
CONCEPT RELEASE ON AUDIT QUALITY
INDICATORS

)
) PCAOB Release No. 2015-005
) July 1, 2015

)
) PCAOB Rulemaking
) Docket Matter No. 041

NOTICE OF ROUNDTABLE

Summary: The Public Company Accounting Oversight Board is issuing this concept release to seek public comment on the content and possible uses of a group of potential "audit quality indicators." The 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. Enhanced discussions, in turn, may strengthen audit planning, execution, and communication. Use of the indicators may also stimulate competition among audit firms focused on the quality of the firms' work and, thereby, increase audit quality overall. Issues raised by the release include: (i) the nature of the potential indicators, (ii) the usefulness of particular indicators described in the release, (iii) suggestions for other indicators, (iv) potential users of the indicators, and (v) an approach to implementation over time of an audit quality indicator project. The Board seeks advice on these subjects through the comment process and will also convene a public roundtable about the concept release, on a date to be determined during the fourth quarter of 2015. Additional details about the roundtable will be forthcoming.

Public

Comment: Interested persons may submit written comments to the Board at the following address: Office of the Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 041 in the subject or reference line. Comments should be received no later than 5:00 p.m., Eastern Standard Time, on September 29, 2015.

Board

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I. Introduction

The responsibilities of the Public Company Accounting Oversight Board (the "Board" or "PCAOB"), under the Sarbanes-Oxley Act of 2002, as amended ("Sarbanes-Oxley")¹ are all ultimately directed at improving audit quality and thereby benefiting investors. The Board's audit quality indicator ("AQI") project, identified as a priority beginning in 2013,² can be an important part of that effort. Its objectives are simply stated: to identify a portfolio of quantitative measures of public company auditing (called "indicators"), whose consistent use may enhance dialogue about and understanding of audits and ways to evaluate their quality; and to explore how and by whom the portfolio of indicators can best be used.³ Ultimately, this effort may produce higher quality audits.

This concept release describes and seeks comment on 28 potential indicators; suggestions for other indicators are specifically sought. The Board hopes ultimately to refine the list to a smaller number that is manageable and effective.

The 28 potential indicators fall into three groups. The first is "audit professionals," and includes measures dealing with the "availability," "competence," and "focus" of those performing the audit. The second is "audit process," and includes measures about an audit firm's "tone at the top and leadership," "incentives," "independence," attention to "infrastructure," and record of "monitoring and

¹ Pub. L. No. 107-204, 116 Stat. 745 (2002). In addition to the direct responsibilities given to the Board in Sarbanes-Oxley, the statute specifically authorizes the Board to act "to promote high professional standards among, and improve the quality of audit services offered by," accounting firms registered with the Board "in order to protect investors, or to further the public interest." Sarbanes-Oxley Section 101(c)(5) of the Sarbanes-Oxley Act, 15 U.S.C. 7211(c)(5).

² *See Public Company Accounting Oversight Board, Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors, 2012 – 2016* 5 (Nov. 2012).

³ The possible application of the indicators to brokers and dealers in securities that are not public companies but whose audits are within the jurisdiction of the Board is discussed below, at pages 29 and 31 (Question 39).

remediation." The third is "audit results," and includes "financial statements," "internal control," "going concern," "communications between auditors and audit committees," and "enforcement and litigation."

The individual indicators are intended to address different variables, but they grow out of a core insight: without a tool such as a portfolio of AQIs the nature of the audit, in which certain drivers of audit quality are less than transparent, makes assessing quality difficult. The indicators discussed in this release are quantitative and operate in an integrated manner along with contextual information for each audit or related comparison. They are not formulas and may have their greatest use as generators of questions for the auditor. Context – provided by each audit to which the indicators are applied and by the application of the indicators to the audit firm that conducts the audit (and perhaps other firms) – is essential to understanding their meaning and implications.

Identifying relevant indicators is only the first step in using them. The release discusses their potential availability and value to audit committees, audit firms, investors, and audit and other regulators. A number of issues are involved, including how to shape the indicators to maximize their value to users, how use of the indicators should be phased in, who should provide the information involved and who should receive it, whether and to what extent the information should be public, and whether any continuing AQI project should focus initially on only certain audits or audit firms.

The five parts of the concept release following this Introduction each focus on one or more of these issues. The release first explains the purpose of AQIs and the AQI project. Next, the discussion lists, and describes the design of, the 28 potential indicators. The release then turns to the best ways to move the AQI project forward and asks which potential users of AQIs could find the indicators most immediately useful. That discussion also explores how variations in the size of audit firms, or the size or nature of audited companies, might be handled. The following section briefly describes AQI outreach efforts in which Board staff has engaged, as well as contemporary efforts, here and abroad, to promote an understanding of the nature and use of AQIs and related data and the elements of audit quality. The release's final part is the detailed description, in Appendix A, of the potential indicators.

The promise of AQIs, in generating insights into the foundations of audit quality, both within and among audit firms, and in creating incentives for competition in quality, is considerable. Still, the Board recognizes that at this stage the AQI project poses many questions, from the appropriateness or operation of particular proposed indicators to the way the information they generate might be obtained and used. This concept release is intended to stimulate informed discussion and elicit detailed comments and suggestions from all interested parties about the answers to these questions. Particular questions of interest to the Board are noted in the release and in Appendix A.

II. The Purpose of Audit Quality Indicators and the AQI Project

Under Sarbanes-Oxley, the Board oversees the audits of both public companies and non-public brokers and dealers in securities.⁴ The AQI project focuses on the audits of public companies. An independent audit committee of the board of directors of each public company⁵ listed on a U.S. national securities exchange or association is responsible for the appointment, compensation, and oversight of the work of the auditor of that company's financial statements.⁶ The shareholders of most listed and non-listed public companies are asked to ratify the selection of their companies' respective auditors. And investors, in considering their companies' financial condition, look to the "preparation of informative, accurate, and independent audit reports."⁷ The goal of the AQI project is to improve the ability of persons to evaluate the quality of audits in which they are involved or on which they rely and to enhance discussions among interested parties; use of the indicators may also stimulate competition by audit firms based on quality. The indicators proposed in this release are not put forward to modify, or to suggest modification of, the objective of the audit of financial statements, or to impose new audit performance requirements.

The 2008 Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury (the "Treasury Advisory Committee," sometimes also called "ACAP") recommended that the Board, in consultation with other parties, "determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators."⁸ The discussion of

⁴ See Section 101 (a) of Sarbanes-Oxley, 15 U.S.C. 7211(a). See supra note 3.

⁵ In this release, the term "public company" is used in place of the more technical term "issuer," in section 2(a)(7) of Sarbanes-Oxley, 15 U.S.C. 7201(a)(7).

⁶ Audit committees of some registered investment companies have similar duties, and audit committees of both listed and non-listed companies have other responsibilities under Sarbanes-Oxley. See the discussion infra notes 11, 23, and 24.

⁷ Section 101(a) of Sarbanes-Oxley, supra note 4.

⁸ United States Department of the Treasury, Final Report of the Advisory Committee on the Auditing Profession, Chapter VIII, Recommendation 3 of Advisory Committee on the Auditing Profession, *Final Report to the Department of the Treasury*, (October 6, 2008), at VIII:14, available at <http://www.treasury.gov/about/organizational-structure/offices/documents/final-report.pdf>. The "other" parties with whom the Committee suggested the Board work included "auditors, investors, public companies, audit committees, boards of directors, and academics." Id. See the discussion at Part V of the concept release (Outreach; Other AQI Projects), infra at pages 31-34. The

that recommendation emphasized the gap such indicators could fill and the effect they could have:

A key issue in the public company audit market is what drives competition for audit clients and whether audit quality is the most significant driver. *Currently, there is minimal publicly available information regarding indicators of audit quality at individual accounting firms.* Consequently, it is difficult to determine whether audit committees, who ultimately select the auditor, and management are focused and *have the tools that are useful in assessing audit quality that would contribute to making the initial auditor selection and subsequent auditor retention evaluation processes more informed and meaningful.* (Emphasis supplied.)

The Committee believes that 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.⁹ (Emphasis supplied.)

The Co-Chairs' Statement at the beginning of the 2008 Final Report noted that the Treasury Advisory Committee's "Subcommittee on Concentration and Competition [which studied the AQI question] discussed enhancing audit quality as a key element in improving the viability and resilience of the auditing profession."¹⁰

The lack of information identified by the Treasury Advisory Committee arises from the inherent circumstances of auditing. Although a public company's audited financial statements and related auditor's report are themselves made public, and certain disclosures are now required by law to be made to the company's audit

Committee also recommended that the Board should monitor the indicators that it found to be feasible. Id. at 16-17.

⁹ Id., at VIII: 14-15. The Board held its first discussion of the feasibility of developing AQIs with its Standing Advisory Group in late October 2008, several weeks after release of the Treasury Advisory Committee Report. The project was deferred thereafter, and it was reopened by the Board in late 2012. See supra note 2.

¹⁰ Id. at II: 5. The Co-Chairs of the Treasury Advisory Committee were Arthur Levitt, Jr., Chairman of the United States Securities and Exchange Commission (the "Commission" or "SEC") from 1993-2001, and Donald T. Nicolaisen, the Commission's Chief Accountant from 2003-05 and a former senior partner of PricewaterhouseCoopers.

committee,¹¹ those items provide limited information on which to evaluate the quality of an audit and explain how auditing actually takes place. The manner in which the audit is conducted lies primarily under the surface, and the strengths and weaknesses of the process are opaque. The sole observable output of the audit is a standardized report that cannot be used to distinguish auditors from one another. Since this is so, it is difficult to evaluate the elements of audit quality (although Board members have learned that some audit committees are experimenting with various kinds of AQIs to inform discussions with their companies' auditors), or to understand how it might be strengthened; it is also hard to recognize and reward audit quality when it is present.

For these reasons, audits currently may fall within the class of what economists call "credence goods."¹² That is, the quality and impact of the auditor's services may be difficult or in some cases impossible to ascertain accurately. The auditor is usually in the best position to determine the scope of the service required; the client has limited ability to make a similar judgment, and the outcome of the service – the quality of the audit – is either unobservable or can only be observed at significant cost to the audited company or others.

As indicated above, the Board hopes through the AQI project to contribute to a clearer view of auditing by identifying key variables, in the form of indicators, that may reflect, and by doing so inform discussions about, audit quality, and then exploring how the data generated by the indicators can be used prudently and effectively. The indicators have been developed around three principles. The first is that, they should

¹¹ See, e.g. Section 10A(k) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. 78j-1k, and Rule 210.2-07 of Regulation S-X, 17 CFR. 210.2-07 which require the auditor to report to the audit committee (i) all critical accounting policies and practices to be used in the audit, (ii) all alternative treatments of financial information within General Accepted Accounting Principles ("GAAP") discussed with management, their ramifications, and the treatment preferred by the auditor, and (iii) other material written communications between the auditor and management, such as any management letter or schedule of unadjusted differences. See also Auditing Standard No. 16, *Communications with Audit Committees*, which requires the auditor to communicate to the audit committee, among other things, the following matters: (i) the overall audit strategy and timing of the audit, (ii) significant risks identified by the auditor, (iii) timely observations arising from the audit that are significant to the financial reporting process, (iv) critical accounting practices and policies, (v) critical accounting estimates, and (vi) qualitative aspects of the company's significant accounting policies and practices.

¹² Monika Causholli and W. Robert Knechel, *An Examination of the Credence Attributes of an Audit*, 26 Accounting Horizons 631(2012), available at <http://aaajournals.org/doi/abs/10.2308/acch-50265>.

be quantitative wherever possible, to add consistency of approach and objectivity to what would otherwise in most situations be only subjective judgments. The second is that they should generate data that enables users to pose critical questions. The third is that they should be used and function together as a "balanced portfolio" of audit quality. No single indicator is likely to be determinative; in application to actual audits (or to comparative analyses of, e.g., audit firm offices, industry audit practices, or even firms themselves), the indicators should work collectively, so that certain indicators can balance others to inform discussion.

The indicators are meant to be a tool. As such, they have inherent limitations that have to be recognized if they are to be effective. They are not algorithms, benchmarks, or safe harbors against enforcement or other claims, and they do not lead directly to formulas for determining the quality of a particular audit or whether an auditor has met its obligations. The reason AQIs cannot be used in any of these ways is that analysis of AQI data almost always requires a context. Their meaning in evaluating audit quality depends on the situation in which they arise. Reasonable explanations can exist for divergent numbers, and a variety of other factors may affect a particular audit; for example, the regulatory environment in which an audited company operates, or the way accounting standards affect a particular company, may become an important prism through which to view AQI data relating to a firm's audit. The quantitative character of the indicators does not exclude – in fact it can and often will require – qualitative analysis, and hence the judgment of the persons using the indicators, about context and the interaction of the indicators as a group. Moreover, not all of the factors that drive audit quality can easily be measured directly. For example, professional skepticism and due care are critical characteristics for auditors.

