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Report from the Working Group on Audit Quality Indicators

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AUDIT QUALITY INDICATORS

Executive Summary:

Investors strongly recommend the PCAOB prescribe a set of audit quality indicators (AQI) that:

- ❑ Measure the quality of the actual audit (output),
- ❑ Help establish accountability for audit quality,
- ❑ Are forward-looking, and
- ❑ Have information or predictive content.

AUDIT QUALITY INDICATORS

The working group believes that the current focus of the PCAOB's AQI Initiative relates more to audit *firm* quality and the audit process than to audit quality.

We believe that investors are most concerned about the reliability and credibility of the audits of the companies they have invested in or are evaluating for future investments.

Those of us who have served on or advised audit committees have found that committee members are most interested in the quality of the auditor's work for their company rather than to actions their audit firm has taken that relate to audit quality in only more general respects.

AQI - OBJECTIVES

The objective of the PCAOB's AQI project should be to develop measurements of audit quality that provide investors with useful and timely information with respect to the credibility of audits. That information would be useful to investors in their annual voting on whether to approve the appointment of auditors.

This project should also result in the publication of timely and useful information for audit committees with respect to both their oversight of their specific audit as well as the selection of an audit firm.

Investors and audit committees need specific information about risks identified in PCAOB inspections and discussed in inspection reports.

AQI - Process

Audit firms should be required to provide the PCAOB with data on selected audit quality indicators compiled at both the engagement level and the firm level.

These data should be subject to review, verification, and comment by the PCAOB.

AQI - Process

The level at which data on audit quality indicators should be collected is very important. We recommend that the PCAOB prescribe indicators at three different levels:

1. Certain indicators should be collected, analyzed, and disseminated at the engagement level.
2. We also recommend indicators that should be measured at the firm level.
3. Our last set of recommendations enumerates indicators that will be of greatest value if they are collected at *both* the engagement and the firm level.

We strongly recommend that all AQI should be stratified because audit firms have varying levels of expertise and market penetration in different industries.

SPECIFIC ENGAGEMENT LEVEL AQI

- ❑ Ratio of partner and manager hours to the hours charged by the rest of the engagement team.
- ❑ Identification of key risk areas and hours spent by the engagement partner in addressing them.
- ❑ Whether the audit had been inspected by the PCAOB in the most recent year. If so, whether any deficiencies in the audit were noted and a description of the types of deficiencies.
- ❑ Hours spent by audit partners and staff in firms that are not subject to an inspection by the PCAOB, as well as the percentage of the balance sheet, income statement and cash flows audited by the non-inspected firm.

SPECIFIC ENGAGEMENT LEVEL AQI

- ❑ Percentage of audit hours outsourced to either another firm or an affiliate in a foreign country.
- ❑ Whether there was any consultation with the national technical office, and if so, on what issue(s).
- ❑ The name of the lead engagement partner, in order to assess whether he or she has participated in other audits whose credibility has been questioned.

AUDIT FIRM LEVEL AQI

- ❑ Policy on measurement and management of audit quality indicators which should be made public.
- ❑ Compensation Policy for (1) executive partners, (2) audit partners and (3) audit staff and whether (and if so, how) compensation levels are linked to audit quality, including specific triggers measured and used in linking audit quality to compensation.
- ❑ Average billing/hours responsibility of audit partners. Also average chargeable hours of (1) partners, (2) managers and (3) audit staff.

AUDIT FIRM LEVEL AQI

- ❑ Number of audit engagements for which an independence review occurred and, of those, the number and aggregate estimated fees of non-audit engagements which the firm declined to accept.
- ❑ Identification of affiliates not subject to an inspection by the PCAOB.
- ❑ Identification of affiliates who do not provide audit documentation to the U.S. affiliate in compliance with SOX

AUDIT FIRM LEVEL AQI

- ❑ Number of restatements, by major industry groups.
- ❑ Number of material weaknesses reported, by major industry group.
- ❑ Billable fees or hours by major industry groups.
- ❑ Portion of audits assessed as being “high risk” audits.
- ❑ Percentage of revenues spent on audit staff.

AUDIT FIRM LEVEL AQI

- ❑ Dollar investment in audit tools and audit technology.
- ❑ Number of pending SEC and PCAOB enforcement actions.
- ❑ Average salary for new hires on the audit staff.
- ❑ The number of first year audit engagements where the prior auditor resigned, or there was a disagreement reported with the prior auditor.

