

## Transparency into the Audit – *Audit Quality Indicators and Transparency Reporting*

### The Issue

Traditionally the financial audit process has been opaque, operating in a black box environment with only a pass or fail judgement rendered by the auditor on an annual basis.

However, there has been a growing realization that increasing transparency into the audit process would be of benefit to audit committees, investors and other stakeholders.

A number of initiatives are underway internationally in order to increase transparency into the audit process. This publication outlines two initiatives: audit quality indicators (AQIs) and transparency reporting.

#### Potential benefits of AQIs and transparency reporting:

- Provides information to audit committees that can improve the discussion about audit quality and assist in their oversight and evaluation of the auditor.
- Increases the efficiency and effectiveness of interactions between the audit committee and the auditor as discussion is focused on areas of risk and relevance.
- Provides additional information to other stakeholders, including investors, which helps drive more meaningful dialogue around audit quality.
- May enable audit firms to better compete on audit quality.

### Audit Quality Indicators

Audit quality can be challenging to define, measure, and quantify. This has resulted in limited information available to investors, audit committees and others to assist them in evaluating the quality of an audit. In response, there has been increased international activity around the concept of audit quality indicators. The aim is to develop a portfolio of quantitative measures that provides insight into audit quality and to enhance the discussion of audit quality drivers among stakeholders. It is anticipated that AQIs would provide a way for audit firms to show their commitment to, and compete on, audit quality.

The Public Company Accounting Oversight Board (PCAOB) in the US issued a Concept Release in July 2015 seeking public comment on the content and possible uses of a group of

potential AQIs they have identified. Forty-seven comment letters were received, with 75 per cent in support of the concept of AQIs, but also voicing concerns over unintended consequences of public disclosure of such information<sup>1</sup>.

#### What are AQIs?

A portfolio of quantitative measures about public company auditing, intended for those concerned with the financial reporting and auditing process, such as audit committees, audit firms and potentially the investing public.

<sup>1</sup> <http://pcaobus.org/News/Events/Documents/11-12-2015-SAG-Meeting/SAG-AQI-Memo.pdf>

## Key Issues

- *Nature and scope of specific indicators* – AQIs can be measured at the engagement or firm level. While some AQIs are more commonly discussed (see Table 1), a widely accepted list of core AQIs has not yet been established.
- *Main users* – While there is general agreement that the main user of AQI information would be audit committees, audit firms and investors may also be interested stakeholders.
- *How AQI information should be shared* – AQI information can be shared privately or publicly. Generally, institutional investors seek public disclosure, but corporate board members and audit firms favour private disclosure to audit committees, except for voluntary disclosures of selected firm level AQIs by audit firms that choose to do so. These firm level AQIs are usually disclosed in Transparency Reports, which are discussed below.

**Table 1: Examples of Common AQIs**

CATEGORY	INDICATOR	EXAMPLE CALCULATION
<b>PROFESSIONALS: Availability</b>	<ul style="list-style-type: none"> <li>• Staffing Leverage</li> <li>• Technical Accounting and Auditing Resources</li> <li>• Persons with Specialized Skill and Knowledge</li> </ul>	<ul style="list-style-type: none"> <li>• Percentage of partner hours spent on an audit compared to total hours</li> <li>• Number of professionals at an audit firm's national office</li> <li>• Number of specialist hours spent on an audit</li> </ul>
<b>PROFESSIONALS: Competence</b>	<ul style="list-style-type: none"> <li>• Experience of Audit Personnel</li> <li>• Training Hours per Audit Professional</li> </ul>	<ul style="list-style-type: none"> <li>• Number of years of audit experience and/or relevant industry experience per engagement team member</li> <li>• Average number of training hours/year per level</li> </ul>
<b>PROFESSIONALS: Focus</b>	<ul style="list-style-type: none"> <li>• Allocation of Audit Hours to Phases of the Audit</li> </ul>	<ul style="list-style-type: none"> <li>• Percentage of total audit hours spent prior to, versus after, year end</li> </ul>
<b>AUDIT PROCESS: Monitoring and Remediation</b>	<ul style="list-style-type: none"> <li>• Audit Firms' Internal Quality Review Results</li> </ul>	<ul style="list-style-type: none"> <li>• Summary of audit firm's internal quality review results</li> </ul>