Placing AQI data in context can involve what might be called "comparability." An audit committee informed of the partner-manager-staff ratio for its upcoming audit might want to know, to obtain context, how the ratio compares with that for other audits by its auditor, and other auditors, and why there are similarities or differences. All audits, even of companies of ostensibly the same size, do not raise the same issues. The same need for context could arise in the case of engagement or retention decisions; an audit committee considering whether to retain an audit firm might want to know how its firm-wide indicators compare with those of firms of similar size and capacity. Without the answers to questions of this sort, with data from both engagement and firm levels based on consistent definitions of the indicators, the audit committee's ability to evaluate what it has been told may be limited. Again, however, the question is not simply whether numbers are comparable, but why (or why not), and at that point qualitative analysis can be helpful. And since AQIs are not benchmarks, even comparability of AQIs in two audits may not imply comparable audit quality.

Comparing AQIs from different audits or audit firms, for example in the context of discussions between an audit committee and an engagement team, depends on

understanding what makes two engagements comparable and which differences among firms or engagements matter. Can audits of companies in different industries be comparable? What about different methods of measurement? Firms may measure various audit activities in their own ways. They may even measure items differently in different segments of their practices. Understanding whether and when these differences are significant is one of the challenges of the AQI project.

The heart of the project, then, is learning what indicators can signal quality in the conduct of audits. If one can measure a number of elements of an audit, one may have a more informed basis for asking about, and understanding, how the audit firm approaches the audit, and similar public company audits, and the results of that approach.¹³ Even if one cannot tie indicators directly to specific results, it may still be possible to generate questions and trigger discussions that strengthen audit planning and execution, and, equally important, create an environment conducive to sustained audit quality and its recognition.

Finding the best ways to use firm-level data illustrates the sorts of inquiries the Board hopes the AQI project may stimulate. When looking to that data for context, is office, regional, industry, or firm-wide data the most likely to be useful? It is hard to answer that question in the abstract. Firm-wide data may be crucial for tone at the top or quality incentive questions, but analyses based on industry audits, or office or regional experience, may be critical to other discussions, especially if there have been quality questions about audits in the industry or geographic area in which a public company operates.

The indicators can also have two broader effects. First, comparative information about audit firms may over time help to drive a more vibrant "market in quality" for audit services and stimulate competition among audit firms on that basis and may counter pressures on audit firms to reduce audit effort or resources inappropriately; both consequences may enhance audit quality across the profession. Second, as the project evolves, the potential availability of AQI information may help investors become better able to evaluate the audit quality associated with particular financial statements, with a consequent effect on investment decisions.

The AQI project is closely related to two other Board projects studying the details of audit quality.¹⁴ These are the Division of Registration and Inspection's analysis of the

¹³ The Board's inspection program indicates that the quality of public company audits inspected remains uneven. Some engagement teams do an excellent job, while others are deficient in important respects.

¹⁴ As noted above, the efforts of the Board are all aimed, directly or indirectly, at audit quality. Audit regulators in other parts of the world are also part of a

"root causes" of audit successes and deficiencies, and the Office of the Chief Auditor's standard setting project updating the Board's quality-control standards.¹⁵ The root cause project is working closely with audit firms to identify factors that differentiate high quality from deficient audits and audit practices. It has informed the AQI project to date (so that there is a significant overlap in the areas on which the two projects focus), and it is likely that the root cause project will continue to surface prime candidates for AQIs in the future. The quality control project focuses, among other things, on the types of information, including AQIs, that an audit firm should incorporate in its audit practice, and then monitor, to allow it to flag and remediate problems before they result in audit deficiencies.¹⁶

Questions – Overview

Readers of the release are encouraged to answer any and all questions posed here and in later parts of the release in which they have an interest and to comment on any aspect of the release not covered by specific questions. They are especially encouraged to provide suggestions for alternative approaches in any relevant area.

Question 1. Is increasing knowledge about, and use of, the audit quality indicators discussed in this release likely to provide insights about how to evaluate, and ultimately improve, audit quality? If so, why? If not, why not?

Question 2. Are the AQI project, and some number of the 28 specific indicators described below, likely to build a strong knowledge base to enhance discussions of audits among those involved in the financial reporting process or other users of AQIs?

Question 3. Can the development of audit quality indicators, as described in this release, have unintended consequences, either positive

similar effort to enhance the strength and usefulness of the auditing of public companies.

¹⁵ All three of the initiatives are discussed in the Board's Strategic Plan for 2014-2018. See *Public Company Accounting Oversight Board, Strategic Plan: Improving the Quality of the Audit for the Protection and Benefit of Investors, 2014 – 2018* at 10-12, 15, 18 (Nov. 2014), <http://pcaobus.org/About/Ops/Documents/Strategic%20Plans/2014-2018.pdf>. See also, paper prepared for the Meeting of the Standing Advisory Group of the Public Company Accounting Oversight Board (June 24-25, 2014), http://pcaobus.org/News/Events/Documents/0624252014_SAG_Meeting/06242014_AQI.pdf.

¹⁶ See also the discussion *infra* at page 14.

or negative, for audit committees, audit firms, investors, or audit or other regulators? What are they? Can any negative consequences be alleviated? How?

Question 4. What is the nature of the context that those using AQIs as a basis for analysis and discussion will generally require to be able to benefit from that use? Is the information required to build that context available? Is access to the necessary contextual information feasible?

III. Potential Audit Quality Indicators

Audit quality can be viewed from several perspectives.¹⁷ One is an auditor's operating in full compliance with professional auditing standards and applicable law. A second is an auditor's meeting the needs of a public company's investors, and the

¹⁷ A classic academic definition speaks of "audit quality" as "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach." Linda E. DeAngelo, Auditor Size and Auditor Quality, 3 J. Acct. & Econ 183 (1981).

The U.S. Government Accountability Office ("GAO") (then named the General Accounting Office) provided a more detailed definition in a study of auditor rotation required by Sarbanes-Oxley, one that incorporated more directly the standards for the conduct of an audit in footnote 14:

[A quality audit is an audit conducted] in accordance with generally accepted auditing standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in conformity with GAAP and (2) are not materially misstated whether due to errors or fraud. This definition assumes that reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was conducted in accordance with GAAS and that, within the requirements of GAAS, the auditor appropriately detected and then dealt with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reasons for the resignation to the SEC.

GAO, Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO-04-216, note 14, at page 13 (November 2003), <http://www.gpo.gov/fdsys/pkg/GAOREPORTS-GAO-04-216/content-detail.html>.

marketplace, for independent, effective, and reliable audits of the company's financial statements, conducted by auditors who exercise due professional care, including professional skepticism; such audits, among other things, reduce the risk of material errors or accounting fraud and provide timely reporting of material weaknesses in the company's internal control over financial reporting ("internal control"), and of going concern issues. A third is facilitating, as part of the process, the timely and effective supply of information, most importantly to the company's audit committee and public investors. The end result should be robust audits that provide "reasonable assurance [that] the financial statements are free of material misstatement," and "present fairly, in all material respects, the financial position of the Company . . . in conformity with generally accepted accounting principles [or another applicable reporting framework]." ¹⁸ (In one sense, the higher the level of audit quality, the more certain users are that financial statements are free of material misstatements.)

These perspectives reflect the dual nature of the audit, as a process and a result, while confirming that the ultimate test is the strength of the result described in the preceding paragraph. More important, they suggest the need for a broad approach to identifying audit quality indicators, to reflect the different factors that can affect such quality.

The framework for analyzing audit quality, developed by the AQI project and discussed in this concept release, has three parts: (i) audit professionals, (ii) audit process, and (iii) audit results. As indicated above, the audit professionals portion of the framework includes indicators relating to auditors' availability, competence, and focus, with emphasis on the details of staffing and experience; audit process includes indicators relating to tone at the top and leadership, incentives, independence, infrastructure, and monitoring and remediation; and audit results includes indicators concerning financial statements, internal control, timely reporting of going concern issues, communications between auditors and audit committees, and enforcement and litigation. The framework focuses as much, if not more, on factors that have not heretofore been observable generally – those relating to audit professionals and process – as on those that have, relating to audit results.

¹⁸ See paragraphs .08 e. and h. of AU Section 508. The basic element of the report in paragraph .08 h is: "[a]n opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles." Of course, audits of public companies must be performed in accordance with the all applicable reporting and related professional practice standards, including the rules relating to evaluation of internal control on financial reporting.

Using this three part framework, the Board has identified 28 indicators as candidates to provide insight into audit quality, out of a total of about 70 possible indicators the project team reviewed.¹⁹ The framework and proposed indicators reflect the experience of the Board's Divisions (as noted above, the work of the Division of Registration and Inspections' root cause initiative has been especially important), but they are to some extent intuitive at this stage of the project. Thus, the "audit professionals" factors are generally consistent with those discussed by the Treasury Advisory Committee and others noted in section V, and the "audit process" factors reflect elements in both the Board's existing quality control standards and widely-used internal control frameworks. Criteria used to evaluate potential indicators (by a team of experienced auditors from the Board's Office of Research and Analysis, Division of Registration and Inspections, and Office of the Chief Auditor) included anticipated correlation to audit quality, potential usefulness, potential for unintended consequences, potential for becoming a "manage to measure" benchmark, scalability, quantifiability, availability of data, redundancy, potential to become a lagging indicator, anticipated precision of the signal the indicator would generate, and ability of the indicator to generate insight into possible root causes of audit strengths or weaknesses.

The AQI project is focusing on ways to evaluate the potential indicators in the future and compilation and evaluation of available data is ongoing. One goal of the concept release is to generate discussion and use of the indicators that can aid in that effort.

¹⁹ Of those, about 40 were presented to the Board's Standing Advisory Group in its May 2013 meeting, which included break-out sessions to discuss possible indicators; the Discussion Paper which included the 40 potential indicators can be found at http://pcaobus.org/News/Events/Pages/05152013_SAG.aspx. Many additional potential indicators came from the ensuing discussion.

The 28 potential indicators are:²⁰

AUDIT PROFESSIONALS	Availability	1. Staffing Leverage 2. Partner Workload 3. Manager and Staff Workload 4. Technical Accounting and Auditing Resources 5. Persons with Specialized Skill and Knowledge
	Competence	6. Experience of Audit Personnel 7. Industry Expertise of Audit Personnel 8. Turnover of Audit Personnel 9. Amount of Audit Work Centralized at Service Centers 10. Training Hours per Audit Professional
	Focus	11. Audit Hours and Risk Areas 12. Allocation of Audit Hours to Phases of the Audit
AUDIT PROCESS	Tone at the Top and Leadership	13. Results of Independent Survey of Firm Personnel
	Incentives	14. Quality Ratings and Compensation 15. Audit Fees, Effort, and Client Risk
	Independence	16. Compliance with Independence Requirements
	Infrastructure	17. Investment in Infrastructure Supporting Quality Auditing
	Monitoring and Remediation	18. Audit Firms' Internal Quality Review Results 19. PCAOB Inspection Results 20. Technical Competency Testing
AUDIT RESULTS	Financial Statements	21. Frequency and Impact of Financial Statement Restatements for Errors 22. Fraud and other Financial Reporting Misconduct 23. Inferring Audit Quality from Measures of Financial Reporting Quality
	Internal Control	24. Timely Reporting of Internal Control Weaknesses
	Going Concern	25. Timely Reporting of Going Concern Issues
	Communications between Auditors and Audit Committee	26. Results of Independent Surveys of Audit Committee Members
	Enforcement and Litigation	27. Trends in PCAOB and SEC Enforcement Proceedings 28. Trends in Private Litigation

Appendix A (which should be read together with this section of the release), describes the objective of each indicator, discusses briefly the reason for its inclusion, and contains possible calculations for the indicator at both the engagement and firm²¹ levels. In the case of one (indicator 7) calculation is suggested only at the engagement level because the scale of an audit firm practice could make generation of meaningful

²⁰ More detailed discussion of Audit Professionals, Process, and Results indicators, appears at pages A-2, A-12, and A-19, respectively, of Appendix A.

²¹ As discussed at several points in this release, the definition of "firm" level raises a number of its own issues.

data at the firm level difficult. In the case of three indicators (13, 14, and 26) calculation is suggested only at the firm level, to assure sufficient sample size and anonymity. Comment is sought below about ways to test the strength of the indicators as ways to evaluate, and their usefulness for informing discussions about, audit quality.

In presenting the indicators for comment, the Board's goal is to identify a manageable number of indicators that can help provide an effective practical picture of audit quality to inform discussions that may produce improvements in quality. Certain indicators on the current list may ultimately prove to be duplicative, and others may not generate sufficiently useful information; comments may suggest new indicators that should be added to the list. Again, the ability of the indicators identified to function as a balanced group is thought to be critical to their successful use.

