



**ACCOUNTANCY  
EUROPE.**

# **KEY FACTORS TO DEVELOP AND USE AUDIT QUALITY INDICATORS**

Position Paper

**VIEWS.**

**AUDIT & ASSURANCE  
JANUARY 2023**

## **HIGHLIGHTS**

It is a common objective for all parties in the corporate reporting ecosystem to improve the quality of financial reporting. Delivering consistently high-quality audits is an essential element to achieve this. However, further work is needed to agree on the definition, drivers and indicators of audit quality.

To support this objective and build on [our factsheet](#) (May 2022), this publication:

- defines key concepts related to audit quality
- presents considerations for developing Audit Quality Indicators (AQIs)
- explains what can and cannot be achieved by AQI reporting

AQIs are not ends themselves but are one important means to increase the audit work's transparency and to support consistent, high-quality audits. A blend of AQIs can help focus on the areas where improvement is needed.

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## INTRODUCTION

High-quality audit contributes to markets' sound functioning. It enhances users' confidence by providing comfort that financial reports are reliable.

Achieving high-quality audits consistently is a common objective for, and shared responsibility of, audit firms, audited entities, shareholders and audit oversight bodies. These parties each play a key role in supporting the audit and should work together to improve its quality.

There are already initiatives launched and ongoing discussions at European and global levels on how to define, measure and improve audit quality. We presented an overview of selected recent initiatives on audit quality indicators (AQIs) in our factsheet [Audit Quality Indicators: a global overview of initiatives \(May 2022\)](#).

Different types of organisations have launched these initiatives to identify and assess quantitative and qualitative aspects of audit quality – audit quality indicators (AQIs). Audit committees, audit oversight bodies and audit firms are considered the primary AQI users (users). The structure of the AQIs to be monitored and the level of transparency varies for each initiative.

This publication builds on the factsheet and offers constructive recommendations based on the discussions with our members' audit experts as well as external stakeholders involved in developing AQI initiatives in their respective jurisdictions. We highlight the key considerations for developing and using AQIs to support potential debates that could take place among the European Commission, the Committee of European Audit Oversight Bodies (CEAOB), national policymakers and regulators, auditors, as well as other parties. We want to keep contributing to this debate; since the evolution of AQI reporting as a means to support audit quality requires continuous discussion with all relevant stakeholders.

## KEY CONCEPTS

### WHAT ARE AUDIT QUALITY INDICATORS?

AQIs are qualitative and quantitative metrics to provide a framework for discussing audit quality rather than measuring it definitively. These will be derived from the metrics within firms' internal quality management systems. Broadly, there are 2 types of AQIs:

- firm-level indicators relate to the factors pervasive to the audit firm (such as *staff turnover ratio and the results of internal quality reviews and external inspections*)
- engagement-level indicators are limited to the characteristics of a specific audit engagement (such as *training hours for the audit team and the level of engagement partner involvement*)

### HOW TO DEFINE AUDIT QUALITY?

Some argue that financial statements audit is an example of a "credence good"; i.e., it may be difficult, if not impossible, to precisely assess its quality and impact. The auditor is in a unique position to determine the nature, timing and extent of the procedures that are appropriate to the circumstances of an audit engagement as the auditor exercises professional judgement throughout the audit. Other stakeholders, however, have limited ability to make similar judgments. They do not usually have detailed insights into the work performed and the issues encountered during the audit.

Audit quality is a complex matter and does not yet have a globally recognised definition. However, the term 'audit quality' is frequently referred to in debates among stakeholders, in academic studies and in communications from oversight bodies and standard setters.

## WHAT IMPACTS AUDIT QUALITY?

Overall, audit quality can be impacted by 4 categories of factors that relate to:

- **input:** such as resources allocated to the audit engagement, audit team's competence and expertise
- **process:** such as effective two-way communication between the auditor and company's management and board, involvement of senior auditors and consultations with experts as necessary
- **output:** such as mechanisms for auditors to report to a company's board and audit committee, to regulatory authorities and to the public
- **context:** relevant to the engagement, such as the quality of the financial reporting framework, supervisory approach and practices in the jurisdiction, maturity of a company's corporate governance and internal control system

The audit team, or firm, does not have direct control over some of the contextual factors. Although these factors have a significant impact on audit quality, as well as on the quality of financial reporting, the metrics used as AQIs should not cover such factors.

