

PCAOB Concept Release on Audit Quality Indicators Summary & Considerations for Stakeholder Comment

THE PROPOSAL

On June 30, 2015, the Public Company Accounting Oversight Board (PCAOB) issued a concept release seeking public comment on 28 potential quantitative audit quality indicators (AQIs), which include over 70 illustrative calculations. The PCAOB's stated purpose of the AQI project is to identify a manageable set of impactful, objective, and measureable indicators that may provide insights into how high quality audits are achieved so that audit firms and audits can be evaluated and compared.

WHY AUDIT COMMITTEE MEMBERS SHOULD COMMENT

The PCAOB's AQI project could impact audit committees and how they oversee external auditors. Accompanied by robust dialogue, AQIs could enhance understanding between the auditor and the audit committee on factors important to audit quality, and could support audit committees in discharging their duties in overseeing the auditor and the audit process. Because audit committees are identified as one of the potential primary users of AQIs, input from audit committee members will be extremely valuable and critical to the PCAOB's project.

SUBMITTING A COMMENT

Content: The PCAOB has specifically requested input from audit committees among others. You do not need to respond to all (or any) of the questions contained in the concept release; you may instead comment at a thematic level and/or focus on the question(s) and/or indicator(s) about which you have a point of view. Similarly, you do not need to provide feedback on each (or any) of the 28 indicators. This document provides additional information on key areas and questions on which you may consider commenting.

Deadline: Comments are due on or before September 29. However, historically the PCAOB has accepted comments after the deadline, especially for concept releases.

How to submit comments:

- Send an email to comments@pcaobus.org with subject line "PCAOB Rulemaking Docket Matter No. 041."
- Mail hardcopy comments to the Office of the Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006-2803.
- **All submissions should refer to PCAOB Rulemaking Docket Matter No. 041.**

Concept Release Summary

The concept release focuses on whether and how AQIs can potentially drive improvements in audit quality. It seeks public feedback on specific issues relating to:

- **The nature of the potential indicators;**
- **The usefulness of particular indicators described in the concept release and suggestions for other indicators;**
- **Potential users and distribution of the indicators; and**
- **An approach to implementation of any audit quality indicator project.**

Why Is the PCAOB Focusing on Audit Quality Indicators?

The PCAOB suggests that the right set of AQIs applied consistently, and when accompanied by a discussion or dialogue, could distinguish audit engagements and audit firms on the basis of audit quality, thereby creating incentives for competition on the basis of quality. The PCAOB summarizes the goal of the AQI project as follows: “to improve the ability of persons to evaluate the quality of audits in which they are involved or on which they rely and to enhance discussions among interested parties; use of the indicators may also stimulate competition by audit firms based on quality.”

Audit Committee Consideration:

Audit committee views on the value of the PCAOB's potential AQIs and their uses will help inform the PCAOB on how the indicators might be modified.

The public company auditing profession has been considering AQIs for the last several years and the PCAOB notes in the concept release the work on AQIs that has been done by the Center for Audit Quality (CAQ) and the increased focus on AQIs among audit firms. The PCAOB's Standing Advisory Group – a multi-stakeholder group established to advise on the development of auditing and related professional practice standards – has deliberated on AQIs on several occasions. The CAQ published its own discussion of audit quality indicators in an April 2014 publication entitled “[CAQ Approach to Audit Quality Indicators](#).” A number of the PCAOB's and the CAQ's potential AQIs are similar. The CAQ, together with audit firms and audit committees, recently completed a pilot test to evaluate the practical implications and assess overall usefulness of the CAQ's potential AQIs. The CAQ will report on the results of the pilot test in a comment letter to the PCAOB.

In developing its concept release, the PCAOB also considered international regulatory efforts associated with AQIs. Both the U.K.'s Financial Reporting Council (FRC) and the International Auditing and Assurance Standards Board (IAASB) have sponsored initiatives to understand and describe audit quality indicators. The FRC issued an “[audit quality framework](#)” that encouraged auditors and audit committees to discuss quality indicators related to areas such as firm culture, auditor skills, and the strength of the audit process. The IAASB issued its own [framework](#), which identifies input, process, and output qualitative factors that contribute to audit quality at the engagement, firm, and national levels for financial statement audits. Many of the IAASB's factors are reflected in the PCAOB's potential AQIs. While there are similarities between the two, the IAASB's framework does not endeavor to quantify their indicators. For the PCAOB, a key criterion for a potential AQI is that it be quantifiable.

PCAOB's Potential Audit Quality Indicators

Audit Committee Consideration: *What concerns do audit committees have about a potential requirement to receive and review AQIs?*

The PCAOB has identified 28 areas for development of AQIs in three main categories – (i) audit professionals; (ii) audit process; and (iii) audit results. In an appendix, the PCAOB suggests several potential AQI illustrative

calculations in each of the 28 AQI areas. Taken as a whole, there are over 70 potential AQI illustrative calculations in the PCAOB's concept release. The PCAOB's intention in issuing the concept release is to generate discussion and debate that will inform identification of a manageable number of indicators.

The indicators have been developed around three principles: (i) they should be quantifiable wherever possible; (ii) they should generate data to enable those to whom they are directed to pose critical questions; and (iii) they should function as a "balanced portfolio" of audit quality. The PCAOB did not propose a definition of audit quality in the concept release.