The choice of indicators is not fixed. The effort is new, and by their very nature audit quality indicators must be capable of change over time to reflect advances in learning and changes in the way audits are conducted. In addition, subsequent events, for example restatements for errors affecting the public company using the indicators, can cause particular indicators to be re-evaluated. One of the purposes of the project is to assemble a sufficiently large collection of information about the indicators and subsequent events to refine the ideas the release puts forward. Additional experience, including that made possible by use of the first generation of AQIs, may suggest valuable new or substitute indicators, or broader approaches to measuring audit quality. In particular, analysis by the Board's Division of Registration and Inspections of data about individual audits, audit firms, and audit quality, especially the work of the Division's root cause analysis project, should become increasingly closely coordinated with the AQI project and may prove critical in evaluating particular AQIs.

Questions - Selection of Indicators (as listed above and described in Appendix A)

Question 5. Should any indicators be omitted from the list proposed in this release? Which indicators? Why?

Question 6. Should any indicators be added to the list? What are they? Why? How would they be quantified?

Question 7. Which indicators are likely to be the most useful in evaluating audit quality and informing discussions of audit quality? Why? The least useful? Why?

Question 8. Which indicators, including any mentioned in response to Questions 6 and 7, are in use today? How are they being used? Which ones are relatively more effective? Less effective?

Question 9. Definition of the Indicators.

- a) Are the indicators clearly defined?
- b) Which indicators would benefit from a clearer definition?
- c) Are the suggested methods for measuring each indicator clear?
- d) Are there other ways to measure particular indicators that would be more effective?
- e) While most indicators depend only on data from a firm's public company practice, some include information concerning workload from both public company and non-public company practice. Are there other indicators that would be more useful if they were extended to the breadth of an audit firm's practice?

Question 10. Do particular indicators risk becoming too complex in operation to reflect the reality of particular audit situations?

Question 11. Does the time lag between an audit year and the availability of information for many of the results indicators (e.g., whether a restatement has occurred) affect their value? How?

Question 12. Are there one or more indicators among the 28 that are superior to other indicators on the list and cover the same subject or subjects, so that one or more indicators are unnecessary for that reason? Please identify the redundant indicators and explain.

Question 13. Are data available for each of the indicators? To what extent, specifically, is the data already broken out in audit firms' operating systems?

Question 14. The indicators operate at the engagement level, the firm level, or in most cases both.

- a) How should "engagement level" be defined in the case of a global audit in which work is referred to one or more "other auditors" (whether or not the firm or firms involved are part of the engagement firm's global network)? Who should make that determination?
- b) Would one or more of the indicators be more useful if it also operated at an audit firm's "office" or "regional" levels, not merely at "engagement" and "firm-wide" levels (so that, e.g., the percentage of an office's work devoted to a single large client would be known)? Which indicator or indicators?
- c) Would one or more of the indicators be more useful if it also operated at the level of the audited company's industry or economic sector (so that, e.g., indicators for the audit of a particular bank could be compared with the average of indicators for all of an audit firm's banking clients)?

Question 15. What are the elements of "context" required for successful analysis of the 28 potential AQIs? Are those elements ordinarily available to AQI users? If not, is it feasible to make the elements of context available?

Question 16. Comparability.

- a) How important is comparability to the value of AQIs?
- b) What are the most important elements of comparability in the analysis of AQIs?
- c) Is comparability more likely to be fostered by firm-wide data (either within or among firms) or data focused on industry, regional, or office practices?
- d) Does the existence of differences among firms in the way certain matters (e.g., classification of personnel) are measured affect the value of AQIs if those differences are disclosed? If they are not disclosed?

Question 17. How should audits of different size and complexity be weighted in the calculation, analysis, and discussion of firm-level data?

Question 18. What are the costs and obstacles to audit firms of compiling the relevant data? Can data be created at reasonable cost for any indicator for which they are not now available? If not, is there another indicator of comparable scope, either among the 28 or otherwise, for which it would be less costly to obtain the necessary data?

Question 19. In what situations could generation of AQI data impose collection or evaluation costs (whether involving specific indicators or the use of AQIs generally) without commensurate benefits? Could those costs be reduced? How?

Question 20. Could the collection and evaluation costs of AQIs be a greater economic burden for smaller audit firms than larger audit firms? Could this burden disadvantage smaller firms in competing for audit business if perceptions of quality are driven by the indicators?

Question 21. In what ways should the various indicators be evaluated or field-tested?

IV. Use and Availability of Audit Quality Indicators

Identifying promising indicators is only the first step. For AQIs to help turn a clearer view of audits into increases in audit quality, people who influence audit quality must use them in their decision-making.

An AQI project can take different shapes for the future, depending on choices among a number of variables. These include (i) the potential users involved, (ii) the options for obtaining and distributing the relevant data, (iii) potential approaches to phasing in AQIs (so that, for example, not all data would be available immediately), and (iv) exclusion of certain audit firms or types of audits from the effort, at least initially, if relevant indicators are not adequately scalable. Again, choices in any of these areas could naturally change with experience.

A. Users of AQIs: The Board believes that the potential primary users and range of uses of AQIs can be summarized as follows:

Potential AQI User	Potential Use (Decisions AQIs Can Influence)
Audit Committees	<ul style="list-style-type: none"> Assess reporting risk and audit quality Retain and compensate auditors Oversee auditors
Audit Firms	<ul style="list-style-type: none"> Assess and manage risk Improve quality control efforts and, ultimately, audit quality Identify root causes of audit deficiencies and remediate weaknesses
Investors ²²	<ul style="list-style-type: none"> Assess reporting risk Vote shares
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

Other users of AQIs could include company management, the business press, academics, and the general public. As noted above, the indicators are intended to function as a balanced portfolio, and the initial assumption is that the portfolio would be the same for all users. (Experience and research, however, may indicate the benefits of modifying the group for situations where scalability or the nature of particular audits is a consideration.) Different classes of users could receive different levels of disclosure of AQI data.

Audit Committees. Independent audit committees of the boards of directors of listed companies are directly responsible by statute or regulation for the appointment, level of compensation, and oversight of their companies' auditors (including resolution of disputes between the auditors and management concerning financial reporting), and those auditors report directly to the audit committee.²³ Audit committees for all (listed or

²² Investors could only use AQI information if, when, and to the extent that information is made publicly available. See the discussion infra at page 27. But of course use of AQI data by audit committees to produce higher quality audits can benefit the investors in the companies involved.

²³ See Section 10A(m) of the Exchange Act and Exchange Act Rule 10A-3(b). Foreign private issuers are exempt from these requirements if their home country law requires their having an independent "board of auditors," with roughly similar authority, and some other listed companies – primarily passive investment vehicles, are also exempt. See 17 CFR 240.10A-3(c)(6). Rule 32a-4 under the Investment Company

not) public companies must be given reports of critical matters related to the audit and are responsible for preapproving provision of auditing and permissible non-audit services by the auditor to the company.²⁴ AQIs may give the audit committees of both listed and other public companies additional relevant data to explore these matters and enhance dialogue with their auditors.

Based on discussion with a number of their members, it appears that at least some audit committees are beginning to consider the idea of AQIs and have started to question and track their company's auditors using ideas like those outlined in this release. A more systematic approach to the definition and aggregation of AQI data could help audit committees take these steps, especially producing enhanced dialogue with their companies' auditors. But even if audit committees obtain information from their audit firms about their own company's audits, they may lack comparative data (derived from other audit operations of the firm, let alone from those of other firms) to place that information in the context necessary to give it the greatest clarity. For example, an audit committee might inquire about the staffing ratio (the ratio of experienced senior personnel to all members of the engagement team) for its audit. The average staffing ratio for all audits the firm performs and all audits the firm performs in the company's industry, as well as comparable figures for audits by other firms (when and if such data is available), might all provide necessary context to indicate what the data means when an audit committee evaluates its audit engagement team or audit firm. Finally, without a more systematic approach, audit committees may have no assurance about the data's significance or the extent to which data from different audits are derived from standard definitions and calculations.

An audit committee would likely focus first on AQI data at the engagement level for the audit the committee oversees. The indicators are intended to provide information to help frame the oversight and evaluation of a current or pending audit.²⁵ Even without a broader set of data, information about an engagement team or its deployment may highlight issues that, if addressed, could increase audit quality.

Act of 1940, 17 CFR 270.32a-4, requires oversight of the audit (but not selection of the auditor) of registered management investment companies by an independent audit committee of the board, but only if the company wishes to eliminate the need for a shareholder vote on ratification of auditor selection. Governance is largely the province of state or non-United States law for the remaining groups of public companies.

²⁴ See Section 10A(h)-(k) of the Exchange Act, Regulation S-X Rule 2-01(c)(7) and Auditing Standard No. 16, supra note 11.

²⁵ An exception would be a committee's review of tenders for new audit engagements, when the audit committee would likely focus on firm-level data from tendering audit firms (and potential competitors), to compare with firm- and engagement-level data relating to prior audits.

Questions arise, however, about how to assemble data for an audit involving more than one auditor.²⁶ Audits of global companies, for example, require participation of auditors from multiple firms that may or may not be part of an affiliated network. Providing AQI data for each firm could provide the most insight if audit quality differed widely from firm to firm. But AQIs for the portion of an audit performed by separate firms might be difficult to compile and might distort the picture of the audit as a whole. Understanding and resolving these issues are challenges of the project going forward.

An audit committee would more than likely then turn to information about the audit firm that performs (or is proposing to perform) the audit in question. The audit committee retains a firm, and it seeks to associate its company with a reputable organization that can provide the market with a basis for confidence in the quality of a company's financial reporting. Moreover, the audit firm's overall commitment to quality can shape the engagement team, which does not operate in isolation; tone at the top, the incentive system, recruiting, retention, training, technology, tools, and knowledge bases all affect the strength of the engagement team's work. The culture of the audit firm, and not just the engagement team, is likely to influence audit performance. Given these realities, the audit committee may have questions about how its engagement compares with engagements conducted by its audit firm for similar companies. AQIs related to the firm are likely to provide context for audit committees to evaluate engagement level AQIs, and ask questions about them, far more effectively than would otherwise be possible.

For the same reason, audit committees may find it helpful to compare AQI data across firms (if the latter data are available). Quality is a relative concept, and differences among firms may be instructive, when context and the details of AQI data are taken into account. The availability of firm-level data, in context, may also help answer the question posed by the Treasury Advisory Committee about the drivers of competition among, and levels of quality at, different audit firms, so that AQI data, properly used and understood, may help spark, and sustain, competition based on audit quality and its improvement generally.

Finally, it may be useful to compare engagement AQIs to AQIs for other audits in the same industry, especially if the audit requires specialized skills. For example, audits of companies in the financial services or telecommunications sectors may require auditors with advanced training and an engagement team with a disproportionate number of experienced personnel. An audit committee may also be especially interested in other audits by engagement teams from the same office or region as the engagement team the audit committee is supervising.

²⁶

See supra Question 14 a).

An audit firm's candid discussion of its AQIs with an audit committee, like its discussion of its external and internal inspection results if that already occurs,²⁷ may add value not only in relation to the committee's oversight and evaluation of a particular audit, but also in relation to the committee's oversight of the financial reporting process more generally. For audit committees that work with auditors who have a strong record of performance, AQIs may offer comforting and confirming evidence of quality. In other cases, the information may present insights (perhaps even troubling ones) that allow audit committees to encourage improvement or seek stronger auditing from others. Audit firms that provide information about the results of a PCAOB inspection coupled with results of the firm's own internal quality reviews may help an audit committee understand how the firm performed on specific audits and in high-risk areas across audits; that information may in turn help the committee to ask more detailed questions than would otherwise be possible about specific substantive audit issues, quality control, and remediation. While AQIs are no substitute for the communications about audit strategy, risks, and other matters required by Auditing Standard No. 16, "Communications with Audit Committees,"²⁸ the information the former contain may complement those communications.

The Board recognizes that ultimately each audit committee will have to judge for itself whether and how it wishes to use AQIs in its decision-making. The majority of audit committee members to whom members of the AQI project team have spoken in developing the project have expressed support. The Center for Audit Quality (the "CAQ"), whose own AQI proposals are discussed below,²⁹ sees audit committees as the logical recipients of the audit quality data they propose, and the Council of Institutional Investors' list of factors audit committees should consider in determining whether to continue the retention of an outside auditor contains several factors that resemble AQIs.³⁰ Other audit committee members, however, question whether AQIs

²⁷ See *Information for Audit Committees about the PCAOB Inspection Process*, PCAOB Release 2012-003 (August 1, 2012).

