

DEEPENING THE AUDIT QUALITY CONVERSATION



Introduction

Consumers today decide on their vendors using a number of factors rather than price alone. As buyers of audit services, Audit Committees (ACs) should also decide on their auditors based on multiple data points. The data points should indicate the auditors' ability to deliver quality audits, so as to help ACs discharge their duties.

To enhance the discussions between ACs and their auditors on audit quality matters, the Accounting and Corporate Regulatory Authority of Singapore (ACRA) has introduced an Audit Quality Indicators (AQIs) Disclosure Framework.

This publication outlines ACRA's AQIs Disclosure Framework, highlighting the evolution of AQIs, the selection of eight indicators and how the indicators can be used by ACs.

I see AQIs complementing the audit committee guidebook. Not all of us are very experienced in our role. Whatever toolkit developed as a guide will be useful.

- Participant of AC focus group

What are AQIs?

The integrity and reliability of the financial statements depend on many factors. These include the quality of financial statements prepared by management, the quality of audits conducted by auditors, the oversight of directors charged with governance, and the enforcement of regulatory requirements. Much work has been done in Singapore to improve these factors. The ultimate aim is to provide investors with a set of trusted and reliable financial information to make informed decisions.

In the academic field, there have been various attempts to define and measure audit quality. Researchers have related audit quality to a range of proxies, including the amount of audit work performed by the auditors, the detection rate of errors, and the accuracy of going-concern opinions issued by auditors for distressed companies. However, there is **no consensus** on the definition of audit quality.

Research has shown that a number of input, process and output factors can **collectively** indicate an auditor's ability and commitment to deliver high quality audits. These factors include:

Quality Control Systems and Processes

Audit firms with stronger quality control systems and structured audit processes produce higher quality audits. According to a study by J. Krishnan and P.C. Schauer in 2000, audit firms that participated in a peer review process were more likely to correctly report financial disclosures. A study by C.F. Malone and R.W. Roberts in 1996 found that audit firms with strong quality control systems were less likely to exhibit reduced audit quality behaviours such as inappropriately signing off on audit procedures.

Audit Team Attributes

The competency and experience of audit professionals are important contributors to audit quality. A study by J.V. Carcello, R.H. Hermanson and N.T. McGrath in 1992 highlighted that the four most important factors in determining audit quality were audit team and firm's experience with the client, industry expertise, responsiveness to client needs, and compliance with the accepted standards of competence, independence and due care. Similarly, a study by J.R. Francis in 2011 also identified competent audit professionals as a key input factor to audit quality.

Inspection Results

The results of external inspections by regulators and internal inspections by audit firms are strong indicators of audit quality. In 2011, a study by J.V. Carcello, C. Hollingsworth and S. Mastrolia found that the Public Company Accounting Oversight Board (PCAOB) inspection has led to improved audit quality of the Big 4 audit firms¹, at least in terms of fewer incidences of earnings management. In 2015, a study by Y. Wang, L. Yu and Y. Zhao found a positive association between an audit partner's past failure rate with the probability of restatements in the current year's financial statements audited by the partner.

In summary, the vast body of research has shown that there is value in understanding and evaluating factors that contribute to audit quality. This raises the question of whether there is a way to bring these factors together in a measurable and comparable form. This is what AQIs strive to do.

International Developments on AQIs

Internationally, audit regulators, audit firms and professional bodies have attempted to add transparency to audit quality. These developments include:

Audit Regulators: The PCAOB in the United States and the Financial Reporting Council (FRC) in the United Kingdom have embarked on projects to identify AQIs that can provide early signs on audit quality. Annually, the Federal Audit Oversight Authority (FAOA) in Switzerland also publishes a range of audit quality measures for the five largest state-regulated audit firms.

Audit Firms: Audit firms in the European Union have published transparency reports, driven by regulatory requirements such as the European Union's Eighth Directive. Besides financial disclosures, these reports included information akin to ACRA's AQIs. Several audit firms in the United States have also voluntarily published reports on their firm-wide AQIs.

