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Sent via email: [acstandard@frc.org.uk](mailto:acstandard@frc.org.uk)

Dear Ms Currie,

## Railpen response | Financial Reporting Council (FRC) Consultation Document: Audit Committee Standard

### About Railpen

Railpen is the trading name of Railway Pension Investments Limited, which is authorised and regulated by the Financial Conduct Authority (FCA). Railpen acts as the investment manager and administrator for the railways pension schemes and is responsible for c. £34.6 billion of assets on behalf of over 350,000 members.

Sustainable Ownership is Railpen's approach to incorporating sustainability considerations into the investments it manages on behalf of members. Railpen's work is empowered by the Trustee's related investment belief: "Incorporating and acting upon climate risk and other environmental, social and governance factors is a significant driver of investment outcomes and part of our fiduciary duty."

A well-functioning audit market that supports high-quality audits and ensures a company's accounts represent a true and fair view of its financial health is vital to investor decision-making. This is why one of Railpen's core thematic stewardship priorities is 'audit quality' and why we welcome the opportunity to contribute to this consultation. This is particularly the case as a key determinant of the quality of a company's audit is the Audit Committee's ability to effectively plan, engage with and scrutinise the work of the external auditor.

Our submission builds on our previous responses on audit issues in the UK, including the 2021 consultation from BEIS on [Restoring trust in audit and corporate governance](#) and the FRC's recent consultation on [Audit Quality Indicators](#). We have focused our response on those issues where we think our expertise can add the most value.

### Our response

As an investor, we have a particular interest in the effective operation and scrutiny of Audit Committees, as we believe this must be the primary vehicle for shareholder engagement with a company's audit (both external and internal) as well as scrutinising the effectiveness of its internal controls. In light of evidence that some Audit Committees are not functioning as

effectively as they should<sup>1</sup>, we welcome the FRC's decision to introduce a Minimum Standard for the Audit Committees of companies within the FTSE 350.

We focus here on three key aspects: i) suggestions as to how the Minimum Standard could better encourage Audit Committee engagement with shareholders; ii) other areas which we believe the Standard should additionally refer to in light of the many excellent recommendations of the Brydon Review<sup>2</sup>; and iii) some thoughts on the wider consultation approach and scope.

## **A. Audit Committee engagement with, and reporting to, shareholders**

Shareholders are the auditor's ultimate client, and Audit Committees should be encouraged to recognise the importance of shareholder input and reporting and to engage shareholders at every stage of the auditor and audit report lifecycle. This is particularly important given, as the Brydon Review stated, "it is not fully clear to me...that all asset managers are giving audit the focus and attention that it deserves."<sup>3</sup>

While the investor community needs to engage more effectively on audit issues, we think that the Minimum Standard would be a useful additional vehicle to support Audit Committees to improve the investor-firm dialogue on audit. At present, we do not think that the Minimum Standard places enough emphasis on the importance of the shareholder audience. To remedy this, we encourage the FRC to include the following in its revised Standard:

- A comment, perhaps under "Responsibilities", which requires Audit Committees to recognise that shareholders are the auditor's ultimate client. This could be supported by further references elsewhere. For instance, in "Tendering" (paragraph 9), the text could also make reference to the fact that one of the factors to be taken into account in choosing an auditor should be evidence that the firm understands that it is the shareholders who are the client, not company management.
- Explicit reference in the "Responsibilities" section to the need for Audit Committees to actively engage with the full breadth of their engaged and long-term shareholder base, including on the Audit and Assurance Policy. *Please also see our comments on "other areas" below.*
- Specific reference to the need for shareholder engagement in the early stages of the tendering process. Although directors are in charge of business strategy, the audit is of importance to shareholders. We believe that when an Audit Committee is considering what they are looking for from a future auditor, as well as planning the tendering process itself, they should ideally seek to engage with their shareholder base. This will help them gain a clearer understanding of shareholder priorities and should also support more constructive future engagements on audit issues (after the auditor has been appointed)<sup>4</sup>.

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<sup>1</sup> For instance, we note the FRC and YouGov' January 2022 research *Audit Committee Chairs' views on, and approach to, audit quality* which noted that "...we saw less challenge in relation to both auditors' judgements, and in relation to company management during the audit process."