²⁸ Auditing Standard No. 16, *supra* note 11. The Standard is effective for audits of fiscal years beginning on or after Dec. 15, 2012. The release that accompanied approval of AS 16 by the Board states that "Auditing Standard No. 16 does not preclude the auditor from providing additional information to the audit committee. Nor does the standard preclude the auditor from responding to audit committee requests for additional information from the auditor." See PCAOB Release No. 2012-004.

²⁹ See the discussion *infra* at page 34.

³⁰ See Council of Institutional Investors, Policies on Corporate Governance section 2.13, available at http://www.cii.org/corp_gov_policies#2.13a.

can provide useful insights in light of the information already available from existing or prospective auditors, the difficulty of tailoring AQIs to a company's unique circumstances, and the possibility that AQIs could disrupt the standards and expectations that audit committees must meet. Some have also noted that audit committees' time is already taken up with a wide range of duties and that devoting the time to use AQIs well could have the unintended consequence of spreading audit committees' attention too thin. The Board specifically seeks comment on whether and how audit committees can most directly benefit from audit quality indicators.

Audit Firms. Firms have long used some AQI-like measures to manage their audit practices. They may use them to measure efficiency and profitability, to flag audits or offices with a higher risk of audit failure,³¹ or to make compensation decisions. In addition, some firms are re-thinking how such measures may help them to understand and respond to internal and PCAOB inspection findings, identify the root causes of the deficiencies involved, and remediate those deficiencies, upgrading management processes as a consequence. AQIs may provide useful perspectives in all of these areas.

Audit firms may be in a unique position to make use of AQI data because of their ability to correlate the information across many audit engagements to strengthen quality control and risk management. Discussion with audit committees could broaden the base of comparison for firms and encourage them to invest in AQI measurement. Possible dissemination of AQIs from other firms might surface insights that a single firm was not in a position to identify itself.

Thus, AQIs, applied carefully and thoughtfully, may become an important tool for audit firms, not only in improving the strength of their audits but in allowing them to distinguish themselves for audit quality and compete on that basis in the marketplace. The Board hopes that firms' comments on the release will discuss their experiences in analyzing audit quality, and that will continue to share those experiences with the AQI project team as the AQI effort continues to take shape.

Investors. Investors are the primary beneficiaries of the financial reporting process and the group at which audit quality is ultimately aimed. They elect the directors of the company in which they invest. In addition, a large majority of public companies request a shareholder vote to ratify the choice of auditor.³²

³¹ Firms may subject those audits to special procedures or to internal inspection.

³² Data obtained from Audit Analytics indicates that 90 percent of the public companies on the Russell 3,000 list as of April 2014 submitted at least one auditor ratification proposal to shareholders between 2011-13. In its 2008 Report, the Treasury

At present, the visibility of the sources of audit quality to investors is even more limited than it is to audit committees. Investors have no direct channel to the auditor; communication is typically restricted to the standard auditor's report about a company's financial statements and internal control over financial reporting.³³

The result is that investor impressions of audit quality come largely from the frequency and magnitude of negative events, such as restatements for errors or fraud, related to public company financial reporting, material failures of internal control over financial reporting, or, on the positive side, the absence of these events. Such events can certainly be significant and indicate lapses in audit quality – or worse. But they generally occur in a vacuum, without context. So they do not often help investors focus on the components of the audit process and, more important, provide little information *about how quality audits are planned and executed*. Over the past decade, the PCAOB public inspection reports have been available to help inform investors' impressions of audit quality, but by design these reports discuss particular audit deficiencies, rather than the broader elements that can make for quality, and then on an anonymous basis. Moreover, the reports are not necessarily representative of a firm's overall practice, because inspections are risk-based and, in the case of the largest audit firms, involve only a small portion of the firm's public company practice.

Advisory Committee noted that "[a]lthough not statutorily required, the majority of public companies in the United States—nearly 95% of S&P 500 and 70%-80% of smaller companies—put auditor ratification to an annual shareholder vote." Report of the Treasury Advisory Committee, supra note 8, at VIII: 20.

³³ To address this circumstance, the Board has proposed changes to its auditing standards and rules that can provide new information to shareholders about the most critical issues addressed by the auditor, the auditor's evaluation of "other information" in the document containing the financial statements, and the identity of the engagement partner and certain other participants in the audit. That information would be largely explanatory but can also help investors and others better evaluate audit quality across engagements. See (i) *Proposed Auditing Standards – the Auditor's Report of an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*, PCAOB Release 2013-005 (August 13, 2013), and (ii) *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit*, PCAOB Release No. 2013-009 (December 4, 2013); *Supplemental Request for Comment: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form*, PCAOB Release No. 2015-004 (June 30, 2015).

Data from a portfolio of properly chosen AQIs might refocus investors' attention on the broader elements of audit strength or weakness and the characteristics of quality audits. It could alert investors to audit quality at a particular engagement, or even a particular firm, provide them with context to understand what constitutes high-quality audits, and enable researchers or analysts to provide investors with further insights into audit quality at the engagement or firm levels. It could also inform investors voting to ratify an audit committee's choice of auditor. By having these effects, AQIs could, again, ultimately increase pressure for differentiation in the audit market in terms of quality and hence drive overall enhancements in quality.

If and when AQI data were to be made publicly available (an issue discussed below),³⁴ investors would likely focus first on engagement level AQI information about particular companies in which they invest or might invest. They might also benefit from firm-level data (whether reflecting industry, office, regional, or firm-wide data) for the reasons discussed above in connection with usage of AQIs by audit committees, namely comparison and context. Investors might receive AQI data from several sources over time, including audit committee reports or documents published by audit firms or the Board.

The ability to better distinguish variations in measures that relate to quality may produce greater market differentiation among audits and stimulate competition in quality that may also have an effect on securities prices. This in turn could generally help investors given the public goods nature of securities prices.

A presentation by the Board's Investor Advisory Group Working Group³⁵ on Audit Quality Indicators at the Advisory Group's October 16, 2013 meeting emphasized that AQIs should "measure the quality of the actual audit," "help establish accountability for audit quality," operate in a "forward-looking" way, and contain "information or predictive content." The Working Group sought measures "that provide investors with timely information with respect to the credibility of audits." Seventeen of the Working Group's 27 proposed indicators are reflected in the 28 potential indicators in this release, and several others are the subject of questions on the indicators. The Board encourages comments that discuss these issues in detail.

The Board. The Board's inspections staff already receives certain data that resemble AQI data, and it has used AQI-like measurements in its work, primarily to flag firms, offices, and audit engagements that are at a relatively higher risk of audit deficiencies. Expanded AQI data, within the context discussed in this concept release,

³⁴ See the discussion infra at page 27.

³⁵ See infra note 41. The Investor Advisory Group is a forum for the investor community to provide its views and advice on matters affecting investors and the work of the Board.

can assist the Board in several ways. First, the data can inform the development of inspection strategies. Second, the data can provide the Board with insights into trends in overall audit quality at the firm, network, or profession levels. Third, it can broaden the foundation for the Board's consideration of policy issues. Finally, as noted above, expanded use and analysis of AQIs could inform analysis of the root causes of inspection findings, evaluation of firms' remediation efforts, and the effort to update auditing standards, including those related to audit firm quality control.

B. Obtaining and Distributing AQI Data

The AQI information envisioned by this release comes most importantly from audit firms. The data for 19 of the 28 potential indicators can be obtained only from the firms (or, in one case, from an independent survey of firm personnel); the data for eight of the nine remaining indicators (the "audit results" indicators, indicators 21-28) can be derived from public sources, while the remaining potential indicator is a possible survey of audit committee members. Information about background and context must also generally come from the firms, who are in the best position to provide it for firm and client industry indicators and for indicators relating to particular engagements. (As experience with AQIs grows, third parties, including academic researchers, may assume a role of assembling, analyzing and providing perspective for AQI information that is public, as is already done for, e.g., financial statement restatements for errors. The Board and other regulators could also analyze the indicators and provide context, subject to applicable disclosure limitations.)

Others could be involved in distributing AQI data, even if firms are the source of that data and much of the accompanying context. Data aggregators might collect and publish AQIs derived from public information. Companies or audit committees could include engagement-level AQIs (and perhaps firm-level AQIs, for context) in their financial filings or audit committee reports to shareholders, as some do now to a limited extent.

The Board could take one or more of several approaches to assisting in the distribution of the data. For example, as and when appropriate as the AQI project matures, it could (i) encourage firms and engagement teams voluntarily to discuss AQI engagement- or firm-level data with audit committees, or to do so publicly, (ii) require audit teams to provide that data to audit committees, (iii) collect and make "combined" AQI data public over time, as a single set of weighted figures for comparable firms, (iv) collate and make public on a firm-by-firm basis AQIs derived from public sources, and (v) consider requiring reporting of the necessary data to the Board so that the Board could make it public, or even require firms to do so directly. (Of course, the strength of any approach, at the stage of the project involved, as well as any legal or other issues, would have to be examined at the time.)

The timing of distribution of AQI data likely depends on, among other things, the user involved, the company's complexity, and the timing of the audit cycle. It is possible that the data could come to be included as a supplement to required communications at the beginning of the audit cycle.³⁶ Audit committees may, however, also benefit from an update following completion of planning and preliminary audit work and before the start of final audit procedures. If engagement-level information were made available to shareholders, directly or indirectly, disclosures might be made most effectively before each year's requested shareholder vote to ratify the appointment of the auditor. Audit firm-level AQIs might be made available to shareholders annually, for example, through an annual report on audit quality released by firms for this purpose. Firms themselves would also receive data about other firms when the latter made the data publicly available, again, assuming that such a level of disclosure becomes part of the project.

C. Implementation over Time

Of course, there is no need to adopt all of these approaches, and certainly no need to adopt them simultaneously. Many projects are implemented in a series of planned steps or phases rather than all at once. The advantages of a phase-in include flexibility to alter the project as initial experience is evaluated and ability to build support among the parties affected, if they perceive tangible benefits from each step along the way. (On the other hand, a phased approach may delay the ultimate benefits of the project and may make it more difficult to implement the project's later stages.)

The manner of phasing in an AQI project would depend on the project's details. For example, the project could initially involve the Board's support of voluntary use of AQIs, by engagement teams, audit committees, and audit firms. A voluntary approach could give audit committees and auditors time to become comfortable with the indicators and gain experience in using them to aid in decision-making. It would also provide time for study of the indicators and their effectiveness. After a period of learning and demonstrated benefits, the project could expand to include required disclosure of AQIs to audit committees, public disclosure of AQI data, or both.

A phased approach might ultimately produce a solidly grounded result. Again, variations are possible. To maximize voluntary use, the Board could specify the most promising AQIs and provide standardized definitions and guidelines that would promote comparable data. The project could even begin with a relatively small number of indicators and expand the list for discussion over time, or consider pilot projects to permit testing and evaluation of the indicators involved.

³⁶ The CAQ suggests this approach in its paper on audit quality indicators. See *Center for Audit Quality, CAQ Approach to Audit Quality Indicators* (2014) at 6, available at <http://www.thecaq.org/docs/reports-and-publications/caq-approach-to-audit-quality-indicators-april-2014.pdf?sfvrsn=2>.

One benefit of a phase-in would be to provide a basis for understanding more fully the implications of making AQI information public. Firms are of course free to do so now, and some are beginning to make some similar information public, as discussed below. Other firms may do the same, providing context for audit committees and beginning to do so for investors. But a general requirement that results in AQI data becoming public, because of its very nature, would have to follow testing, and evaluating, the use of AQIs and weighing the benefits and costs of public dissemination. No decision has been made about this subject, but phasing in the use of AQIs may produce the experience and information that can produce a basis for such a decision in the future.

However the issues involved in moving an AQI project forward are ultimately resolved, the Board will have the responsibility, as the Treasury Advisory Committee intended, to monitor the terms and performance of any AQI project.

D. Possible Exclusion of Certain Audit Firms or Certain Audits

The optimal scope for an AQI project is also an important issue; its consideration raises three broad questions. The first is whether the project should extend to all, or only some, registered accounting firms. The Treasury Advisory Committee suggested that one of the uses of AQIs could be to "enhance . . . the ability of smaller auditing firms to compete with larger auditing firms . . ." ³⁷ But evaluations of AQI data likely need to consider differences in results in relatively larger and smaller firms, respectively, and the ramifications of those differences.

Issues of scalability such as these are complex. The Board may need to consider whether the management of a smaller firm is sufficiently different than the management of a large firm that some AQI's are not as relevant for one type of firm as the other, and how to create meaningful measures of quality for firms of significantly different sizes. The Board could decide, for example, to focus the AQI project initially on the largest audit firms, who audit the financial statements and internal control over financial reporting of most of the nation's public companies (in terms of market capitalization). This approach will provide more time to study scaling of the indicators, but it may also limit the benefits for the excluded firms and their public company clients and encourage the market to differentiate between firms solely by size (because AQIs begin to apply to larger firms first) rather than audit quality.

