

CAQ APPROACH TO AUDIT QUALITY INDICATORS



CENTER FOR AUDIT QUALITY

*Serving Investors, Public Company Auditors & the Markets*

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA).

The CAQ Approach to Audit Quality Indicators reflects the views of the Center as of April 2014.



The Center for Audit Quality (CAQ) has closely followed the Public Company Accounting Oversight Board's (PCAOB or the Board) Audit Quality Indicators (AQI) initiative and appreciates the efforts shown by the Board to (1) develop measures that may provide further insight into audit quality, as outlined in the PCAOB's briefing paper<sup>1</sup> presented at the May 15-16, 2013 Standing Advisory Group (SAG) meeting, and (2) conduct outreach to the SAG<sup>2</sup> and Investor Advisory Group (IAG)<sup>3</sup> members, and other stakeholders, to further inform its thinking in this important area. The CAQ also recognizes that there have been a variety of other research projects and global initiatives on the topic of audit quality. However, there has not been universal agreement on a definition of audit quality, an audit quality framework,<sup>4</sup> or the most relevant indicators of audit quality and how and to whom they should be communicated.

In May 2013, the CAQ submitted a letter to the PCAOB,<sup>5</sup> in which we expressed agreement that reliable AQIs could be used by both the PCAOB and auditors to enhance audit quality; and noted our belief that AQIs could be used to better inform stakeholders about key matters that contribute to audit quality, including how those matters evolve over time. We also (1) outlined our perspectives on the components of an audit quality definition; (2) highlighted the role the audit committee plays in providing oversight of the audit and the importance of linking the AQIs to the quality control standards; and (3) presented selection criteria to be applied during the process of identifying potential AQIs.

Since this letter was submitted, we have continued to develop perspectives regarding which indicators may be most relevant and how they should be communicated to stakeholders. In doing so, the CAQ has performed outreach to investors, audit committees, and other stakeholder groups.<sup>6</sup> These outreach efforts have led the CAQ to develop an approach to communicating AQIs, which focuses on the communication of engagement-specific metrics to audit committees and recognizes the critical role that audit committees play in the oversight of the audit.<sup>7</sup>

The CAQ has also developed a set of potential AQIs that we believe, collectively, will provide the greatest opportunity to enhance discussions between auditors and audit committees and the most benefit to audit committees in fulfilling their responsibility relative to the oversight of the audit. The CAQ plans to subject these potential AQIs to pilot testing, and to solicit additional feedback through outreach efforts to assess their overall usefulness to audit committees.

In this paper, the CAQ provides its perspectives regarding: (1) the background and context for the discussion of AQIs, (2) a suggested approach for the communication of AQIs, (3) the identification of a set of potential AQIs, and (4) an overview of the CAQ's pilot-testing initiative.

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<sup>1</sup> See, PCAOB Briefing Paper, Discussion — *Audit Quality Indicators*, May 15 – 16, 2013.

<sup>2</sup> See, PCAOB's *AQI Update*, SAG Meeting, November 14, 2013.

<sup>3</sup> See, *Report from the Working Group: Audit Quality Indicators*, IAG Meeting, October 16, 2013.

<sup>4</sup> In February 2014, the International Auditing and Assurance Standards Board released, *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*, which describes the different elements that create the environment for audit quality at the engagement, firm, and national levels, as well as relevant interactions and contextual factors. However, the IAASB's framework does not present a definition of audit quality or provide AQIs.

<sup>5</sup> See, CAQ letter to PCAOB, May 13, 2013.

<sup>6</sup> For instance, feedback was solicited from the CAQ's Stakeholders Advisory Panel, which consists of investors, audit committees, preparers, audit professionals, academics, and former standard-setters. Additionally, the CAQ held a roundtable with audit committee members to solicit feedback.

<sup>7</sup> See, SEC Final Rule, *Standards Relating to Listed Company Audit Committees*, Section B. *Responsibilities Relating to Registered Public Accounting Firms*.

# Overview of Audit Quality Indicators

The term ‘audit quality indicators’ has been used by various stakeholder groups, including the PCAOB, the U.S. Department of the Treasury’s Advisory Committee on the Auditing Profession, the International Auditing and Assurance Standards Board (IAASB), audit committees, and the audit profession, to describe a way to assess the quality of an audit. However, depending on the stakeholder, the meaning and purpose of an AQI may differ. For this reason, we believe it is important for readers to understand how the term AQI is being used in this paper.

