Our focus on audit quality

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pwc
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*Our commitments*
The US firm of PwC is one of the largest professional services firms in the country and our assurance practice is our largest business. Through this practice, we carry out our most important role in the financial reporting system: enhancing the credibility and reliability of financial statements through the issuance of an audit report. Maintaining investor confidence in the quality of our audits is therefore a paramount objective for us.

This report is aimed at giving investors, audit committee members, managements, regulators, and others who have an interest in the vibrancy of the capital markets a greater understanding of what we are doing to fulfill our commitment to consistently perform high-quality audits—a commitment that starts with the firm’s leadership and extends throughout the firm. In it we explain how our core behaviors and other factors provide a foundation for achieving our audit quality objectives.

A high-quality audit requires well-executed procedures combined with technical expertise and an independence of mind that enables the auditor to act with integrity and exercise objectivity and professional skepticism. Because of the judgments, business understanding, and effective communications needed, an audit is an inherently subjective process that depends on the quality of the people performing the audit and the firm’s supporting processes.

To achieve high audit quality, we must monitor and keep pace with the changes that make the business environment in which we practice highly dynamic. Those changes include rapid technological advances, increased globalization, and evolving investor expectations, along with rigorous regulatory oversight aimed at promoting greater investor protection. In this environment, auditors must consider whether the skills, methods, and technologies that have been effective so far will continue to result in high-quality audits.

We think the answer is clear. We must be prepared to meet increasing challenges and expectations and we are committing now to make the significant investments and changes that we believe are necessary for us to do so. This report describes changes we have already made and the specific near-term people, structural, and process changes we are making to further enable the firm to meet the challenges of consistently performing high-quality audits for the long term.

Today there are discussions among capital market participants about how auditors can enhance audit quality and bring more insight and value to investors through possible changes to the auditor’s report and to the information audited. We are supportive of these discussions and are listening intently to the views of many different stakeholders, recognizing that changes are needed.

We are also engaged in the dialogue on broader issues, such as the pace of change in accounting standard setting and the path forward for incorporating international accounting standards in the United States. As a leader in the profession, we recognize our obligation to speak out on these and other important matters and share our point of view.

The actions we are taking will help us to maintain our stature as a leading firm in the audit profession. Meeting the challenges that must be addressed to consistently perform high-quality audits is our top priority.

Tim Ryan
US Assurance Leader

Bob Moritz
US Senior Partner
At PwC, the most important way the firm contributes to the vibrancy of the capital markets is by providing financial statement assurance that enables investors and other capital market participants (collectively “investors”) to have confidence in the financial statements they use in making capital allocation decisions. Our audit reports also enable the companies we audit to enter the capital markets, which in turn enables them to raise funds, grow their businesses, and, as a result, contribute to the growth of the economy. For these reasons, our audits must be of consistently high quality.

Audits today are conducted in a business environment that is dynamic. Economic cycles, financial crises, rapid changes in technology, increasingly complicated accounting standards, evolving investor and regulator expectations, and the importance of the profession’s role in the capital markets all mean that we must adapt to constant change. This means having in place an infrastructure that enables us to recognize changes in these environmental factors and helps us to continuously improve.

Our infrastructure includes our system of quality control and our processes to monitor our performance and identify when changes are needed to promote sustained audit quality. Firm leadership and all of our partners involved in the audit process each have a role in, and are accountable for, promoting audit quality.

Our infrastructure also includes locally based audit support, a largely centralized national office staffed with experts who assist audit teams in addressing accounting, regulatory, and auditing issues, and training programs that are responsive to the dynamics of the business environment. And, when auditing complex areas, such as fair value measurements and tax amounts recorded by management, our audit teams receive support from partners and other professionals in the firm’s advisory and tax practices.

To effectively serve our clients with global operations, we are members of a global network of firms. This network helps us to gain an understanding of changes in local economic, business, and regulatory issues, and how they impact a company’s business and financial reporting. The network provides processes, tools, and resources to its member firms to assist them in meeting the high quality standards of the network. It also monitors member firms’ audit quality, which can help each member firm to identify areas that would benefit from increased attention.

A key aspect of any continuous improvement process is to understand where to invest in improvements.

We gain that understanding in several ways. We have dialogues with external stakeholders, including investors, audit committees, management, and regulators, such as the Public Company Accounting Oversight Board, regarding their expectations of an audit. The views we obtain help us to focus on what lies ahead for the audit profession. To remain a leader in the profession, we must proactively prepare ourselves to address the challenges of successfully meeting their expectations.

We also maintain open dialogues internally with our partners and other professionals regarding where to focus our improvement efforts. We conduct internal inspections of our audit practice and monitor our performance in other ways to identify areas where we can improve. And, we consider the results of the PCAOB’s inspections of our audit practice.

Continuous improvement efforts often involve incremental changes. Other times, bolder steps are needed to respond to the challenges of a rapidly changing business environment. Based on the increasing expectations of investors and regulators, and our keen desire to maintain our stature as a leading firm when it comes to quality, we believe this is one of those times. The bolder steps we have decided to take include making significant investments in people, structural, and process changes to enhance our ability to meet greater investor expectations, the challenges of an increasingly complex business environment, and our objective of achieving sustained audit quality over the long term.
We have prepared this report to give investors and other stakeholders an understanding of the changes we are making. The extent of the changes reflects the seriousness with which we take our responsibility to perform high-quality audits that meet the increasing expectations of investors and regulators. The changes also reflect our desire to prepare now to meet the challenges of maintaining sustained audit quality, which is more important than ever. The investments we are making include:

- Strengthening our culture of quality by reinforcing throughout the firm the tone at the top, stressing the importance of independence, objectivity, professional skepticism, and accountability for audit quality
- Reinforcing for partners at all levels of leadership their role, responsibility, and accountability with respect to audit quality
- Modifying our performance review and compensation models to more explicitly recognize individuals for achieving our audit quality objectives
- Devoting additional experienced audit partners and other audit professionals to the ongoing process of enhancing our audit methodology
- Allocating more time of seasoned audit partners and other audit professionals across the country to assist audit teams in consistently achieving our audit quality objectives
- Enhancing training in specific audit areas involving complex judgments, such as fair value and other accounting estimates
- Increasing the number of audit partners and other audit professionals who lead or participate in our internal inspections of selected, recently completed audits

In addition to allocating more resources and enhancing our infrastructure devoted to quality, we have been pursuing a strategy aimed at further developing and retaining our people, from entry-level staff through partners. We are also broadening our talent pool in ways that will support our audit quality objectives.

