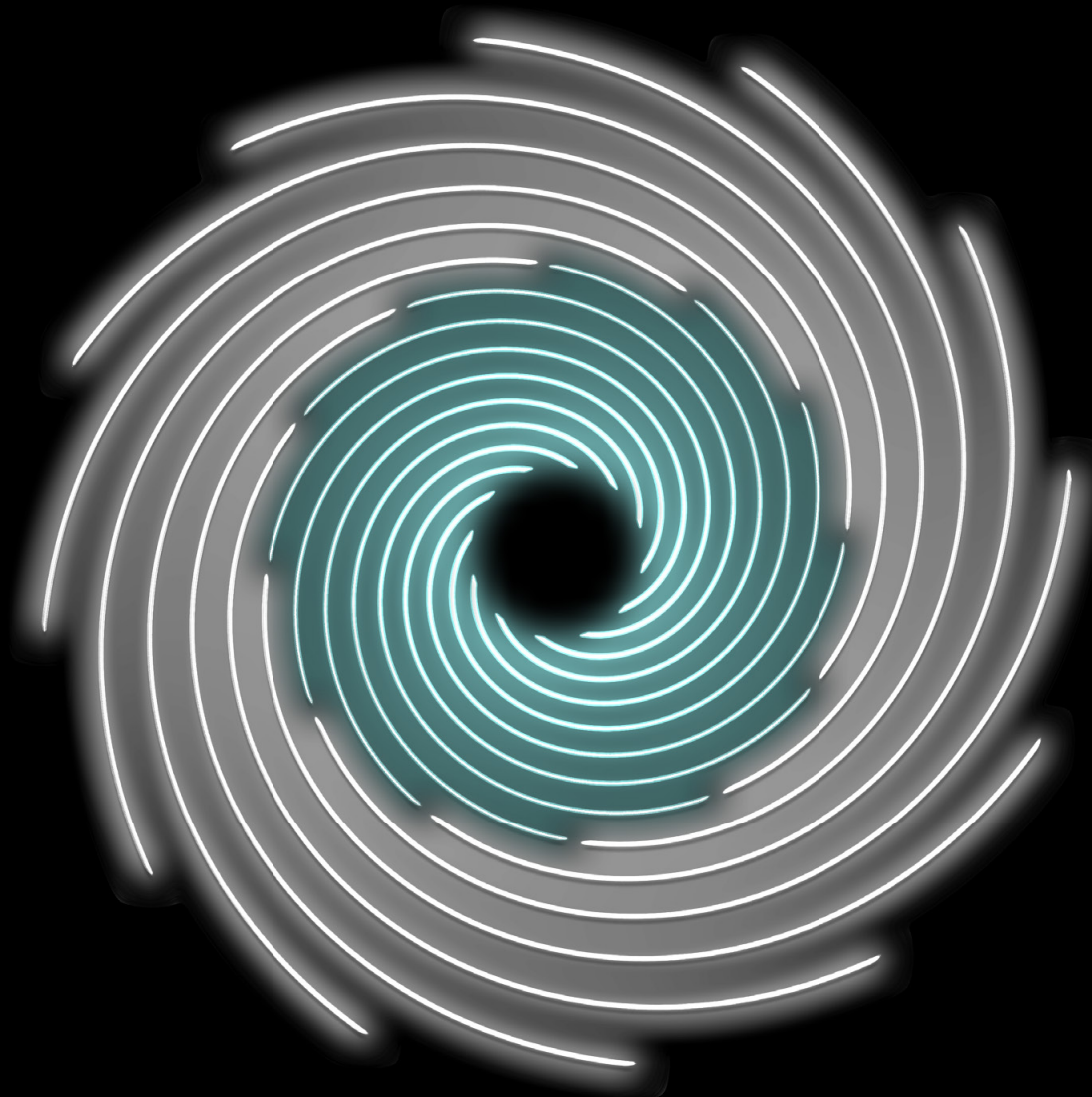



**Deloitte.**



**Optimizing the value of  
audit quality indicators**  
Lessons we have learned

Deloitte Institute *for*  
**Audit Innovation  
and Quality**



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# Enabling the evaluation of the seemingly elusive concept of audit quality

A lot of attention is being paid of late to the ways audit committees (ACs) evaluate whether they are getting quality work from their auditors. For all the ongoing talk about “audit quality,” however, the concept is short on widely accepted definitions—which is why companies and their ACs struggle to evaluate it.

We see audit quality as meeting auditing standards so we can issue the appropriate opinion, innovating our audit approach to keep pace with advances in clients’ business and systems, and providing additional insights so ACs and management know more about their companies after our audit than they did before.

