Audit Quality Indicators Update

Greg Jonas
Director, Office of Research and Analysis

George Wilfert
Deputy Director, Office of Research and Analysis
Caveat – Disclaimer

This presentation was developed by the staff of the Office of Research and Analysis for the purpose of capturing tentative thinking about audit quality indicators for discussion. It is not a statement of the Board; nor does it necessarily reflect the views of the Board members or other staff.
Purpose of Session

- Review project objectives
- Update on staff work
- Outline possible concept release
- AQIs
- AQI users and uses
- Next steps
AQI Project Objectives

- Inform PCAOB regulatory processes and policy-making with additional insight into audit quality
- Consider providing audit committees, investors, management, audit firms, other regulators, or the public with AQIs
- Provide firms with additional incentives to compete based on audit quality
- Next milestone: concept release around year-end
AQI Project Workstreams

- Concept
- Testing
- Research & Outreach
- Concept Release
Outside resources consulted

- Firms
- Academics
- SAG members
- IAG members
- CAQ
- CPAB
- Subset of IFIAR
- Audit committee members
- SEC staff
Process For Screening AQIs

About 70 Possible AQIs

Screen #1: Survey SAG & IAG
Screen #2: ORA scoring based on 10 criteria
Screen #3: Internal PCAOB advisory group

40 Indicators Discussed with SAG

Other Ideas

27 Indicators Proposed by SAG Members

30 Promising AQIs

Future work & testing

Concept Release

20-30 Promising AQIs

Without reservation

With challenges

Public input, field testing, redeliberation

15 indicators for future release
Criteria for Screening AQIs

- Scalable
- Quantifiable and/or well-defined
- Availability of data
- Not redundant
- Anticipate to be correlated with audit quality
- Leading indicator
- Anticipated precision of the signal
- Provides insights into possible root causes
- No unintended consequences
- Usefulness to Audit Committees / Stakeholders
Possible Concept Release

Part I: Objectives and Background
- Pose series of questions related to the objectives

Part II: Definition, Framework, Top AQI Metrics
- Working definition of audit quality
- Three-part audit quality framework: audit inputs, audit processes, and audit results
- Identification of 25 – 30 potential indicators within the framework and explanation of why the staff believes these are most promising
- Pose series of questions related to the proposed indicators

Part III: Potential Use of Metrics
- Unit of measurement (e.g., registered firm level, engagement level)
- Collection of information (e.g., public information, information collected from firms)
- Dissemination of AQI information (e.g., by Board, by firms, etc.)
- Recipients and their use of AQI information (e.g., PCAOB, audit committees, investors, etc.)
- Phasing and scope of project
- Pose series of questions related to the potential uses of indicators
# Audit Quality Definition and Framework

## Definition
Operating in full compliance with PCAOB standards and SEC requirements in order to (i) meet the needs of an issuer’s investors and the marketplace for independent, skeptical, and reliable audits of the issuer’s financial statements and (ii) facilitate the timely and effective supply of information to the issuer’s audit committee.

## Framework

<table>
<thead>
<tr>
<th>Audit Inputs</th>
<th>Staffing composition</th>
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<tr>
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<td>Qualifications</td>
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<td>Review and supervision</td>
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<table>
<thead>
<tr>
<th>Audit Processes</th>
<th>Risk assessment</th>
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<td>Quality control</td>
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<td>Monitoring activities</td>
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<tr>
<th>Audit Results</th>
<th>Financial statements and related disclosures</th>
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<td>Internal control over financial reporting</td>
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<td>Going concern warnings</td>
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# Examples of Promising AQIs

## Inputs
- Staffing leverage
- Partner workload
- Staff utilization
- Industry expertise
- Outsourcing to service centers

## Processes
- Tone at the top: survey of firm personnel
- Audit firm internal quality review results
- PCAOB inspection results
- Senior personnel compensation rewards for audit quality

## Results
- Frequency and impact of financial statement restatement for errors
- Timely reporting of internal control weaknesses
- Reasonable warning of going concern
- Material frauds discovered and reported
- Trends in Board and SEC enforcement proceedings
## AQI Users

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<tr>
<th>Customer</th>
<th>Benefits</th>
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| Audit Committees  | • Demonstrate due diligence  
                    • Assess risk and audit quality  
                    • Retain and compensate auditors                                       |
| Investors         | • Assess risk  
                    • Proxy voting                                                           |
| Audit Firms       | • Assess risk  
                    • Monitor audit quality  
                    • Facilitate root cause analysis to improve remediation efforts         |
| PCAOB             | • Inform policy making  
                    • Assist root cause and quality control projects  
                    • Stimulate public discussion of and market demand for quality          |

1 AQI users also include other regulators (e.g., SEC) and policy makers, company management, business press, academics, and the general public. The staff believes that their information needs are a subset of the information needs of primary users.
## AQI Uses: Possible Questions

<table>
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<tr>
<th>Area</th>
<th>Possible Questions</th>
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<tr>
<td><strong>Customers</strong></td>
<td>• Should engagement teams discuss AQIs with audit committees?</td>
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<td>• Should the public receive AQIs?</td>
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<td><strong>Unit of account</strong></td>
<td>• Audit industry?</td>
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<tr>
<td></td>
<td>• Audit firm?</td>
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<tr>
<td></td>
<td>• Audit engagement?</td>
</tr>
<tr>
<td></td>
<td>• Issuer industry?</td>
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<tr>
<td><strong>Collection and dissemination</strong></td>
<td>• Who should collect and disseminate AQIs?</td>
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<td>• Voluntary or mandatory?</td>
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<td>• Should the provider of AQIs provide context?</td>
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<td>• What are the drivers of costs and benefits?</td>
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<td><strong>Phasing and scoping</strong></td>
<td>• Should steps be phased-in over time?</td>
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<td>• Should some audit firms or audits of some issuers be exempt?</td>
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Next Steps

- Continue staff solicitation of advice on AQIs
- Continue developing models for empirical testing of selected AQIs
- Develop concept release for Board consideration around year-end
  - Public comment period
  - Public roundtables?
  - Staff analysis of comments