A broader talent pool will help us to responsibly grow the firm, which enables us to provide even more challenging opportunities for our people to develop professionally. For example, we are admitting more audit partners and hiring more experienced audit staff to help us meet the growing demand for our firm to provide assurance services. This helps to provide our partners and staff with more manageable workloads that are conducive to delivering high-quality audits.

We are also admitting partners and hiring other professionals who possess specialized knowledge and skills to support our audit teams, expand our business knowledge, and help us to meet requests for professional services other than audits.
Another way we are broadening our talent pool is by growing the firm through acquiring certain businesses that provide professional services other than audits. Providing such services is an important part of our overall growth strategy. Although this aspect of our business focuses on companies we do not audit, such services are also provided to audit clients if permitted by regulatory and professional rules.

Some have expressed concerns about audit firms providing to audit clients professional services other than audits. Our view is that the collective experience and insights our professionals gain from providing such services increase our ability to understand companies’ businesses and the risks inherent in those businesses. Thus, providing such services not only gives us an opportunity to help our clients deal with a variety of business needs, we can leverage the experience and insights we gain to build a broader base of knowledge that can benefit the audit. These service capabilities also help us to develop our people by providing them with diverse experiences. These are benefits that are important to the quality and vibrancy of our audit practice. This report explains these human capital and growth strategies in more detail and how they help us to perform high-quality audits.

Certain foundational elements of our infrastructure that promotes audit quality also are discussed in greater detail in this report. Our steadfast focus on being independent and objective is critical to the performance of high-quality audits, as is a tone at the top that conveys and reinforces expectations about audit quality. It is also important to be mindful of the relationship between audit fees and audit quality. And, we must have effective methodologies, tools, and processes, and an effective decision-making philosophy. Additionally, we explain how our firm’s four core behaviors—investing in relationships, sharing and collaborating, putting ourselves in others’ shoes, and enhancing value—contribute to audit quality.

This report is designed to give investors, audit committees, managements, regulators, and other interested parties an understanding of the improvements we are making to achieve our objective of sustained audit quality for the long term. It describes changes we have already made and specific near-term people, structural, and process changes aimed at further enabling the firm to consistently perform high-quality audits.

The report also discusses our participation in broader activities intended to strengthen the audit profession and promote greater investor protection. Those activities include discussions on how financial reporting can be made more useful for investors, including whether the auditor should report on information presented outside of the financial statements. We also continue to support efforts to advance the deterrence and detection of financial reporting fraud.

A commitment to performing high-quality audits, today and in the future, is a commitment that we fully embrace.

We believe that continuous improvement of the audit profession is important for the profession to remain relevant. We are focused on finding the right changes that will enhance audit quality for investors and other stakeholders in the financial reporting system.

A commitment to performing high-quality audits, today and in the future, is a commitment that we fully embrace. We hope you will find that this report demonstrates that commitment.
We are proud of PwC’s 1 long history of providing audit and other assurance services. Our brand value has been built on a reputation for performing high-quality audits. And, it is important that each succeeding generation of our professionals understand the importance of that reputation and contribute to maintaining and building on it.

We learned early on that a strong system of quality controls is important for the performance of high-quality audits. The people, structural, and process changes that we are implementing and that are described in this report would not be effective without a foundation that includes a strong system of quality controls. Such a foundation has been in place in our firm for years.

A key element of our foundation is the tone at the top: clear messaging accompanied by actions from firm leadership demonstrating that quality is our top priority. Other elements are discussed below.

Independence and integrity
Maintaining compliance with various laws, regulations, and our high standards of behavior are critically important to the success of our firm. An underpinning of our audit quality foundation is our commitment to be independent of mind and in appearance. Being independent of mind enables us to arrive at and express accounting and audit conclusions without being affected by influences that can compromise our professional judgment. It facilitates our acting with integrity and exercising objectivity and professional skepticism, which are critical to making the sound judgments required in an audit.

Maintaining independence is critical not only for our partners and other professionals as individuals, but for the firm as well. So, we focus our compliance efforts on all matters that have independence implications, including the delivery of professional services other than audits, entering into joint business relationships, and procurement of goods and services by the firm.

Given the importance of independence to audit quality, we continue to provide ongoing independence training to our people, as we have for many years. In this way, we reinforce the critical importance of personal and firm independence in fact and in appearance.

We continue to improve our processes and procedures to minimize exceptions and promote compliance with all applicable independence requirements. We are also improving communications about independence matters within the PwC Network2.

We encourage our professionals to exercise a high degree of professional skepticism, and we hold ourselves to firm-wide independence standards that are more rigorous than those required by professional standards.

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1 Throughout this report, the terms “PwC,” “firm,” “we,” and “our” refer to PricewaterhouseCoopers LLP, the US member firm of PricewaterhouseCoopers International Limited (PwCIL).

2 The “PwC Network” refers collectively to those firms that are members in PricewaterhouseCoopers International Limited. Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm.
And, we continue to enhance our monitoring efforts, for example, through wider application of our regular reviews of partners’ independence compliance.

