
STANDING ADVISORY GROUP MEETING

DISCUSSION – TREASURY ADVISORY COMMITTEE'S RECOMMENDATION RELATING TO THE FEASIBILITY OF DEVELOPING KEY INDICATORS OF AUDIT QUALITY AND EFFECTIVENESS

OCTOBER 22-23, 2008

Introduction

At the October 2008 meeting the Standing Advisory Group ("SAG") will discuss a recommendation of the Department of the Treasury's ("Treasury") Advisory Committee on the Auditing Profession ("Advisory Committee" or "Committee") relating to assessing the feasibility of developing key indicators of audit quality and effectiveness. The Treasury established the Committee in October 2007 to "examine auditing industry concentration, financial soundness, audit quality, employee recruitment and retention, in addition to other topics."^{1/} On October 6, 2008, the Committee released its Final Report ("Committee's Final Report"), which includes a recommendation relating to key indicators of audit quality and effectiveness.^{2/} Specifically, the Committee's Final Report includes the following recommendation:

^{1/} U.S. Department of the Treasury, "Paulson Announces Auditing Committee Members to Make Recommendations for a More Sustainable, Transparent Industry," Treasury Press Release No. hp 585 (October 2, 2007); available at <http://www.treas.gov/press/releases/hp585.htm>.

^{2/} U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (October 6, 2008), pp. VIII:14 - VIII:17; available at <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>.

This paper was developed by the staff of the Office of Research and Analysis to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

Chapter VIII. Concentration and Competition

Recommendation 3: Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.^{3/}

This paper provides SAG members with background information related to the Committee's recommendation. At the SAG meeting, panelists will provide background information on audit quality, including an overview of the Advisory Committee's recommendation, a review of selected academic research on audit quality, and key points from initiatives on audit quality by the UK Financial Reporting Council ("FRC") and the Transparency Report required by the EU's Eighth Directive.^{4/} After the panelists' remarks, the SAG members, as a group and in three break-out sessions, will have an opportunity to discuss issues regarding the feasibility of developing such indicators.

In separate recommendations the Advisory Committee (1) urges the PCAOB to require that in 2010 all large auditing firms begin to produce a public annual report, which would include, among other things, any key indicators of audit quality and effectiveness as determined in accordance with the recommendation above^{5/} and (2) states its belief that the proxy statement "ratification process would be made more meaningful if accompanied by the development and disclosure of key indicators of audit

^{3/} Ibid., p. VIII:14. Appendix A includes an excerpt of the Committee's Final Report.

^{4/} European Union, Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC ("EU Eighth Directive"), Article 40 Transparency Report; available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0107:EN:PDF>.

^{5/} *Committee's Final Report*, p. VII:20, Recommendation 7.

quality."^{6/} While these reporting proposals make reference to audit quality, the SAG discussion will be focused on the feasibility of developing key indicators of audit quality and effectiveness.

Advisory Committee's Recommendation Regarding Audit Quality

The Advisory Committee's Final Report states that "[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".^{7/} The report also notes the following:

Currently, there is minimal publicly available information regarding indicators of audit quality at individual auditing 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. In addition, with the majority of public companies currently putting shareholder ratification of auditor selection to an annual vote, shareholders may also lack audit quality information important in making such a ratification decision.^{8/}

The Advisory Committee's Final Report suggests possible sources of information to consider in connection with the audit quality recommendation, such as:

- Annual reports currently filed by auditing firms in other jurisdictions, such as the UK;

^{6/} *Committee's Final Report*, pp. VIII:20 - VIII:21, Recommendation 5, footnote 70.

^{7/} *Committee's Final Report*, p. VIII:14.

