Concurrent Session: PCAOB Issues

Thursday, March 31st
2:45pm – 4pm
Marriott Marquis, Washington DC

Moderator:
Lori Silverstein, VP & Controller, Boston Properties, Inc.

Panelists:
Robert Herz, Former Chair, Financial Accounting Standards Board
Catherine Nance, Sr. Director-Professional Practice, The Center for Audit Quality
Marc Panucci, Partner, PwC
Melanie Pinto, Director-Accounting Policy, Annaly Capital Management, Inc.

Audit Quality Indicators

The Journey and Path Ahead

Center for Audit Quality

Serving Investors, Public Company Auditors & the Markets

Foreword

January 2016

The CAQ is pleased to share recent insights learned from a series of roundtable discussions with audit committee members and other interested stakeholders around the globe to gather their feedback on a potential set of audit quality indicators. This outreach, together with the results from pilot testing of the CAQ's approach, has led to an understanding that audit committee members may benefit from a multidimensional resource that can assist them in gauging the performance of the audit using qualitative and quantitative factors.

As this report documents, we found that determining audit quality is more art than science. It is the conversation that is important; having a dialogue to explore the context and relevance of certain indicators is critical to obtaining a deeper understanding of the quality of a particular audit. We heard that audit committee members desire assistance with their efforts to grasp the more qualitative aspects of the audit, such as the engagement team having the right mindset to bring forth professional skepticism, which is difficult to measure, and is best achieved through dialogue.

We also learned that audit committee members believe this conversation is most impactful in driving actions that improve or maintain audit quality when audit committees have the flexibility to tailor the discussion around the facts and circumstances of their particular audit. The potential components, or indicators, of audit quality, detailed in the CAQ's April 2014 publication, can support or be used to initiate these conversations about auditor performance, but by themselves cannot lead to a holistic understanding of audit quality.

We have learned a great deal on this journey, but much more remains to be done to strengthen our ability to assess audit quality. We invite you to join us as we continue down the path towards this vital goal.

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Executive Summary

Audit committees serve an essential role in corporate governance by protecting investors through their oversight of a company's financial reporting process and the audit. The Center for Audit Quality (CAQ) believes that reliable quantitative metrics regarding the audit, commonly referred to as "audit quality indicators" or "AQIs," could be used to better inform audit committees about key matters that may contribute to the quality of an audit. The CAQ developed an approach to communicate AQIs that recognizes the roles and responsibilities of audit committees and reinforces the importance of, and enhances the dialogue around, the auditor's communications with the audit committee. The approach is focused on the communication of engagement-level indicators that can be tailored based on the information needs and interests of a specific audit committee to support its oversight responsibility. Firm-level indicators, which focus on an audit firm's overall strategies and initiatives, can be used to complement these engagement-level indicators. The focus on communication of AQIs to audit committees is appropriate because AQIs:

- **Provide relevant information to audit committees –** AQIs provide greater value to those who have direct oversight responsibilities for the audit.
- **Increase the quality of the dialogue with audit committees –** Audit committees are uniquely positioned to engage in dialogue with the auditor to obtain the context necessary to give meaning to AQIs and potentially take actions that might help maintain or increase audit quality on an engagement.
- **Assist with selection/evaluation of the external auditor –** Given their governance authority and knowledge of the particular circumstances of the audit engagement, audit committees are in a position to act upon the information communicated to make decisions about reappointing the auditor, appointing a new auditor, and selecting a lead engagement partner.

To develop perspectives on the key elements of a quality audit and a sample set of quantitative indicators that provide information about the performance of those elements over time, the CAQ worked with a Stakeholder Advisory Panel composed of investors, audit committee members, former standards-setters, auditors and others. The CAQ and the Panel identified a set of potential AQIs they believed would provide the greatest opportunity to enhance discussions between auditors and audit committees, and the ability of audit committees to fulfill their responsibilities relative to oversight of the audit. In January of 2014, the CAQ assembled a roundtable of audit committee members to get their reactions to these indicators. The set of indicators were amended slightly based on their feedback to make them more risk-based. The CAQ in April 2014 published the CAQ *Approach to Audit Quality Indicators* (*Approach*).[1]

In coordination with its member firms, the CAQ subjected the set of potential AQIs to pilot testing. The objective of the pilot testing was to identify potential barriers to auditor preparation and communication of AQIs, and to assess the overall usefulness of the *Approach* to audit committees. Most of the participating audit committees and engagement teams generally expressed overall support for a discussion of AQIs between the audit committee and the engagement team, although feedback on individual AQIs varied.

To continue to evaluate the set of potential AQIs and suggested communication approach, the CAQ convened a series of roundtable discussions with audit committee members around the globe throughout the summer of 2015. The roundtables were designed to spur discussion of whether and how AQIs might assist audit committee members in performing their important audit and financial reporting oversight responsibilities on behalf of investors. Roundtable participants thoughtfully considered the findings from pilot testing and shared their views on the potential benefits and challenges of identifying and developing a set of AQIs. Key findings from the roundtables included the following:

- Desire for information that can assist audit committees in their assessment of the more qualitative aspects of the audit, such as the engagement team having the right mindset to bring forth professional skepticism and auditor judgment, which cannot be adequately captured in a quantitative AQI, and is best achieved through dialogue.
- Recognition that although AQIs can help audit committees oversee the quality of their external audit, the external audit is just one aspect of quality financial reporting.
- Endorsement of a flexible approach that allows an audit committee, working with the external auditor, to tailor or customize the selection and portfolio of AQIs that best suit its specific information needs.
- General support for the concept of AQIs and recognition of their potential value to audit committees' auditor oversight responsibilities, although some participants felt they already have the tools necessary for them to gauge the quality of their audit.
- Agreement that AQIs alone, without context, cannot adequately communicate factors relevant to any particular audit engagement or audit firm.

[1] CAQ *Approach to Audit Quality Indicators*, is available at http://www.thecaq.org/reports-and-publications/caq-approach-to-audit-quality-indicators.

- Agreement that the process of identifying and evaluating AQIs needs to be audit committee-driven and iterative, and will require continuous assessment and refinement in order to meet the changing information needs of audit committees.
- Belief that mandated public disclosure of engagement-level AQIs could lead to unintended consequences and that any disclosures of engagement-level AQI information should be voluntary.

This report is intended to advance consideration of the issues uncovered during these roundtable discussions, pilot testing, and through additional outreach and efforts in recent years on this important topic. While the CAQ has learned a great deal since the launch of its AQI initiative, more remains to be done. For example, because audit committee members are interested in more qualitative information to evaluate audit quality at the engagement level, a potential path forward is to create a tool for audit committees that guides their assessment of both quantitative and qualitative information. Further dialogue and continued collaboration among all stakeholders is needed so that we all can participate in the development of a path forward on AQIs and, potentially, best practices for their use.

Background

In 2012, the CAQ began work to attempt to define and measure audit quality with the goal of determining a set of measures, or framework, from which key stakeholders could communicate and discuss the quality of an audit. Like others around the world, the U.S. public company auditing profession recognized the importance of a common vision and understanding of factors that may contribute to the performance of a quality audit. To inform its efforts, the CAQ convened a Stakeholder Advisory Panel comprising audit committee members, investors, academics, profession representatives and others.[2] An initial roundtable held in January of 2014 with audit committee members helped provide insights on the development of the CAQ's *Approach*.

In developing the *Approach*, the progress of others working on AQIs was considered. The United Kingdom's Financial Reporting Council and the International Auditing and Assurance Standards Board have both sponsored initiatives to help understand and describe AQIs. In identifying potential indicators of quality, the CAQ also evaluated the indicators employed to review quality in other professions and industries, such as the airline, manufacturing, and service industries, and the medical profession. In parallel to the efforts of the CAQ and its member firms, the Public Company Accounting Oversight Board (PCAOB) identified AQIs as a priority in 2013.[3] The CAQ has shared and continues to share with the PCAOB its perspectives regarding the components of audit quality, including potential AQIs to measure those components, as well as the feedback received through pilot testing.[4] While there have been a number of research projects and global initiatives centered on the topic of audit quality in recent years, there remains little consensus on a definition of audit quality, an audit quality framework, and the most relevant indicators of audit quality and how and to whom they should be communicated.

Recognizing the challenges associated with putting words around a specific definition of audit quality, the CAQ instead worked with its Stakeholder Advisory Panel to agree on a framework that describes the elements of audit quality. The elements of audit quality that were included as part of this framework were largely drawn from the PCAOB's quality control standards and other professional standards. The indicators in the *Approach* fall into four principle areas:

1. Firm leadership and tone at the top
2. Engagement team knowledge, experience, and workload
3. Monitoring
4. Auditor reporting

[2] See the Appendix for a list of Stakeholder Advisory Panel members.

[3] PCAOB Briefing Paper, *Discussion – Audit Quality Indicators*, SAG Meeting, May 15–16, 2013. See also, PCAOB's *AQI Update*, SAG Meeting, November 14, 2013.

[4] See, for example, the CAQ's letter to Greg Jonas, Director of the PCAOB's Office of Research and Analysis, on May 13, 2013, which is available at http://www.thecaq.org/newsroom/2013/05/13/caq-provides-perspectives-on-understanding-audit-quality-to-pcaob-ahead-of-sag-meeting. See also, the CAQ's comment letter in response to the PCAOB's July 2015 *Concept Release on Audit Quality Indicators*, which was submitted on September 28, 2015, and is available at http://thecaq.org/resources/comment-letters/caq-comment-letter--pcaob-s-concept-release-on-audit-quality-indicators. The PCAOB's Concept Release sought public comment on 28 potential quantitative AQIs, with over 70 illustrative calculations.

As a guiding principle in developing a set of potential AQIs, the CAQ established that each of the indicators should measure an input or output related to an element of this audit quality framework. Other guiding principles used by the CAQ required that the AQIs collectively avoid or minimize unintended negative consequences, and be scalable to audit firms and audit engagements of different types and sizes.

The feedback received during stakeholder outreach efforts led the CAQ to focus primarily on the communication of engagement-level metrics to audit committees — an approach that recognizes the critical role that audit committees play in the oversight of audits on behalf of investors. Consequently, the *Approach* includes a set of potential AQIs that could aid audit committees in their oversight of the audit and potentially enhance discussions between auditors and audit committees.

