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Consultation on Draft Minimum Standard for Audit Committees published in November 2022

Comments

The emphasis on the primary responsibility of the Audit Committee for holding and managing the relationship with the company's auditors is helpful; as are the mention of some of the specific ways in which should be done.

The objectives of securing a diverse and competitive set of potential auditors for a firm, and delivering higher quality audit are also clearly sound. Much less helpful and practical, and indeed quite probably counter-productive, however, are several of the specific guidelines seemingly aimed at securing access to a diversity of suppliers and higher quality audits.

It makes sense as an objective that: *"the company manages its non-audit relationships with audit firms to ensure that it has a fair choice of suitable external auditors at the next tender and in light of the need for greater market diversity and any market opening measures which may be introduced."*

It makes sense that an AC have regard to: *"developing and implementing policy on the engagement of the external auditor to supply non-audit services, ensuring there is prior approval of non-audit services, considering the impact this may have on independence, taking into account the relevant regulations and ethical guidance in this regard"* (my underlining, see below).

It makes sense that: *"There is a strong public interest in audit market diversity and the market as a whole having sufficient resilience, capacity and choice. To support this, Audit Committees should ensure companies have a sufficient number of potential auditors that are independent, or capable of becoming so, in order to allow for adequate competition and choice in a subsequent tender. Tenders should also be conducted far enough in advance of appointment for firms to exit relationships which may cause a conflict of interest."*

However, for large and especially international companies, at a mandatory rotation, it is rare to have three qualified and *really* interested firms tendering. It is, I suspect, more common to have none than three.

The injunction: - *"If some eligible audit firms are unwilling to tender for an audit, the Audit Committee should communicate with those firms to seek to obtain an understanding of why they are unwilling to tender and whether there is anything that could be done that might change that. The Audit Committee should also consider asking those firms how such action is in the public interest. In such circumstances, the Audit Committee should ensure that it has not excluded other firms from tendering without good reason to believe they would not be able to perform a high-quality audit. The Audit Committee should remind eligible firms that refuse to tender that they may as a result be ineligible to bid for non-audit services work."* - does not address the reality of the tendering process. It appears rare for an audit firm to say that it will not tender. More often: "of course we will tender if you ask us to. We will act for you in whatever way you prefer" – followed by a tender which is led by a less experienced partner, supported by a less capable team, with a larger fee.

As the large audit firms become progressively smaller parts of very large and diverse consulting firms, the desire to tender for audits is diminishing. Unsurprisingly: the audit will often lead to a material reduction in fee income and partner profit. How should we expect a firm to systematically tender for work, or invest in the systems and processes raising the quality of work, which systematically lowers its owners' profits? Why not focus instead on the higher growth, higher return, and lower risk activities of the firm?

And the draft standard looks to increase this negative trend – as follows: *“The choice of auditor should be made based on quality, rather than price”*. *“The Audit Committee should consider running a price-blind tender”*.

It feels quite surprising for a standard drafted by government in response to a CMA request in respect of an oligopolistic industry, to be, in practice, increasing that industry's market place power. Reducing its competitive incentive to increase quality and increasing its ability to take price.

That the standard guides an AC to focus on quality in a tender does not lead to increasing quality if the tender (as is often the case) is inherently not competitive.

The department might instead consider strengthening the guidance provided in respect of using any firm that could in the foreseeable future reasonably be asked to tender for the audit for any non-audit work. The current *“relevant regulations and ethical guidance in this regard”* seem ineffective in practice. A one year period to “clean” (the terminology commonly used says a lot) a firm from the effects of non-audit work before taking on an audit has become out of kilter with the nature of the work that the relevant firms are doing – often de facto of multiple year duration to be effective.

To be effective, the department might consider guiding Boards and ACs to decline to use for any non-audit work any firm that it might reasonably wish to ask to tender for its audit within five years from the end of any piece of non-audit work being commissioned.

If effective, such a guideline would lead the large audit firms to consider splitting their audit and non-audit practices. From the perspective of the AC, this feels like an essential step to achieving a competitive choice of auditor, a competition which can then be used to raise quality, whilst keeping a sensible competitive tension around price.

Today an AC and Board can increasingly feel like a supplicant in seeking a new auditor – not running a competitive process.

The department's standard seems likely to entrench further a position where there is too little/no real competition in the supply of audit to large firms, to diminish further the competitive incentive to raise quality (relying instead on regulation and litigation to achieve this – “blunt instruments”) and to support further monopolistic returns.