## Pilot testing results – US and International

Several jurisdictions have tested, or are testing, the use of AQIs to enhance private conversations between audit firms and audit committees. The Center for Audit Quality in the US undertook a pilot program in 2014 and 2015 with 30 audit committees, and the Accounting and Corporate Regulatory Authority (ACRA) in Singapore initiated a voluntary AQI program in 2016 to share certain AQIs with audit committees, in which the Big Four audit firms in the country have agreed to participate.

Early results show that the addition of AQIs deepens the audit committee's understanding of the audit process, and results in more meaningful and effective conversations between the auditor and audit committee.

## Pilot testing – Canada

There are limited examples of the use of AQIs by Canadian audit firms and audit committees. During 2016 CPAB is reaching out to audit committee members to participate in a pilot project to obtain Canadian feedback on the usefulness and practical implications of using audit quality indicators. The results of this pilot will be shared in 2017. Audit committees interested in taking part can contact Jeremy Justin ([Jeremy.Justin@cpab-ccrc.ca](mailto:Jeremy.Justin@cpab-ccrc.ca)) or Lindsay Colley ([Lindsay.Colley@cpab-ccrc.ca](mailto:Lindsay.Colley@cpab-ccrc.ca)) for more information.

## Transparency Reporting

In many jurisdictions<sup>2</sup>, audit firms are required or encouraged to publish public Transparency Reports. This type of reporting has been gaining international interest, as evidenced by the recent release of transparency reporting guidelines by the International Organization of Securities Commissions (IOSCO) in November 2015. The purpose of Transparency Reports is to foster greater confidence in the audit process by assisting stakeholders in understanding how an audit firm's management and operations support the performance of high quality audits.

In jurisdictions where transparency reporting is more established, the reports provide a greater range of information. This is particularly true in the UK where transparency reporting has been mandated for certain audit firms since 2010. While early attempts at transparency reporting produced marketing-like materials, recent examples of Transparency Reports are more substantial – a number of audit firms now provide quantitative metrics related to audit quality. This has improved dialogue between investors and audit committees with the auditor.

Sample Transparency Report metrics<sup>3</sup>:

- Results of the firm's internal audit quality reviews.
- Number of hours of training undertaken per person in the Audit service line.
- Results of a staff survey related to audit quality (example question: "the time and resources available to me enables the delivery of a high quality audit").
- Revenue from audit work, non-audit work from companies that the firm also audits, and non-audit work from other companies.

<sup>2</sup> For example, the United Kingdom, Australia, Austria, Germany, the Netherlands, Switzerland, and Belgium

<sup>3</sup> Example transparency report metrics were taken from the Big Four (Deloitte LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP) audit firm 2015 UK Transparency Reports

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### What is a Transparency Report?

Also called an Audit Quality Report, it is a public report published by an audit firm providing information about the firm's organizational structure, governance and systems for ensuring audit quality.

While not mandatory, Transparency Reports are also being produced in the US. In the last two years, Audit Quality Reports (US terminology) produced by the largest audit firms have included some firm-level quantitative metrics, similar to the metrics reported in the UK. This indicates that audit firms are responding to an increasing interest by stakeholders in audit firm quality control systems and level of investment in audit quality.

While transparency reporting is not required in Canada, some audit firms publish them to meet requirements of their registration in certain European countries. The content of these reports tends to be limited, and the reports are neither widely shared nor publicized.

## Final Words

Each of these transparency initiatives aims to provide more information to investors and other stakeholders to enhance conversations among interested parties and ultimately increase confidence in financial reporting. We encourage investors and other users to learn more about these topics and provide their perspectives to ensure that their needs are being met.