The CAQ engaged in two separate efforts to assess the usefulness and feasibility of the *Approach* for audit committees. First, the CAQ coordinated with 10 audit firms of various sizes to pilot test these indicators during the 2014 audit cycle. A total of 30 audit engagements participated encompassing a broad range of operations and industries. None of the selected audit engagements were identified to the CAQ and participating audit firms shared the pilot testing results on a confidential basis. During the pilot testing, audit committees were asked for feedback on the usefulness of a number of proposed AQIs in fulfilling their auditor oversight responsibilities.[5] Although the AQIs, on average, were seen as useful by audit committees, some were more relevant to certain audit committees than others. The audit committee members ranked certain AQIs related to engagement team experience and workload as the most useful indicators, including years of industry experience relevant to the audit engagement, years on the engagement, changes in audit hours between years, and audit hours spent on the audit engagement by engagement team members grouped by their seniority in the audit firm. Many audit committee members expressed a preference for flexibility in the approach to discussing AQIs and a desire to be able to tailor the discussion to include those AQIs most relevant to their company and its audit.

Secondly, in the summer of 2015, the CAQ convened four roundtables with audit committee members in London, Chicago, New York, and Singapore to further explore the issues around AQIs. Through these activities, the CAQ gathered the perspectives of audit committee members and information on current practices around the globe on the identification and communication of AQIs.

[5] Some of the AQIs in the *Approach* that were communicated to audit committees overlapped with existing audit committee communications required by professional standards. For example, Auditing Standard (AS) No. 16, *Communications with Audit Committees*, requires that the nature and extent of specialized skills or knowledge needed related to significant risks be communicated to the audit committee (AC). The *Approach* includes metrics to quantify factors related to "specialists and national office personnel involvement by significant risk area."

Major Themes From the Roundtable Discussions

Most participants supported the concept of AQIs and recognized their potential value to audit committees in execution of their auditor oversight responsibilities. However, some of the audit committee members who participated in the roundtables believed they had sufficiently robust audit evaluation and oversight processes without the need for additional AQI information. Participants agreed that deriving value from AQIs would be dependent upon their ability to tailor or customize the selection and portfolio of AQIs that best suit their specific information needs. Participants also agreed that AQIs alone, without context, cannot adequately communicate factors relevant to the audit of any particular engagement or firm. The PCAOB also notes the importance of context in its *Concept Release on Audit Quality Indicators* and emphasizes that for this reason, AQIs cannot be used as benchmarks.[6] Participants stressed that context is integral to the proper understanding of any AQI, which can lead to an enhanced dialogue between the audit engagement team and the audit committee regarding matters that affect audit quality. Using PCAOB inspections reports as an example, participants said they would find them more useful as an indicator of audit quality if it were clear how identified deficiencies relate to the facts and circumstances of their own audits. Such an understanding requires dialogue with the engagement team to understand the nature of the deficiencies identified, how they may or may not relate to the particular audit, and how the engagement team has addressed them as part of their audit plan.

Another example of the importance of context heard during earlier outreach efforts is a scenario in which an engagement team is experiencing higher than expected overtime. This could be caused by many different factors, including, for example, that the engagement team encountered an unforeseen issue that required extra time, or that the team is overburdened. A timely dialogue with the auditor regarding such matters would allow the audit committee to better understand the specific factors driving the measure and to address potential issues with the engagement team and evaluate the reasonableness of any response.

Another common theme that emerged in the roundtable discussions was that, in many cases, the drivers of the quality of an audit are not inherently quantifiable and, as a result, require evaluation of qualitative factors, such as the engagement team having the appropriate mindset to bring forth professional skepticism and requisite auditor judgment. While quantitative AQIs may inform qualitative aspects of the audit, they cannot be a substitute for an audit committee member's judgment of these qualitative aspects. Moreover, many participants pointed out that evaluating audit quality should be a multidimensional process that focuses on more than the external auditor. While recognizing that responsibility for performing an audit rests with external auditors, these participants noted that without a high-quality internal organization — management and internal audit — achieving high-quality financial reporting and the related audit is challenging.

[6] PCAOB Release No. 2015-005, July 1, 2015, p. 7.

Participants agreed that the process of identifying and evaluating AQIs needs to be driven by the audit committee and iterative. It also will require continuous assessment and refinement in order to meet an audit committee's changing information needs.

Generally, participants also believed that any disclosures of engagement-level AQI information should be voluntary, and expressed concern that mandated public disclosure of engagement-level AQIs could lead to unintended consequences in the marketplace. For example, some participants said that publication of engagement-level AQIs could lead to the production of boilerplate, or one-size-fits-all, approaches that would likely change the nature and usefulness of the information in their discussion with the external auditor. These and other key themes are discussed below.

Audit Committees Support the Concept of AQIs

As noted above, there was widespread agreement that audit quality is a function of the competency and effectiveness of the external audit team, and recognition that the same attributes in company management, internal audit, and audit committees also play critical roles in contributing to the quality of financial reporting and the related audit.[7] While a few participants felt they had what they needed, and that the development of AQIs was "a solution in search of a problem," most participants generally agreed that AQIs could enhance audit committee discussions with the auditor about the engagement team's experience and skills and lead to greater understanding of how those attributes contribute to the audit process. Participants also believed that AQIs could help focus discussions on how the engagement team allocates key resources to address and manage potentially serious audit risks, such as using a specialist to audit a significant estimate. High value

> "I particularly liked the range of AQIs that were being suggested for engagement team knowledge experience and workload because those give insights into the capability of the firm to take on the task and some check about whether what was put into the original plan — the assessment of risk and the allocation of resources — has worked out."
>
> *– Chicago Roundtable Participant*

[7] While the roundtable discussions focused on indicators that could help audit committees assess the quality of their external audit, some noted that the external auditor's performance is but one aspect of quality financial reporting, albeit a critical one.

was attributed to AQIs that could help clarify how the audit firm's tone at the top and system of quality control support the engagement team in delivering quality audit outcomes. One audit committee member said that if AQI information was distributed to the audit committee in advance of the meeting, it likely would help the committee ask more insightful questions of the auditor and increase the efficiency and impact of their limited time together.

Several participants offered that AQIs could be another tool for audit committees to use when selecting the external auditor, as some feared the primary consideration too often used by some may be the audit fee. Some audit committee members favored AQIs as a way to provide a framework supporting a deliberate process in reviewing competing audit firm proposals and ultimately choosing a new audit firm or reappointing the incumbent firm, as the case may be, during an audit tender.[8] For example, AQIs on the extent, distribution, and timing of planned audit hours could be gathered from prospective audit firms at the tendering stage. Audit committees could use the information to gain perspective on strategy and timing of work, which would help audit committees evaluate competing auditors' proposals.

"As with anything of quality, it starts with people. For audit committees, audit quality starts with the lead audit partner — the quality, experience, background, perspective, and philosophy of how they approach client service and working with an audit committee. That's tough to quantify."

– New York Roundtable Participant

Some participants viewed AQIs as a potentially useful tool in initiating dialogue with prospective lead engagement partners in anticipation of the current lead engagement partner rotating off the engagement. Many participants said they evaluate a prospective lead engagement partner to determine whether he or she has the right mix of skills and experience to manage audit risk and can set the right tone with the rest of the engagement team in promoting independence, objectivity, and skepticism. While many accepted that AQIs can support this process, they did not believe that analyzing quantitative AQIs alone could replace the audit committee's assessment of the independence, objectivity, and skepticism of partner candidates.

8 Participants thought this would be of growing importance when mandatory audit firm rotation becomes effective in the United Kingdom and other European Union member states in 2016.

> “Quality is subjective.”
>
> *– London Roundtable Participant*

Qualitative Aspects of the Audit Necessary to Inform Quality

Many participants noted that quantitative AQIs can provide a good starting point for a discussion, but by themselves cannot lead to an understanding of those factors that are the actual drivers of audit quality. Participants emphasized the importance of the external auditor’s mindset in terms of the engagement team’s capacity and propensity to exercise professional skepticism and question and critically assess audit evidence. To participants, the importance of this mindset went hand in hand with those skills associated with a person’s emotional intelligence quotient or EQ.[9] According to participants, engagement teams with high EQ display intellectual rigor, and strong communication and influencing skills, and are highly valued for their ability to quickly and effectively resolve matters with management, the audit committee, and their firm’s national office, as appropriate.

> “An independent professional’s skepticism is most important and is also the most immeasurable of any criteria.”
>
> *– New York Roundtable Participant*

Participants acknowledged that there are AQIs that might contribute to a conversation about the competence and capacity of the engagement team to apply independent judgment and professional skepticism, but they did not believe that relying on these types of AQI data alone would be helpful in assessing such skills, as they are not easily quantified. The participants noted that they can better assess mindset and EQ through conversational discourse with the engagement team, and explained that they would value additional tools to help them consider these important qualities.

Participants agreed that an audit firm’s tone at the top serves as an important indicator of the incentives that drive auditors to deliver quality outcomes. Through an audit firm’s tone at the top, the leadership emphasizes audit quality and holds itself accountable for the audit firm’s system of quality control. Having the proper tone at the top is essential for creating a firm culture that supports professional skepticism and the expression of EQ at the engagement level. It is also something that is difficult to capture in an AQI or set of AQIs. Some participants indicated that they do review audit firms’ messaging around their tone at the top and the

[9] Emotional Intelligence Quotient (EQ) is a term created by two researchers – Peter Salavoy and John Mayer – and popularized by Dan Goleman in his 1996 book of the same name. In a workplace, this term refers to the individual’s ability to sense, understand and effectively apply the power and acumen of emotions to facilitate high levels of collaboration and productivity.

> “What I depend on first and foremost is the tone at the top — the integrity of the organization.” *– New York Roundtable Participant*

measures meant to capture the effectiveness of such messaging, like employee surveys provided to the audit committee by the engagement team. In their minds, however, these measures fall short of being sufficient indicators of how audit firms incentivize their audit partners and personnel to deliver high quality audits.

Participants offered suggestions on qualitative factors that could serve to more adequately validate a firm’s tone at the top and commitment to audit quality. A recurring suggestion related to how firms structure compensation of audit partners and personnel to reward quality. Having an appropriate “compensation philosophy,” some reasoned, would be one indication that a firm has the right tone at the top. Another suggestion was to include information about the systems in place at the audit firm to strengthen quality control and detect and deter wrongdoing within its own organization.

