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Dear Susan,

FRC CONSULTATION DOCUMENT ON THE DRAFT MINIMUM STANDARD FOR AUDIT COMMITTEES

Thank you for providing me with the opportunity to comment on my own behalf on the above consultation document. My views are set out below.

1.It is puzzling that the proposed standard for such a key area of corporate governance, namely audit committees, would apply only to premium listed FTSE350 companies with a suggestion that it may be applied by companies that aspire to become FTSE 350 companies. Surely it would be in the public interest that it be applied to all premium listed companies that are subject to the UK Corporate Governance Code.

2.Furthermore, it is astonishing that, whilst reference is made to fulfilling a CMA recommendation, no mention is made of any of the contents or recommendations set out in Sir Donald Brydon's (2019) independent report on 'improving the quality and effectiveness of audit' which deals with audit and risk committees. Key omissions appear to include the following references to audit committees:

(i)reviewing the company's internal control and risk management systems. See 27.0.1;

(ii)assessing the company's financial statements and other financial announcements including reviewing the significant judgements contained within them. See27.0.2;

(Sir Donald Brydon's 2019 Report says that amongst other activities these are " critical to providing assurance on a company's resilience". See 27.0.3)

(iii)providing insight into "how" the committee has reached a successful conclusion regarding the handling of financial reporting and risk. See 27.1.2;

(iv)disclosing “how” the committee has, where necessary, challenged the executives, the senior management, the internal audit function or the external auditor to change behaviour or reporting for the benefit of the company as a whole. See 27.1.2;

(v)publishing audit committee minutes with a time-lag of eighteen months and with approved redactions. See 27.1.2.

3. It is also strange that the draft minimum standard makes no mention of an assessment of risk, oversight over the scope and activities of internal audit and the allocation of work between internal auditors, external auditors and other assurance providers to cover off the various business areas, entities and geographies. This is pivotal to the work of an audit committee and to the thinking behind a key part of Sir Donald Brydon’s report.

4. The argument that the minimum standard should be applied only to the audit committee oversight of external audit appears suboptimal. Not only does it seem to ignore the report of Sir Donald Brydon, but also it omits key activities that are needed by audit committees to help ensure that sufficient scepticism, professional judgement and challenge have been applied during the processes of the preparation and external audit of the annual report and accounts and of internal audit.

5.In addition, the consultation document does not refer to any audit committee role in relation to various other key proposals made by Sir Donald Brydon including the publication of a three-year rolling Audit and Assurance Policy and director reporting on the actions they have taken to prevent and detect material fraud against their assessment of their fraud risk assessment.

6. The above omissions should be rectified as soon as possible. With respect, too much drift is taking place on these matters and there appears to be too much emphasis on tendering processes at the expense of meaningful ongoing oversight. Also the opportunity is being missed to encourage companies to be ‘early movers’ rather than just to wait for legislation which is already long overdue. It is also most worryingly that the concept of a minimum standard for audit committee couid result in a reduction in the scope of audit committee activities when the risks faced by many UK premium listed companies have never been higher and more rather than less trust is needed in UK corporate governance.

7.As an ‘arms length body’ of the Government and a regulatory authority, the FRC/ ARGA needs to follow HM Treasury’s Green Book on Appraisal and Evaluation. See section 1.1. It is therefore also surprising that the consultation document contains no specific questions that would assist the development of a meaningful impact assessment. Major issues that need to be evaluated properly include the extent to which the proposed standard and any associated regulation would or not:

* increase the time commitment and remuneration of audit committee members;

* undermine their preparedness to serve on such committees;

*result in unintended consequences;

*meet increasing public expectations in respect of energy efficiency, greenhouse gas emissions and the natural environment (see section 9 A1 of HM Treasury's Green Book and paragraphs 15 to 18 below);

*meet the needs of investors;

*improve trust in UK corporate governance;

*create burdens on business;

*impact upon the UK as a ‘destination of choice’ for business and for listing;

*avoid the risk within regulatory impact assessments of ‘optimism bias’ particularly when there is a independence ‘self review’ threat arising when the same team drafts the standards and performs the impact assessment.

