



FRC CONSULTATION ON FIRM-LEVEL AUDIT QUALITY INDICATORS

Issued 18 August 2022

ICAEW welcomes the opportunity to comment on the FRC's Consultation Document: Firm-level Audit Quality Indicators published by the FRC on 22 June 2022, a copy of which is available from [this link](#).

For questions on this response, please contact our Audit and Assurance Faculty at tdaf@icaew.com quoting REP 67/22.

This response of 18 August 2022 has been prepared by the ICAEW Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the faculty is responsible for audit and assurance submissions on behalf of ICAEW. The faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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MAIN POINTS

1. We welcome this consultation and agree with the FRC that the consistent, effective use of AQIs has the potential to prompt better quality discussions between audit committee chairs (ACCs) and firms, to broaden ACCs' views of firms when making recommendations on the appointment of external auditors, and thereby to lead to increased focus on quality.
2. The consistent and effective use of AQIs also has a place in the public sector. The National Audit Office (NAO) may benchmark itself against private sector firms, which will help the Public Accounts Commission as it assumes responsibility for establishing oversight arrangements of the National Audit Office. Most local authority auditors are appointed by Public Sector Audit Appointments Ltd which also carries out quality monitoring. AQIs may be useful as part of this process.
3. Nevertheless, our outreach suggests that a wide range of stakeholders, both supportive of these proposals and not so supportive, have concerns about:
 - the level of prescription proposed; and
 - misuse of the metrics.

The use and misuse of prescriptive AQIs that do not in practice command a wide range of support and are believed to lack consistency, are likely to drive dysfunctional behaviour and poorer audit quality.

4. Firms taking part in the FRC's successful engagement-level AQI pilot believe that key to the project's success was the non-prescriptive approach taken that promotes innovation and allows for improvement and refinement. At this still-early stage in the evolution of firm-level AQIs, the level of prescription evident in the proposals risks stifling innovation, discouraging competition in the audit market and driving a target-based compliance approach. We understand that alternative proposals are being suggested for an FRC Framework within which firms would develop their own firm-level AQIs. Such an approach is worthy of serious consideration.

Firms outside the Big 6

5. In developing this response, we reached out to firms currently considering whether they want to be part of the market subject to the FRC's proposed requirements. They, like the larger firms who commented, emphasised the costs of collection of the data required, and the need to adapt off-the-shelf systems to facilitate reporting. They expressed concerns that without the greater resources available to larger firms, the complexity of the requirements will act as a disincentive to their or other firms' participation in the relevant markets.

Audit committee chairs

6. We also reached out to several experienced audit committee chairs (ACCs) of large, listed companies. The FRC notes in its consultation that it believes that used effectively, firm level AQIs:

...would prompt rich discussions between Audit Committee Chairs (ACCs) and firms, and potentially broaden ACCs' views of firms when making recommendations on the appointment of external auditors. It is these discussions that should lead to increased focus on quality.

We asked ACCs whether they agreed with these statements. Responses were mixed. Roughly half suggested that both firm-level and engagement-level AQIs have their place. The other half said that the value of firm-level AQIs as proposed will be of limited or no value to audit committees.

7. Among other things, ACCs suggested or supported:
 - better quality transparency reports which they described as too long and glossy;
 - better quality AQR reports by the FRC, which should not need bolstering with highly prescriptive firm-level AQIs;

- tripartite meetings between the FRC, audit firms and ACCs, to address serious audit quality issues arising, along the lines of similar meetings in the financial services sector.

Several ACCs challenged the perceived assumption in the FRC's proposals suggesting that neither audit committees nor audit firms are focused on audit quality. One noted that AQR reports on individual firms are easily misread as implying that audit reports or accounts are wrong, leading to an unwarranted loss of confidence in audit firms and, in turn, increased audit market concentration.

8. ACCs on both sides of the divide strongly suggested that to be of value, AQIs should focus on a smaller number of considerably harder to measure outputs (such as the effectiveness of training) rather than inputs (such as training hours). We believe that this approach is also worthy of serious consideration.

