



Financial Reporting Council

Audit Committees and the External Audit: Minimum Standard

May 2023

Introduction

Scope and Authority

1. This Standard is applicable to Audit Committees of companies with a Premium Listing on the London Stock Exchange, and which are included within the FTSE 350 index. It should be read in conjunction with the UK Corporate Governance Code and the FRC Guidance on Audit Committees.
2. Assuming primary legislation is passed to bring the Audit, Reporting and Governance Authority (ARGA) into being, the Standard would, subject to the appropriate powers being provided in the legislation, become mandatory. Companies within scope are encouraged to begin to apply the Standard as soon as they are able.
3. Companies which are not within the FTSE 350 index are not required to apply this Standard. However, those companies which aspire to join the FTSE 350 may wish to do so in order to minimise disruption in the event that they succeed in doing so. Even where a company has no plans to grow to that size, if it is subject to mandatory tendering and rotation of audit firm appointments, it may wish to apply the Standard anyway – the provisions are examples of good governance.

Responsibilities

4. Audit Committees are subject to the UK Corporate Governance Code and other guidance, and legislation. This Standard focuses on the following Audit Committee responsibilities:
 - Requiring 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.
 - Conducting the tender process and making recommendations to the board, about the appointment, reappointment and removal of the external auditor, and approving the remuneration and terms of engagement of the external auditor.
 - Engaging with shareholders on the scope of the external audit, where appropriate.
 - Ensuring that the external auditor has full access to company staff and records.
 - Inviting challenge by the external auditor, giving due consideration to points raised and making changes to financial statements in response, where appropriate.
 - Reviewing and monitoring the external auditor's independence and objectivity.

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- Reviewing the effectiveness of the external audit process, taking into consideration relevant UK professional and regulatory requirements.
 - 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, and reporting to the Board on any improvement or action required.
 - Reporting to the Board and the members of the company on how it has discharged its responsibilities with respect to the external audit.
5. The Audit Committee's responsibilities for oversight of the audit, and for the audit tender process, are discussed in more detail below.

Tendering

6. Public Interest Entities (PIEs) are currently required to put their audits out to tender every ten years, and to rotate auditors every twenty. The tendering process should be led by the Audit Committee and not by the entity's executive management. This includes initiating a tender process, influencing the appointment of an engagement partner, negotiating the fee and scope of the audit, and making formal recommendations to the board on the appointment, reappointment and removal of the external auditors. Audit Committees may, of course, make use of the entity's employees for research and evaluation.
7. The tendering process must not preclude the participation of "challenger"¹ audit firms without good reason. 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, 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.
8. The selection criteria should be transparent and non-discriminatory. When considering possible new appointees as external auditors, the Audit Committee should oversee the selection process, and ensure that all tendering firms have the necessary access to information and individuals during the tendering process and that all tenders, including non-Big Four firms, are given fair and objective consideration.
9. The choice of auditor should be based on quality, including independence, challenge and technical competence, not price or perceived cultural fit. Public reports published by the FRC and where relevant other regulators, including those overseas, on the quality of each firm's audit should be scrutinised as part of the process. Audit Committees should also review audit quality indicators published by firms and / or the FRC.

¹ "Challenger" firms in this context refers to those other than the four largest firms

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10. All members of the Audit Committee should be involved throughout the tender process, not just attending the audit firms' final presentations.
 11. A typical tender process may involve three or four audit firms. In some industries, however, there may be circumstances such as limited numbers of firms with the necessary expertise that make it difficult to identify more than two. Companies should manage their relationships with audit firms to allow them sufficient choice in a future tender and to take account of the need to expand market diversity and any market opening measures that may be introduced.
 12. Audit Committees should submit two possible audit firm options for the engagement to the Board, together with a justified preference for one of them.
 13. The Audit Committee should consider running a price-blind tender.
 14. If some eligible audit firms are unwilling to tender for an audit, the Audit Committee should communicate with those firms to understand why they are unwilling to tender and whether there is anything that could be done to 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.

