



**CENTER
FOR AUDIT
QUALITY**

Serving Investors, Public Company Auditors & the Markets

September 28, 2015

EXECUTIVE DIRECTOR

Cynthia M. Fornelli

GOVERNING BOARD

Chairman

Robert E. Moritz, Chairman and Senior Partner
PricewaterhouseCoopers LLP

Vice Chair

Joe Adams, Managing Partner and CEO
McGladrey LLP

Wayne Berson, CEO
BDO USA, LLP

Lynne M. Doughtie, U.S. Chairman and CEO
KPMG LLP

Cathy Engelbert, CEO
Deloitte, LLP

Michele J. Hooper, President and CEO
The Directors' Council

Stephen R. Howe, Jr., U.S. Chairman and
Managing Partner, Americas Managing Partner,
Ernst & Young LLP

J. Michael McGuire, CEO
Grant Thornton LLP

Barry C. Melancon, President and CEO
American Institute of CPAs

Lynn S. Paine, John G. McLean Professor of
Business Administration, Senior Associate Dean
for Faculty Development
Harvard Business School

James L. Powers, CEO
Crowe Horwath LLP

Mary Schapiro, Vice Chairman Advisory Board
Promontory Financial Group

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

**Re: PCAOB Release No. 2015-005, Rulemaking Docket Matter No. 041:
*Concept Release on Audit Quality Indicators***

Dear Office of the Secretary:

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

The CAQ welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Release No. 2015-005: Concept Release on Audit Quality Indicators* (the Concept Release). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

In this letter, we offer for the Board's consideration our views regarding certain topics outlined in the Concept Release. Our views are organized into the following sections:

- I. General Views on the Concept Release
- II. Consideration of Potential Audit Quality Indicators and Pilot Testing of the CAQ Approach
- III. Practical Application of Potential Audit Quality Indicators

I. General Views on the Concept Release

The CAQ shares the PCAOB's goal of continuously strengthening audit quality and supports the PCAOB's efforts to foster exploration of audit quality indicators (AQIs or indicators), that could generate "insights into the foundations of audit quality."¹ We believe that use of AQIs by audit committees and auditors could help promote and enhance their dialogue and focus on audit quality.

We commend the PCAOB for its measured and thoughtful approach to developing and bringing forth the matters addressed in the Concept Release, including its outreach efforts and consideration of other approaches, such as the *CAQ Approach to Audit Quality Indicators*² (CAQ approach) and those of regulators in other jurisdictions. We view development of AQIs as an evolutionary process with more experience in using AQIs and evidence of their correlation to audit quality outcomes needed. The CAQ approach includes an example of a potential set of AQIs and a method for communicating them. We hope that as part of evaluating stakeholder input, the PCAOB will consider the CAQ approach and our pilot- testing observations discussed further in this letter as a starting point for a dialogue on potential indicators and how they might be used.

As shared with the PCAOB previously,³ the CAQ has been actively engaged in developing and seeking perspectives on potential AQIs in an effort to assist in the discussion. Through this process, the CAQ considered many of the potential AQIs that are put forward for consideration in the Concept Release. Due to the dynamic nature, inherent complexity, and variability of public companies and their audits, AQIs alone (whether input or output measures) without context cannot adequately communicate factors relative to the audit of any particular engagement or firm. However, the right AQIs as determined by the audit committee could provide perspective on factors that may contribute to or detract from audit quality. Quantitative AQIs, like those in the Concept Release and in the CAQ approach, can only inform this perspective when accompanied by appropriate context. Our pilot-testing efforts have demonstrated that this context is best achieved through dialogue between the audit engagement team and the audit committee.

Given this need for context through dialogue, and the audit committee's important audit oversight role on behalf of investors, we believe that the right set of AQIs as determined by the audit committee can help promote and enhance the audit committee's and auditor's focus on audit quality. The audit committee is best positioned to receive, interpret, and ultimately respond, if necessary, based on the information provided by AQIs. Public company audit committees have statutory responsibilities to appoint, compensate, and oversee the external auditor. In addition to their fiduciary duties as members of the Board of Directors, audit committees also have been delegated special responsibilities with respect to the audit and the financial reporting process, which were strengthened by the Sarbanes-Oxley Act of 2002⁴ and related SEC⁵ and stock market rules.⁶ AQIs could potentially help audit committees in discharging these crucial responsibilities by promoting a better understanding of the audit firm's system of quality controls and factors related to the quality of the audit engagement.

