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Firm-level Audit Quality Indicators consultation
Financial Reporting Council
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Dear AQI Consultation Team

FIRM-LEVEL AUDIT QUALITY INDICATORS CONSULTATION

I am writing to set out Deloitte LLP's response to the Financial Reporting Council's (FRC) Consultation Paper issued in June 2022. This letter describes our overall views on the consultation and is supplemented by our detailed response to each question (Appendix 1).

We develop and report on audit quality indicators (AQIs), both at firm and engagement level, to help monitor and manage audit quality internally and as a source of information for business intelligence gathering to support risk management. Audit committees and other stakeholders, including regulators, use AQIs when overseeing and assessing the quality of external auditors as well as to monitor the overall trend of audit quality in the profession.

Deloitte believes that the overarching principles for public reporting of firm level AQIs should be:

- Relevance and a clear linkage to audit quality, usefulness and understandability by relevant stakeholders.
- That metrics and supporting narrative be viewed in the round and not in isolation and focus on improving the public's understanding of, and confidence in audit quality.
- Comparability across audit firms, being able to measure the metric on a consistent basis (e.g., there are likely variations as to how certain terms are defined across audit firms).

Whilst we are supportive of firm level AQIs being published, and indeed have been publishing them in our annual Audit Transparency Reports for a number of years, we would like to draw out what we believe are some limitations and potential concerns with the FRC's objective of reporting firm level AQIs in its proposed form, where we consider further reflection may be necessary. We don't believe all proposed AQIs should be published in their current form (for example AQIs 1,2,3,4, 11 and 12 for the reasons given below) as these could be misleading where published and inappropriately compared by stakeholders.

Our response specifically highlights the following three aspects:

- *The importance of relevance:*
  For measures to be relevant, these need to be clearly linked to audit quality or a causal factor for its failure - that causal factor has to be relevant to the audit profession as a whole rather than to a function of which entities a particular firm audits. Several of the proposed AQIs by themselves cannot currently be linked to audit quality – in those cases, a link should be established.

- *The importance of context around AQIs:*
  The firm's transparency reports provide an existing mechanism and governance structure around the context, disclosure and basis of preparation for metrics. Following on from the point above on relevance, clear context and narrative should be provided to explain movements and, more importantly, trends to avoid AQIs being looked at in isolation, which would impair their meaningfulness.

  The consistency and comparability of AQIs also remains a challenge given the different structures and business models of the firms (e.g. what is included in the ring-fence and what is excluded), the different approaches taken by the different firms for example with regards to project management and the definition of specialists - which is why context (at times, extensive context) is required to interpret AQIs.

- *Avoiding confusion and unintended consequences:*
  Presenting AQIs as proposed by the FRC may inadvertently result in a firm 'league table' (even where that is not the intention of the FRC) based on measures that are of varying relevance to the firms. There is a risk that external stakeholders purely evaluate audit quality based on the AQIs presented, without regard to any context around the metrics and measures presented or actions being taken by the firm to address audit quality and thus making inappropriate comparisons. Publicising certain measures creates unwarranted competitive and reputational pressures. A number of the proposed measures will have additional risks attached to them given unintended consequences when presented publicly.

  There also remains a risk of a firms' AQI results being skewed by a portfolio weighted towards more complex, higher risk engagements, potentially resulting in a more conservative approach from firms to taking on those higher risk or more complex audits.

Lastly, a need exists to ensure any changes align to changes in the Audit Firm Governance Code and wider reform agenda e.g. PIE categorisation, so that there is a clear expectation on those preparing and those relying on the indicators.,

In addition to the consultation initiated by the FRC, we are aware that others are focused on the topic of AQIs, including regulators in the Netherlands and the US. We believe it could be optimal to have one international view, perhaps coordinated through IFIAR, consistent with IFIAR's overall objective to promote collaboration and consistency in regulatory activity.

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We remain supportive of further developments in firm level AQIs and we would be very happy to discuss our comments in more detail. Please do feel free to contact me or my colleague Clare Tebbenham (ctebbenham@deloitte.co.uk).

Yours sincerely

Paul Stephenson
Managing Partner Audit & Assurance

Deloitte.

