
DISCUSSION – AUDIT QUALITY INDICATORS

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INTRODUCTION

The Public Company Accounting Oversight Board (the “Board”) has initiated a project on the creation and usage of a set of potential audit quality gauges, referred to as “audit quality indicators” (“AQIs”). The Board’s AQI project reflects an underlying premise, namely, that identifying measures for analyzing key aspects behind the quality of public company auditing can provide additional insight for audit committees, investors, and others and thus encourage audit firms to compete on the basis of audit quality. Such measures can also inform the Board’s policy and inspection decisions, aid work of other regulators, and assist audit firms themselves in quality control and remediation efforts.

This paper summarizes the Board’s previous public discussions with its Standing Advisory Group (“SAG”)¹ and Investor Advisory Group (“IAG”).² After providing background on the AQI project, it discusses the staff’s views on the nature of the AQIs and how we identified them. We next turn to possible uses of AQIs, including possible customers and examples of questions about usage the Board may include in the Concept Release. We conclude with a list of discussion questions and the Appendix provides examples of AQIs.

¹ Standing Advisory Group Meeting, May 15-16, 2013. Audit Quality Indicators Briefing Paper available at http://pcaobus.org/News/Events/Pages/05152013_SAG.aspx. Webcast and podcast available at http://pcaobus.org/News/Webcasts/Pages/05152013_SAG.aspx.

² Investor Advisory Group Meeting, October 16, 2013. Report from the Working Group: Audit Quality Indicators available at http://pcaobus.org/News/Events/Pages/10162013_IAGMeeting.aspx. Webcast and podcast available at http://pcaobus.org/News/Webcasts/Pages/10162013_IAGMeeting.aspx.

The staff of the Office of Research and Analysis developed this document to capture 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.

BACKGROUND

The project originated from the Final Report of the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession.³ The Committee recommended that the Board, in consultation with other parties, (i) "determine the feasibility of developing key indicators of audit quality and effectiveness and requiring audit firms to publicly disclose these indicators,"⁴ and (ii) create an approach to monitoring those indicators on an ongoing basis.

The Committee identified as a "key issue in the public company audit market what drives competition for audit clients and whether audit quality is the most significant driver." It concluded that "requiring audit firms to disclose indicators of audit quality" could promote such quality, and perhaps lower obstacles to competition among auditors.⁵

Other efforts to understand and fashion AQIs and to increase the flow of information about auditing firms began at about the same time. For example, the United Kingdom's Financial Reporting Council, the International Auditing and Assurance Standards Board, and other organizations have addressed audit quality indicators.

The Board identified the AQI project as a priority for 2013. The project joined two related efforts of the Board. The first was formulation of an audit quality improvement cycle by the Division of Registration and Inspection to encourage effective root cause analysis and remediation of audit deficiencies by audit firms; the second was development, by the Office of the Chief Auditor, of a Concept Release to explore improvements to the Board's existing audit firm quality control standards.

The Board expects to issue a Concept Release later this year to solicit public input on the project's goals, audit quality indicators, and potential uses of those indicators to promote audit quality. The Concept Release will include a public comment period, and the Board may also schedule one or more public roundtables to discuss the Release. In the meantime, the staff continues to solicit advice on the project.

NATURE OF THE AUDIT QUALITY INDICATORS

The indicators are a tool to cast light on the strength or weakness of key factors influencing audit quality. The indicators are quantitative, a factor distinguishing the Board's AQI project from other efforts to discuss audit quality in purely qualitative terms. Their power is enhanced when observing trends in the data or when comparing indicators across audit engagements or firms.

³ U.S. Department of the Treasury, Final Report, Advisory Committee on the Auditing Profession (October 6, 2008), available online at: <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>.

⁴ Id., Chapter VIII, Recommendation 3, at VIII:14.

⁵ Id. at VIII:15

The indicators are an integrated set of criteria. No single indicator is determinative, and while the indicators may not be equally significant, they are designed to operate as a “balanced scorecard” to provide broad information about audit quality. The indicators are not a formula for determining whether a particular audit is accurate or fairly presents the audited corporation’s financial condition. They are not algorithms, nor are they safe harbors or benchmarks.

AQI data always requires context, that is, a qualitative analysis of what the data implies about quality. The meaning of the numbers depends on the situation to which they are applied. Reasonable explanations can exist for divergent numbers and a variety of other factors may affect a particular audit.

