



FRC CONSULTATION ON DRAFT MINIMUM STANDARD FOR AUDIT COMMITTEES

Issued 7 February 2023

ICAEW welcomes the opportunity to submit a **representation** to the FRC's consultation document on the draft Minimum Standard for Audit Committees (the Standard).

The restoration of trust in the UK's corporate reporting, governance and audit regime requires a fully 'joined-up' approach to reform. Anything less is likely to lead to lop-sided change and demonstrate a failure to learn one of the key lessons of Carillion and other recent company failures – that there needs to be a strong emphasis on tightening internal controls and modernising corporate governance.

Our feedback and recommendations can be summarised as follows:

- The Draft Minimum Standard for Audit Committees only covers one aspect of the audit committee's operation and as such we recommend that the Standard is renamed to reflect this narrow remit to avoid confusion.
- We call for a more comprehensive and joined up review of all guidance relating to audit committees that will sit alongside the Standard. Such a review should consider not only the CMA's recommendations but those of the Brydon and Kingman Reviews. Such a review should include audit committee responsibilities relating to important new initiatives around ESG reporting, resilience statements, fraud and audit & assurance policy statements.
- We also recommend a more joined up approach to addressing the CMA's recommendations. ICAEW has previously argued that to fulfil the CMA's recommendations will require a set of measures which address three interconnected aspects: implementing changes to how the Big Four audit firms operate, reducing the obstacles which currently deter their potential challengers from entering the PIE market and, finally, supporting audit customers to exercise their extended freedom of choice. The Draft Standard only attempts to address the latter and we believe the Standard's impact will be limited in addressing the CMA's concerns if it is not closely linked to other FRC and BEIS initiatives addressing the other interconnected aspects.
- We are of the opinion that in turning the guidance into regulation, the FRC should only include objective minimum requirements and retain subjective provisions in the guidance documents.
- The language used in the Draft Standard is too imprecise for the purpose of turning the draft into regulation. Even though the Standard will not become regulation straight away, the Standard should be written so that companies are clear about precisely what regulation will require them to do.
- The consultation document contains several clauses which we think are unworkable as regulation as they may conflict with existing legislation or may have an unintended adverse impact on the audit market. We recommended that those clauses are either removed or rewritten and left as guidance.

ABOUT ICAEW

The response of 7 February 2023 has been prepared by ICAEW's Reputation & Influence Department.

Since our Royal Charter was granted in 1880, ICAEW has been responsible for maintaining the highest professional standards as well as delivering technical excellence in the public interest.

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For questions on this response please contact our team at representations@icaew.com quoting REP 12/23.

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FEEDBACK FROM ICAEW MEMBERS

We have consulted with our members and have received detailed feedback from our corporate governance and our technical audit committees as well as a number of members who are either senior leaders from auditing practice or those who work in business.

The feedback we received can be summarised as follows:

- The consultation was seen as a missed opportunity to strengthen the remit and effectiveness of audit committees. In particular, it was suggested that the consultation does not include any of the recommendations made in Sir Donald Brydon’s report (2019) on improving the quality and effectiveness of audit. In light of the three reports which underpinned the *Restoring trust in audit and corporate governance* white paper (CMA, Kingman and Brydon), a more comprehensive review across all audit committee guidance along with the Draft Standard would have been justified.
- The language used is too imprecise for the purpose of turning this into regulation.
- The consultation document contains several clauses which were deemed unworkable as regulation.

DETAILED COMMENTS

Scope and Purpose

1. We believe that some of the feedback we have received in relation to the consultation being a missed opportunity is most likely largely due to the naming of the consultation. Calling it a “Minimum Standard for Audit Committees” has created the impression that the scope of the consultation is much broader than described in the Consultation Document. We suggest a more focussed title, such as “Minimum Standard for the Appointment and Oversight of Auditors by Audit Committees”. This should help avoid confusion in relation to the scope of the final Standard.
2. As we explained in our response to the FRC’s draft three-year plan ([Rep 07/23](#)), the FRC has an important role in ensuring a ‘joined-up’ approach to activity aimed at restoring trust in the UK’s corporate reporting, governance and audit regime. Reforms on all aspects of this should be considered together to ensure they are well aligned. Anything less is likely to lead to lop-sided change and demonstrate a failure to learn one of the key lessons of Carillion and other recent company failures – that there needs to be a strong emphasis on tightening internal controls and modernising corporate governance.
3. The CMA Market Study (2019) was completed around the same time as both the Kingman Review and the Brydon Review of the Effectiveness of the UK Audit Market, and all three underpinned the UK Government’s white paper *Restoring trust in audit and corporate governance*. Although we appreciate that the scope of the Standard is narrowly focussed on the appointment and oversight of auditors, it seems a missed opportunity to not also consider recommendations from the Brydon and Kingman reports and consult on updating the broader Audit Committee Guidance and Corporate Governance Code.
4. Even if the Guidance and Code are updated in this aspect at a future date, such a piecemeal approach is unsatisfactory given the many interdependencies that audit committees need to manage, for example, their interdependencies with management, internal audit, internal controls, risk management and compliance. In light of the three reports (CMA, Kingman and Brydon), a more comprehensive and coordinated review across all audit committee guidance along with the Draft Standard would have been justified. Such a review should include audit committee responsibilities relating to important new initiatives around ESG reporting, resilience statements, fraud and audit & assurance policy statements. If such a coordinated

review of guidance is not feasible alongside the draft standard (which would have been our preference), we would strongly urge a follow-on comprehensive consultation on all guidance relating to audit committees.