There is a lot of attention on how ACs evaluate whether they are getting quality. While many use annual assessments and periodic comprehensive reviews, some are charting new territory. They are evaluating quality in real time by experimenting with a metric-driven approach, referred to as Audit Quality Indicators (AQIs).

AQIs have been researched by groups like the Centre for Audit Quality (CAQ) and the Public Company Accounting

Oversight Board (PCAOB) in the US. In Canada, CPAB recently released its interim [report](#) on the AQI pilot project it is now completing.

At Deloitte, we audit half of the companies that participated in the CPAB pilot and some ACs of our other clients have been independently experimenting with AQIs. Through these interactions especially, we are developing a perspective on AQIs grounded in our actual experience.

The final outcome of an audit is the standard form audit report. For substantially all audits, the audit report is identical, providing little insight on the quality of the audit. For ACs and others inside the company being audited, better visibility on the audit process occurs through discussions with the auditor and formal written communications.

Through these interactions an AC must assess, for itself, the quality of the audit. The AQI experiment is exploring whether an AC’s subjective assessment can be meaningfully supplemented with quantitative measures.

AQIs therefore strive to provide additional information to an AC to enable the evaluation of the seemingly elusive concept of audit quality. Typically, in concert with its auditor, an AC determines six to eight AQIs that it will use in its particular circumstances. Frequently, the selected AQIs are drawn from the potential AQIs developed to date through research by the PCAOB and CAQ.

## Possible AQIs developed by PCAOB

<b>Audit quality indicators</b>	
<b>Audit professionals</b>	
<b>Availability</b>	
1	Staff leverage
2	Partner workload
3	Manager and staff workload
4	Technical accounting and audit resources
5	Persons with specialized skill and knowledge
<b>Competence</b>	
6	Experience of audit personnel
7	Industry expertise of audit personnel
8	Turnover of audit personnel
9	Amount of audit work centralized at service centres
10	Training hours per audit professional
<b>Focus</b>	
11	Audit hours and risk areas
12	Allocation of audit hours to phases of the audit
<b>Audit process</b>	
<b>Leadership and tone at the top</b>	
13	Results of independent survey of firm personnel
<b>Incentives</b>	
14	Quality ratings and compensation
15	Audit fees, effort, and client risk
<b>Independence</b>	
16	Compliance with independence requirements
<b>Infrastructure</b>	
17	Investment in infrastructure supporting quality auditing
<b>Monitoring and remediation</b>	
18	Audit firms' internal quality review results
19	PCAOB inspection results
20	Technical competency testing
<b>Audit results</b>	
<b>Financial statements</b>	
21	Frequency and impacts of financial statement restatements for errors
22	Fraud and other financial reporting misconduct
23	Inferring audit quality from measures of financial reporting quality
<b>Internal control</b>	
24	Timely reporting of internal control weaknesses
<b>Going concern</b>	
25	Timely reporting of going concern issues
<b>Communications between auditors and audit committee</b>	
26	Results of independent surveys of audit committee members
<b>Enforcement and litigation</b>	
27	Trends in PCAOB and SEC enforcement
28	Trends in private litigation

### Our experience with AQIs in the last year leaves us with two fundamental conclusions:

1. AQIs that are thoughtfully developed during planning can add immediate value during the audit, well before any post-audit evaluation. They are most effective when they spur new conversations between the auditor and the AC on matters key to audit execution.

2. It's important to turn things upside down. Don't simply start with a list of possible indicators and then select several you think might be interesting. Instead, both the auditor and the AC should conclude on audit execution matters they believe are key and then select or design AQIs that deepen that discussion.

To demonstrate what we mean by these two conclusions, we'll take you through eight lessons we've learned.



## Lesson 1

# AQIs can trigger new constructive conversations on audit quality

AQIs take time and effort to develop and discuss. AC agendas are already full and no one wants to add something that isn't worth the time allocated to it. The lesson, then, is to identify where there are questions or concerns; then, select or design AQIs accordingly.

A common AC concern is that too much of the critical audit work is done too late in the audit, creating the potential for unwanted surprises. These ACs want to know how we would keep that from happening. We explained how our formal

Milestones program mandates completion of certain activities by specified dates. Typically, we would then agree with these ACs that we set out those milestones as part of our audit plan and then report each quarter on whether the milestones were reached.

Conversely, our ability to execute on our own work plans is dependent on management delivering its committed audit support working papers on schedule. Consequently, in the CPAB pilot, we agreed with several of the participant companies

that an AQI that enabled us to report on the timely delivery of each item committed to by management was critical.