A critical part of that context, and hence of the usefulness of AQI data, is comparability. For example, an audit committee told about the engagement’s staffing ratio for its upcoming audit may ask how the ratio compares with that for other audits by its auditor, and why. The Committee might also ask how the ratio compares with that for other auditors. Absent comparable data, the audit committee’s ability to evaluate what it has been told is limited.

IDENTIFYING AUDIT QUALITY INDICATORS

The staff sought to identify the broadest range of possible indicators, a process that has surfaced over 70 indicators thus far. To surface a broad range of indicators, the staff created a quality framework defining inputs to the audit (e.g., competent people), control features of the audit process, (e.g., inspections of audit work) and results of the audit (e.g., reliable financial reporting). We then considered indicators cited in academic research, previous efforts related to audit quality indicators, and discussions with the Board’s advisory groups (SAG and IAG), firms, other regulators, audit committees and others. We surfaced indicators related to each of the elements of our framework.

The staff is currently narrowing the list to the most promising indicators. We previously asked members of our advisory groups to rank the usefulness of the indicators. In addition, a cross-divisional team within the PCAOB is evaluating all candidates based on a set of criteria⁶. Ultimately, we speculate that roughly 10-15 indicators may be sufficient to present a balanced scorecard. We expect the Concept Release will result in comments that will help narrow the candidates to a viable and useful scorecard.

Appendix provides examples of indicators the staff is considering. We group indicators into “inputs,” “processes,” and “results,” consistent with the staff’s quality framework. Of course, public comment on possible indicators, were the Board to authorize exposing certain indicators in the Concept Release, could add useful indicators to the list, or help us narrow the list further.

⁶ Examples of indicators include: usefulness to audit committees and investors, potential for unintended consequences, scalability, availability of data, and correlation to audit quality.

POSSIBLE USES OF AUDIT QUALITY INDICATORS

Deciding on the best use of the indicators to promote audit quality requires answers to basic questions. They include: Who can best use the indicators? How can they be used most effectively? How should the necessary data be obtained and distributed?

The answers to these questions will determine the scope, timing and potential effect of the project. We expect the Concept Release will take no position on the questions. Rather, it will identify alternatives and seek public comment on the alternatives.

For example, the staff has identified tentative customers for AQIs and how those customers could benefit from their usage:

Customer⁷	Possible Benefits
Audit Committees	<ul style="list-style-type: none"> • Assess risk and audit quality • Retain and compensate auditors • Demonstrate due diligence
Investors	<ul style="list-style-type: none"> • Assess risk • Proxy voting
Audit Firms	<ul style="list-style-type: none"> • Assess risk • Monitor and improve audit quality • Facilitate root cause analysis to improve remediation efforts
PCAOB (and other regulators)	<ul style="list-style-type: none"> • Inform policy making • Assist root cause and quality control projects • Stimulate public discussion of and market demand for quality

There are alternative ways to provide benefits of AQIs to some or all possible customers. The range of those alternatives depends upon several factors, including: the nature of customers that AQIs will intend to serve; the unit of account (i.e. the entity that the AQI data relates to); the identity of entities that collect and disseminate AQIs; whether the AQI program is voluntary or mandatory; the scope of audits and audit firms that are subject to AQI reporting; and the possibility of phasing in steps toward a complete AQI program. Below we outline possible options for these factors:

⁷ AQI customers 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.

Area	Possible Options
Customers	<ul style="list-style-type: none"> • Audit engagement teams discuss AQIs with their audit committees • Firms share AQI data with regulators • Firms or others publish AQI data publically for the benefit of customers who would not otherwise receive AQI data
Unit of Account	<ul style="list-style-type: none"> • Audit industry • Global audit firm • National audit firm • Audit engagement • Issuer industry for all audits in that industry
Entities that could collect and disseminate AQIs and related analysis	<ul style="list-style-type: none"> • Engagement teams • Audit firms • Third parties • Regulators
Voluntary or mandatory	<ul style="list-style-type: none"> • Voluntary, with no standards • Voluntary, with standards • Mandatory
Scope	<ul style="list-style-type: none"> • Exempt no one • Exempt certain audit firms • Exempt audits of certain issuers
Phasing	<ul style="list-style-type: none"> • Phase-in certain steps toward a complete AQI program • Adopt AQI program in a single step