Audit firms are required to establish a system of quality control that complies with regulatory and legal requirements and that ensures audit reports issued by the firm are appropriate. An audit firm’s system of quality control is intended to address certain key elements, such as independence, integrity, objectivity, personnel management (which includes sufficiency of resources, technical knowledge and experience), engagement performance, communication and reporting, and monitoring.

The CAQ believes a set of potential AQIs could provide additional perspective on the key elements of a firm’s system of quality control as it applies to a particular audit, and could be useful to further an audit committee’s understanding of matters that may contribute to the performance of a quality audit. For instance, a set of AQIs could promote robust discussions about an audit firm’s ability to support and perform quality audits. They may also assist audit committees in better understanding the audit firm’s policies, procedures, and processes related to its system of quality control. Additionally, a set of AQIs may provide audit committees insight into the engagement team’s performance. A set of AQIs may also assist audit committees in better understanding the risks to audit quality that may exist on the audit, which could allow for more robust discussions about the audit firm’s plan to manage such risks. However, due to the nature and number of inputs that can impact the quality of an audit, no single metric should be viewed as having a causal relationship to audit quality. Nevertheless, we believe a set of indicators, taken as a whole, may provide those overseeing the audit with information and additional transparency into the systems and processes that underlie the performance of an audit.

In identifying potential AQIs for this purpose, we believe it is important to consider the following thematic elements of audit quality, which were developed with consideration of perspectives provided by various standard setters around the world,<sup>8</sup> and are based upon the key elements discussed above. Therefore we believe they facilitate the identification of matters that are most relevant to an audit committee’s oversight responsibilities.

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<sup>8</sup>For example, the United Kingdom’s Financial Reporting Council’s five potential key drivers of audit quality; the IAASB’s publication *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*; the International Standard on Quality Control No. 1; and the PCAOB’s Quality Control Interim Standard, Section 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*.

- 1. Firm Leadership and Tone at the Top** — The audit firm’s leadership, through its tone at the top, emphasizes the importance of audit quality, adherence to professional standards, independence and objectivity, and holds itself accountable for the effectiveness of the audit firm’s system of quality control.
- 2. Engagement Team Knowledge, Experience, and Workload** — Professional staff are knowledgeable, experienced, and have sufficient time to perform quality audits.
- 3. Monitoring** — Processes and controls are in place to assess audit engagement performance and the sufficiency of the audit firm’s system of quality control and make any necessary changes.
- 4. Auditor Reporting** — Reports are reliable, useful, and timely; auditor communications are effective.

Further, AQIs, like most evaluative data, are most effective when accompanied by a robust discussion (written or oral). Without these discussions, there is a risk that an AQI, or changes in an AQI over time, may not tell a complete story or could be misleading. For example, the fact that an engagement team is experiencing higher than expected overtime could reflect that they have encountered an unforeseen issue and are spending extra time in order to maintain high audit quality. Alternatively, it could mean that the team is overburdened, which could have an impact on audit quality. As a result, it is important to provide the appropriate context when communicating AQIs.

# CAQ Approach to Communication of AQIs

Audit committees serve an essential role in corporate governance, by protecting investors through their oversight of a company's financial reporting process and the audit. The CAQ has developed a suggested approach to communicate potential AQIs that recognizes the role and responsibilities of audit committees and reinforces the importance of (and enhances the dialogue around) the auditor's communications with audit committees, by providing additional relevant information about the auditor and the audit. The CAQ's approach is focused on the communication of engagement-specific indicators, with firm-wide indicators included where they provide context or enhance an audit committee's understanding of engagement-specific matters. These communications are intended to supplement other communications already provided to the audit committee, including an auditor's required communications under professional standards,<sup>9</sup> as well as the audit quality and transparency reports (if issued by the audit firm). We believe that this approach is appropriate for the following reasons:

1. Focusing on communications with the audit committee will allow the AQIs to be discussed with those responsible for overseeing the independent audit.
2. Dialogue between the audit committee and the audit firm about AQIs could promote an active discussion on matters important to the execution of the audit, which could increase the audit committee's understanding of factors that may affect the quality of the audit, as well as enhance the audit committee's ability to evaluate actions that have been or may need to be taken. In addition, a robust dialogue can provide additional context with respect to the various measures, such as year-over-year changes, as well as provide further perspective on matters and their potential impact on the execution of the audit.
3. Enhanced communication through the use of AQIs at the engagement level could also drive actions that might help maintain or increase audit quality on an engagement, and may also assist audit committees in evaluating the effectiveness of the audit firm.