<sup>2</sup> *The quality and effectiveness of audit: independent review* (Sir Donald Brydon, 2019).

<sup>3</sup> P.44 *ibid.*

<sup>4</sup> This should also ensure that Audit Committees are better able to respond to future accounting and audit developments. An example of this is the growing investor demand for companies, and their

- Under “Reporting”, the FRC could suggest that Audit Committees encourage publishing – or releasing to investors upon request – their *engagement-level* Audit Quality Indicators (AQIs), as well as reporting on the reasons and rationale in circumstances where i) an auditor has departed (out of cycle) or where ii) there has been any significant reduction in the auditor(s)’ fees over the year<sup>5</sup>.

## B. Other suggested areas for inclusion

We think that the current Minimum Standard is too narrowly focused on the Audit Committee’s role in overseeing the external auditor and audit process. Furthermore, within this we also believe that too much emphasis has been placed on *tendering* for the external auditor: this is, after all, just one (albeit important) part of the audit cycle.

Additional areas which we think should be included in the Minimum Standard are as follow:

- As the Brydon Review recognised, an important role of the Audit Committee is also reviewing a company’s internal control and risk management systems. This should be included in the Standard under “Responsibilities”, with further clarity offered under “Reporting” (and elsewhere) around disclosing how the Committee has, where necessary, challenged the internal audit function to change behaviour where there is a benefit to the company and its shareholders.
- Similarly, a key Audit Committee responsibility is to allocate resources between internal and external audits. This requires the Committee to take a step back and consider the overall risks in light of a company’s entities and geographies and then, in collaboration with the external auditor and shareholders, to consider how to allocate resources appropriately. This should be central to the Committee’s Audit and Assurance Plan and should accordingly be referenced in the Minimum Standard.
- In reference to the Committee’s responsibility for a company’s public reporting, it is important Committees are explicitly reminded of their duty to assess the company’s financial statements and other financial announcements, including reviewing the significant judgements contained within them.
- A comment regarding the Minimum Standard required of Audit Committee members in terms of culture, behaviour and approach. Although not a *responsibility* as such, we think that every opportunity should be taken to remind members of the broader attributes (and Committee culture) required to function effectively. This includes members who: feel genuinely independent both from

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auditors, to effectively report on whether and how they have incorporated material climate-related matters within financial statements. Railpen is a signatory of the [IIGCC's Investor Expectations for Paris-aligned Accounts](#) and continues to engage with – and where necessary, vote against the Audit Committee and auditors of – companies on climate accounting issues.

<sup>5</sup> The definition of “significant” is naturally a subjective one. At Railpen, we consider a 15% reduction in auditors’ fees over the course of a year to be significant. Since 2021, our Global Voting Policy, we will vote against the re-appointment of the auditor where we do not feel a sufficient rationale for this reduction in fees has been provided.

the company being audited and the audit firm; recognise that their role is to effectively scrutinise and, where necessary, challenge both parties; and who are motivated to keep abreast of important developments in financial reporting, both those areas as highlighted by the FRC and more broadly.

### **C. Consultation approach**

We welcome the FRC's decision to take steps to improve Audit Committee standards even before the shift to the new Auditing, Reporting and Governance Authority (ARGA), and we recognise that its ability to enforce is limited until this shift happens. However, we believe that even on a 'comply or explain' basis, the new Minimum Standard represents an important opportunity to set the mood music and signal regulatory expectations for Audit Committees. This is particularly the case given the operational time required to formally establish ARGA.

A minor point, but one which we think is worthwhile raising now in the hope that this is of use and is taken in the constructive spirit in which it is intended, is that we believe that consultations which have more than one question, and where the questions are clearly targeted towards specific areas where the consulting body would particularly appreciate the guidance, are often more useful – both to the consultation respondents and the consulting body itself. We recognise that one overarching question may have been provided in the spirit of ensuring respondents do not feel constrained or overly directed. However, a few more questions would have provided additional insight into what the FRC would find most useful from respondents.

We hope the comments we have made are helpful and would welcome the opportunity to discuss further or provide any additional clarity.

Yours sincerely,

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