THE INVESTMENT ASSOCIATION

Audit Firm Supervision Team
FRC
By email: AQIs-consultation@frc.org.uk

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

+44 20 7831 0898
andrew.ninian@theia.org
@InvAssoc @The Investment Association

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Dear FRC – AQI Consultation Team

RE: Investment Association Response to the Consultation on Firm-Level Audit Quality Indicators (AQIs)

The Investment Association (IA) welcomes the opportunity to respond to the FRC's consultation on Firm-Level AQIs. Our members welcomed the findings from the FRC's Thematic Review of Audit Quality Indicators in 2020, and the further commitment to consult on publicly reported firm-level AQIs.

Improving the quality of audit will be fundamental to restoring trust in audit and corporate reporting. Investors, as primary users of corporate reporting, rely on the information presented in a company's annual report and accounts to make informed capital allocation decisions, and to hold company management and boards to account. In order to ensure market trust and confidence in company disclosures, investors require information that will help them to judge the quality and robustness of the company's audit.

While we welcome the recommendations within the Government Response on Corporate Governance and Audit Reform on improving audit quality (and encourage the Government to implement them in a expedite manner), our members have been calling for improvements to audit quality for several years. Audit Quality has featured in the IA Shareholder Priorities since 2020, with a focus on the role that Audit Committees play in overseeing the role of the auditor and the quality of the audit they provide. The fact that Audit Quality has been a shareholder priority for several years is indicative of the lack of desired progress in this area.

Following the FRC's 2020 thematic review of AQIs, some of our members agree that in principle firm-level AQIs (as a metric-driven approach) can be a useful tool to help Audit Committees and other users of audit to understand the aggregate view of the quality of audits from a particular auditor, beyond the FRC's Audit Quality Review (AQR) scores.

While not driving better audit quality in and of themselves, publishing a set of firm-level AQIs could have a number of benefits that will allow individual audit firms to consider areas for improvement while allowing them to benchmark their AQI scores against other firms. AQIs will also allow Audit Committee Chairs to make more informed choices when selecting an auditor. This includes: (i) allowing richer dialogue between Audit Committee Chairs and audit firms about overall firm-level quality—especially when tendering for a new auditor; (ii) enabling comparisons between the largest firms and challenger firms on AQIs which extend beyond external inspection results; and (iii) an increased focus on audit quality by users of audit is also likely to lead to opportunities for audit firms to self-reflect and make improvements, where required.

However, our members are not entirely convinced that the publication of a set of consistent firm-level AQIs will allow users of accounts to assess the quality of the audit and financial statements of an investee company. We recognise that audit quality is a complex and multi-faceted issue, for which there is unlikely to be a silver bullet. In principle, while greater transparency on AQIs can lead to increased engagement between the users of audits and auditors, it needs to drive meaningful change on issues impacting the material, long-term growth of the individual company, rather than creating engagement for engagement's sake. Disclosing indicators at both the individual audit and firm level is likely to be most helpful to shareholders in providing an overall assessment of audit quality at the individual company while also leading to meaningful engagement between investors and audit committees. However, we are sceptical this assessment will be achieved where AQIs are published on an aggregated basis. We strongly believe that the FRC should seek to address this, and where it cannot, it should provide proxies for the individual data.

As we noted in our response to the BEIS Consultation on Audit and Corporate Governance, it is equally important to recognise the differing roles of investors and company directors. Investors are reliant on company directors to run the company, ensure it is meeting its statutory obligations and to promote its success for the benefit of its members. As part of their responsibilities, investors expect Audit Committees to assess whether an auditor has: (i) provided a high- quality audit (ii) appropriately challenged managements judgments and assertions; and (iii) exercised professional scepticism. Shareholders, in turn, will hold directors to account for the decisions they take.

The FRC envisages an enhanced role for investors in engaging with audit firms and upholding audit outcomes. However, the responsibility for the day-to-day running of the company (including ensuring that the company receives a high- quality audit) rests with directors, and the FRC need to be realistic about the role of shareholders in policing audit quality, or in being able to direct companies to take a specific approach to audit. In our view, the first step to aid investors in having an enhanced role in holding audit committees to account on audit quality, is for audit committees to provide more information on how they have assessed the audit quality and ensured that the auditor is providing a good quality audit. Shareholders can then use their engagement and voting approaches to hold audit committees to account for their oversight of the auditor. In addition, we have supported the need for a robust and independent regulator and welcome the creation of ARGA on a statutory basis. This will allow the FRC to focus on ensuring that the regulator has the capacity and resource to take swift and appropriate action against audit failings.

