



CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

Affiliated with the American Institute of CPAs

CAQ RESOURCE

Audit Quality Reporting

Introduction

Public company audit firms serve the public interest and play an important role in the U.S. capital markets by performing audits that enhance the reliability of financial statements. Those audits are conducted under the standards of the Public Company Accounting Oversight Board (PCAOB). The Center for Audit Quality (CAQ) believes that audit quality reporting can foster greater confidence in the public company audit process by assisting financial statement users, audit committee members, and other stakeholders in understanding how an audit firm's management and operations support the performance of high quality audits. Some audit firms currently report this type of information through various mechanisms, aimed at different audiences, including the audit committees of the companies they audit and their own personnel.¹ In addition, several U.S. audit firms currently publicly issue audit quality reports. Some firms may choose to combine the required and voluntary elements into single reports.

¹ Some audit firms must produce reports to audit committees in response to securities exchange listing requirements. In addition, some firms must produce public reports to comply with disclosure requirements mandated by other jurisdictions (e.g., the European Union's 8th Company Law Directive 2006/43/EC, Article 40 Transparency report). These reports may contain some of the elements of audit quality reporting discussed in this resource.

Objective

The CAQ has developed this resource to highlight some important elements of audit quality that U.S. audit firms could consider in refining or developing their own reporting regarding their public company audit practice. Generally, the CAQ believes that the elements of an audit firm's system of quality control that must be established and maintained in accordance with standards issued by the PCAOB could serve as a framework for audit quality reporting. Importantly, this resource is not intended to include all possible audit quality reporting topics, nor is this resource suggesting that all such topics be reported.

The CAQ encourages individual audit firms to tailor this type of reporting to best describe the specifics of its public company/issuer practice and to periodically update such reporting to highlight any significant changes in audit firm policies and practices or recent investments in audit quality. We believe that the breadth, size, and complexity of an audit firm's public company/issuer audit practice are relevant factors when considering the extent, frequency, and content for reporting on audit quality.

This resource provides examples of possible firm-specific information that could be reported in the following six thematic areas, but is intended to provide each audit firm with the flexibility to determine what, when, how, and to whom information regarding audit quality is reported. For example, firms might consider a range of possible audiences for this type of reporting (e.g., audit committees, regulators, firm employees) as well as a variety of delivery or availability mechanisms (e.g., website postings, emails, oral communications, printed reports).

- I. Firm Leadership and Tone at the Top
- II. Independence, Objectivity and Skepticism
- III. Audit Process, Methodology and Performance
- IV. Professional Development and Competency
- V. Monitoring
- VI. Firm Organization and Structure

Possible Elements of Audit Quality Reporting

I. Firm Leadership and Tone at the Top

Audit quality reporting could describe how the audit firm's leadership, through its tone at the top, emphasizes audit quality and holds itself accountable for the audit firm's system of quality control and to the public interest by devoting sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures. For example, information reported could describe how messaging from firm leadership to all personnel underscores the importance of quality throughout the audit process, including the exercise of professional skepticism.

Audit quality reporting could also describe how the firm leadership is responsible for developing, implementing and operating the audit firm's quality control system. The description could discuss the importance of performing work that complies with PCAOB standards and Securities and Exchange Commission (SEC) regulatory requirements and issuing audit reports that are appropriate under the circumstances. In addition, it could include a discussion of the firm's emphasis on the importance of ethics and integrity in every decision its personnel make, particularly at the engagement level.

II. Independence, Objectivity and Skepticism

Audit quality reporting could describe how the audit firm promotes and ascertains personnel compliance with ethics, independence, and issuer confidentiality requirements of the SEC, PCAOB, American Institute of Certified Public Accountants (AICPA) and state boards of accountancy and, how the firm encourages professionals to maintain an objective and skeptical mindset in conducting the audit. The audit firm could describe how its policies and practices promote personnel maintaining independence (in both fact and appearance) as well as exhibiting objectivity and integrity in fulfilling their professional responsibilities.

The description could include how an audit firm establishes procedures to identify and evaluate possible threats to independence and objectivity and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying appropriate

safeguards. In addition, the description could include policies addressing when an audit firm withdraws from an engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied. Lastly, the description could include, if relevant, whether the audit firm has established policies and procedures for confirming the independence of another audit firm performing part of the audit engagement.

Information reported could indicate how the audit firm establishes expectations and promotes adherence to such policies and procedures through, for example, the audit firm's code of conduct, communications from firm leadership, firm training requirements, and compliance programs (e.g., employee hotlines). The audit firm could also describe how it monitors and holds personnel accountable for compliance with such policies and procedures (e.g., through written personnel independence representations, independence monitoring of senior personnel, the performance evaluation process, or firm consultations on independence matters).

III. Audit Process, Methodology and Performance

Audit quality reporting could describe the audit firm's commitment to quality in each step of the audit process by reporting information about its policies and procedures and recent enhancements, if any, related to engagement acceptance and continuance, audit methodology, resource deployment, engagement team supervision and review, consultation, audit committee communications, and audit documentation.

IV. Engagement Acceptance and Continuance of Engagements

Information could be provided about the audit firm's policies and practices regarding whether to accept or continue an engagement, how the audit firm endeavors to undertake only those engagements that it believes can be executed competently, and how the audit firm considers the risks associated with providing potential services to a company. The description could discuss how the audit firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.

V. Audit Methodology

Audit quality reporting could describe how the audit firm's audit methodology and guidance promote the consistent execution of quality audits in accordance with applicable professional standards and PCAOB and SEC regulatory requirements. Information could be reported about how the audit firm provides that its audit methodology satisfies professional standards and regulatory requirements and is appropriately updated. The firm also could generally describe how the audit plan is tailored to address identified risks, how professional skepticism is exercised throughout the audit, and how the audit is conducted and documented to allow for appropriate review.