^{8/} *Ibid.*

- The recently published framework of audit quality developed by the UK FRC;^{9/} and
- Factors that auditing firms present to audit committees, such as engagement team composition, the nature and extent of firm training programs, and the nature and reason for client restatements.^{10/}

The Advisory Committee's Final Report states that "[t]estimonies and comment letters have suggested specific output-based audit quality indicators ... and input-based audit quality indicators...."^{11/} The two types of audit quality indicators are described by the Committee as follows:

- Output-based – indicators determined by what the auditing firm has produced in terms of its audit work, such as number of frauds discovered and nature and reason for financial restatements related to time periods when the underlying reason for restatement occurred during the auditing firm's tenure as auditor for the client; and
- Input-based – indicators of what the auditing firm puts into its audit work to achieve a certain result, such as the auditing firm's processes and procedures used for detecting fraud, the average experience level of auditing firm staff on individual engagements, the average ratio of auditing firm professional staff to auditing firm partners on individual engagements, and annual staff retention.^{12/}

^{9/} Financial Reporting Council, *The Audit Quality Framework* (February 2008); available at http://www.frc.org.uk/documents/pagemanager/frc/promoting_audit_quality_responses/Audit%20Quality%20Framework%20for%20web.pdf. Appendix B provides an excerpt of FRC's Framework.

^{10/} *Committee's Final Report*, p. VIII:15.

^{11/} *Ibid.*

^{12/} *Ibid.*

Comment Letters and Written Submissions to the Advisory Committee

The Committee received many comment letters and written submissions on the two draft versions of the report.^{13/} The vast majority of individuals and institutions that provided feedback to the Committee agreed in substance with the recommendation. Auditing firms commented that the FRC's audit quality framework and Article 40 Transparency Report of the EU's Eighth Directive^{14/} can be used as starting points to build upon in this effort.^{15/} One firm stressed that audit quality indicators may be more meaningful in the context of an individual audit versus an entire firm.^{16/} The firms also cautioned that, because their size, structure, and client base can vary significantly, any indicators of audit quality and effectiveness should be designed so that they do not disadvantage smaller firms.

Academics noted in their comments a lack of empirical evidence that links better audit quality to many of the input-based measures suggested by the Committee. One input-based measure that researchers say has a well-established positive relationship to better audit quality is auditor industry specialization.^{17/}

^{13/} Comment letters are available at http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1 and written submissions are available at: <http://www.treas.gov/offices/domestic-finance/acap/submissions-06032008.shtml>.

^{14/} European Union, EU Eighth Directive, Article 40, Transparency Report; available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0107:EN:PDF>.

^{15/} See Deloitte LLP Comment Letter (June 27, 2008); available at http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf and Center for Audit Quality Comment Letter (June 27, 2008); available at http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf.

^{16/} See BDO Seidman LLP Comment Letter (June 27, 2008); available at http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF.

^{17/} See Corporate Governance Center Comment Letter (May 15, 2008); available at http://comments.treas.gov/_files/ACAPCommentLetterMay152008.pdf.

FRC's Audit Quality Framework

In November 2006, the UK FRC embarked on an audit quality project by issuing a discussion paper seeking views on ways to promote audit quality.^{18/} The FRC noted that a number of organizations have tried to define the essence of a high-quality audit in order to establish a standard for assessing actual performance of individual audits. After considering various definitions, the FRC concluded that the most appropriate approach is to define those key factors, or drivers, that determine whether a quality audit is undertaken and to assess the way in which audit firms and individual audit teams perform against them. The November 2006 FRC discussion paper outlined four main drivers of audit quality:

- The culture within an audit firm;
- The skills and personal qualities of audit partners and staff;
- The effectiveness of the audit process (being a combination of ethical, auditing and quality control standards together with the firms' audit methodology); and
- The reliability and usefulness of audit reporting.

The FRC developed indicators for each one of these drivers by seeking comments from interested parties. In October 2007 the FRC published a document containing a summary of the comments received and added a fifth audit quality driver – "factors outside the control of auditors affecting audit quality," such as corporate governance, audit committee effectiveness, reporting deadlines, etc.^{19/} These five drivers and their respective indicators make up FRC's Audit Quality Framework, which the FRC says is intended to be complementary to existing UK regulations and

^{18/} Financial Reporting Council, *Discussion Paper: Promoting Audit Quality* (November 2006); available at <http://www.frc.org.uk/images/uploaded/documents/Promoting%20Audit%20Quality%20paper%20web%20optimised1.pdf>.