**Core behaviors**
Our audit quality foundation also includes the core behaviors that are the basis of our culture: investing in relationships, sharing and collaborating, putting ourselves in others’ shoes, and enhancing value.

**Investing in relationships**
When performing high-quality audits, we carefully consider others’ perspectives, apply critical thinking, make balanced independent judgments, and “call it like we see it.” Having open and candid dialogue with audit committees (the representatives of investors), boards of directors, and key members of management of the companies we audit facilitates these actions. We achieve that dialogue by building professional relationships with those individuals, being mindful of the importance to audit quality of maintaining our independence, acting with integrity, and exercising objectivity and professional skepticism.

The relationships we develop also make it more conducive for us to challenge, in a professional manner, the thinking of management and the audit committee. In short, our relationships assist us in delivering advice, particularly when that advice differs from management’s, the audit committee’s, or conventional thinking.

Just as we insist on being direct about sharing our views, we require that management be forthright with their perspectives and motivations to engage in transactions. The relationships we develop facilitate timely and frank dialogue with audit committees and management teams, and enable us to better understand the company’s business issues and audit risks.

**Sharing and collaborating**
At PwC, sharing and collaborating are cultural attributes that we have nurtured for years. All of our professionals are taught that they must share their experiences with others, within the bounds of confidentiality restrictions, and that they never need to make decisions alone.

Exercising professional judgment is a necessary part of performing a high-quality audit. By watching other, more senior professionals resolve issues, individuals learn to exercise good professional judgment.

Engaging professionals across our three main businesses (assurance, tax, and advisory services), including the assurance National office, brings the proper expertise to bear on complex issues and helps audit partners make good decisions.

In fulfilling our responsibilities as auditors, we must always maintain professional skepticism about what we hear, and don’t hear, from management. This is the case even though our goals and management’s goals with respect to financial reporting should be aligned, given that management must certify that the financial statements are fairly presented.

This collaborative approach to decision-making, combined with our ability to quickly assemble people with the right expertise, is an important component of our strategy for achieving sustained audit quality. It is part of what has driven our decision to increase the allocation of resources to our Chief Auditor Network, which is described later in this report, so that more professionals in that network are available to advise audit partners as they design and conduct high-quality audits.
Collaboration among members of an audit team is, of course, necessary to achieve audit quality. But performing high-quality audits is further facilitated by obtaining input during the audit planning and execution stages from individuals with deep expertise on matters that are relevant to the audit. This is particularly important when tax or business transactions subject to audit are complex, making collaboration between audit teams and members of our tax and advisory practices imperative. In addition, knowledge about industry issues and professional standards is shared among audit teams and members of our different market and industry groups.

Collaborations between the National office and audit teams are important depending on matters such as the size of the engagement and the complexity of the accounting and auditing issues. Our National office experts regularly visit audit teams and the companies we audit. These visits facilitate the early identification, discussion, and resolution of financial reporting issues. They also help to remove the mystique, for both our audit teams and our clients, that is sometimes associated with a firm’s national office.

Collaborations between the firm and other member firms of the PwC Network also benefit audit quality when the companies we audit have global operations.

Sharing and collaborating extends to clients and other stakeholders. Candidly sharing our financial reporting expertise and other experiences with audit committees and management teams as they think through difficult issues helps inform their thinking on matters that impact the quality of their financial reporting. And, we share and collaborate with investors, regulators, and other stakeholders in the financial reporting system as we seek to understand the changing needs of financial statement users and determine where to focus our audit improvement efforts.

**Putting ourselves in others’ shoes**

Listening to and understanding others’ perspectives, whether they are investors, audit committee members, other stakeholders, management, or our partners and other professionals, facilitates enhanced dialogue and allows us to think about issues from various angles. When we understand a company’s motivations, pressures, and business, we can design and conduct better audits and make better decisions. We can also more effectively communicate with an audit committee and management about matters relevant to their accounting and financial reporting.

Putting ourselves in others’ shoes does not mean compromising our objectivity or subordinating our judgment to that of an audit committee or a company’s management. Although
we will demonstrate empathy in our interactions, we steadfastly remain independent of mind.

We strive to listen and communicate in a manner that demonstrates an understanding of and appreciation for the challenges associated with an accounting and financial reporting matter, all while retaining our ability to act with integrity and exercise objectivity and professional skepticism. In our view, this is a key ingredient necessary to work effectively with others and facilitates the building of relationships that give us greater access to insights we need to perform high-quality audits.

**Enhancing value**

As a provider of audits, we enhance value in several ways. First, we provide value through the independent assessments and judgments we make when performing audits. This includes having the courage and integrity to ask difficult questions, challenge questionable accounting, and voice concerns. These actions are important to providing high-quality audits, which is our most important responsibility. And the resulting value to investors is that they can confidently rely on the financial statements that are accompanied by our audit report.

We also enhance value by working with audit committees and managements to understand the business environments and industries in which their companies operate. That understanding enables us to identify issues that are important to audit committees and managements. We can then provide them with relevant insights, while adhering to applicable independence requirements, on how they can improve operations, controls, and other aspects of the business that may enhance shareholder value.

On top of that, performing high-quality audits enhances value, albeit indirectly, by providing career-enhancing on-the-job training to the talented audit professionals performing the work. These professionals learn the importance of independence of mind, objectivity, and exercising their curiosity to ask questions and understand business transactions. They hone their skills in ways that few other organizations can offer. These professionals will benefit the financial reporting system as a whole, regardless of whether they continue in the role of an auditor or become a member of management or an insightful user of financial statements.

