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**STANDING ADVISORY GROUP MEETING**

**INITIATIVES TO IMPROVE AUDIT QUALITY—ROOT CAUSE ANALYSIS, AUDIT  
QUALITY INDICATORS, AND QUALITY CONTROL STANDARDS**

**JUNE 24–25, 2014**

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**Introduction**

At its June 24–25, 2014 Standing Advisory Group ("SAG") meeting, SAG members will discuss three initiatives of the Public Company Accounting Oversight Board ("PCAOB" or "Board") to improve audit quality—root cause analysis, audit quality indicators, and quality control standards.

This briefing paper provides information on each of these three PCAOB initiatives. This briefing paper also includes questions for SAG members to express their views on certain aspects of each of these initiatives and the need for and potential ways to further integrate these initiatives. The PCAOB's oversight activities are intended to protect investors by improving the quality of audits. Among other things, the PCAOB works to improve audit quality by: (1) establishing auditing and related professional practice standards for registered public accounting firms to follow in the preparation and issuance of audit reports; (2) inspecting audits of issuers, brokers, and dealers conducted by registered public accounting firms; and (3) investigating and disciplining registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes-Oxley Act of 2002, professional standards adopted by the PCAOB, and provisions of the federal securities laws relating to preparation of audit reports and obligations of accountants with respect thereto.

The PCAOB has a number of specific initiatives currently underway to improve audits. This briefing paper discusses three of these initiatives:

- Root cause analysis, an initiative through the Division of Registration and Inspections ("DRI"), seeks improvements in firms' overall systems of quality controls through analysis of measures or indicators of audit quality to further improve and sustain audits.
- Audit quality indicators ("AQIs"), an initiative through the Office of Research and Analysis ("ORA"), seeks to develop a portfolio of measures of audit quality that may provide information and tools to generate greater insight into audit quality.

This paper was developed by PCAOB staff as of June 18, 2014, to foster discussion among the members of the SAG. It is not a statement of the Board, nor does it necessarily reflect the views of the Board or staff.

- Quality control standards, an initiative through the Office of the Chief Auditor ("OCA"), considers enhancements to PCAOB quality control standards to improve firms' quality control systems.

While these three initiatives are separate projects, each involves the identification and analysis of internal and external factors that influence how auditors fulfill their responsibilities. They also share a common focus by emphasizing key factors associated with audit quality. The information learned in connection with one project may be relevant to the identification and work being done in another. Root cause analysis may identify important areas where quality control standards need to be improved or may provide an area where audit quality indicators should be explored or can help establish benchmarks.

For example, the technical competence<sup>1/</sup> of the engagement partner and other engagement team members is important to audit quality. Root cause analysis may identify competencies of engagement partners and other members of engagement teams as root causes for certain auditing and quality control deficiencies. AQIs can be used to help track, put in context, and report on key indicators of competencies. The quality control standards project is considering changes to enhance the effectiveness of firm quality control systems regarding, among others, competencies, assignment of personnel to engagements, and evaluation of firm personnel.

After an introduction of the topics on the first day of the SAG meeting, SAG members and observers will form breakout groups to discuss the topics. On the second day of the meeting, PCAOB staff and certain SAG members will present a summary of the discussions, and SAG members will have an opportunity to provide additional perspectives.

## **I. Root Cause Analysis**

### ***Background***

Both the PCAOB and audit firms monitor the audits of issuers and broker-dealers for compliance with applicable standards and rules. PCAOB inspections continue to find a high number of deficiencies in important audit areas of issuers and broker-dealers of

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<sup>1/</sup> See QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*, Auditing Standard No. 9, *Audit Planning*, Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, and U.S. Securities and Exchange Commission Practice Section ("SECPS") 1000.08(d), "Continuing Professional Education of Audit Firm Personnel."

various sizes. Examples of these areas include critical and high-risk portions of audits, such as revenue, fair value, management's estimates, and auditing internal controls for both the financial statement audit opinion and the opinion on the effectiveness of internal control over financial reporting. In addition, PCAOB inspections identify deficiencies in the systems of quality control of firms. Many audit firms have established audit quality monitoring practices, including internal inspections, to assess compliance with standards and firm policies and procedures.

In response to the identification of audit and quality control deficiencies, firms have taken various remedial actions to address these deficiencies, including enhancing their quality control policies and procedures, changing their audit methodologies and processes, developing technical guidance targeted to specific issues, developing and requiring training targeted to specific issues, developing new audit tools, and requiring additional audit procedures to ensure compliance with PCAOB standards. As discussed below, the PCAOB and some firms have begun to identify practices and other factors that contribute to compliant audits.

DRI staff continues to explore ways to further improve audit quality and has begun development of its own root cause analysis program. The concepts discussed below are the staff's current views on how firms may further refine the monitoring element of their quality control systems in light of the requirements in QC sec. 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*.

DRI staff's views on root cause analysis will be informed by input from the SAG. This input may provide DRI more direction to further enhance its root cause analysis program, which also may lead to additional improvement in audit quality.

### *The Need for Root Cause Analysis*

The development, implementation, and execution of effective remedial actions by firms are a challenge because, while certain remedial actions may address a particular deficiency or defect, they may not address the underlying causes of the audit and quality control deficiencies. Further, since many findings recur year after year in the same or similar types of inspections, it is important for audit firms to take steps to gain a clearer understanding of the causes that underlie these deficiencies and then take appropriate remedial actions. It is also important for firms to make quality a priority, proactively monitor the effectiveness of the implemented changes, and evaluate whether they are taking sufficient, meaningful actions to accompany messaging regarding audit quality.

### *Development of Root Cause Analysis*

In 2011 and 2012, DRI staff expanded its review of certain firms' systems of quality control to include an analysis of the underlying causes of audit deficiencies,

referred to as the root cause analysis program. Root cause analysis is a widely used concept in various industries to analyze and understand problems as a way to develop solutions that address the underlying problem rather than symptoms of the problem. DRI staff explored whether this approach would provide a better understanding of the underlying root causes of the audit deficiencies identified and might lead to more effective corrective actions to improve and sustain audit quality.

Inspection teams performed their own analyses of known deficiencies, but they also evaluated the processes certain firms had in place, if applicable, to identify and evaluate the root causes of those known audit deficiencies.

In 2013, this program was expanded by selecting specific quality events, both negative (for example, audits with significant inspection findings) and positive (for example, audits with no inspection findings and the audit was perceived as being higher quality). DRI staff analyzed each quality event using causal analysis techniques. The analysis involved reviewing the many complex interrelationships between each cause and effect that resulted in a positive or negative audit quality event. This analysis was performed to identify the various contributing causes of these events, including measures or indicators that have observable objective evidence of audit quality within each firm's processes. This program is continuing in 2014.

DRI staff has focused its efforts to further improve audit quality on developing and understanding those components or elements of a firm's system of quality control which would improve and sustain audit quality throughout a firm's practice; these components and elements are outlined in this briefing paper. Further, the staff believes as it continues its root cause analysis efforts, this data may inform the Board on potential audit quality indicators, as well as enhancements that should be considered to existing PCAOB quality control standards. The staff requests input regarding additional factors that should be considered in this context.

### ***Improving Audit Quality***

As a result of the development of DRI's root cause analysis, DRI staff considers root cause analysis to be part of a larger framework or continuous audit quality improvement process—which includes other elements, in addition to root cause analysis—namely remediation, monitoring, and measurement (Figure 1.).

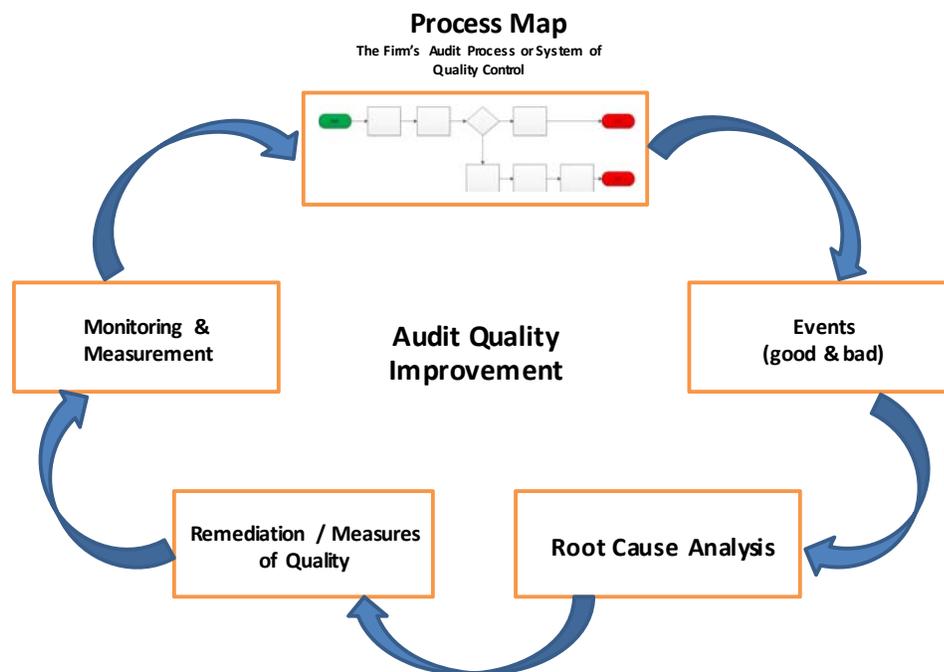


Figure 1. Continuous audit quality improvement.