> “You can’t have audit quality without a quality audit committee, quality management, and quality internal audit. To me, the evaluation of audit quality is more multidimensional than just focusing on those items that relate back to the audit firm and the team.”
>
> *– New York Roundtable Participant*

> “...the quality comes from the entire audit which includes the input, the audit process, as well as the output.”
>
> *– Singapore Roundtable Participant*

Several participants noted that the audit committee also plays a role in setting the right tone that supports and encourages auditors, both internal and external, to maintain a questioning mindset and work effectively with the audit committee and management to address and resolve issues. In pursuit of setting the appropriate tone, some audit committees conduct a system-wide review that includes an assessment of how well the work of internal audit was integrated into the external audit process. Some participants pointed to the fact that the audit committees on which they serve routinely undertake some form of performance self-assessment, which often included a conversation about whether the audit committee’s process for evaluating the previous year’s audit and planning for the current year audit was adequate and complete. This evaluation might be another type of indicator of audit quality. Some participants advocated for the development of additional tools that could guide audit committee self-assessments of not only their oversight of the external audit, but also that of the company’s controllership, internal audit functions, and tone at the top.

Audit Committees Should Drive Process of Using and Reporting on AQIs

Because audit committees represent investors, most roundtable participants view themselves as the primary audience for AQI information as it relates to a particular company's financial reporting and audit oversight. Participants felt that as audit committee members they are best informed of the circumstances surrounding the audit engagement, and are, therefore, ideally placed to determine which AQIs are relevant to a given audit engagement. Participants also felt that audit committees are best situated to discuss AQI information with the audit engagement team and management to obtain the necessary context that gives significance to AQIs or fluctuations in AQIs over time.

> "I think indicators precipitate important conversations, but those conversations need to be tailored to the individual engagements, voluntary, and very qualitative."
>
> *– Chicago Roundtable Participant*

There was agreement among those audit committee members who participated in the pilot testing and those who participated in the roundtables that there is no "right" set of AQIs that could, for every audit engagement, consistently add value and insight to audit committee discussions with the engagement team. This is due in part, they explained, to variations among companies' geographic locations, industries, and scope of operations. An overwhelming majority of roundtable participants agreed that the use and reporting of AQIs should remain voluntary to allow for audit committees to experiment with AQIs and tailor the information to address the unique facts and circumstances of their particular audit. For example, audit committee members who serve on boards of global companies said they would focus on AQIs that helped them evaluate how well the global aspects of the audit are being managed by the audit firm. Participants also believed that mandating the communication or reporting of specific AQIs could overburden audit committees with required or expected communications on matters that may not be relevant to the quality of their particular audit. Some participants expressed that they viewed AQIs as generators of questions for the audit committee to ask of the external auditor, as opposed to serving as sources of useful information about audit quality on their own.

Some participants thought a list of common AQIs that could be widely accepted and understood might elevate the use of AQIs among a greater population of audit committees. Over time, experimentation by audit committees may result in the fine tuning or identification of AQIs or a set of AQIs that are widely accepted as useful in the audit committee's dialogue with the auditor.

“I think we will continue to fine tune these measures or indicators and this will allow us to have a useful dialogue with the auditor.”

– Singapore Roundtable Participant

“We ought to be careful not to be too prescriptive because every company is different and every audit is going to be unique.”

– New York Roundtable Participant

This also could serve to promote consistency among audit firms in terms of how certain AQIs are calculated and to generate expectations for audit firms to assist in providing the data associated with these AQIs. Firm-level transparency reports or audit quality reports that are made publicly available by some of the audit firms provide an example of some level of consistency of AQI reporting across firms.[10] The CAQ has observed that among those publicly available reports issued by the largest audit firms in the United Kingdom, the United States, the Netherlands, and Australia, examples of similar types of AQIs include measuring revenue splits between audit and non-audit services, the results of externally published inspections, and a qualitative description of investor engagement. Such voluntary reporting allows for comparison of firm-wide AQI data, to the extent that two firms report the same AQIs.[11]

Audit committee members who serve on the boards of multiple companies pointed out that standardization of AQIs at the engagement level would be challenging given the variation among companies' business models, scope of operations, and risk profiles. They observed that choosing which AQIs best fit the facts and circumstances of each audit engagement requires the audit committee to apply judgment. In applying that judgment, participants said they would likely choose different AQIs on which to focus depending on the company, and that AQIs of importance to a company could change from one year's audit to the next. Even in those cases where they would look at the same AQIs across the different companies, the contextual information they would solicit from the external audit team to explain the significance of an AQI or change in that AQI over time likely would be very different. On the other hand, some participants wondered whether a core set of AQIs could be identified as particularly useful to certain types of companies, such as those in certain complex or high risk industries, or for companies with significant operations in many different countries. Others cautioned that standardization of AQIs runs the risk of turning reports of AQI information into boilerplate documents, which in turn could diminish their usefulness to audit committees.

[10] In general, these reports are intended to provide greater transparency into 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.

[11] Since 2007, the International Organization of Securities Commissions (IOSCO) has been evaluating the role of audit firm transparency reporting in protecting investors and ensuring that markets are fair, efficient and transparent. In November 2015, IOSCO issued a final report on this work which posits that high quality transparency reports issued by audit firms could reinforce audit firm internal policies and practices aimed towards improving audit quality and assist those responsible for selecting a public company auditor by providing information that would enable them to compare firms on the basis of information on a firm's audit quality. See, *Transparency of Firms that Audit Public Companies* (Final Report), available at www.IOSCO.org. See also the CAQ's *Resource on Audit Quality Reporting* (August 2013), which highlights elements of audit quality that audit firms could consider in refining or developing their own reporting regarding their public company audit practice, and which is available at http://www.thecaq.org/docs/audit-committees/caqresourceonauditqualityreporting.pdf?sfvrsn=0.

Potential Unintended Consequences of Public Reporting of AQI Information

Participants acknowledged growing interest from investors for more information about how the work of the audit committee fulfills its responsibilities. In the case of AQI information, participants observed that it is not possible for investors to be privy to the dialogue necessary to bring focus on the significance of AQIs to audit quality at the engagement level. On this basis, many participants believed it would do more harm than good to publicize engagement-level AQI information.

> "This is ultimately a judgment. It's not a math test to see whether or not you got a 90% to have quality."
>
> *– New York Roundtable Participant*

Participants expressed concern that public AQIs could turn into a set of inconsistent and misleading benchmarks or tests. Such metrics, without an accompanying dialogue to provide the appropriate context, could lead the recipient to draw incomplete or uninformed conclusions regarding the presence or lack of audit quality. Also, there could be a tendency to choose a particular set of metrics because they are easily and reliably measured rather than being relevant to audit quality. This could lead to a check-the-box compliance exercise or, worse, a misallocation of resources and overemphasis on managing select metrics to the detriment of a focus on other factors that might be more pertinent to quality performance.

> "It's an evolution, not a revolution."
>
> *– London Roundtable Participant*

Some participants observed that the audit model is also changing in response to technical improvements to audit methodologies and as new, macro and microeconomic risks emerge. For example, audit firms are developing capabilities to incorporate data analytics testing procedures on audit evidence into their audit methodologies, which should increase the efficiency and effectiveness of auditors. Accounting and auditing standards also are evolving to address emerging risks. In light of these factors, some participants posited that the development and required use of a static set of AQIs could serve to reinforce outdated audit methodologies and impede innovation in audits, which over time could risk reducing the overall relevance of the audit, the role of the auditor, and, ultimately, audit quality. To continue to be helpful and not a hindrance, AQIs, they asserted, should be allowed to evolve as well.

Conclusion

By sharing input, feedback, and findings from its multi-year effort to explore AQIs, the CAQ aims to further the dialogue and study of AQIs. This publication is intended to advance that effort. The CAQ anticipates that greater awareness, discussion, and collaboration will lead to the development of a common path forward on AQIs and, potentially, best practices for their use.

> "I am a supporter of audit quality indicators. I believe the project has great merit, and I'm glad to see people out in front of it."
>
> – *New York Roundtable Participant*

The feedback received on the *Approach* through these efforts has reinforced the view that although there is no "right" set of AQIs for every audit engagement, the *Approach* provides a good foundation for further development of tools that could advance the oversight capability of the audit committee with respect to both the quantitative and qualitative aspects of the audit process. Audit committee members expressed an appetite for more qualitative information, as well as guidance on how to use firm-level AQI information already publicly available to enhance the dialogue about their audits. Allowing audit committees to continue to explore AQIs in an audit committee-driven, voluntary environment could facilitate the development of a common principles-based framework that could promote consistency in application of AQI use and reporting while maintaining the flexibility audit committees need to tailor approaches to their specific information needs.

All stakeholders in the financial reporting and audit process can benefit from an understanding of how certain AQIs may correlate with audit quality. For its part, the CAQ will continue to monitor and engage in this exciting and important global dialogue. The CAQ looks forward to the outcome of the PCAOB's project on root cause analysis, which seeks to analyze certain measures of audit quality.[12] The CAQ also will monitor the work of other organizations around the world that have an AQI project on their agenda. The involvement of these organizations and their efforts will continue to be invaluable for driving continued stakeholder interest in identifying AQIs that are both relevant to audit quality and which can be consistently and reliably measured.

12 PCAOB staff briefing memo, *Initiatives to Improve Audit Quality – Root Cause Analysis, Audit Quality Indicators, and Quality Control Standards*, June 24–25, 2014 SAG meeting.

The CAQ expresses its sincere thanks and gratitude to the roundtable participants, as well as the investors, academics, audit committee members, and audit firm representatives who served on the Stakeholder Advisory Panel, and the participants in the pilot testing. Their generosity with their time — and their valuable insights and perspectives — have helped to advance the discussion on this critical issue. Additionally, the CAQ extends its gratitude and appreciation to the Singapore Institute of Directors and the Singapore Accounting and Corporate Regulatory Authority for their support in organizing the Singapore roundtable. The CAQ will continue its rewarding interaction with these stakeholders as it further explores and studies AQIs.

Appendix:
Stakeholder Advisory Panel and Roundtable Participants

Stakeholder Advisory Panel

Stephen Chipman, Retired Chief Executive Officer, Grant Thornton LLP; Former CAQ Governing Board AQI Lead (2012–2015)

Peggy Foran, Senior Vice President, Chief Governance Officer, and Corporate Secretary, Prudential Financial, Inc.