FRC use of AQIs

9. The FRC does not discuss its own use of AQIs for inspection purposes but the proposal to align the reporting of AQIs with the inspection cycle strongly suggests that AQIs will play a leading role in the monitoring process. This is a legitimate use of AQIs but only if they are used properly. To fully manage expectations and obtain the best quality outcomes, the FRC should be more transparent in this respect. It should also produce clear guidance for audit committees on how to understand and interpret AQIs, as well as guidance for auditors on compiling them.
10. To mitigate the risk of the misuse of firm-level AQIs, the FRC must emphasise the importance of narrative and context to a greater extent than it does in the consultation paper to avoid:
 - audit reform and enhanced competition being hampered, if the regime acts as a further disincentive to good firms to entering or remaining in the PIE audit market;
 - shallow and muddled discussions with ACCs.

As a minimum, the FRC should publish summaries of context and explanations for changes on its website. A failure to explain changes in KAM was a weakness highlighted by the FRC in the early days of enhanced auditor reporting. It would be odd to stand in the way of this in the context of AQIs.

DRAFT ANSWERS TO SPECIFIC QUESTIONS**1. Do you agree that the firms reporting their AQIs should be aligned to the scope of the (revised) Audit Firm Governance Code? If not, what scope would you prefer and why?**

11. We agree that the firms reporting their AQIs should be aligned with the scope of the revised Audit Firm Governance Code (the Code). Any addition to the Code might be construed as a disincentive to firms aspiring to adopt it on a voluntary basis and transitional provisions should be considered for such firms.
12. We note in our main points above our belief that that the FRC should be more transparent regarding its own use of published AQIs for regulatory purposes.

2. Do you agree that the AQIs should include all audit engagements, but segmented between PIE and non-PIE audits? If not, which engagements do you think should be included?

13. Mixed views were expressed in response to this question. Some suggested that further consideration should be given to the restriction of AQIs to PIEs in the first instance and the inclusion of all audits at a later stage to permit the system to be refined.
14. Others suggested that no such distinction should be made for three reasons:
 - PIEs and non-PIEs are highly heterogenous groups;
 - all audits serve the public interest and to make this distinction suggests that audit quality is either less important for non-PIE audits or lower in absolute terms;
 - the distinction introduces an unjustified level of complexity and cost into reporting, and scope for manipulation as well as misunderstanding.

3. Do you expect any additional costs to be incurred by firms reporting over a period which is not aligned with their financial years? Are there ways to minimise these costs?

15. The FRC should not underestimate the costs and challenges associated with these proposals which are likely to be significant on a one-off and ongoing basis, for firms of all sizes. Audit committees do not expect proper governance processes to support the attestation process to cost nothing. Smaller firms are less likely to be able to capture the information easily using off-the-shelf systems and the FRC needs to do more to encourage suitable firms to step up to the audit of larger and more complex audits.
16. The one-off costs associated with changing firms' internal reporting systems to capture the required data are likely to be outweighed by the on-going data capture and reporting costs. Firms' internal reporting systems will need to be closed out three times, potentially, for their own internal purposes, for the busy period, and for the remainder of the period.
17. We are not convinced that there is significant value in disclosing separate AQIs for a busy period, but if separate disclosure is to be made, we suggest that the period should extend to June, to ensure that all PIE audits are covered. The FRC should look to mitigating these costs for smaller firms seeking to adopt the Code by means of transitional provisions.

4. Do you agree that it would be useful to include supporting narrative? Please provide suggestions to ensure that the information is concise and useful for users of audit services.

18. Meaningful supporting narrative is essential if this regime is to work and AQIs are genuinely to be the start of better-quality conversations with ACCs. The much-vaunted conversations with ACCs and investors built around enhanced auditor reporting have taken many years to materialise, not because auditors include too much in their audit reports, but because of the quality thereof. The idea that limited explanations are better explanations is superficially attractive, but wrong - Haiku is no less impenetrable than War and Peace, simply because it is shorter.
19. The audit of complex PIEs requires complex audits and to reduce them to soundbites will lead to sub-optimal decision-making until all stakeholders have a much better understanding

of firm-level AQIs in practice. There will be a long learning curve for the FRC, audit firms, audit committees and investors. The FRC might require limited summaries of explanations, but it should not limit supporting explanations. The FRC should publish summaries of context and explanations for changes on its website, as it encourages firms to do in the context of KAM.

5. Do you agree with our proposed AQIs? If not, or in addition, do you prefer some of the alternatives presented above? Please explain, using the reference numbers.

20. The quality of FRC guidance published towards the end of 2022 is critical to the success of this project. It must acknowledge the limitations of AQIs, particularly in the context of network firms and group audits. Different business and operational models, including widely varying approaches to the use of offshore and specialist units, combined with the use of network and non-network components on large global audits limits the value of AQIs and renders their compilation complex and difficult, as well as expensive.
21. See also the Appendix, below.