Putting ourselves in others’ shoes does not mean compromising our objectivity. We demonstrate empathy in our interactions, but we steadfastly remain independent of mind.
Human capital strategies
Today auditors face a considerably more complex and rapidly changing business landscape than auditors of past generations. To perform a high-quality audit, specialized skills and attributes are increasingly needed. In fact, the quality of our work depends on the quality of the people we hire and the firm's programs designed to support their development. Accordingly, effective human capital strategies are critical to achieving sustained audit quality.

We are innovators in developing leading-edge human capital strategies. Our strategies begin at the university level. They include providing grant programs to help shape curriculums, interacting with professors, and interacting with students to provide internship opportunities and convey the relevance of the profession and the value we bring to investors. Our strategies also include a rigorous recruiting program to bring in talented individuals, at all levels of the firm, with diverse backgrounds and skills.

Once hired, our professionals participate in a training curriculum that provides a broad range of business, industry, and relevant technical learning, with a significant emphasis on accounting and auditing skills for audit professionals. We provide our professionals with increasingly challenging experiences and growth opportunities in our three main businesses. They also receive on-the-job coaching and mentoring, enhanced communications about career and compensation opportunities, and recognition of milestone successes. As a result, our people are highly motivated and disciplined about achieving their growth and leadership aspirations, which increases their desire to remain with the firm longer. This helps us to broaden our talent pool so that we increase the number of people in our firm with the skills to contribute to our audit quality objectives.

To further enhance the considerable breadth of knowledge and skills our firm already has, we have embarked on a targeted search for professionals.

In the fiscal year that began July 1, 2011, assurance partner admissions increased by more than 60% over admissions in the prior fiscal year.
who possess the specific skills, knowledge, and personal attributes we desire. In the fiscal year ended June 30, 2011, we aggressively sought and hired into our assurance practice approximately 1,100 experienced professionals (we had approximately 12,000 assurance professionals as of June 30, 2011).

We have also increased the number of non-audit specialists in our firm through both direct hiring and strategic acquisitions of businesses. Some of these specialists have a dual focus of delivering professional services other than audits and assisting our audit teams directly by providing support in certain highly technical audit and accounting areas. For example, our valuation experts advise audit teams in auditing purchase price allocations after a business combination and auditing fair values of financial assets and liabilities. And, our tax experts often assist audit teams in evaluating the tax amounts reported by management.

Having service capabilities to address leading-edge issues contributes to audit quality by enabling us to leverage the knowledge and expertise of talented specialists to identify audit risks, better design our audits, and more fully understand certain financial reporting matters. Said simply, we believe we can perform higher-quality audits because we can draw upon these specialized skills.

Our valuation experts were an important contributor as we responded to issues arising from the financial crisis. Many of these professionals were added to audit teams during the financial crisis to provide teams with immediate access to the expertise necessary to be able to make sound judgments on difficult issues, such as asset and liability valuations and going concern determinations.

Methodologies, tools, and processes

Conducting high-quality audits requires effective methodologies, tools, and processes. Using current technology, our common audit methodology incorporates relevant professional standards and industry information, facilitates a customized audit approach, and promotes the application of judgment and consistent execution of our audits.

The analysis and evaluation of audit risks is a central feature of our methodology, and is characterized by a healthy professional skepticism fueled by the intellectual curiosity of members of the audit team. Insights are sought into the business, the risks
inherent in the business and financial reporting, the internal control over financial reporting, and the economics of transactions. Risk findings are built into our audit strategy to develop an effective risk-based audit approach.

Our tools and processes, such as our audit software (Aura), independence compliance systems, and other databases, have been designed to increase our effectiveness and efficiency. We enhance our tools and processes, along with our audit methodology, on an ongoing basis to respond to the changing environment and take advantage of new technologies. This is an essential part of our continuous improvement efforts, described later in this report.

**Global network**

Today our clients increasingly expect us to serve them across borders and regions, and in emerging markets. Our people expect us to provide them with greater development opportunities around the world. And the PwC brand creates the expectation of a distinctive and consistent experience with PwC wherever our clients and people interact. To meet these expectations, the firm is a member of PricewaterhouseCoopers International Limited.

The member firms of PricewaterhouseCoopers International Limited together form the PwC Network. The member firms that belong to the network are from more than 150 countries throughout the world. The partners in each member firm understand their local economic, business, and regulatory environments, and can help other member firms understand how those environments impact a company’s business and financial reporting.

The network provides processes, tools, and resources to member firms to assist them in meeting the high

Since the member firms in the PwC Network consist of different people with diverse backgrounds and experiences gained in different cultural environments, our membership in the network enables us to bring both cultural diversity and local resources to audit teams, and a rich diversity of ideas and perspectives to audits.
Our focus on audit quality

Quality standards of the network. These include allocating resources to develop quality programs, maintaining a global audit methodology, coordinating member firms’ delivery of resources to perform quality reviews, and assisting member firms in enhancing their supporting infrastructures to promote high-quality audits. In addition, the network’s overall monitoring of member firms’ audit quality can help each member firm to identify areas that would benefit from increased attention.

The network also has processes and tools available when audit quality issues are identified with respect to a member firm. These include increased monitoring of the member firm’s audit quality and its implementation of remediation plans. The network may also assist member firms to improve their audit quality by facilitating inbound and outbound secondments of experienced audit partners and other professionals. These secondments help to improve the auditing skills and accounting knowledge of the partners and other professionals in the member firms. In instances where a member firm has severe or repeated audit quality issues, the member firm may have to replace its leadership.

Growth and profitability strategies

Our strategy is to continuously invest in the fundamentals of our business. This includes a significant investment in our people, recognizing that our human capital is our greatest asset. To help our people to be effective, we make appropriate investments in our audit processes. And, our strategy includes growing the firm by expanding both our assurance practice and our non-assurance practice in a careful and controlled manner.