Arnold Hanish, Audit Committee (AC) Chairman, Omeros Corp.

Michele Hooper, President and CEO, The Directors' Council; AC Chairman, PPG Industries, Inc.; CAQ Governing Board Lead AQI (2015–Present)

Robert H. Herz, Executive in Residence, Columbia Business School

William Kinney, Charles and Elizabeth Prothro Regents Chair in Business, University of Texas at Austin

Charles Noski, AC Chairman, Microsoft Corp. and Avon Products, Inc.

Lynn Paine, Senior Associate Dean, Harvard Business School

Zoe-Vonna Palmrose, Professor of Accounting, University of Washington

Anne Sheehan, Director of Corporate Governance, California State Teachers' Retirement System

Roundtable Participants

London: June 2, 2015

Discussion Moderator:

Mark Jeffries, Economist and Keynote Speaker

Participants:

Mike Ashley, AC Chairman, Barclays

Steve Bailey, Managing Director, Aim Proactive Ltd

Hywel Ball, Managing Partner, EY LLP

Lisanne Barrell, Senior Manager, Deloitte LLP

Wanda Eriksen, AC Member, AXA Winterthur and Meyer Burger

Thorsten Grenz, AC Chairman, Draeger

David Isherwood, Partner, BDO LLP

Shonaid Jemmett-Page, AC Chairman, GKN plc

Nick Land, AC Chairman, Vodafone Group plc

David Lindsell, AC Chairman, Drax Group plc and Premier Oil plc

Gillian Lord, Partner, PwC LLP

Steve Maslin, Partner, Grant Thornton UK LLP

John Ormerod, AC Chairman, ITV plc

Kevin Parry, AC Chairman, Standard Life plc

Richard Pinckard, Partner, KPMG LLP

Eric Tracey, AC Chairman, Findel Plc.

Guy Wilson, AC Chairman, Fresnillo plc

Chicago: June 23, 2015

Discussion Moderator:

Leslie Seidman, Executive Director, Center for Excellence in Financial Reporting, Pace University, Lubin School of Business; Director, Moody's Corp. and FINRA

Participants:

Michelle Applebaum, AC Member, Northwest Pipe

Jeffrey Brown, AC Chairman, Teachers Insurance and Annuity Association

Jennifer Burns, Partner, Deloitte LLP

Howard Carver, AC Member, Assurant Inc., Pinnocal Assurance, and StoneMor Partners

Rodney Chase, AC Chairman, Tesoro

Ruth Ann Gillis, Board Committee Member, Snap-On, Inc. (Audit), KeyCorp (Risk), and Voya Financial (Finance)

David Landsittel, Former Chairman and Former AC Chairman, COSO

Janet Malzone, Midwest Audit Practice Leader, Grant Thornton LLP

Mark Zorko, AC Chairman, MFRI, Inc.

New York: June 29, 2015

Discussion Moderator:

Leslie Seidman, Executive Director, Center for Excellence in Financial Reporting, Pace University, Lubin School of Business; Director, Moody's Corp. and FINRA

Participants:

Joan Amble, AC Member, Brown-Forman Corp. (Chair), Sirius XM Radio (Chair), Booz Allen Hamilton, and Zurich Insurance Group

Raymond J. Bromark, AC Chairman, YRC Worldwide, Inc., CA, Inc. and Tesoro Logistics GP, LLC

J. Frank Brown, Managing Director and COO, General Atlantic

Stephen Chipman, Retired Chief Executive Officer, Grant Thornton LLP; Former CAQ Governing Board AQI Lead (2012–2015)

John Cody, AC Chairman, Gannett

J. Michael Cook, AC Chairman, Comcast

William Ehrhardt, AC Chairman, Oppenheimer Holdings, Inc.

Timothy Flynn, AC Chairman, Walmart

Robert Hagemann, AC Chairman, Zimmer Biomet Holdings and Ryder Systems

Robert Herdman, AC Chairman, Cummins, Inc. and WPX Energy, Inc.

Robert H. Herz, Executive in Residence, Columbia Business School

Michele Hooper, President and CEO, The Directors' Council; AC Chairman, PPG Industries, Inc.; CAQ Governing Board Lead AQI (2015–Present)

Peter Kind, AC Member, Enable Midstream Partners (Chair) and NextEra Energy Partners

Lewis Kramer, AC Chairman, L-3 Communications

Catherine Lego, Board Member, SanDisk Corp. (AC Chair), Lam Research and Fairchild Semiconductor

Douglas L. Maine, Limited Partner and Sr. Advisor, Brown Brothers Harriman & Co.

Charles Noski, AC Chairman, Microsoft Corp. and Avon Products, Inc.

Joseph Perry, AC Member, Dime Community Bancshares

Thomas Presby, AC Chairman, ExamWorks Group, Inc.

Richard Randall, AC Chairman, Steve Madden, Ltd.

Singapore: July 27, 2015

Discussion Moderator:

Willie Cheng, Chairman, Singapore Institute of Directors, and AC Chairman, United Overseas Bank

Special Guest:

Julia Tay, Deputy Chief Executive, Singapore Accounting and Corporate Regulatory Authority

Participants:

Fong Heng Boo, AC Chairman, CapitaRetail China Trust Management Ltd

Euleen Goh, AC Chairman, Capitaland Ltd

Chua Phuay Hee, AC Chairman, Perennial Real Estate Holdings Ltd

Tan Boon Hoo, AC Chairman, Bumitama Agri Ltd

Lee Chiang Huat, AC Chairman, Keppel Reit

Tan Ngiap Joo, AC Chairman, Oversea-Chinese Banking Corp.

Goh Boon Kok, AC Chairman, Pan Asian Holdings Ltd

Soon Tit Koon, AC Chairman, SPH Reit

Kevin Kwok, AC Chairman, Singapore Exchange Ltd

Fang Ai Lian, AC Chairman, Banyan Tree Holdings Ltd

Jenny Lim, AC Chairman, CDL Hospitality Real Estate Investment Trust

Paul Ma, AC Chairman, Keppel Infrastructure Trust

Yap Chee Meng, AC Chairman, Keppel Land Ltd

Bahren Shaari, AC Chairman, Singapore Press Holdings Ltd

Alan Ow Soon Sian, AC Chairman, M1 Ltd

Neo Boon Siong, AC Chairman, Keppel Telecommunications & Transportation Ltd

Bernard Tay, AC Chairman, SIIC Environment Holdings Ltd

Timothy Teo, AC Chairman, Guocoland Ltd

Danny Teoh, AC Chairman, Keppel Corp. Ltd

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Seven Habits of Effective Audit Fee Management

Robert Herz (http://www.complianceweek.com/authors/robert-herz) | December 22, 2015

I suspect it will come not as a surprise to readers of *Compliance Week* involved in public company reporting that external audit fees continue to rise for a majority of Securities and Exchange Commission registrants.

The 2015 Audit Fee Report issued in October by the Financial Executives Research Foundation (FERF) reported that median external audit fees increased by 3 percent, 3.5 percent, and 3.4 percent in 2012, 2013, and 2014, respectively. That outpaces the rise in the producer price index, which rose less than 2 percent in each of these years. Increased audit fees were experienced by a majority of the 7,000-8,000 public companies that report their audit fees in SEC filings.

Increased audit fees can result from a combination of higher hourly rates charged by the audit firm and increases in the hours required to complete an audit. Rising compensation and other costs incurred by audit firms can translate into increases in the hourly rates charged for audits, while higher audit hours reflect increases in audit scope. For example, more than 46 percent of the respondents to the FERF survey said the increase in their 2014 audit fees resulted from acquisitions; 36 percent attributed the increase to other changes in company structure.

Another significant factor cited by survey respondents is the heightened focus by audit firms on internal controls over financial reporting. In its inspection reports of audit firms in recent years, the Public Company Accounting Oversight Board has noted many deficiencies relating to the assessment by auditors of internal controls. Auditors are therefore looking more closely at internal controls.

Nearly 40 percent of respondents to the 2015 FERF survey said audit firms “review of manual controls resulting from PCAOB inspections and other PCAOB issues” was a significant contributor to the rise in audit fees. When I was an auditor, yes, there were situations where we increased our review of manual entity-level controls in key areas, and in areas where the company either did not have automated activity-level controls or we concluded that these could not be relied upon because the company had not instituted sufficiently robust access controls over the automated systems.

> Companies can experience many benefits from improving and automating internal controls and the related processes and documentation, including helping better manage and even reduce audit fees. As one company told FERF, "Our external fees have decreased because our internal processes have gotten better."

The FERF study also found that companies that reported ineffective internal controls over financial reporting saw more than twice the increase in their audit fees, compared to companies with effective internal controls: a 6.4 percent increase in 2014 for firms reporting ineffective internal controls, compared to 3.1 percent for others.

Interestingly, although public companies face increased scrutiny of their internal controls, not all have experienced higher audit fees. FERF found that more than 40 percent of public companies reported flat or lower fees in 2014 than in the prior year, and 15 percent of the companies achieved decreases in audit fees for multiple consecutive years.

FERF has begun to explore the reasons why some companies have been able to hold their audit fees flat or reduce them over multiple years, even in the face of significant acquisition activity. While the FERF researchers have not yet completed their investigation of these matters, their findings so far are quite interesting. In interviews with companies that reported decreased audit fees for multiple consecutive years, FERF identified the following seven actions that can make a difference.

Review current processes to identify areas for improvement. One interviewee suggested that immediately after an audit, the internal team takes "inventory" of the audit processes and determines ways that they could be enhanced to address audit inefficiencies. Another interviewee reported that, after carefully considering all key controls, he concluded that the number of these controls be cut nearly in half and still achieve the desired level of coverage. Moreover, by focusing attention on a smaller number of controls, the company was able to improve the quality of control documentation and testing with fewer resources.

Improve internal controls. Interviewees reported that there were improvements in their internal controls resulting from centralization, standardization of work papers, and automation that promoted enhanced consistency of control processes and related documentation. Improving internal control can have a direct effect on the effort and cost of external audits. As Gregory Wilson, former deputy director of the PCAOB Inspection Division, put it, "Show me a company with weak internal controls, and I'll show you an expensive audit."

