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8 February 2023  
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Dear Susan,

Response to draft minimum standard for audit committees (ACs)

We welcome the opportunity to comment on the draft minimum standard for audit committees ('the standard').

As the decision to introduce the standard has already been taken by Government, our response focuses on its contents (rather than its existence), the practicality of its application, its enforcement, and the timing of implementation.

We support that progress needs to be made in implementing the UK Government's audit and corporate governance reforms. While much of the standard codifies (other than new text on audit market diversity) what high performing ACs currently do, we have some concerns which are noted below. We acknowledge that the matters we raise could have implications on the FRC's desired timetable for introducing the standard. However, in our view, careful consideration of our points, especially on sequencing of change and clarity on enforcement (points 1 and 2 below), will more likely help achieve meaningful change in the longer term.

#### 1. Sequencing of change

a. Competition and market diversity – We note the policy paper you issued in December 2022 outlining your approach to competition in the audit market. In our view, more concrete progress needs to be made in key areas of the Government's and/or the FRC's work on competition and audit market diversity before this standard is made effective (even on a voluntary basis) because of the interdependency between the standard and these aspects of the reforms.

For example, Para 7 states "*The tendering process must not preclude the participation of challenger audit firms without good reason*". ACs will be unable to implement such aspects of the standard of their own accord as clarity is needed on the appetite of challenger firms to participate in FTSE 350 tenders and on their capacity and ability to deliver high quality audits. Some of this will come from initiatives such as the FRC's research into firm entry, growth and exit from the Public Interest Entity (PIE) and non-PIE audit markets.

It is also notable that the standard makes no reference to Managed Shared Audits, even if only as an introduction. While accepting that this is a longer-term initiative, it feels remiss not to set this standard in some broader overall context in which FTSE 350 ACs of UK incorporated companies will have to make auditor appointment decisions in the near future.

b. Audit and Assurance Policy (AAP) - In our view the AAP is a cornerstone in demonstrating to stakeholders how the AC has discharged its assurance responsibilities. We are therefore surprised that there is no reference to it.

One of the three "pillars" of the AAP is the external audit and the Government's response noted that the AAP will require "a description of the company's policy in relation to the tendering of external audit services including whether a company is prepared to commission non-audit services from its statutory auditor." (Para 3.2.13 of the Government's response of May 2022).

In our view, to implement an AAP properly, ACs will need to develop their thinking holistically on the current and future “assurance landscape” i.e.,

- ▶ the level/type of assurance they desire over corporate reporting in the medium term,
- ▶ the choice of assurance providers and what inherently fits with the auditor’s role (e.g., given link to financial statements),
- ▶ the plans to tender the external audit. and
- ▶ the interaction of these matters on the “diversity” of choice both for the external audit and broader assurance services.

To provide a specific example; Para 4 of the standard states that a key responsibility is “*developing and implementing policy on the engagement of the external auditor to supply non-audit services...*”. This should be an intrinsic part of the AC’s thought process in developing the AAP and therefore the AAP should be specifically referenced in the standard in our view.

c. Audit quality – More progress needs to be made on meaningfully defining audit quality and framing the outcomes of a high-quality audit. We are aware that the Audit Committee Chairs’ Independent Forum (ACCIF) is nearing the final stages of a project it has led on agreeing a set of proportionate audit quality objectives and outcomes which every audit engagement and audit inspection should (at minimum) include (“Project Spring”). The seven largest audit firms and the Financial Reporting Council (FRC) have been involved in Project Spring and we understand that all involved parties including the FRC, have committed to some actions. We hope that once the outcomes of this project are finalised and the actions implemented and embedded over time, ACs will have a better commonly agreed framework by which they can assess audit quality.

From a sequencing perspective, time is also needed for firms to implement and for ACs to use the firm-level audit quality indicators (AQIs) that were published by the FRC in December 2022. A few reporting cycles will be needed for ACs to establish whether and how these AQIs help them assess audit quality. In reference to Para 16 which suggests reporting by auditors on engagement level AQIs which have been agreed with the AC, it would be useful to hear from the FRC about the outcomes from the pilots it ran in 2022, before this standard is issued.

In our view, instead of introducing the standard in 2023 for use on a voluntary basis for 2023 year-ends, the remainder of 2023 should be used to make progress on the three matters above and to create clarity on how it will be enforced (see 2 below). The standard can then be issued in final form in 2024. This would create better conditions for ACs to be able to comply with it more meaningfully.

## 2. Lack of clarity on enforcement

a. As noted above, in large part this standard codifies existing good practice. The key change for FTSE 350 ACs will be that this is now a standard which will be enforced by the Audit, Reporting and Governance Authority (ARGA) once it has the statutory powers. Given enforcement is the key mechanism to “increase performance across audit committees in the FTSE350”, and to “ensuring a consistent approach and supporting a well-functioning audit market”, we would have expected some discussion in the consultation paper of how it will be enforced, even if on an indicative basis pending the full grant of ARGA’s powers.

ACs and individuals who are seeking to join FTSE 350 ACs, ought to be clear what enforcement by ARGA could entail and the implications for them as individuals if the AC was found to be non-compliant or indeed could not comply. This would enable them to start thinking about the procedural changes they may need to make in preparation for when the standard is fully enforceable.

b. Delineating “matters to consider” vs minimum mandatory requirements – In many places the standard uses the words “should consider”. For example, “*The Audit Committee should consider running a price-blind tender.*” (Para 13); or “*Details of how effective oversight has been achieved throughout the year should be documented and the Audit Committee should consider reporting on this where appropriate* (Para 21).