In both cases, the selected AQI resulted in constructive conversations. Why did the situation occur? What was the response? What was the impact on the audit? These were all new conversations, occurring in real time well before a normal auditor evaluation and they added to everyone's understanding of the audit's intricacies.



## Lesson 2

# Customize for greater value

Early research on AQIs speculated that an ideal set of measures would emerge and that they would then be reported uniformly across all firms and all audit engagements. Our experience is the opposite. ACs and management are most engaged on AQIs when they are specifically customized to their circumstances.

ACs do not want additional burdensome, rote responsibilities. They are seeking concise, simple, and tailored reporting that leads to insightful discussion. In one instance, we were challenged that audit quality could only be delivered by industry-experienced professionals. Several AQIs were devised to measure the industry experience and training of each audit team member.

This requires forethought so that the right set of meaningful AQIs is agreed upon as part of planning the audit. No one should be shy about suggesting improvements to their AQIs over time; in fact, participants expect that this is exactly what will happen as the company and the audit evolve.



## Lesson 3

# Good AQIs can cover a lot of territory

As ACs set the right AQIs for their specific circumstances, they should be sure to consider the full breadth of possible focus areas for audit quality evaluation.

Getting to the most useful AQIs will require a thoughtful process. We suggest thinking first about the area(s) of audit quality that the AC

feels most merit discussion. Then, having made these choices, think about the specific topics or questions that should be discussed.

The following table shows the link between areas for focus and the specific questions that can guide the selection and design of AQIs.

Area of audit quality	Examples of topics of interest to an AC
How the audit firm performs overall	<ul style="list-style-type: none"><li>• How much experience does the firm have in our company's specific industry?</li><li>• How deep is the firm's specialty in areas of key risks? Who are its preeminent specialists? How is their expertise impacting our audit?</li><li>• What is the firm's audit quality record?</li></ul>
What this specific engagement team's capabilities are	<ul style="list-style-type: none"><li>• How much experience do the assigned audit team members have on our company's audit?</li><li>• What other assignments do our audit's team members have, especially during critical times of the year?</li></ul>
How well this particular audit is executed	<ul style="list-style-type: none"><li>• How much of the audit effort will be spent in the risk areas that the AC has discussed with the audit team?</li><li>• What are the critical milestone tasks and deadlines that must be met during the audit to ensure efficient completion with no surprises?</li><li>• On what critical deadlines are the audit team dependent on management to provide support materials?</li></ul>
How the results of the year-end process are assessed (both management's financial reporting and the auditors' work)	<ul style="list-style-type: none"><li>• How did the timing of reporting on internal control weaknesses or deficiencies affect the AC's ability to do its work?</li><li>• How many adjustments were triggered by the auditor's findings? How many unadjusted items were reported?</li></ul>

Designed in this way, a relatively small portfolio of AQIs can allow an AC to cover the full breadth of areas it wishes to focus on.



## Lesson 4

# Without comparators and qualitative analysis, AQIs don't mean much

On first reporting of any AQI, the natural response should be “so what?” Let’s say the AQI reported is that 32 percent of the planned audit work was completed before the year-end date. Absent accompanying qualitative analysis, that number does not actually provide meaning.

First, a comparator is needed. Continuing the example, the AQI is more helpful if you know that in last year’s audit, the same measure was 25 percent and that the target for this year was 40 percent. The conversation then gets even more interesting when we describe our firm’s view that peak audit quality enhancement occurs for this particular issuer when that AQI is 45 percent or more.

Second, a deeper conversation is needed. For example, why was the target below 45 percent? What caused actual to be less than target? How is the delayed work being

accommodated? If additional staff are making up the time, are they industry-experienced? What will the impact be? Such a conversation highlights the interdependence of the various elements of audit quality and allows an AC to see the integration of the various audit planning and execution decisions that must be made.

There will be temptation to ask what the industry standard is for a given AQI, or to compare to measures reported on other audits. Resist that temptation. Each audit is unique, influenced by many factors, including the company’s circumstances and its management processes. The best comparators are prior experience on that audit and the specific AQIs target, as agreed to with the AC.

Knowing the target—which must be generated by discussion between the auditor, the audit committee, and management—is critical to evaluating what an AQI is saying.



## Lesson 5

# Timing and style of reporting matters—as does thoughtful reflection

We've acknowledged that AC agendas already leave little time to cover new reporting such as AQIs. But in our experience, carefully planning the timing of AQI discussions during the year can allow effective management of that time crunch. AC agenda time can in fact be used most efficiently when there are high-quality deliverables available that reflect thoughtful presentation of the AQIs, including commentary and analysis designed to foster meaningful discussion.