One of the companies FERF interviewed reduced its audit fees despite multiple acquisitions that doubled its size in recent years not once, but twice. The company's vice president of accounting policy and SOX reported that while the company did not set out to reduce audit fees, this was a byproduct of the focused effort to improve controls in the light of its recent rapid growth through acquisitions and its reconsideration of controls against the 2013 COSO Framework.

Continual communication and collaboration with external auditors. Almost all interviewees suggested that there should be regular and active communication with the external auditor during the audit. This helps identify efficiencies for both the company and the auditor, and it helps ensure that the auditors are provided the information they need on a timely basis.

Centralize the audit footprint. Respondents indicated that an audit of the financial statements of a company with centralized operations could be more efficient and less costly than that of a company with decentralized operations.

Companies also described the importance of centralizing critical information and information systems. One company achieved important efficiencies by replacing three or four different enterprise resource planning systems with a single system that was easily accessible at one location.

Automation. Interviewees suggested that automation has major benefits, especially of time-consuming, error-prone tasks. One company reported using a cloud-based solution to automate internal controls documentation and to manage and execute SOX testing documentation (including evidence of the performance of key controls), certification, and the reporting process. This system also provided the auditors with all the necessary information to review and test the company's controls. Companies also reported benefits from standardizing and automating account reconciliations. Among other benefits, such automated systems allow auditors to view reconciliations on their own without the need to involve company staff.

Overall, significant cost savings and other benefits can arise from automation via reducing the administrative burden and freeing up critical resources to focus more attention on the risks and controls that matter most.

Skilled staff. Not surprisingly, interviewees reported that having well-trained company staff involved with the audit will help reduce audit fees. One interviewee suggested that having an employee with prior audit experience is critical to this effort.

Review audit hours and fees, and don't be afraid to push back. Companies that monitor the hours auditors spend on particular audit areas are in a better position to question the number of hours they were billed for and why these hours were incurred. Companies should not just blindly accept an explanation by their auditors that they had to perform additional audit steps because "the PCAOB says so."

Sound internal controls are critical to financial reporting. Companies can experience many benefits from improving and automating internal controls and the related processes and documentation, including helping better manage and even reduce audit fees. As one company told FERF, "Our external fees have decreased because our internal processes have gotten better."

Related articles

The U.S. Financial Reporting System, Circa 2015: Are We OK? (http://www.complianceweek.com/blogs/robert-herz/the-us-financial-reporting-system-circa-2015-are-we-ok)

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

October 31, 2014

Ms. Phoebe W. Brown
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Delivered Electronically

Re: Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements, August 19, 2014* (the Staff Paper).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 209 companies representing an equity market capitalization of $789 billion[1] at September 30, 2014. Of these companies, 169 were Equity REITs representing

[1] http://www.reit.com/sites/default/files/reitwatch/RW1410.pdf at page 21

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91.8% of total U.S. listed REIT equity market capitalization (amounting to $724.5 billion). The remainder was 40 publicly traded Mortgage REITs with a combined equity market capitalization of $64.5 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. However, NAREIT has significant concerns with the Staff Paper as drafted.

Why is a change to the existing audit framework for auditing estimates warranted?

NAREIT is not persuaded that a change to the audit framework for auditing estimates is necessary. In NAREIT's view, a single standard for auditing estimates and fair value measurements is an unworkable solution given the multiple iterations of accounting estimates in U.S. Generally Accepted Accounting Principles (GAAP). Additionally, NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to auditing estimates fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on the number of deficiencies found in the inspections process. While NAREIT acknowledges that PCAOB inspection reports have identified shortcomings in the audit work surrounding estimates, we observe that these criticisms could be caused by a number of factors:

- Auditors are not following the current standards;

- Auditors are performing the required procedures but are not adequately documenting the work that they perform;

- Auditors lack sufficient knowledge with respect to quantitatively sophisticated methods of developing estimates used by their clients or third party specialists and therefore are not capable of designing appropriate audit procedures to test the estimates; or,

- The expectations of the PCAOB inspection teams do not reflect the inherent uncertainties and imprecision that underlies estimates, including estimates of fair value measurements.

NAREIT is not aware of any significant audit failures (with "audit failures" defined as restatements of financial statements) driven by erroneous estimates in recent history that would necessitate standard setting by the PCAOB. NAREIT questions whether the PCAOB's inspection findings in the areas of estimates, including estimates of fair value measurements, are more likely driven by auditor shortcomings relative to existing standards rather than problems with the auditing standards themselves.

As illustrated by FASB Member Larry Smith and former FASB Chairman Robert Herz[2] at the October 2, 2014 PCAOB Standing Advisory Group Meeting, estimates are prevalent throughout financial statements prepared under U.S. GAAP. Further, accounting estimates extend above and beyond fair value measurements and the GAAP hierarchy for fair value measurements that was introduced by FAS 157 *Fair Value Measurements*. Examples of accounting estimates within the real estate industry include: depreciation and amortization, asset impairment, reserves for tenant receivables, accrued expenses, deferred revenues, commitments and contingencies, contingent rental revenue, unrealized gains and losses on derivatives, foreign currency translation adjustments, changes in value for available-for-sale securities, etc. Developing estimates and fair value measurements is not new to the accounting profession. NAREIT fails to see where audits have failed to assess the reasonableness of the financial statements in accordance with U.S. GAAP.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the portions of the Staff Paper that suggest expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor's testing of the accuracy of information provided to the third party is appropriate. Additionally, NAREIT considers the evaluation of information provided by third parties to be sufficient in accordance with current audit literature. However, we disagree with requiring the auditor to "test the information provided by the specialist as if it were produced by the company"[3] or to "evaluate the audit evidence obtained [from the third-party source] as if it were produced by the company.[4]" The idea that either management (in its assessment of the adequacy of the company's internal controls over financial reporting) or the external auditor (in its evaluation of management's assessment) could evaluate third parties' processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting*

[2] http://pcaobus.org/News/Events/Documents/10022014_SAG/Herz_slides.pdf
[3] Staff Paper, page 38, Management's Use of a Specialist
[4] Staff Paper, page 44, Use of Third Parties

Estimates acknowledges that "[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.[5]" Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; or (ii) the company's management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties' processes and controls as if they were part of the company itself would exacerbate the company's resource constraints in the first scenario and potentially discourage the company's efforts in the second scenario. As indicated earlier, in NAREIT's view, the costs of implementing such audit requirements would far outweigh any incidental benefits.

Isn't an accounting estimate, by its very nature, merely one possibility in a range of reasonable outcomes?

While NAREIT understands the importance of auditing estimates, we have to wonder whether the Staff Paper is attempting to reach a level of precision via the audit process that contradicts the inherent nature of the subject being audited.

Estimates, including fair value measurements, are used extensively in the preparation of real estate entities' financial statements. Preparers, auditors and, most importantly, investors and other users of this financial information understand the imprecision that results from the use of estimates. In the context of financial reporting, management's responsibility is to use its judgment regarding available information in making accounting estimates. AU 342.03 notes that "[m]anagement's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take." The auditor's responsibility is *not* to conclude whether the estimate is right or wrong, but to assess whether management's accounting estimate is *reasonable.* Auditing Standard No. 14 *Evaluating Audit Results* states: "If an accounting estimate is determined in conformity with the relevant requirements of the application financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement.[6]"

[5] http://pcaobus.org/standards/auditing/pages/au342.aspx
[6] http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_14.aspx

NAREIT's recommendation: Focus on targeted improvements to identified problems

In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach instead of wholesale changes to the audit framework for estimates. For example, if there are shortcomings in the use of the work of specialists, the PCAOB might consider focusing on auditing the work of specialists to further evaluate the expertise and/or objectivity of the specialist or auditing the inputs provided by the company to the specialist. Alternatively, if the shortcomings stem from inadequate documentation or insufficient subject matter knowledge, the PCAOB could consider steps that would target those issues.

As a starting point, NAREIT recommends that the PCAOB address how proposed changes to auditing literature would impact the auditor's consideration of materiality. NAREIT observes that the Staff Paper is silent on the assessment of materiality. The intersection of where estimates and materiality meet would appear to be a fundamental starting point for the PCAOB's focus in making targeted improvements to audit literature.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites fair value as a common area of "significant audit deficiencies[7]", NAREIT fails to see where these deficiencies have translated into restatements of previously reported financial results. Thus, NAREIT questions whether the Staff Paper simply represents rule-making for the sake of rule-making, without a clearly articulated underlying problem. As indicated above, in the event that the PCAOB concludes that further standard setting is required, NAREIT recommends that the Board make targeted improvements to specific sections of audit guidance as opposed to wide-ranging changes to the entire audit framework.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

[7] Staff Paper, page 3, Introduction

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

December 11, 2013

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Delivered Electronically

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements (PCAOB Release No. 2013-005, August 13, 2013, PCAOB Rulemaking Docket Matter No. 034)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 193 companies representing an equity market capitalization of $659.6 billion[1] at September 30, 2013. Of these companies, 154 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to $598.5 billion). The remainder, as of September 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of $61.1 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. NAREIT acknowledges the PCAOB's substantive consideration of the feedback it received on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, Notice of Roundtable, (PCAOB Release No. 2011-003, June 21, 2011, PCAOB Rulemaking Docket Matter No. 34*[2]*)* (the Concept Release) that discussed alternatives for changing the auditor's reporting model. In particular, NAREIT supports the PCAOB's decisions to retain the current pass/fail model of auditor reporting and to reject the requirement for an auditor's discussion and analysis. However, NAREIT does not support a requirement for the auditor to report on "critical audit matters" (as that term is defined in the Proposal). In our view, such a requirement would not meet the PCAOB's objective of providing users of financial statements with additional meaningful information. As discussed further below, it is our view that the PCAOB's proposal for auditor reporting of critical audit matters would largely result in generic disclosures that are duplicative of information that is provided by management while simultaneously increasing audit cost.

NAREIT Comments on Critical Audit Matters

We understand that the PCAOB is trying to add value to the audit report and enhance its decision usefulness by requiring that the auditor identify and discuss critical audit matters as a part of the annual audit report. However, we believe that a requirement to disclose critical audit matters in the audit report would potentially:

- Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand;

- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

- Duplicate information already disclosed by the issuer;

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[1] http://returns.reit.com/reitwatch/rw1310.pdf at page 21
[2] http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf

- Increase audit fees for, among other things, the senior level time the auditor would incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee; and,

- Exacerbate existing time pressures to meet financial reporting deadlines.

