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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 041
Request for Comment: Concept Release on Audit Quality Indicators

Dear Ms. Secretary:

We appreciate 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). We would like to take this opportunity to formally recognize the effort of the PCAOB and its staff in the development of the Concept Release. We continue to believe that the use of concept releases is an effective approach to solicit input from various stakeholders, and we encourage the PCAOB to continue to use this approach in the future.

Overview

The Board has requested public comment on the content and possible uses of a group of audit quality indicators (AQIs or indicators). We generally support the Board's view, as stated in the Concept Release, that "[t]he indicators are a potential portfolio of quantitative measures that may provide new insights about how to evaluate the quality of audits and how high quality audits are achieved. Taken together with qualitative context, the indicators may inform discussions among those concerned with the financial reporting and auditing process, for example among audit committees and audit firms."¹

We acknowledge and are supportive of the PCAOB's efforts to develop AQIs that could be used by audit committees and auditors to stimulate and enrich dialogue on the topic of audit quality as it relates to a particular audit engagement. Further, we commend the PCAOB for its deliberate and thoughtful approach in developing the Concept Release, including its consideration of other approaches relative to the use and communication of AQIs.

In the remainder of this letter, we offer for the Board's consideration our views regarding certain topics outlined in the Concept Release. Our views are informed by, among other things, our participation in the Center for Audit Quality's (CAQ) pilot testing of indicators, and the development of the *CAQ Approach to Audit Quality Indicators* (CAQ Approach). In responding to the Concept Release, we provide overarching comments on concepts associated with the development and communication of AQIs.

¹ See page 1 of the Concept Release.

Communication of AQIs Should be Between the Auditor and Audit Committee

We believe that communications related to audit quality should occur between the auditor and audit committee, and the communication and information presented should not be made public. Without the two-way contextual conversation that would occur between the auditor and the audit committee, the public reporting of indicators is unlikely to provide truly meaningful information to investors and other stakeholders and could be misunderstood or misleading. The two-way contextual conversation is what adds value to the AQIs that are relevant to a particular audit engagement, and allows for a continuous and dynamic improvement in the communication of AQIs over time. In addition, integrating the discussion of AQIs with other non-public communications required under PCAOB standards will allow both parties to discuss all significant drivers that relate to the performance of that particular audit, including its quality.

Communication of AQIs Should be Voluntary

We believe that communication of AQIs should be voluntary, rather than mandatory, and driven, primarily, by the needs and interests of the audit committee (although the auditor is always free to communicate information that the auditor believes is relevant). A voluntary non-prescriptive approach provides both the auditor and the audit committee the flexibility necessary to focus on the relevant information that affects the quality of a particular audit. Conversely, the establishment of a requirement to communicate AQIs may detract from the ability to customize the communication to be most effective in enhancing audit quality on an individual audit engagement. We believe that any communication of AQI information should be tailored to the individual circumstances of a particular audit engagement and that sufficient flexibility is possible only in an environment where the communication of the AQI related content is voluntary.

The qualitative discussion relative to and the context of the communication around the indicators is what makes the indicators most consequential. Hence, allowing the auditor and the audit committee to voluntarily select from a population of possible AQIs and then tailor those indicators to the specific facts and circumstances of a particular audit will make the data more meaningful to the audit committee.

A mandatory reporting to the audit committee may create a checklist mentality in communicating AQIs to the audit committee and dilute the importance of the most meaningful AQIs, which could be distracting and potentially have an inadvertent negative effect on audit quality. Additionally, a forced discussion that is not sensitive to existing required communications and evaluations may duplicate or weaken the discussions that are already taking place in the current environment, for example, those communications with the audit committee required by PCAOB Auditing Standard No. 16, *Communications with Audit Committees*.

The changing economic and regulatory environment also lends support to the voluntary and flexible identification and evaluation of AQIs. To be effective, meaningful and informative, the communication of AQIs must be an evolutionary process that can be continually assessed and refined by both the auditor and the audit committee.

In our opinion, the indicators likely to be selected by the auditor and the audit committee will be those that have the strongest correlation with audit quality for that particular audit engagement, while striking a

balance in the quantity and relevance of information that both constituents will find beneficial. Allowing the auditor and the audit committee the flexibility to timely reevaluate communications and respond to changing circumstances will ensure that the communications remain fresh and meaningful.

Engagement Level Versus Firm Level AQIs are Most Relevant

We believe that communication of AQIs should be focused on information that is relevant at the engagement level. There may be situations where indicators focused on data at the firm level are relevant to the communication, for example, when they provide context or are intended to enhance an audit committee's understanding of the engagement level indicators. Providing data that is not specific to the engagement may raise questions about the comparability of data between engagements or between audit firms and could lead to misperceptions or false conclusions about what factors may affect audit quality on a particular audit engagement.

As an example, one of the firm level indicators proposed in the Concept Release related to the *Audit Hours and Risk Areas* AQI is proposed to be calculated as follows:

For audits by industry, computed separately, average chargeable hours overall and by significant risk area for partners, managers, audit staff, technical accounting and auditing resource personnel, specialists, and the engagement quality reviewers, respectively, for the prior year (actual).

There also is a corresponding engagement level indicator proposed for the same AQI that discusses similar chargeability statistics for a particular engagement, which based on the entity specific risk factors and other key variables relating to that entity's operating, reporting and compliance situation, could vary considerably from the firm level indicator across the entire industry.