Audit services

Our assurance practice provides a variety of services, with audits being the predominant part of the practice. Audit services define our brand because of our long history as auditors and how our audits contribute to the vibrancy of the capital markets. To maintain a strong assurance practice, we invest in our assurance professionals by making available to them diverse and challenging opportunities and attractive forms of compensation. The growth and profitability of our assurance practice is essential to our ability to help our people grow professionally, which positively impacts employee retention. This, in turn, contributes to our ability to improve audit quality.

We position our audit practice as a whole to contribute significantly to the overall profitability of the firm. We price our audits accordingly and we monitor our audit fees across the firm to determine whether collectively our audit practice achieves our overall profitability objective. As with any service business, profitability by engagement may vary for a number of reasons.

A challenge we face every day is to provide high-quality audits at a reasonable cost. That challenge has been particularly acute in recent times as companies struggle to deal with the difficult economy. Nonetheless, our efforts to price our audits appropriately have continued, even as the difficult economy sometimes results in pressures to reduce our fees.

We engage with audit committees in a fair and balanced discussion of the level of fees that is necessary to perform an appropriately scoped, risk-based audit. At times, we’ve made some difficult decisions to give up audit engagements where fees have not been sufficient to support a sustainable high-quality audit, and we will continue to do so.
In addition to monitoring our audit fees across our audit practice, we monitor audit fees on individual engagements. We understand our clients’ cost concerns, and accordingly, we strive to maximize audit efficiency while maintaining audit effectiveness. Among other things, we employ effective risk-based audit approaches, leverage our audit tools, assign partners and staff with the appropriate skill sets, and learn from our experiences.

Pressure to reduce audit fees can result in pressure to reduce audit quality. We are keenly aware of this. We communicate to audit committees and management teams the importance of setting fees at a level that is necessary to perform a high-quality audit. We also communicate the value we deliver through the audit process. We believe that when we are able to demonstrate the value we bring to our clients—through efficient and effective high-quality audits, as well as timely and relevant insights about their businesses—we can have productive discussions about audit fees, even in a difficult economic environment.

But the bottom line for us is that regardless of any individual fee amount, audit teams are expected to perform all audit work that is necessary for us to meet our audit quality objectives. We will not compromise audit quality for any reason.

Other professional services

We also have a large practice dedicated to delivering professional services other than audits through our three main businesses: assurance, tax, and advisory. Our strategies to achieve sustained high quality apply to the performance of these services.

Continued growth in professional services other than audits is important because we must maintain a diversified and financially sound business to enable us to invest in our people and in the other fundamentals of our business. So, it is fair to say that one of our strategies is to grow our firm through strategic acquisitions that are focused more specifically on the delivery of high-quality professional services other than audits, including services that are permitted to be provided to our audit clients.

Some have expressed concerns about audit firms providing to audit clients professional services other than audits. Our view is that the collective experience and insights our professionals gain from providing such services increase our ability to understand companies’ businesses and the risks inherent in those businesses. Thus, providing such services not only gives us an opportunity to help our clients deal with a variety of business needs, we can leverage the experience and insights we gain to build a broader base of knowledge that can benefit the audit. These service capabilities also help us to develop our people by providing them with diverse experiences. These benefits are important to the quality and vibrancy of our audit practice.

We take great care to evaluate all professional services to be provided to audit clients, whether audits or professional services other than audits, for compliance with applicable independence rules, and seek preapproval of these services from audit committees.
Although the primary focus of some of our strategic acquisitions is not audit-related, there are possible synergies. An example is our recent acquisition of Diamond Consulting, which provides business design and information management consulting services, particularly in the financial services and healthcare industries. In the future, we can leverage the expertise and insights of our Diamond consultants as part of audit training and audit planning to, for example, increase our understanding of how financial institutions evaluate and manage risks inherent in their loan and investment portfolios.

Our decision-making philosophy

To conduct high-quality audits, audit teams must reason through difficult accounting and financial reporting issues and reach appropriate conclusions. While accounting standards provide specific guidance for many situations, in other situations there is plenty of “gray.” To assist our audit teams, we have developed a guiding philosophy on how to think about getting to an appropriate resolution of an issue.

Our approach starts with a great deal of listening to understand the transaction, the surrounding business context, and different perspectives as to the accounting. Our philosophy is to focus on whether the company’s accounting is appropriate and its financial reporting transparent; it is not about finding a way to simply agree with management’s views.

Because accounting for certain transactions can be complex, we recognize that, at times, there can be more than one acceptable accounting treatment. Within this context, we will accept a treatment only if there is appropriate accounting support for it, such treatment reasonably reflects the economics of the transaction, and appropriate transparency exists in the financial statements.

If management decides to use a treatment that we find acceptable, but not preferable, our philosophy dictates that we discuss our thinking with senior management and the audit committee so that they understand our point of view regarding their accounting and disclosure.

As we highlighted in the discussion of our core behaviors, our culture is a collaborative one. And collaboration is a key part of applying our decision-making philosophy. When difficult matters arise, the audit partner is first expected to leverage the full quality support network of the firm. This includes, among others, our National office, Chief Auditor Network, the engagement quality review partner, and partners who lead the audit practices within our market and industry groups.

The audit partner is also expected to consider and resolve, pursuant to our established policies, internal differences in professional views should they arise. In this way, the audit partner and the firm will have an opportunity to align their views before a final decision is conveyed to management of the client. The benefit of this collaborative approach is enhanced audit and financial reporting quality.
Continuous improvement

To achieve sustained audit quality, we must closely watch our environment and understand—and even anticipate—the changing expectations of investors, regulators, and others who rely on audited financial statements to make capital allocation decisions. We also must monitor our own performance and learn from our experiences. Based on the information we obtain, we must then recognize where improvements will best enhance the quality of our work and make appropriate changes to continuously improve.