The CAQ believes the discussion of AQIs would occur on an annual basis — possibly in connection with the timing of the required communications that take place in conjunction with the planning of the audit — with updates provided throughout the audit cycle if significant changes occur in performing the audit. However, we anticipate the timing of these communications could vary, depending on the issuer's complexity and the timing of the audit cycle.

Further, under our proposed approach, we believe there should be flexibility in communicating the potential set of AQIs, as the nature and format should be tailored based upon the audit committee's information and reporting needs. The CAQ has prepared a communications document to provide an approach to engagement teams for communicating the identified set of potential AQIs to audit committees.<sup>10</sup>

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<sup>9</sup>For example, PCAOB Auditing Standard No. 16, *Communications with Audit Committees*; S-X Rule 2-07; discussions required by listing standards, such as the NYSE which requires the discussion of inspections and reviews, which includes PCAOB inspection reports; PCAOB Rules 3524 pre-approval of certain tax services, 3525 pre-approval of non-audit services, and 3526 independence disclosure.

<sup>10</sup>See, Appendix A: Potential Communication of AQIs.

In identifying a set of potential AQIs,<sup>11</sup> the CAQ considered a large number of indicators related to audit quality, including those referenced by other parties. For instance, the CAQ considered, the PCAOB's measures discussed at the May 2013 SAG meeting, indicators cited in academic research, and indicators suggested during the CAQ's discussions with various stakeholder groups (e.g., audit firms, regulators, investors, audit committees, and academics). The CAQ's AQI selection criteria<sup>12</sup> and consideration of the thematic elements of audit quality (discussed above) served as a basis for narrowing the larger population of indicators to a listing of potential AQIs that we believe could provide audit committees with a broader understanding of engagement teams, audit firms, and audit quality. Based upon these efforts, the CAQ has identified a set of potential AQIs that we believe, taken as a whole, could aid audit committees in their oversight of the audit. These AQIs will be the subject of upcoming pilot-testing and outreach efforts.

AQIs may primarily be quantitative in nature. However, as previously described, these indicators are more useful when supplemented by contextual qualitative narrative and dialogue between the auditor and the audit committee. Further, an understanding of an audit firm's system of quality control is important in providing appropriate context for the engagement-specific indicators presented to an audit committee. In providing this information, engagement teams could reference the audit firm's audit quality and transparency reports (if issued by the audit firm).

Finally, we expect the identification and evaluation of AQIs to be an evolutionary process that will require assessment and refinement in order to meet the needs of the changing business environment. For instance, refinement of the identified set of potential AQIs, including modifying indicators or eliminating indicators that no longer meet the selection criteria<sup>13</sup> and replacing them with new indicators that do, will improve the quality assessment. We believe that such assessments should also include robust validation, including pilot testing, to provide evidence that the indicators are accomplishing the objectives set forth in the criteria noted above.

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<sup>11</sup> See, Appendix B: Potential Set of AQIs Subject to the CAQ's Pilot-Testing Efforts.

<sup>12</sup> See Appendix C: The CAQ's AQI Selection Criteria.

<sup>13</sup> Ibid.

# Pilot Testing

In the coming months, in coordination with certain of its member firms, the CAQ plans to subject the set of potential AQIs to pilot testing and to solicit additional feedback through outreach efforts. The objectives of these efforts are to identify any potential barriers to auditor preparation and communication and to assess the overall usefulness of the AQIs to audit committees. The pilot-testing initiative will allow for feedback from key members of the audit firms' national offices and engagement teams about the process of accumulating information and communicating it to audit committees, as well as from audit committees about whether this information is helpful in fulfilling their audit oversight responsibilities. Pilot testing will also enable the CAQ to form a perspective on the effort required to implement any changes to audit firms' internal reporting mechanisms to facilitate timely and consistent data gathering.

Further, understanding the benefits and challenges of producing and communicating indicators, including potential unintended consequences, will enable the CAQ to continue to refine the information to reflect those indicators that are most meaningful to the audit committee. The results of pilot testing could also provide meaningful guidance to engagement teams to promote greater consistency, as audit firms produce and communicate the indicators.

