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THE INVESTMENT ASSOCIATION

FRC: Audit Committee Standards

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. The investment management industry supports 122,000 jobs across the UK. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.

Introduction

Investment managers are seeking to invest in companies which will deliver long-term value to their clients. Delivering these returns to clients necessitate that investors have access to verified and reliable financial information, as presented in a company's annual report and accounts, to make informed investment decisions. The quality and robustness of the audits of these accounts are therefore essential to making good investment decisions and to hold management and boards to account. Investors expect companies to have a well-planned and resourced auditor, capable of providing a quality audit and bringing the requisite attention and scrutiny to a company's financial concerns.

Audit committees play a vital role in the audit process, from overseeing the audit tender, recommending the ongoing appointment of the auditor, through to ensuring the auditor has demonstrated enough challenge and professional scepticism in completing the audit. Investors encourage and expect audit committees to be active in this role, and that its actions are driven by the need to provide shareholders with a robust and high- quality audit.

For a number of years, the IA and its members have continued to expect that audit committees assess the quality of the audit they receive. The fact that audit quality has remained as a shareholder priority for several years is indicative of the lack of desired progress in this area. Investors expect a statement from the audit committee on whether they believe the auditor has provided a high-quality audit, including through challenging managements judgements and assertions in exercising professional scepticism. During the 2022 AGM season, while a growing number of companies were able to disclose how the auditor had demonstrated professional scepticism and challenged managements assumptions, fewer were able to set out how they had assessed the quality of the audit. The accurate reporting of this information is crucial to investors as they continue to rely on the financial information presented in a company's annual accounts and report to assess the quality of the audit and in turn to make capital allocation decisions.

To this end, the IA and its members welcome the increased focus from the FRC in response to the CMA's recommendation, to introduce minimum requirements for Audit Committees, which build upon existing requirements under the Corporate Governance Code. This should help to better capture the audit committees responsibilities to the extent that they relate to external audit. Similarly, as detailed in our response to BEIS' white paper, the IA strongly supports the regulator being given powers to mandate and impose minimum standards on FTSE 350 audit committees in relation to the appointment and oversight of auditors. It is imperative that FRC play a role in emphasising the need for audit committees to continuously monitor audit quality, and consistently demand challenge and scepticism from auditors.

While we welcome the focus of the standards on the role that auditors should play as part of the external process, our members have noted that at present the current title of the Standards is not reflective of this. Beyond the tendering and oversight of the audit process, our members are concerned that the Standards do not touch on the other responsibilities an audit committee may have. There is a risk that companies may look to these Standards as the only obligations they need to fulfil, when in reality the scope of these Standards is limited. As such, the title of the Standards should be amended to make clear that they focus on the relationship between an audit committee and the external auditor.
Our members have the following comments on the Draft Standard:

1. Scope & Authority

We support that the standards build upon existing requirements and guidance for Audit Committees, familiarity with existing standards should in theory enable preparers to provide this information as soon as practicable. We further support minimum standards applying across the FTSE 350 on a mandatory basis (once legislation has been passed to bring the Audit, Reporting and Governance Authority into existence), and also welcome the references in the standard which encourage the FTSE Small Cap to adopt the standards. The importance of audit committee standards and the risk of corporate failure are not limited to companies with larger market capitalisation. If a company plans to grow or is subject to mandatory tendering or rotations of audit firm appointments, it should apply these Standards as a practice of good governance.

2. Responsibilities

We support the responsibilities as set out in paragraph 4 of the standards.

We would also like to signal our support for the minimum standards including "where appropriate, engaging with shareholders on the scope of the external audit" as a responsibility of the audit committee. We think that this strikes the right balance in terms of not creating engagement for engagements sake. The Brydon Review suggested that shareholders be provided with a formal opportunity to engage on the scope of the audit plan by providing "areas of emphasis" that they wish to be considered as part of the audit, and for these views to be taken into consideration by the audit committee. While we recognise that this proposal goes some way to encouraging better dialogue between the audit committee and shareholders, we are concerned that the current drafting could lead to boilerplate disclosures which are not necessarily going to provide investors or other users with decision useful information. However, we are pleased to note Paragraph 22, where the FRC has taken forward Sir Donald's recommendation on audit committees setting out the reasons why they did not take certain shareholder suggestions on the scope of the audit forward and explaining why, as part of their disclosures within the annual report. We strongly believe that this level of detail is likely to facilitate more meaningful engagement with shareholders.

Investors are increasingly using a growing range of information found within the company's report to inform investment decision-making (for example, sustainability-related information). However, the extent to which such information is subject to audit or assurance remains low (particularly for sustainability risks manifesting over the medium to long-term). If the audit and assurance is to remain relevant to shareholder needs, the scope of the information subject to audit should also remain an important point of engagement between shareholders and auditors. This should be captured as part of the ongoing oversight that the audit committee has over the audit and auditor.

We would note that the range of issues which investors are keen to engage on is not limited to the scope of the external audit. As set out in the IA's annual Shareholder Priorities, investors expect companies to set out their assessment of how the auditor has demonstrated professional scepticism, how the auditor has challenged managements assumptions and judgements (where necessary) and most vitally how the audit committee has assessed that the auditor delivers a quality-audit. We note that this is somewhat reflected in the following bullet in the Standards: "inviting challenge by the external auditor, giving due consideration to points raised and making changes to financial statements in response where appropriate".