The second question of scope facing the Board is which public company audits should be reflected in indicator data. As discussed above, only listed companies are required to vest auditor selection, compensation, and oversight in independent audit

³⁷ United States Department of the Treasury, Advisory Committee on the Auditing Profession Final Report, supra note 8.

committees; many registered management investment companies operate in a similar fashion under the Investment Company Act of 1940.³⁸ Equally important, at all public companies the audit committee (or if there is none the board of directors) must preapprove any auditing or non-audit service performed by the company's auditor. The fact that AQIs may potentially be of use to any public company directors with governance responsibilities, their shareholders, and their auditors, is a consideration in answering this question.

A third, related, question is whether to exclude from the AQI project audits in certain industries where the nature, timing, and extent of audit work can differ from the norm and differ equally widely within the particular group of audits involved. For example, audits of employee benefit plans and registered investment companies are likely to prove very different from the audits of global manufacturing companies. Are the differences enough to render application of AQIs to the former audits irrelevant, or make the comparison of AQIs in these situations misleading, or can problems be addressed by comparing AQIs for one engagement against AQIs for other engagements in similar industries or entities? Conversely, would excluding certain types of audits distort the results of firm-wide public company audit comparisons, or suggest that only industry-based comparisons are valid? (Brokers and dealers in securities pose their own issues, because few, if any, are free-standing public companies; many are small, and audit requirements for those companies focus both on financial reporting to the Commission and compliance with critical customer protection rules.)

Again, the Board could decide to exclude audits in certain industries from the AQI project. But an exclusion may limit the benefits of AQIs and perhaps signal, incorrectly, that audits in certain industries are less important than audits in other industries. As an alternative, the project could initially apply to certain firms or to certain types of audits, with the Board making clear its intention to expand the number of firms or audits to which AQIs apply, over time. Finally, the Board could undertake special AQI efforts aimed at entities with special characteristics, including brokers and dealers in securities.³⁹

³⁸ See discussion supra at note 23. Registered management investment companies are required to select their auditor by a vote, cast in person, of a majority of the disinterested members of the board of directors. See section 32(a)(1) of the Investment Company Act of 1940.

³⁹ As of May 24, 2014 (according to Commission data), 377 of the 4,007 brokers and dealers that filed audited financial statements with the Commission were subsidiaries of public companies of various sizes, but the remaining 3,630 were privately-owned companies, many of which were small. The Board is not aware of information indicating that any of the brokers or dealers were free-standing public companies.

Questions – Use of Audit Quality Indicators

Question 22. For what class or classes of users would AQIs be most valuable? Would some AQIs be more valuable than others to various classes of users?

Question 23. Are there one or more groups, in addition to audit committees, investors, audit firms, and the Board and other regulators, that the Board should consider to be primary users of audit quality indicators? If so, what are they? Does their need for the indicators, in each case, differ from those of other primary users?

Question 24. Does the discussion of the uses of the indicators identify all likely uses? If not, what other uses should be considered?

Question 25. How important to the usefulness of the indicators by audit committees and other users is AQI engagement-level data? AQI firm-level data for the audit engagement firm?

Question 26. To what extent do audit committees already receive AQI-like information from their audit firms? What are the most significant gaps in the information they receive compared to the information that could be contained in the potential AQIs?

Question 27. To what extent would engagement-level AQIs be useful to investors? AQI firm-level data for the engagement firm? What AQIs would be most useful? Why?

Question 28. Should engagement level AQI data be made public in whole or part? Should firm level AQI data be made public in whole or part?

Question 29. How important to the usefulness of the indicators by, audit committees, audit firms, investors the Board and other regulators, and others is the public availability of firm-wide AQI data for the audit firm that performs a particular engagement? How important is the public availability of AQI data for other audit firms of comparable size?

Question 30. To what extent would firm-level data be more useful, for all or some indicators, if it were broken out in industry categories?

Question 31. Would it be useful to phase in any ongoing AQI project? For example, should the project be voluntary for at least some period? If phasing is a good idea, what steps should the phasing involve? How should any phasing of the project be monitored?

Question 32. How should AQI data be made available, either during a phase-in or ultimately? Which of these approaches is preferable?

- a) By audit firms voluntarily to audit committees, at the engagement level, the firm level, or both?
- b) By audit firms voluntarily to the public, at the engagement level, the firm level, or both?
- c) By audit firms on a required basis to audit committees, at the engagement level, the firm level, or both?
- d) By audit firms on a required basis to the public (whether directly or through the Board), at the engagement level, the firm level, or both? Would disclosure by audit firms directly or by the Board be preferable?

Question 33. Should the Board consider steps to require audit firms to make engagement- and firm-level AQI data available to audit committees? To investors?

Question 34. Should distinctions be made, in the timing or nature of AQIs, among the audit firms that audit more than 100 public companies?⁴⁰ What potential distinctions would be most useful?

Question 35. Should smaller audit firms be treated differently than large ones in designing an AQI project? What would small mean for this purpose? Having less than a certain number of auditors? Auditing 100 or fewer public companies per year and not being part of a global network of firms?

Question 36. Should the size of the audited company set a limit on initial application of an AQI project? What would an appropriate size be? Should the fact that a public company is not a listed company affect the way AQIs apply to it?

⁴⁰ For 2014, nine U.S.-based firms audited more than 100 public companies: BDO USA, LLP, Crowe Horwath LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, MaloneBailey, LLP, McGladrey LLP, and PricewaterhouseCoopers LLP. See <http://pcaobus.org/Inspections/Pages/default.aspx>. Sarbanes-Oxley requires the Board to inspect annually "each registered public accounting firm that regularly provides audit reports for more than 100 issuers [*i.e.*, public companies]. See Section 104(b)(1)(A) of Sarbanes-Oxley.

Question 37. How should the nature of the industry affect the design of an AQI project? For example, is the nature of audits of investment companies or employee benefit plans sufficiently different than that of other public companies that the former require their own set of AQIs?

Question 38. Would excluding certain types of audits from an AQI project distort the results of firm-wide public company audit comparisons, or suggest that only industry-based comparisons are valid?

Question 39. Should an AQI project apply to brokers and dealers in securities?

- a) Should the project apply to carrying brokers, introducing brokers, or both? Should it apply differently to broker-dealers that are subsidiaries of public companies than to broker-dealers that are privately-owned?
- b) What indicators would be most appropriate? Would indicators aimed at the special regulatory requirements for broker-dealer reporting be advisable?
- c) Who would the users of the information be?
- d) Do the variations within the audited population make comparability of information difficult?

V. Outreach; Other AQI Projects

In formulating the ideas reflected in this release, the Board and staff have engaged in a broad project of outreach, speaking with representatives of a number of interested parties, as the Treasury Advisory Committee suggested. They have met several times with the Board's Standing Advisory and Investor Advisory Groups;⁴¹ the first of those meetings involved an extensive review of potential AQIs that helped guide

⁴¹ The staff made formal presentations to meetings of the Standing Advisory Group on May 15-16 2013, that included break-out sessions to discuss possible indicators (available at http://pcaobus.org/News/Events/Pages/05152013_SAG.aspx), November 14, 2013 (available at http://pcaobus.org/News/Events/Pages/11132013_SAG.aspx), and June 24-25, 2014 that included a presentation on "Initiatives to Improve Audit Quality – Root Cause Analysis, AQIs, and Quality Control Standards" (available at http://pcaobus.org/News/Events/Pages/05282014_SAG.aspx). The staff attended and participated in a discussion that included a presentation by the Investor Advisory Group's Working Group on Audit Quality Indicators on October 16, 2013 (available at http://pcaobus.org/News/Events/Pages/10162013_IAGMeeting.aspx).

development of this release. Equally important, the project has been discussed with a wide range of parties who reflect the classes of users outlined above. These include the Commission staff and federal banking regulators, the National Association of Corporate Directors (and smaller groups of audit committee members), the CAQ and individual audit firms, and Financial Executives International. Presentations have been made at various professional conferences, including ones sponsored by the American Institute of Certified Public Accountants and by the American Accounting Association, as well as at the PCAOB's own Academic Conference. Board staff have met as well with representatives of the U.K.'s Financial Reporting Council (the "FRC"), and the Canadian Public Accountability Board. Finally, the Board and staff coordinated and led discussions on audit quality indicators at the April 2014 plenary meeting of the International Forum of Independent Audit Regulators ("IFIAR"). Discussion of AQIs during that meeting indicated that a number of audit regulators around the world were using AQI-like ideas to plan and evaluate their inspections. Attention was again devoted to the subject at the 2015 plenary meeting of IFIAR, which indicated that interest in AQIs had continued to grow; a month earlier there had been extensive discussion of AQIs at the IFIAR 9th Inspection Workshop in London.

The Board has also reviewed contemporaneous efforts to raise audit quality by increasing audit transparency. In 2008 and 2009, the U.K.'s FRC, and the International Auditing and Assurance Standards Board (the "IAASB"), began their own efforts to understand and describe audit quality indicators. The FRC issued a February 2008 "audit quality framework (emphasizing firm culture, auditor skills and personal qualities, and the strength of the audit process)," in the hope of "support[ing] effective communication between auditors, audit committees, preparers, investors, and other stakeholders on audit quality."⁴² The IAASB issued "A Framework for Audit Quality – Key Elements that Create an Environment for Audit Quality," on February 18, 2014. That document lists factors that can contribute to audit quality at the engagement, firm, and national levels for financial statement audits; a number of the factors are reflected in the AQIs discussed in this release, and the IAASB framework is based on an "input, process, and output" model similar to the potential AQI framework discussed in this release. But the IAASB framework does not attempt to create a system for quantifying particular elements of audit quality.⁴³

⁴² Financial Reporting Council, The Audit Quality Framework (2008) 1, available at [https://www.frc.org.uk/Our-Work/Publications/FRC-Board/The-Audit-Quality-Framework-\(1\).aspx](https://www.frc.org.uk/Our-Work/Publications/FRC-Board/The-Audit-Quality-Framework-(1).aspx).

⁴³ International Auditing and Assurance Standards Board, A Framework for Audit Quality, Key Elements That Create An Environment For Audit Quality (2014), available at <http://www.ifac.org/publications-resources/framework-audit-quality-key-elements-create-environment-audit-quality>.

The European Union (2006), the Technical Committee of the International Organization of Securities Commissions (2009), and the Basel Committee on Banking Supervision (2008 and 2014), have also addressed aspects of the need for audit firm transparency and the link between transparency and audit quality.⁴⁴ In addition, as indicated above, independent audit regulators around the world are interested in the possible use of AQIs and in making information about audit quality available to interested parties. For example, the Swiss Federal Audit Oversight Authority publishes certain aggregated AQIs for the country's five largest firms.⁴⁵ In the United Kingdom, the FRC discusses its inspection reports, which include a numerical score, with the relevant audit committees; the FRC is now considering the extent to which the content of inspection findings should be made public by audit committees and is allowing audit committees of FTSE 350 companies that wish to do so to make certain inspection information public in the period before a final decision about the terms for publicity is made.⁴⁶ The Australian Securities & Investments Commission has issued rules to govern voluntary disclosure of AQIs, in part to assure comparability.⁴⁷

⁴⁴ See Council Directive 2006/43/EC, Article 40, now implemented in national regulations, Technical Committee of the International Organization of Securities Commissions, *Transparency of Firms that Audit Public Companies, Consultation Report* (2009), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD302.pdf>, Basel Committee on Banking Supervision, *External audit quality and banking supervision*, *supra* note 24, and *External audits of banks* (Bank for International Settlements, 2014), available at <http://www.bis.org/publ/bcbs280.htm>.

⁴⁵ Federal Audit Oversight Authority FAOA, *Activity Report 2013* (2014), 24-25, available at <http://www.revisionsaufsichtsbehoerde.ch/bausteine.net/file/showfile.aspx?downlaaid=7814>.

⁴⁶ U.K. Financial Reporting Council, FRC Statement PN 69/14: Transparency of AQR Findings (2014), available at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/November/Transparency-of-AQR-Findings.aspx>. The Council's statement raises many of the issues discussed above, for example in discussing the limits on grading of inspections.

⁴⁷ Australian Securities & Investments Commission, Information Sheet 184 – Audit transparency reports, Table 2, "Internal Indicators of Audit Quality," (2013) 3, available at <http://www.asic.gov.au/regulatory-resources/financial-reporting-and-audit/auditors/audit-transparency-reports/>.