DRI staff uses the concepts above as guidance when evaluating firms' internal root cause analysis processes and remedial efforts and has observed that firms are in varying stages of development of these elements.

### ***Understanding Certain Key Elements of Improving Audit Quality***

Through its root cause analyses, DRI has identified what it believes may be the key elements to further improve audit quality within a firm. Further, as the DRI root cause analysis program continues to evolve, these concepts may be taken into account when considering further enhancements to existing PCAOB quality control standards.

### *Process Map*

Improving audit quality starts and ends within each firm's own processes. The process map in Figure 1. represents the underlying work flows of how a firm conducts its practice. Some examples include a firm's audit process at the engagement level, including sub processes such as auditing revenue, auditing an account balance involving management estimates, or using the work of a specialist. It also includes a firm's quality control system, such as the client acceptance and continuance process or the partner evaluation and compensation process.

### *Events (Negative Quality and Positive Quality)*

Of course, not all things go according to plan; problems do occur, such as an adverse inspection result or a restatement. There are also good events, such as a favorable inspection result. These events can be referred to as negative quality events or positive quality events, respectively.

### *Root Cause Analysis*

Following negative quality and positive quality events, detailed and comprehensive causal analysis of all contributing causes to these events is needed in order to understand what went wrong or to determine potential measures or indicators of audit quality that may be used to further drive sustained quality.

### *Remediation or Measures of Quality*

Once a comprehensive causal analysis of negative events is performed, the appropriate remedial actions that specifically address identified contributing causes of the problem may be developed. In addition, comprehensive causal analysis of positive events may further allow firms to refine those same remedial actions to replicate positive quality events. Firms also may consider using the results of their root cause analysis of positive quality events to further measure and manage aspects of their audit practices. For example, as indicators of audit quality are developed at firms, individual firms may consider comparing them across their engagements and industry or global practices.

### *Monitoring and Measurement*

PCAOB standards require a firm to design and implement a system of quality control to provide reasonable assurance that its personnel comply with applicable

professional standards and the firm's standards of quality.<sup>2/</sup> Monitoring and measurement are essential to validate the overall operating effectiveness of a firm's system of quality control. This may occur through either remedial actions, in the case of negative events, or measures or indicators of audit quality, in the case of positive events. This validation is cycled back into the underlying work process, either to adjust the underlying work process when negative events occurred or to validate the operating effectiveness of the measures, indicators of audit quality, and the related work process when positive events occurred.

### ***Important Considerations in Improving Audit Quality***

DRI's root cause analysis initiative has resulted in the following observations that might be helpful for further improvement in the key elements for continuous audit quality improvement.

#### ***A Well-Defined Process***

First, if the firm's process is not well defined through a process map or other means, then it is very difficult, if not impossible, to perform a proper and thorough root cause analysis of negative events. The better delineated the underlying processes, the easier it is to analyze negative events to determine what went wrong.

#### ***Analyses of Both Positive and Negative Quality Events***

Second, DRI staff believes that root cause analysis should contemplate not only negative audit quality events, but also positive quality events. That is, both good and bad quality events should be analyzed. The premise of root cause analysis is to find the origin of and prevent future occurrences of the negative event from happening again. Analyzing positive events may enable firms to articulate what is needed to again achieve those positive events. For example, by implementing a comprehensive causal analysis, firms are able to compare and analyze differences in the factors that contribute to both negative and positive quality to proactively identify actions that may lead to sustained audit quality across the entire audit practice. It also may enable firms to develop and articulate measures or indicators of audit quality within each work process, which in turn will result in firms developing, maintaining, and improving well-defined work flows — which is the first important consideration in improving audit quality. DRI staff believes that analysis of only negative events may not allow firms to fully identify and articulate measures or indicators of audit quality or well-defined work flows.

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<sup>2/</sup> See paragraph .03 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

### *Good Root Cause Analysis Drives Better Remediation*

Third, the effectiveness and success of a firm's remedial efforts are aided by robust underlying root cause analysis processes. A detailed and comprehensive root cause analysis of not only negative quality events, but also positive quality events, may drive more successful remediation. DRI staff believes this analysis will improve the firms' ability and confidence to appropriately remediate systemic issues. Further, firms may get a better road map from a systemic problem to a work process that consistently produces high audit quality.

### *Monitoring and Measurement—Observable Objective Evidence of Quality*

Objective measures are needed for monitoring the impact of remedial actions and related improvements, and therefore it is important for firms to articulate and measure various aspects of audit quality, including measuring, in real time, the effectiveness of remedial actions and audit quality improvement plans or initiatives. All too often, subsequent internal and external inspection results show that quality initiatives did not have the intended impact or were not effective. Further, relying upon subsequent inspection results often provides information that is not timely. Thus, it is important for remedial actions and other quality initiatives, including identified measures or indicators of audit quality within each process, to contain objective evidence of quality so that it can be observed and measured for operating effectiveness in real time.

### **The Root Cause Analysis Component**

#### *Root Cause Analysis Defined*

The practice of root cause analysis is predicated on the belief that problems are best solved by attempting to address, correct, or eliminate root causes, as opposed to merely addressing the symptoms. Although root cause analysis is not a single, sharply defined process or methodology, root cause analysis is broadly defined as any structured approach to identifying all causes that contributed to an outcome.<sup>3/</sup> This in turn enables the identification of appropriate remedial actions to drive continual improvement. There are many different tools, techniques, processes, and philosophies for performing root cause analysis.

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<sup>3/</sup> As noted in "Analyses of Both Positive Quality and Negative Quality Events," root cause analysis should contemplate not only negative events, but also positive events, which may allow each firm to articulate what is needed to achieve good events and acceptable levels of quality. It also may allow firms to articulate measures or indicators of audit quality within each process, which in turn will result in a well-defined process, necessary to better understand and remediate negative quality events.

Common misconceptions of root cause analysis are that only one factor is the cause of an issue or that there is a single solution. That may not be the case, at least not in complex environments, such as audits. There may be multiple contributing causes that converge to cause a negative quality or positive quality event. Each problem being analyzed needs a thorough root cause analysis. Selecting from a list of potential causes, opting for prepopulated fields, or even using the "five-whys technique"<sup>4/</sup> appears to be too linear and limiting for complex problems. They do not show the many intricate interrelationships between each cause and effect.

### ***The Evolution of Improving Audit Quality***

DRI staff sees the establishment of appropriate root cause analysis processes as an evolutionary process that is in various phases of development at different firms. In more recent inspections, DRI staff has obtained an understanding of certain firms' root cause analysis processes through its root cause analysis initiative, along with certain testing procedures, to the extent possible. In evaluating firms' processes, DRI looks at the: (1) observability, robustness, and extent of the analysis; (2) specificity and adequacy of the developed remedial actions; and (3) ability to monitor and measure the remedial actions for the desired improvement and effect. As a result of DRI feedback, some firms have already made efforts to improve their processes.

In DRI staff's view, an effective approach to remediating known systemic issues involves establishing forward-looking processes that identify potential issues and deficiencies and that prevent such deficiencies from occurring or escalating into systemic problems and is not merely reactive and focused on problem containment. Remedial actions undertaken without fully understanding all of the causes and underlying problems that contributed to a particular problem or deficiency are less likely to prevent similar deficiencies from occurring in the future.

Such comprehensive analysis may enable firms to develop and articulate measures or indicators of what constitutes audit quality, both at the audit engagement level and the firm's system of quality control level. In turn, DRI staff believes it may enable a higher degree of confidence in the appropriateness and effectiveness of remedial actions aimed at addressing known deficiencies. Finally, through real-time monitoring and measurement of the effectiveness of remedial actions and measures or indicators of audit quality, changes can be incorporated into the underlying work process and system of quality control to engender sustained improved audit quality. This may enable firms to address areas of concern within their practices in a more proactive manner, before problems become systemic.

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<sup>4/</sup> See a discussion of the "five-whys technique" at <http://www.isixsigma.com/tools-templates/cause-effect/determine-root-cause-5-whys/>.

### ***The Result***

DRI staff believes that implementing these concepts, as presented here, could lead to a more robust and comprehensive root cause analysis of both positive quality and negative quality events. It also could effectuate: (1) a higher degree of confidence and success rate in the resulting proactive, rather than reactive, remedial actions; (2) an articulation of what constitutes quality through the identification of measures or indicators of audit quality; and (3) real-time monitoring and measurement of the effectiveness of remedial actions and measures or indicators of audit quality. In an evolved and fully implemented state, these concepts could induce sustained improved audit quality, including the reasonable assurance necessary for firms to conclude that they have designed and implemented a system of quality control in compliance with QC sec. 20.