Commented [SM1]: what do we say in shareholder priorites on audit quality and what have we seen in terms of trends.

3. Tendering

Overall, we are supportive of the requirements on audit tender, noting that to a large extent they mirror the IA's own Guidelines on Audit Tenders for investee companies. The IA's Guidelines on Audit Tenders outline the importance of transparency around the audit tendering process to ensure that the integrity, independence and objectivity of the auditor is not impacted, which would ultimately impact on audit quality.

We would like to explicitly state that we welcome that paragraph 7 states that in scope firms "must not preclude the participation of "challenger" audit firms without good reason." Investors are concerned that the lack of competition in the audit market is detrimental to audit quality. To this end we welcome some of the market opening measures within the BEIS Reform package which will help challengers to build up their capacity and resilience before tending for a FTSE 350 audit. The FRCs latest Policy Paper on Audit add demonstrates that the Big Four still largely appear to be auditing the FTSE 100, which suggests that a lack of choice in the audit market still prevails. The FRC should focus on encouraging audit committees to set out why in some circumstances a challenger firm may not appropriate. Audits for FTSE 350 firms are often considered complex to conduct, and so were 'complexity' to be considered a good reason to preclude challenger firms from pitching for the tender, this could be seen as an excuse and is likely to be unhelpful in building choice and resilience within the audit market.

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We are also particularly supportive of paragraph 9 in that "The choice of auditor should be made based on quality, including independence, challenge and technical competence, rather than price or perceived cultural fit". Investors want an auditor that will provide the highest quality audit selected and prospective auditors should demonstrate clearly that they can provide a quality service. This requires that criterion such as audit quality, and factors that contribute to quality such as, independence, objectivity, and competence are prioritised as criterions over price.

Furthermore, we agree that audit committees should continue to review Audit Quality Indicators published by firms, particularly as a way of assessing quality at the firm level. However, as we have previously noted in response to the FRC's consultation on AQIs, disclosing indicators at both the individual audit and firm level is likely to be the most helpful to shareholders in providing an overall assessment of audit quality at the individual firm while also leading to meaningful engagement between investors and the audit committee. To facilitate this, we have already urged the FRC to publish AQIs on a disaggregated basis, or where it cannot do this, provide proxies for individual data.

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At paragraph 11, we note that in some industries given the difficulties in obtaining technical expertise within audit firms, the number of audit firms pitching during the tender process could be limited. Investors are concerned that this could lead to a circumstance where auditors "cherry pick" audits by avoiding more complex ones, which could in turn result in certain companies struggling to find an auditor. This is likely to have a knock-on impact on how the audit market is perceived and could lead to market failure. To this end, we would urge the FRC to try and identify instances where this is likely to happen as early as possible, potentially through a monitoring function which reports back regularly to stakeholders, including shareholders.

4. Oversight of Auditors and Audit

We generally support the requirements set out under the oversight section.

Paragraph 15 states that "external audit is a public interest function". We encourage the FRC to also make a similar statement about the role of the audit committee to shareholders. Whilst it will be evident to the directors that comprise the audit committee that they have a duty to act to promote the success of the company for the benefit of its members as per s.172 of the Companies Act, we encourage the FRC to explicitly state that the audit committee has a particular role to protect the interests of shareholders in relation to the external audit, in particular through upholding independent scrutiny of the audit process which helps facilitate a high quality audit.

We are pleased with the suggestions at Paragraph 16, which should go some way to helping the audit committee demonstrate how it has received a high-quality audit. As noted, this is something which is of paramount importance to investors yet is lacking in current disclosures from corporates.

In terms of the auditor's own assessment of the quality of audit, some members question the utility of statements from the auditor on 'limited' vs 'reasonable' assurance- particularly as there is a risk of auditors carving out judgements on certain information that may have been deemed as useful to investors. Instead, members would prefer to see a statement from directors on the audit committee setting out what they expect from the auditor in terms of its work and how this will be useful to investors.

5. Reporting

As previously mentioned, the report of the audit committee is a vital piece of disclosure that should provide investors with sufficient information to assess whether the audit committee has upheld its responsibilities and to provide challenge and appropriately engage with management and auditors where necessary.

As part of its Shareholder Priorities, the IA has consistently called for audit committee reports to improve their reporting, in particular to properly disclose how it has assessed the quality of the audit, how the external auditor has demonstrated professional scepticism and challenged the assumptions of company management. In addition, the IA's Guidelines on Audit Tenders outline the importance of transparency around the audit tendering process to ensure that the integrity, independence and objectivity of the auditor is not impacted, which would ultimately impact on audit quality.

We therefore welcome that the minimum standards expand on the provisions within the Corporate Governance Code (the 'Code') to include how the committee has met the requirements within the standard. Whilst provisions within section 25 of the Code and sections 4 of the FRC's 2016 Guidance on Audit Committees have been welcomed, in practice audit committee disclosures have often been generic and fail to provide meaningful, informative statements on the quality of audit and how it was assessed. As noted, above, we support the requirements set out in paragraph 22 as a means of facilitating more informative engagement between investors and corporates. In conjunction with paragraph 24, this Standard should lead to a further increase in the comprehensiveness of audit committee reports. Taken together, these disclosures will increase investor confidence in the entirety of the reporting package and ensure investor decision making is made against the most robust disclosures.