Oversight of Auditors and Audit

15. External audit is a public interest function. The Audit Committee is responsible for overseeing and assessing the entity's external audit and its auditors. It should work to create a culture which recognises the work of, and encourages challenge by, the auditor. The Committee should review and monitor the external auditor's independence and objectivity as well as the effectiveness of the external audit process.
16. Key to the Audit Committee's oversight of the external audit is an assessment of the effectiveness of the audit process. An assessment of external audit quality in the particular circumstances of the company requires consideration of the auditor's mind-set and culture; skills, character and knowledge; quality control; and judgment, including the robustness and perceptiveness of the auditors in handling key judgements, responding to questions from the audit committee, and in their commentary where appropriate on the systems of internal control.
17. In the course of its assessment of effectiveness, the Audit Committee should:
 - Ask the auditor to explain the risks to audit quality that they identified and how these have been addressed.

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- Discuss with the auditor the key audit firm and network level controls the auditor relied on to address the identified risks to audit quality and enquire about the findings from internal and external inspections of their audit and their audit firm.
 - Review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks.
 - Obtain feedback about the conduct of the audit from key people involved, for example the finance director and the head of internal audit, including consideration of the external auditor's reliance on internal audit.
 - Review and monitor the content of the external auditor's management letter, and other communications with the audit committee, to assess whether it is based on a good understanding of the company's business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.

18. The Audit Committee should also obtain evidence of the effectiveness of the external audit and the auditor from those impacted by the audit/auditor. The following approaches may be suitable, and should be documented if used:

- Evidence of occasions where the auditor has challenged management and the result of those challenges.
- How the auditor has responded to its previous assessments of the audit quality and whether any concerns expressed by the Audit Committee have been addressed satisfactorily.
- The auditor's own assessments of the quality of the audit, and its quality assurance systems more broadly.
- Engagement level Audit Quality Indicators agreed with the Audit Committee against which the auditor will report on a regular basis.
- If the company's audit has been subject to a review by the FRC, the auditor's response to the findings and details of any action it plans to take in response.
- Tailored surveys of a sample of those subject to audit to gain their perspective.
- Feedback from external sources including investors.

19. The Audit Committee should satisfy itself that the quality of the audit is of a sufficiently high standard supported by evidence and be able to justify how the Committee arrived at its conclusion.

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20. The Audit Committee should refer to the annual audit plan and to any commitments made during the tender process and consider whether these have been met. The Committee should consider whether the volume and type of resource (in terms of seniority and where relevant specialism) envisaged in the audit plan has been deployed.
 21. The Audit Committee should review the FRC's annual report on the auditor. It should discuss the report with the auditor and obtain an understanding of how any issues identified are being addressed.
 22. There should be regular open communication between the Audit Committee and the auditor, as well as with the entity's management.
 23. 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.

Reporting

24. 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.
 - The significant issues that the Audit Committee considered relating to the financial statements, and how these issues were addressed.
 - An explanation of the application of the entity's accounting policies.
 - Where shareholders have requested that certain matters be covered in an audit and that request has been rejected, an explanation of the reasons why.
 - An explanation of how it has assessed the independence and effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of retendering plans.
 - Where a regulatory inspection of the quality of the company's audit has taken place, information about the findings of that review, together with any remedial action the auditor is taking in the light of these findings.
 - In the case of a board not accepting the Audit Committee's recommendation on the external auditor appointment, reappointment or removal, a statement from the Audit Committee explaining its recommendation and that of the board, and the reasons why the Board has taken its different position (this should also be supplied in any papers recommending appointment or reappointment).

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- An explanation of how auditor independence and objectivity are safeguarded, if the external auditor provides non-audit services.

25. If a tender process has taken place within the year, the Audit Committee should explain the criteria used to make the selection and the process followed.

26. The Audit Committee should report on the activities it has undertaken to meet the requirements of the Standard.



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