

September 29, 2015

Mr. Martin F. Baumann  
Chief Auditor and Director of  
Professional Standards  
Public Company Accounting Oversight Board  
c/o Office of the Secretary  
1666 K Street, N.W.  
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By e-mail: [comments@pcaob.org](mailto:comments@pcaob.org)

Dear Mr. Baumann,

**Re.: PCAOB Concept Release on Audit Quality Indicators and Notice of Roundtable: PCAOB Release No. 2015-005, July 1, 2015**

The IDW would like to thank you for the opportunity to comment on the above mentioned Concept Release on Audit Quality Indicators and Notice of Roundtable, released July 1, 2015 (hereinafter referred to as the "Concept Release"). We have chosen not to respond individually to the 73 questions posed throughout the Concept Release, but instead comment on the first five specific sections.

***Section I – Introduction, and  
Section II – The Purpose of Audit Quality Indicators and the AQI Project***

This is an important initiative for the auditing profession as well as for other interested parties. As with many initiatives, both positive and negative associated consequences could shape the PCAOB's decisions.

Some of the larger firms are already reporting certain AQIs or qualitative information in jurisdictions such as the U.S. In jurisdictions such as Germany transparency reports also provide firm-specific information relevant to audit quality. Audit committees are increasingly asking questions of their auditors regarding factors related to audit quality. Although various parties throughout

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the world have already issued or embarked on initiatives in this area, there is no global common understanding of what audit quality constitutes or as to the mix of factors that contribute to it.

In our view, such an initiative is likely to gain traction in audit markets far beyond the capital market in the U.S., potentially with worldwide impact. For this reason, it does not appear desirable for there to be numerous different approaches – rather a global solution that is sufficiently flexible to take account of different national environments is desirable. The regulatory environment in which firms operate will vary – e.g., non US PCAOB registered firms will differ from “pure” US firms – this will need sensitive handling.

In focusing solely on factors depicting the behavior of audit firms at firm and engagement level, this initiative could, however, detract from the impact of further external factors on audit quality. Some issues affecting audit quality potentially need to be addressed elsewhere or by other parties, and so it would be a shame if these were pushed into the background by this initiative. The IAASB framework points out the key role others, including regulators and standard setters also play in enhancing audit quality.

In general, we agree with much of the introductory text in the PCAOB’s paper, and in particular the discussions on pages 3 and 7, which clarify the significance of contextual information for interpretation of AQIs, the need to use AQIs as a balanced portfolio rather than in isolation, and the potential for their use in generating questions to drive discussions with auditors. In our view, these factors are crucial to the success of this initiative.

Indeed, developing numerical values or ratios that could potentially be (mis)used if taken in isolation seems to be potentially at odds with much of the PCAOB’s aforementioned explanations. AQIs, taken in isolation or out of their relevant context are unsuitable for conveying a meaningful understanding of the individual factors contributing to audit quality. We would therefore caution the PCAOB not to make numerical AQIs across the board publically available, as this would inevitably result in goals or ideals being established and various comparisons being made, which without contextual information would often lead to misinterpretation, misinformed decisions but not necessarily to the enhancement of audit quality.

Furthermore, whilst benchmarks may be useful in many respects, there could be some drawbacks. Rigid application of benchmarks could encourage firms to strive to meet or exceed numerical benchmark AQIs, even when the specific circumstances indicated otherwise. For example, a ratio of partner hours could be lower in an engagement of little complexity and of relatively low risk than

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would be appropriate for an engagement involving considerable complexity and risk. The drive to adhere to benchmarks might be exacerbated by inspections placing excessive focus on AQIs. Overly focusing on making it “look good on paper” will generally not increase audit quality. We therefore fully agree that it is clearly important to aim to add objectivity to numerical values as well as context to inform their interpretation.

### ***Section III – Potential Audit Quality Indicators***

We agree that developing 28 AQIs would probably be counterproductive, as the higher the number the less practicable application will prove. Although several of the 28 potential indicators are factual, there is a danger that some other AQIs could be calculated in different ways. A few may be more useful calculated at firm level; others at engagement level. Besides, it is probable that most AQIs need to be interpreted in the specific engagement, environmental context or both. For issues e.g., technical accounting and auditing resources, this would be crucial; some firms have technical departments that would be measured in hours spent in research whereas others may not; instead using other equally effective measures such as a technical inquiries hotline provided by institutes such as the IDW, where the firm is charged a flat rate and is not aware of the number of research hours. Indeed, the quality and sufficiency of technical expertise cannot be measured in hours spent or expenditure made.

We are not convinced that using survey results as an AQI is appropriate, since surveys by nature can deliver highly subjective information. Certain further proposed AQIs, e.g., number of restatements or instances of fraud may reveal more about the audited entity than the true quality of the audit.

### ***Section IV – Use and Availability of Audit Quality Indicators***

We would support an initial focus on using AQIs as a basis for a) firms' internal tracking of quality factors and b) more expansive discussion with audit committees to ensure that auditor selection decisions are appropriately informed.