### ***Discussion Questions***

In preparation for the June SAG meeting, PCAOB staff would like SAG members to consider the following questions related to root cause analysis:

1. In which types of cases and circumstances would it be beneficial for audit firms to perform root cause analysis of positive quality events, including the identification of measures or indicators of audit quality within the construct of that firm's internal processes, to help articulate audit quality?
2. Are there other techniques or elements that should be considered in the context of performing root cause analysis that could supplement the process or yield similar objectives and results?

## **II. Audit Quality Indicators**

In November 2012, the Board identified a project to develop AQIs, which seeks to answer two fundamental questions:

- Can the Board develop a portfolio of quantitative measures that provide new insight into audit quality?
- If so, how can the Board deploy those measures in a manner that best promotes quality?

At last year's SAG meetings, ORA focused on the tentative definition of audit quality, on framework, and on specific AQIs. While ORA staff received substantial input on AQIs over the past year, it received less input on the possible uses of AQIs. Thus, at the June 2014 meeting, ORA seeks the SAG's input on uses, and this portion of the briefing paper discusses that subject. To help ORA collect input in an organized

manner, it asks that SAG members complete the survey in Appendix A and bring it to the meeting; SAG members will have the chance to update surveys after the breakouts. Following the breakouts, PCAOB staff will collect the surveys and summarize the responses for discussion at the debriefing session the next day.

ORA plans to recommend that the Board issue a concept release on AQIs this year, consisting of three parts: (1) the need for AQIs, the Board's objectives, and background; (2) definition, framework, and promising AQI metrics; and (3) possible uses of AQIs. A concept release is not a rule proposal; rather, it would discuss issues and alternatives and seek public comment.

Given the immature state of AQIs, their use is likely to be evolutionary. The staff is eager to learn SAG members' views on possible uses of AQIs, but it is especially important to think through early steps and phasing options. The staff also is interested in how AQIs can be used in the other PCAOB initiatives to improve audit quality.

Shaping the evolution of the indicators to promote audit quality requires answers to the following basic questions:

- Who can best use AQIs? How can AQIs most effectively be used? For which entities should AQI data be gathered to be most useful?
- Who should collect and disseminate AQI data?
- Should AQI reporting be voluntary or mandatory?
- Should an AQI program have different requirements for certain firms or audits?
- Should AQI reporting be phased in?

Each of these questions is discussed below, along with potential considerations and options, creating a menu of possibilities for the development and implementation of an AQI program. Some options for the use of AQIs are relatively simple and could be implemented quickly. Examples include expanded use of AQIs within the PCAOB and encouraging engagement teams to discuss certain AQIs with their audit committees on a voluntary basis. Other options would take longer to implement. Examples include possible public disclosure of firm-level or engagement-level AQIs. The Board has made no decisions on these or other concepts and seeks input on the considerations discussed.

***Who Uses AQIs and How Will They Be Used?***

For AQIs to be effective, people who influence audit quality must use them in their decision making. ORA has identified the following potential users<sup>5/</sup> of AQIs and actions or decisions AQIs can influence. Following the table is a discussion of each possible user.

<b>AQI user</b>	<b>Actions Potentially Influenced by AQIs</b>
Audit committees	<ul style="list-style-type: none"> <li>• Assess reporting risk and audit quality</li> <li>• Retain and compensate auditors</li> <li>• Oversee auditors</li> </ul>
Investors	<ul style="list-style-type: none"> <li>• Assess reporting risk in context of investment decisions</li> <li>• Vote on auditor retention</li> </ul>
Audit firms	<ul style="list-style-type: none"> <li>• Assess audit risk</li> <li>• Monitor and improve audit quality</li> <li>• Remediate deficiencies</li> </ul>
PCAOB and other regulators	<ul style="list-style-type: none"> <li>• Inform policy making, including root cause and quality control projects</li> <li>• Stimulate public discussion of, and market demand for, quality</li> <li>• Influence inspection selections or other regulatory steps</li> </ul>

*Audit Committee Use of AQIs*

The Board does not regulate audit committees. But both audit committees and the Board have a common interest in promoting audit quality because audit committees are a critical part of the legal and practical infrastructure supporting quality auditing.

While the AQI project may assist some audit committees, each audit committee would have to judge for itself the extent to which it wishes to use such measures in its decision making.

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<sup>5/</sup> Other users of AQIs could include management, policy makers, the business press, academics, and the general public.

Audit committees have a keen interest in audit quality. They retain and compensate the independent auditors and oversee their work. The quality of the firm and professionals rendering the service is a key element in their selection. Audit committees also oversee companies' financial reporting and related internal control, and high quality auditing may inform those efforts.

AQIs may assist the audit committee in evaluating audit quality. They may inform the audit committee about the quality of the audit firm's audit practice and the quality of the specific engagement team. Also, audit committees may find it helpful to discuss AQIs in explaining their responsibilities and actions to shareholders and others. To the extent that AQIs provide genuine insight into audit quality, they may provide audit committees with additional, relevant data to consider when assessing their external auditors or when discussing audit quality with their auditors.

Audit committees already can (and often do) request quality-related information from their own audit firms and PCAOB standards require auditors to share certain information with audit committees in connection with their audit. Audit committees may also benefit from additional information and context about AQIs that impact quality. For example, an audit committee might inquire about the staffing ratio (the ratio of highly experienced people to all people on an engagement team) for its own company's audit. However, that ratio alone provides little insight without additional context, such as the average staffing ratio for the audits the firm performs in the company's industry or the staffing ratio of other audit firms in that industry.

Without comparability, the use of data to provide context is difficult if not impossible. Comparability requires standard definitions and consistent calculations based on reliable data. Audit committees who are interested in AQI data may not have access to the standardized data needed for comparability.

Audit committees may be interested in several categories of AQI data, including engagement-level AQIs for the particular audit the audit committee oversees, as well as industry or firm-level AQIs.

Although interested mostly in the audits they oversee, audit committees may also benefit from metrics about the quality of the firm's entire audit practice. Audit committees retain the firm. Companies and audit committees desire to be associated with reputable firms to enhance their image. This is particularly true for auditing, as the very purpose of the audit is to provide the market with a basis for confidence in the quality of a company's financial reporting.

AQIs related to the firm also are likely to provide context for audit committees to evaluate AQIs at the engagement level. Differences between firm-level and engagement-level AQIs may cause audit committees to ask their auditors probing

questions about why the differences exist and whether they are reasonable in the company's particular circumstances.

Industry-level AQIs for audits in the company's industry (for context) may also prove important. The industry in which a company under audit operates can influence the skills required—hence the nature of quality—for its engagement team. To the extent audits of companies in specific industries require unique attributes to ensure quality, it may be useful to compare an engagement's AQIs to the average of AQIs for the firm's other audits for companies in the same industry.

Audit committees may also find it helpful to compare AQI data across firms. Quality is a relative concept, and differences between firms can aid an audit committee's inquiry about reasons for those differences, which in turn could inform their judgments about audit quality. Indeed, availability of firm-level data may encourage competition in audit quality.

Audit committee review of AQIs at the engagement and audit-firm levels could be conducted privately between the audit committee and the audit firm. However, audit committee use of AQI data related to other firms would require public dissemination of the data and possibly a discussion of the data to provide needed context.

### *Investor Use of AQIs*

Investor communications to the Board have consistently demonstrated a keen interest in audit quality. Investors view it as critical to obtaining reliable financial information about companies and to counterbalancing some managements' natural optimism about their businesses. Moreover, in some companies, the choice of auditor is confirmed by a shareholders' vote.

The visibility of audit quality to investors is limited. Auditor communication to investors is typically restricted to standard language in the auditor's report about a company's financial statements and internal controls over financial reporting. Further, investors have no communication channel to the auditor, aside from annual shareholder meetings. Investor impressions of audit quality largely come from the frequency and magnitude of negative events, such as fraud or restatements, related to companies' financial reporting.

The Board's Investor Advisory Group ("IAG") has stated it would welcome AQIs as a vehicle to provide visibility into the audit.<sup>6/</sup> Other investors, including investor

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<sup>6/</sup> See *Report from the Working Group: Audit Quality Indicators*, PCAOB (October 16, 2013), [http://pcaobus.org/News/Events/Documents/10162013\\_IAGMeeting/AQI\\_Report.pdf](http://pcaobus.org/News/Events/Documents/10162013_IAGMeeting/AQI_Report.pdf).

representatives on the Board's SAG, have cited three reasons they too would welcome AQIs as a vehicle:<sup>7/</sup>

- Transparency into the audit provides an incentive for auditors to invest in, and compete on the basis of, audit quality because indicators of quality would become more visible to the market.
- AQIs related to the audits of specific companies could alert investors to specific risks related to the quality of certain firms or audits, which could influence their views of the risk of existing or potential investments. Even if investors themselves don't use the AQI data, disclosure of AQIs could enable researchers to provide investors with insight into audit quality at the firm or engagement level.
- AQIs at the firm or engagement level could provide insight when shareholders are considering voting on the selection of a company's auditors.