Others Organisations: The International Auditing and Assurance Standards Board (IAASB) has developed a Framework for Audit Quality. It describes the input, process and output factors that contribute to audit quality at the engagement, audit firm and national levels for financial statement audits. Similarly, the Center for Audit Quality (CAQ) in the United States, an autonomous organisation which counts the largest US audit firms as members, has identified 21 potential AQIs and has started pilot testing these AQIs.

How can AQIs be useful?

AQIs can be useful to various stakeholders of the financial reporting value chain.

Auditors should use AQIs to demonstrate their ability and commitment to uphold and deliver high quality audits. These indicators will provide insights into the time spent on an audit engagement, investments in staff training and implementation of other quality assurance measures. Such information is currently kept largely within the audit firm. By sharing with the ACs, auditors can illustrate the value they could bring to the audit.

Audit committees should have access to commonly-defined and comparable AQIs that signal the quality it can expect from the auditors. ACs should use AQIs to trigger its conversation with the auditors on audit quality, such as whether the industry experiences of the senior team members are aligned with the companies' needs or the auditors' action to address the external or internal inspection findings. This is particularly important because ACs need the auditors, aside from management, to help discharge their duties.

Investors, unlike ACs, will not use or have direct access to AQI data. However, AQIs benefit investors in the longer-run as they provide ACs with a tool to evaluate and choose quality auditors to deliver quality audits. This gives them the much-needed assurance over the integrity and reliability of the financial statements.

Trending of AQIs over time will be good as an indicator of audit quality.

- Participant of AC focus group

AQIs provide insights on how seriously audit firms take issues of quality, independence, integrity and training. Results of internal and external inspections are very key.

- Participant of AC focus group

Having AQIs is a good start - people are more conscious and will know more about the audit firm, its culture, processes, methodology, and how they train their staff.

- Participant of AC focus group

Any framework proposed as a guideline can improve audit quality and ensure that ACs can fully discharge their responsibilities.

- Participant of AC focus group

Development of AQIs in Singapore

In Singapore, as the regulator of public accountants, ACRA has inspected work performed by auditors since 2004 through its Practice Monitoring Programme (PMP). From these inspections, ACRA has observed that poor quality audits are often driven by two root causes.

The first root cause is inadequate supervision and review by senior audit team members. The lack of **time spent by audit partners and managers** often gives rise to a higher number of problem areas. In some instances, they are caused by the firm's structure and strategy to maintain fewer audit partners and managers relative to junior staff, as reflected by the **staff leverage ratio**.

The second root cause is inadequate level of competent resources dedicated to the audit. With the increasing complexity in accounting and auditing standards, having sufficient audit professional staff with the right competencies and knowledge is critical to maintaining audit quality. Audit quality would be undermined when the audits are conducted by untrained or relatively inexperienced staff without adequate supervision. As such, the firm's development of its audit staff in terms of **training, experience levels and low attrition rates** are good indicators of audit quality.

With insights from these root causes, ACRA set out to select eight AQIs that would **work well collectively** to indicate audit quality. The eight AQIs were developed in consultation with audit firms and ACs in Singapore. Between March and July 2015, more than 70 AC chairs or members provided valuable feedback on the AQIs through five focus group discussions, independently facilitated by CPA Australia and the Singapore Institute of Directors (SID).

ACRA's AQIs Disclosure Framework

The Framework is available for voluntary adoption by ACs of all listed entities in Singapore from 1 January 2016.

Audit firms are encouraged to share the AQI data privately with ACs:

1. after each financial year's audit is completed (when ACs are considering whether to re-appoint the incumbent auditor); and
2. when ACs are considering a change of auditor.

ACRA's Framework comprises 8 AQIs. Some indicators are disclosed at the firm-level, some at the audit engagement-level and some at both levels.

The AQIs work collectively to provide insights into audit quality. They are selected based on two principles.

First, the AQIs are mainly quantitative so they can be easily compared by ACs. Qualitative information to supplement the AQI data may be included by auditors where relevant.