^{19/} Financial Reporting Council, *Promoting Audit Quality* (October 2007); available at <http://www.frc.org.uk/images/uploaded/documents/Feedback%20Document%20Final3.pdf>.

guidelines. Its purpose is to support effective communication among auditors, audit committees, preparers, investors, and other stakeholders.^{20/}

The FRC has stated that it plans to periodically update the framework in recognition that audit quality is a dynamic concept and that the drivers and indicators of audit quality may change over time. The first review is expected to take place in the fall of 2008.

EU's Eighth Directive

As discussed above, some comment letters have indicated that Article 40 of EU's Eighth Directive may be a good starting point for the development of key indicators of audit quality and effectiveness. The Eighth Directive on Statutory Audits, passed by the European Parliament in May 2006, required member-state adoption by June 29, 2008. Article 40 of the Directive provides that auditors of public entities publish, on their websites, an annual Transparency Report to include at least the following information:

- Legal structure and ownership;
- Association with any network, and its structure and arrangements;
- Governance structure;
- Internal quality control system and leadership statement on its effectiveness;
- Date of last quality assurance review;
- List of public entities audited during the last fiscal year;
- Independence practices and confirmation of independence compliance review;
- Policy on continuing professional education;

^{20/} Financial Reporting Council, *The Audit Quality Framework* (February 2008); available at http://www.frc.org.uk/documents/pagemanager/frc/promoting_audit_quality_responses/Audit%20Quality%20Framework%20for%20web.pdf. Appendix B provides an excerpt of the Audit Quality Framework.

- Financial information, such as total audit fees as a percentage of total revenues; and fees charged for other assurance, tax, and non-audit services; and
- Partners' compensation policies.

Separate from the more recent Article 40 requirements, for several years auditing firms in the United Kingdom have published annual reports on their web sites, pursuant to local requirements applicable to all limited liability partnerships, which include financial disclosures.^{21/} Some reports of UK auditing firms have also included such items as management discussion, disclosures on corporate governance, key performance indicators, and other information.

Academic Research

Academic research so far has not produced a common definition of audit quality. One proposed by Linda DeAngelo in the early 1980s and used in a number of subsequent studies defines quality of audit services 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."^{22/} However, a growing body of more recent academic research does not rely on a definition of audit quality when exploring the topic. Instead, academics have focused their efforts on identifying factors, indicators, and attributes as proxies for audit quality.

Significant input-based factors to audit quality that have been frequently examined by academics include: a firm's tenure with a client; firm independence; engagement team industry experience, competence, and adherence to professional standards; and staffing and supervision on individual audit engagements. Significant output-based factors considered in academic studies include: appropriateness of audit opinion issued; restatements; litigation; enforcement actions; and results of peer

^{21/} Limited Liability Partnerships Regulations 2001, S.I. 2001 No.1090 (U.K: March 19, 2001), available at <http://www.opsi.gov.uk/si/si2001/20011090.htm>

^{22/} Linda Elizabeth DeAngelo, "Auditor Size and Audit Quality," *Journal of Accounting & Economics*, 3 (December 1981), pp.183 -199.

reviews and regulatory inspections. Some studies have also explored firm size and audit fees as possible indicators of audit quality.^{23/}

Academic studies that focused on many input-based factors have failed to find conclusive evidence of a direct positive relationship with better audit quality.^{24/} Engagement team industry experience and professional competence may be two factors for which results appear to more consistently support an association with improved audit quality. Professional competence, however, remains difficult to measure in an objective manner and is often assessed through surveys capturing participants' perceptions.^{25/}

Measuring audit quality through output-based factors can also be problematic since the outcome of an audit is not immediately observable. Information about poor audit quality usually emerges in the context of a subsequent business failure or restatement, or it may never become known.^{26/} Simplistic indicators, such as bigger firm size and higher audit fees, also cannot be viewed as true measures of higher audit quality.

^{23/} See Andrew Bailey and Audrey Gramling, "Financial Reporting Quality: A Focus on the Role of the Independent Auditor," *Research on Professional Responsibility and Ethics in Auditing* (2005), pp. 3 - 35, for a survey of existing academic research on audit quality.

^{24/} See Corporate Governance Center Comment Letter (May 15, 2008); available at http://comments.treas.gov/_files/ACAPCommentLetterMay152008.pdf.