Investors may be able to benefit from several types of AQI data. The IAG noted that investors are mostly concerned with the quality of audits at particular companies in which they have invested or may invest. As such, AQIs related to particular audit engagements are likely to be of the greatest interest.

The IAG also noted that AQI data related to audits of companies in an industry of interest to an investor (or to the firm auditing those companies) could provide insight. The logic for the value of firm-level or industry-level data is the same as discussed in connection with "Audit Committee Use of AQIs." At present, shareholders have little information to use in deciding whether to confirm their company's choice of auditor, other than the recommendation of the audit committee. AQIs might provide such information or, at least, a basis for raising questions that could provide such information.

On the other hand, understanding AQIs requires substantial knowledge about a particular audit and its circumstances, a context that investors may have challenges acquiring. In addition, AQIs generally would not provide answers. Rather, they would serve mainly to allow investors to ask probing questions. However, under our current

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<sup>7/</sup> See, e.g., webcast archives of SAG discussions at *PCAOB Standing Advisory Group Meeting, PCAOB* (November 13–14, 2013), [http://pcaobus.org/News/Events/Pages/11132013\\_SAG.aspx](http://pcaobus.org/News/Events/Pages/11132013_SAG.aspx) and *PCAOB Standing Advisory Group Meeting, PCAOB* (May 15–16, 2013), [http://pcaobus.org/News/Events/Pages/05152013\\_SAG.aspx](http://pcaobus.org/News/Events/Pages/05152013_SAG.aspx).

system of corporate governance, investors may have little direct auditor access and must rely on audit committees to question auditors and to evaluate audit quality. The staff will continue to explore with investors the best use of AQIs in their work.

#### *Audit Firm Use of AQIs*

Large firms have long used AQI-like measures to manage their audit practices because they help to:

- Manage the efficiency of their audit work and the profitability of their audit practices;
- Flag audits or offices with a higher risk of deficiency, subjecting those audits to special procedures or additional resources to mitigate the risk; and
- Incorporate AQIs into performance measurement and compensation decisions.

The Board's consideration of AQIs may provide additional information that firms may find useful. Examples may include:

- The PCAOB's study of AQIs for many audit engagements across many firms could provide useful AQIs that a single firm may not identify.
- Possible public dissemination of AQIs could provide context in which firms could evaluate their own performance.
- Discussion with audit committees about AQIs or public dissemination of AQI data could encourage firms to invest in AQI measurement and use those measures to improve quality.

#### *PCAOB Use of AQIs*

The PCAOB has long used AQI-like measurements in its oversight. The PCAOB has used this information to date to flag firms, offices, and audit engagements that are at higher risk of audit deficiencies for inspection activities. Expanded AQI data also may inform the evaluation of firm quality control processes and remedial actions taken in response to negative quality events. In addition, expanded AQI data may:

- Provide insight into the state of, and trends in, overall audit quality to inform regulatory policy;

- Provide the basis for reports on the state of audit quality at the firm, network, or profession level;
- Further inform the Board's analysis of root causes of inspection findings and its evaluation of firms' remediation efforts;
- Assist the Board in its risk-assessment process when planning inspection scope and coverage in firms; and
- Inform the Board's project to explore enhancements to the quality control standards as well as other standard-setting projects.

Increased use of AQIs by the Board could be purely internal or could involve some public disclosure of AQI data.

### ***Which Entities Would Collect and Disseminate AQI Data?***

The data for certain indicators can be derived from public sources of information. However, the underlying data for most of the promising input and process indicators must come from firms. Furthermore, contextual and explanatory information about the indicators must also come from the firms, with some exceptions.

Firms may be the best sources to provide the context for indicators about their firms and the industry. Individual engagement teams may be the best sources to provide the context for indicators about their audit engagements. There could be a role for third parties to provide context and explain indicators. Academics or other researchers could analyze public indicators; this already occurs for indicators such as financial-statement restatements. The Board or other regulators also could analyze indicators and provide contextual information.

The PCAOB could play a role in disseminating AQI data through one or more of the following options:

- It could explore the feasibility of requiring audit engagement teams to provide AQI data to audit committees.
- It could collect and disseminate combined AQI data to the public over time, as a single set of weighted figures for comparable firms, but not by individual firm.
- It could collate and make public on a firm-by-firm basis AQI data derived from public sources (or require firms to do so).

- It could explore the feasibility of reporting publicly AQIs on a firm-by-firm basis (or require firms to do so).

The Board will seek input into whether it should adopt any or all of these approaches and the potential phasing or timing of implementation.

### ***Voluntary or Mandatory?***

The PCAOB could encourage firms and engagement teams to discuss AQI information, either privately with audit committees or publicly, or on a voluntary basis. A voluntary approach could encourage creativity and innovation in presenting and discussing AQI data, assuming interest in AQIs at firms continues to grow. This approach could enable auditors and companies to become comfortable with the indicators, to field-test them, and to gain experience in using them as a decision-making tool. A voluntary approach also should not necessarily require rulemaking and could begin without delay, though comparability would be greatest if voluntary disclosure of AQI data is based on a set of common definitions.

Alternatively, the PCAOB could consider mandating certain features of an AQI program, in order to maximize its use, standardize the approach to best facilitate comparability, and allow for verification of information through inspections.

Hybrid approaches, offering features of both voluntary and mandated programs, are also possible. Examples include:

- The Board could begin with a voluntary approach, study its effectiveness, and subsequently mandate the best features of that approach.
- The Board could encourage a voluntary program but specify the most promising AQIs and related definitions, thereby promoting comparable data.
- A mandated AQI program could require certain features but be flexible in certain key respects, thus encouraging creativity and innovation.

### ***Should an AQI Program Have Different Requirements for Certain Firms or Audits?***

An AQI program may need to consider whether smaller audit firms are sufficiently different from larger audit firms such that some AQIs may be relevant for one type of firm but not another. Further, when evaluating AQIs, it may be useful to compare AQIs of one firm against those of firms of comparable size or scale.

The nature, timing, and extent of audit work may vary widely, depending on the industry of the company being audited. For example, audits of employee benefit plans,

mutual funds, and of brokers and dealers may be very different from the audits of global manufacturing companies. Are such differences enough to render certain AQIs irrelevant or the comparison of AQIs misleading? One method of dealing with these differences may be to compare AQIs for one engagement against AQIs of engagements in similar industries.

Further, the Board could exempt audits of certain types of entities from a mandatory AQI program. The advantage of exemption is that it would reduce the costs of the program. But, the disadvantage is that it would limit the benefits for audits in excluded entities and perhaps signals that audits of certain entities are less important.

### ***Should AQI Reporting Be Phased in?***

An AQI program could be implemented in phases. The advantages of phasing in a program may include:

- An appropriate period of time is available to study the effects of the AQI in practice.
- One can judge benefits step by step and, if benefits are less than projected, further steps can be altered or cancelled.
- Later steps can benefit from learning in earlier steps.
- Stakeholders may be more accepting of an incremental approach, particularly if they perceive tangible benefits from each step along the way.

The disadvantage of a phased-in program is that it would delay the benefits of the ultimate program.

Potential approaches to phasing in an AQI program include:

- The AQI program could begin as a voluntary program. After a period of learning and demonstrated benefits, the program could mandate certain features, perhaps adding features to the program over time.
- The AQI program could begin with a small number of AQIs and later expand the list for discussion.
- The program could begin with private discussions between engagement teams and audit committees. After a period of learning and demonstrated benefits, the program could expand to include public disclosure of AQI data and context.

- The program could initially apply to certain firms or to certain types of audits and could expand the number of firms or audits over time.

Appendix A contains a survey regarding SAG member views on possible uses of AQI data. To help PCAOB staff collect input in an organized manner, it asks that SAG members complete the survey and bring it to the meeting; SAG members will have the chance to update surveys after the breakouts. Following the breakouts, PCAOB staff will collect the surveys and summarize the responses for discussion at the debriefing session the next day.

In addition, the staff will seek input from the SAG on the series of questions posed above and on other questions or considerations relating to AQIs that may merit consideration by the Board.

### **III. Exploring Enhancements to the Quality Control Standards**

In a registered accounting firm, quality control is the process through which the firm administers its audit practice such that engagement teams perform their audits in accordance with PCAOB and U.S. Securities and Exchange Commission ("SEC") requirements. PCAOB standards require a firm to design and implement a system of quality control to provide reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.<sup>8/</sup> PCAOB quality control standards also set forth the elements of a system of quality control and establish certain requirements for firms' quality control policies and procedures.

