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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 041

McGladrey LLP appreciates the opportunity to offer our comments on Public Company Accounting Oversight Board (PCAOB) Release No. 2015-005, *Concept Release on Audit Quality Indicators*. McGladrey LLP is a registered public accounting firm serving middle-market issuers, brokers and dealers.

We support frequent, meaningful, two-way communication between the auditor and the audit committee throughout the year, including candid, timely discussions about accounting, auditing, internal control and other issues. In our interactions with audit committees, we find the information discussed varies widely, depending upon the client's industry, the size and complexity of the client, the complexity of the current year's audit and many other factors. Our discussions with audit committees generally focus on matters audit committee members deem most important to their particular audit – and we believe it is important to provide information that is helpful to them in their selection and supervision of the auditor.

In our opinion, and as discussed in more detail below, some of the engagement-level and firm-level audit quality indicators (AQIs) discussed in the PCAOB's concept release could be helpful to audit committees, but only if adequate context is provided through a discussion with the auditor. Without significant context, many of the AQIs might be misinterpreted, resulting in unintended consequences and misuse of the AQIs. Dialogue with the audit committee is critical in providing the context necessary to understand the significance and meaning of the quantitative indicators.

We believe AQIs would be most effective in facilitating discussions about audit quality when they are focused primarily on engagement-level indicators and tailored to each audit committee's unique needs and interests. Because audit committee members are in the best position to know what information is most useful in their selection and oversight of the auditor, we believe they should have the flexibility to choose which, if any, AQIs they wish to evaluate.

Further, we believe public disclosure of firm-level AQIs would not provide meaningful insight into audit quality for investors or others. The background and context needed to analyze any potential impact of engagement-level and firm-level AQIs on audit quality can only be achieved through dialogue. Because investors are not a direct part of the audit process and do not interact directly with the auditor, they cannot receive the qualitative information that provides context related to a specific AQI or set of AQIs. Without this qualitative information, we believe disclosure of AQIs could be misleading to investors. It is impractical for the auditor to interact directly with each individual investor. Through their responsibility to appoint, compensate and oversee the external auditor, audit committees have fiduciary duties to serve the interests of investors. We therefore believe the disclosure of engagement-level and firm-level AQIs should be voluntary, at the discretion of the audit committee, and should not be mandated for disclosure on every engagement or made available to the public.

Should the PCAOB decide to proceed with policy making regarding AQIs, we believe further study should be conducted to validate whether each AQI has a direct correlation to audit quality, is comparable among audit engagements or firms as appropriate, and is useful for issuer audit committees. Should their use become required, we believe they only should be required for issuers and not for nonissuer brokers and dealers. Also, many of the potential AQIs would need additional detailed instructions so that the related computations could be precise and consistently applied across firms and individual engagements as appropriate. Our thoughts on these and other issues are reflected in our detailed comments and suggestions, which are organized by AQI categories below. These comments and related examples further validate that there is no one-size-fits-all solution to identifying AQIs that are consistently meaningful to audit committees in their assessments of audit quality.

Audit professionals

Availability

Staffing leverage

If narrowed so as to only apply to issuer audit engagements, the "staffing leverage" indicator could provide a useful measurement of the time of experienced senior personnel relative to the volume of audit work they oversee – both at the engagement level and the firm level. We reiterate, however, that providing context in the disclosure of this AQI as calculated at both the engagement and firm levels will be important to explain the difference in leverage among engagements and firms. For example, staffing leverage may be different for larger engagements than for smaller engagements and for firms that primarily audit nonaccelerated filers than it is for those that primarily audit accelerated filers. Further, additional context will be needed in the disclosure of this AQI at the engagement level as the measurement will also be affected by the inherent risks of the particular engagement, the experience of the staff, and many other factors.