¹ The Concept Release, p. 3.

² The *CAQ Approach to Audit Quality Indicators* publication is available at <http://www.thecaq.org/docs/reports-and-publications/caq-approach-to-audit-quality-indicators-april-2014.pdf?sfvrsn=2>.

³ See CAQ comment letter dated May 13, 2013 on the PCAOB's briefing paper "Discussion – Audit Quality Indicators", in which we provided a detailed discussion of the guiding principles and other criteria the CAQ considered while developing the AQIs and method of communication in the CAQ Approach.

⁴ Sarbanes-Oxley Act of 2002 §301

⁵ Rule 10A-3, 17 C.F.R. §240.10A-3, under the Securities Exchange Act of 1934, which was adopted in accordance with section 301 of the Sarbanes-Oxley Act.

⁶ NYSE Listed Company Manual §303A.07; NASDAQ Marketplace Rule 4350(d)(3).

The CAQ believes that AQIs should be used and reported voluntarily. We believe this is particularly appropriate given that the development of AQIs is in the early stages. Furthermore, there is insufficient evidence of the correlation between any one set of AQIs and audit quality outcomes. Our pilot testing confirmed that most audit committee members who participated in the study valued the discussion of AQIs that gave them insights into particular audit processes as well as aspects of the firm's system of quality control that impacted the audit engagement. However, audit committee members had varied opinions about the value and usefulness of certain individual AQIs. As a result, we believe that a voluntary approach would give audit committees the most flexibility and opportunity both to tailor the information to matters that are most relevant to their oversight and to engage in the necessary two-way dialogue that can provide the appropriate context to enable them to interpret the AQIs and ultimately respond if necessary. Moreover, mandating the communication or reporting of specific AQIs could burden audit committees with required communication of AQIs which may not be relevant to the particular facts and circumstances of their audit engagement.

We also believe that mandatory public reporting of AQIs is not appropriate due to the early-stage nature of AQI concepts and the necessity of the contextual discussion to interpreting AQIs. We agree with the PCAOB that AQIs "are not formulas and may have their greatest use as generators of questions for the auditor."⁷ AQIs are a data point or collection of data points that may be directional in nature. Any AQI or set of AQIs needs to be evaluated in their complete context. As a result, we believe that focusing efforts on providing the audit committee with additional information about the audit is a prudent step with respect to any AQI effort to (1) allow the audit committee to determine what information is relevant to their oversight of the audit, (2) take into account the audit's particular facts and circumstances and (3) allow for the two-way dialogue that is necessary to put the AQIs into context. Also, we are concerned that mandatory public reporting may create a perception that an arbitrarily selected measurement, or a range of measurements, could serve as a "benchmark." For instance, a ratio of audit partners to staff varies from audit engagement to audit engagement. Staffing decisions require context and principally reflect the auditor's judgment. The engagement team's dialogue with the audit committee allows the audit committee to consider whether the ratio is appropriate based on the specific facts and circumstances; without this context and dialogue, one might erroneously presume that a particular number is more indicative of audit quality.

II. Consideration of Potential Audit Quality Indicators and Pilot Testing of the CAQ Approach

Given the lack of consensus among all stakeholders in the financial reporting process on what constitutes audit quality, it is difficult to identify a single set of AQIs. Even among audit committee members, a key participant in the process, there is lack of agreement on which metrics are most helpful in fostering discussion around audit quality, and assessing factors that may impact audit quality.⁸ These challenges represent important reasons supporting a flexible approach that lets audit committees drive AQI development.

The CAQ undertook its initiative to develop an example of a potential set of AQIs and an approach for communicating them to audit committees in response to the demand for arriving at a common language around certain drivers of audit quality and the need for continuous improvement. In developing the CAQ approach, we established that the indicators, taken as a whole, should conform to the following criteria: (1) convey information that has value and utility to audit committees; (2) measure an input or output related to an element of the audit quality framework (as developed based

⁷ The Concept Release, page 3

⁸ Refer to PCAOB's May 2013 Annual Standing Advisory Group Meeting.

on the PCAOB's quality control standards and other professional standards); (3) avoid or minimize unintended negative consequences; and (4) be scalable to audit firms and audit engagements of different types and sizes.