Existing PCAOB standards, which are described in more detail in Appendices B and C, set forth the following required elements of a firm's system of quality control:<sup>9/</sup>

- Independence, integrity, and objectivity;
- Personnel management;
- Acceptance and continuance of clients and engagements;
- Engagement performance; and

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<sup>8/</sup> See QC sec. 20.03.

<sup>9/</sup> Existing PCAOB quality control standards consist of certain standards that apply to all registered firms and SECPS requirements that apply only to registered firms that were members of the American Institute of Certified Public Accountants ("AICPA") SECPS as of April 16, 2003.

- Monitoring.

The PCAOB standard-setting agenda includes a project to review existing PCAOB quality control standards. This section of the briefing paper describes some potential enhancements to the quality control standards that the SAG will discuss in breakouts, including potential changes in light of the related initiatives regarding root cause analysis and AQIs.

### ***Reasons for Reviewing the Existing Quality Control Standards***

A number of sources have suggested the need for the PCAOB to review its quality control standards, including the following:<sup>10/</sup>

- Observations from PCAOB oversight activities; and
- Input from outreach activities.

These sources suggest that, as discussed below, existing PCAOB QC standards may benefit from stronger requirements or other enhancements, for example, with respect to firm culture and tone at the top; firm risk assessment; and monitoring of the quality control system, including use of root cause analyses. In addition, PCAOB staff is continuing to seek insights from other PCAOB oversight activities to assess further areas for potential improvement of the QC standards.

#### *Observations from Oversight Activities*

Deficiencies identified by PCAOB inspectors in their reviews of issuer audits suggest that improvements are needed in firms' systems of quality control. For instance, DRI staff identifies audit deficiencies that should have been detected and remedied

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<sup>10/</sup> The review of the quality control standards also is informed by, among other things, the activities of other standard setters, such as the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the AICPA. The PCAOB also is considering other quality control frameworks or relevant aspects of those frameworks. Examples of such other frameworks include: (1) the Committee of Sponsoring Organizations of the Treadway Commission's ("COSO's") *Internal Control—Integrated Framework* (May 2013), which describes the components of internal control; (2) the International Organization for Standardization 9000, which includes a series of standards for defining, establishing, and maintaining a system of quality assurance; (3) total quality management, which focuses on continuous improvement; and (4) Six Sigma, which addresses, among other things, the identification and removal of the causes of defects.

before the audit report was issued. Improvements in firms' systems of quality control could improve audit quality not only by detecting more audit deficiencies prior to the issuance of the audit report, but also by preventing and deterring the occurrence of many such deficiencies.<sup>11/</sup>

The PCAOB's initiatives regarding root cause analysis and AQLs provide important input into the review of the quality control standards. For example, DRI staff has observed that some firms have experienced challenges in determining appropriate corrective actions to be taken and necessary improvements in quality control systems to address deficiencies identified in inspection reports. Although PCAOB standards do not specifically require root cause analysis, implementing root cause analysis could strengthen firms' processes for monitoring the effectiveness of their quality control systems.

Similarly, the PCAOB's study of potential audit quality indicators may help to identify drivers of audit quality and inform users of this information to consider how those measures can be used by firms to establish and maintain an effective quality control system.

#### *Input from Outreach Activities*

The staff's review of the quality control standards also is being informed by outreach and research. For example, input from SAG members in past meetings has indicated a need for updating and improving the quality control standards in areas such as firm culture, tone at the top, and firm risk assessment.<sup>12/</sup>

More specifically, the Board has sought comment on the need for and approaches to rulemaking regarding assignment of firm supervisory responsibilities. A

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<sup>11/</sup> See, e.g., *Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms*, PCAOB Release No. 2008-008 (December 5, 2008), [http://pcaobus.org/Inspections/Documents/2008\\_12-05\\_Release\\_2008-008.pdf](http://pcaobus.org/Inspections/Documents/2008_12-05_Release_2008-008.pdf).

<sup>12/</sup> See, e.g., *Potential Standard—Elements of Quality Control*, PCAOB (November 17–18, 2004), [http://pcaobus.org/News/Events/Documents/11172004\\_SAG\\_Meeting/Quality\\_Control.pdf](http://pcaobus.org/News/Events/Documents/11172004_SAG_Meeting/Quality_Control.pdf); and *Designing and Implementing a System of Quality Control*, PCAOB (October 13–14, 2010), [http://pcaobus.org/News/Events/Documents/10132010\\_SAGMeeting/QC\\_Briefing\\_Paper.pdf](http://pcaobus.org/News/Events/Documents/10132010_SAGMeeting/QC_Briefing_Paper.pdf).

number of respondents to the request for comment suggested that the PCAOB consider requiring such assignments through updating the quality control standards.<sup>13/</sup>

### ***Possible Areas for Improving the Quality Control Standards***

In reviewing its quality control standards, the PCAOB is evaluating whether its standards adequately describe the essential elements of an effective system of quality control. This includes taking into account insights gained through its oversight activities and input from outreach.

The following section describes some possible enhancements to the quality control standards that will be discussed by SAG members in breakouts. Certain areas have been topics of discussion at previous SAG meetings;<sup>14/</sup> however, they are worthy of additional dialogue considering the results of recent PCAOB oversight activities that continue to identify audit quality concerns and the other initiatives being undertaken by the PCAOB to stimulate audit quality.

#### *Firm Culture and Tone at the Top*

A firm's culture reflects the cumulative actions and behaviors of its personnel, including those that affect audit quality. Those cumulative actions and behaviors are influenced by firm leadership's communications, directives, actions, and behaviors, also referred to as the *tone at the top*.<sup>15/</sup> The quality control standards could be expanded to address the relationship between firm culture and tone at the top to an effective quality control system.

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<sup>13/</sup> See *Application of the "Failure to Supervise" Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment on Rulemaking Concepts*, PCAOB Release No. 2010-005 (August 5, 2010), [http://pcaobus.org/Rules/Rulemaking/Docket031/Release\\_2010-005\\_Failure\\_to\\_Supervise.pdf](http://pcaobus.org/Rules/Rulemaking/Docket031/Release_2010-005_Failure_to_Supervise.pdf).

<sup>14/</sup> See, e.g., *Potential Standard—Quality Control Standards*, PCAOB (June 21–22, 2004), [http://pcaobus.org/News/Events/Documents/06212004\\_SAGMeeting/Agenda\\_item\\_11.pdf](http://pcaobus.org/News/Events/Documents/06212004_SAGMeeting/Agenda_item_11.pdf); and *Designing and Implementing a System of Quality Control*, PCAOB (October 13–14, 2010), [http://pcaobus.org/News/Events/Documents/10132010\\_SAGMeeting/QC\\_Briefing\\_Paper.pdf](http://pcaobus.org/News/Events/Documents/10132010_SAGMeeting/QC_Briefing_Paper.pdf).

<sup>15/</sup> See, e.g., *SECPS Section 1000.46, Appendix L—Independence Quality Controls*, PCAOB, [http://pcaobus.org/Standards/QC/Pages/SECPS\\_1000.08\\_appendices.aspx#appendix\\_l](http://pcaobus.org/Standards/QC/Pages/SECPS_1000.08_appendices.aspx#appendix_l), which refers to firm culture and tone at the top in the context of independence quality controls.

In prior SAG meetings, many SAG members indicated that firm culture and tone at the top should be addressed in the quality control standards and suggested mechanisms such as codes of conduct and whistleblower hotlines.<sup>16/</sup> Other standard setters have included requirements related to firm culture and tone at the top within their quality control standards.<sup>17/</sup> Also, regulators continue to observe a significant number of deficiencies related to leadership and culture, which may suggest the importance of firm culture and leadership to an effective quality control system.<sup>18/</sup>

If the quality control standards were updated to expand the discussion of firm culture and tone at the top, the PCAOB would need to decide what principles and requirements it would articulate in the standards. For example, one approach might be to set forth in the standards some basic principles about a firm's leadership being responsible for the firm's quality control system, including establishing a tone at the top and firm culture consistent with the aforementioned purpose of the quality control system. Another approach might be to establish specific requirements—instead of or in addition to the principles in first approach—regarding firm governance structures and codes of conduct.<sup>19/</sup>

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<sup>16/</sup> See, e.g., webcast archives of SAG discussions at *PCAOB Standing Advisory Group Meeting, PCAOB* (November 17–18, 2004), [http://pcaobus.org/News/Webcasts/Pages/11172004\\_SAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/11172004_SAGMeeting.aspx).

<sup>17/</sup> See, e.g., paragraph 18 of *International Standard on Quality Control 1: Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, IAASB (December 15, 2009), [http://www.ifac.org/sites/default/files/publications/files/A008\\_2012\\_IAASB\\_Handbook\\_ISQC\\_1.pdf](http://www.ifac.org/sites/default/files/publications/files/A008_2012_IAASB_Handbook_ISQC_1.pdf), that states "The firm shall establish policies and procedures designed to promote an internal culture recognizing that quality is essential in performing engagements. Such policies and procedures shall require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent) to assume ultimate responsibility for the firm's system of quality control."