Finally, over the last few years there has been increased focus on AQIs among audit firms themselves, for internal management and public outreach purposes. One firm published a 2013 Audit Quality Report that contains data on nine "transparency data points" that resemble or in some cases are the same as the AQIs discussed in Appendix A; the number grew to 12 in the firm's 2014 Report. A second firm is beginning on the same path. The CAQ published its own discussion of audit quality indicators in April 2014; the discussion, entitled "CAQ Approach to Audit Quality Indicators,"⁴⁸ focused on possible disclosures, for internal discussions, in ten subject areas involving: audit firm leadership, characteristics of engagement teams, monitoring by firms of audit engagement performance and quality control, and reliability of audit reports; again the CAQ's proposals overlap with some of the AQIs suggested by the Board. Finally, and ultimately more important, as noted above, some firms have turned to data and concepts similar to those described in this release in working with the Board on quality control and remediation.

VI. Opportunity for Public Comment

The Board will seek comment for a 90-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to the Office of the Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 041 in the subject or reference line. Comments should be received no later than 5:00 p.m., Eastern Standard Time, on September 29, 2015. The Board will consider all comments received.

The Board will also convene a roundtable meeting in Washington, D.C., during the fourth quarter of 2015, about this Concept Release. Additional details about the roundtable will be announced at a later date.

⁴⁸ Center for Audit Quality, *CAQ Approach to Audit Quality Indicators* (2014), supra note 36.

On the 1st day of July, in the year 2015, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

July 1, 2015

APPENDIX A: POTENTIAL AUDIT QUALITY INDICATORS

The description of each potential audit quality indicator ("AQI") that appears below has three parts. The first explains the nature of the indicator. The second illustrates how the indicator could be calculated at the audit engagement and audit firm levels. The third discusses briefly the reason the indicator has been suggested, and, in some cases, issues the indicator may raise.

The illustrative calculations offered below for defining each indicator are only one approach to doing so; the Board expects that other approaches may also be appropriate. In addition, as discussed in the concept release itself, all of the indicators are only as good as the context in which they operate; a measurement that is a valuable indicator in one situation may, because of specific facts, be of little significance in another. The description of the indicators has been kept as general as possible, in keeping with the purpose of a concept release. Thus, for example, technical definitions of various classes of firm personnel would likely be refined as part of a continuing AQI project. The same is true of measures outside of firm-wide (for example measures by industry, by region, or by office). The goal now is to outline the general concepts around which each indicator operates.

The indicators focus on data for a 12-month period, unless the description specifically indicates otherwise.

The concept release, of which this appendix is a part, contains general questions about AQIs and their potential uses. This appendix contains a second set of questions focused more specifically on the language of the 28 potential indicators themselves and the manner in which they could operate. As before, readers of the release are encouraged to comment on any matters not covered by specific questions. They are especially encouraged to provide suggestions for other approaches to particular issues relating to operation of the indicators.

Question 40. How might the description of each indicator and the illustrative calculation be improved or replaced by other approaches that would be more effective or easier to use?

Question 41. To what extent should the description of one or more indicators and its illustrative calculation be revised to make clear that all indicators are evaluated in context?

Question 42. To what extent could any suggested indicators produce uninformative results either because of the context in which they operate or because the variables they involve can be managed for results that emphasized form over substance?

Question 43. How should the indicators be applied at the firm level? Are different "firm" perspectives (firm-wide, region, office, industry practice) appropriate for different indicators? Is firm-wide data always appropriate for those indicators that call for firm-level data?

AUDIT PROFESSIONALS

Availability

1. **Staffing Leverage.** The "staffing leverage" indicator measures the time of experienced senior personnel relative to the volume of audit work they oversee.

Illustrative Calculations:¹

Engagement Level²	Firm Level
a. Ratio of audit partners' chargeable hours for the engagement to chargeable hours of all other engagement personnel	a. Ratio of firm audit partners' chargeable hours to chargeable hours of all other engagement personnel
b. Ratio of audit partners' chargeable hours for the engagement to chargeable hours of audit managers' on the engagement	b. Ratio of firm audit partners' chargeable hours to firm audit managers' chargeable hours
c. Ratio of audit managers' chargeable hours for the engagement to chargeable hours of all staff below manager on the engagement	c. Ratio of firm audit managers' chargeable hours to chargeable hours of all staff below manager

Partners and managers are responsible for oversight of the audit and the audit team, which will include less experienced staff. Sufficient time to oversee the work of the audit staff is typically critical to quality. The lower the amount of partners' time per audit managers and audit staff time, the wider the scope of partners' and managers' supervision and review responsibilities, and the greater the risk that partners and

¹ Hours spent by partners as engagement quality reviewers would not be counted for purposes of these calculations.

² The definition of "engagement level" in the case of global audits is an open question on which comment has been specifically requested. See Concept Release, Question 14 a), at page 16.

managers may not have sufficient time to supervise and review staff work and evaluate audit judgments. Less extensive supervision raises the risk of less effective audit procedures and a reduction in audit quality.

Question 44. Would addition of a calculation of staffing leverage indicators that measures the ratio of partner and manager hours to total audit hours be helpful?

2. Partner Workload. The "partner workload" indicator generates data about the level of work for which the audit engagement partner is responsible and the number of claims on his or her attention.

Illustrative Calculations:

Engagement Level	Firm Level
a. Chargeable hours managed by audit engagement partner for all public and private clients for the current year (planned) and prior year (actual)	a. Average chargeable hours managed by public company audit engagement partners for all public and private clients for the current year (planned) and prior year (actual)
b. Number of public clients, and number of private clients, whose audits are managed by the audit engagement partner and audits for which that partner is a quality control reviewer, noting those with calendar year-ends, for the current year (planned) and prior year (actual)	b. Public company audit engagement partners' average utilization percentage for the current year (planned) and prior year (actual)
c. Audit engagement partner's utilization percentage ³ for the current year (planned) and prior year (actual)	

Heavy workloads could distract an engagement partner from giving adequate and focused attention to an audit engagement. The figures generated by this indicator can help bring that issue to light and aid understanding of the implications of division of a partner's attention among several audit clients and competing client deadlines. (In addition, the data can provide perspective on the leverage calculation if it shows, for

³ The term "utilization," used in this Appendix A, means a fraction whose numerator is the number of all chargeable hours (i.e. for both public and private clients) in a year and whose denominator is the number of working hours in a year.

example, that senior personnel in fact devote large amounts of time to an audit with high staffing leverage or relatively low amounts of time to an audit with a low staffing leverage.) However, workload figures may have different meanings. For example, partners may supervise relatively few audit engagements because their time is devoted to firm management or other firm leadership positions.

3. Manager and Staff Workload. This indicator would provide information about the workload of audit managers and audit staff.

Illustrative Calculation:

Engagement Level	Firm Level
<p>For managers and audit staff, respectively:</p> <p>a. Utilization percentage for the current year (planned) and prior year (actual)</p> <p>b. Average hours worked per week measured from day after clients' year-end date through audit opinion date, for all engagements, by personnel level</p>	<p>a. Manager and audit staff average utilization, respectively</p> <p>b. Manager and audit staff average chargeable hours at different periods within the year (<u>e.g.</u>, during periods of peak audit workload)</p>

The greater the workload, the greater the risk staff may have insufficient time to perform appropriately the necessary audit procedures and take the other steps that create a quality audit. Staff may become less effective when working long hours, and such an environment may affect the level of due professional care they exercise. For example, a heavy workload may create pressure on the staff to focus more on efficiency in executing auditing procedures than on ensuring the effectiveness of those procedures and of supervision of more junior engagement team members.

In applying this indicator, measurements may be made on a person-by-person basis in the case of relatively small audit firms but on an average basis for larger firms.

4. Technical Accounting and Auditing Resources. This indicator measures the level of a firm's central personnel (or other resources engaged by the firm) available to provide engagement teams with advice on complex, unusual, or unfamiliar issues and the extent to which they are used in a particular engagement.⁴

Illustrative Calculations:

Engagement Level	Firm Level
a. Technical resource chargeable hours as a percentage of total engagement hours	a. Size of a firm's "National Office" or other technical audit resources as a percentage of its total audit personnel, using a "full-time -equivalent" measurement to account for individuals who spend only part of their time on technical resource matters

An audit firm's technical accounting and auditing (e.g., national office) resources (or their equivalent) can enable it to deal with complex questions during an audit. The measurement in this indicator provides a sense of a firm's capacity to resolve complex accounting and auditing issues in an effective way. It may also provide a sense of whether and how a firm promotes consultation and collaboration with others for the benefit of audit quality.

Question 45. How should technical accounting and auditing resources be measured in a situation in which those resources are retained from outside the firm conducting the audit?

5. Persons with Specialized Skill or Knowledge. This indicator measures the use in an audit engagement of persons with "specialized skill and knowledge," other than accounting and auditing personnel counted as technical accounting and auditing resources under indicator 4. These individuals may be firm personnel or they may be retained by the firm.⁵

⁴ Governing professional standards require that a firm's policies provide reasonable assurance that engagement teams can consult with individuals outside the engagement when appropriate. See Quality Control Standard 20.19. In most larger firms the individuals are part of a "national office" staff, but they may be retained from outside the firm especially in the case of smaller audit firms. Cf. Paragraph 15 of Auditing Standard No. 16.

⁵ See Paragraphs 16 and 17 of Auditing Standard No. 9.

Illustrative Calculations:

Engagement Level	Firm Level
a. Chargeable hours by persons with specialized skill or knowledge (except as counted as technical resources under indicator 4), in total and by functional specialty, as a percentage of an engagement's current year (planned) and prior year's (actual) total chargeable hours	a. Chargeable hours of persons with specialized skill or knowledge (except as counted as technical resources under indicator 4) in total and by functional specialty, as a percentage of a firm's actual chargeable hours

An audit firm's capacity to provide valuation, actuarial, forensic, tax, technology, financial instrument, legal, and other experts is increasingly necessary to plan and perform complex audits. Recognition of the need to use experts, and their careful deployment, can show a commitment to robust auditing in those industries in which their use is beneficial.

In light of the different ways firms obtain the assistance of persons with specialized skills or knowledge, the application of this indicator should measure effort, not simply hours expended or revenue generated, to take account of the importance of the role experts can play, but also, for example, the situation of experts who are retained on a fixed-fee basis. Thus, appropriate measures could in some cases involve hours, but in other cases reflect the percentage of total fees paid to experts.

Question 46. How should this indicator count participation by audit firm personnel and managers who have dual skills (i.e., as accountants or auditors but also as experts in another relevant discipline)?

Competence

6. Experience of Audit Personnel. This indicator measures the level of experience of members of a particular engagement team and the weighted average experience of firm personnel generally.

Illustrative Calculations:

Engagement Level	Firm Level
For partners, managers, staff auditors, specialists, and engagement quality reviewers: ⁶	a. Average experience for total audit personnel
a. Number of years on the engagement	b. Weighted average years of experience for partners, managers, staff auditors, and specialists respectively
b. Number of years in present assignment and personnel level	
c. Number of years: (i) with the firm and (ii) in the auditing profession	

Auditors with relevant experience, both in general and with a particular client, may be able to approach the audit in a more knowledgeable and effective manner. But auditors who spend too much time on a particular team may begin to lose their capacity for skepticism through simple familiarity. Thus, there may be a need to retain a balance between preserving the benefit of an audit team's experience with a particular client and adding new auditors who may provide a fresh look at audit issues. Evaluation of data produced by this indicator should take that balance into account.

7. Industry Expertise of Audit Personnel. This indicator addresses the experience of senior members of the audit team, as well as specialists, in the industry in which the audited company operates.

Illustrative Calculations:

Engagement Level	Firm Level
a. Number of years of cumulative experience of partners, audit managers, specialists, and engagement quality reviewers, respectively, in the audited public company's industry	None

Experience with a particular industry helps an auditor understand the industry's operating practices, the critical audit and accounting issues confronting companies in

⁶ For purposes of the AQIs in Appendix A, the term "specialist" means persons with specialized skill and knowledge, described in Indicator 5, who are part of the engagement team. Thus, the term excludes technical accounting and auditing resources discussed in Indicator 4.

that industry, and the best ways to resolve those issues to further audit quality. This computation indicates the extent to which the firm has encouraged the development of industry specialization and assigns partners, managers, specialists, and engagement quality reviewers to audit engagements based on that specialization.

Question 47. In measuring experience, would overall experience (including auditing and accounting experience) in the relevant industry be the best measure? Would such a measure disadvantage smaller firms? Would a measure based on number of audits performed in a particular industry be a better indicator for smaller firms?

Question 48. Are there ways to measure the industry expertise of a firm's audit staff against its public company client base? How?

Question 49. Would adoption of the commonly-used Standard Industrial Classification ("SIC") codes issued by the U.S. Department of Labor be appropriate to define industries for purposes on the indicators?⁷

8. Turnover of Audit Personnel. This indicator measures turnover, that is, transfers to other engagements or movement to other firms, at the engagement and, more generally, at the firm, level.

