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Report from the Working Group on Audit Quality Initiatives

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Audit Quality Initiatives

Protecting Investor Interests in Audit Quality
“You Manage What You Measure”

Presentation Topics

- Why Audit Quality and AQIs Matter to Investors
- PCAOB Authority and Efforts to Date to Enact AQIs
- Audit Quality Initiatives in Other Jurisdictions
- Summary of 2013 IAG Discussions on AQI
- 2017 Working Group Recommendations

Audit Quality Initiatives

Investor Concerns: Why AQIs Matter

- Public interest in greater transparency regarding audit quality
 - AQIs would enable investors to make better informed decisions on ratification of auditor
 - Could provide early warning signs of auditor capacity, resource, competence issues
 - Important complement to PCAOB inspection regimen
- Inspection reports in U.S. and globally show disturbing trends in audit quality: below expected or acceptable levels

Audit Quality Initiatives

Investor Concerns: Why AQIs Matter

- Professional skepticism has been the subject of many efforts, over many decades, with little visible impact on audit quality
 - Noble and useful concept but often elusive in audits
 - Additional guidance and application material will likely have limited impact on improving audit quality
- ACAP recommendations published *nine years ago*, yet still no consensus or final PCAOB action on AQIs
- Firms' audit quality publications no substitute for PCAOB-mandated disclosures: largely promotional and don't define AQIs or disclose whether all measured AQIs being reported

Audit Quality Initiatives

PCAOB Responsibility for Ensuring Audit Quality

- ❑ PCAOB shall perform such other functions as it deems necessary *"to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms."* **Sarbanes-Oxley Act, Section 101(c)(5)**
- ❑ *"The responsibilities of the Public Company Accounting Oversight Board (the "Board" or "PCAOB"), under the Sarbanes-Oxley Act . . . are all ultimately directed at improving audit quality and thereby benefiting investors."* **PCAOB Concept Release on Audit Quality Indicators, July 1, 2015**

Audit Quality Initiatives

History of Audit Quality Project: ACAP Report (2008)

- *"Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, board of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators."*
- *"Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators."*
- *"The Committee believes requiring firms to disclose indicators of audit quality may enhance not only the quality of audits provided by such firms, but also the ability of smaller auditing firms to compete with larger auditing firms, auditor choice, **shareholder decision-making related to ratification of auditor selection, and PCAOB oversight** of registered auditing firms."*

Audit Quality Initiatives

History of Audit Quality Project: PCAOB

- ❑ **November 2012** – PCAOB establishes project to develop audit quality measures as a priority project for 2013, “with a longer-term goal of tracking such measures with respect to domestic global network firms and reporting collective measures over time.”
- ❑ **May 2013** – AQI Briefing Paper discussed with SAG
- ❑ **October 2013** – IAG presentation on audit quality indicators
- ❑ **June 2014** – Audit quality discussed with SAG
- ❑ **July 2015** – PCOAB issues *Concept Release on Audit Quality* with 28 potential audit quality indicators. Chairman Doty: “All of the proposed measures are based on more than two years of extensive research and outreach by our Office of Research and Analysis and others.” Comments due Sept. 2015
- ❑ **Nov. 2015** – PCAOB discusses AQI project with SAG

Audit Quality Initiatives

Global Audit Quality Initiatives: IFIAR

- 2014: IFIAR meets and discusses audit quality
- 2015: IFIAR meets with six largest audit firms to set goals for reducing audit deficiencies
 - IFIAR 2016 Annual Report notes decline in deficient audits from 47% to 42% but states that “the level of deficiency is still too high and improvement must be accelerated In particular, consistency of execution and quality control systems are not robust enough.”
- June 2016: IFIAR submits comment letter on IAASB proposal

Audit Quality Initiatives

Global Audit Quality Initiatives

- **2008** - UK Financial Reporting Council issues audit quality framework. (PCAOB staff has met with FRC representatives)
 - March 2017 FRC report on audit quality: 31% of audits reviewed were assessed by the FRC as “requiring more than limited improvement”
- **December 2013**: FRC CEO states:
 - “Our mission is to promote high quality corporate governance and reporting to foster investment”
 - “We grade each audit engagement we inspect”
 - “The Competition Commission feels that these grades are a powerful driver of quality and potential of stronger competition between firms”
 - “Currently we use the grade to inform public reports on each firm”