<sup>18/</sup> See, e.g., *International Forum of Independent Audit Regulators: IFIAR Report on 2013 Survey of Inspection Findings*, IFIAR (April 10, 2014), [https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014\\_1.pdf](https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014_1.pdf).

<sup>19/</sup> Although existing PCAOB standards do not prescribe a particular firm code of conduct, *SECPS Section 1000.08(l), Communication by Written Statement to All Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided*, requires communication to firm personnel of the

### *Firm Risk Assessment*

Like many organizations, registered public accounting firms face risks to achieve their objectives.<sup>20/</sup> To maintain effective quality control systems, firms need to design and implement policies and procedures that provide reasonable assurance that their personnel comply with applicable professional standards and the firm's standards of quality.<sup>21/</sup> This includes policies and procedures to address risks to achieving the required reasonable assurance.

Firms might face risks from a variety of sources, for example: staffing shortages, changes to the firm's audit practice that affect its quality control system, or changes to the industries in which the firm's audit clients operate that present new audit risks.

Although some registered firms already have individuals or functions who are responsible for risk management, the quality control standards could be amended to add an element relating to firm risk assessment that would include the process of identifying risks to the quality control system.<sup>22/</sup> Adding a firm risk-assessment element could lead registered firms to take proactive measures to identify and address risks to their quality control systems and thus avoid potential systemic issues in their practice.

### *Monitoring*

Monitoring procedures provide the necessary feedback for a quality control system to evaluate current practices and determine where changes are needed to maintain an effective quality control system. PCAOB standards provide that monitoring

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principles of the firm's philosophy. *SECPS Section 1000.42, Appendix H—Illustrative Statement of Firm Philosophy*, presents an illustrative statement of firm philosophy.

<sup>20/</sup> See generally, *Internal Control—Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission (May 2013), which discusses risks to achieving objectives in conjunction with the risk assessment component of internal control.

<sup>21/</sup> See QC sec. 20.03.

<sup>22/</sup> This element is different from the risk-assessment process that engagement teams perform for individual engagements under Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. However, it is possible that activities in the firm's risk-assessment process could provide information that would be relevant to the risk assessments for an engagement, such as the industry-related risks discussed above.

procedures taken as a whole should enable the firm to obtain reasonable assurance that its system of quality control is effective.<sup>23/</sup>

Root cause analysis may provide important input into a firm's monitoring activities to support its quality control system. For example, root cause analysis could help a firm identify contributing causes of deficiencies (that is, negative quality events), potentially resulting in more responsive remediation efforts that may prevent identified issues from recurring. Or root cause analysis could assist a firm in identifying positive quality events, thereby providing the firm with an understanding of certain practices on an engagement that led to an effective audit. These analyses could then spur enhancements to a firm's quality control system that may ultimately promote effective audits.

Similarly, AQIs can be used to monitor aspects of the operation of the firm's quality control system; for example, measurements of staff workload could be monitored to highlight potential risks to audit quality, such as situations in which partner or staff workloads might impair those individuals' abilities to accomplish their assignments effectively. As another example, measures of engagement team industry expertise could be monitored to identify training needs and determine whether engagement team members have the necessary knowledge, skills, and abilities.

The quality control standards could be amended to address more specifically the use of root cause analysis and AQIs in monitoring the quality control system.

### ***Discussion Questions***

3. Should the PCAOB quality control standards address the relationship between firm culture/tone at the top and an effective quality control system? How detailed should the requirements be in this area?
4. Should a firm risk-assessment element be included in the quality control standards? What should be the parameters for such a requirement?
5. Should the quality control standards address the use of root cause analysis and audit quality indicators in monitoring and, if so, how?
6. Are there other changes to the quality control standards that should be considered? If so, what are they?

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See Appendix C of this briefing paper for QC sec. 30.

## **Linkage of PCAOB Initiatives to Improve Audit Quality**

As noted above, the three initiatives discussed in this paper—root cause analysis, AQIs, and quality control standards—are related in important ways. They each involve identifying and analyzing internal and external factors related to audit quality. Each of the projects also informs the other.

As noted in Section I. of this briefing paper, establishing a robust and comprehensive root cause analysis program should induce sustained improvements in audit quality. Information obtained from root cause analysis of audit deficiencies may inform: (1) the development of audit quality indicators by, among other things, identifying positive and negative quality events (that is, root cause analysis of audit deficiencies would identify issues that directly correlate to audit quality indicators) and (2) the quality control standards project, by identifying underlying issues affecting audit quality and considering whether enhancements to the quality control standards are necessary.

AQIs may inform a firm's root cause analysis by identifying potential audit quality concerns at a firm or engagement level. When AQI data highlight audit quality concerns, a firm could perform root cause analysis to determine the underlying issues. Similarly, insights from the root cause analysis and AQI initiatives could highlight areas within a firm's quality control system to which the staff should consider giving additional attention within the PCAOB quality control standards.

Information from these initiatives also can be combined to provide insights about audit quality. For example, root cause analysis combined with audit quality indicators could provide information to identify or prevent potential issues that affect audit quality. And, the quality control standards could explore the use of these tools within various elements of a firm's system of quality control, such as firm risk assessment and monitoring.

This briefing paper highlights such links among these initiatives. The PCAOB project teams have been collaborating to share knowledge and ensure that the initiatives are aligned appropriately.

### ***Discussion Questions***

7. Do you agree that the three PCAOB initiatives discussed in this briefing paper are linked? If so, what recommendations do you have for promoting appropriate alignment among the three projects?
8. How can root cause analysis inform the development of AQIs and consideration of enhancements to the quality control standards?

9. How can AQIs be used in a firm's root cause analysis and monitoring of audit quality and remediation activities?
10. Are there additional initiatives for improving audit quality that the PCAOB should undertake? If so, what are those initiatives, and how should they be coordinated with the other three initiatives?

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The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

## Appendix A

### Survey of SAG Member Views on Possible Usage of AQI Data

To prepare for the SAG breakouts on AQIs, the staff requests that SAG members complete this survey and bring it with them to the SAG meeting. SAG members will have time to change their views on the form in response to the breakout discussions. Following the breakouts, the staff will collect the surveys and summarize the responses for discussion at the debriefing session the next day.

When responding, bear in mind our intention to develop a portfolio of 10 to 15 AQIs that adds incremental insight into audit quality; if AQIs add little value, then questions about usage become irrelevant. The staff views AQIs as a tool to help stakeholders pose insightful questions about audit quality. They are not a formula, algorithm, or benchmark to determine audit quality.

Given the immature state and knowledge of AQIs, their use likely will be evolutionary. The Board is eager to learn SAG members' views on possible end states for the use of AQIs, but meticulous early steps and phasing options are important. One part of the survey addresses possible short-term, easy actions; another part addresses long-term and complex actions. The Board has made no decision on these options.

#### ***Demographic Data***

1. Write your name in the space below. Your response is for internal purposes only, for aggregation for presentation purposes. You will remain anonymous; your name will not be displayed or associated with public documents.

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2. Which category best represents your current, primary professional focus?

Issuer	
Investor or Investor Advocate	
Auditor	

Audit Committee Member	
Academic	
Other	

***Usefulness of AQI Data to Stakeholders***

3. Please rank on a five-point scale (1 = not useful, 5 = highly useful) the usefulness of AQI data for each of the following stakeholders:

Stakeholder	Rank usefulness of AQI data for each type of user			
	Engagement level	Firm level	Other (name)	Other (rank)
Audit committees				
Investors				
Audit firms				
The PCAOB and other regulators				

Company management				
Academic researchers				

***Possible Near-Term Actions to Promote Use of AQI Data***

4. Please rank on a five-point scale (1 = fully disagree, 5 = fully agree) your reaction to the following list of possible nearer-term actions to promote usage of AQI data. Please add to the list additional near-term actions that you believe would be useful.

<b>Possible action</b>	<b>Reaction</b>
After considering comments on AQI concept release, PCAOB identifies and defines 10 to 15 useful AQIs and encourages engagement teams to voluntarily discuss certain AQIs with audit committees.	
PCAOB encourages audit firms to voluntarily disclose and discuss certain, defined firm-level AQIs.	
PCAOB adds a rulemaking project to its agenda to consider requiring engagement teams to discuss specified AQIs with audit committees.	
PCAOB requests specified new AQI data from firms and tests the usefulness of that data in evaluating audit quality.	

PCAOB field-tests specified AQIs with firms and engagement teams.	
PCAOB monitors results of voluntary discussions and disclosures to identify benefits and costs.	
PCAOB publishes AQIs by firm for AQIs that can be derived from public data.	
PCAOB performs other near-term action (please specify):	

***Possible Long-Term Actions to Promote Use of AQI Data***

5. Please rank on a five-point scale (1 = fully disagree, 5 = fully agree) your reaction to the following long-term actions to promote use of AQI data. Assume when answering that experience with near-term usage has been positive (we would not take additional steps if experience did not promote audit quality). Please add to the list additional long-term actions that you believe would be useful.