The CAQ's pilot-testing efforts will be performed in several phases throughout the 2014 audit cycle and will include presentation of comparative AQIs for the current year (2014 audit cycle) and prior year (2013 audit cycle). Although it is anticipated that engagement teams will coordinate these discussions with audit committees, we expect that the discussion may be performed in conjunction with other required communications during the 2014 audits. As we move forward with our pilot-testing efforts, the CAQ plans to assess findings after each pilot-testing phase and evaluate the need for changes to the set of potential AQIs and suggested communication approach. The CAQ also anticipates sharing these findings, including enhancements to the set of potential AQIs (if any).

The CAQ believes our approach to communicating a set of AQIs to audit committees — focusing primarily on engagement-specific indicators, with firm-wide indicators included where they provide context or enhance an audit committee’s understanding of engagement specific matters — will provide audit committees with a greater understanding of factors that may affect the quality of an audit. We believe these communications between the auditor and audit committee could lead to further opportunities to enhance audit quality. As the CAQ commences pilot testing of the proposed approach outlined in this paper, we will continue to refine our thinking on the identified set of potential AQIs.

# Appendix A: Potential Communication of AQIs

The purpose of this appendix is to highlight the CAQ's rationale for including this set of measures as potential AQIs. The appendix also provides suggested quantitative and qualitative information for engagement teams to consider in their AQI discussions with audit committees. However, the form of these communications is intended to be flexible and should be tailored to meet the individual needs of each audit committee.

## **I. Firm Leadership and Tone at the Top**

### ***Rationale for Including as a Potential AQI***

The audit firm's leadership, through its tone at the top, emphasizes audit quality and holds itself accountable for the audit firm's system of quality control.

### ***Quantitative or Qualitative Information***

The engagement team discussions with the audit committee could include an overview of the audit firm's audit quality and transparency reports on how it emphasizes audit quality, through its tone at the top. The manner in which the audit firm's leadership measures the effectiveness of such messaging (for example through an employee survey) on a firm-wide basis could also be included, as engagement-specific information may not be available.

Engagement teams could also communicate how the audit firm's tone at the top influences and reinforces audit quality at the engagement level. For example, this might include discussion of firm-wide and local communications and training that include among others, quality best practices or lessons learned from prior inspection results.

## **II. Engagement Team Knowledge, Experience, and Workload**

The knowledge, experience, and workload of the audit engagement partner and certain other members of the engagement team are important elements in the execution of an audit. It is the responsibility of the engagement partner to determine that, collectively, the engagement team has the appropriate experience and competencies, and that specialists are engaged, as needed. The level of detail that may be provided on changes in the composition of the engagement team is dependent on the audit committee's needs and expectations, size of the engagement team, and other considerations.

### **A. Knowledge and Experience of Key Engagement Team Members**

#### ***Rationale for Including as a Potential AQI***

The collective knowledge and experience of the engagement team is important for achieving audit quality. These indicators are intended to help an audit committee understand the structure of the engagement team and illustrate certain information relative to the knowledge, relevant experience (such as auditing complex group structures or other companies in a similar industry) and the tenure of key engagement team members.

### ***Quantitative and Qualitative Information***

In communicating with audit committees on this topic, engagement teams may consider:

- Focusing on the experience levels of key engagement team members (e.g., the engagement partner(s), manager(s), and the engagement quality reviewer [EQR]).
- Measures of experience that may be most relevant to the specific engagement, such as:
  - Years on the engagement
  - Years of industry experience relevant to the audit engagement. For instance, for a financial services audit engagement, years of financial services experience for each key engagement team member.
  - Years with the audit firm
  - Years at present level

## **B. Audit Firm Training Requirements**

### ***Rationale for Including as a Potential AQI***

Partners and staff continuously enhance their technical expertise through periodic training.

### ***Quantitative and Qualitative Information***

In communicating with audit committees, engagement teams may consider including measures or information that provide insight into the audit firm's training requirements (which are often in excess of minimum professional requirements), focusing in particular on the relevant training of key engagement team members. Also, if key members of the engagement team are not in compliance with the audit firm's continuing education requirements, such exceptions may be communicated, including whether any remedial action is being taken.

To the extent the issuer is in a highly specialized industry, engagement teams may communicate their approach for determining that appropriate industry knowledge is obtained (e.g., attendance at audit firm industry training courses, external industry conferences).

## **C. Trends in Engagement Hours and Related Timing**

### ***Rationale for Including as a Potential AQI***

The extent, distribution, and timing of audit hours can be important to achieving audit quality.

