

Auditing the Auditors: Audit Quality Indicators

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With regulations and financial reporting standards set to change the audit landscape in India, audit committees must evaluate their existing auditors for their audit quality and independence, and establish criteria for selecting new auditors. To assist audit committees with this change, IiAS has drafted a list of 'Audit Quality Indicators' which may be used as a guiding reference to evaluate and select auditors.

Audit quality is difficult to assess in its absolute terms, but there are indicators that can reduce the subjectivity involved in evaluating audit quality. AQIs are a set of qualitative and quantitative parameters to provide a basis for comparison across different audits and audit firms. AQIs can be defined at both engagement level (indicators related to the specific audit engagement) and audit firm level (indicators to gauge the audit firm's overall focus on quality). Globally, several initiatives have been taken (see [Annexure A](#)) to outline such measures.



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Legal: These indicators highlight the instances of litigation and penalties imposed by regulatory bodies on the audit firm.

Independence: These indicators can be used to evaluate the independence of the audit team and steps taken by the audit firm in ensuring that the independence policy is not violated.

Technology: These metrics indicate how well the audit firm understands the technology being used by the audit client, and leverages technology and analytics in audit execution.

The detailed IiAS AQI framework can be found [here](#).

The audit committee has a multi-faceted role - a key responsibility is that of auditor selection and evaluation. Two significant changes have made these responsibilities more crucial than ever:

- The Companies Act, 2013 has made it mandatory for the companies to rotate their statutory audit firms after a maximum of two terms of five years each, before 1 April 2017. 46 of the S&P BSE 100 index companies will likely appoint new auditors in their 2017 AGMs.
- India is in the process of converging towards globally uniform financial reporting standards by the implementation of the Indian Accounting Standards ('Ind-AS'). The transition is not just a change in accounting framework, but will have an impact on almost all business functions of the company. The internal control framework will need a complete overhaul and the audit function needs to play a pivotal role in testing them and reporting any deficiencies to stakeholders.

An AQI framework will help the committee in laying down objective criteria for evaluating audit firms and benchmark audit firms against one another.

Being transparent about audit quality is in the best interest of all stakeholders. It provides confidence to the capital markets in the sanctity of financial numbers reported by companies. AQIs will allow audit firms to provide evidence of their expertise and quality in a tangible, quantitative form. Such a framework will also help audit firms push themselves to a higher standard and foster healthy competition between audit firms on their quality metrics.

Audit committees can use the framework provided by IiAS as a starting point; and finalize a set of AQIs by incorporating industry-specific and company-specific nuances. As AQIs are a relatively new concept, there are no established benchmarks to evaluate audit quality. However, we believe that the audit committee must define what works for them, based on their own criteria and filters. Over time, as more audit firms report AQIs on a regular basis, benchmarks for quality will be automatically set.

AQIs can supplement the government's effort of monitoring and improving the audit quality in India. The [Quality Review Board](#) (QRB), established by Parliament under The Chartered Accountants Act 1949, is a 10-member panel (50% of whom are members of The Institute of Chartered Accountants of India - ICAI). Its [Report on Audit Quality Review 2015-16](#) indicates that the QRB has conducted 454 reviews since August 2012, of which 257 reviews have been finalized. As a result of finalizing 257 reviews, in 136 cases (53%), the QRB issued advisories to audit firms "for improvement in quality"¹, and referred 6 cases to ICAI for "initiating disciplinary proceedings".

¹ Source: Report on Audit Quality Review 2015-16, Executive Summary

With companies implementing AQIs in selecting or retaining audit firms, the agenda to improve audit quality will spread faster – the need to compete will ensure audit firms undertake self-improvement measures. This will benefit not just companies, but the audit industry. Over time, it may well put to rest the oft-repeated lament from corporate India on the paucity of good quality, experienced audit firms.

Sample Audit Quality Indicators for Indian companies

Category I: Workforce metrics

Higher involvement of senior audit partners in the engagement may lead to higher audit quality on account of better oversight and technical knowledge. High attrition rates may also indicate a loss of knowledge and experience.