QUESTIONS FOR DISCUSSION

1. Is the effort to formulate AQIs feasible? If not, what are the most significant factors undermining its feasibility?
2. Is increasing transparency about the subjects of AQIs likely to result in a higher level of general audit quality?
3. Can the Board accomplish its goal of using AQIs to assist audit committees? Investors? Audit firms?
4. Can the development of AQIs have unintended consequences? What are they?
5. Should any AQIs be omitted from the examples included in Appendix I? Why?
6. Are there one or more user groups in addition to audit committees, investors, audit firms, and the Board and other regulators that the Board should consider to be a primary user of AQIs? If so, what is the nature of that group or groups? Do its needs for the AQIs, in each case, differ from those of other primary users?

7. How important to the usefulness of the AQIs by audit committees is AQI engagement-level data? How important is firm-wide data related to the audit engagement firm? Would audit committees benefit from public disclosure of AQI data for audit firms of comparable size?
8. How useful would investors find AQI data? Which AQI data would they find most useful?
9. To what extent would firm-level data be more useful if it were broken out in industry categories, according to, for example, the SEC's basic "SIC codes?"
10. How should AQI data be made available?
 - a. By audit firms voluntarily to audit committees, at the engagement and firm-levels?
 - b. By audit firms voluntarily to the public, at the firm level?
 - c. By others?
11. Should an AQI program be voluntary or mandatory?
12. What are the drivers of costs and benefits for an AQI program?
13. Would it be useful to phase-in any AQI system? For example, should the system be voluntary for some period and mandatory thereafter? If phasing is a good idea, what steps should the phasing involve?
14. Should collection of AQI data be limited to audits of certain companies? For example, to companies with at least one class of securities listed on a national securities exchange? Or, to those companies plus registered open-end investment companies? To all public companies?
15. Should collection of AQI data be limited to certain auditors? For example, should only firms that audit more than 100 issuers be the initial focus of an AQI program? Should the initial focus be limited to only the seven largest U.S. accounting firms? To another subset of registered firms? Should the global network affiliates of the firms that are the initial focus of the program be included in the program as well? Should all registered firms be included?

APPENDIX – EXAMPLES OF AUDIT QUALITY INDICATORS

Similar to those previously outlined for the SAG and IAG, the following pages provide examples of AQIs classified into inputs, processes, and results that the staff is considering.

INPUTS INDICATORS	
1.	<p>Staffing leverage</p> <p>Partners are responsible for the oversight of the less experienced staff and require sufficient time to supervise and review the work of the audit staff. The greater the oversight responsibility, as measured by the number of less experienced staff to partners, the greater the risk that they may not have sufficient time to supervise and review staff work. Less extensive supervision and review may result in less effective audit procedures, and thus adversely affect audit quality.</p>
2.	<p>Partner workload</p> <p>This indicator could provide insight into the quality implications of leverage, by focusing on partner workload. Again, heavy workloads can result in inadequate time to supervise staff and review audit procedures.</p>
3.	<p>Staff utilization</p> <p>The greater the audit staffs' workload, the greater the risk staff may not have sufficient time to perform necessary audit procedures as required under PCAOB Standards. Staff may become less effective when working long hours, and such an environment may affect the level of due professional care exercised by staff. For example, a heavy workload may create pressure on the staff to place more focus on efficiency in executing auditing procedures rather than ensuring the effectiveness of audit procedures and supervision of other more junior engagement team members. Evidence also suggests that firms use this metric to manage their practices.</p>
4.	<p>Turnover and transfers of audit personnel</p> <p>While some level of attrition is expected within public accounting, a comparatively higher rate of turnover or auditor transfers within a firm may adversely affect audit quality.</p>
5.	<p>Average years' experience</p> <p>Measuring the audit experience of mid- and senior-level personnel (i.e., senior associates, managers, senior managers, and partners) provides a baseline view of the expected knowledge, skill, and expertise of an audit practice.</p>
6.	<p>Industry expertise and proficiency</p> <p>This indicator could measure the extent to which the firm has encouraged the development of industry specialization and assigns partners and managers to audit engagements based on that specialization.</p>
7.	<p>Partner, manager, and engagement quality reviewer hours</p> <p>Measuring the hours that partners, managers, and engagement quality reviewers devote to an engagement, and when they spend such hours, as a percentage of total engagement hours, can measure the effort of key personnel, as well as the amount of supervision provided to staff.</p>