### ***Quantitative and Qualitative Information***

The audit committee communication may incorporate appropriate measures of the following:

- Audit hours by various levels, including partner(s), manager(s) and staff (e.g., percentage of planned hours for current year and actual audit hours for prior year)
- Changes in audit hours between years (i.e., comparing current year planned hours to prior year actual hours)
- The breakdown of audit hours incurred by phase of the audit cycle, particularly the allocation between planning and execution/completion

Engagement teams may focus their discussions with audit committees on significant changes year-over-year and share their perspectives on the timing of the activities undertaken during the course of the audit. If the information on trends in total engagement hours has been provided as part of the fee discussion, the engagement teams may also reference such communication.

### D. Allocation of Resources by Significant Risk Areas

#### *Rationale for Including as a Potential AQI*

The communication of significant risks identified during the auditor's risk assessment is already an important attribute in the auditor's discussion of the overall audit strategy with the audit committee.<sup>14</sup> This AQI is intended to provide further insight and context into the identified significant risk areas.

#### *Quantitative and Qualitative*

Engagement teams could discuss with the audit committee the planned allocation of resources associated with significant risk areas for the current year audit, as well as the actual allocation to the prior year audit. The engagement team's discussion with the audit committee could focus on: (a) an explanation of the nature and significance of the areas identified as significant risks; (b) a review of significant changes in these risks year-over-year; and (c) perspectives on overall audit strategy to be undertaken for each significant risk area based on the current year audit, which may include the use of a specialist based on the nature and complexity of each significant risk area. This discussion could cross-reference other communications with the audit committee and the Specialist and National Office Personnel Involvement AQI below.

### E. Specialists and National Office Personnel Involvement by Significant Risk Areas

#### *Rationale for Including as a Potential AQI*

The use of a specialist(s) and/or consultation with the national office may be warranted, based on consideration of the significant risk areas associated with the engagement, and the nature and complexity of information, data or assertions to be audited. This AQI provides insight into the depth of specialists' involvement within these risk areas and contributes to an audit committee's understanding of the team's composition, competencies, and audit firm policies.<sup>15</sup>

#### *Quantitative and Qualitative Information*

The engagement team's discussion with the audit committee could include:

- The number of hours or percentage of audit hours expected to be incurred by specialists or national office personnel by significant risk area, including a comparison of the prior year audit.

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<sup>14</sup> See, Paragraph 9, PCAOB Auditing Standard No. 16, *Communications with Audit Committees*.

<sup>15</sup> Consistent with AU 336, *Use of a Specialist*, paragraph 1, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

- In instances where an outside specialist assisted in the audit, an engagement team's discussions could focus on the fees paid to the specialist, possibly in relation to total audit fees.

The engagement team's discussion with the audit committee could focus on the nature of the issues expected to be encountered and planned level of specialist involvement in the audit by significant risk areas (as applicable), in comparison to the prior year. Other specialist information (such as years on the engagement, years with the audit firm or relevant certifications) could also be shared.

The CAQ acknowledges that not all audit firms maintain a national office structure and such consultations are difficult to anticipate in advance; however, to the extent issues requiring consultations are identified early (such as an anticipated consultations on a revenue testing approach) engagement teams may consider communicating these anticipated consultations to audit committees. The engagement team may also refer to the audit firm's audit quality and transparency reports for a description of the audit firm's specialist network and national office resources, if applicable.

## **F. Key Engagement Team Members' Workloads**

### ***Rationale for Including as a Potential AQI***

Workload related indicators could assist audit committees in better understanding whether engagement teams have appropriate time to perform the audit, review and supervise the audit work, and address difficult issues, if and when they arise. Key engagement team members usually work on a number of audits, some with similar reporting timetables. This can lead to concentrated periods of activity. Key engagement team members also have additional responsibilities (such as recruiting, practice development and technical or management roles). A workload AQI may, therefore, be a good indicator of partner(s)' and manager(s)' capacity to effectively supervise the audit, review the work of subordinates, and execute audit procedures.

### ***Quantitative and Qualitative Information***

Workload levels for key engagement team members could be communicated in a number of ways, such as:

- Average number of hours (current year planned and prior year actual) for each key member, possibly indicating the split between client and non-client activities, if desired.
- Providing workload information in relation to a standard workload by level (determined by the audit firm) or the total number of hours available in a year, based on a 40-hour work week (2,080).
- Workload levels in excess of a standard workload by level (40-hour work week or comparable level determined by the audit firm) and anticipated excess during the current year compared to workload in prior year, focusing either on full-year totals or on excess during the critical period of completion of audit procedures and sign-off.