Sub-category	Engagement level metrics	Firm level metrics
Partner leverage	Audit Partner billable hours/Billable hours for all other personnel for engagement	Audit Partner billable hours/Billable hours for all other personnel for firm
Partner oversight	Partner/Total audit team size	Number of partners/Total audit workforce
Partner utilization	Total billable hours for audit partner for all engagements in current year (hrs)	Average annual billable hours per partner for firm (hrs)
Staff utilization		Utilization % (Billable hours worked/Billable hours capacity)
Partner experience	Audit partner experience (yrs)	Average audit partner experience (yrs)
Audit team experience	Cumulative experience of audit team (yrs)	Average experience of total audit team (yrs)
Audit team industry experience	Cumulative experience of audit team for companies in same industry (yrs)	Average experience of audit team for companies in same industry (yrs)
Attrition	Attrition rate - % of personnel on the team that have left the firm or have been reassigned	Attrition rate - % of personnel in the firm that have left the firm in the last year

Category II: Training

Higher number of training hours may indicate better technical skills and an ability to adapt to the changing audit landscape.

Sub-category	Engagement level metrics	Firm level metrics
Partner training	Industry-specific training hours for audit partner (hrs)	Average training hours for audit partner (hrs)
Audit team training	Annual training hours for audit team in last 12 months	Average annual training hours for audit team in last 12 months

Category III: Quality

A higher number of hours spent in quality review may point to a better focus on quality. Higher restatements may indicate deficiencies in conducting audits.

Sub-category	Engagement level metrics	Firm level metrics
Quality review	% of total billable hours spent in quality review	
Audit deficiencies	Number of deficiencies in audit process identified via internal quality inspections	% of audits where more than one audit deficiency observed via internal quality inspections
Audit restatements	Number of restatements for errors at engagement level	% of audits where restatements were required
Audit restatement magnitude	Magnitude of restatements due to errors	Top ten magnitude of restatements due to errors

Category IV: Trends in audit metrics

Where audit fees and billable hours have grown disproportionately with respect to complexity of audit work, audit committees may ask audit firms to justify such increases.

Sub-category	Engagement level metrics	Firm level metrics
Audit fees	% change in audit fees (over previous year)	Average % change in audit fees for firm
Billable hours	% change in billable hours (over previous year)	Average % change in billable hours for firm
Non-audit to Audit revenue		Average ratio of non-audit revenue to audit revenue for firm

Category V: Legal

A higher quantum of legal actions and fines against the firm may point to poor internal control mechanisms.

Sub-category	Engagement level metrics	Firm level metrics
Litigation by regulators	Number of litigation proceedings by regulatory bodies against audit firm with respect to engagement client	Number of litigation proceedings by regulatory bodies against audit firm
Audit fines	Number of fines from regulators with respect to engagement client	Number of fines from regulators
Quantum of fines	Amount of fines from regulators with respect to engagement client	Amount of fines from regulators

Category VI: Independence

A longer tenure for the audit partner and high revenue contribution by the company/group may hamper the independence of the audit firm.

Sub-category	Engagement level metrics	Firm level metrics
Training	Annual training hours on independence for audit team in last 12 months	Average annual training hours for audit team in last 12 months
Client & Group Concentration	Revenue contributed by client to overall revenues	Revenue contributed by the group to overall revenues
Partner rotation	Audit partner tenure for the engagement	Average audit partner tenure for all engagements
Reported violations	Number of internally reported violations of independence policy at engagement level	Number of internally reported violations of independence policy at firm level

Category VII: Technology

Audit firms need to be able to absorb and implement the latest technologies and build their analytical capabilities.