<b>Possible action</b>	<b>Reaction</b>
PCAOB makes public average AQIs for audits in particular industries to provide context for firms, audit committees and others evaluating AQIs.	
PCAOB makes public average AQIs for comparably sized audit firms to provide context for firms, audit committees, and others evaluating AQIs.	
PCAOB investigates possibility of making public firm-level AQIs.	
PCAOB investigates possibility of making public engagement-level	

AQIs.	
PCAOB publishes a periodic report on the state of audit quality, based, in part, on AQI data.	
PCAOB offers other long-term action (please specify):	

## Appendix B

### Summary of PCAOB's Quality Control Standards

This appendix highlights certain aspects of the quality control standards in order to assist the SAG members in responding to questions raised in the breakouts. The complete set of quality control standards is available at <http://pcaobus.org/Standards/QC/Pages/default.aspx>.

#### I. **QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice***

##### ***System of Quality Control***

This standard states that a system of quality control is broadly defined as a process to provide reasonable assurance that firm personnel comply with professional standards and the firm's standards of quality control.<sup>1/</sup> Further, the system of quality control should provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign offices or by its domestic or foreign affiliates or correspondents are performed in accordance with professional standards.<sup>2/</sup>

##### ***Quality Control Policies and Procedure—Elements of Quality Control***

QC sec. 20 identifies five interrelated elements of quality control, which are described in the following paragraphs. This interrelationship can be observed, for example, by comparing the objectives of the element of personnel management (encompassing criteria for professional development, hiring, advancement, etc.) to the objectives of the element of engagement performance.<sup>3/</sup>

##### **Independence, Integrity, and Objectivity**

A firm should establish policies and procedures to provide it with reasonable assurance that personnel maintain independence (in fact and in appearance) in all

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<sup>1/</sup> See QC sec. 20.03.

<sup>2/</sup> See QC sec. 20.06.

<sup>3/</sup> See, e.g., QC sec. 20.08.

required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.<sup>4/</sup>

### **Personnel Management**

A firm should have quality control policies and procedures that encompass hiring, assigning personnel to engagements, professional development, and advancement activities.<sup>5/</sup> Those quality control policies and procedures should provide reasonable assurance that:

- a. Those hired possess the appropriate characteristics to enable them to perform competently.
- b. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.
- c. Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies.
- d. Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.<sup>6/</sup>

### **Acceptance and Continuance of Clients and Engagements**

A firm should establish policies and procedures for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Those policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized.<sup>7/</sup>

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<sup>4/</sup> See QC sec. 20.09.

<sup>5/</sup> See QC secs. 20.12–13.

<sup>6/</sup> See QC sec. 20.13.

<sup>7/</sup> See QC sec. 20.14.

## Engagement Performance

A firm should establish policies and procedures to provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality.<sup>8/</sup> Such policies and procedures encompass all phases of the design and execution of the engagement.<sup>9/</sup> For example, a firm should establish policies and procedures to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues). Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.<sup>10/</sup>

## Monitoring

A firm should establish policies and procedures to provide the firm with reasonable assurance that the policies and procedures established by the firm for each of the other elements of quality control are suitably designed and are being effectively applied.<sup>11/</sup> Monitoring activities consider the effects of the firm's management philosophy and the environment in which the firm practices and its clients operate and involve an ongoing consideration and evaluation of the:

- a. Relevance and adequacy of the firm's policies and procedures;
- b. Appropriateness of the firm's guidance materials and any practice aids;
- c. Effectiveness of professional development activities; and

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<sup>8/</sup> See QC sec. 20.17.

<sup>9/</sup> See QC sec. 20.18.

<sup>10/</sup> See QC sec. 20.19.

<sup>11/</sup> See QC sec. 20.20.

- d. Compliance with the firm's policies and procedures.<sup>12/</sup>

### ***Administration of a Quality Control System***

QC sec. 20 requires firms to assign responsibility for the design and maintenance of the firm's quality control policies and procedures to an appropriate individual or individuals of the firm, taking into account the proficiency of the individuals, the authority to be delegated to them, and the extent of supervision to be provided.<sup>13/</sup> This standard also emphasizes that all firm personnel are responsible for complying with the firm's quality control policies and procedures.<sup>14/</sup> QC sec. 20 states that a firm should prepare appropriate documentation to demonstrate compliance with its policies and procedures for the quality control system.<sup>15/</sup>

### **II. QC Section 30, *Monitoring a CPA Firm's Accounting and Auditing Practice***

QC sec. 30 provides guidance on how a CPA firm implements the monitoring element of a quality control system in its accounting and auditing practice.<sup>16/</sup> QC sec. 30 is attached as Appendix C to this briefing paper.

### **III. QC Section 40, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement***

#### ***Personnel Management Element of Quality Control***

Personnel management encompasses hiring, assigning personnel to engagements, professional development, and advancement activities.<sup>17/</sup> This standard describes the competencies of the practitioner-in-charge (that is, the engagement partner), as he or she is ultimately responsible for the engagement and its performance.

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<sup>12/</sup> Id.

<sup>13/</sup> See QC sec. 20.22.

<sup>14/</sup> Id.

<sup>15/</sup> See QC sec. 20.25.

<sup>16/</sup> See QC sec. 30.01.

<sup>17/</sup> See QC sec. 40.02.

## **Competencies**

This standard defines competencies as the knowledge, skills, and abilities that enable a practitioner-in-charge to be qualified to perform an accounting, auditing, or attestation engagement. A firm is expected to determine the kinds of competencies that are necessary in the individual circumstances. Competencies are not measured by periods of time because such a quantitative measurement may not accurately reflect the kinds of experiences gained by a practitioner in any given time period. Accordingly, for purposes of this section, a measure of overall competency is qualitative rather than quantitative.<sup>18/</sup>

## **Gaining Competencies**

A firm's policies and procedures would ordinarily require a practitioner-in-charge of an engagement to gain the necessary competencies through recent experience in accounting, auditing, and attestation engagements. In some cases, however, a practitioner-in-charge will have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. If necessary, the experience of the practitioner-in-charge should be supplemented by continuing professional education ("CPE") and consultation.<sup>19/</sup> Regardless of the manner in which a particular competency is gained, a firm's quality control policies and procedures should be adequate to provide reasonable assurance that a practitioner-in-charge of an engagement possesses the competencies necessary to fulfill his or her engagement responsibilities.<sup>20/</sup>

## **Competencies Expected in Performing Accounting, Auditing, and Attestation Engagements**

In practice, the kinds of competency requirements that a firm should establish for the practitioner-in-charge of an engagement are necessarily broad and varied in both their nature and number. However, the firm's quality control policies and procedures should ordinarily address the following competencies for the practitioner-in-charge of an engagement: (1) understanding of the role of a system of quality control; (2) understanding of the service to be performed; (3) technical proficiency; (4) familiarity

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<sup>18/</sup> See QC sec. 40.04.

<sup>19/</sup> See QC sec. 40.05.

<sup>20/</sup> See QC sec. 40.06.

with the industry; (5) professional judgment; and (6) understanding the organization's information technology systems.<sup>21/</sup>

**IV. SECPS Section 1000.08(d)—Continuing Professional Education of Audit Firm Personnel**

This section requires firms to ensure that all professionals in the firm residing in the United States, including certified public accountants ("CPAs") and non-CPAs, participate in at least 20 hours of qualifying CPE every year and at least 120 hours every three years. Effective for CPE years beginning on or after January 1, 1995, professionals who devote at least 25 percent of their time to performing audit, review, or other attest engagements (excluding compilations), or who have the partner/manager-level responsibility for the overall supervision or review of any such engagements, must obtain at least 40 percent (eight hours in any one year and 48 hours every three years) of their required CPE in subjects relating to accounting and auditing. The term accounting and auditing subjects should be broadly interpreted, and include subjects, for example, relating to the business or economic environments of the entities to which the professional is assigned.<sup>22/</sup>

**V. SECPS Section 1000.08(l)—Communication by Written Statement to All Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided**

This section requires firms to communicate through a written statement to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures on, as a minimum, matters related to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and to inform professional firm personnel periodically that compliance with those principles is mandatory.

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<sup>21/</sup> See QC sec. 40.08.

<sup>22/</sup> See SECPS Section 8000: *Continuing Professional Education Requirements Effective for Educational Years Beginning After May 31, 2002*, PCAOB, <http://pcaobus.org/Standards/QC/Pages/SECPS8000.aspx>, for additional information about the CPE requirement and the manner in which compliance is to be measured.