Audit Quality Initiatives

Global Audit Quality Initiatives

- August 2016: Singapore Accounting and Corporate Regulatory Authority (ACRA), 10th Public Report:
 - “ACRA is introducing two new regulatory initiatives that are calibrated to help specific groups of the profession”
 - “The first initiative...seeks to drive a 25% reduction in the percentage of inspected audits of listed entity engagements with at least one finding over a four-year period from 2015 to 2019”
 - “The second initiative focuses on public accountants that have not shown significant improvements despite repeated findings of poor audit quality. From inspections commencing on or after 1 April 2017, the names of public accountants imposed with hot review or restriction orders on revisit inspections will be published on ACRA’s website”

Audit Quality Initiatives

Global Audit Quality Initiatives

- ❑ **October 2011:** *Incentives for Audit Quality: exploratory review* by Netherlands Authority for the Financial Markets (AFM):
 - “For the benefit of the users of financial statements, the AFM supports clearer, unambiguous and more restrictive rules for auditor independence and the appointment, appraisal, remuneration and sanctioning of external auditors.”
 - “AFM supports the position of the Minister of Finance, who prefers clear requirements and prohibitions in this area over the existing conceptual framework, which is based on threats to independence and safeguards against such threats.”
- ❑ **January 2017:** Swiss Federal Audit Oversight Authority, 2016 Annual Report: “AQI were either not supplied to audit committees or only sparingly. The FAOA supports the emerging trend to prepare such performance indicators for audit committees.”

Audit Quality Initiatives

Other Audit Quality Initiatives: Auditing Organizations

- ❑ **January 2011:** IAASB publishes *Audit Quality, An IAASB Perspective*
- ❑ **January 2013:** IAASB Consultation Paper on a *Framework for Audit Quality*
- ❑ **February 2014:** IAASB publishes *A Framework for Audit Quality; Key Elements that Create An Environment For Audit Quality*
 - But does not create system for quantifying elements of audit quality
- ❑ **December 2015:** IAASB issues *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*
- ❑ **December 2015:** IAASB publishes *An Overview, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*
- ❑ **January 2016:** AICPA Center for Audit Quality publishes *Audit Quality Indicators, The Journey and Path Ahead*

Audit Quality Initiatives

Audit Quality Initiatives: Auditing Organizations

- **January 2016:** AICPA Center for Audit Quality publishes *Audit Quality Indicators, The Journey and Path Ahead*
- **July 2016:** Federation of European Accountants (FEE), *Overview of Audit Quality Indicators Initiatives:*
 - “This paper is an overview setting out audit quality indicators (AQIs) which have been developed by nine different organisations worldwide, including regulators, oversight bodies, professional bodies, and audit firms. It also provides insight into key differences between these AQIs; namely, if they are rules or principles-based, qualitative or quantitative, and whether reporting on these AQIs is made public or kept private.”
- Deloitte Annual Audit Quality Report, and Audit Quality Advisory Council

Audit Quality Initiatives

Where Are We Today?

- ❑ It has been nine years since publication of ACAP audit quality recommendations, yet PCAOB has not fulfilled its mandate to implement AQIs
- ❑ Other jurisdictions appear to have moved ahead of the U.S. in efforts to measure and report on audit quality – it's time to catch up
- ❑ Over the 9-year period, other professional and market factors have had negative effects on audit quality:
 - Increasing tension between firms' investments in audit quality and strategy to grow business lines and revenues
 - Independence rules once again under assault
 - Lack of regulation creates a "Too Big To Fail" mindset as we have now seen in South Africa

Audit Quality Initiatives

IAG 2013 Working Group on AQIs: Summary

- ❑ Investors urge the PCAOB to prescribe a set of AQIs that:
 - Measure the quality of the actual audit (output)
 - Help establish accountability for audit quality
 - Are forward-looking and
 - Have information or predictive content
- ❑ Current focus of PCAOB's AQI Initiative relates more to audit *firm* quality and the audit process than to *audit* quality
- ❑ Investors are most concerned about the reliability and credibility of the audits of the companies they have invested in or are evaluating
- ❑ Audit committee members are most interested in the quality of the auditor's work for their company rather than to actions their audit firm has taken more generally that relate to audit quality