RESOURCE DEPLOYMENT

The integrity, objectivity, competence, and experience of personnel who perform, supervise, and review the audit are critical to audit quality. Audit quality reporting could describe how the firm's policies and procedures are designed to provide that work is assigned to personnel having the appropriate degree of technical training and proficiency required in the circumstances. The firm could describe how the engagement team is structured to achieve quality audits through the assignment of personnel with the appropriate knowledge, skills, and abilities to exercise skepticism and sound professional judgment based on the characteristics of a particular company, its industry and environment. For example, information could be provided about the engagement partner and audit team selection process and the use of specialists or other subject matters experts.

ENGAGEMENT TEAM SUPERVISION AND REVIEW

Audit quality reporting could provide information related to how engagement team supervision and review promote audit quality. The firm could describe the role of the audit partner and other personnel in supervising the engagement. A description of other processes in place at the firm to promote audit quality also could be described, such as the role and responsibilities of the engagement quality reviewer.

CONSULTATION

Audit quality reporting could describe the audit firm's consultative environment and related policies that promote audit teams reaching appropriate and timely conclusions. The firm could describe the accounting and auditing consultation process, the consultation resources available to firm personnel, attributes of the personnel performing consultations, and policies to resolve any differences of professional opinion.

AUDIT COMMITTEE COMMUNICATIONS

Section 301 of the Sarbanes-Oxley Act of 2002 requires the audit committee to be responsible for the appointment, compensation and oversight of the external auditor, and for audit firms to report directly to the audit committee. Robust and timely communications between an auditor and audit committee can benefit a committee's oversight of the financial reporting process and the external audit, contributing to audit quality. Audit quality reporting could describe how, when, and what the firm generally communicates to the audit committee about the audit and the firm's system of quality control. For example, reporting could include how the firm communicates information about the scope and results of the audit, obtains pre-approval of non-audit services, and provides other information that could bear on the auditor's independence and objectivity. In reporting on communications with the audit committee about the firm's system of quality control, the firm could explain how it communicates information about its internal and external inspection processes.²

² See CAQ Practice Aid, *Discussions with Audit Committees About Inspection Findings and Quality Control Matters*. Available at: <http://www.thecaq.org/resources/pdfs/AuditCommitteeCommunications.pdf>.

AUDIT DOCUMENTATION

Audit documentation, as described by PCAOB Auditing Standard 3, “is the written record of the basis for the auditor’s conclusions” and “also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work. . . .” Audit quality reporting could describe how the audit firm’s policies and procedures are designed to provide that the auditor document, consistent with applicable standards and laws, the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. Information on how the firm maintains the confidentiality, safe custody, integrity, accessibility and retrievability of engagement workpapers could be provided.

VI. Professional Development and Competency

HIRING AND ADVANCEMENT

Audit quality reporting could describe how the firm promotes quality through its commitment to hiring and advancing competent personnel and appropriately developing them through each stage of their careers. The firm could describe its policies and practices for hiring and advancing qualified personnel (e.g., through information about goal-setting, performance evaluations, compensation and advancement, mentoring, and on-the-job training) and how those policies and practices are related to audit quality and the firm’s system of quality control.

TRAINING

Audit quality reporting could provide information about how the firm’s training is designed to instill the appropriate proficiency in professional and leadership skills. Information could describe the firm’s training requirements for personnel by level, types of training offered, related monitoring practices of internal and continuing professional education requirements, and the utilization of on-the-job training. The firm might also include a discussion of resources within or external to the firm focused on training.

MONITORING

Audit quality reporting could describe how the firm monitors adherence to its policies and practices that make up its system of quality control. For example, the firm could describe its internal inspection process and firm resources within the internal inspection group. Information could also be provided about the firm’s process for evaluating and remediating PCAOB and other inspection findings, and how lessons learned from inspection results are utilized for continuous improvement.

FIRM ORGANIZATION AND STRUCTURE

Audit quality reporting could describe the firm’s organization and structure. The firm could provide information about how the governance structure of the firm — including the composition, authority, and selection process of the firm’s governing body and executive management team — influences the firm’s system of quality control. Information could also be reported that describes how the firm’s legal structure and membership in, or affiliation with, any network, alliance or similar arrangement enhance audit quality and auditor independence, objectivity and professional skepticism.

Summary

Audit quality reporting can be an effective mechanism for an audit firm to communicate information that describes how its system of quality control supports the performance of high quality audits and any recent enhancements or other firm initiatives intended to enhance audit quality – information that can demonstrate to capital market stakeholders the audit firm’s commitment to audit quality and foster greater confidence in the public company audit process.

Looking Ahead

The PCAOB is currently undertaking a project on the feasibility of identifying measures that provide insight into financial statement audit quality, or audit quality indicators (AQI), “with a longer-term goal of tracking such measures with respect to domestic global network firms and reporting collective measures over time.”³ The PCAOB’s stated project goals are to:

- Inform PCAOB regulatory processes and policy making with additional insight into the status and trends of audit quality;
- Possibly provide audit committees, investors, management, audit firms, other regulators, and the public with AQIs, providing insight into audit quality for their decisions and policy-making; and,
- Provide firms with additional incentives to compete based on audit quality.

The CAQ’s corresponding project, which is focused on providing a perspective to capital market participants regarding the key elements in the performance of a quality audit, also contemplates an audit quality framework.

As the PCAOB and CAQ projects progress and thought leadership advances, we expect to periodically evaluate whether this resource should be revised to reflect relevant considerations regarding audit quality indicators.

³ *Public Company Accounting Oversight Board Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors 2012–2016*, November 30, 2012, p.5.



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Note: This document should not in any way be construed as legal advice.