Sub-category	Engagement level metrics	Firm level metrics
Specialist	Number of hours spent by IT specialists on the engagement in last 12 months	Number of technology specialists available that audit clients' technology systems / software for controls
Training	Annual training hours spent on technology and data analytics by audit team in last 12 months	Average annual training hours spent on technology and data analytics in last 12 months
Investment		Investment in Technology and data analytics as a % of annual revenue
Proficiency	No of check points established to test controls of the technology system used by the audit client	Average number of hours spent by IT specialists on all engagements in last 12 months

Annexure A: Global relevance of Audit Quality Indicators

Globally, several regulatory, oversight, and professional bodies have issued/proposed AQIs that can be voluntarily disclosed by audit firms. For example:

- **Netherlands** -In September 2014, the [NederlandseBeroepsorganisatie van Accountants](#) (NBA) published a paper on audit quality, which provides examples of AQIs proposed by the Accountancy Profession working group. The NBA published a follow-up practice note '[Disclosure of Audit Quality Factors](#)' in March 2016. It is expected that audit firms will report on the AQIs listed in the practice note for the accounting year starting on or after 15 December 2015.
- **Switzerland** -The [Federal Audit Oversight Authority](#) (FAOA) in Switzerland has collected audit quality measure data for the five largest audit firms for the past seven years. The FAOA provides for quantitative AQIs – in the form of ratios. It provides a range of ratios for AQIs for the five audit firms and a trend analysis.
- **United Kingdom** -The [UK Financial Reporting Council](#) (FRC) developed an *Audit Quality Framework* in 2008. This specified the five key drivers of audit quality. Further, their [Statutory Audit \(Transparency\) Instrument](#) of 2008 provided a list of what should be included in an audit firm's transparency report. Six of the largest audit firms in the United Kingdom voluntarily provide information on AQIs prescribed by the FRC. Audit firms provides qualitative as well as some quantitative information under each category.
- **Unites States of America** -The [United States Centre for Audit Quality](#) (US CAQ) initiated pilot projects to identify key AQIs that can provide signs of audit quality. In January 2016, the US CAQ published the results of the pilot testing. The US CAQ sees audit committees as main users of AQIs and therefore focuses mainly on the communication of engagement-specific AQIs, including firm-wide indicators to provide more content where appropriate.
- **Singapore** -The [Accounting and Corporate Regulatory Authority](#) (ACRA), Singapore has published an AQI disclosure framework in October 2015, which can be adopted voluntarily by audit committees of all listed entities in Singapore from January 2016. The indicators are mainly quantitative with an option to add qualitative information where relevant. ACRA suggests that audit firms can privately share information on AQIs with audit committees in two instances: after the financial year's audit and at the time of change in the auditor. Certain AQIs are communicated at engagement level, others at firm level and some at both levels.
- **Canada** -The [Canadian Public Accountability Board](#) (CPAB) issued a publication on AQIs: '*Audit Quality Indicators: in Search of the Right Measures*' in 2014 which prescribed quantitative indicators for audit quality. Further in March 2016, the CPAB published another report '[Transparency into the Audit – Audit Quality Indicators and Transparency Reporting](#)' which talks about gathering feedback on the usefulness and practical implications of using AQIs.

Sources:

1. [Deepening the Audit Quality Conversation](#) – published by the Accounting and Corporate Regulatory Authority, Singapore in association with CPA – Australia
2. [Overview of Audit Quality Indicators Initiatives](#) – published by the Federation of European Accountants

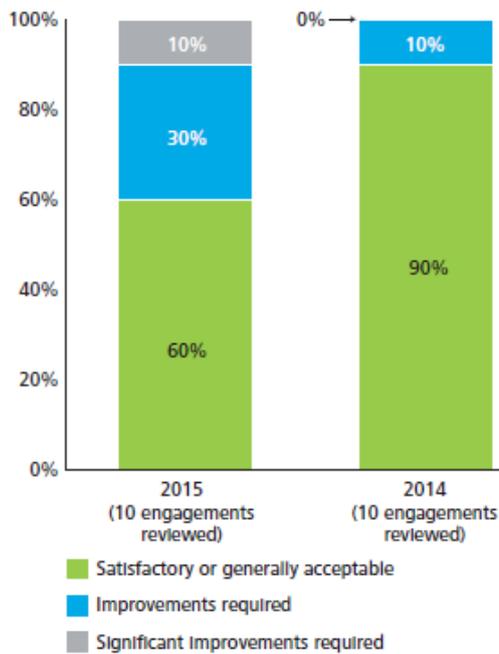
Annexure B: Audit Quality Indicators reported by Deloitte (UK)