As an example, on a December year-end company, one engagement team used the August AC meeting to propose some possible AQIs together with management. These alternatives were based on a prior discussion with the AC and management on the areas of greatest focus for them. The alternatives were also compared to the list of AQIs proposed by the PCAOB and CAQ. At that meeting, agreement on the AQI set for that year was reached with the AC and management.

At the November meeting, the target comparators were presented for the AQIs and some interim performance

measures that were available at the time. Then, at the first meeting of the new year, the final AQIs, the learnings, and some initial views on improvements being considered for the following year's audit were presented.

Of course, not every AC will follow the same pattern. For example, we were directed in one circumstance to focus on completing the audit and not report year-end AQIs until the meeting after the audit report was presented. In this situation, this process provided more time for thoughtful analysis of the AQIs and the accumulation of parallel data from component auditors in other countries.

Depending on the AQI, it can be reported to the AC quarterly, once a year during planning, or annually after the completion of the audit. Not that every AQI needs to be covered at every AC meeting. But when an AQI is presented, any commentary that can help the participants in the AC meeting derive maximum value from the discussion must accompany it.





## Lesson 6

# Know what's in, what's out, and what's required to develop the AQI

Frequently, a consolidated audit covers more than one country or company. Generally, it is expected that AQIs are measured at a consolidated level. However, if your consolidated group employs several auditors, consistently reliable information from all countries or entities may not be available (i.e., on a timely basis or at all) or the cost to gather it may be too high.

For example, Canadian-only data may be the easiest to obtain, at least initially, in large global audits. In other cases, some global audit engagements may include individual country statutory audits completed only for local purposes, and which are not undertaken to support the consolidated audit opinion. In this situation, a determination should be made whether local statutory audit information (such as audit hours or staffing mix) should be in or out of consolidated AQI calculations.

The ACs we've dealt with wanted relevant AQIs and they wanted an efficient process for gathering them that wouldn't burden management or the auditor. In some cases, we agreed to defer measuring certain

AQIs during their pilot year based on a cost-benefit consideration. While a suggested AQI was judged to be valuable, it was not deemed worth the difficulty to gather the information needed to formulate the AQI.

By their nature, AQIs are bespoke. Generally, whether calculated by management or the auditor, they do not flow naturally from system-generated reports.

So, understand the scope and cost of the agreed AQIs. Recognize related limitations. Act accordingly. If you are not finding the AQI discussion valuable, say so.



## Lesson 7

# Without management buy-in, AQIs will not add value

Before an audit can be undertaken, management must execute on its internal control and financial reporting responsibilities. Management must also provide materials to the auditors and engage in discussions to assist in the gathering of evidence. The timing of these activities must be planned in such a way that integrates with the auditor's requirements so that the audit can be completed by the reporting deadline. Let's refer to this integrated set of activities as the "audit interaction."

Developing meaningful AQIs, gathering related data, and then analyzing those data will have implications that reverberate throughout the audit interaction—from initial planning through formal file archiving. This will be the case whether an AQI measures some aspect of auditor performance or assesses management's contribution to the audit.

Discussions can be wide-ranging—exploring the cause of a certain

AQI result, the responses needed to address it, or agreement that a change in audit process is called for in the next year. These conversations are incomplete without management's earnest participation and willingness to take time during the audit to advance the AQI agenda. Frequently, advances in audit quality targeted after an AQI discussion are, in part, dependent on management's intent to help improve financial reporting and audit processes.





## Lesson 8

# Your first set of AQIs is only the start of meaningful audit quality discussions

A good first-year experience with AQIs does not guarantee future success. A solid set of AQIs will evolve with the AC, the auditor, management, and the company. Changes in the company's business, systems, or management may even lead to new AQIs, as can changes in the lead audit partner or the countries around the world involved in the audit. By evolving each year with the situation, AQIs will remain relevant and continue to add value to the audit process.

Remember that while AQI conversations can indeed yield valuable information on audit quality, they are not the only source. Ask

your auditor what other tools they have at their disposal to help you in your evaluation. For example, we [published the first Canadian audit quality report](#) by an audit firm, setting out our quality aspirations, the investments we are making in quality, and the advances we have achieved.

Finally, never underestimate the value of a candid, direct conversation with your lead audit partner. Whether this is a private conversation with the AC chair, during the AC meeting, or in the in-camera session, we believe there is no substitute for forthright dialogue on areas the AC sees as key to audit quality.