Appendix 1 – Responses to detailed consultation 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?*

Yes, firms reporting their AQIs should be aligned to the scope of the (revised) Audit Firm Governance Code (AFGC). The provisions in the AFGC operate on a comply or explain basis and a similar approach could be taken to firm-level AQIs, enabling smaller firms to choose to explain if the compliance burden was too high (guidance to audit committees may help to ensure those firms would not be at any disadvantage by doing so).

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?*

Yes, we believe all audits should be in scope of any public reporting of audit quality indicators. We consider that it would be more appropriate to require AQIs across the whole population of audits to ensure a consistent drive for audit quality.

We would suggest following the new tiering system proposed in the White Paper response and have three separate groupings:

- Large Public Interest Entities;
- Other Public Interest Entities (OPIEs); and
- Non-Public Interest Entities.

Using the three tiers above would result in improved comparability, consistency and simplicity and propose a baseline of AQIs to be used for Non-Public Interest Entities and layered up for OPIEs and Large PIEs – the roll-out of AQIs should begin with Large PIEs and over time extended to OPIEs and Non-PIEs. Whilst these are defined in the White Paper, we acknowledge that the definitions above are still being worked through, and the work on developing those definitions is complex and we would encourage the FRC to provide further clarity on how the BEIS definitions will interplay with existing definitions.

Using the tiers above would also avoid making comprehensive changes when legislation is passed. Transition rules for entities moving in and out of any tier should be aligned with the conclusions reached by BEIS.

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?*

An overly prescriptive definition of metrics may not be representative of how the business is run and measured by the firm, therefore requiring the production of additional metrics simply for public reporting purposes at an additional cost.

Where the cadence of reporting is arbitrarily fixed, say end of March on an annual basis, this could be burdensome, both in terms of time and resources for those firms who do not have a coterminous year end – these costs will be borne by engagement teams and ultimately, passed on to audited entities.

In an effort to minimise these costs, we propose that the timing is not fixed but should happen at a fixed cadence (e.g. on an annual basis) aligned to the existing business and transparency reporting timetable or updated in the intervening period if there has been a significant change in business model, operating structure or methodology.

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.*

Yes, we think this is essential to ensuring the AQI is meaningful data and fully understood. AQIs or any other metrics provided without context significantly reduces the meaningfulness of a measure. Clear context and narrative should be provided to explain movements and, more importantly, trends.

Supporting narrative should set out the controls and measures being taken to avoid the unintended consequences of some of the AQIs and the degree to which the measure is affected by outside influence.

Enhancements can be made to transparency reports by:
- Firms providing more context and narrative explanations around themes at the firm level driving audit quality rather than prescriptive measures; and
- Clearly explaining the rationale for the firm selecting their specific AQIs;
- Including alternative helpful information such information on international component reviews and engagement quality reviews as set out in Q7.

These enhancements will drive the “interesting conversation and challenge” as opposed to a scorecard which would risk being the sole focus rather than the context, and which could result in tension between a “league table” and richness of conversation.

More can be done to help users navigate and understand transparency reports from the different firms – either by firms increasing the circulation of their transparency reports amongst audited entities or by the FRC collating the data from the transparency reports in a single repository and making that freely available.

Whilst conciseness is a concern, limiting the character count in a free text box risks the fullness of context being lost upon users of the report.

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.*

We acknowledge the FRC's intended purpose behind this overall exercise of broadening the range of information available to audit committees/ACCs and other users of audit services - this aim needs to be to try to overcome the differences arising from firms' differing operating models and extrapolate some indicators that can be compared across the firms.

We agree with some of the proposed AQIs, as explained in more detail below, but don't believe all proposed AQIs should be published in their current form (for example AQIs 1,2,3,4, 11 and 12 for the reasons given below) as these could be misleading where published and inappropriately compared by stakeholders.

It is important to note that AQIs will be very different depending on the business model and operating structure of the individual firm as well as the strategic objectives the relevant firm is aiming to achieve. The objectives of the firm in its reporting of AQIs will determine whether the firm is reporting measures versus indicators e.g. is the firm trying to identify red flags? The objectives of external stakeholders will impact the interpretation of the presented AQIs, e.g. measure or improve market confidence, are the indicators or metrics driving competition or providing guidance for audit tender decisions? The answers to these questions are dependent on the business model, overall portfolio and position of the firm in the market.

Clearly defining the AQIs needs to be a key priority to enable clarity in the reporting of AQIs. Rather than have a core defined list with prescribed calculation methods which firms can overlay with additional firm specific metrics, we propose a framework against which firms will have to disclose why they select their AQIs and what the AQIs tell the users about the business.  Consistency year on year is important.