The CAQ used these selection criteria to choose indicators to include in the CAQ approach. The CAQ and certain of its member firms also reviewed a variety of sources for insight into approaches others had taken⁹ and indicators used in other professions and industries subject to quality control reviews (e.g., medical profession, airline industry). We initially identified over 100 potential indicators. The CAQ established a Stakeholder Advisory Panel composed of investors, audit committee members, preparers, audit professionals, academics, and former standard setters to help it narrow the list of potential AQIs to those the CAQ believed would be most impactful. The CAQ then hosted a roundtable with audit committee members to solicit their input before finalizing the CAQ approach. The result of this process was an example of a set of AQIs that focused primarily on engagement-specific matters and aspects of a firm's system of quality control as well as an approach to communicating them to audit committees that provides context through the necessary two-way dialogue.

The CAQ approach focuses on the communication of primarily engagement-level indicators, with firm-wide indicators included where they provide context or enhance an audit committee's understanding of engagement-specific matters. Audit committee members who participated in the pilot testing received both (1) engagement-level indicators focused on input measures; and (2) firm-level indicators focused on the firm's tone at the top and negative events, such as restatements and PCAOB inspection results. Generally, audit committee members reported they found engagement-level indicators most useful, as many of them are already receiving firm-level indicators from their auditor through, for example, the auditor's transparency or audit quality report or as part of discussions required under professional and listing standards. Discussion of firm-level AQIs put engagement-level indicators into further context by providing insight into the audit firm's system of quality control.

To obtain initial feedback on the CAQ approach, the CAQ sought certain member firms to voluntarily participate in pilot testing, the results of which were provided to the CAQ on a confidential basis. Auditors and audit committee members of 30 audit engagements participated in this effort throughout the 2014 audit cycle. The selected audit engagements were not identified to the CAQ, and while the pilot testing does not form a representative sample, the type of engagements included were diverse, covering a broad range of industries, as well as issuer operations and audit firms of varying sizes.

We asked audit firms to provide information on the feedback they received from audit committees regarding (1) the usefulness of the proposed AQIs in fulfilling their auditor oversight responsibilities and (2) the level of effort on the part of the audit firms required to collect AQI information. Results from this testing, introduced for the first time in this letter, include the following observations:

- Overall, audit committee members found that, for the most part, the presentation and discussion of AQIs facilitated dialogue with the engagement team about factors that could potentially contribute to audit quality and provided additional transparency into the audit process.
- There was little consistency with respect to the AQI information that the audit committees thought was helpful – most participants wanted the information tailored based on the specific

⁹ Sources include materials developed by the PCAOB for the May 2013 meeting of its Standing Advisory Group; by the U.K. Financial Reporting Council; by the International Auditing and Assurance Standards Board; and academic research.

facts and circumstances of their audit, history with the auditor, familiarity with the audit profession, and existing auditor evaluation procedures.

- Some audit committee members cited a desire for more qualitative information than the quantitative nature of the AQIs in the CAQ approach. For example, many of the factors that are critical to audit quality, such as professional judgment and skepticism, are more qualitative than quantitative, and therefore are much more difficult to capture in an indicator. Such qualitative factors may require even greater dialogue between the auditor and audit committee than what is necessary to understand and interpret quantitative indicators.
- Audit committees had varying opinions on what contextual information was useful in their analysis of AQIs. Given differences in issuers, industries, and other factors, the comparability of data varied from engagement to engagement and demonstrated that without context and additional discussion, use of such indicators could provide information that is not helpful, contain false positives or negatives, or lead to misperceptions about factors that may affect audit quality.
- Some audit committees were concerned that adding individual indicators to existing required or other ordinary auditor and audit committee communications and evaluations would overwhelm and perhaps weaken discussions they have today. Audit committees preferred flexibility with respect to the nature, extent, frequency, and timing of AQI communications.
- Engagement teams who participated in the pilot testing utilized various methods of reporting and communicating the AQI data to facilitate a discussion with the audit committees: PowerPoint presentations, heat-map matrices, and written narratives, among others. However, all teams paired their desired reporting method with a robust dialogue.
- Engagement teams concluded that the framework presented in the CAQ approach was useful in the communication of AQIs to audit committees.
- Engagement teams also found that data underlying certain engagement-level AQIs were readily available at some firms, while special data collection efforts and calculations were required at other firms.

We believe the results of the pilot testing confirmed that: (1) audit committees value engagement-level AQIs and are an appropriate audience for such indicators; (2) the two-way communication that is uniquely available to the audit committee and the audit engagement team provides a mechanism to receive the necessary context to evaluate and interpret AQIs; and (3) use and reporting of AQIs should be voluntary and flexible to allow audit committees and auditors to tailor them to their particular facts and circumstances.