^{25/} See W. Robert Knechel, Vic Naiker, and Gail Pacheco, "Does Audit Industry Specialization Matter? Evidence from Market Reaction to Auditor Switches", *Auditing: A Journal of Practice and Theory*, May 2007, Vol. 26, No. 1, pp. 19 - 45 for a recent study on industry specialization and Joseph Carcello, Roger Hermanson and Neal McGrath, "Audit Quality Attributes: the Perceptions of Audit Partners, Preparers and Financial Statement Users", *Auditing: A Journal of Practice and Theory*, Spring 1992, Vol. 11, No. 1, pp. 1 - 15 for both industry specialization and professional competence.

^{26/} Thomas C. Wooten, "Research About Audit Quality," *The CPA Journal*, (January 2003), pp. 48 - 51.

Other Relevant Studies

Between 2003 and 2008, the United States Government Accountability Office ("GAO") has published two studies that were not focused on audit quality, but contained two definitions of audit quality developed by GAO staff. These definitions were developed for purposes of the reports and do not appear to have been used in another context.

In November 2003, the GAO released a study that defined a quality audit as one in which the auditor conducts the audit –

in accordance with generally accepted auditing standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in accordance with generally accepted accounting principles (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 auditing standards and that, within the requirements of those auditing standards, 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 changes or other adjustments were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reasons for the resignation to SEC.^{27/}

In January 2008 the GAO released another study in which audit quality was considered "to include experience and technical capability of the audit firm partners and

^{27/} United States General Accounting Office, *Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216 (November 2003), p.13; available at <http://www.gao.gov/new.items/d04216.pdf>. (On July 7, 2004, GAO's name changed to the Government Accountability Office.)

staff as well as the capability to efficiently respond to a client's needs and identify and communicate material reporting issues in financial reports".^{28/}

Discussion Format of the SAG Meeting

A panel will provide background information on audit quality, including an overview of the Advisory Committee's recommendation, a review of selected academic research on audit quality, and key points from initiatives on audit quality by the UK Financial Reporting Council and the Transparency Report required by the EU's Eighth Directive. After the panelists' remarks, SAG members will have an opportunity to ask questions and participate in a discussion with the panel.

SAG members and observers will then form three break-out groups to consider the Committee's recommendation and discuss various topics pertinent to the development of key indicators of audit quality and effectiveness from the perspective of investors, issuers, and auditors. On the second day of the meeting, a SAG member from each break-out group will summarize the results of the break-out sessions to the entire SAG, and SAG members will be able to provide additional commentary at that time.

Discussion topics to be considered during the panel and break-out sessions are presented below.

Discussion Topics – Panel

Discussion may address the following topics:

- Whether a definition of audit quality is a prerequisite for developing meaningful key indicators of audit quality and effectiveness. If so, how should audit quality be defined?
- Whether it is feasible to develop meaningful key indicators of audit quality and effectiveness at:

^{28/} United States Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, GAO-08-163 (January 2008), p.91; available at <http://www.gao.gov/new.items/d08163.pdf>.

- an individual audit engagement level;
- an auditing firm level; or
- a combination thereof.

Discussion Topics for all Break-out Groups – General

Discussion may address the following topics:

- At an individual audit engagement level:
 - whether there are measurable input-based and output-based indicators that have an established relationship to audit quality;
 - whether auditor industry experience has a positive relationship to better audit quality;
 - whether audit engagement complexity and size need to be considered when developing key indicators of audit quality and effectiveness, and, if so, how.
- At an auditing firm level:
 - whether any individual pieces of information required by the Transparency Report would have a positive relationship to audit quality, including whether a leadership statement on the effectiveness of a firm's internal quality control system, as required by the Transparency Report, would have a positive relationship to audit quality;
 - whether an auditing firm's size, ownership structure, and client portfolio need to be considered when developing key indicators of audit quality and effectiveness, and, if so, how.

Discussion Topics for Group A

Group A will address the feasibility of and the need for key indicators of audit quality from an investor's point of view:

- Importance and usefulness of currently available key indicators of audit quality and effectiveness, both at an individual audit engagement level and an auditing firm level, in making investment decisions.
- Whether any additional key indicators of audit quality and effectiveness pertaining to an individual audit engagement would be useful to investors, and if so, what specific indicators.
- Other steps that may be necessary to improve the public's knowledge of and confidence in auditing firms' audit quality.