## Appendix A: Potential Communication of AQIs (continued)

The engagement team's discussion with the audit committee could focus on the key engagement team members' workloads and how possible time conflicts have been or will be managed.

### III. Monitoring

#### *Rationale for Including as a Potential AQI*

Compliance with professional standards in the execution of an audit is partially assessed through inspection processes conducted by the PCAOB and the audit firm, although such assessments may not lend themselves to extrapolation to the population of audits as a whole due to the criteria used to make inspection selections. To inform auditor communications to audit committees regarding inspections and quality control improvement, consideration should be given to the PCAOB's August 1, 2012 Release (No. 2012-003). The Release specifically identifies topics audit committees may wish to discuss with auditors in order to gain a better understanding of PCAOB inspections of audit firms. The CAQ also has developed a practice aid to assist engagement teams with discussing inspection findings with an audit committee.<sup>16</sup>

#### *Quantitative and Qualitative Information*

Communications with the audit committee regarding audit deficiencies identified by a PCAOB or internal inspection of the issuer's audit engagement could describe the nature of the finding(s), including the audit procedures considered to be either omitted or insufficient, the audit firm's perspective on the issues identified, the nature and extent of any additional audit procedures that were performed to address the respective deficiency and the planned effect on the current year audit.

#### **A. Internal Quality Review Findings**

Engagement teams could consider broadly discussing the matters identified during the firm-wide internal quality review program. Those findings are an indicator of audit quality that may be of interest to the audit committee and may serve to indicate the areas where audit quality could be improved practice-wide. The engagement team may reference the audit firm's quality and transparency reports (if applicable) for a description of the audit firm's internal inspection program, including how often each individual partner is inspected or the percentage of engagements inspected in the recent fiscal year.

If the engagement has been subjected to an internal inspection, the discussion could focus on the findings that required additional audit procedures and the planned effect on the current year.

#### **B. PCAOB Inspection Findings**

The engagement team could notify the audit committee if that issuer's audit engagement is selected or was selected in the prior year for PCAOB inspection, rather than wait for the subsequent issuance of the inspection report. Engagement teams could also keep the audit

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<sup>16</sup> See, CAQ Practice Aid, *Discussions with Audit Committees About Inspection Findings and Quality Control Matters*.

committee informed of the progress of that inspection up to and through issuance of the final inspection report.

In addition to information on the specific results of an inspection of an issuer's audit engagement, the engagement team may also consider whether an audit committee would benefit from receiving information about trends in the results of PCAOB inspections of the entire audit firm, including:

- Number of engagements inspected
- Number of inspections with Part I comments
- Percentage of inspections with Part I comments
- Common issues/themes in Part I comments

An audit committee can obtain useful information about whether such trends may affect the issuer's current year audit (e.g., are the common findings or issues relevant to the audit?). The engagement team may also share its view of the audit firm's efforts to understand potential causes of deficiencies and any remediation plans being undertaken, including changes to the audit firm's system of quality control.

Engagement teams may also evaluate whether local regulatory inspections of component teams not discussed in this document should be communicated to the audit committee. Such evaluations should consider confidentiality restrictions, if any.

## **IV. Auditor Reporting**

### **A. Reissuance Restatements and Withdrawn Auditor's Reports**

#### ***Rationale for Including as a Potential AQI***

The level of reissuance restatements of previously issued financial statements by public companies and instances where the auditor has withdrawn its previously issued report on internal controls over financial reporting (ICFR) is considered by some to be a potential indicator of audit quality.

#### ***Quantitative and Qualitative Information***

An auditor's discussion with the audit committee could focus on:

- Firm-level trends of:
  - Reissuance restatements of financial statements
  - Withdrawal of previously issued ICFR reports
- Common themes/issues in restatements and withdrawn ICFR reports

# Appendix B: Potential Set of AQIs Subject to the CAQ's Pilot-Testing Efforts

The purpose of this appendix is to identify the CAQ's set of potential AQIs that will be included in the pilot-testing efforts.