Identifying where improvements are needed

Our continuous improvement processes are important in an environment characterized by constant changes in factors that increase audit risk. For example, companies today are entering into increasingly sophisticated business, tax, and financial transactions, while expanding their operations globally. Their supporting systems and processes have similarly evolved and have increased in complexity. And, the uncertain economy has forced companies to make difficult spending decisions.

At the same time, we’ve learned through dialogues with investors and other external stakeholders that they are looking for greater assurance. And, the regulatory environment continues to be rigorous as regulators seek to promote greater investor protection. Today, more than ever, achieving sustained audit quality requires a process that recognizes all of these factors and enables an audit firm to evolve as those factors change.

Another important aspect of our continuous improvement processes is monitoring our performance. Under our internal inspection program, we inspect completed audits using teams made up of individuals who were not involved with the audit. Among other matters, the inspection teams consider the appropriateness of the judgments reached by the audit teams and look for instances where our audit quality objectives were not fully achieved.

We also listen to the messages of our regulator, the Public Company Accounting Oversight Board, and look to the results of their external inspections of our audit practice to determine where to make improvements. We study instances where our audit quality objectives were not fully achieved and consider their potential underlying causes.

The objective of an audit is to obtain reasonable assurance about whether the financial statements are free of material misstatements and whether there are material weaknesses in internal controls over financial reporting. Inspection findings and our clients’ financial statement restatement experience indicate that only in a low percentage of cases did we reach an incorrect conclusion on these matters.

However, the findings also indicate more or different audit procedures should have been applied to support the judgments made in certain instances. Accordingly, while we achieve our audit quality objectives on a large majority of our audits, inspection findings and feedback from our audit teams have identified aspects of our audits and processes that we should improve.

Types of improvements

Each year we make improvements to our audit approach, training, and other relevant factors as necessary to address the specific findings of our internal and external inspections and in response to the challenges of a rapidly changing environment. In recognition of changing investor and regulator expectations of our profession, we have decided to take bolder steps this year by significantly investing in the support processes of our assurance practice to enhance our audit quality for the long term.

The extent of the changes, some of which we have already made, reflects the seriousness with which we take our responsibility to perform high-quality audits that meet the
increasing expectations of investors and regulators. The changes also reflect our keen desire to maintain our stature as a leading firm by preparing now to meet the challenges of maintaining sustained audit quality, which is more important than ever.

We are focusing our efforts on a combination of people, structural, and process improvements. Our people changes include devoting additional experienced audit partners and other audit professionals to support our audit teams and further improve the methodologies they use.

We are also working on enhancements to our existing partner assignment process, which assists us in providing partners with the requisite capacity to perform high-quality audits. In that regard, we have moderated our goals for growing our assurance practice. This will enable partners to further strengthen their audit quality efforts.

We are also enhancing our training curriculum and further strengthening our monitoring and inspection efforts.

All of these improvements are being overseen by a partner who is working with leadership throughout the firm to coordinate and align the missions and objectives of each of our quality-improvement efforts so that they are working synergistically. This includes interacting with partners who lead the audit practices within our market and industry groups.

**Strengthening our culture of quality**

The firm’s leadership is committed to consistently performing high-quality audits. A substantial portion of their attention is focused on how to attain this goal both today and in the future by having the best processes and procedures and by hiring, developing, and retaining the best professionals.

To that end, leaders throughout the firm will be reinforcing, clearly and consistently, the tone at the top of the firm—that achieving sustained audit quality is our top priority. This will help professionals who join our firm to understand our commitment to quality and help them to become ingrained into our culture, while also serving as a constant reminder to all of our professionals.

We believe that messaging from the firm that continuously emphasizes our leadership team’s commitment to quality as our top priority will help clarify and reinforce where our audit quality agenda stands in relation to other agenda matters, such as firm growth.

Our firm has experienced strong growth over the past several years. While we are proud of this fact, we will not sacrifice audit quality for the sake of growth. Thus, we are working to ensure that audit partners have the requisite capacity to perform high-quality audits. This means we are focused on expanding our talent pool to provide our audit partners with more manageable workloads that are conducive to performing high-quality audits.
Partners who lead our assurance practices in various market and industry groups have unique insights into the business, financial reporting, and auditing issues in their respective practices. They also collaborate with others in making the majority of practice-related decisions, such as partner assignments and client acceptance and continuance. These leaders are responsible for audit quality in their areas of oversight and are held accountable for achieving it.

We’ve also made a conscious decision to moderate our goals for growing our assurance practice to reinforce that audit quality should be top of mind for our audit partners and other professionals. This and other important commitments to audit quality will continue to be communicated throughout the firm.

**Accountability for audit quality**

A basic premise under which we operate is that quality is best achieved if it is built into our processes and everyday activities. This means that all levels of firm leadership and all of our partners involved in the audit process have important roles in achieving audit quality. For example, our market and industry group leaders have a front-and-center role in implementing and monitoring our audit quality initiatives and overseeing our system of quality control.

To help them more effectively oversee quality, we are working to provide our assurance practice leaders with more guidance and better tools to carry out this responsibility. For example, to assist them in determining partner assignments, we are enhancing the process for reviewing partner assignments within our market and industry groups. These reviews focus on individual partner capacity and assigning roles to partners that best align with the partner’s tenure, capability, and industry experience. To drive consistent execution, we are also re-emphasizing who within assurance leadership is responsible for various activities that affect audit quality.

At the individual partner level, we are identifying ways to increase the focus on audit quality as part of partner compensation. Today an audit partner’s compensation can be negatively impacted by deficiencies in audit quality identified on that partner’s engagements. While this will continue, we have been looking at new ways to provide positive reinforcement by rewarding our audit partners and other professionals for achieving sustained audit quality. Additionally, in our partner planning and appraisal processes we are re-emphasizing to our partners the primary importance that should be placed on audit quality relative to their contributions to developing people, firm growth, and other initiatives.