Discussion Topics for Group B

Group B will address the feasibility of and the need for key indicators of audit quality from an issuer's point of view:

- Factors related to audit quality that issuers consider when making decisions on the selection or renewal of an auditing firm.
- Sufficiency of information on audit quality currently available to make an informed decision regarding retention of an auditing firm.
- Consideration of information regarding a board of directors' recommendation on the selection or renewal of an auditing firm, including items such as:
 - audit hours and fees;
 - ratio of partner(s) to staff hours;
 - average years of professional experience per hour;
 - years of partner(s) industry experience;
 - years of auditing firm's tenure with the company;

- discussion of reasons for recommending a particular firm as auditor.

Discussion Topics for Group C

Group C will address the feasibility of and the need for key indicators of audit quality from an auditor's point of view:

- The most meaningful key indicators of audit quality and effectiveness at an individual audit engagement level, including how they are currently used.
- The most meaningful key indicators of audit quality and effectiveness at an auditing firm level.
- With regard to Article 40 of EU's Eighth Directive, the extent to which a firm leadership statement on effectiveness could serve as a key indicator of audit quality and effectiveness.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

APPENDIX A

Excerpt from

FINAL REPORT

**of the
ADVISORY COMMITTEE
on the AUDITING PROFESSION**

**to the
DEPARTMENT OF THE TREASURY**

October 6, 2008

VIII. CONCENTRATION AND COMPETITION

Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.

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 auditing 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.^{49/} In addition, with the majority of public companies currently putting shareholder ratification of auditor selection to an annual vote, shareholders may also lack audit quality information important in making such a ratification decision.^{50/}

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.

The Committee recognizes the challenges of developing and monitoring indicators of audit quality, especially in light of the complex factors driving the

^{49/} See, e.g., New York Stock Exchange, Listed Company Manual § 303A, which the SEC approved on November 4, 2003, for the responsibilities of exchange-listed companies' audit committees.

^{50/} Institutional Shareholder Services, U.S. Corporate Governance Policy – 2007 Updates 3 (2006).

potential impact on the incentives of market actors, and the resulting effect on competitive dynamics among auditors.^{51/}

The Committee has considered testimony and comment letters as well as other studies and reports in developing this recommendation. A possible framework for PCAOB consideration is reviewing annual auditing firm reports in other jurisdictions. For example, one auditing firm's United Kingdom affiliate lists in its annual report nine "key performance indicators, including average headcount, staff turnover, diversity, client satisfaction, audit and non-audit work, proposal win rate, revenue, profit, and profit per partner."^{52/} The Financial Reporting Council recently published a paper setting out drivers of audit quality.^{53/} In addition, the PCAOB also could consider some of the factors that auditing firms present to audit committees, such as engagement team composition, the nature and extent of firm training programs, and the nature and reason for client restatements.^{54/}

The Committee therefore recommends that the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of

^{51/} If the idea proves to be workable, implementation could be a major undertaking for the PCAOB. Developing meaningful quality indicators, defining how they should be measured, and rolling out the measurement process could take significant PCAOB time and effort. Auditing firms, public companies, investors, and academics would all likely have valuable ideas as to approaches the PCAOB could take. However the indicators were devised, firms would have to build their internal processes for measuring the audit quality indicators and the PCAOB would have to develop procedures and training to monitor those processes.

^{52/} See KPMG LLP, UK Annual Report 2007 46.

^{53/} FRC Update 4.