Audit Quality Initiatives

IAG 2013 Working Group on AQIs: Summary

- ❑ PCAOB's objective should be to develop measurements of audit quality that provide investors with useful and timely information with respect to the credibility of audits
- ❑ Project should also result in publication of timely and useful information for audit committees for both audit oversight and auditor selection
- ❑ Investors and audit committees need specific information about risks identified in PCAOB inspections and discussed in inspection reports
- ❑ Audit firms should be required to provide the PCAOB with data on selected audit quality indicators compiled at both the engagement level and the firm level
- ❑ These data should be subject to review, verification, and comment by the PCAOB

Audit Quality Initiatives

AQI Working Group 2017 Recommendations

- ❑ Final action on AQIs overdue: a decade has been more than sufficient time to prescribe a new standard
- ❑ Working Group endorses AQI working group recommendations from 2013 IAG discussion
- ❑ Transparency the central element of any rulemaking relating to audit quality:
 - Transparency in inspections (e.g., U.K. grading system)
 - Transparency in disciplinary actions (support legislative action)
 - Transparency in annual audit firm reports

Audit Quality Initiatives

AQI Working Group 2017 Recommendations

- AQIs proposed in Concept Release all have merit
- PCAOB should propose a new standard requiring disclosure to audit committees and investors of:
 - Inspection grades – with *issuer identified*
 - Audit Quality Indicators supported by investors
- BOTH firm and specific company audit AQIs are important and relevant
- PCAOB should expedite release of annual inspection reports and ensure timely release of Part 2 reports

Audit Quality Initiatives

AQI Working Group 2017 Recommendations

- Working Group members recommend the following AQI categories as priority areas:
 - Compliance with independence standards
 - Transparency of inspection grades and results
 - Frequency of undetected financial statement errors and IC material weaknesses
 - Staffing levels, leverage, and workload
 - Audit hours spent including in risk areas
 - Trends in both private and regulatory legal actions
 - Timely reporting of going concern reports

Audit Quality Initiatives

AQI Working Group 2017 Recommendations

- Accountability
 - There needs to be increased accountability for audit quality at both firm leadership AND audit engagement team levels
 - Continued high levels of failure to follow GAAS are unacceptable

- Other factors
 - Rapidly growing independence issues and “too big to fail” concerns contribute to audit quality issues
 - Relationship between “user pays” audit model and audit quality deserves careful examination – inherent conflict likely contributes to audit deficiencies

Audit Quality Initiatives

Questions



Audit Quality Initiatives

Appendix A PCAOB Inspection Results

**Based on most recent inspections as of
September 30, 2017**

Audit Quality Initiatives

An Auditor's Obligation

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a **public** responsibility **transcending** any employment relationship with the client. The independent public accountant performing this special function **owes ultimate allegiance to the corporation's creditors and stockholders**, as well as to the **investing public**. This "**public watchdog**" function demands that the accountant maintain **total independence** from the client at all times, and requires **complete fidelity to the public trust**.

United States v. Arthur Young & Co.
465 U.S. 805 (1984)