We have some additional observations in response to the questions which we hope will be helpful as the FRC refines its approach to AQIs. These are attached as an Annex to this letter.

Yours sincerely,

Andrew Ninian
Director- Stewardship and Corporate Governance

Annex 1

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?**

Audit firms which audit 20 or more listed companies are already within the scope of the 2016 Audit Firm Governance Code (AFGC) and therefore voluntarily agree to report on AQIs as part of the Transparency Report. Our members welcomed the FRC's most recent revisions to the AFGC to ensure that it reflects expectations of audit firms and continues to drive improvements to audit quality and audit market resilience. As part of this, we supported extending the scope to audit firms who audit 20 PIEs or at least one FTSE350 company. We believe this scope is appropriate for the disclosure of AQIs and will capture firms that are already voluntarily providing disclosures. However, we note that a lead in time may be necessary for those audit firms that fall within the proposed new scope. We would also add that challengers should be brought within the scope of these requirements, particularly where they will be undertaking Managed Shared Audits.

The FRC claim that more frequent reporting and monitoring allows corrective action to be taken on a real-time basis against AQIs. However, some members question how often such remedial action is being taken by firms, particularly where users of audit are not aware of the disclosures being made as part of the Transparency Reports. As such, more could be done to promote existing disclosures on AQIs, rather than requiring firms to publish more. To this end we agree that the FRC, as a body independent of particular firms, should maintain information related to AQIs on its website for users of audit to easily navigate.

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?**

We agree that AQIs should be provided for all audit engagements as this will ensure that the riskier audits across an auditors' client base are also captured. However, further consideration needs to be given to how reporting will differ for those businesses that are UK based and those that have a global footprint. We agree, in principle, that the AQIs should cover UK audit firms only and that the FRC should introduce a segmented approach where AQIs are presented for PIEs and non-PIEs separately. We believe that such an approach will be informative while also enabling users of AQIs to identify and compare issues in audit quality between the two groups.

In addition, our members want to see AQIs provided at both the firm level (audit practice) and individual audit level as this provides a holistic view of audit quality and will be most useful to shareholders. However, where the FRC requires disclosures at the firm level only, it will need to ensure that the ratios are reflective of an auditor's entire client base.

We do not think that a holistic assessment of audit quality can be achieved whereby the FRC continues to provide data on an aggregated basis only. Our members believe that the FRC should move towards disaggregating data. If the FRC is unable to provide audit-specific details (for example, where it does not have the statutory powers to do so), it should move towards providing proxies for this. For instance, it could consider providing aggregated audit quality data for specific sectors or based on the market capitalisation of a company. Providing a time series of data will help investors to position issues, assess outliers and identify trends over time. This will be particularly important for challenger firms who will have different ratios in comparison to the Big 4.

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?**

We do not have any specific comments on cost. As we suggest at Q1, an appropriate lead in time may be required for those firms that do not currently voluntarily publish AQIs and will fall within the proposed new scope. We agree that only firms currently publishing AQIs in their Transparency Reports should be expected to report for the period 1 April 2023 to 31 March 2024.

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. Narrative disclosures can be helpful in contextualising the ratios, through providing an overview and rationale for changes in audit quality and any actions that the auditor is taking as a result to improve audit quality. This also allows users to track how audit firms have addressed audit quality over time. We do not think that users of reporting should be signposted to an audit firm's webpage, where they provide this information. This is likely to lead to similar issues which users currently experience with the Transparency Reports (please see Q1 on this). Instead, these disclosures should be maintained by the FRC.

   Our members would also welcome some form of verification of the AQIs and narrative disclosure and agree that a sensible approach would be for the audit firm's senior partner to provide an attestation confirming the accuracy of the information.

