

# Audit Committee *Brief*

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## AQIs: Measuring quality through metrics

The idea of establishing measures of audit quality that can be used by stakeholders in the audit process—including audit committees—has been discussed at least since the U.S. Treasury Advisory Committee on the Auditing Profession advocated for it in 2008. This year promises to be a significant one for this topic, as there are several active projects focused on the question of whether metrics that provide insight into audit quality (often referred to as audit quality indicators or AQIs) can be developed.

Over the past few years, the PCAOB has been developing a concept release to seek feedback on a potential approach. The Center for Audit Quality (CAQ) has also been gathering perspectives from stakeholders, including the profession, audit committee members, and others. In addition, methods for enhancing audit quality have been receiving increased international attention through efforts such as the International Assurance and Auditing Standards Board's [Framework for Audit Quality](#).

The goals of these projects are for all stakeholders in the audit process to be aware of and agree on the fundamental elements that contribute to a quality audit, and to spur productive dialogue among the various stakeholders on how to support and enhance audit quality.

## PCAOB AQI initiative

The PCAOB’s Office of Research and Analysis has been engaged in developing a portfolio of measures that it believes could offer greater insight into what might constitute a high-quality audit. The PCAOB has discussed various aspects of its project with its Standing Advisory Group (SAG) and Investor Advisory Group (IAG).

Throughout its AQI project, the PCAOB has focused on identifying the metrics that would be most useful to a variety of potential stakeholders, including audit committee members. The PCAOB’s initial list of more than 80 potential AQIs has been significantly narrowed over the course of its project, largely due to feedback from the advisory groups.<sup>1</sup> The AQIs the PCAOB is considering include both overall metrics for audit firms—including affiliates and global networks—and specific metrics for engagement teams. Although the PCAOB has not formally proposed or finalized a list of indicators, general categories of AQIs it has discussed during the development process include:

Operational inputs	Processes	Results
<ul style="list-style-type: none"> <li>• Partner workload</li> <li>• Staff workload</li> <li>• Audit team composition</li> <li>• Professional experience</li> <li>• Continuing education</li> <li>• Supervision and review</li> </ul>	<ul style="list-style-type: none"> <li>• Tone at the top</li> <li>• Personnel management</li> <li>• Risk assessment and response</li> <li>• Information and communications</li> <li>• Control activities</li> <li>• Monitoring</li> </ul>	<ul style="list-style-type: none"> <li>• Reliable financial statements, including related disclosures</li> <li>• Assurance about internal control</li> <li>• Going-concern warnings</li> <li>• Robust audit committee communications.<sup>2</sup></li> </ul>

These elements seem likely to form the foundation of the PCAOB’s approach. They reflect the board’s view that the context in which work is performed, the processes followed, and the results that are communicated all strongly influence audit quality and should be carefully tracked.

In a SAG meeting [discussion](#), the PCAOB noted that each potential AQI will likely be formulated in quantitative terms. Even seemingly subjective elements could be converted to a quantitative score to enhance their usefulness through approaches such as surveys. For example, a specific AQI that has been considered is a survey of audit committee members regarding the quality of the communications received from audit firms.

The PCAOB expects to issue a concept release in 2015 to seek further input on its AQI project. We anticipate that the release will include up to 30 potential AQIs,<sup>3</sup> but will not specify to whom the AQIs should be reported or in what form.<sup>4</sup> The PCAOB has said that the concept release will likely seek input on how it might further narrow the list of potential AQIs, and the shape an AQI program could take (e.g., voluntary or mandatory discussion with audit committees, or public disclosure).<sup>1</sup> The PCAOB has indicated that the next steps will be to continue soliciting feedback and to develop models for testing potential AQIs.

### My perspective

“As the newly elected chief executive officer of Deloitte, with a long history of serving public companies, I have the privilege of interacting with numerous audit committee members and understand the crucial oversight role audit committees perform in our capital markets system. At Deloitte, we recognize the merits of audit quality indicators (AQIs) and are committed to working with the regulators and other key stakeholders to achieve our common goal of having audits of the highest quality. We believe AQIs have the potential to support audit committees in fulfilling their important governance role of overseeing the quality of the audit.”



Catherine M. Engelbert  
Chief Executive Officer,  
Deloitte LLP

1 [Comments](#) by Greg Jonas, director, PCAOB Office of Research and Analysis, December 10, 2013.

2 PCAOB SAG Meeting: Discussion – Audit Quality Indicators, May 15–16, 2013.

3 PCAOB SAG Meeting: Audit Quality Indicators Update, November 14, 2013.

4 PCAOB SAG Meeting: Initiatives to Improve Audit Quality—Root Cause Analysis, Audit Quality Indicators, and Quality Control Standards, June 24–25, 2014.

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## CAQ project on AQIs

In anticipation of the PCAOB's concept release, Deloitte and other firms have been working with the CAQ to develop the profession's point of view regarding:

- The most useful way to communicate AQIs
- The target audience for AQI communications
- The AQIs that may be most relevant and useful in terms of assessing audit quality.

The [CAQ Approach to Audit Quality Indicators](#), published in April 2014, provides the CAQ's views on "(1) the background and context for the discussion of AQIs, (2) a suggested approach for the communication of AQIs, (3) the identification of a set of potential AQIs, and (4) an overview of the CAQ's pilot-testing initiative."

## Communication between audit committees and auditors

A fundamental element of the CAQ's approach is the communication about AQIs with audit committees in their role as the primary overseer of the external auditors. The CAQ noted that dialogue between the auditors and the audit committee regarding AQIs could focus discussions on the most important audit matters and strengthen the committee's knowledge regarding factors directly affecting audit quality.