The table of possible uses of AQIs supplied on page 18 of the Concept Release appears optimistic. Specifically it is difficult to assess potential benefits that AQIs could be expected to give rise to in terms of their influence on the decisions listed. In contrast the danger for misuse or misinterpretation we have discussed elsewhere means that potential users and application methods will require careful consideration.

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Specifying the intended audience as well as the intended application of each AQI developed would seem a sensible way forward. In deciding on the intended audience for the AQIs, the PCAOB will need to ensure there is a reliable way to ensure that like can be compared with like in a consistent manner by each intended audience, particularly where numerical AQIs are concerned. We suspect that this will prove to be challenging in practice. For example, matters such as staffing leverage and workload indicators will inevitably lead to firm by firm comparison, despite the lack of any individual engagement context.

The Concept Release stresses that an understanding of the context of the individual audit and environment is essential to the interpretation of the meaning and implications of AQIs, and that the variations in size of audit firms and the size and nature of audited companies need to be handled. For example, page 17 refers to the possibility of excluding certain types of audit firm, at least initially, if relevant indicators are not readily scalable. This proposal is problematical, as it could have a significant impact on the market for audit services. Were such exclusion to lead to a general perception that some firms appear not to be holding up in comparison to other larger firms, concentration within the audit market would probably increase even more. Therefore, it seems to make sense to use the attributes of the audited entity, not the size of the audit firm as a guide in this context.

Whatever solution the PCAOB decides upon in this initiative, the PCAOB will need to follow its due process in making any corresponding adjustments e.g. to its rules or standards. Public expectations and especially perceptions e.g., in respect of ideal AQIs on the other hand may develop rapidly. To be really useful, the development and appropriate application of AQIs will need to develop over time and so it would appear that an initially conservative approach along the lines we have suggested above may be advisable.

#### Use of AQIs by Audit Committees

The Concept Release focuses heavily on the use of AQIs by audit committees, and, as noted, we support the PCAOB focusing on enabling audit committees to make well informed auditor selection.

This initiative may be helpful in persuading audited companies (in particular audit committees) that it is not appropriate to view price as a key factor in auditor selection. Using AQIs to inform more discussions with audit committees could lead to a perception of increased value for money in “good” AQIs, which ideally would translate into a willingness to pay a premium for sound audit quality.

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The paper contains many references to comparisons (e.g., engagement : firm, engagement : engagement in same industry etc.). We question whether it is realistic to expect that individual audit committees will actually perform these comparisons (and risk losing context) so that a set of “numerical ideals” becomes established.

#### Use of AQIs by Audit Firms

The Concept Release discusses the potential for this initiative to create incentives for audit firms to compete on quality both internally and amongst various firms. Firms use their own indicators already, as the Concept Release notes. Standardization at international level may be helpful in ensuring firms focus on appropriate factors.

We suggest the PCAOB explore further the potential for firms to use certain AQIs to track their own performance on specific engagements, as this project is, by its nature, linked to the PCAOB’s (and IAASB’s) quality control standards. We understand that in deliberations ahead of the revision of its own quality control standard ISQC 1, the IAASB is considering the application of quality management systems by firms. Specifically, this initiative could explore how AQIs might be used to identify quality risk factors and to respond appropriately as part of a firm’s quality control system. This issue is not yet explicitly dealt with in the quality control standards of either the PCAOB or the IAASB, and thus could also impact the development of those standards.

As we have noted above, there are benefits but also dangers of using what will likely become “standardized” AQIs as competitive tools, especially if AQIs are publicized. We note the discussion as to the potential for AQIs to “drive a more vibrant market in audit quality” (page 8), and urge the PCAOB to remain sensitive to the need to deal with potential negative consequences, including the potential to increase concentration in certain sectors of the audit market.

#### Use of AQIs by Investors

We note that the Concept Release talks of “if and when” AQIs might be made public. As explained above, we do not believe general publication is appropriate at this stage. It is not clear whether audit quality indicators really will have as much influence on investment decisions as the paper alludes to. The potential adverse impact on the audit market seems a bigger issue to debate in this context (see page 24: “investors increase pressure for differentiation...”). Indeed, it is questionable whether this will always be true or whether investor pressure might even achieve the opposite.

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At best, publication of extensive firm by firm comparison has the potential to highlight single instances of extremely poor performance factors. At worst, and for the majority of cases where extremes would be unlikely, the potential for misinterpretation, misinformed decisions etc. would probably outweigh any benefits. Indeed, since audit committees could use AQIs to “weed out” potential audit firms with inadequate audit quality prior to, or during, their pre-appointment discussions with individual firms, we do not believe disclosure in the public domain of each and every AQI the PCAOB may develop would be appropriate at all.

If you have any further questions about our comments, we would be pleased to discuss our comments with you.

Yours very truly,

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