Each of these concerns is further discussed below.

Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand

In reporting critical audit matters, auditors would likely feel compelled to describe the audit procedures they performed, consistent with the examples in the proposal. NAREIT questions whether the substantial majority of financial statement users are likely to understand a discussion of audit procedures. When the auditor discusses its audit process with the audit committee, the auditor has the opportunity to answer questions and provide additional information to the audit committee members, thus limiting the risk of confusion or misunderstanding about the nature and extent of audit procedures performed. Further, when the audit committee and auditor are discussing the audit work in discrete areas, they are doing so in the context of the audit taken as a whole. In this context, there is no potential for confusion about whether the auditor is, in some way, effectively providing a piecemeal opinion on an individual line item within the financial statements.

NAREIT believes that users would likely be confused by the discussion of audit procedures in an audit report not only because they lack an understanding of the audit process as a whole but because they lack the context for the discussion of discrete audit procedures on an individual financial statement line item. We are therefore concerned that the Proposal would widen the existing expectation gap regarding the nature and extent of audit work required by the PCAOB's auditing standards.

Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

One of the examples in the Proposal (Hypothetical Auditing Scenario #3) illustrates a fact pattern in which the auditor discloses a "control deficiency less severe than a material weakness noted in the Company's internal control system."[3] This information is part of the auditor's required communication to the issuer's audit committee, under current PCAOB standards, but there is nothing in securities law that requires public reporting of either significant deficiencies in internal controls or audit adjustments.

[3] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77

The Proposal acknowledges a fact pattern whereby control deficiencies that are not material weaknesses would be disclosed by the auditor. For example, Appendix V of the Proposal states:

> Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.[4]

This would mean that the auditor would be disclosing sensitive information that is not otherwise required to be reported by the issuer. Furthermore, unlike the existing audit requirement to discuss such matters with the audit committee, the information is being presented to users of financial statements with limited context and no opportunity for the clarifying discussion that occurs during most audit committee meetings.

We strongly believe that an audit firm should not report sensitive information that is not required to be disclosed under existing securities laws and/or generally accepted accounting principles. We believe that existing U.S. securities laws and existing U.S. GAAP are sufficient to provide users with the appropriate amount of information to make investment decisions. Further, the expansion of existing disclosure requirements is the purview and responsibility of the SEC and the FASB. Accordingly, if the PCAOB were to go forward with this Proposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

Duplicate information already disclosed by the issuer

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the critical accounting policies and estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover critical accounting policies and estimates provide the reader with management's assessment of the most judgmental aspects of the financial statements, NAREIT questions why the Board would require auditors to duplicate this information. If the PCAOB believes that this existing information is not sufficiently robust or transparent, NAREIT recommends that SEC or the Financial Accounting Standards Board (FASB) evaluate this aspect of financial reporting and provide additional guidance through the comment letter process. Another possibility would be to request that the FASB evaluate these disclosures as part of its Disclosure Framework Project.

Increase audit fees for, among other things, the senior level time the auditor will incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee

[4] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-32

NAREIT acknowledges that the current audit standards require the auditor to identify and communicate significant audit matters to the audit committee. However, NAREIT believes that requiring the auditor to report critical audit matters in the audit opinion would lead to increased audit fees. At a minimum, each and every audit engagement team would incur additional senior level time in order to determine the critical audit matters (CAMs) for purposes of drafting the proposed disclosure and discussing both the CAMs and the related disclosure with management and the audit committee.

Further, given the significant degree of subjectivity involved in determining which significant audit matters are "the most critical" and the inevitable second guessing of that determination by audit committees, management, PCAOB inspection teams, SEC staff and litigators, NAREIT anticipates that audit partners would need to consult others in the firm regarding both the selection of CAMs as well as the report language. The added time and related increased risk incurred by the audit firm would directly translate into an unnecessary and avoidable increase in annual audit fees. Further, we believe that there is a risk of inconsistent disclosure of CAMs both within and among the audit firms. We sense that the added disclosure in the audit report would open both audit firms and issuers to increased litigation risk, the cost of which will be passed on to issuers (and thus investors) in the form of increased audit fees.

Exacerbate existing time pressures to meet reporting deadlines

Given the nature of the audit process, auditors are unlikely to be able to conclude definitively on "the most" significant, judgmental or complex audit matters until substantially all the audit work has been completed. That necessarily places the decisions and discussions surrounding CAMs into the very final stages of the audit and just prior to the release of the audited financial statements on Form 10-K. If the Board moves forward with this Proposal, NAREIT foresees the addition of a very time consuming step into the late stages of what is already a tight deadline for many issuers.

In light of time pressures, liability concerns and fee issues, audit firms may feel compelled to develop standardized audit report language for common critical audit matters. Thus, stepping back and looking at the sum total of our concerns, we believe there is a significant risk that the PCAOB's proposal will result in boilerplate, duplicative disclosures that add to the cost of the audit without adding to the information available to users of financial statements.

NAREIT Comments on Auditor Tenure

NAREIT understands that there is some interest amongst financial statement users about auditor tenure. We observe that for many issuers, the tenure of an audit firm can be determined by a review of the issuer's public filings. However, NAREIT does not support the Proposal that auditors report on their tenure because that information, placed in the audit report, infers a direct relationship between auditor tenure and the quality of the audit or the content of the audit report that does not exist. NAREIT is unaware of evidence indicating that auditor tenure has a direct correlation to audit quality.

Perhaps more importantly, NAREIT considers auditor tenure to be a corporate governance matter under the direct purview of the issuer's audit committee only. A statement regarding auditor tenure placed in the audit report would provide no information about how the audit committee assesses the quality of the audit work and determines that a change in auditor is appropriate. It also would provide no information regarding the most recent tendering of the audit. Some users might incorrectly infer that longer auditor tenure indicates that the audit has not been retendered when, in fact, the audit committee's decision to retain the incumbent audit firm was made after an extensive retendering process.

Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report. If users of financial statements believe this information would provide significant value, the SEC should consider adding relevant disclosure requirements to proxy statements that are filed coincident with audit committee reports or in connection with company shareholder ratification of auditor appointments.[5]

NAREIT Comments on Other Information

We do not understand the purpose of expanding the audit report to explicitly address information that is not audited and that is often outside the expertise of an auditor. More importantly, NAREIT believes the proposed language that would be included in the audit report regarding other information would mislead users into believing that the auditor has an authoritative basis to conclude on the sufficiency, accuracy or completeness of the other, unaudited information. This, in turn, would cause auditors to do additional work and invest additional resources into the reading of the unaudited information beyond what may be required by the standard because they would be perceived as being more closely associated with that information. Inevitably, this exercise would increase the cost of the audit as well as the cost of preparing the unaudited information. The result would be more cost to shareholders without additional assurance to those same shareholders.

In NAREIT's view, there is no need to change the existing audit standard related to other information contained in a report that includes audited financial statements. We are unaware of any evidence indicating that auditors are either not meeting their existing (albeit very limited) responsibilities for other information or that users are misinformed about which elements of an SEC filing are audited and which are not. In fact, in its Proposal, the PCAOB notes that "investors generally were not supportive of auditor assurance on other information outside the financial statements."[6] To the extent that the audit committee or external third parties (*e.g.*, underwriters, institutional investors, or analysts) believe it is appropriate to obtain additional assurance on other information included in SEC filings, the PCAOB's existing standards provide auditors with the tools to meet those requests. Accordingly, nothing more is needed.

[5] In its Proposal, the PCAOB notes that the UK-listed companies are "required to provide information about auditor tenure in a separate section of the annual report" (page A5-16.) The approach used by the UK is consistent with our view that information about auditor tenure, while potentially of interest to investors, is a matter of corporate governance.

[6] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 25

The PCAOB states that

> The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit.[7]

NAREIT views these requirements as largely consistent with the existing audit standard which states that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."[8] However, the proposed changes to the standard, and the related proposed language in the audit report, suggest that the auditor's responsibility should extend beyond what has been historically required. Specifically, under the Proposal the auditor would be required to state that, "in addition to auditing the financial statements and the Company's internal controls over financial reporting," the auditor would also be required to "evaluate" the other information in the filing, an evaluation that was "based on relevant audit evidence obtained and conclusions reached during the audit." What level of assurance is provided by an "evaluation?" Absent clarification by the PCAOB, users of financial statements could mistakenly perceive the audit firm's work and the level of assurance provided surrounding other information as something substantial, with no meaningful understanding as to the distinction between an "evaluation" and an "audit." This perception gap could have severe ramifications on the investment community as well as the audit profession. Instead of adding more clarity to the audit report and narrowing the expectation gap, we view this Proposal as significantly obfuscating the nature and scope of an audit and dramatically widening the expectation gap.

In NAREIT's view, this aspect of the Proposal is fraught with many issues involving each financial statement users' perspectives, and would likely lead auditors by default to performing a far more significant amount of unnecessary work on other information than under current standards due to the lack of clarity regarding the nature and scope of the auditor's responsibility. This would cause increases in audit fees when there is absolutely no demand or requirement for any type of assurance on this information and could lead to less useful information being provided to investors.

Summary

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report, disclosure of auditor tenure, and the auditor's responsibility for other information are warranted. These requirements would add costs without improving the quality of the audit. Furthermore, these proposals would be likely to confuse and in some cases even mislead users of

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[7] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 7
[8] See AU 550.04

financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Proposal, and instead focus its time and resources on improving aspects of the audit procedures that would enhance audit quality so as to provide investors with more confidence that the audited financial statements are, indeed, free of material misstatement.

In the event that the PCAOB decides to move forward with the Proposal, NAREIT recommends that the Board consider conducting robust field testing. In our view, field testing should involve not only the preparer and auditor community, but also representatives from the investment community in order to fully assess both the costs and the benefits of the Proposal. This would provide the Board with evidential matter in evaluating whether the Proposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Proposal's objectives could actually be achieved.

* * *

We thank the PCAOB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher T. Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 3, 2015

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Delivered Electronically

Re: Staff Consultation Paper No. 2015-01 - *The Auditor's Use of the Work of Specialists*

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper, *The Auditor's Use of the Work of Specialists* (the Staff Paper).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 224 companies representing an equity market capitalization of $890 billion at June 30, 2015. Of these companies, 183 were Equity REITs representing 93.5% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $832 billion)[1]. The remainder, as of June 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $58 billion.