INPUTS INDICATORS	
8.	<p><i>Audit work outsourced to service centers</i></p> <p>Outsourcing audit work to service centers domestically and abroad widens the audit partner’s review responsibility. The outsourced work risks being isolated from the audit. The increased use of outsourcing by public accounting firms is important, but measurement difficulties remain, in part because its use varies by firm. The staff also believes that it is important for audit committees to understand the extent to which the audits for which they are responsible may be outsourced.</p>

PROCESSES INDICATORS	
1.	<p><i>Anonymous independent survey of firm personnel</i></p> <p>Data from anonymous independent surveys of audit firm personnel could provide unique insights about staff perceptions of their firms’ commitment to critical elements of quality.</p>
2.	<p><i>Tone at the top</i></p> <p>“Tone at the top” of an audit firm is frequently cited as a key to audit quality. If partners, managers, and staff auditors understand that the firm’s ethos demands and rewards knowledge, competence, skepticism, and fortitude, those qualities are more likely to become ingrained within personnel. However, tone at the top is very difficult to measure. The use of an anonymous survey could provide some information, but additional perspectives on measuring tone at the top may also be helpful.</p>
3.	<p><i>Findings of an audit firm’s internal quality reviews</i></p> <p>Data from the internal quality reviews conducted by each audit firm can provide perspective on a firm’s ability or inability to both monitor and improve audit quality. Having many internal findings, along with appropriate remediation, might indicate a thorough approach to internal quality review at a firm.</p>
4.	<p><i>Findings from an audit firm’s inspections by the Board</i></p> <p>The Board’s own inspections focus on the way audits are conducted and can provide insight on breakdowns that may cause repeated deficiencies. In addition to Part I findings, inspections may provide a baseline for evaluating other indicators (e.g., comparing leverage ratios with inspection findings) and testing the strength of firms’ internal quality control systems.</p>
5.	<p><i>Independence</i></p> <p>Several indicators partially or indirectly address the expected objectivity and independent attitude of firm personnel. Examples include, but are not limited to the following: survey of firm personnel; non-audit service fees as a percentage of total fees; number and nature of SEC independence violations; percentage of a firm’s employees subject to the firm’s personal independence compliance reviews; percentage of issuer audit engagements subject to the firm’s internal quality control reviews over independence compliance; average number of mandatory independence training hours per employee; number of issuer audit clients lost due to independence violations; percentage of full-time equivalents dedicated to the firm’s independence function per 100 issuer audit clients (for firms with more than 500 issuer audit clients only).</p>

RESULTS INDICATORS	
1.	<p><i>Frequency and impact of financial statement restatements for errors (i.e., not for changes in accounting principles)</i></p> <p>The number and impact of financial statement restatements is generally considered a signal of potential difficulties in an audit firm’s practice and approach to auditing.</p>
2.	<p><i>Reporting material weaknesses</i></p> <p>This measure captures the extent to which an audit firm identifies material weaknesses in an issuer’s internal controls over financial reporting, and does so on a timely basis.</p>
3.	<p><i>Absence of going concern paragraph within an audit report before a bankruptcy or similar financial distress</i></p> <p>Failure to include a going concern paragraph within an audit report in the face of reasonably-foreseeable business distress for an issuer can indicate a significant lack of audit quality.</p>
4.	<p><i>Material frauds</i></p> <p>The nature, frequency, and market impact of auditor-reported material frauds can provide insights into a firm’s consideration of fraud in an audit, its commitment to quality, as well as the risk of its client portfolio. Measurement difficulties, however, can be expected, and the staff is still considering how best to present this indicator.</p>
5.	<p><i>Trends in Board and SEC litigation in audit or audit-related matters, incorporating public litigation with a five-year lookback</i></p> <p>The frequency, nature, magnitude, and results of Board and SEC litigation in audit and audit-related matters should help reveal weaknesses or strengths in a firm’s practice, as well as particular quality issues affecting either specific firms or auditing in general.</p>
6.	<p><i>Surveys of audit committees about the quality of communications from the auditor</i></p> <p>Data from anonymous independent surveys of audit committee members could provide uniquely valuable information about the way auditors actually interact with audit committees. Such surveys could pose logistical and conceptual issues given the range of companies involved. The staff is still considering these issues, but believes it would be useful to include the possibility of such surveys in a concept release.</p>