Second, the AQIs comprise a mix of engagement-level and firm-level indicators. Whilst engagement-level indicators are more specific and relevant to ACs, firm-level indicators provide ACs with the understanding of the audit firm's overall commitment and quality assurance measures.

For details on how AQIs may be interpreted by ACs, please refer to the Guidance to Audit Committees on ACRA's AQIs Disclosure Framework². To guide audit firms to prepare AQI data consistently, ACRA has also developed a Guidance to Audit Firms on ACRA's AQI Disclosure Framework³.



How can ACs use AQIs?

AQIs are not conclusive on their own. AQIs serve to guide conversations between ACs and their auditors on audit quality matters. Judgement by ACs is critical in interpreting the context of the AQI data and assessing how the AQIs will interact with each other and as a group.

Where there are significant variances in the AQI data for a given period, ACs are encouraged to ask their auditors to explain. When external and internal inspection results are unfavourable, ACs are encouraged to find out if the findings also apply to their engagements and whether these are systemic or one-off issues. ACs may also want to know the steps taken by the audit firm or partner to remedy the failings highlighted.

For continuing appointments, ACs are encouraged to look at the historical trends of AQIs. The trends, applied in the context of their companies, will help ACs set future expectations for auditors. For example, ACs may request an increase in partner time spent and more experienced staff to be assigned in a specific year's audit due to the acquisition of a significant subsidiary. At the same time, ACs should be cognisant of the costs associated with such requests.

The AQIs complement existing resources and guidance available to ACs to evaluate their auditors, such as the 2014 Guidebook for Audit Committees in Singapore that offers a list of possible questions for private sessions with external auditors, as well as a sample checklist for evaluating external auditors. In addition, the ACRA-SGX Guidance to Audit Committees on Evaluation of Quality of Work Performed by External Auditors published in 2010 is also available.

For AQIs to be easily compared between firms and over time, they should be disclosed in a standard format to ACs. A sample AQI report is shown on the next page.

We should not rank the AQI guidelines. It should be up to the company to say 'to me this is important'.

- Participant of AC focus group

Sample Presentation Format on ACRA's AQI Disclosure Framework

AQI	SAMPLE FORMAT				
AUDIT HOURS 	Audit Hours of Senior Audit Team Members				
			FY 20X5	FY 20X4	
	Lead Audit Partner Hours		[70]	[56]	
	Concurring Partner Hours		[18]	[16]	
			Singapore Firm	Member Firms	
			Singapore Firm	Member Firms	
	Other Partner(s) Hours		[0]	[150]	
	Audit Manager(s) Hours		[170]	[300]	
Total Audit Hours		[1,402]	[3,052]		
Total Audit Hours		[1,201]	[2,804]		
Total Partner(s) and Audit Manager(s) Hours as a % of Total Audit Hours					
- Singapore Firm only		[18%]	[19%]		
- Member Firms of the Same Network		[14%]	[16%]		
[Firms can include relevant narratives/commentaries (e.g. analysis of significant variances)]					
Note:					
<ul style="list-style-type: none"> For audit tenders, budgeted hours of the proposed audit team for the first year audit will be provided. At the end of the first year audit, a comparison of actual hours against budgeted hours will be provided. At the end of the second and subsequent year audit, actual hours for the past two years will be provided. 					
EXPERIENCE 	Years of Audit Experience		FY 20X5	FY 20X4	
	Lead Audit Partner		[20]	[19]	
	Concurring Partner		[25]	[24]	
	Audit Manager(s)		[10]	[8]	
	Audit Professional Staff		[3.4]	[3.0]	
[Firms can include relevant narratives/commentaries (e.g. analysis of significant variances)]					
Note:					
<ul style="list-style-type: none"> For audit tenders, estimated years of experience of the proposed audit team for the first year audit will be provided. At the end of the first year audit, a comparison of actual years of experience against budgeted figures will be provided. At the end of the second and subsequent year audit, actual years of experience for the past two years will be provided. 					
<u>Industry Specific Experience of Senior Audit Team Members</u>					
[E.g. Mr X has been an audit partner in Firm ABC since 1990. He has approximately 30 years of experience in the audits of financial institutions. He specialises in the audits of retail and commercial banks, and sits on the audit firm's technical consultation panel on financial institution audits. Mr X is also the Chairman of the Institute of Singapore Chartered Accountants' Banking and Finance Committee. He was previously the audit partner for (name of past clients in similar industry).]					
TRAINING  	FIRM-LEVEL (AVERAGE TRAINING HOURS)				
	Training Hours		12 months ended 30 Sep 20X5	12 months ended 30 Sep 20X4	
	Audit Partners		[50]	[40]	
	Audit Managers		[60]	[56]	
	Audit Professional Staff		[80]	[84]	
	[Firms can include relevant narratives/commentaries (e.g. description of training hours committed by the firm for each staff grade if they are significantly different to actual training hours)]				
	ENGAGEMENT-LEVEL (INDUSTRY SPECIFIC TRAINING OF SENIOR AUDIT TEAM MEMBERS)				
	Industry Specific Training Hours		12 months ended 30 Sep 20X5	12 months ended 30 Sep 20X4	
	Lead Audit Partner		[15]	[14]	
	Concurring Partner		[25]	[25]	
Audit Manager(s)		[8]	[8]		
[Firms can include relevant narratives/commentaries (e.g. description of courses or topics covered)]					