Partner, manager and staff workloads

We believe the "partner workload" and "manager and staff workload" indicators could be starting points of discussions with audit committees when measured at the engagement level and accompanied by appropriate context. Although these measurements can be calculated at the firm level, we believe the comparison of such AQIs would not be meaningful and could result in an inappropriate conclusion in evaluating a particular engagement because, among other reasons:

- An annual calculation or even a calculation on a quarterly basis does not necessarily reflect the skewed workloads auditors experience at various times throughout the year
- The calculations do not take into account other professional responsibilities, such as professional development or administrative functions
- Not all firms record chargeable hours using the same method (e.g., some firms record travel time, while others do not)

Technical accounting and auditing resources/persons with specialized skill or knowledge

Information provided to audit committees regarding "technical accounting and auditing resources" and "persons with specialized skill or knowledge" at the engagement level begins with a discussion regarding the current-year identified risks of material misstatement, which is followed by a dialogue about the plan to address them, including the credentials of those involved and perhaps the hours those individuals plan to charge to the engagement. Measuring the chargeable hours of these professionals as a percentage of total engagement hours would not provide an indicator of audit quality because each audit has a unique level of complexity and need for the involvement of technical resources every year. For example, a client's adoption of a new stock compensation plan may result in additional technical accounting and auditing resources only in its first year of implementation. A lower or higher percentage of hours charged by technical resources might not necessarily correlate with a lower or higher level of audit quality.

We do not believe the size of the technical accounting and auditing resources of a firm or the number of chargeable hours of persons with specialized skill or knowledge is necessarily indicative of audit quality, especially for smaller firms that may not have traditional national office structures. If used, such a disclosure should not extend to all registered accounting firms, but rather should be limited to firms that audit more than 100 issuers. Also, this disclosure would need more precise instructions as there may be differing interpretations among audit firms as to which professionals should be included in technical accounting and auditing resources or persons with specialized skill or knowledge.

Competence

Experience and industry expertise of audit personnel

Disclosures of the actual level of experience and the industry expertise of audit engagement personnel are commonly made to audit committees and are relevant indicators of audit quality for a particular engagement if provided with the relevant context. We believe that average experience for total audit personnel at the firm level as cited in the Concept Release has no bearing on the audit quality for a particular engagement.

Turnover of audit personnel

Turnover rates on individual engagements fluctuate from year to year and are the result of a variety of circumstances, including required partner rotation, promotions that result in engagement reassignments, and the termination of professionals whose performance is not congruent with high audit quality. Turnover of audit personnel on a particular engagement is not necessarily an indicator of poor audit quality, but rather is an issue that influences how the auditor staffs the engagement team with appropriate personnel. Disclosures regarding the turnover on a particular engagement team and the plan for addressing the turnover typically are currently shared with audit committees, as requested. We believe such discussions with the audit committee about the qualitative aspects of turnover on a particular engagement are important; however, disclosure of calculated turnover percentages of audit personnel is not an indicator of audit quality for a particular engagement. Likewise, disclosure of firm-level turnover percentages is not a meaningful indicator of audit quality.

Amount of audit work centralized at service centers

We believe there is no empirical evidence as to whether audit work carried out on a centralized basis at service centers weakens or improves audit quality. Therefore, we do not believe an indicator measuring the degree to which audit work is centralized by the audit firm at service centers would be useful.

Training hours per audit professional

Effective training is essential in an audit firm because it enables audit professionals to provide high-quality services and comply with professional standards. Further, high-quality training is a key factor in employee engagement and retention. At the engagement level, it is critical that teams are adequately trained on matters specific to the client’s industry and on accounting matters that are relevant to the particular audit, such as those related to the business combinations or multiple-element revenue recognition. We therefore agree that it would be appropriate to provide audit committees with information regarding the subject matters and annual accounting and auditing training hours, and industry-specific training hours, for partners, audit managers, staff auditors, specialists and engagement quality reviewers assigned to the engagement.

The number of hours of required independence and ethics training is regulated and monitored by the state boards of accountancy. Thus, the disclosure of such hours would simply be commensurate with what is required in each state and would not be a differentiator among audit firms, nor would it be an indicator of audit quality.