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.**

AQIs should be based on a mix of input and output measures, which are proven to be related to audit quality. Given that the FRC have been monitoring audit quality and failures as part of the AQR for some time, we believe that it should be able to provide a more empirical correlation between indicators and quality improvements. For example, measures relating to the number of post-year adjustments or errors identified in the audited accounts are likely to be more helpful in identifying failures in audit quality and can be leveraged as an indicator from prior audit failings.

We believe that there should be a series of 'red flag' indicators that all firms should disclose against. We would suggest grouping together indicators under the following themes:

Time involved in performing an audit: Our members note that many of the prior failures have seen auditors putting in hours to meet artificial reporting deadlines. On this basis metric A2 (audit planning milestones) is not helpful. Quality should not be about hitting a planning milestone; it should be about the ability to insist more work is needed and therefore call for an extension. On this basis, we think metrics 3b, (average % of audit hours spent in the 2 weeks before sign-off), 9 (staff utilisation) and 10 (staff attrition) could be brought together in some way.

Structure of the team: Our members believe that partner involvement as captured by metric 8 (partner involvement in audit) is important, but the middle ranks in between junior auditors and partners are just as important. It is likely that given their experience, they will spot key problems and make major judgments, or at least flag them to a partner. We believe this is somewhat captured by metric 12 (staff/ partner and staff/ manager ratios) but we would prefer that this is reported at the individual audit rather than firm-level.

Reward and promotion: There should be clarity on what the firm recognises in terms of pay and promotion—this should be transparent internally and externally so that audit quality performance is appropriately reflected in the approach to auditor remuneration. Disclosure of the proportion of audit staff in each of the firm's performance ratings for audit quality, and how many in each rating get promoted would be helpful. The attrition rating at metric 10 could be further strengthened if it were disclosed not just across the firm but also against these audit quality ratings.

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.)**

We believe that the following additional indicators would be helpful:

Prevalence of technology: Given the increasing use of technology in the future of corporate reporting, we believe that a measure on how technology and Artificial Intelligence (AI) are driving the audit plan and execution of the audit would be a helpful addition. This could capture data on: (i) how much is spent on AI; (ii) and how many junior auditors have been replaced by AI. We recognise that the Big 4 are more likely to invest in AI packages and that this could cause the AQI ratio for this indicator to look worse for challengers. Nonetheless, we think this data would help users of audit to understand the shift towards the use of technology and identify any concerns (for example overreliance) at an early stage.

Requests from the regulator: As we note in our response to Q7, an AQI which measures how firms' have followed up on an audit inspection, including any suggestions to invest in it systems and capabilities to improve audit quality, would provide some insight into: (i) how seriously audit firms take requests from the regulator; (ii) how responsive they are in following up; and (iii) the type of relationship they have with the regulator.

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

We have the following additional comments:

Greater Supervision and Monitoring of Audit Quality
Following the publication of the FRC's latest annual inspection and supervision results of the largest audit firms in July, we were pleased to see that 75% of audits inspected were either good or required limited improvement. Notably, this has increased by almost 10% since 2020. However, some of our members believe that audit inspections and any suggestions for improvement by the regulator need to be followed up more rigorously by supervision of a firm's investment into its systems, training, people and capabilities to improve audit quality, under the Audit Firm Monitoring Regime. We therefore support the intention to provide the ARGA with powers to ensure that it is better equipped in both its capacity and capabilities to take action against audit failure.

Audit Quality Review
Generally, our members are supportive of the work of the FRC's Audit Quality Review (AQR) and believe that this has the potential to be a valuable indicator of audit quality, alongside AQIs. However, as we noted in our response to the White Paper on Restoring Trust in Audit and Corporate Governance, the AQR process is currently hampered by a lack of transparency on the outcomes of AQR into individual companies. This prevents investors from being able to understand the regulators' findings and concerns and therefore articulating them as part of their engagement with investee companies. To this end, we welcome the Government Response, which will move forward with the publication of significant findings within the AQR report[1]. We would, however, still call for disaggregation of the outcomes of AQR at the company level.

The FRC will also encourage greater dialogue between audit firms and users of audit to ensure that they play an active role in shaping the published information relating to audit monitoring and supervisory activities. We welcome this, but as a first step we believe that for investors to better hold audit committees to account on audit quality, they need to provide more information on how they have assessed the audit quality and ensured that the auditor has provided a good quality audit.

[1] Subject to the consent of the audit firm.