**FIRM-LEVEL (INSPECTION RESULTS)**

Type of Inspection: External Inspections by ACRA		
Inspection Year	[20X4]	[20X2]
No. of Audit Partners Inspected	[10]	[10]
Inspection Results	[9 Pass, 1 Fail]	[10 Pass]

[Firms can include relevant narratives/commentaries]

Type of Inspection: Internal Inspections		
Inspection Year	[20X4]	[20X3]
No. of Audit Partners Inspected	[13]	[14]
Inspection Results by Audit Partner*	[11 Satisfactory] [2 Improvement Required]	[11 Satisfactory] [2 Improvement Required] [1 Not Satisfactory]

* Inspection results should be presented by audit engagement in instances where more than one audit engagement is inspected per partner.

[Firms can include relevant narratives/commentaries (e.g. scope and rating of inspection programme)]

ENGAGEMENT-LEVEL (INSPECTION RESULTS OF AUDIT PARTNER AND CONCURRING PARTNER)

	External Inspections		Internal Inspections	
	Year last inspected	Results	Year last inspected	Results
Lead Audit Partner	[20X4]	[Fail]	[20X3]	[Satisfactory]
Concurring Partner	[Not Inspected]	[Not Inspected]	[20X4]	[Satisfactory]

Inspection findings for: [Lead Audit Partner] / [Concurring Partner] Type of Inspection: [External / Internal] Inspections	
[Details of findings] [E.g. Inadequate work was performed to ascertain whether the client's revenue recognition policy was appropriate]	[Details of remediation actions taken by the audit team / firm] [E.g. Remediation actions taken include: - Mandatory refresher training on revenue by the audit team; - Subsequent consultation and collaboration with the firm's technical department to address the finding; - Assignment of a more experienced concurring partner on the audit; and - Communication of the finding as a case study during firm's training]

[Firms can include relevant narratives/commentaries (e.g. root causes of finding and applicability to the audit engagement)]



FIRM-LEVEL (INDEPENDENCE COMPLIANCE TESTING RESULTS / DESCRIPTION OF BREACHES)

i) Independence Compliance Testing Results

Area and description of independence testing	Scope	12 months ended 30 Sep 20X5		12 months ended 30 Sep 20X4	
		No. of Samples tested	No. of Breaches	No. of Samples tested	No. of Breaches
[E.g. Partner, Manager and Professional Staff Independence]	[E.g. To ascertain whether the partner, manager and professional staff of the firm (including their immediate family members) held shares in any of the firm's audit clients.]	[28]	[1] (Breach described below)	[30]	[0]