8.The proposed ‘responsibilities’ set out in the minimum standard should also include, during the planning stage and other key junctures of the audit, an assessment of whether the financial reporting and audit timetables are sufficient, and whether workload issues or the delivery of late or poor-quality documents from the audited entity mean that time pressure results in scepticism and challenge being more likely to be sacrificed. The compelling rationale for this is clearly explained in section 5.3.3 of the independent research agency BritainThinks’ Report on Audit Firm Culture which was conducted on behalf of the FRC itself. It would also respond directly to the key point made by James Ferris, the FRC’s Head of UK Auditing Standards in 2021 in the ICAEW Insight on ‘changes to the fraud auditing standard explained’ that, “ If more time had been taken in some recent high profile cases to assess the plausibility of explanations and contradictory evidence, the outcome may have been different”. Danielle Friend (2022) a director of Create Balance Limited has also made a powerful related point,” Professional scepticism requires thought, thought requires time”.

9.Paragraph 5.4.2 of the BritainThinks Report(2022) on Audit Firm Culture also makes the key point that audit committees are felt to work best when the audit committee feels to act genuinely independent from the audited entity and the audit firm, and sees their role as holding both parties to account to achieve the best possible outcome, and an environment in which challenge is welcomed. It is therefore recommended that the ‘responsibilities’ section also clearly make this point.

10.Paragraph 5.2.1 of the compelling and particularly timely BritainThinks report also makes a telling observation that the majority of auditors surveyed have had negative experiences with committees that they felt were out-out-of-touch and less capable of engaging in the granularity of an engagement; ultimately creating further barriers to challenge and scepticism rather than facilitating them. Some within the survey sample also had experience of working with committee members that they felt lacked motivation to engage with the granularity required during an audit, evidenced by a lack of questions during meetings and an absence of scrutiny towards auditor reports. Ultimately, this lack of motivation to actively engage(sic) was felt to stymy conversations and challenge during the audit engagement, giving rise to the concern that committees often give the audited entity an 'easy ride'.

11.A worrying comment made by a
senior manager/ director was as follows;

"It feels like the committees that don't challenge are the ones that don't have the drive. It's almost like a retirement move, rather than a position you work towards because you're good. " (See the BritainThinks report pages 52 and 53.)

12.Given these highly relevant and independent research report results, with respect the draft minimum audit committee standard seems rather underwhelming. One has to question seriously whether the FRC/ARGA will actually meet the first of the strategic objectives set out in page 5 of its Draft 3-Year Plan, namely to "set high standards in corporate governance….". In particular matters that could be dealt with include:

*the importance of audit committees that engaged and expert members with enough financial literacy to engage in the detail of an audit, and to interrogate that detail in sufficient rigour;

*the need to engage actively with the audit engagement partner on the priorities for the audit including the exercise of scepticism and challenge;

*being active in pushing back against workload and time pressures within the audited entity itself or the audit firm that inhibit proper completion of the audited financial statements and other financial pronouncements;

*supporting rather than being a barrier to the exercise of scepticism and challenge;

* ensuring that the frequency and timing of meetings is sufficient;

*maintaining an ongoing engagement between the audit committee chair and the audit engagement partner between committee meetings;

*actively responding to any significant external criticisms of the company's business model or accounting, material whistleblowing and other 'signalling concerns' as described in the Brydon Report;

*carrying out an oversight role on the steps being taken to address climate-related risks (see more on this in 15 to 18 below;

*ensuring that the hot topics identified by the FRC/ARGA including new financial reporting standards and current economic challenges are actually considered in a timely manner by the audited entity's management and its auditors;

*maintaining an ongoing interaction with the head of internal audit and taking proper account of the role, scope and output of internal audit;

*taking steps taken to develop and publish an audit and assurance policy as recommended by Sir Donald Brydon's (2019) report;

*encouraging and challenging the development of anti-fraud measures;

*putting in place a sufficiency of frequency of reporting to the main Board;

*having an active programme of meetings with investors and reporting thereon;

*reporting on the extent and level of granularity of challenge by the audit committee.

13. It needs to be appreciated that successful financial reporting and auditing are dependent on a co-production between management and external auditors, and that audit committees have a key role in ensuring that this happens. See Knechel WR et al 2019. Also the US SEC(2019) has made the key points under the heading of ' Tone at the Top' that "it is important for the audit committee to set an expectation for clear and candid communication to and from the auditor, and likewise to set an expectation with both management and the auditor that the audit committee will engage as reporting and control issues arise. The SEC also says that it is similarly important that audit committees proactively communicate with the independent auditor to understand the audit strategy and status, and ask questions regarding issues identified by the auditor and understand their ultimate resolution". With respect, it is essential that the SEC's (2019) 'Statement on role of audit committees in financial reporting and reminders regarding oversight responsibilities' should be factored into the minimum standard.