## **I. Firm Leadership and Tone at the Top**

- Overview of how the audit firm's leadership, through its tone at the top, emphasizes audit quality and holds itself accountable for the audit firm's system of quality control

## **II. Engagement Team Knowledge, Experience, and Workload**

### **A. Knowledge and Experience of Key Engagement Team Members** (e.g., engagement partner(s), manager(s), and EQR(s))

- Years on the engagement
- Years of industry experience, relevant to the audit engagement (for instance, for a financial services audit engagement, years of financial services experience for each key engagement team member)
- Years with the audit firm
- Years at present level

### **B. Audit Firm Training Requirements**

- Discussion of the audit firm's training requirements
- Communication of the engagement team's non-compliance with the audit firm's training requirements or other standards (if any), and related remediation actions

### **C. Trends in Engagement Hours and Related Timing**

- Audit hours by various levels, including partner(s), manager(s) and staff (e.g., percentage of planned hours for current year and actual audit hours for prior year)
- Changes in audit hours between years (i.e., comparing current year planned hours to prior year actual hours)
- The timing of audit hours, particularly the allocation between planning and execution/completion

### **D. Allocation of Resources by Significant Risk Areas**

- Planned and actual allocation of resources associated with significant risk areas

### **E. Specialists and National Office Personnel Involvement by Significant Risk Areas**

- The number of hours or percentage of audit hours expected to be incurred by specialists or national office personnel, including a comparison to the prior year audit

## *Appendix B: Potential Set of AQIs Subject to the CAQ's Pilot-Testing Efforts (continued)*

- Explanations regarding the nature of the issues expected to be encountered and the types of specialist engaged in comparison to the prior year audit

### **F. Key Engagement Team Members' Workloads**

- Average number of hours (planned for the current year audit and actual hours for prior year audit) for each key member, possibly indicating the split between client and non-client activities, if desired
- Providing workload information in relation to a standard workload by level (determined by the audit firm) or the total number of hours available in a year based on a 40-hour work week (2,080)
- Workload levels in excess of a standard workload by level (40-hour work week or comparable level determined by the audit firm) and anticipated excess during the current year compared to workload in prior year, focusing either on full-year totals or on excess during the critical period of completion of audit procedures and sign-off

## **III. Monitoring**

### **A. Internal Quality Review Findings**

- Broadly discuss the matters identified during the firm-wide internal quality review program
- If the engagement has been subject to an internal inspection, discuss review findings that required additional audit procedures and their impact on the planned current year audit

### **B. PCAOB Inspection Findings**

- If the engagement has been subject to a PCAOB inspection, discuss inspection findings (if any) and the impact these findings would have on the current year audit
- Trends in firm-wide PCAOB inspection results, including:
  - Number of engagements inspected
  - Number of inspections with Part I comments
  - Percentage of inspections with Part I comments
  - Common issues/themes in Part I comments
- Views on the audit firm's efforts to understand potential causes of deficiencies and any remediation plans being undertaken, including changes to the audit firm's system of quality control

#### **IV. Auditor Reporting**

##### **A. Reissuance Restatements and Withdrawn Auditor's Reports**

- Focus on firm-level trends of
  - Reissuance restatements of financial statements
  - Withdrawal of previously issued ICFR reports
- Common themes/issues in restatements and withdrawn ICFR reports

# Appendix C: The CAQ's AQI Selection Criteria

This appendix illustrates the CAQ's AQI selection criteria and their related categorization into essential criteria (that all indicators should meet), important criteria (that should be strongly consider), and collective criteria (that the collective set of indicators should meet). These criteria were used to identify a set of potential AQIs to communicate with audit committees.

<b>Essential Criteria</b>	<ul style="list-style-type: none"><li>• Convey information that has value/utility to audit committees</li><li>• Measure an input or output related to an element of the audit quality framework</li><li>• 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)<sup>17</sup></li><li>• Be scalable to audit firms of different sizes<sup>18</sup></li></ul>
<b>Important Criteria</b>	<ul style="list-style-type: none"><li>• Be capable of consistent measurement over time</li><li>• Information can be captured without unduly significant efforts</li><li>• Be objective and quantifiable</li></ul>
<b>Collective Criteria</b>	<ul style="list-style-type: none"><li>• Help narrow, or at least not further exacerbate, any existing expectation gaps</li><li>• Address all important elements of the audit quality framework</li><li>• Be supported by an accompanying narrative that provides the context for consideration of audit quality indicators</li></ul>

<sup>17</sup> 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 AQIs was explored. See, the PCAOB's SAG Meeting Archives: October 22 – 23, 2008.

<sup>18</sup> Ibid.



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