Additionally, AQIs that are tailored to be relevant and useful to a particular audit engagement, by design, are not determined consistently and precisely across all engagements, audit firms and the profession, and hence generally would not be comparable. Conversely, if consistent determination is prioritized, it would detract from the usefulness and ability to personalize and tailor the AQIs to improve the relevance of the information provided to the audit committee.

We believe that the priority should be focusing on the relevant and useful engagement-specific AQIs, both quantitative and qualitative, which when accompanied by a robust dialogue on matters important to the execution of the audit, are likely to enhance the audit committee's understanding of which factors may affect the quality of an audit and assist in oversight of the independent audit process.

Other Matters

Scalability

We believe that the indicators should be general enough to be scalable to all companies, from large conglomerates to mid-market entities. As an example, one of the engagement level indicators referenced

in the Concept Release related to the *Allocation of Audit Hours to Phases of the Audit* AQI is proposed to be calculated as follows:

Current year's (planned) and prior year's (actual) total chargeable hours for each related audit phase (i.e., planning, quarterly reviews, interim field work, final field work up until report release date, and post-field work until audit documentation completion date) for partners, managers, the audit staff, technical resources staff, specialists, and the engagement quality reviewer, respectively.

While generally time consuming to collect, this information may be more meaningful for a mid-market entity, and significantly more challenging to collect and potentially less meaningful for a large multi-national, multi-location group audit with standalone statutory filings in foreign jurisdictions.

Implementation Timeline

We understand that the Division of Registration and Inspections at the PCAOB is currently conducting a root cause analysis initiative which will analyze “measures or indicators of audit quality to further improve and sustain audits.”² We encourage the PCAOB to continue this analysis, since it is uniquely positioned to gather empirical evidence to assess and isolate the potential AQIs that are shown to have a high correlation with positive and negative quality audits. Once the correlation has been established, we believe it would be appropriate for the PCAOB to share its findings with the various stakeholders.

While we believe that the communication of AQI information should be voluntary, if the PCAOB were to require it, we believe that the communication of AQI information should be phased in, with the engagement level information phased in sooner than the firm level information. Prioritizing the engagement level information will allow the auditor and audit committee to have informed discussions about the financial reporting and auditing process, which in turn will strengthen the audit planning and execution, and hence positively impact audit quality.

Assuming that the PCAOB requires the communication of firm level information, most firms will need a period of time to take affirmative steps to produce or gather the data in the format and level of detail prescribed by the PCAOB. As an example, one of the firm level indicators proposed in the Concept Release related to the *Tone at the Top and Leadership* AQI is that firms conduct:

Anonymous independent surveys of current and former firm personnel about “tone at the top,” quality of supervision and training, and the extent to which the firm promotes an environment that favors speaking up about potential issues, and promotes and rewards professional skepticism.

The logistically complex process of hiring an independent organization to administer an anonymous survey, and compile the results in a manner that would be comparable within the profession, would take longer than gathering engagement specific indicators that would be more readily available.

² See PCAOB staff briefing paper prepared for the June 24-25, 2014 meeting of the Standing Advisory Group.

Costs

There will be costs to firms, and in all likelihood operational challenges, related to accumulating the information required by the indicators. In addition, it will be necessary to periodically refresh the information to ensure that the information being presented is relevant and up to date, and such refreshment efforts will also have a corresponding cost.

A mandatory approach could result in AQI data being collected, analyzed and presented that could be irrelevant to a particular audit engagement. The effort and related cost of gathering and interpreting the relevant data for a distinct set of measures tailored to be meaningful to a particular audit engagement's facts and circumstances would be more reasonable when the constituents are able to correlate the metrics directly to audit quality. We believe it is important for the PCAOB to recognize this fact as the topic of AQIs is advanced.

Global Convergence of Audit Quality

We believe that the PCAOB should consider the thematic elements of audit quality already developed by other organizations around the world. As the Board narrows the population of indicators, it should consider those example indicators that regulators in other jurisdictions and other organizations have concluded are drivers of audit quality. Examples of previously issued documents to consider include, but are not limited to, the United Kingdom's Financial Reporting Council's five potential key drivers of audit quality³; the International Auditing and Assurance Standards Board's (IAASB) publication *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*⁴; and the International Standard on Quality Control No. 1.⁵ In addition, we suggest that the PCAOB consider the concepts embodied in the CAQ Approach, in its further deliberation on the topic of AQIs.

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Recognizing the need for additional insight, we commend the PCAOB for planning to conduct additional stakeholder outreach by way of a public roundtable, in which we would be pleased to participate and share our experiences.

As discussed above, we believe that a contextual and voluntary discussion between the auditor and audit committee of those AQIs that are most highly correlated with high quality audits, while not distracting either constituent with indicators that are not essential for furthering the understanding of a particular audit

³ *Audit Quality – Practice aid for audit committees*, Financial Reporting Council, March 2015.

⁴ *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*, IAASB, February 18, 2014.

⁵ International Standard on Quality Control No. 1, *Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, IAASB, December 15, 2009.

engagement, will equip the audit committee with information to facilitate a discussion that could enhance audit quality.

We appreciate the Board's careful consideration of our comments, and, again, fully support the Board's efforts to improve audit quality. If you have any questions regarding our comments included in this letter, please do not hesitate to contact George Herrmann ((212) 909-5779 or gherrmann@kpmg.com) or Craig Crawford ((212) 909-5536 or ccrawford@kpmg.com).

Very truly yours,

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cc:

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