We have significant concerns with disclosure of a firm's average annual training hours. The effectiveness of training is not solely determined by the number of hours – it is determined by the quality of the training and the appropriateness of that training for the individual's assignments. For example, an audit partner who serves clients in two industry sectors may participate in twice as many hours of industry-specific accounting and auditing training than a partner who serves clients in one industry. The additional number of hours, however, does not necessarily result in a higher level of audit quality.

Focus

Audit hours and risk areas

It is important that auditors discuss with audit committees a summary of the significant risks identified through risk assessment procedures, together with planned audit responses, and any changes therein identified during the course of the audit. Therefore, it would be appropriate to disclose to the audit committee the current-year planned and the prior-year actual chargeable hours for members of the audit team for significant risk areas identified by the firm during audit planning. Disclosing chargeable hours by significant risk areas at a firm level, however, would be meaningless because significant risks vary widely between engagements.

Allocation of audit hours to phases of the audit

A comparison of current-year planned and prior-year actual chargeable hours related to the various audit phases could be useful in facilitating discussions with audit committees regarding the effort and staffing devoted to audit planning and execution for a particular engagement. As with any AQI, this indicator must be accompanied by robust dialogue with the audit committee because it is a product of the audit approach used by the firm, the complexity of the audit, and the seasonality of the work, among other factors. As such, the percentage of hours a firm devotes to each audit phase is not a meaningful indication of audit quality at the firm level.

Audit process

Tone at the top and leadership

Our firm leadership sets a tone at the top that emphasizes quality as a critical component of our business strategy. More importantly, it is expected that each engagement partner establish a tone at the top for the engagement team that emphasizes high audit quality and excellent client service. We believe most audit firms provide leadership in achieving high-quality professional performance within the framework of individual accountability. However, we do not believe that a survey of firm personnel about "tone at the top" would be a relevant indicator of audit quality.

Incentives

Quality ratings and compensation

We do not believe internal firm quality ratings, such as "exceptional performance", "meeting expectations" or "needs improvement" could be applied to produce comparability among firms. Most firms incorporate the evaluation of audit quality into their compensation and rewards systems. However, like the compensation of most professionals, the compensation of audit professionals is complex and is dependent upon a variety of factors.

Audit fees, effort and client risk

Audit committees already know the engagement audit fees and changes from the prior year and generally have an understanding of the chargeable hours for partners and managers on their particular engagement. We support this indicator at the engagement level as it could provoke discussion between the audit committee and the auditor regarding the relationship between engagement audit fees/hours and the level of client risk. However, this indicator at the firm level would not be meaningful because the definition of “high risk” is affected by many factors, some of which may, and should, be interpreted differently by the various firms.

<u>Independence</u>

For issuer audits, independence is mandated by the AICPA Code of Professional Conduct, PCAOB Ethics and Independence Rules, and SEC regulations. The number of hours of required independence and ethics training is regulated and monitored by the state boards of accountancy. Each firm manages these requirements differently. Therefore, indicators measuring elements of a firm’s independence training and monitoring program will not be comparable and, as stated earlier in our comments regarding training disclosures, would not be an indicator of audit quality.

<u>Infrastructure</u>

Defining the expenditures that represent an “investment in infrastructure supporting quality auditing” is difficult at the firm level and cannot be measured at the engagement level. Even if a specific definition could be developed, it would be subject to yearly fluctuations. For example, if a firm adopted a new platform for its audit methodology in the current year, the “investment in infrastructure” may not be repeated in the following year when the new platform is in maintenance mode. Such a decrease in investment would not indicate poorer audit quality.

<u>Monitoring and remediation</u>

Audit firms’ internal quality review results and PCAOB inspection results

We support including internal quality review results and PCAOB inspection results as part of the AQI-related discussion with the audit committee. Most audit committees already are asking for information about the results of any internal quality and PCAOB inspections of their engagement. At a firm level, PCAOB inspection results are reported publicly by the PCAOB, and many firms already have disclosed in their transparency reports whether their internal findings are consistent with those of the PCAOB’s inspections.