Overall, our primary focus is to increase accountability in the spirit of continuous learning and improvement. However, as in the past, lapses in quality that warrant action by leadership will continue to be addressed appropriately. In summary, we have made it clear that quality is the top priority for all partners.

**Methodologies**

We are adding additional experienced auditors to our National office to further improve our audit methodology. These will be seasoned audit partners working together with a number of other highly experienced audit professionals. With significant input from our audit partners and other audit professionals, they
will evaluate ways to streamline and improve certain audit processes, including those focused on substantive analytics, fair value measurements, audits of multinational companies, and how we gather and analyze evidence. The intent is to make our audit approach more effective and enhance our ability to more consistently meet our quality objectives.

These experienced auditors also will work closely with those responsible for our global Audit Transformation Program, an important multi-year undertaking that was initiated a couple of years ago to enhance the quality and effectiveness of our audits. The goal of the program is to enable us to conduct increasingly effective audits that reflect an enhanced risk-based focus.

We developed the elements of the program based on our understanding of the changing needs and expectations of financial statement users, audit team feedback, and changing staff resource models. Two key elements of the program are Aura, our audit software, and our Global Assurance Delivery Model.

Aura is used by the member firms of the PwC Network and represents a significant investment by the PwC Network. It enables us to plan, execute, and document our audits in a more standardized and structured way. Its features also allow us to customize our audits based on a company’s business and the risks inherent in its operations using our professional judgment.

When using Aura, the audit team first identifies the audit risks relevant to a company. The audit team then plans and documents an effective audit approach by identifying the audit procedures that are necessary for us to gain sufficient audit evidence, especially in those risk areas.

Our Global Assurance Delivery Model allows audit teams to assign more routine audit activities to staff located in centralized service centers in lieu of a completely local staffing model. While its use to date has been limited relative to our total audit hours, over time this model will have three primary benefits.

First, it will help us standardize and improve the quality of these activities because they will be performed consistently by individuals who are focused on these specific aspects of our audits. This should also enhance our ability to be more cost effective.

Second, it will afford our audit teams additional time to focus on more challenging aspects of our audits, learn more about our clients’ businesses, and further develop working relationships with audit committees and management teams that are so vital to audit quality.

Our audit software, Aura, was designed to facilitate our application of professional judgment in considering risks when developing our audit plan. Aura’s technology platform works in a synchronized way with our audit methodology and knowledge management tools.
Finally, it will provide a better experience for our people as they seek to develop professionally. We expect that this will positively contribute to our goal of retaining high-performing professionals.

The enhanced Chief Auditor Network will consist of approximately 30 such partners, each of whom will devote about 1,000 hours to chief auditor activities.

We believe that concentrating these activities among fewer partners, but for more than double the total number of hours, will better enable our Chief Auditor Network partners to share their deep expertise in support of audit teams. In addition, over time, we are adding approximately 70 other locally based, full-time, highly experienced audit professionals to the Chief Auditor Network to assist the partners in carrying out chief auditor responsibilities.

With their increased level of commitment and continued close alignment with our National office, we expect that the partners and other professionals who comprise the Chief Auditor Network will improve their knowledge of how best to audit in an increasingly complex business environment. They also will perform independent reviews of aspects of certain audit engagements while they are still in process to identify areas where additional testing may be appropriate. All of this will better enable them to support audit teams, identify opportunities to further enhance our audit methodology, and contribute to our training agenda.

The Global Assurance Delivery Model provides us with good opportunities to improve audit quality. For example, our asset management group developed standardized procedures for testing audit areas that are common to the group. Those procedures were transferred to the centralized service centers. Audit teams in the group can now look to the centers to perform this work. This gives audit teams the ability to focus on more challenging areas of the audit, which promotes enhanced quality.

Chief Auditor Network
Our Chief Auditor Network has been providing valuable locally based support for our audit partners and audit teams on auditing matters. The primary activities of partners who comprise the Chief Auditor Network are to (i) support audit teams by providing auditing advice, leveraging their expertise on auditing standards, policy, and methodology; (ii) facilitate consistent implementation of our audit methodology; and (iii) facilitate effective training for audit teams and support local office training.

The Chief Auditor Network previously consisted of approximately 40 locally based audit partners in our 20 geographic regions and in our various market groups, with each devoting about 200–300 hours annually to chief auditor activities.

We have decided to enhance the Chief Auditor Network by allocating more time of seasoned partners and other professionals across the country to assist audit teams in consistently achieving our quality objectives.

Our focus on audit quality
Training

Effective training is essential to maintaining financial reporting acumen, and quality and consistency in our audits. In the past, when we identified areas for improvement or areas that would benefit from additional communications to our audit professionals, we acted quickly to get that information to them.

For example, in our 2010 locally conducted, year-end training, we included time for an additional instructor-led session. This session was designed to be a sharing of best practices by professionals and instructors regarding additional matters to consider when auditing difficult areas, such as fair value measurements and other accounting estimates.

In addition to our quarterly webcasts dedicated to accounting and financial reporting matters, in the second half of 2010 we conducted a series of webcasts for all audit partners and other audit professionals at the manager level and above, tailored to the matters we determined should be communicated to better prepare us for our 2010 year-end audits. These webcasts were supplemented by direct communications from the leadership of our assurance practice, highlighting specific areas to focus on during those audits.

Even though the training we provide our professionals in all of our businesses has consistently been recognized as best in class, we are continuing to evaluate and enhance our training programs to improve their timeliness and relevance. In this process, we are making important changes to better align training with our other quality initiatives.