^{54/} Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 4), available at <http://www.treas.gov/offices/domesticfinance/acap/submissions/12032007/Kolins120307.pdf>

audit quality and requiring auditing firms to publicly disclose these indicators.^{55/} Testimonies and comment letters have suggested specific output-based audit quality indicators – indicators determined by what the auditing firm has produced in terms of its audit work, such as number of frauds discovered and nature and reason for financial restatements related to time periods when the underlying reason for restatement occurred during the auditing firm's tenure as auditor for the client – and input-based audit quality indicators – indicators of what the auditing firm puts into its audit work to achieve a certain result, such as the auditing firm's processes and procedures used for detecting fraud, the average experience level of auditing firm staff on individual engagements, the average ratio of auditing firm professional staff to auditing firm partners on individual engagements, and annual staff retention.^{56/}

^{55/} See, e.g., Deloitte LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 29, (June 27, 2008), *available at* http://comments.treas.gov/_files/DeloitteLLPCommentLetter.pdf; Ernst & Young LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 33-34, (June 27, 2008), *available at* http://comments.treas.gov/_files/EYACAPCommentLetterFINAL.pdf; Cynthia Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 36-38, (June 27, 2008), *available at* http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf (noting that the feasibility study should state the overarching objectives of quality indicators, consider the differences in firm size, partnership model, audit practice scope and audit specialty, and recognize the costs, difficulty and complexity involved); Record of Proceedings (June 3, 2008) (Written Submission of Kenneth Nielsen Goldman, Capital Markets and SEC Practice Director, J.H. Cohn LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/Goldmann060308.pdf>.

^{56/} See, e.g., Anonymous Retired Big 4 partner, Comment Letter Regarding Discussion Outline (Nov. 2007) (recommending public disclosure of the following audit quality drivers: 1) average years of experience of audit professionals, 2) ratio of professional staff to audit partners, 3) chargeable hours per audit professional, 4) professional chargeable hours managed per audit partner, 5) annual professional staff retention, and 6) average annual training hours per audit professional); Matthew J. Barrett, Professor of Law, Notre Dame Law School, Comment Letter Regarding Draft Report and Draft Report Addendum (June 13, 2008), *available at*

The Committee believes that the PCAOB should consider both output-based and input-based indicators.^{57/} The Committee also recommends that, if the proposal is feasible, the PCAOB, through its inspection process, should monitor these indicators.

http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=1.; Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, Comment Letter Regarding Draft Report and Draft Report Addendum 3, (June 13, 2008), *available at* http://comments.treas.gov/_files/200806_13ACAP_addendum_commentltr.pdf (suggesting to include, among other things, "average headcount, staff turnover, diversity, client satisfaction, audit and non-audit work, proposal win rate, revenue, profit, profit per partner, engagement team composition, the nature and extent of training programs and the nature and reason for client restatements"); Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 4), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf> (recommending the issuance of regulatory guidance on qualitative factors to be used by audit committees and other market participants to evaluate auditing firms); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (suggesting that disclosure of " key elements that drive audit quality would be a useful benefit to the capital markets" and could include "firm disclosure and discussion of the levels of partner and staff turnover, average hours of professional training, risk management and compliance measurements, and metrics related to the quality of management and firm governance processes"); Anonymous Private Investor, Former Auditor, and Former CFO, Comment Letter Regarding Draft Report and Draft Report Addendum (May 11, 2008), *available at* http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=2. (recommending that the auditor's report disclose, in addition to the location of the office conducting the audit, the percentage of office revenue attributed to the client, the length of the audit firm's tenure with the client, and the length of time until the lead and concurring partner must rotate).

^{57/} See, e.g., Matthew J. Barrett, Professor of Law, Notre Dame Law School, Comment Letter Regarding Draft Report and Draft Report Addendum (June 13, 2008), *available at*