Illustrative Calculations:

Engagement Level	Firm Level
a. Percentage of prior year's partners, managers, audit staff, specialists, and engagement quality reviewers, respectively, that have left the firm or been reassigned to another audit engagement within the firm ⁸	a. Percentage of partners, managers, audit staff, and specialists, respectively, that have left the firm or left the firm's audit practice, in the preceding 12 months

The degree and nature of the changes in a company's audit team from year to year help measure the readiness and ability of the team to perform a quality audit. Some level of attrition is expected within audit firms. But a comparatively high rate of turnover or auditor transfer within a firm may adversely affect audit quality.

⁷ The SIC code structure can be found at https://www.osha.gov/pls/imis/sic_manual.html

⁸ The calculation should note separately the number of audit partners whose rotation was required by Regulation S-X Rule 2-01(c)(6).

As noted in the discussion of indicator 6 (experience of audit personnel), the benefit of retaining an audit team's experience with a particular client needs to be carefully balanced with the benefit of adding new auditors who may provide a fresh look at audit issues. Evaluation of data produced by this indicator in particular cases, and issues of context and comparability, should take that balance into account.

Question 50. Should a distinction be made between partner retirements and other turnover in applying this indicator?

9. Amount of Audit Work Centralized at Service Centers. This indicator measures the degree to which audit work is centralized by the audit firm at service centers.⁹

Illustrative Calculations:

Engagement Level	Firm Level
a. Percentage of total engagement audit work (by chargeable hours) whose performance is carried out on a centralized basis at service centers	a. Percentage of audit work (by chargeable hours) whose performance is carried out on a centralized basis at service centers

The degree to which work on the audit is carried out at service centers can be an important element in audit quality. Centralizing audit work at service centers here and abroad widens the geographic scope of the audit partner's supervision and review responsibility.

Centralization of this sort can have a positive impact. It may concentrate processing of audit work in the hands of people skilled in that processing and, by doing so, may free experienced engagement personnel to focus on more complex or judgmental areas of the audit.

On the other hand, centralization may introduce risks of insufficient or ineffective communication among engagement team members and create obstacles to effective supervision and staffing, for junior auditors especially. Centralization can also limit junior auditors' exposure to basic audit processes and could reduce the ability of firms to train their staffs about those processes, weakening the model under which staff auditor training has historically taken place.

⁹ Centralizing audit work means assigning lower risk audit work to domestic or foreign service centers established by the firm conducting the audit.

Despite the debate about centralization, however, the indicator can provide an understanding of the extent to which audit tasks are or may be centralized in service centers.

10. Training Hours per Audit Professional. This indicator focuses on the hours of relevant training—including industry-specific training—that members of the engagement team, and of the team's firm, have received.

Illustrative Calculations:

Engagement Level	Firm Level
a. Annual accounting and auditing training hours, and industry-specific training hours for partners, audit managers, staff auditors, specialists, and engagement quality reviewers, respectively	a. Average annual accounting and auditing training hours, and industry-specific training hours, in total and for partners, managers, staff auditors, specialists, and engagement quality reviewers, respectively
b. Total independence and ethics training hours for personnel groups in "a"	b. Average independence and ethics training hours for personnel groups in "a"

The amount of continuing training auditors receive should increase their capacity to perform effective audits. While the number of training hours is easily measured, the quality of training is harder to gauge; the training must be relevant to raising audit quality by, for example, focusing in some cases on back-to-basics audit issues that have constituted inspection deficiencies and in other cases on more sophisticated accounting and auditing issues specific to the industry in which audit clients of those being trained operate. Independence and ethics issues are an important part of the training curriculum as well, and the evolution and evaluation of training in that area might also be followed.

The application of this indicator may depend on the size of the audit involved. Thus per-person calculations may be appropriate for smaller audits, while averages might be used, by class, for larger audit teams.

Question 51. Should training hours be computed on a per-person basis, by personnel class, or as an average by class? Should the size of the firm involved make a difference in this regard?

Question 52. How can the effectiveness of a firm's training program best be measured?

Question 53. Should the effect of the way training is delivered (e.g., live, web-based, or self-study) be factored into the evaluation of a firm's training program? How?

Focus

11. Audit Hours and Risk Areas. This indicator measures the time spent by members of the audit team at all levels on risk areas identified by the firm during audit planning.

Illustrative Calculations:

Engagement Level	Firm Level
a. Total chargeable hours, and percentage of hours, by significant risk area ¹⁰ for partners, managers, audit staff, technical accounting and auditing resource personnel, specialists, and the engagement quality reviewer, respectively, for the current year (planned) and the prior year (actual)	a. 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)

Measuring the hours that levels of an audit team devote to risk areas can suggest whether audit managers have staffed the audit appropriately to reflect the risk areas identified during the planning phase of the audit and the extent to which senior members of the team have focused sufficiently on those areas. The data produced by this and the following indicator should complement the picture of senior-level attention to audit supervision created by indicators 1 through 3.

Measuring hours that other engagement teams from the same audit firm devote to risk areas in audits of other public companies in the same industry as the engagement client may provide grounds for a greater understanding of the nature of the risks the firm identifies in audits of that industry, how it staffs to deal with them generally, and the degree of focus its audit teams give them. This is another situation in which context may be very important: different companies in the same industry may present different risks due to, for example, systems, people, or process issues at one or more of those companies.

¹⁰ See Paragraphs 70-71 of Auditing Standard No. 12 and Paragraph 9 of Auditing Standard No. 16.

12. Allocation of Audit Hours to Phases of the Audit. This indicator measures the effort and staffing the audit devotes to audit planning, interim field work, and audit completion.

Illustrative Calculations

Engagement Level	Firm Level
a. 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	a. Percentage of hours of the firm devoted respectively to 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 engagement quality reviewers

Audit quality depends in part on proper planning and execution and on the way the overall audit hours are phased to construct a successful process. The amount of time allocated to planning for the audit can be critical, and it can be equally important who participates in the planning process. The same is true with the other stages of the process.

Question 54. Does the "percentage of hours" metric at the firm level of this indicator provide a meaningful basis for comparison with the engagement level of the metric? Would it help to disaggregate the numbers by audit client size?

Question 55. Is there any way to expand this indicator to quantify audit personnel experience with audit clients, to provide additional context?

AUDIT PROCESS

Tone at the Top and Leadership

13. Results of Independent Survey of Firm Personnel. This indicator measures an audit firm's "tone at the top" through use of a survey tool.

Illustrative Calculations:

Engagement Level	Firm Level
None	a. Anonymous independent ¹¹ 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

An appropriate "tone at the top" and the way the firm communicates and stands behind that tone is generally essential to foster professional skepticism, objectivity, and independence in the firm's personnel. Data from anonymous independent surveys of audit firm personnel could provide unique insights about staff perceptions of their firm's commitment to critical elements of quality.¹²

Question 56. Who should administer the survey described in this indicator? What steps would be necessary to assure that the results of anonymous surveys were comparable? Would the same set of questions be necessary? Would the same individual or organization have to administer each of the surveys?

Question 57. How often would a survey of this type have to be administered to retain its validity?

Question 58. What other logistical issues might arise from a survey of this sort?

Incentives

14. Quality Ratings and Compensation. This indicator measures the potential correlation between high quality ratings and compensation increases and the comparative relationship between low quality ratings and compensation increases or decreases.

¹¹ An independent survey would require independently-determined methodology, independently-drafted questions, and anonymity.

¹² Comments on other ways to measure "tone at the top" are also specifically requested.

Illustrative Calculations:

Engagement Level	Firm Level
None	<p>a. Percentage of partners and managers, respectively, with exceptional performance ratings on audit quality</p> <p>b. Percentage of partners and managers, respectively, with exceptional quality ratings who receive above-average increases in compensation</p> <p>c. Percentage of partners and managers, respectively with low quality ratings</p> <p>d. Average percentage compensation increase or decrease for partners and managers, respectively, with low quality ratings</p>

Comparing internal firm quality ratings and compensation levels can provide an important signal of the value a firm places on quality. This indicator would capture the extent to which a firm's personnel evaluation process distinguishes among personnel at each level of the firm based on audit quality and awards compensation accordingly. Linking compensation to quality may provide strong evidence of the firm's commitment to that goal and may create equally strong incentives for audit personnel.

Question 59. Can this indicator be applied to produce comparability among firms, e.g. in terms of definitions of "exceptional performance ratings" and "low quality ratings"? How?

15. Audit Fees, Effort, and Client Risk. This indicator provides insight into the relationship between engagement or firm audit fees and hours, on the one hand, and levels of client risk, on the other.

Illustrative Calculations:

Engagement Level	Firm Level
a. Percentage change from prior year in each of: (i) audit fees and (ii) chargeable hours for partners and managers, respectively, together with whether client was identified by firm as high risk.	a. Percentage change from prior year in each of: (i) total audit revenues charged to public company clients and (ii) chargeable hours for partners and managers, respectively, together with percentage of firm's public company clients assessed as high risk.

The combination of falling audit fees and decreased audit effort can lead to reduced audit quality. That combination can be especially serious for a high risk public company audit client. This indicator attempts to highlight situations in which economic pressures can create such a relationship. It may provide perspectives on: (i) how audit fees vary with audit risk (e.g., to reflect a risk premium or higher audit effort) and (ii) whether work is reallocated from senior to more junior auditors as fees change.

Question 60. One issue that this indicator raises is how to fashion a workable definition of "high risk" that allows comparability among firms or even among engagements within a firm. Comment is specifically requested on that subject.

Independence

16. Compliance with Independence Requirements. This indicator measures several elements of a firm's independence training and monitoring program and the importance it assigns to that program.

Illustrative Calculations:

Engagement Level	Firm Level
<p>a. Percentage of engagement personnel subject to firm's personal independence compliance reviews.</p> <p>b. Average of mandatory independence training hours per engagement team member</p>	<p>a. Percentage of firm personnel subject to firm's personal independence compliance reviews annually.</p> <p>b. Average of mandatory independence training hours per audit employee and other firm professional employees covered by Commission independence rules (whether or not involved in the firm's audit practice), respectively</p> <p>c. Percentage of issuer audit engagements subject to firm internal quality control reviews over independence compliance annually.</p> <p>d. Level of investment in centralized support for, and monitoring of compliance with, independence requirements per 100 public company audit clients (for firms with 500 such clients)</p> <p>e. Percentage of public company audit clients lost due to independence violations.</p>

Auditor objectivity is a critical precondition for audit quality, and several indicators indirectly address that condition. The survey of firm personnel—indicator 13 (Process) is an example. Other independence issues are equally important, including arrangements involving mutuality of interest between the auditor and client, an auditor's performing as a member of a client company's management, and an auditor's providing prohibited nonaudit services.

Investment in training, a firm's independence function generally, and internal compliance reviews can all illustrate a firm's commitment to objectivity and to producing quality audits. The level of investment called for by this indicator may need to take account of both personnel costs and the cost of technology.

Question 61. What other measures of independence, or independence issues, would be appropriate? Would information generated by this indicator be more meaningful if measurements were stratified by personnel level?

Infrastructure

17. Investment in Infrastructure Supporting Quality Auditing. This indicator measures the amounts audit firms invest, in people, process, and technology, to support the base on which quality auditing depends.

Illustrative Calculations:

Engagement Level	Firm Level
a. Investment in engagement team as a percentage of revenue generated on engagement	a. Investment in audit practice as a percentage of firm revenue

A firm's investment in auditing practice infrastructure (that is, in its people, processes, and technology) can demonstrate its commitment to audit quality. Defining the expenditures that represent such investment, however, is difficult. Firm-sponsored advanced training in auditing and accounting certainly qualifies, but not all training is consistent with that focus. Investment in audit technology can produce better audits, but it is sometimes designed to streamline procedures to improve efficiency in a way that does not improve audit effectiveness.

Question 62. In what ways can investments in infrastructure that are relevant to improving audit quality best be defined?

Question 63. How should such investments be measured? Is measurement in dollar terms (or dollars per auditor) appropriate? Can such investments be measured at the engagement team level?

Monitoring and Remediation

18. Audit Firms' Internal Quality Review Results.¹³ This Indicator contains information about the internal quality reviews conducted by each audit firm.

Illustrative Calculations:

Engagement Level	Firm Level
a. Results of any internal quality inspections of audits of the engagement client, including number (if any) of audit deficiencies of a magnitude similar to a PCAOB Part I finding	a. Percentage of public company audits subjected to internal quality review inspections by audit firm b. Percentage of such inspections with one audit deficiency of a magnitude similar to a PCAOB Part I finding c. Percentage of such inspections with more than one such audit deficiency

An audit firm's internal quality review program can show the level of attention the firm pays to monitoring and improving quality in its audit practice. Analysis of audit quality review findings requires care, however. Although a higher volume of findings may raise questions about aspects of a firm's operations, a record of timely identification and appropriate remediation could indicate a robust approach to internal quality review that signals a firm's commitment to improved quality. In addition, a comparison of firm and PCAOB findings may cast light on strengths and weaknesses of quality control efforts more generally.