ENGAGEMENT AND AUDIT FIRM LEVEL AQI

- ❑ Average hours of professional education for (a) partners, (b) managers, and (c) staff assigned to audit.
- ❑ Turnover in staffing at (a) partner, (b) manager, and (c) staff levels
- ❑ Average years of experience of audit partner and personnel staff assigned: (a) experience on specific engagement; (b) experience in the industry; and (c) overall audit experience.
- ❑ Any violation of the PCAOB auditor independence rules.

INVESTOR SURVEY RESULTS

CFA Institute Regulatory Oversight and the Independent Audit Survey

- ❑ The CFA Institute surveyed 498 members in its Financial Reporting Survey Pool in September, 2012. The response rate was 21% (104 respondents) and the margin of error was $\pm 8.5\%$ at the 95% confidence level.
- ❑ The CFA Institute used the resulting feedback to inform the International Forum of Independent Audit Regulators for use in their deliberations of proposed changes to the audit process. We use these results to illustrate investor preferences for expanded transparency in auditor regulation as well as the independent audit report.
- ❑ Survey results and survey questionnaire available at www.cfainstitute.org.

INVESTOR SURVEY RESULTS

Quality of the Audit:

To what extent do you agree or disagree that regulatory oversight and enforcement of the independent audit improves the quality of the audit?

- ❑ 72% of the respondents agreed that regulatory oversight and enforcement improve audit quality.
- ❑ There was a divergence of views around the world: More APAC members (47%) strongly agree with this contention compared to 40% in EMEA and 34% in AMER.

INVESTOR SURVEY RESULTS

Current Regulatory Oversight and Enforcement

To what extent do you agree or disagree that current regulatory oversight and enforcement of the independent audit is effective?

- This question produced mixed results: 37% neither agree nor disagree and 30% agreed that current regulation and oversight are effective.
- Interestingly, the EMEA (47%) and AMER (33%) do not believe that the current regime is effective but only 18% of APAC members disagreed.

INVESTOR SURVEY RESULTS

Transparency of Inspection Reports

In your opinion, do inspection reports issued by regulators of audit firms need to be more transparent?

- ❑ The results are clearer in this case: 80% of respondents called for increased transparency.
- ❑ The highest proportion was 88% in AMER, followed by 73% in the APAC and 69% in EMEA.

INVESTOR SURVEY RESULTS

Independent Auditor's Report

In your opinion, should risk factors associated with measurement uncertainties in an entity's financial statements be included in the independent auditor's report?

- ❑ Respondents called for disclosure of risk factors by a 3 to 1 margin.
- ❑ 57% of the respondents would limit that disclosure to significant risk factors and the other 18% asked for all risk factors.

INVESTOR SURVEY RESULTS

Summary

- ❑ Investors represented by CFA Institute members responding to this survey agree that regulatory oversight and enforcement have a positive impact on the quality of the audit but 1 in 3 respondents do not believe that the current level of oversight and enforcement is sufficient.
- ❑ 75% of the respondents would like to see more disclosure of risk factors and a significant number (80%) called for greater transparency of regulatory inspection reports.

OUTPUT-BASED AQI

We strongly recommend the PCAOB develop output based indicators of the quality and credibility of audits. We believe this requires the development of indicators that are credible early warning signals or forecasts of risks.

Output-based AQI with predictive content involve assessments of recognition (timing) and measurement (amount) choices based on variable or uncertain data that require significant judgment and estimates applied to a comprehensive understanding of the underlying business.

OUTPUT-BASED AQI

One example is the use of discretionary accruals – we understand the PCAOB has decided to include an indicator based on discretionary accruals.

The fundamental challenge with the development of informative, forward-looking AQI is that many output-based AQI are observed ex post. For example, the number and frequency restatements, the errors in going-concern assessments, impairments, valuation, the adequacy of allowances or reserves for contingencies, and the valuation allowance for deferred tax assets.

OUTPUT-BASED AQI

We believe that an important characteristic of forward-looking and informative AQI is their ability to forecast risks and problems. For example, research shows that financial statement recognition of impairments of long-lived tangible assets (for example, machinery and equipment) are often preceded by LIFO inventory liquidations.

Similarly, financial distress in bricks and mortar retailers has long been timely assessed by analyzing the trends in the operating cycle (Days inventory is on hand plus Days credit sales are outstanding) and the cash cycle (the operating cycle less the number of days the retailer takes to pay its suppliers) of the retailers.

OUTPUT-BASED AQI

Similar analyses of the deferred tax footnotes, valuation allowance for the deferred tax assets, statements of cash flow (preferably based on the Direct Method) would yield significantly useful AQI.

Thus, our challenge lies in identifying appropriate risk measures to develop useful AQI.

Questions?