[1] https://www.reit.com/sites/default/files/reitwatch/RW1507.pdf at page 21.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. However, NAREIT has significant concerns with the Staff Paper as drafted. NAREIT's comments are primarily focused on the areas that would impact NAREIT member companies (*i.e.*, use of specialists in valuing investment properties, equity and mortgage-backed securities, and derivative positions.)

Why is a change to the existing audit framework for the auditor's use of specialists warranted?

NAREIT is not persuaded that a change to the audit framework for the auditor's use of specialists is necessary. In NAREIT's view, the expansion of audit requirements for the work of specialists is an unnecessary change given the amount of work performed by auditors today. NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates prepared by specialists pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to the auditor's use of the work of specialists fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on academic research papers and limited circumstances where *existing* audit guidance was not followed by the auditor. Further, NAREIT is not aware of any significant audit failures (with "audit failures" defined as restatements of financial statements) driven by the inappropriate reliance on work performed by a specialist in recent history that would necessitate standard setting by the PCAOB.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the alternative of expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor's evaluation of the objectivity of the specialist and the accuracy of information provided to the third party are appropriate. Additionally, NAREIT considers the existing requirements for both management and auditors to evaluate the information provided by third parties to be sufficient in accordance with current audit literature.

The idea that either management (in its assessment of the adequacy of the company's internal controls over financial reporting) or the external auditor (in its evaluation of management's assessment) could evaluate third parties' processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting Estimates* acknowledges that "[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.[2]" Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; and (ii) the company's management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties' processes and controls as if they were part of the company itself would exacerbate the company's resource constraints in the first scenario and potentially discourage the company's efforts to utilize outside specialists in the second scenario. NAREIT cautions the PCAOB of the potential for the unintended consequence of management deciding not to use outside expertise in order to avoid incremental audit fees.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites academic research papers and limited examples of where the auditor failed to follow existing auditing standards, NAREIT fails to see the impetus for a change in auditing standards. In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach that address the root cause of problems that are identified.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

[2] http://pcaobus.org/standards/auditing/pages/au342.aspx

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In brief
The latest news in financial reporting

pwc

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December 18, 2015

At a glance

The PCAOB adopted new rules and related amendments to its auditing standards to require public reporting of the name of the engagement partner and other accounting firms that took part in the audit.

PCAOB adopts final rules to disclose name of partner and others on new form

What happened?

On December 15, 2015, the Public Company Accounting Oversight Board ("PCAOB") adopted new rules and amendments to its auditing standards requiring disclosure of the name of the engagement partner and information about other accounting firms that took part in the audit, including other firms within the same network as the group auditor. This information will be filed with the PCAOB on a new PCAOB form, *Auditor Reporting of Certain Audit Participants* ("Form AP") and will be searchable on the PCAOB's website.

The rules and amendments to the auditing standards require disclosure for all audits of issuers, including employee stock purchase, savings, and similar plans that file annual reports on Form 11-K. At this time, the PCAOB is not extending the Form AP requirements to audits of brokers and dealers unless the broker or dealer is an issuer required to file audited financial statements. Additionally, the PCAOB is recommending the rules and amendments to its auditing standards apply to emerging growth companies, which will be subject to a separate determination by the Securities and Exchange Commission (the "SEC"), pursuant to the JOBS Act.

Disclosure requirements and effective dates

The rules require disclosure of:

- The name of the engagement partner;
- The names, locations, and extent of participation of other accounting firms that took part in the group audit, if their work constituted 5 percent or more of the total group audit hours; and
- The number and aggregate extent of participation of all other accounting firms that took part in the group audit whose individual participation was less than 5 percent of the total group audit hours.

Subject to SEC approval, disclosure of the engagement partner will be required for audit reports issued on or after January 31, 2017 (or three months after SEC approval, whichever is later), while disclosure of information about other accounting firms that took part in the audit will be required for audit reports issued on or after June 30, 2017.

Form AP

The filing deadline for Form AP will be 35 days after the date the auditor's report is first included in a document filed with the SEC, with a shorter filing deadline of 10 days for initial public offerings.

The filing of Form AP is required the first time an audit report is included in a document filed with the SEC. Subsequent inclusion of precisely the same audit report in other documents filed with the SEC does not give rise to a requirement to file another Form AP. Conversely, any changes to the auditor's report, including if it is dual-dated, requires a new Form AP even when no information on the form, other than the date of the report, changes.

For audits of mutual funds, the rules permit one Form AP to be filed in cases where multiple audit opinions are included in the same auditor's report, such as in the case for mutual fund families. If multiple audit opinions included in the same auditor's report involved different engagement partners, a Form AP will be filed for each engagement partner.

Partner identifying number

The final rules require each registered accounting firm to assign a 10-digit partner identifying number to each of its partners serving as the engagement partner on audits of issuers. The number will be assigned to a particular partner and will not be reassigned if the partner retires or otherwise ceases serving as engagement partner on issuer audits conducted by that firm.

Use of estimates

Firms may use a reasonable method to estimate audit hours of other accounting firms participating in the audit.

Why is this important?

It is intended to help the public know the name of the engagement partner and understand how much of the audit was performed by the accounting firm signing the auditor's report and how much was performed by other accounting firms.

What's next?

The PCAOB will formally submit the rules and amendments to its auditing standards to the SEC, and the SEC will consider them for approval through their normal process. PCAOB staff plans to publish guidance in 2016 to assist firms in complying with the reporting requirements of Form AP.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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At a glance

The staff of the PCAOB's Office of the Chief Auditor is evaluating whether existing PCAOB standards relating to auditing accounting estimates and fair value measurements can and should be improved.

PCAOB issues staff consultation paper seeking comment on auditing accounting estimates and fair value measurements

What happened?

On August 19, 2014, the Public Company Accounting Oversight Board ("PCAOB") issued for public comment a staff consultation paper on standard-setting activities related to auditing accounting estimates and fair value measurements. The staff consultation paper discusses and solicits comment on certain issues related to auditing accounting estimates and fair value measurements in order to assist the PCAOB staff in evaluating whether the existing PCAOB auditing standards can and should be improved. The PCAOB staff is specifically seeking feedback on: (i) the potential need for changes to the PCAOB's existing auditing standards to better address changes in the financial reporting frameworks related to accounting estimates and fair value measurements, (ii) current audit practices that have evolved to address issues relating to auditing accounting estimates and fair value measurements, (iii) a possible approach to changing existing auditing standards, and the requirements of a potential new standard, and (iv) relevant economic data about potential economic impacts to inform the PCAOB's economic analysis associated with standard setting in this area.

Overview of the approach being considered by the PCAOB staff

Although the PCAOB staff identified a number of alternative approaches that the PCAOB may wish to consider, the PCAOB staff is considering developing a single standard related to auditing accounting estimates and fair value measurements instead of separate standards that exist today. The staff consultation paper discusses that the potential new standard could be designed to:

- Align with the PCAOB's risk assessment standards
- Generally retain the approaches to internal control and substantive testing from the existing standards, but include requirements that apply to both accounting estimates and fair value measurements
- Establish more specific audit requirements related to the use of third parties in developing accounting estimates and fair value measurements, and
- Create a more comprehensive standard related to auditing accounting estimates and fair value measurements to promote greater consistency and effectiveness in application

Use of third parties

A new standard could include the existing requirement related to testing assumptions for fair value measurements developed by a company's specialist, but apply it more broadly to information provided for accounting estimates. As such, if a company uses a specialist to develop an accounting estimate, a new standard could direct the auditor to test that information as if it were produced by the company. In this case, the auditor would be required, as applicable, to evaluate the appropriateness of the methods, test the data used, and evaluate the reasonableness of significant assumptions, with respect to the information provided by the specialist.

Additionally, the PCAOB staff is considering how a potential new standard could address audit evidence obtained from third-party sources, such as pricing services and broker-dealers. Given the differences in how values of financial instruments are derived and obtained, the PCAOB staff is exploring whether a new standard should set forth specific requirements for evaluating information from third-party pricing sources as part of evaluating the reliability and relevance of the evidence. For example, to evaluate reliability, the auditor could take into account the methods used by a third-party in determining fair value and whether the methodology used is in conformity with the applicable financial reporting framework. As it relates to evaluating the relevance, the auditor could determine, among other matters, when there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed, including whether the inputs developed represent the assumptions that market participants would use when pricing the asset or liability, if applicable.

Why is this important?

Financial statements and disclosures of most companies include accounting estimates and fair value measurements.

What's next?

Comments on the staff consultation paper are due on November 3, 2014. Additionally, the PCAOB announced it will host a meeting of its Standing Advisory Group ("SAG") on October 2, 2014, in Washington, D.C., to discuss matters related to auditing accounting estimates and fair value measurements. The agenda and meeting logistics will be announced closer to the meeting date.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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No. US2015-16
June 3, 2015

PCAOB issues staff consultation paper seeking comment on the auditor using the work of specialists

At a glance

The staff of the PCAOB's Office of the Chief Auditor is considering ways to improve the existing PCAOB standards that apply to the auditor using the work of a specialist, including areas related to objectivity and oversight of specialists.

What happened?

On May 28, 2015, the Public Company Accounting Oversight Board ("PCAOB") issued for public comment a staff consultation paper on potential standard-setting activities related to the auditor using the work of specialists. The staff consultation paper discusses the increased use and importance of specialists in recent years due, in part, to the increasing complexity of business transactions reported in a company's financial statements. The staff consultation paper also raises questions about whether PCAOB standards adequately address the auditor's use of the work of an auditor's or a company's specialists, and whether more rigorous standards and specific procedures are needed in this regard to help the auditor respond to the risks of material misstatement in financial statements. The PCAOB staff is seeking feedback on: (i) additional information on current practice, (ii) the potential need for changes, (iii) possible alternatives to address the issues discussed in the staff consultation paper, and (iv) relevant economic data about potential economic impacts to inform the PCAOB's economic analysis associated with standard-setting in this area. The staff consultation paper builds on feedback received on an earlier staff consultation paper related to auditing accounting estimates and fair value measurements.