Audit Quality Initiatives

What an Audit is Supposed to Do

“The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” AU 110.02

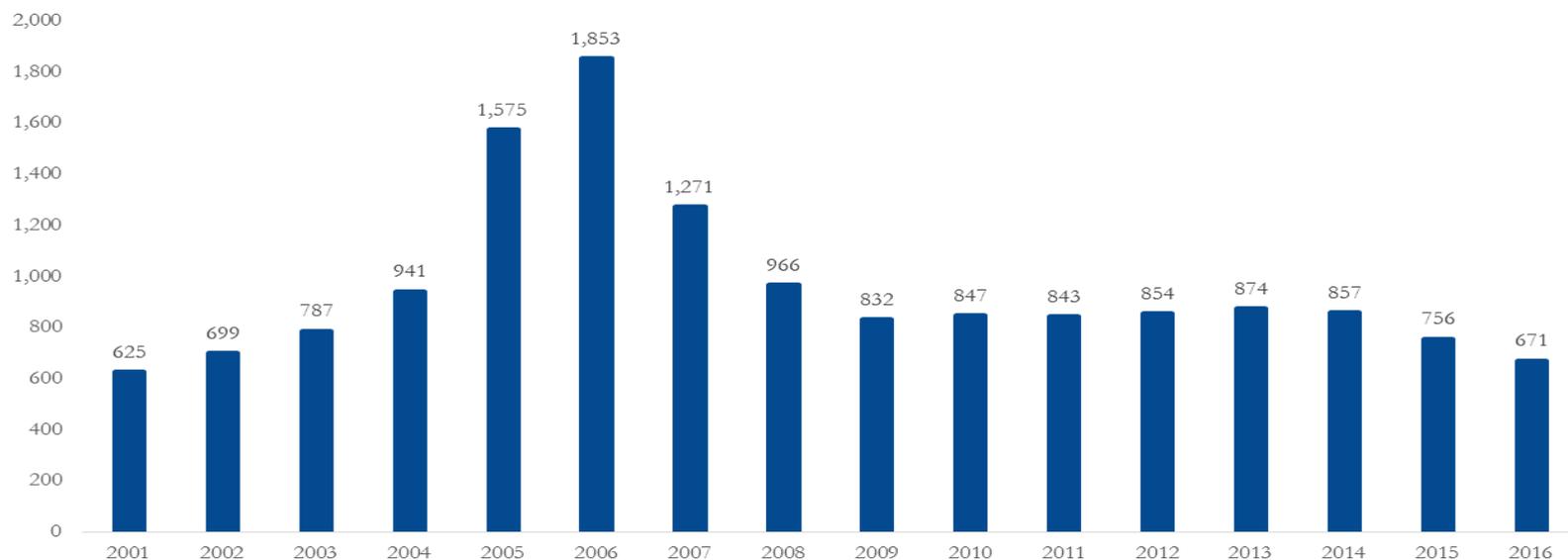
Audit Quality Initiatives

Perspective on Audits

“In our complex society the accountant’s certificate and the lawyer’s opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.” *United States v. Benjamin*, 328 F.2d 854, 862 (2d Cir. 1964)

Audit Quality Initiatives

Restatements by Year: 2001-2016



- Restatements relatively stable 2009 to 2014.
- Dropped 12% to a total of 756 in 2015, and dropped another 11% to a total of 671 in 2016.

Source: Audit Analytics, "2016 Financial Restatements: A Sixteen Year Comparison," May 2017.

Audit Quality Initiatives

Restatements by Year: 2006-2016

Restatements as % of Population by Year			
Disclosure Year	Total Restatement Disclosures	Denominator Population	Restatement Percentage
2006	1,853	15,515	11.94%
2007	1,271	15,469	8.22%
2008	966	14,623	6.61%
2009	832	13,551	6.14%
2010	847	12,713	6.66%
2011	843	12,215	6.90%
2012	854	11,519	7.41%
2013	874	10,757	8.12%
2014	857	10,723	7.99%
2015	756	10,345	7.31%
2016	671	9,831	6.83%
	Total: 10,624	Average: 12,478	85.14%

Source: Audit Analytics, "2016 Financial Restatements: A Sixteen Year Comparison," May 2017.

Audit Quality Initiatives

PCAOB Inspection Results Big Four – Summary of All

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	208	219	219	217
Deficient Audits Identified	76	85	76	61
Deficiency Rate	36.5%	38.8%	34.7%	28.1%

“Inspection Year” is when the PCAOB primarily performs its inspection procedures. Typically the PCAOB completes its inspection work in year one and issues the Reports on Inspection the following year. In the table above, Reports on Inspection for Inspection Year 2015 were issued in 2016. As of September 12, 2017, no Reports on Inspection for Inspection Year 2016 have been issued.

Audit Quality Initiatives

PCAOB Inspection Results Deloitte & Touche LLP

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	52	53	53	55
Deficient Audits Identified	13	15	11	13
Deficiency Rate	25.0%	28.3%	20.8%	23.6%

- Deficiencies in auditor testing of:
 - Inventory
 - Revenue
 - Other asset values
- Relied too heavily on internal controls, which were not sufficiently tested.

Audit Quality Initiatives

PCAOB Inspection Results Ernst & Young LLP

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	52	57	56	55
Deficient Audits Identified	25	28	20	16
Deficiency Rate	48.1%	49.1%	35.7%	29.1%

- Deficiencies in auditor testing of controls over:
 - Revenue
 - Accounts receivable
 - Valuation of inventory
 - Valuation of deferred tax assets
 - Reserves for sales returns and discounts
- Relied too heavily on internal controls, which were not sufficiently tested.
- Failed to evaluate the reasonableness of issuer's methods of revenue recognition.