## WHO USES AUDIT QUALITY INDICATORS FOR WHAT?

### AUDIT FIRMS

**Firms** develop and use various metrics as part of their quality management systems. International Standard of Quality Management 1<sup>1</sup> (ISQM 1) will become effective as of 2023. Accordingly, firms will identify quality objectives, the risks of not achieving them, and appropriate responses to mitigating those risks. This risk-based approach to quality management will make firms reconsider the indicators they need to monitor to achieve their objectives. Audit firms monitor AQIs to be able to identify the factors that can be detrimental to audit quality and focus proactively on the areas in which there is room for improvement. This allows them to take the necessary actions on a timely basis. AQIs monitored and measured by the firms will be the main source of information for AQIs to be communicated to other users listed below.

### OTHER USERS

**Audit committees** can benefit from AQIs when selecting the auditor and monitoring the auditor's performance. Firm-level indicators may be more relevant in the selection process, whereas engagement-level indicators are crucial in assessing audit quality on an ongoing basis. An agreed-upon set of AQIs could result in a better understanding and richer discussions between an audit committee and the auditor because such discussion enables an interpretation in the appropriate context.

**Audit oversight bodies** may collect selected AQI data from audit firms along with contextual information and analyse them to determine their supervisory approach and priorities. Such an analysis could provide insights into overall audit quality in the market and inform regulatory policymaking. It will be very beneficial if the analysis outcome is shared with the firms in detail and with the general public at a higher level.

**Investors and others** (company's management, policy makers, media, academics, and the general public) may benefit from having a selected set of AQIs available to them. The two main tools for enabling this are the transparency reports by firms and annual reports by oversight bodies. This group of users will not benefit from information including all the details and metrics possible. Rather, they would like to be provided with an overview of trends and insights relevant to their needs.

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<sup>1</sup> International Standard on Quality Management (ISQM) 1, Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements

## TYPES OF AQI REPORTING

Based on the different users and their needs noted above, we can identify four types of external AQI reporting:

- Type-1: Firms may be required to report certain AQIs publicly
- Type-2: Audit committees and auditors may agree on a set of AQIs to have effective two-way communication throughout the audit
- Type-3: Audit oversight bodies may request firms to communicate selected AQIs to them
- Type-4: Audit oversight bodies may present a summary of their own analysis, including key trends, points of focus and planned responses, in their publicly available reports

## DEVELOPING AQIS

### AVAILABLE DATA AS STARTING POINT

Firms already operate quality management systems that include collecting and analysing data on audit quality. These systems are updated as necessary, e.g., as a result of new legal requirements and standards. Efficiency and proportionality can only be achieved if the metrics monitored by the firms are taken as the starting point when developing AQIs. Otherwise, there is a risk that significant costs associated with data collection and reporting will outweigh the benefits of AQI reporting.

The AQI set developed for the first time may not be the perfect combination of metrics. Nevertheless, it will pave the way for meaningful audit quality discussions and a learning curve is inevitable. Policymakers, oversight bodies and audit committees can demand supplementary data based on justified needs or changing circumstances. The evolution of AQIs after a period of learning and demonstrated benefits, however, should not hamper comparability over time.

### PRACTICAL EXAMPLE

The Financial Reporting Council (FRC-UK) published in December 2022 [a set of firm-level audit quality indicators](#) that the largest audit firms will be required to report publicly. Prior to this, the FRC sought stakeholders' views via a public consultation. The consultation was based on the thematic review where the FRC benchmarked the AQIs monitored by the largest six audit firms in the UK.

### A MULTI-STAKEHOLDER APPROACH

It is crucial to discuss relevant stakeholders' needs and expectations before and while developing AQIs. Audit firms should report only the indicators that stakeholders find helpful. Otherwise, AQI reporting will be more of a compliance exercise for the firms and deliver limited benefit to other parties.

Audit oversight bodies, for example, should seek firms' and other users' input before selecting the AQIs to be communicated by firms (Reporting Type-3). Having a multi-stakeholder approach is also relevant for policymakers who plan to mandate AQI reporting (Reporting Type-1) for audit firms. The scope of such a requirement should be determined based upon discussions with the firms, oversight bodies and investors.

Both oversight bodies and policymakers should reassess the appropriateness of the scope based on users' feedback once the AQIs are developed and reported.

### PRACTICAL EXAMPLE

[The AQIs proposed](#) to the Ministry of Finance in the Netherlands were developed by a working group which involved members from the oversight body, academics, firms of different size and representatives from NGOs.

## CLEAR AND AGREED UPON DEFINITIONS

Comparability requires standard definitions and consistent calculations derived from reliable data. AQI disclosures should be based on clear definitions set by policymakers in coordination with firms and other relevant parties. This will allow the users to make reasonable comparisons and conclusions.

In the same way, oversight bodies will not be able to properly analyse the AQI data they receive from the firms when agreed upon definitions are lacking. Our outreach with stakeholders who were involved in AQI initiatives demonstrated that audit firms are organised and collect data in different ways. Hence, a lack of clear definitions would lead to unintended consequences and misinterpretations.