6. Do you think there are any other firm-level AQIs that we should consider? If so, please explain.

22. We note in our main points above that ACCs suggest that to be of value, AQIs should focus on a smaller number of considerably harder to measure outputs (such as the effectiveness of training) rather than inputs (such as training hours). We also note alternative proposals for an FRC Framework within which firms would develop their own firm-level AQIs. Both approaches are worthy of serious consideration.
23. See also the Appendix, below.

7. Are there any other comments you wish to make about these proposals, including concerning costs, benefits, or impacts not discussed above?

24. The FRC's implementation timetable suggests that guidance can be produced towards the end of 2022, with a view to firms collating information from April 2023 for April 2024 reporting. This may be feasible for larger firms with systems already in place but firms that do not already report under this regime are much less likely to be able to accommodate this timetable. We therefore welcome the FRC's proposal to exclude this category of firms from the first reporting period.
25. The FRC should produce and publicise clear guidance for audit committees on how to understand and interpret AQIs. Some audit committees have in the recent past displayed a lack of awareness of the existence of transparency reports or AQIs. If the rich conversation the FRC hopes for is to materialise, the FRC needs to make an effort to explain its intentions to audit committees and not just require auditors to provide information in the hope that audit committees will 'get on with it'. If audit committees have not looked at transparency reports, they are unlikely to look at the FRC's website without prompting.
26. The FRC proposes that the firm's senior partner should attest to the information published. Should this not be the person with responsibility for the SOQM within the firm? For some firms, the senior partner may not be an RI and is unlikely to be an Audit Compliance Principal.

APPENDIX

5. Do you agree with our proposed AQIs? If not, or in addition, do you prefer some of the alternatives presented above? Please explain, using the reference numbers.

A. Performance monitoring & remediation

1 – Staff / culture survey results

Culture does not lend itself to standardisation. Firms have different approaches and little UK control in many cases over the questions asked globally. Spurious consistency is a very real risk. Even if 'favourable' and 'unfavourable' can be defined, consistent implementation seems unlikely and engineering of systems to achieve the desired outcome very likely. It will be virtually impossible to make meaningful distinctions between PIE and non-PIE audits and the FRC should give serious consideration to dropping this AQI.

Indicator 2 – Audit planning milestones

These too vary widely, particularly in the case of non-PIE audits.

Alternatives 3a – Proportion of audit hours by phases of audit and 3b - Average percentage of audit hours spent in the two weeks before sign off

Collecting data for both AQIs will be difficult and distinguishing between audit quality, and poor company management or controls and other issues outside the auditors' control, will be virtually impossible without extensive explanations. We do not support the inclusion of either AQI.

B. Quality Monitoring

Indicator 4 Internal Quality Review – see Alternative 7

Indicator 5 External inspection results

Indicator 6 Internal inspection results

Alternative 7 Involvement of EQCR

This is a considerably better indicator of quality than the proposed indicator 4 above.

C. Resource planning and people management

Indicator 8 Partner involvement

This AQI can be affected by the experience of the audit team, the risks associated with the entity, and many other matters outside the auditors' control including management structures and the quality and timeliness of the financial information provided. However, it can also be indicative of higher audit quality and drive a more appropriate level of partner involvement. Explanations are therefore important.

Indicator 9a Staff utilisation

Without definitions and guidance, it is not possible to assess the value of this AQI and we have concerns that this information is commercially sensitive.

Indicator 9b Staff Utilisation (“busy period”)

We note in our answer to question 3 above, that we are not convinced of the value of this AQI. If it is included the period should be extended to June.

Indicator 10 Staff attrition

We have concerns that this AQI is particularly vulnerable to misunderstanding and misuse given the wide range of reasons for staff attrition.

Alternative 11 Use of Specialists

Alternative 12 Staff/partner/manager ratios

Different firm operating structures will make comparability difficult.

D. Information and communication

Indicator 13

This AQI is limited to the extent of inputs to training and gives little indication of the quality of that input, or any related output. It should at the very least be limited to audit-specific training.

E. Governance and leadership

Indicator 14

The proposed definition of diversity is restricted to gender and ethnicity. Social and academic background are equally important.

6. Do you think there are any other firm-level AQIs that we should consider? If so, please explain.

We note elsewhere in this response suggested alternatives to the AQIs proposed. We believe that *unplanned prior adjustments* may be a worthwhile AQI and should be included.