Audit Quality Initiatives

PCAOB Inspection Results PricewaterhouseCoopers LLP

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	54	59	58	55
Deficient Audits Identified	21	19	17	12
Deficiency Rate	38.9%	32.2%	29.3%	21.8%

- Deficiencies in auditor testing of the accounting and controls for:
 - Business combinations
 - Revenue and deferred revenue
 - Impairment of goodwill and other intangible assets
- Did not sufficiently test data used by issuers in determining reported values.
- Relied too heavily on internal controls, which were not sufficiently tested.

Audit Quality Initiatives

PCAOB Inspection Results KPMG LLP

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	50	50	52	52
Deficient Audits Identified	17	23	28	20
Deficiency Rate	34.0%	46.0%	53.8%	38.5%

- Deficiencies in auditor testing of:
 - Assets and liabilities assumed as part of business combinations
 - Derivatives
 - Deferred Revenue
- Failed to evaluate whether identified control weaknesses individually or in combination represented a material weakness.
- Did not sufficiently test identified fraud risks related to revenue recognition and allowances for loan losses or related controls.

Audit Quality Initiatives

PCAOB Inspection Results

Grant Thornton, BDO, McGladrey/RSM - Summary of All

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	70	72	72	72
Deficient Audits Identified	40	39	35	31
Deficiency Rate	57.1%	54.2%	48.6%	43.1%

Audit Quality Initiatives

PCAOB Inspection Results Grant Thornton LLP

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	34	36	34	34
Deficient Audits Identified	22	20	11	14
Deficiency Rate	64.7%	55.6%	32.4%	41.2%

- Failed to sufficiently test controls related to:
 - Revenue
 - Impairment of property and equipment
 - Cash flow projections
- Relied too heavily on internal controls, which were not sufficiently tested.

Audit Quality Initiatives

PCAOB Inspection Results BDO USA LLP

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	20	23	23	23
Deficient Audits Identified	11	15	17	12
Deficiency Rate	55.0%	65.2%	73.9%	52.2%

- Deficiencies in auditor testing of the accounting and controls for:
 - Revenue recognition
 - Inventory
 - Business combinations
- Did not sufficiently test identified fraud risks related to revenue recognition.

Audit Quality Initiatives

PCAOB Inspection Results McGladrey LLP / RSM US LLP

Inspection Year:	2012	2013	2014	2015
Total Audits Inspected	16	13	15	15
Deficient Audits Identified	7	4	7	5
Deficiency Rate	43.8%	30.8%	46.7%	33.3%

- Deficiencies in auditor testing of:
 - Revenue
 - Cost of sales
 - Accounts Receivable
- Did not obtain sufficient appropriate audit evidence to support its audit opinions on the financial statements.

Audit Quality Initiatives

PCAOB Interim Inspection Program Audits of Brokers and Dealers

Deficiencies	Percentage of Engagements with Deficiencies	
	2016	2015
Audit Engagements		
Auditing Revenue	66%	70%
Responding to the Risks of Material Misstatement Due to Fraud	57%	42%
Auditing Supplemental Information Related to the Net Capital Rule	27%	30%
Auditing Supplemental Information Related to the Customer Protection Rule	52%	53%
Engagement Quality Review	57%	57%
Attestation Engagements		
Examination Procedures of a Broker-Dealer's Compliance Report	70%	78%
Engagement Quality Review Related to Examination Engagements	20%	48%
Review Procedures of a Broker-Dealer's Exemption Report	28%	34%
Engagement Quality Review Related to Review Engagements	26%	34%

Source: PCAOB Release No. 2017-004, Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, August 18, 2017.

Audit Quality Initiatives

PCAOB Interim Inspection Program Independence Findings

2016 inspections:

- ❑ Inspections staff identified independence findings in 11 of 115, or 10%, of the audits covered by inspections.
 - An increase from 7% of the audits covered by inspections in 2015
- ❑ Inspections staff observed:
 - Firms performed bookkeeping or other services related to the broker-dealer's accounting records.
 - Firms prepared, or assisted in the preparation of, the broker-dealer's financial statements, supplemental information, or exemption reports.
 - One audit firm's independence appeared to be impaired because the audit engagement letter stated the broker-dealer would indemnify the audit firm.

Source: PCAOB Release No. 2017-004, *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*, August 18, 2017.