**VI. SECPS Section 1000.08(m)—Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants**

Pursuant to this standard, when a member firm has been the auditor for a U.S. Securities and Exchange Commission ("SEC") registrant that is required to file current reports on Form 8-K and the firm has resigned, declined to stand for re-election or been dismissed, that firm is required to report the fact that the client-auditor relationship has ceased directly in writing to the former SEC client, with a simultaneous copy to the Office of the Chief Accountant of the SEC, unless the former client reports the change in auditors in a timely filed Form 8-K. When a member firm has been the auditor for an SEC registrant that is not required to file current reports on Form 8-K and has resigned, declined to stand for re-election or been dismissed, that firm is required to report the fact that the client-auditor relationship has ceased directly in writing to the former SEC client, with a simultaneous copy to the Office of the Chief Accountant of the SEC.

**VII. SECPS Section 1000.08(n)—Audit Firm Obligations with Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms**

This section requires SECPS member firms that are members of, correspondents with, or similarly associated with international firms or international associations of firms, seek adoption of policies and procedures by the international organization or individual foreign associated firms<sup>23/</sup> that are consistent with the objectives set forth in Section 1000.45, *Appendix K—SECPS Member Firms with Foreign Associated Firms That Audit SEC Registrants*.

The procedures in Appendix K consist of two primary components: (1) procedures for individual SEC filings by SEC registrants that include or incorporate the foreign associated firm's audit report and (2) policies regarding a firm's internal inspection procedures.

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<sup>23/</sup> For this purpose, a foreign-associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international association of firms with which the SECPS member is associated.

**VIII. SECPS Section 1000.08(o)—Policies and Procedures to Comply with Independence Requirements**

This section requires that the member firm has policies and procedures in place to comply with applicable independence requirements of the AICPA, SEC and Independence Standards Board. Section 1000.46, *Appendix L—Independence Quality Controls*, contains information for determining compliance with the membership requirements.

The requirements of Appendix L cover, among other things: (1) establishing written independence policies covering relationships with restricted entities; (2) communicating independence policies to all professionals; (3) establishing a training program on the firm's independence policies; (4) maintaining a database of restricted entities;<sup>24/</sup> (5) identifying one or more senior-level partners with certain responsibilities related to independence; (6) communicating restricted entity lists to member firms; (7) establishing policies and procedures for firm personnel prior to obtaining a security or other financial interest in an entity; (8) requiring firm personnel to certify their understanding and compliance with the firm's independence policies; (9) requiring firm personnel to report apparent violations involving the firm personnel, his or her spouse and dependents, and the corrective action taken or proposed to be taken; (10) establishing a monitoring system to determine that adequate corrective steps are taken and documented related to independence violations; and (11) developing guidelines for actions to be taken against professionals for violations of independence.

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<sup>24/</sup> Member firms that provide an annual audit to more than 500 SEC registrants are required to have the automated system.

## Appendix C

### QC Section 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*

#### ***Introduction***

.01

This section provides guidance on how a CPA firm implements the monitoring element of a quality control system in its accounting and auditing practice.<sup>1/</sup>

.02

Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, describes *Monitoring* as one of the five elements of quality control. It provides that a CPA firm<sup>2/</sup> should establish policies and procedures to provide the firm with reasonable assurance that the policies and procedures relating to each of the other elements of quality control are suitably designed and are being effectively applied. Monitoring involves an ongoing consideration and evaluation of the—

- a. Relevance and adequacy of the firm's policies and procedures.
- b. Appropriateness of the firm's guidance materials and any practice aids.
- c. Effectiveness of professional development activities.
- d. Compliance with the firm's policies and procedures.

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<sup>1/</sup> *Accounting and auditing practice* refers to all audit, attest, accounting and review, and other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under rule 201 or 202 of the AICPA Code of Professional Conduct [ET sections 201 and 202]. Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

<sup>2/</sup> A *firm* is defined in the AICPA Code of Professional Conduct as "a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof" [ET section 92.05].

When monitoring, the effects of the firm's management philosophy and the environment in which the firm practices and its clients operate should be considered.

### ***Monitoring Procedures***

.03

Monitoring procedures taken as a whole should enable the firm to obtain reasonable assurance that its system of quality control is effective. Procedures that provide the firm with a means of identifying and communicating circumstances that may necessitate changes to or the need to improve compliance with the firm's policies and procedures contribute to the monitoring element. A firm's monitoring procedures may include—

- Inspection procedures. (See paragraphs .04 through .07.)
- Preissuance or postissuance review of selected engagements. (See paragraphs .08 and .09.)
- Analysis and assessment of—
  - New professional pronouncements.
  - Results of independence confirmations.
  - Continuing professional education and other professional development activities undertaken by firm personnel.<sup>3/</sup>
  - Decisions related to acceptance and continuance of client relationships and engagements.
  - Interviews of firm personnel.
- Determination of any corrective actions to be taken and improvements to be made in the quality control system.
- Communication to appropriate firm personnel of any weaknesses identified in the quality control system or in the level of understanding or compliance therewith.
- Follow-up by appropriate firm personnel to ensure that any necessary modifications are made to the quality control policies and procedures on a timely basis.

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<sup>3/</sup> The term *personnel* refers to all individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

.04

Inspection procedures evaluate the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with its quality control policies and procedures. Inspection procedures contribute to the monitoring function because findings are evaluated and changes in or clarifications of quality control policies and procedures are considered.

.05

The need for and extent of inspection procedures depends in part on the existence and effectiveness of the other monitoring procedures. Factors to be considered in determining the need for and extent of inspection procedures include, but are not limited to—

- The nature, complexity, and diversity of, and the risks associated with, the firm's practice.
- The firm's size, number of offices, degree of authority allowed its personnel and its offices, and organizational structure.
- The results of recent practice reviews<sup>4/</sup> and previous inspection procedures.
- Appropriate cost-benefit considerations.<sup>5/</sup>

.06

The nature of inspection procedures will vary based on the firm's quality control policies and procedures and the effectiveness and results of other monitoring procedures. The adequacy of and compliance with a firm's quality control system are evaluated by performing such inspection procedures as—

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<sup>4/</sup> Practice reviews include, but are not limited to, peer reviews performed under standards established by the AICPA and reviews conducted by regulatory agencies.

<sup>5/</sup> Although appropriate cost-benefit considerations may be considered in determining the need for and extent of inspection procedures, a firm must still effectively *monitor* its practice.

- Review of selected administrative and personnel records pertaining to the quality control elements.
- Review of engagement working papers, reports, and clients' financial statements. (See also paragraphs .08 and .09.)
- Discussions with the firm's personnel.
- Summarization of the findings from the inspection procedures, at least annually, and consideration of the systemic causes of findings that indicate improvements are needed.
- Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
- Communication of the identified findings to appropriate firm management personnel.
- Consideration of inspection findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.

Inspection procedures with respect to the engagement performance element of a quality control system are particularly appropriate in a firm with more than a limited number of management-level individuals<sup>6/</sup> responsible for the conduct of its accounting and auditing practice.

.07

Inspection procedures may be performed at a fixed time(s) during the year covering a specified period(s) of time or as part of ongoing quality control procedures, or a combination thereof.

.08

Procedures for carrying out preissuance or postissuance review of engagement working papers, reports, and clients' financial statements by a qualified management-level individual (or by a qualified individual under his or her supervision) may be considered part of the firm's monitoring procedures provided that those performing or

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<sup>6/</sup> The term *management-level individual* refers to all owners of a firm and other individuals within the firm with a managerial position as described in Interpretation 101-9 of the Code of Professional Conduct.

supervising such preissuance or postissuance reviews are *not directly associated with the performance of the engagement*. Such preissuance or postissuance review procedures may constitute inspection procedures provided—

- a. The review is sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.
- b. Findings of such reviews that may indicate the need to improve compliance with or modify the firm's quality control policies and procedures are periodically summarized, documented, and communicated to the firm's management personnel having the responsibility and authority to make changes in those policies and procedures.
- c. The firm's management personnel consider on a timely basis the systemic causes of findings that indicate improvements are needed and determine appropriate actions to be taken.
- d. The firm implements on a timely basis such planned actions, communicates changes to personnel who might be affected, and follows up to determine that the planned actions were taken.

A preissuance and, except as described in paragraph .09, a postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement does not constitute a monitoring procedure.

.09

In small firms with a limited number of qualified management-level individuals, postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement may constitute inspection procedures, provided the provisions in paragraph .08a-d are followed. (See also paragraph .11.)

***Monitoring in Small Firms With a Limited Number of Management-Level Individuals***

.10

In small firms with a limited number of management-level individuals, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. To

effectively monitor one's own compliance with the firm's policies and procedures, an individual must be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and in the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

.11

The performance of inspection procedures in firms with a limited number of management-level individuals can assist the firm in the monitoring process. An individual inspecting his or her own compliance with a quality control system may be inherently less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm may have a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm in this circumstance may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.

### ***The Relationship of Peer Review to Monitoring***

.12

A peer review does not substitute for monitoring procedures. However, since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for some or all of its inspection procedures for the period covered by the peer review.

### ***Effective Date***

.13

The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997.