within which it operates. Therefore, we propose the following criteria and their related categorization into essential criteria (all indicators should meet), important criteria (should strongly consider), and collective criteria (the collective set of indicators, taken as a whole, should meet):

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Essential Criteria

- Convey information that has value/utility to stakeholders;
- Measure an input or output related to an element of the audit quality framework;
- Avoid or minimize unintended negative consequences (i.e., evaluation of the indicator would not lead to actions that are contrary to audit quality, result in misplaced priorities or are costly without commensurate benefit); and
- Be scalable to audit firms of different sizes.  

Important Criteria

- Be capable of consistent measurement over time;
- Information can be captured without unduly significant efforts; and
- Be objective and quantifiable.

Collective Criteria

- Help narrow, or at least not further exacerbate, any existing expectation gaps;
- Address all important elements of the audit quality framework; and
- Be supported by an accompanying narrative that provides the context for consideration of audit quality indicators.

The selection process of audit quality indicators also should be supported by a careful analysis of pros and cons of each proposed indicator. We believe that such analysis should include robust validation, including field testing, to provide evidence that the indicators are accomplishing the objectives set forth in the criteria noted above. In some cases, academic research may also provide an important source to inform the analysis.

We believe the criteria above could serve as a basis for identifying potential indicators that will have the greatest likelihood of providing a broader understanding of audit quality. However, similar to the pursuit of audit quality, the evaluation of audit quality indicators is an iterative process that requires continual assessment and improvement in order to meet the needs of the changing business environment. Continuously assessing information, including past experiences and results, will assist in the identification and development of relevant indicators. Further, eliminating indicators that no longer meet the criteria, and replacing them with new indicators that do, will improve the quality assessment and enhance credibility.

Conclusion

In the coming months, the CAQ will continue to develop its thinking in the areas presented in the PCAOB’s discussion paper. As the PCAOB seeks additional feedback on its initiative, the CAQ hopes to continue to contribute to the evolving dialogue associated with providing a broader understanding of audit quality, its underlying elements, and potential indicators. While we have not commented in this letter on the audit quality framework included in the PCAOB discussion paper, we know that the IAASB is also currently engaged in an audit quality framework study. We encourage the PCAOB to continue to consider the views of the IAASB on this important topic, with the hope that the efforts of the PCAOB and the IAASB are coordinated and views are aligned.

We appreciate the opportunity to share our perspectives and would welcome the opportunity to respond to any questions you may have regarding any of our comments.

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3 Such criterion was discussed during one of the break-out sessions held at the PCAOB’s October 2008 Standing Advisory Group (SAG) meeting where feasibility of audit quality indications was explored, PCAOB’s SAG Meeting Archives: October 22 - 23, 2008 Meeting Transcript (link) and Webcast (link).

4 Ibid.
Sincerely,

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:
James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor
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