Audit Committee Consideration: *Does limiting AQIs to those that are quantifiable pose a risk that particular indicators would be chosen because they are more easily measured? What, if any, indicators do audit committees currently use in selecting and overseeing their external auditor?*

The Usefulness of PCAOB's Potential Audit Quality Indicators

Audit Committee Consideration: *The PCAOB does not provide examples of what context may be necessary for its potential AQIs. What insights can audit committees provide on how they currently receive that context from their auditors when making their own assessments of audit quality? What are the pros and cons of potential publication of AQI data to the general public?*

The PCAOB notes that AQIs "are not algorithms, benchmarks, or safe harbors against enforcement or other claims, and they do not lead directly to formulas for determining the quality of a particular audit or whether an auditor has met its obligations." The PCAOB emphasizes that AQIs are effective when context is provided. Without context, a quantitative indicator, or changes in a quantitative indicator over time, may not tell a complete story.

However, AQIs can enhance dialogue and understanding between the auditor and the audit committee on factors important to audit quality. This dialogue supports audit committees in discharging their duties in overseeing the auditor and the audit process.

Audit Committee Consideration: *Can AQIs help audit committees assess qualitative aspects of the engagement team, such as judgment and skepticism? Are there specific AQIs that can readily accomplish this?*

Users of the PCAOB's potential quantitative indicators would need to apply their judgment in determining the type of contextual information needed to understand their significance and how they interact with the other indicators in the portfolio. Many of the factors that are critical to audit quality, such as professional judgment and

skepticism, are more qualitative than quantitative, and are therefore much more difficult to capture in an indicator and may require more dialogue between the auditor and audit committee.

Potential Users and Distribution of the Indicators

Based on the premise that primary users of AQIs should be in a position to influence audit quality, the PCAOB has identified four potential primary users of AQIs.

Audit Committees: Audit committees can use AQIs to discharge their duties related to auditor engagement, compensation, and the oversight of the auditor and audit process. Some audit committees are already incorporating AQIs into their communications with the auditor. The PCAOB acknowledges that “ultimately each audit committee will have to judge for itself whether and how it wishes to use AQIs in its decision-making.”

Audit Committee Consideration: *The PCAOB notes that there are inherent limitations to AQIs. In addition to AQIs, what other tools could help audit committees assess audit quality?*

Audit Committee Consideration: *Would publication of certain AQIs provide investors with greater insight into audit quality and enhance their ability to assess financial reporting risk and vote shares? Are there potential unintended consequences of publication of engagement-level and/or firm-level AQIs? For example, would public disclosure lead to a ‘scorecard’ mentality and result in ‘managing to the indicators’? What, if any, indicators do audit committees currently use in selecting and overseeing their external auditor?*

Audit Firms: Firms might benefit from application of AQIs to improve quality control efforts, manage audit risk, and identify root causes of audit deficiencies to better focus their remediation efforts.

Investors: As the primary targets of the financial reporting process, investors might benefit from AQIs as a way to gain greater insight into the quality of the audit. The PCAOB suggests that “investors might receive AQI data from several sources over time, including

audit committee reports, or documents published by audit firms or the [PCAOB].”

Regulators: The PCAOB notes that it and other regulators could use AQIs to gauge the risks of firms, offices, and audit engagements, to refine inspection and supervisory strategies, and to inform policy and rulemaking.

The PCAOB is considering various approaches to collect and report its potential AQIs, which include indicators that are calculated at both the engagement and firm level. These approaches include encouraging firms and engagement teams to voluntarily discuss engagement- or firm-level AQI data with audit committees or requiring such a discussion. The PCAOB is seeking comment on whether the AQI data should be made public over time, or whether AQIs derived from public sources should be collected and made public on a firm-by-firm basis, either by the PCAOB or by the firms.

Audit Committee Consideration: *Do audit committees agree with the PCAOB’s view that AQIs are helpful to their oversight? Would potential mandatory use of AQIs impact the effectiveness of audit committee oversight? Which areas would be most impacted?*

An Approach to Implementation

Audit Committee Consideration: *Should AQI implementation be phased in? Should AQIs be scalable to be appropriately applied to firms and public companies of all sizes?*

The PCAOB seeks comment on whether all, or only some, accounting firms should be included in the AQI project, at least initially, due to complex issues of scalability and questions around how to create

meaningful AQIs appropriate for firms of significantly different sizes. The PCAOB also seeks comment on a phased approach and reasons that, at least in the early stages of the project, focusing on the largest audit firms that audit the largest U.S. public companies could provide time to study ease of extracting the information. Just as with excluding smaller firms, excluding certain industries could result in audit committees and investors in those industries missing out on the benefits of AQIs.

Audit Committee Consideration: *Considering potential costs to implement AQI reporting, how do audit committees view the costs and benefits of the AQI proposal?*

The PCAOB recognizes that not all AQIs will be relevant or appropriate for each audit. Thus, the PCAOB is seeking comment on whether to exclude certain industries where the nature, timing, and extent of audit work can differ from the norm (e.g., employee benefit plan

audits, registered investment companies). Such an approach could allow the PCAOB to move forward with the overall AQI initiative while it continues to assess scalability issues for audits in certain industries. On the other hand, audit committees and the investors they serve could miss out on the potential benefits that AQIs could bring to their governance responsibilities. Additionally, excluding certain industries could signal that audits in those industries are less important.

Audit committee members are strongly encouraged to submit comments to the PCAOB as it considers the use of audit quality indicators and their impact on their oversight, appointment, and compensation of external auditors. The views provided by audit committees will help inform PCAOB about the practical implications of the AQI project.