ii) Description of Breaches

Detected via:	Description of breach, including follow-up actions
[E.g. Partner, Manager and Professional Staff Independence testing]	[E.g. An audit assistant had held shares in an audit client of the firm he audited. The shares were disposed upon discovery of the breach. The firm had assessed that audit work had not been compromised as it was adequately reviewed by the audit manager. The audit work also did not involve any significant risk or judgement areas. The firm had issued a stern notification letter to the audit assistant, which was reflected in his annual performance review.]
[E.g. Self-Reported, if any]	[E.g. An audit manager had went for an interview with an audit client for the position of a finance manager before the audit report was finalised. The firm had removed the individual from the audit team and subjected his work performed to an additional layer of review by the firm's quality assurance team prior to sign-off. The firm had ascertained that the audit work had not been compromised. The firm had also issued a stern notification letter to the audit manager.]

[Firms can include relevant narratives/commentaries (e.g. scope of independence compliance testing)]

ENGAGEMENT LEVEL (COMPLIANCE BY AUDIT TEAM MEMBERS)

[E.g. One audit manager and two professional staff of the audit team were subjected to the firm's staff independence testing in 20X5. No breaches were detected.]

[Firms can include relevant narratives/commentaries]

QUALITY CONTROL



Quality Control Functions (QCF)	12 months ended 30 Sep 20X5		12 months ended 30 Sep 20X4	
	Partner	Manager	Partner	Manager
Risk Management	[0.6]	[3.3]	[0.5]	[3.0]
Training	[0.5]	[6.0]	[0.2]	[7.1]
Quality Assurance	[0.7]	[5.6]	[0.7]	[6.1]
Technical Enquiries	[0.5]	[7.5]	[0.4]	[7.4]
Total Headcount	[2.3]	[22.4]	[1.9]	[23.6]

Ratio of:	12 months ended 30 Sep 20X5	12 months ended 30 Sep 20X4
QCF Partners to Total Audit Partners	[1 : 12]	[1 : 11]
QCF Partners and Managers to Total Audit Partners and Audit Managers	[1 : 27]	[1 : 26]

[Firms can include relevant narratives/commentaries (e.g. overview of quality control set-up)]

STAFF OVERSIGHT



Ratio of:	12 months ended 30 Sep 20X5	12 months ended 30 Sep 20X4
Partners to manager and audit professional staff	[1 : 23]	[1 : 31]
Managers to audit professional staff	[1 : 5.0]	[1 : 4.8]

[Firms can include relevant narratives/commentaries (e.g. comparison vis-à-vis the audit team assigned to the audit engagement)]

ATTRITION RATE



	12 months ended 30 Sep 20X5	12 months ended 30 Sep 20X4
Attrition rate	[30%]	[32%]

[Firms can include relevant narratives/commentaries (e.g. the retention rate of key audit engagement team members or attrition rates of high potential professional staff in the audit firm)]

Additional Resources

- ACRA, SGX (2010), *Guidance to Audit Committees on Evaluation of Quality of Work Performed by External Auditors*
- ACRA, MAS and SGX (2014), *Guidebook for Audit Committees in Singapore, 2nd edition*
- ACRA (2015), *Practice Monitoring Programme Public Report*
- ACRA (2015), *Guidance to Audit Committees on ACRA's AQIs Disclosure Framework*
- ACRA (2015), *Guidance to Audit Firms on ACRA's AQIs Disclosure Framework*
- CAQ (2014), *CAQ Approach to Audit Quality Indicators*
- IAASB (2014), *A Framework for Audit Quality*
- PCAOB (2015), *Concept Release on Audit Quality Indicators*

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- Wang Y., Yu L., and Zhao Y. (2015), "The Association between Audit-Partner Quality and Engagement Quality: Evidence from Financial Report Misstatements", *Auditing: A Journal of Practice & Theory*, Vol. 34, No.3: 81-111.

Footnotes

- ¹ The Big-Four firms comprise Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers.
- ² https://www.acra.gov.sg/Publications/Guides/Guidance_to_ACs_on_AQI_Framework/
- ³ https://www.acra.gov.sg/Publications/Guides/Guidance_to_Firms_on_AQI_Framework/

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