Such language is not commensurate with a minimum standard which is subject to enforcement as an AC could consider these matters but ultimately make a judgement not to implement/comply. The FRC

should review the drafting of the standard to remove wording that is ambiguous in the context of its status as a minimum standard subject to enforcement, and such wording be delegated to guidance.

Conversely, there are matters which we believe are best left to the judgment of an AC. For example, Para 14 states *“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.”* If there are sound reasons for an audit firm not to participate in an audit tender for example, because it would not be in the public interest if it could not guarantee the delivery of a high-quality audit due to capacity reasons, it would be inappropriate for an AC to issue such a reminder. The standard should “stop” at requiring ACs to understand the reasons behind an audit firm’s decision not to bid. The ensuing actions should be left to an AC’s judgement or at best be detailed in good practice guidance.

### 3. Clarity on the role of an AC in a tender process

The drafting on the role of an AC during a tender process would benefit from clarification in the following places:

- ▶ AC involvement in the tender process - Para 10 states *“all members of the Audit Committee should be involved throughout the tender process, not just attending the audit firms’ final presentations”*. We question the need for all members of the AC to be involved throughout the process. There are practical implications e.g., with some AC members being based overseas, but irrespective some companies which have large ACs may decide to allocate responsibility among AC members for efficiency reasons. Instead, we suggest, wording to the effect of *“relevant AC members should be involved at key milestones during...”*.
- ▶ AC role on fees - Para 6 states that the role of the AC in leading the tender includes *“negotiating the fee”*. Para 4 uses the term *“approving the fee”*. There should be consistency throughout the standard on the AC’s role on fees i.e., to negotiate the audit fee.

### 4. Reporting

a. It is unclear why some reporting matters are covered in the standard. Specifically, under Para 22, the annual report must detail:

- ▶ *“The significant issues that the Audit Committee considered relating to the financial statements and how these issues were addressed”* - this is already covered in the UK Corporate Governance Code (the Code). Even if the FRC plan to remove it when the Code is revised, it does not relate to scope of this standard i.e., auditor appointment and oversight.
- ▶ *“An explanation of the application of the entity’s accounting policies”* - this is not covered currently in the Code, but irrespective, we do not understand its relevance to the scope of the standard. It is management’s role to apply accounting policies derived from accounting standards. The more pertinent point from an AC’s perspective, is around significant accounting policy judgements made in preparing the financial statements, but this would be covered in the point above.
- ▶ *“Where shareholders have requested that certain matters be covered in an audit and that request has been rejected, an explanation of the reasons why”* - here and in Para. 4 there is an implicit responsibility for ACs to engage with shareholders on the scope of the external audit. If this is intended, it should be explicit rather than implied. In our experience, there is a lack of investor interest/appetite - and in some cases, knowledge - to engage on audit related matters. It therefore seems unfair to place this obligation on ACs without a commensurate obligation for investors to engage. The Government’s response (Para 7.3.19) noted that *“...when appropriate, the regulator will also put forward revisions to the Stewardship Code and ...will consult on specific proposed changes in due course”*.

If this requirement is retained in the standard, the AC’s responsibility should be explicit rather than implicit; there should be a clear reference made to the AAP; a mirror obligation should be

placed on shareholders to engage on audit related matters; and the timing of implementing changes to the standard and revisions to the Stewardship Code should be aligned.

b. Reporting on the effectiveness of the audit process (as used in Paras 4, 15, 16, 22) vs on assessment of the quality of the audit – There is a difference between these concepts and while the Code has long used the term “assessing the effectiveness of the audit process”, given the active focus on audit quality for some years now, the FRC should take the opportunity to standardise the use of terms and for ACs to undertake and report on their assessment of audit quality.

5. Holistic overview and risk of duplication:

In complement with our response in 4 above, it would be useful (before the standard is issued in final form) to understand how its contents will interact with the requirements of:

- ▶ The Code (recognising that it is to be revised later this year),
- ▶ The Disclosure Guidance and Transparency Rule (DTR) 7.1.3
- ▶ s489A of Companies Act 2006 relating to auditor appointment by public companies, which has specific procedural steps relating to an audit tender process and
- ▶ The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014.

It also raises the question on whether the content of the Code on matters which fall in the scope of this standard, will be retained for foreign incorporated premium listed companies as the standard only applies to UK incorporated FTSE 350s.

While acknowledging that the standard usefully pulls together in one place aspects of existing FRC documents e.g., the Code, the FRC’s Practice Aid for ACs on Audit Quality and the Best Practice Note on Audit Tenders, it also creates yet one more document to which ACs will have to refer to. For example, with reference to reporting Para 22 states *“The annual report should describe the work of the Audit Committee as set out below, along with any other matters set out in the Corporate Governance Code”*. It would be helpful for the FRC to pull together all other remaining requirements emanating from different sources (as noted above) that relate to the AC’s overall remit. This could be done via an online appendix which can be updated more readily and allow for cross references (via hyperlinks) to source documents.

6. Clarity of title

The title “Minimum Standard for Audit Committees” is misleading given it deals with only a small part - external auditor appointment and oversight – of an AC’s overall remit which covers risk management, internal control, corporate reporting and increasingly, broader matters too such as the impact of climate on the financial statements.

If the words “minimum standard” are to be retained, we suggest that it is titled as a “Minimum Standard for UK incorporated FTSE 350 audit committees in relation to external auditor appointment and oversight”. This is also important as Companies Act requirements relating to auditor appointment and the DTR 7.1.3 are also minimum regulatory requirements.

We hope our comments are useful and we are happy to discuss them further if you would find this helpful.

Yours sincerely



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