Technical competency testing

State boards of accountancy impose licensing and continuing education requirements on certified public accountants in their state and typically investigate alleged violations of statues, suspending or revoking licenses as appropriate. Firm competency is monitored through the AICPA peer review process and through PCAOB inspections. We do not believe further measures of technical competency are needed.

Audit results

<u>Financial statements</u>

Frequency and impact of financial statement restatements for errors

If there is a restatement of the client’s financial statements, the audit committee will be fully aware of the magnitude and impact of the restatement and will have discussed such matters in detail with the auditor.

Also, the number of restatements of issuers' financial statements at a firm level already is publicly available. The percentages of such restatements are too small to provide meaningful information, and disclosing the firm's top five annual restatements measured by magnitude is not relevant to audit quality.

Fraud and other financial reporting misconduct

An audit firm already communicates all material weaknesses and significant deficiencies identified during the audit of an issuer to both the audit committee and management in writing prior to issuing its report on the financial statements. Further, material weaknesses are identified and included in management's assessment of the effectiveness of internal control over financial reporting, which is disclosed publicly. All of these communications would provide relevant information about controls designed to address the risk of material misstatement due to fraud if applicable and would be discussed with the audit committee. We do not believe the development of AQIs related to fraud or other financial reporting misconduct would be helpful to those discussions.

Inferring audit quality from measures of financial reporting quality

The concept of inferring audit quality from measures of financial reporting quality is one that would require extensive study and testing of data prior to its use.

<u>Internal control</u>

As stated above, both audit committees and investors are fully aware of material weaknesses in internal control over financial reporting, as well as restatements of financial statements. We do not believe AQIs are warranted or meaningful in this area.

<u>Going concern</u>

It is important for investors to understand that the timely disclosure of uncertainties about an entity's ability to continue as a going concern is first the responsibility of management as dictated by Financial Accounting Standards Board Accounting Standards Update 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.* Management's evaluation is based on relevant conditions and events that are known and reasonably knowable at the date the financial statements are issued. Business difficulties are not always reasonably foreseeable even by the most experienced audit team. AQIs focused on going concern issues would need ample context and could have unintended consequences.

<u>Communications between auditors and audit committee</u>

We agree that communication between auditors and audit committees is at the center of the audit process, and we believe a robust discussion with the audit committee is the best form of communication. Conducting an anonymous independent survey of audit committee members seems to contradict the importance of an open, communicative relationship between the auditor and the audit committee. Certainly if the audit committee is not satisfied with the level or quality of communication from the auditor, the committee is in an excellent position to personally deliver that message to the auditor.

<u>Enforcement and litigation</u>

Trends in PCAOB and SEC enforcement proceedings

Information about finalized PCAOB and SEC enforcement proceedings is already available to the public. Information about pending PCAOB and SEC enforcement proceedings is meaningless because the facts in the proceedings have not been vetted and rulings have not yet been issued. Also, the instances of PCAOB and SEC enforcement proceedings are too few for even the largest firms to develop a trend.

Trends in private litigation

Plaintiffs who assert claims against audit firms often do so based on loss of their investments, which may not have anything to do with audit quality. For various business reasons, including the cost of defending a case, which may not be indicative of a failed audit, audit firms may choose to settle litigation, and the terms of such settlements often are confidential. Even if a case is decided in a court of law, by the time such proceedings are finalized, any evidence of poor audit quality may no longer be relevant to the current level of audit quality. Further, the instances of such matters are too few for even the largest firms to develop a trend.

We would be pleased to respond to any questions the Board or its staff may have about our comments. Please direct any questions to Leroy Dennis, National Director of Public Policy, at 612.455.9417.

Sincerely,

McGladrey LLP

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