

AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT

ASSURANCE



► SUBJECT

CENTER FOR AUDIT QUALITY APPROACH TO AUDIT QUALITY INDICATORS

The Center for Audit Quality (CAQ) has released a white paper on its approach to communicating potential Audit Quality Indicators (AQIs). In the near term, the PCAOB will also be issuing its own concept release on AQIs. Both the PCAOB's and the CAQ's projects on AQIs are aimed at identifying potential measures of audit quality, in addition to inspection results, which audit engagement teams and audit committees may discuss, consider, and use to gauge audit performance.

► The CAQ AQI Project

Background

The CAQ's approach is one that recognizes the role the audit committee plays in providing oversight of the audit and facilitates additional dialogue with the external auditors. The potential AQIs being considered by the CAQ are the result of an extensive project and will be subject to pilot testing during 2014 and 2015.

Audit firms are required, under both international and PCAOB standards, to establish a system of quality control. A potential set of AQIs could provide additional perspective on the key elements of a firm's system of quality control as it applies to a particular audit and could be useful to further an audit committee's understanding of matters that may contribute to the performance of a quality audit, including risks to audit quality which could allow for more robust discussions about the audit firm's plans to manage such risks.

In identifying potential AQIs, the CAQ believes it is important to consider the following thematic elements of audit quality, which are based upon key

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elements of an audit firm's system of quality control and, therefore, facilitate the identification of matters that are most relevant to an audit committee's oversight responsibilities:

- **Firm Leadership and Tone at the Top** - The audit firm's leadership, through its tone at the top, emphasizes the importance of audit quality, adherence to professional standards, independence and objectivity, and holds itself accountable for the effectiveness of the audit firm's system of quality control.
- **Engagement Team Knowledge, Experience and Workload** - Professional staff are knowledgeable, experienced and have sufficient time to perform quality audits.
- **Monitoring** - Processes and controls are in place to assess audit engagement performance and the sufficiency of the audit firm's system of quality control and make any necessary changes.
- **Auditor Reporting** - Reports are reliable, useful, and timely; auditor communications are effective.

The communication of AQIs would supplement other communications already provided to the audit committee and is intended to promote an active discussion about the conduct of the audit.

► Potential Audit Quality Indicators

The AQIs currently being considered by the CAQ are primarily focused on indicators at the *engagement specific level*; while other potential indicators are at the *firm level*. The following represent the potential audit quality indicators identified by the CAQ that will be subject to the pilot-testing efforts:

| Thematic Element of Audit Quality | Audit Quality Indicator | Audit Quality Indicator – Metric | Engagement Specific (ES) or Audit Firm Level (FL) |
|---|--|---|---|
| Firm Leadership and Tone at the Top | | <ul style="list-style-type: none"> • Overview of 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 | FL |
| Engagement Team Knowledge, Experience, Workload | Knowledge and Experience of Key Engagement Team Members: <i>Partners, Managers, Engagement Quality Reviewers</i> | <ul style="list-style-type: none"> • Years on engagement • Years of relevant industry experience • Years with the audit firm • Years at present level | ES ES ES ES |
| | Audit Firm Training Requirements | <ul style="list-style-type: none"> • Discussion of audit firm's training requirements • Communication of engagement team's non-compliance (if any) and related remediation actions | FL ES |
| | Trends in Engagement Hours and Related Timing | <ul style="list-style-type: none"> • Audit hours by various levels, including partner, manager, and staff (e.g., % of planned audit hours for current year (CY) and actual audit hours for prior year (PY)) • Changes in audit hours between years (i.e., CY planned hours vs. PY actual hours) • Timing of audit hours, particularly allocation between planning and execution/completion | ES ES ES |
| | Allocation of Resources by Significant Risk Areas | <ul style="list-style-type: none"> • Planned and actual allocation of resources associated with significant risk areas | ES |

| Thematic Element of Audit Quality | Audit Quality Indicator | Audit Quality Indicator – Metric | Engagement Specific (ES) or Audit Firm Level (FL) |
|-----------------------------------|--|---|---|
| | Specialists and National Office Personnel Involvement by Significant Risk Areas | <ul style="list-style-type: none"> • Number of hours or percentage of audit hours expected to be incurred by specialists or National Office personnel, including a comparison to the PY audit • Explanations regarding nature of issues encountered and types of specialty skills engaged in comparison to the PY audit | ES ES |
| | Key Engagement Team Members' Workloads (<i>Client vs. Non-Client Activities</i>) | <ul style="list-style-type: none"> • Average hours incurred (actual and/or planned) for each category (partner/manager/etc.) indicating split between client and non-client activities, if desired • Providing workload information in relation to a standard workload by level (determined by the audit firm) or the total hours available in a year based on a 40 hour work week (2,080) • Workload level in excess of a standard workload by level (determined by the audit firm) or a 40 hour work week experienced in the PY and anticipated excess during the CY, focusing either on full-year totals or on excess during the critical period of completion of audit procedures and sign-off | ES ES ES |
| Monitoring | Internal Quality Review Findings | <ul style="list-style-type: none"> • Broadly discuss the matters identified during the firm-wide internal quality review program • If the engagement has been subject to internal inspection, discuss any internal quality review findings that required additional audit procedures and their impact on the planned CY audit | FL ES |
| | Firm-Wide PCAOB Inspection Findings | <ul style="list-style-type: none"> • Trends including: <ul style="list-style-type: none"> ○ Number of engagements inspected ○ Number of inspections with Part I comments ○ Percentage of inspections with Part I comments ○ Common issues/themes in Part I comments • Views on the audit firm's efforts to understand potential causes of deficiencies and any remediation plans being undertaken, including changes to audit firm's system of quality control | FL FL |
| Auditor Reporting | Reissuance of Auditors Reports and Restatements | <ul style="list-style-type: none"> • Focus on firm-level trends of reissuance restatements of financial statements and instances where the auditor has withdrawn its previously issued report on ICFR • Any common issues that resulted in restatements | FL FL |

▶ AQI Pilot Testing

The CAQ's pilot test will be conducted in several phases with feedback collected after each phase to identify challenges in accumulating the necessary information, as well as to assess whether the information communicated is helpful to audit committees in fulfilling their responsibilities pertaining to oversight of the auditor. The pilot test is expected to start in Q2 2014 and continue through the completion of the 2014 audit cycle in early 2015.

- Phase 1 will consist of pilot engagement teams from participating auditing firms will prepare specific annual engagement metrics while the firm's National Office will prepare the firm level metrics (audit committees participation is anticipated to be minimal during this phase).
- Phase 2 will be the discussion of these metrics with the audit committee, presumably that will take place as part of 2014 planning with updates provided throughout the audit cycle if significant changes occur in performing the audit. Pilot engagement teams will be expected to solicit feedback from the audit committees regarding the presentation and usefulness of the metrics.
- Phase 3 will be the update of the metrics during the completion phase of the audit.

The CAQ's white paper may be accessed under "Reports and Publications" at: <http://www.thecaq.org/>.

▶ The PCAOB AQI Project

The exact nature and number of potential AQIs that will be proposed by the PCAOB is currently unknown. BDO will issue an additional *Flash* report upon release of further information from the PCAOB.