# Sample AQI reporting

This table shows the AQI reporting agreement reached between a fictional AC and its auditor. It represents the game plan on which AQIs will be tracked, why they are important, when they will be discussed, and what they will be compared to. Remember that, when they are actually tabled and discussed, each AQI must be accompanied by a thoughtful analysis of what caused its result and what further actions might need to be taken by the auditor or by management.

<p><b>1</b></p> <p><b>Assessing:</b> Quality track record</p> <p><b>Question:</b> What comments were raised on files selected during the firm's inspection?</p> <p><b>AQI:</b> Publicly available inspection results</p> <p><b>Timing:</b> Present at audit planning</p> <p><b>Comparator:</b> Prior year result</p>	<p><b>2</b></p> <p><b>Assessing:</b> Engagement team</p> <p><b>Question:</b> How much of the audit is done by specialists?</p> <p><b>AQI:</b> Total specialist hours and % of total hours</p> <p><b>Timing:</b> Present planned resourcing at audit planning; actual at year-end</p> <p><b>Comparator:</b> Plan</p>	<p><b>3</b></p> <p><b>Assessing:</b> Audit execution</p> <p><b>Question:</b> Is audit work done early enough?</p> <p><b>AQI:</b> % of audit hours incurred each quarter</p> <p><b>Timing:</b> Present each quarter</p> <p><b>Comparator:</b> Current year plan and last year actual</p>	<p><b>4</b></p> <p><b>Assessing:</b> Audit support by management</p> <p><b>Question:</b> Is management's delivery timely?</p> <p><b>AQI:</b> % of materials delivered late; number of days late</p> <p><b>Timing:</b> Present each quarter</p> <p><b>Comparator:</b> Set target through discussion</p>
<p><b>5</b></p> <p><b>Assessing:</b> Audit execution</p> <p><b>Question:</b> How much of the audit is focused in risk areas?</p> <p><b>AQI:</b> % of total hours on significant risk areas, by risk</p> <p><b>Timing:</b> Present plan at audit planning; actual at year-end</p> <p><b>Comparator:</b> Plan</p>	<p><b>6</b></p> <p><b>Assessing:</b> Year-end results</p> <p><b>Question:</b> What do unadjusted items tell us?</p> <p><b>AQI:</b> Analysis (number and \$) by financial reporting area and root cause</p> <p><b>Timing:</b> Year-end</p> <p><b>Comparator:</b> No concentration by area or root cause</p>	<p><b>7</b></p> <p><b>Assessing:</b> Year-end results</p> <p><b>Question:</b> How current is our understanding of control deficiencies?</p> <p><b>AQI:</b> Number of control deficiencies at year-end, with timing of their initial disclosure to AC</p> <p><b>Timing:</b> At year-end</p> <p><b>Comparator:</b> Reporting spread throughout the year</p>	

# Our commitment to using AQIs

We want to help ACs in their evaluation of audit quality. So we're committed to two specific actions:

## 1. Publishing Firm AQIs

In our annual audit quality report, published in the fall after the completion of each year's inspection cycle, we will publish several firm-wide AQIs for our Canadian public company audit practice.

## 2. Working with ACs on engagement-specific AQIs

Where ACs of our clients are interested in exploring them, we will eagerly initiate discussions on how AQIs can be used. Each situation will call for evaluation of how AQIs would benefit that audit and the capacity of the engagement team to add development and analysis of AQIs to its workload.



# The next frontier

We are exploring several aspects of AQIs. This summary of the lessons we have learned to date on using AQIs is the first of three perspectives we intend to publish related to AQIs.

As you consider how AQIs might be effectively used in your audit, we will be working on two more topics:

The annual audit is a key part of the process by which a public company fulfills its legal obligation to report its financial results. Preparation of the financial statements and approval of the annual report are also important. Management, the AC, and the audit firm all play essential roles in upholding the integrity of the audit process and audit quality.

In our next installment of this series on AQIs, we want to share our observations on the contributions that management and ACs make specifically to the quality of the audit.

We've also been thinking about how we measure and assess audits as they progress, so that we can redirect efforts as necessary.

We see the ability to do so as a foundation from which to address the expectations of the CPAB that we "identify key quality controls and determining metrics to monitor and measure effectiveness<sup>1</sup>."

The third segment of this series on AQIs will outline our thinking on this leading topic.

<sup>1</sup> CPAB. 2016 Big Four Inspections Report. November 2016.  
[http://www.cpab-ccrc.ca/Documents/Annual%20Reports/CPAB\\_2016\\_Big\\_Four\\_Inspections\\_Report\\_EN.pdf](http://www.cpab-ccrc.ca/Documents/Annual%20Reports/CPAB_2016_Big_Four_Inspections_Report_EN.pdf).  
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