The CEAOB can play a key role in promoting consistency in definitions and comparability of the publicly reported AQI data by firms and oversight bodies (Reporting Type-1 and Type-4) in the EU Member States.

### PRACTICAL EXAMPLE

The Portuguese Securities Market Commission (CMVM) provided detailed definitions of the indicators in its [AQI framework](#) along with reporting models and contextualisation. The CMVM updated its model after the first year of implementation to clarify the definition of one indicator and several concepts in relation to the four indicators included in the framework.

## AQIS AS MEANS RATHER THAN AN END

There is no silver bullet or a one-size-fits-all set of AQIs. Any indicator will have its own limitations. For instance, the number of training hours as an indicator will not measure the relevance or quality of the training undertaken. Similarly, an indicator of the level of subject matter expert involvement in an audit engagement will not assess the adequacy of experts' experience and competence. Such limitations and how to alleviate their impact should be considered while developing AQIs.

In addition, users' expectations should be managed to make them aware that AQIs do not give definitive results. Instead, they form a valuable starting point and enrich progressive discussions about audit quality. Accordingly, their limitations should be accepted without overshadowing their value and benefits. Narrative reporting accompanying quantitative metrics and discussions on them are key to better understanding the limitations and their implications.

### PRACTICAL EXAMPLE

The Institute of Public Auditors (IDW-Germany) highlights in [its position paper](#) (in German, December 2021) that the assessment of audit quality should always be made using a combination of communicated AQIs. This should be done following discussions with the auditor and considering contextual circumstances related to the company audited. The paper also states that the relevance of the information provided by AQI reporting will depend on the contextual circumstances, including complexity of the audit engagement and size of the audit firm.

## USING AQIS

### WHAT CAN BE ACHIEVED WITH AQIS?

AQI reporting in various forms could support consistent delivery of high-quality audits. AQIs can be an integral part of audit firms' quality management systems. Monitoring these indicators will help them identify the risks to quality objectives and respond to these risks on a timely basis.

Audit committees and auditors can have insightful discussions on audit quality with the help of concise and tailored AQI reporting. In collaboration with company's management and board, they can also use the AQIs to identify areas where changes can be made to enhance audit quality.

Oversight bodies can use selected AQIs not only for shaping their supervisory approach but also for informing the public about the outlook and the trends in the audit market. Furthermore, by sharing their assessments with the firms, they can better play their role as improvement regulators.

Finally, making selected AQI data publicly available would assist investors and other users of financial reporting to better understand the drivers of quality in audit firms. This is important as these parties do not ordinarily have proximity to the audit process.

## **WHAT CANNOT BE ACHIEVED WITH AQIS?**

AQIs cannot be considered proxies for measuring the quality of financial reporting. Similarly, AQIs can provide only limited insight into the quality of public oversight over auditors. Therefore, stakeholders would need separate indicators for the evaluation of quality in financial reporting, its supervision and audit oversight.

The indicators to be used in monitoring audit quality and the optimal level for each indicator will vary from one audit engagement to another. Depending on the circumstances of an audit engagement, some indicators may become more relevant. Hence, comparing AQIs at the engagement level is unlikely to give meaningful results.

An indicator alone would provide little insight without considering other indicators and the context. Therefore, users should not draw conclusions based on a single or a few indicators. They would have to judge for themselves to what extent they wish to rely on AQIs in their decision making.

In short, AQIs cannot provide conclusive answers. AQI reporting serves mainly to allow firms, audit committees, oversight bodies and investors to ask probing questions and focus on the high-risk areas in terms of audit quality so that enhancements can be made if, when and where needed.

## **CONCLUSION**

All the components in the ecosystem need to be of high-quality and closely connected to supply high-quality financial reporting. The very purpose of the audit is to provide the market with confidence in the quality of a company's financial reporting.

Audit quality is best achieved in an environment where there is support from and appropriate interactions among the parties in the financial reporting ecosystem. Continuously learning and improving together should be the overarching objectives.

AQIs can trigger new constructive conversations on audit quality and add to everyone's understanding of the audit's intricacies. They should not be considered as an end in themselves but could be a useful tool to drive audit quality. A combination of metrics, considering the contextual factors, would provide a profound insight into audit quality.

Transparency is only useful if it provides useful information to the addressee and as such, it should strike the right balance to avoid information overload. Stakeholder engagement is needed to understand which AQIs are important to users and would enable them to make informed decisions.

Accountancy Europe will keep monitoring AQI initiatives launched in European countries and other jurisdictions and share good practices as well as any lessons learnt from these experiences.





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