The CAQ added that strong communication about engagement-level AQIs could help spur actions that lead to quality improvements and could assist committee members in better evaluating both the overall firm and the engagement team. Regular communication on these topics could also help the committee understand changes from year to year and assess the effectiveness of efforts to mitigate performance shortfalls.

## The CAQ's recommended audit quality indicators

In identifying a set of potential AQIs, the CAQ considered a large number of indicators related to audit quality. The list was ultimately narrowed to those metrics that the CAQ believes could provide audit committees with a broader understanding of engagement teams, audit firms, and audit quality. The CAQ divided its potential AQIs into four categories:

- 1 Firm leadership and tone at the top** – Organizational leaders should be focused on audit quality, independence and objectivity, controls, and adherence to standards and requirements.
- 2 Engagement team knowledge, experience, and workload** – Professionals should have the preparation, experience, and bandwidth to ensure audit quality. AQIs could include:
  - Knowledge and experience of key engagement team members
  - Audit firm training requirements
  - Trends in engagement hours and related timing
  - Allocation of resources by significant risk areas
  - Specialist and national office personnel involvement in significant risk areas
  - Key engagement team members' workloads.
- 3 Monitoring** – There should be confirmation that the appropriate quality control processes have been instituted to evaluate the auditor's work. AQIs could include:
  - Internal quality review findings
  - PCAOB inspection findings.
- 4 Auditor reporting** – Audit reports should be accurate and timely, and all auditor communications should be effective and appropriately targeted. AQIs could include the number of reissuance restatements and withdrawn auditor's reports.

In its discussion paper, the CAQ emphasized that AQIs cannot be truly meaningful unless they are delivered in the context of a thorough discussion, whether through meetings or written communications. The reasons for certain AQI results, or for changes in AQIs, could be misunderstood if only the raw data is presented.

The categories of the CAQ's recommendations differ slightly from the PCAOB's approach, but the overall principle is similar. Both engagement-level and firm-wide issues are taken into consideration, and both consider input measures, processes, and output measures relative to the audit.

## Pilot testing of the CAQ approach

The usefulness of the CAQ’s approach to AQIs is being evaluated among certain accounting firms that are members of the CAQ. The CAQ is conducting outreach to evaluate the benefits of AQIs for audit committees and determine whether there are issues related to the auditor’s readiness to communicate them. The CAQ highlighted in its report that “understanding the benefits and challenges of producing and communicating indicators, including potential unintended consequences, will enable the CAQ to continue to refine the information to reflect those indicators that are most meaningful to the audit committee.” Similarly, the CAQ expressed that the outcomes of the pilot project could help guide engagement teams and facilitate consistent and effective results.

The pilot testing began in the summer of 2014 and is continuing through the 2014 audit cycle. A phased approach is being used, with the first two phases involving the presentation of comparative AQIs. Phase one is the presentation of AQIs versus the current year, based on the audit plan for the 2014 audit cycle. Phase two is the presentation of AQIs versus the prior year, based on actual data from the 2013 audit cycle. These phases are largely complete, and feedback is being accumulated and processed. Phase three will entail presenting updated current-year AQIs based on data from the 2014 audit cycle. As the CAQ moves forward with pilot-testing efforts, it plans to assess findings and evaluate the need for changes to the set of potential AQIs and suggested communication approach.

## Deloitte’s internal performance indicators

Against the backdrop of the PCAOB and CAQ activities, Deloitte has been pursuing the use of internal performance indicators. We have identified initial metrics that we believe may be predictive of audit quality, and have created an executive-level dashboard of these indicators that enables our leadership to monitor them and drive timely follow-up actions. The indicators were developed through evaluating various factors, including statistical correlation, and using informed professional judgment to determine which metrics are most likely to be correlated with high audit quality. The nine initial indicators we are utilizing are depicted in the following graphic.

Headcount composition	Utilization by level	Client service hours by level
Proportion of hours incurred during non-peak versus peak periods	Specialist hours	Voluntary turnover by level
Consultations	Audit quality monitoring milestones missed	Mandatory learnings missed or late

We are currently reviewing these indicators as part of our quality monitoring processes. We recognize that no one indicator is determinative. However, we believe this is an area that holds promise, and that performance indicators provide another piece of valuable input as part of the total mix of information we use to manage our practice.

The identification and utilization of indicators as an operating tool will continue to evolve as we consider new metrics and enhancements to the process. We are committed to being at the forefront as the profession moves toward wider use of quality indicators and will continue to consider new metrics and ways to enhance the effectiveness of this important resource.

“At Deloitte, we view our commitment to quality as a hallmark of our firm. We are committed to providing audit committees with the information they need to fulfill their important oversight role, including evaluating the quality of our work. We encourage audit committee members to share their perspectives on the current efforts to identify metrics that can be used to support and enhance audit quality.”



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## Conclusion

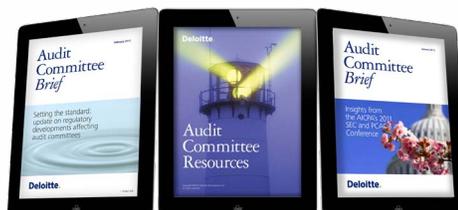
It remains to be determined whether any communications regarding AQIs between the auditor and the audit committee will be formally required. Nevertheless, it may be beneficial for audit committees to discuss with the external auditor quantitative and qualitative elements relevant to audit success, which could include those highlighted by the PCAOB and CAQ. The PCAOB is interested in hearing from audit committee members regarding the metrics that would be most useful in performing their duties. The comment process for the expected concept release will provide an opportunity for audit committees to provide their views on this effort.

## Additional Deloitte resources

[Heads Up, July 14, 2014: Summary of the PCAOB's Standing Advisory Group June 24–25 Meeting](#)

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