Results of AQR reviews of the firm



METRICS ON AUDIT QUALITY REVIEWS

Results of inspection by the QAD of the ICAEW



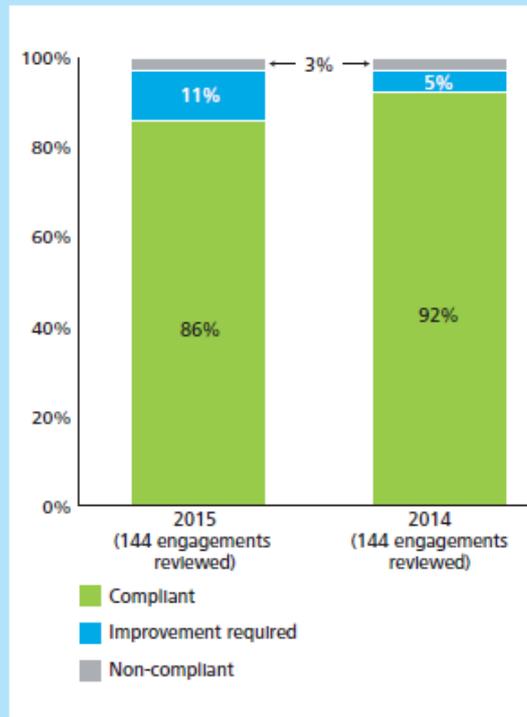
Comments

The QAD undertakes inspections of UK statutory audits which are outside the scope of the AQR's inspections. The firm receives a private annual report from the QAD documenting its findings.

The overall conclusion in the report dated 15 April 2015, which covered reviews of audit reports signed in 2014, was that the audit work continued to be generally good. Areas identified for improvement included a localised weakness in revenue testing and insufficient challenge of an impairment model. The reviews also identified a small number of other points for improvement, primarily relating to documentation. We have already taken action to respond to the key themes of the QAD report and will continue to undertake further activities to embed the changes into our practice.

METRICS ON AUDIT QUALITY REVIEWS

Results of the firm's own assessment of audit engagement quality



Comments

Results of firm's own assessment of audit engagement quality

The firm conducts an internal practice review of the Audit service line every year during the summer months. Both audit and advisory engagements are covered by this practice review along with an assessment as to whether the overall system of quality control for the practice is operating effectively.

A central quality team is responsible for planning the reviews and moderating and each office or sub-group review team is overseen by a partner from another part of the UK firm.

The results included in this year's metric relate to the practice review conducted in Summer 2014, with the comparative data from the practice review conducted in Summer 2013 (including the engagements selected from the Swiss audit practice for both periods). Any comparison of 2015 and 2014 results should bear in mind that we continually seek to refine our approach to internal practice review and make the reviews more challenging and robust.

Annualised % of RIs subject to the firm's internal audit quality reviews

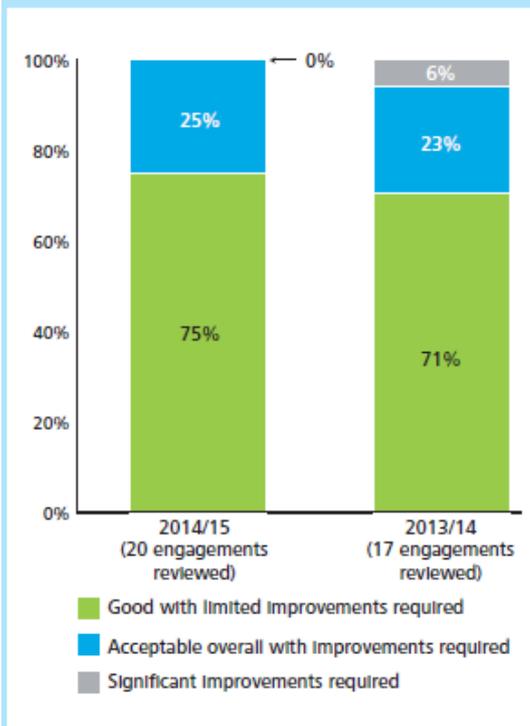
2015 – 59% and 2014 – 41%

We are changing our approach to internal audit practice review selection so that RIs will generally be covered every two years. This shorter cycle started in 2014 and is due to be fully in place from 2016.