For example, our training has increased our people's awareness that investors are key stakeholders in the financial reporting system and in our audits. To be responsive to the expectations of investors, much of our training has been focused on refining our auditing skills, including those related to the exercise of an appropriate level of professional skepticism. Our training also includes raising the awareness of broader issues being discussed by the PCAOB and regulators outside the United States regarding audit quality. Understanding those issues is an important part of making our training programs timely, relevant, and effective.
We have also accelerated the timing of our internal inspections of 2010 year-end audit engagements so that we can utilize what we’ve learned from these inspections, and the PCAOB’s inspections, to develop this year’s training for audit professionals. That enhanced audit training includes a three-day program attended by virtually all audit professionals, from first-year staff to partners.

This year we will also enhance the focus on audit quality at our annual market and industry group conferences, which are held for partners and other professionals at the manager level and above to communicate key messages, share knowledge, and discuss other market and industry-specific matters. And, we will continue to conduct focused webcasts and issue quality-focused communications from leadership as they are needed.

**Internal inspections**

Historically, our internal inspections were performed by experienced audit partners and other professionals on a limited, part-time basis. We are changing our Inspections group to comprise a larger core team of mostly dedicated professionals in order to drive greater consistency and quality in internal inspections. This core team will be supplemented by experienced partners and other professionals from our audit practice, including those with special industry or technical expertise as needed.

We expect that this core team will grow to approximately 15-20 audit partners and 55 other highly experienced audit professionals. In addition to conducting inspections, the group will consider the potential underlying causes of unfavorable inspection findings to further our continuous improvement efforts.

Our training has increased our people’s awareness that investors are key stakeholders in the financial reporting system and in our audits.
Continuous improvement of our audits is important for our firm to remain relevant. Continuous improvement of the audit profession is also important for the profession to remain relevant. Because these are complementary, helping the profession keep pace with changes in the professional, regulatory, and business environments in which we practice is an important part of our activities.

Looking forward

Our focus on audit quality includes being actively involved in developing the profession's perspectives on the events and trends in those environments. Among other activities, we are fully engaged in discussing and developing ideas to improve audit quality within the profession and promote greater investor protection. For example, financial reporting fraud is an ongoing concern for investors. We continue to support efforts to advance the deterrence and detection of financial reporting fraud.

Our role as auditors is to obtain reasonable assurance that the financial statements are not materially misstated, whether caused by fraud or error, and we design our procedures and execute our audits with that responsibility in mind. We are actively engaged in activities led by the profession to increase communication with investors to help them to better understand the auditor’s responsibilities in general and with respect to the identification of fraud in financial reporting.

Other improvements are on the horizon as well. The financial regulatory environment remains fluid, both in the United States and abroad.
Various regulators and policymakers are examining lessons learned from the financial crisis and considering what can be done to promote greater investor protection. These examinations include increased scrutiny on financial reporting, auditing, and their supporting systems.

Specifically, regulators are considering what additional information auditors, audit committees, and managements might provide to investors. Discussions of potential changes include providing additional information in the audit report to reduce the gap between what investors expect of auditors and what auditors are responsible for performing under professional standards. For example, possible changes include clarifying the meaning of “reasonable assurance” and the auditor’s responsibility related to disclosures and other information presented outside of the financial statements.

Other considerations include whether the auditor should (i) provide its views on the quality of a company’s financial statements; (ii) provide an assessment of management’s significant judgments, estimates, accounting policies, and related disclosures; (iii) provide attestation services related to management’s discussion and analysis in public filings; and (iv) report additional information about communications between the auditor and audit committee.

Policymakers outside the United States are also seeking input on a broad range of audit policy matters beyond the role of the auditor, such as the governance, independence, and supervision of audit firms, and concentration in the audit market. Other topics being examined include (i) whether auditors should be appointed and paid by a third party, such as a regulator, who would decide how long they should be retained; (ii) mandatory joint audits where at least one of the auditors is not one of the largest firms; and (iii) whether audit firms should be prohibited from providing to audit clients professional services other than audits.

Potential changes in these areas would have implications for audit firms, audit committees, and company managements. And decisions reached by foreign regulators and policymakers could influence the views of US regulators and policymakers as they consider similar issues. We are actively leading a number of the discussions about these potential changes and participating in most others. We also are listening to the thoughtful views of investors and are actively providing our views in professional meetings, other forums, and through comment letters. We are focused on finding the right changes that will enhance audit quality.

We also are significantly involved in current discussions on how financial reporting can be made more useful for investors. Topics range from improvements to individual US and international accounting standards, to improvements in integrating financial, social, and environmental reporting, to wider debates about the appropriate structures of standard-setting organizations. We proactively reach out to investors, audit committee members, managements, standard setters, and regulators to listen to their views and share our perspectives on these and other financial reporting matters, both privately and publicly. This includes publishing materials containing our views, even if they are controversial.

As the role of the auditor evolves, we believe that our involvement with these discussions and the significant investments we are making in our own audit quality initiatives will promote higher quality financial reporting and improve audit quality for investors.
We appreciate the privileged role we have in the capital markets, and understand the importance of performing audits that provide investors with confidence in the financial statements of the companies we audit. Our goals are to consistently achieve our audit quality objectives and foster a sustainable culture of audit quality within our firm. To meet these goals in the dynamic business environment in which we operate, we will strive to continuously improve at all levels of our firm. This includes in our processes, in our audit methodology, and in the individual audits we perform.

Meeting these goals will require that we continue to make significant investments in our assurance business. We must also demonstrate a willingness to change as a firm and to facilitate change in our profession in order for the profession to remain relevant. We will listen to investors, engage in debates on matters impacting investor confidence in financial reporting and our profession, and thoughtfully come to our own perspectives on the most productive way the profession can improve audit quality and provide more value to investors.

These are our continuing commitments. Stakeholders in the capital markets should expect nothing less.