Specific comments on the proposed AQIs:

- AQI 1 – Staff / culture survey results: Unless all firms use the same survey questions, the result will be less meaningful. The result may also be skewed and made less meaningful by the response rate. Often, firms that are part of a global network will use globally produced surveys, so international consistency in the requirements in this area would be beneficial.
- AQI 2 - Audit planning milestones: Audit quality milestones are defined and measured differently across firms, which will impact the AQI results. The timing of these milestones and scope of work to be completed given the statutory audit load for each may differ considerably across the firms and thus any reporting on these milestones will not be comparable.
- AQI 3 - Proportion of audit hours by phases of audit: This metric is portfolio dependent. For firms with a larger proportion of non-PIE engagements, the results are likely to show the majority of the audit work performed after year end and/or within a short period of time, which would be appropriate for non-PIE engagements and not indicative of poor audit quality across the firm. The metric is also heavily impacted by (i) whether a controls approach is taken; (ii) how much work is performed by components overseas; and (iii) also by late breaking events or management inefficiency – both of which are not within the auditor's control. We oppose the use of AQI 3b as it is enormously expensive to collate, creates a significant administrative burden and, depending on the systems employed by the firm, cannot be calculated until engagement files have been archived.
- AQI 4 - Internal quality review: When considering the internal quality review hours as a percentage of total audit hours, the depth and robustness of reviews is not taken into consideration – these are firm specific. An internal review which has taken a significant number of hours is not a reliable measure of the robustness or quality of that internal review.
- AQI 5 - Inspection results – external: No comment.
- AQI 6 - Inspection results – internal: Internal inspection results are firm dependent based on the grading of internal inspections, which varies across firms. Internal inspection results that are better or worse than external inspection results could result in users reaching inappropriate conclusions around the robustness of the inspection standards of the firm compared with the FRC. Overall, this metrics does not allow for innovation to grow, e.g. quality will be served by the smallest audits being performed thematically.
- AQI 7 - Involvement of Engagement Quality Control Reviewers (EQCRs): No comment.
- AQI 8 - Partner involvement in audits: This is a measure of effort and a clear definition of "partner" needs to be provided. An alternative suggested AQI is "senior team hours" to reflect how directors are utilised or hours per partner and RI, to capture all those who sign, which should lead to a common definition across firms.

- AQI 9 - Staff utilisation: Staff utilisation is measured differently across firms, and thus the results of this metric are likely to vary considerably. This AQI adds pressure to dropping time and that is a pressure on the individual despite the culture of the firm. We object to the AQI related to utilisation between January and March – it is likely to detract from quality, it would be better to look at a thematic of how firms try to manage this instead.
- AQI 10 - Staff attrition: No comment.
- AQI 11 - Use of specialists: There is an inconsistency at the firm level given different structures and business models of the firms (e.g. ring-fence) and different approaches taken to defining what a "specialist" is.
- AQI 12 - Staff / partner & staff / manager ratios: This metric is structure dependent and likely to vary considerably across firms with differing portfolios so is not a useful indicator of audit quality.
- AQI 13 - Training: A clear definition will need to be developed as to what constitutes "learning" or "training", to avoid subjectivity in what each firm defines as training and the mandatory courses included in the learning curriculum of the relevant firm will significantly impact the reported metric and vary across firms.
- AQI 14 - Diversity and inclusion: We do not object to a diversity and inclusion metric, but note that diversity goes beyond gender and ethnicity.

During the roundtable discussions most participants thought 8-12 AQIs would be sufficient, with the FRC proposing a maximum of 16 AQIs – given the proposed consultation AQIs (including subsets) currently total 16 metrics, any further metrics added may result in an overwhelming amount of data being provided to stakeholders.

6. *Do you think there are any other firm-level AQIs that we should consider? If so, please explain. (If relevant, please refer to the list of AQIs we have considered but not proposed, in Appendix 1.)*

Please refer to comments above on existing audit quality indicators presented in the transparency report.

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

Apart from the points mentioned above, we would like to see the proposed AQIs take into consideration international component reviews and engagement quality reviews, etc. given the nature of many audits today being group audits with component audits across the globe.

Another benefit that should be drawn out is how AQIs provide more transparency (with the appropriate context) on how audit firms assess and manage risk which impacts audit quality.