Question 64. How should internal quality inspection findings be compared to or analyzed alongside PCAOB inspection results in applying indicators 18 and 19?

¹³ PCAOB inspection results and audit firm internal quality review results are counted as audit process indicators, but they possess elements of both audit process and audit results indicators.

19. PCAOB Inspection Results.¹⁴ This indicator contains information about PCAOB inspection results relating to the engagement or the audit firm involved.

Illustrative Calculations:

Engagement Level	Firm Level
a. Results of any PCAOB inspections of audits of the engagement issuer as well as the number and nature of any Part I findings identified	a. Number and percentage of PCAOB-inspected audits that result in a "Part I finding" b. Number and percentage of PCAOB inspected audits that result in more than one "Part I finding" c. Number and percentage of PCAOB inspected audits that led to a restatement d. Number, nature, and dates of quality control defects dealt with in released Part II PCAOB inspection reports (and dates of such releases), if any, combined with information about firm's subsequent remediation efforts

The Board's own inspections focus on whether audits are conducted in accordance with the Board's rules and standards. They can provide insight, in their Part I findings (and any quality control defects, described in Part II of an inspection report, that becomes available if adequate remediation by firms with quality control defects does not occur), about breakdowns that may cause audit deficiencies. Public inspection findings may provide a baseline for evaluating other indicators (e.g., comparing staff utilization rates, or use of persons with specialized skill and knowledge, with inspection findings) and testing the efficacy of firms' internal quality control systems.

20. Technical Competency Testing. This indicator seeks to measure the level of technical competence of a firm's audit personnel, and the success of efforts to keep up that level of competence.

¹⁴ See *Information for Audit Committees about the PCAOB Inspection Process*, PCAOB Release 2012-003 (August 1, 2012).

Illustrative Calculations:

Engagement Level	Firm Level
a. Content requires study	a. Content requires study

Audit firms recognize that technical competence is critical for maintaining quality in a rapidly changing business and financial environment. But there is at present no recertification examination for auditors, as there is, for example, for medical specialties in some states and for most members of the securities industry. State boards of public accountancy typically impose continuing education requirements but do not require retesting.

Comment is specifically requested on ways audit firms might measure technical competence, encourage its development and maintenance, and report on the result.

AUDIT RESULTS

Financial Statements

21. Frequency and Impact of Financial Statement Restatements for Errors. This indicator measures the restatements for error of financial statements whose audit the audit firm has performed.

Illustrative Calculations:

Engagement Level	Firm Level
a. Number and magnitude of audit practice's restatements for errors at engagement level, computed annually.	a. Number and percentage (of audited financial statements) of an audit practice's restatements for errors, computed annually, and magnitude of those restatements. b. The audit firm's top five annual restatements measured by the magnitude of those restatements.

The number and impact of restatements for errors (*i.e.*, not for changes in accounting principles) are generally considered a signal criterion of potential difficulties in at least parts of an auditor's practice and approach to auditing. This indicator tries to place restatements in context by focusing on their magnitude. Magnitude of restatements could be measured in a number of ways, including impact of the restatement on income, on cash flows and balance sheet, and on market capitalization.

Question 65. What are the best methods for measuring magnitude of restatements for errors? Is one method superior to the others? Why?

22. Fraud and other Financial Reporting Misconduct. This indicator is concerned with reporting of fraud and other financial misconduct, at both the engagement and audit firm levels.

Illustrative Calculations:

Engagement Level	Firm Level
a. Content requires study	a. Content requires study

Given the historical harm to investors from fraudulent financial reporting and auditors' responsibilities to help prevent or detect fraud that materially affects financial statements,¹⁵ one or more AQIs on the auditor's work in the fraud area may be useful. Although the content of specific AQIs requires further study, ideas include:

Positive indicators:

1. Number of significant deficiencies or material weaknesses in controls designed to address the risk of material misstatement due to fraud, raised by the audit firm in the absence of an error or fraud that has already occurred
2. Number and severity of material or immaterial errors in financial reporting from fraud or other financial reporting misconduct discovered by the audit firm early enough to avoid errors in published financial statements

¹⁵ AU Section 110.02 states, "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. [footnote omitted]." AU Section 316 establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements. Auditing Standard No. 5 states when planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment. "As part of identifying and testing entity-level controls... and selecting other controls to test... the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls." See Paragraph .14 of Auditing Standard No. 5.

Negative indicators:

1. Number of restatements for errors resulting from fraud or other financial reporting misconduct with no previously reported material weakness in internal control
2. Number and severity of material errors in financial reporting from fraud or other financial reporting misconduct that the audit firm did not detect prior to restatements of financial statements

Developing AQIs related to these ideas is challenging. Data needed for the AQIs may be difficult to obtain as it would require determining whether an internal control deficiency related to fraud prevention, or determining whether errors in financial reporting, resulted from fraud or other financial reporting misconduct. Also, the AQIs listed above could reflect the riskiness of an audit firm's client base rather than the quality of the audit firm's work.

Question 66. Would one or more AQIs related to fraud and other financial reporting misconduct be helpful to discussions of audit quality? If so, what AQIs would best inform those discussions? How could the challenges listed above be overcome?

23. Inferring Audit Quality from Measures of Financial Reporting Quality.

This potential indicator focuses on whether (and which) measures of financial reporting quality used by investment analysts, academics, and regulators can also be used as measures of audit quality.

Illustrative Calculations:

Engagement Level	Firm Level
a. Content requires study	a. Content requires study

Academics, analysts, and regulators have developed measures of financial reporting quality. The measures are used by academics in their research, analysts, and investors for investment decisions and by regulators to identify risky situations to scrutinize. Examples include measures of the nature and size of accounting accruals, the extent to which companies consistently and narrowly beat earnings targets, and the complexity or relevance of financial disclosures.

Using reporting quality measures as AQIs requires answers to two questions: (i) do the financial reporting measures reliably gauge reporting quality and, if so, (ii) do they also provide useful inferences about audit quality? If the answers to those

questions are positive, a related issue is whether the measures provide insight into audit quality at the audit firm level, at the specific engagement level, or both. For example, if measures suggest the reporting quality for an audit firm's portfolio of clients differs from the average for all public companies, does that suggest that the audit firm is performing stronger or weaker audits? Or, at an engagement level, if measures suggest that the specific company's financial reporting quality differs from the average, does that suggest that the engagement team's performance is strong or should improve?

If the measures are reliable, and if users can infer audit quality from them, then there are at least two ways forward for related AQIs:

1. Identify specific AQIs related to financial reporting quality (i.e. specific AQI measures)
2. Ask auditors to report whether their firm uses measures of financial reporting quality to measure risk and, if so, what those measures suggest about the firm's and engagement team's audit quality (i.e. allow the firm process to determine the AQI)

Question 67. Comment is requested on each of the issues raised about this indicator. Would it be preferable to identify specific indicators related to financial reporting quality or to focus on audit firms' measures of reporting quality to measure risk? How would the latter approach control for differences among firms?

Internal Control

24 Timely Reporting of Internal Control Weaknesses. This measure captures the extent to which an audit firm identifies material weaknesses in an issuer's internal controls over financial reporting on a timely basis.

Illustrative Calculations:

Engagement Level	Firm Level
a. Same as firm level but concerning audit reports for the engagement client	<p>a. Percentage of findings of material weakness in internal control over financial reporting with no corresponding: (i) restatements for errors or (ii) known errors</p> <p>b. Percentage of: (i) restatements for errors, or (ii) known errors, with no corresponding material weakness in internal controls over financial reporting identified in the prior year</p>

In the words of Auditing Standard No. 5, and relevant SEC guidance, "effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes."¹⁶ A firm's failures to identify material internal control weaknesses may raise issues about staffing, training, or audit focus for these important issues.

It is unclear whether such material weaknesses serve as leading indicators (i.e., evidence of risks of future reporting flaws), lagging indicators (i.e., evidence that reporting flaws may already have occurred), or both. Data assembled by the AQI project can help illuminate that issue.

Going Concern

25. Timely Reporting of Going Concern Issues. This indicator focuses on the timeliness of the auditor's use of a going concern paragraph in its opinions.

Illustrative Calculations:

Engagement Level	Firm Level
a. Same as firm level "a," but concerning audit reports for the engagement client	<p>a. The number and percentage of audit reports with no going concern reference in the year preceding an engagement client's financial distress, <u>e.g.</u>, bankruptcy, troubled debt restructuring, troubled buyout, or bailout</p> <p>b. The five largest issuers by market capitalization from the above indicator</p>

Failure to include a going concern paragraph within an audit report in the face of an issuer's reasonably foreseeable business distress (whether the distress results in bankruptcy, a technical default, or a troubled buyout or bailout) can indicate issues about the effectiveness of the auditing involved. This measure captures the extent to which an audit firm identifies on a timely basis companies whose ability to continue as a going concern is subject to substantial doubt.

All the same, any indicator focused on going concern issues can raise issues of context and unintended consequences. Business difficulties are not always reasonably

¹⁶ Paragraph 2 of Auditing Standard No. 5 and Exchange Act Rules 13a-15(f) and 15d-15(f). Paragraph 2 of Auditing Standard No. 5 provides that "[i]f one or more material weaknesses exist, the company's internal control over financial reporting cannot be considered effective," citing to Item 308 of Regulation S-K.

foreseeable even by the most experienced audit team. And some going concern warnings are given for companies that do not experience financial distress; an indicator should not provide an incentive for an auditor to consider giving a going concern warning where one is not truly called for.

Question 68. How should factors such as difficulties in foreseeing business difficulties, or the risk of providing an incentive for unnecessary going concern warnings be reflected in an indicator of this kind?

Communications Between Auditors and Audit Committees

26. Results of Independent Surveys of Audit Committee Members. This indicator measures the effectiveness of the communication between auditors and audit committees through use of a survey tool.

Illustrative Calculations:

Engagement Level	Firm Level
None	a. Anonymous independent ¹⁷ survey of audit committee members overseeing one or more of a firm's audit engagements, to evaluate level and quality of communication between auditors and clients

Communication between auditors and audit committees is at the center of the audit process. Auditing Standard No. 16, states the "objectives of the auditor" to communicate with the audit committee about the engagement and the auditor's role, audit strategy and timing, and "timely observations arising from the audit that are significant to the financial reporting process."¹⁸

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 pose logistical issues about which comments are sought.

¹⁷ See discussion of independent surveys, infra at note 11.

¹⁸ Paragraph 3.a.-d. of Auditing Standard No. 16. A note following the quoted language emphasizes the purpose of Auditing Standard No. 16 is "to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit."

Question 69. Who should administer the survey described in this indicator? What steps would be necessary to assure that the results of anonymous surveys were comparable? Would the same set of questions be necessary? Would the same individual or organization have to administer each of the surveys?

Question 70. How often would a survey of this type have to be administered to retain its validity?

Question 71. What other logistical issues might arise from a survey of this sort?

Enforcement and Litigation

27. Trends in PCAOB and SEC Enforcement Proceedings. This indicator measures Board or SEC proceedings in audit and audit-related matters against an audit firm.

Illustrative Calculations:

Engagement Level	Firm Level
a. Public, SEC or Board enforcement proceedings, measured over the preceding five years, against the firm or its partners, with respect to the engagement client	a. Public, SEC, or Board enforcement proceedings, measured over the preceding five years, against the firm or its partners, with respect to audit matters

The frequency, nature, magnitude, and results of Board and SEC litigation in audit and audit-related matters might help reveal weaknesses or strengths of a firm's practice. Information generated by this indicator may include quality issues affecting either particular firms or auditing in general. The length of the period required for litigation, however, may create problems of timeliness of information.

Question 72. Should tabulation of cases for purposes of this indicator include all cases filed or only cases that result in findings against an accountant or accounting firm? What about settlements entered into without an admission of wrongdoing?

28. Trends in Private Litigation. This indicator focuses on private litigation involving the audit firm.

Illustrative Calculations:

Engagement Level	Firm Level
a. Frequency, nature, and results of private litigation relating to firm's audit work for the engagement client	a. Frequency, nature, and results of private litigation relating to firm's public company audit practice

The frequency, nature, magnitude, and results of private litigation against audit firms might reveal either weaknesses or strengths of a firm's public company practice. Again, the information generated by this indicator may include quality issues affecting either particular firms or auditing in general. But the quality of the information is uncertain, given the fact that a particular litigation may or may not result in findings of liability, and the amount of information derived from settled litigation is ambiguous.

Question 73. Should tabulation of cases for purposes of this indicator include all cases filed or only cases that result in findings against an accountant or accounting firm? What about settlements?