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PERSPECTIVE

Focusing on Audit Quality

A question and answer on audit quality with KPMG's James P. Liddy, Vice Chair - Audit, KPMG LLP.

What should directors know about audit quality today? I would say that audits have never been more rigorous. When I talk to audit committees and investors, they consistently express confidence that auditors are executing high-quality audits. Confidence in financial statements is also high, and the steady decline in restatements has a lot to do with that. But we also know that audit quality needs to keep improving to keep pace with the complexity of business and changes in the risk and control environments. The effectiveness and value of the audit should keep improving over time particularly as technology enables auditors to test large populations of data and provide enhanced business insights.

Audit committees have also been a driving force on audit quality. Our dialogue with audit committees—for example, around critical accounting judgments and estimates and the factors underlying those estimates—has never been better; they're highly engaged, asking the right questions, and clearly focused on what we're auditing and how we're executing the audit.

Discussions about audit quality and audit fees tend to go hand-in-hand, whether fees are going up or down. It's an important conversation to have. No audit committee wants to cut back on audit costs at the risk of hampering the audit. At the same time, they want to know that the audit is being done efficiently, that it's well-coordinated, and that we're using technology and internal audit resources to support our work as appropriate.

Certain companies may also see an increase in audit fees because we've increased our auditing efforts around internal control over financial reporting. Based on root cause analysis of deficiencies observed in our internal and external inspection findings, we've reassessed the nature of the work to be performed on internal controls—and that might mean gathering more evidence, reevaluating which controls are being tested, and doing more thorough walk-throughs.

Accounting firms are also spending more time and money on training, which is important for everybody—from the partners down to the staff. It's particularly critical that staff is up to speed on the auditing standards themselves and also the findings in internal and external inspections that have led to enhancements to the

firm's audit methodology. With continual training, the staff will be in a better position to understand the objectives and execute their procedures in accordance with professional standards.

All of this impacts the cost but, ultimately, it's about fulfilling our responsibility to the capital markets and other stakeholders to deliver a quality audit.

What's driving the focus on internal controls? Reliable financial statements require effective internal controls over financial reporting—so it's a critical area of focus for management, audit committees, and auditors. The auditor's goal generally is to determine three things: Is the control's objective appropriate for the risk it is addressing? Is it designed with an appropriate level of precision to meet that objective? And, is it operating effectively? And, for certain controls, is there contemporaneous documentation of the control's actual performance? Even though auditors employ a top-down, risk-based approach to testing, this can still involve a significant number of key controls to test—so it's a lot of work. There's also more focus on the evaluation of control deficiencies and determining how large a potential financial statement error could be—the level of work involved in testing controls that mitigate those deficiencies and understanding the precision of those controls is steadily increasing. The internal control environment is more complex than ever—particularly for global companies. Internal controls will also get a fresh look in 2014 as most companies transition to the new COSO framework.

How are audit committees reacting to the additional audit work, and the impact on audit costs? There's certainly frustration about fees and questions about the additional work. But most audit committees today have a deeper understanding of what an audit entails, and they're engaged in discussions about how to continually improve audit quality. Ultimately, like us, audit committees want to be comfortable that sufficient time and resources are being devoted to produce a quality audit.

So there's pressure in the system. Yes, but I would be more concerned if there wasn't pressure in the system. I think it's a sign that everyone's pushing to continually improve audit quality. Audit committees, auditors, and regulators are all focused on these matters—and that can only be good for the capital markets and the economy.