http://comments.treas.gov/index.cfm?FuseAction=Home.View&Topic_id=9&FellowType_id=1&CurrentPage=1 (suggesting that the SEC require registrants to publicly disclose any financial fraud uncovered by the auditor, including numbers and amount of all audit adjustments, and the number of restatements of financial statements with unqualified opinions); Joseph V. Carcello, Chair, American Accounting Association Task Force to Monitor the Activities of the Treasury Advisory Committee on the Auditing Profession, Ernst & Young Professor and Director of Research, Corporate Governance Center, University of Tennessee, Jean C. Bedard, Timothy B. Harbert Professor of Accountancy, Bentley College, Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise and Professor of Accounting, Kennesaw State University, Comment Letter Regarding Draft Report and Draft Report Addendum 10 (May 15, 2008), available at http://comments.treas.gov/_files/ACAPCommentLetterMay152008.pdf (suggesting that the Committee consider "output-based measures of audit quality" such as fewer client frauds, fewer client restatements, less earnings management, and more accurate auditor reporting before a bankruptcy filing); Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>; Gilbert F. Viets, Comment Letter Regarding Draft Report and Draft Report Addendum 2-3, (May 19, 2008), available at http://comments.treas.gov/_files/TREASURYLETTER3.doc (suggesting disclosure of instances where the auditor found and corrected, prior to their disclosure, material financial statement errors and the firms' "acceptable audit risk" in discovering material errors). The Committee recognizes the concerns noted by certain testimony and commentary regarding the use of audit quality indicators. See, e.g., Cynthia M. Fornelli, Executive Director, Center for Audit Quality, Comment Letter Regarding Draft Report and Draft Report Addendum 37 (June 27, 2008), available at http://comments.treas.gov/_files/CAQCommentletter62708FINAL.pdf ("Any feasibility study should also consider—as the re[UK's Financial Reporting Council] has recognized—how the key indicators being considered may vary due to factors unrelated to audit quality."); Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman, LLP, Comment Letter Regarding Draft Report and Draft Report Addendum 11 (June 27, 2008), available at http://comments.treas.gov/_files/ResponsetoAdvisoryCommittee0627final.PDF ("Disclosure of indicators would only be meaningful if they have a clear and demonstrable relationship to audit quality and, even if they do, only if they can be understood in the context of a particular audit."); Record of Proceedings (June 3, 2008) (Written Submission of Brian O'Malley, Senior Vice President

and Chief Auditor, Nasdaq OMX, 3), available at
<http://www.treas.gov/offices/domestic-finance/acap/submissions/06032008/OMalley060308.pdf> (cautioning against an auditing industry managing itself towards some set of preconceived metrics that might sway them from investor protection).

APPENDIX B

Excerpt from

FINANCIAL REPORTING COUNCIL

AUDIT QUALITY FRAMEWORK

February 2008

Two – Audit Quality Framework

Driver	Indicators
The culture within an audit firm	<p>The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:</p> <ul style="list-style-type: none"> • Creates an environment where achieving high quality is valued, invested in and rewarded. • Emphasises the importance of 'doing the right thing' in the public interest and the effect of doing so on the reputation of both the firm and individual auditors. • Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise. • Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality. • Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgement. • Ensures robust systems for client acceptance and continuation. • Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing. • Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.
The skills and personal qualities of audit partners and staff	<p>The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Partners and staff understand their clients' business and adhere to the principles underlying auditing and ethical standards. • Partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit. • Staff performing detailed 'on-site' audit work have sufficient experience and are appropriately supervised by partners and managers. • Partners and managers provide junior staff with appropriate 'mentoring' and 'on the job' training. • Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.

<p>The effectiveness of the audit process</p>	<p>An audit process is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • The audit methodology and tools applied to the audit are well structured and: <ul style="list-style-type: none"> ○ Encourage partners and managers to be actively involved in audit planning. ○ Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently. ○ Require appropriate audit documentation. ○ Provide for compliance with auditing standards without inhibiting the exercise of judgement. ○ Ensure there is effective review of audit work. ○ Audit quality control procedures are effective, understood and applied. • High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with. • The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor. • The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.
<p>The reliability and usefulness of audit reporting</p>	<p>Audit reporting is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Audit reports are written in a manner that conveys clearly and unambiguously the auditor's opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations. • Auditors properly conclude as to the truth and fairness of the financial statements. • Communications with the audit committee include discussions about: <ul style="list-style-type: none"> ○ The scope of the audit. ○ The threats to auditor objectivity. ○ The key risks identified and judgements made in reaching the audit opinion. ○ The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.

<p>Factors outside the control of auditors</p>	<p>Factors outside the control of auditors which are likely to make a positive contribution to audit quality include:</p> <ul style="list-style-type: none">• An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process.• Audit committees that are active, professional and robust in dealing with issues identified during the audit.• Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements.• Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period.• Appropriate agreed arrangements for any limitation of liability.• An audit regulatory environment that focuses on the drivers of audit quality.
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