Further information about our internal practice review can be found earlier in this section.

METRICS ON AUDIT QUALITY REVIEWS

Results of AQR reviews on the firm



Comments

The results of our most recent AQR inspection are discussed above and the full 2014/15 report of the AQR on Deloitte can be found at: <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Inspection-Report-2014-15-Deloitte.pdf>

We have given careful consideration to each of the FRC's comments and recommendations. We use the external inspection process, as well as findings from our own quality review procedures, to drive further improvements to our quality agenda. We have already taken action to respond to the key themes of the 2014/15 AQR report and will continue to undertake further activities to embed the changes into our practice.

METRICS ON EXTERNAL INVESTIGATIONS RELATED TO OTHER MATTERS

Number of cases in the last 12 months in which the FRC's Conduct Committee has found against the firm or one of its members

2015:

1

2014:

1

Comments

In the year to 31 May 2015, there was an Adverse Finding by an Appeal Tribunal against the firm (fine of £3m and severe reprimand) regarding corporate finance services for MG Rover relating to one transaction in 2001.

In addition there is an ongoing investigation relating to the conduct of a partner in Deloitte in connection with actuarial advice provided to Equity Syndicate Management Limited between 2007 and 2009. This is yet to be concluded and is therefore excluded from the 2015 metric.

METRICS ON EXTERNAL INVESTIGATIONS RELATED TO AUDIT

Number of cases in the last 12 months in which the FRC's Conduct Committee has found against the firm or one of its members

2015:

0

2014:

0

Comments

In the year to 31 May 2015, there have been no findings by the FRC's Conduct Committee in relation to the firm's audit work. However:

- There is one ongoing investigation relating to the audit work of the firm or its partners, though this is yet to be concluded and is therefore excluded from the 2015 total for cases concluded (**Autonomy Corporation plc**: an investigation commenced in February 2013 concerning the firm's audit work on Autonomy's 2009-2011 financial reporting).
- There is also one investigation relating to the audit work of the firm or its partners which was concluded in the last 12 months, a formal complaint brought and Tribunal hearing set for 2016. This is also excluded from the 2015 total for cases concluded as no finding has been reached (**Aero Inventory plc**: an investigation commenced in February 2011 concerning the firm's audit work on Aero's 2006-2008 financial statements).

Number of cases in the last 12 months in which the disciplinary committee of any other regulatory body has found against the firm or one of its members

2015:

1

2014:

1

Comments

In the year to 31 May 2015 the firm accepted a regulatory penalty of £16,650 in respect of a breach, in respect of accounts for the year ended 31 December 2012, of audit regulation 3.02 for failing to ensure that an individual did not act as audit engagement partner of a subsidiary of a listed entity for more than five years.

METRICS ON INVESTMENT

Number of hours training undertaken per person (partners and qualified staff) in the audit service line

Training hours

2015:

60

2014:

55

Comments

This metric is derived from taking the total hours of learning delivered in structured sessions to Audit professionals and dividing this by the number of qualified personnel in the Audit service line. Audit professionals are deemed to be any individual from qualified assistant manager through to partner inclusive.

Structured learning includes:

- Summer Audit Academy, which is mandatory for all audit professionals
- Mandatory training for personnel accredited to work on SEC audit engagements
- Mandatory firm-wide training for example on ethics and anti-money laundering regulations
- Industry related learning for audit personnel including seminars and masterclasses

In addition, all qualified staff are required to view regular technical webinars and this is monitored. These one hour sessions provide updates on corporate and financial reporting, auditing and regulatory information to audit partners and staff in the UK. Eight webinars were made available for professionals during the year.

Further description of the learning and development programmes provided to audit professionals can be found in section 2.1.

Note: This metric does not include any of the exam training provided to non-qualified staff under training contracts, nor does it include the hours of personal learning undertaken to fulfil Continuing Professional Development requirements.

Source: [Deloitte \(UK\) Transparency Report 2015](#)

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