14.The above would help raise the standard of functioning of UK audit committees which would respond to some of the deep concerns explicitly raised about such committees in the independent BritainThinks report and in the FRC's own work in publishing a collection of perspectives on ' Audit firm culture: Challenge. Trust. Transformation'.

15.Importantly, it has also been reported by Principles for Responsible Investment (2020) that Global investment firms that represented over $US103 trillion in assets under management have called publicly on the pressing need to reflect climate-related risks in financial reports. Also, The Investors Group on Climate Change (2020) has published detailed expectations for both audit committee directors and auditors. These include, where climate risks represent a material headwind to a business and the reporting of these risks is deemed inadequate or the financial statements are viewed as inadequate, holding the following directors to account:

- the chair of the audit committee as the most obvious director to hold accountable for inadequate representation or inadequate climate risk reporting;
- the audit committee members where the reporting failure is severe or fails to improve over time as following engagements on this topic shareholders may want to vote against the entire audit committee
- the board chair as ultimately the annual report and accounts are the responsibility of the entire board even where the audit committee takes the lead.(See pages 52 and 53)

16. In addition, in its recent report 'Still flying blind: The absence of climate risk in financial reporting' the independent and influential think tank, Carbon Tracker(2022) recommended that companies should disclose whether and how they have incorporated material climate-related matters within financial statements and ensure appropriate governance and board oversight thereof. This is as part of companies needing to ensure that audit committees (or their equivalent) take the financial impacts of climate matters into account. This includes:

*exercising appropriate oversight over such matters (including adequate interaction with external auditors) for the relevant financial reporting year;

*interacting with board committees responsible for developing and overseeing execution of climate plans and targets;

*engaging with investors to ensure that audit and financial statements are fit for purpose;

*ensuring auditors use their own or independent specialists as appropriate; and

*conditioning reappointment on meeting these expectations .

17.It is already clear that investors are increasingly holding larger companies to account in relation to such matters. It therefore follows that the absence of climate risk in financial reporting needs to be tackled by recognizing that part of the solution needs to involve more activity by audit committees on this extremely important matter.

18.Therefore it is surprising and indeed most concerning that the draft minimum standard for audit committees makes no mention of any responsibilities relating to oversight of tone at the top, risk management, internal control systems, internal audit or reporting on 'climate-related matters'. This needs to be responded to by the FRC/ARGA on an urgent basis.

19. Also the minimalist approach to standards for audit committees seems out of line with paragraph 25 of the FRC's (2018) UK Corporate Governance Code and the FRC's(2016) Guidance on Audit Committees which set out wider roles and responsibilities for audit committees. This minimalist approach would cause some confusion and be viewed as a retrograde step. It would also 'sow the seeds' for some audit committees to adopt a more minimalist and less active stance than is currently the case for essential areas not dealt with in

the draft minimum standard. Areas that could suffer include: the monitoring of the integrity of financial statements, other pronouncements and of significant financial reporting judgements; providing advice when requested by the board on the annual report and accounts; reviewing internal financial control and risk management systems; and reviewing and monitoring the effectiveness of the internal audit function. This could open up the way for yet more UK financial scandals and get ARGA off to a poor start. It would also not serve investors well.

20. It is appreciated that during the current very difficult economic times that UK premium listed companies should not be overburdened with minimum standards that are too detailed. There is also a need to take account of HM Treasury's Managing Public Money' (2022) 'Standards expected of Accounting Officer's Organizations' and in particular of the stated need to " avoid over defining detail and imposing undue compliance costs, either internally or on its customers and stakeholders"(see Box. 3.1). Therefore detail could be included in guidance rather than in the minimum standards themselves, bearing in mind that the FRC has already established good precedent by way of its 2016 guidance on audit committees and a useful series of " What makes a good …." guidance.

21.In summary it appears that much needs to be done urgently to improve the draft minimum standard on audit committees, and indeed it seems sensible that a revised and less minimalist version is issued for exposure. It needs to be accompanied by a set of meaningful questions to enable a proper impact assessment to be carried out and published. This would help meet the relevant HM Treasury Green Book guidance. Sufficient meaningful and specific questions should be asked not only of companies but also of investors. There also seems to be scope for the FRC/ARGA to develop and issue guidance entitled, 'What makes a good audit committee' to support the final version of the standard and to assist its implementation.

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DECLARATION OF INTEREST

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I hope that you find the above comments to be constructive.

Yours sincerely,

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