III. Practical Application of Potential Audit Quality Indicators

As noted above, the CAQ believes that a robust, two-way discussion of AQIs between an engagement team and the audit committee provides additional information that could enhance understanding between the auditor and audit committees about the audit process and drive actions by auditors and audit committees that could lead to improvements in audit quality for the benefit of all capital market participants. We agree with the PCAOB that reporting of AQIs should be integrated “with contextual information for each audit or related comparison.”¹⁰ In fact, we believe AQIs, like most evaluative data, are effective only when accompanied by a robust discussion. Without these discussions, there is a high risk that an AQI, or changes in an AQI over time, will not tell a complete story or could be misleading.

¹⁰ The Concept Release, page 3.

Context and dialogue are especially important for engagement-level AQIs because without it the information is insufficient for decision-making or comparative purposes. Consider a scenario in which an engagement team is experiencing higher than expected overtime. This could be caused by many different factors, including that the engagement team encountered an unforeseen issue that required extra time, or that the team is overburdened. A dialogue with the auditor will allow the audit committee to understand the factors leading to the AQI with respect to that specific audit and to derive more meaningful insight as a result. Such dialogue could also drive actions that might help maintain or increase audit quality on the engagement.

The dynamic business and economic environment contributes to our belief that a voluntary, flexible, and nonpublic approach to using engagement-level AQIs is appropriate. We expect the identification and evaluation of AQIs to be a market-driven, evolutionary process that will require continuous assessment and refinement in order to meet the needs of the users.

It should be noted that some audit firms have begun publicly reporting firm-level metrics on a voluntary basis in annual firm-wide transparency reports or audit quality reports. We believe that the voluntary nature of such reporting should continue at the discretion of the audit firm. In general, audit firms that have not reported this information could find items discussed in these reports to be instructive on how to communicate these or similar items to audit committees or others either through their own transparency reports or other means. However, we do not believe that firm-level AQI reporting should be mandated; audit firms should continue to have the flexibility to respond appropriately to what the intended users decide is relevant.

More knowledge is still needed about AQIs to determine which indicators could be viewed as having a relationship to audit quality and their usefulness. The profession, audit committees, and regulators are in the early stages of assessing various potential AQIs, and more experience and empirical evidence are needed to understand and evaluate how potential AQIs, or changes in AQIs over time, correlate with audit quality outcomes. The PCAOB's root cause analysis initiative is highly relevant in this regard because it seeks to analyze "measures or indicators of audit quality to further improve and sustain audits."¹¹

We continue to gather input on the CAQ approach through outreach to various stakeholders, including through roundtable discussions and other efforts. We look forward to sharing that information with the PCAOB in the future; we would be pleased to do so at the planned roundtable.

In conclusion, we commend the PCAOB for recognizing the need for additional insight on these matters and for planning to conduct additional stakeholder outreach in a public roundtable. As a result of our continued efforts to develop perspectives regarding which indicators may be most relevant to auditors and audit committees, the CAQ gained significant insights through its development of the CAQ approach, pilot testing involving audit firms and audit committees, and extensive stakeholder outreach. We ask that the PCAOB consider this approach as a starting point for an ongoing dialogue on potential indicators and how they might be used. The CAQ recommends that the PCAOB continue to collaborate with and raise awareness among stakeholders, including investors and audit committees, on developments in connection with AQIs, including the AQI information already publicly available

¹¹ See PCAOB staff briefing paper prepared for the Meeting of the Standing Advisory Group of the PCAOB (June 24-25, 2014), http://pcaobus.org/News/Events/Documents/0624252014_SAG_Meeting/06242014_AQI.pdf

in some of the audit firms' audit quality or transparency reports, and any insights the PCAOB has gathered through root cause analysis or other initiatives to identify AQIs that correlate with audit quality. We anticipate that this dialogue and collaboration could lead to the development of a common language around AQIs and, potentially, best practices for their use.

The CAQ appreciates the opportunity to comment on the Concept Release and would be pleased to discuss our comments or answer any questions that the Board may have regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

PCAOB

James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor and Director of Standards
Gregory J. Jonas, Director, Office of Research and Analysis
Stephen Kroll, Senior Advisor, Office of Research and Analysis
George Wilfert, Deputy Director, Office of Research and Analysis

SEC

Mary Jo White, Chair
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
James V. Schnurr, Chief Accountant
Wesley R. Bricker, Deputy Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Julie A. Erhardt, Deputy Chief Accountant