Overview of the approach being considered by the PCAOB staff

This staff consultation paper describes that the PCAOB staff is considering:

- Requirements to improve the auditor's oversight and review of the work of an auditor's specialist, whether employed or engaged by the auditor, by creating consistent requirements that would apply to any auditor's specialist.
- Requirements to improve the auditor's evaluation of the objectivity of an auditor's specialist, whether employed or engaged by the auditor. Those requirements are based on the independence requirements in Rule 2-01 of Regulation S-X of the Securities and Exchange Commission. An auditor's employed specialist is already required to follow the independence requirements.
- Alternatives that would improve the auditor's evaluation of the work of a company's employed or engaged specialist. The alternatives would require more rigorous procedures than those currently required by PCAOB AU 336, *Using the Work of a Specialist* ("PCAOB AU 336").

Auditor's employed or engaged specialist

Under existing PCAOB standards, an auditor's specialist is either an employee of the audit firm and supervised by the auditor under PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement*, ("AS No. 10"), or engaged by the audit firm and overseen by the auditor under PCAOB AU 336. Under the alternatives being explored by the PCAOB staff, which include either developing a single standard for using the work of an auditor's specialist or extending the supervision requirements in AS No. 10 to an auditor's engaged specialist, the PCAOB staff would also consider including enhanced requirements for (i) evaluating the knowledge, skill, and objectivity of an auditor's specialist, (ii) informing an auditor's specialist of his or her responsibilities, including by reaching agreement in writing regarding certain matters such as nature, timing, and extent of the work that the auditor's specialist is to perform and the nature and extent of audit documentation the auditor's specialist will provide, and (iii) reviewing the auditor's specialist's work and conclusions including, if an auditor's specialist develops an independent estimate, determining whether the methods are appropriate and significant assumptions are reasonable.

The PCAOB staff is also considering revising requirements that apply to an auditor's determination of whether an auditor's specialist is capable of exercising objective and impartial judgment in his or her work. The alternatives being considered would require a more rigorous evaluation of the business, employment, and financial relationships that may impair the objectivity of an auditor's specialist, including obtaining written information of any relationships and the process used by the specialist to formulate the response.

Auditor's use of a company's specialist

Under existing PCAOB standards, auditors may use the work of a company's employed or engaged specialist to obtain audit evidence. The PCAOB staff is considering two alternatives, including (i) amending the current PCAOB standards, including removing certain provisions that may be considered to limit the extent of the auditor's testing of the specialist's work that is needed to obtain sufficient appropriate audit evidence, or (ii) rescinding the current PCAOB specialists standard. Under either alternative, the PCAOB staff is exploring whether the auditor would be required to evaluate the reasonableness of significant assumptions and appropriateness of methods used by a company's specialist in the same manner as the auditor evaluates information produced by others in the company.

Why is this important?

If the PCAOB staff alternatives are finalized in a PCAOB standard, the incremental effort may be significant for auditors, specialists, and company management, as auditors may need to use their own employed or engaged specialists and not directly use the work of a company specialist as can be done today. As a result, the staff consultation paper is seeking feedback on the likely benefits and costs of a potential new set of requirements.

What's next?

Comments on the staff consultation paper are due no later than July 31, 2015. Additionally, the PCAOB announced it will host a meeting of its Standing Advisory Group on June 18, 2015, in Washington, D.C., to discuss matters related to the auditor's use of the work of specialists. The agenda for this meeting can be found here.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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No. US2015-22
July 7, 2015

PCAOB seeks comment on potential audit quality indicators

What happened?

On July 1, 2015, the Public Company Accounting Oversight Board (“PCAOB”) issued a concept release to seek public comment on a group of twenty-eight potential audit quality indicators (“AQIs”) and the availability and value of those AQIs to audit committees, audit firms, investors, PCAOB and others. The AQIs are meant to enhance the dialogue on ways to evaluate audit quality. The concept release follows the PCAOB’s outreach process through public meeting with its Standing Advisory Group and Investor Advisory Group and receipt of input from others, including the Center for Audit Quality.

At a glance

The PCAOB is seeking comment on a portfolio of twenty-eight potential quantitative measures (audit quality indicators) that may enhance the dialogue on ways to evaluate audit quality.

The PCAOB developed the AQIs considering three principles: (i) AQIs should be quantitative wherever possible to add consistency of approach and objectivity to minimize subjective judgments, (ii) AQIs should generate data that enable users to pose critical questions, and (iii) AQIs should be used, and function together as a “balanced portfolio”, as no single indicator is likely to be determinative of audit quality. The AQIs are designed to operate in an integrated manner and, although quantitative in nature, contextual information is to be provided. The AQIs pertain to three broad categories:

- Audit Professionals — measures relating to availability of resources, competence, and focus (e.g., percentage of hours by significant risk for partners, managers, and staff) of those performing the audit.
- Audit Process — measures relating to an audit firm's tone at the top and leadership, incentives, independence, attention to infrastructure (e.g., investment in audit practice as a percentage of firm revenue), and record of monitoring and remediation of identified matters impacting audit quality.
- Audit Results — measures relating to financial statements (such as the number and impact of restatements and other measures of financial reporting quality), internal control over financial reporting, going concern reporting, communications between auditors and audit committees, and enforcement and litigation.

Most of the AQIs include measures at the engagement and firm level and are further described in the concept release.

The PCAOB observes the nature of AQI data and the method for its distribution will depend on, among other things, the users involved. The PCAOB is considering one or more approaches to assisting in the distribution of the AQI data. For example, 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 PCAOB so that the PCAOB could make it public, or even require firms to do so directly.

Areas in which feedback is being solicited

Information the PCAOB is seeking feedback, includes:

- The nature of the potential AQIs, including whether there are additional AQIs to consider and if other subgroups should be included (e.g., by office, region, or industry),
- The availability and value of AQIs to various potential users of the information, which includes whether the AQIs should be publicly available,
- How the data from which AQIs are derived might be obtained and distributed,
- Whether audit firms' use of AQIs should be voluntary or mandatory,
- The scope of audits and audit firms that may be subject to AQI reporting, and
- The possibility of phasing-in steps toward AQI reporting and use.

Why is this important?

The PCAOB is considering, among other matters, whether the AQIs will enhance the discussion around audit quality and contribute to the identification of key variables that drive audit quality. In turn, the PCAOB suggests that this will provide another objective measure for audit committees, management and others to further evaluate the performance and stimulate competition based on audit quality among the audit firms.

What's next?

Comments on the concept release are due no later than September 29, 2015. Additionally, the PCAOB will host a public roundtable to discuss views on the concept release on a date to be determined during the fourth quarter of 2015.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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SEC considers changes to audit committee disclosure of auditor oversight

What happened?

On July 1, 2015, the SEC published a concept release to solicit public input on possible changes to its audit committee disclosure requirements. The concept release is focused on disclosures relating to the audit committee's oversight of the independent auditor.

At a glance

The SEC is seeking public input on whether investors would benefit from enhanced disclosure relating to the audit committee's oversight of the independent auditor and, if so, what information would be useful.

Current audit committee disclosure requirements

Audit committees play a critical role in protecting the interests of investors, and disclosures about audit committee interactions with the independent auditor promote investor confidence. The majority of the SEC's current audit committee disclosure requirements were adopted in 1999. Since that time, there have been significant changes in audit committee responsibilities, including the 2002 Congressional mandate that the audit committee of a listed issuer be directly responsible for the appointment, compensation, retention, and oversight of the work of the independent auditor.

Current audit committee disclosure requirements (e.g., that the committee has discussed certain required communications with the auditor and has received written communications relating to the auditor's independence) provide some information about the audit committee's role in overseeing the independent auditor. However, the SEC's current rules do not provide insight into how the audit committee executes its responsibilities.

Focus of the concept release

The concept release seeks public input on a number of potential changes to the SEC's audit committee disclosure requirements on topics such as:

- communications between the audit committee and the auditor;
- frequency of meetings between the audit committee and the auditor;
- discussions about the auditor's internal quality review and most recent PCAOB inspection report;
- how the audit committee assesses, promotes, and reinforces the auditor's objectivity and professional skepticism;
- how the audit committee assessed the auditor (including the auditor's independence, objectivity and audit quality) and its rationale for selecting or retaining the auditor;
- whether the audit committee sought proposals for the independent audit and if so, the process the committee undertook and the factors it considered in selecting the auditor;
- policies for an annual shareholder vote on the selection of the auditor, and the audit committee's consideration of the voting results;

- disclosures of certain individuals on the engagement team (e.g., the naming the engagement partner);
- audit committee input in selecting the engagement partner;
- the number of years the auditor has served as the company's independent auditor; and
- information relating to other firms involved in the audit.

Some of these topics (e.g., naming the engagement partner and disclosing auditor tenure) are the subject of on-going projects by the PCAOB. The SEC is also seeking input on those topics so it can evaluate whether the disclosures, if they are important, would be more appropriately placed (or perhaps repeated) in company filings where they can be made in the broader context of the audit committee's oversight of the independent auditor.

Why is this important?

High quality, independent audits are critical to the proper functioning of the capital markets because they give the public confidence in the credibility and reliability of financial statements. Audit committees promote confidence through their oversight of the independent auditors.

In this concept release, the SEC is exploring whether additional disclosure about the audit committee's oversight of the independent auditor could be beneficial to investors, for instance, by providing useful information for making investment decisions or helping inform voting decisions regarding the ratification of auditors and the election of directors who are members of the audit committee.

It is important to note the SEC's current audit committee disclosure rules establish the "floor" for audit committee disclosure, not the "ceiling." Many audit committees have already gone beyond these minimum reporting requirements to provide enhanced disclosures around their independent auditor oversight activities. In November 2013, a group of nationally recognized corporate governance and policy organizations known as the Audit Committee Collaboration published *Enhancing the Audit Committee Report: A Call to Action* to encourage audit committees to voluntarily strengthen their disclosures. The Audit Committee Collaboration recently published its *External Auditor Assessment Tool: A Reference for U.S. Audit Committees* to assist audit committees in evaluating the external auditor. Audit committees may find these resources helpful as they consider their own disclosures.

What's next?

Comments are due within 60 days after the concept release is published in the Federal Register. The SEC will use the input it receives to evaluate whether to propose changes to its rules. The issuance of the concept release is only the first step in the rulemaking process.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group (1-973-236-7800).

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