5. We recommend a more joined-up approach to addressing the CMA's recommendations emanating from its Statutory Audit Services Market Study (2019). ICAEW has previously argued fulfilment of the CMA's recommendations will require a set of measures which address three interconnected aspects: implementing changes to how the Big Four audit firms operate, reducing the obstacles which currently deter their potential challengers from entering the PIE market and, finally, supporting audit customers to exercise their extended freedom of choice. The Draft Standard only attempts to address the latter and we believe the Standard's impact will be limited in addressing the CMA's concerns if it is not closely linked to other FRC and BEIS initiatives addressing the other interconnected aspects.
6. We appreciate that the CMA recommendations were specific to FTSE350 listed companies but improving audit firm choice and diversity through this standard should be considered more widely than just the FTSE350. It also seems inconsistent with the broader PIE definition that sits at the core of the FRC's Audit Firm Supervision.

Turning Guidance into Regulation

7. Overall, we are of the opinion that in turning the guidance into regulation, the FRC should only include objective minimum requirements and retain subjective provisions in the guidance documents.
8. For a standard to be effective (ie, monitored and enforced), it requires clear and precise language. Much of the current Draft Standard does not meet this requirement as it is written as guidance. To turn guidance into regulation "must" should be used instead of "should". This is problematic in many paragraphs. For example, phrases like "where appropriate" or "without good reason" make sense in the context of guidance but cannot be turned in hard regulation. We recommend that where such phrases occur, this remains guidance.
9. There are also paragraphs where the audit committee is encouraged to consider a particular approach which are problematic if turned into regulation. For example, in paragraph 13 "the audit committee should consider a price-blind tender". It may be good guidance for audit committees to consider such tenders, carefully balancing a number of other considerations. However, turning "should" into "must" here will make the use of price-blind tenders mandatory, which is not the intention of the original guidance and may lead to unintended market distortions.
10. Likewise, Paragraph 20 outlines "there should be regular open communication between the audit committee and the auditor, as well as with the entity's management". If this were turned into regulation, how would regular, open communication be defined and measured? This is probably better left as guidance. These are but a few of many examples.
11. There are a number of clauses which, as currently written, may conflict with existing legislation. For example, paragraph 7 requires that the tender process should not preclude the participation of challenger audit firms without good reason. The Companies Act and the Audit Regulation do not allow preclusion of non-Big 4 firms, whatever the reason.
12. We do not support turning paragraph 14 into regulation. If an audit committee wishes to exclude an audit firm from providing non-audit services due to their lack of interest in their tendering for audit, this seems a matter for the audit committee and the board as part of their statutory duties to act in the good faith and in the best interest of the company as outlined in the Companies Act 2006. We also do not believe this is the best way to increase audit choice or diversity.

13. We would suggest that if paragraph 14 is retained, it is retained as guidance and that, rather than threatening to exclude non-bidding audit firms as outlined in the current draft Standard, we would suggest that audit committees could take steps to encourage more auditor choice through ensuring they have oversight of the company's contractual exposure of non-audit work by the audit firms they wish to include in future tenders. The audit committee should carefully monitor and, where necessary, influence the company's contractual exposure to non-audit work of audit firms ahead of the tender process. This could help remove some of the commercial considerations encouraging larger audit firms to not bid for audit work due to already providing non-audit services to the company.

Inconsistencies

14. As outlined in the FRC's consultation document, the Draft Standard has been created from various guidance documents. In our opinion, this has resulted a number of inconsistencies that should be fairly straightforward to rectify. For example, in paragraph 4, the audit committee conducts the tender process whereas in paragraph 6 it leads the tender process and in paragraph 8 it has oversight of the tender process.
15. Another inconsistency in paragraph 4 is the requirement that the audit committee approve the remuneration of the external auditor. This conflicts with paragraph 6 which requires that the audit committee negotiates the audit fee. This difference is perhaps more than just linguistic inconsistency as the language in paragraph 6 is also the language used in the CMA's Statutory Audit Services Order 2014.

Other Considerations

16. For the standard to be effective, audit committees need to have the expertise and experience on board. Although most if not all FTSE350 firms will undoubtedly already have "relevant financial experience" (as outlined in the UK Corporate Governance Code) on their audit committees, it would strengthen audit committee guidance if it were recommended that at least one member of the audit committee should also have practical audit expertise and experience.
17. There are a number of sectors that currently struggle to attract more than one audit firm to bid for an audit. We are aware of organisations which have no adverse findings in their annual report nevertheless struggling to find a suitable alternative auditor. Anecdotally we have heard of this in relation to, for example, local authorities and housing associations. We would encourage the FRC to look at mechanisms for increasing audit choice in all sectors and not just those for FTSE350 listed companies.

APPENDIX**ICAEW Response to the CMA Statutory Audit Services Market Study 2019**

ICAEW outlined the following points in relation to the regulatory scrutiny of audit committees in its response to the CMA Study in 2019 ([Rep 13/19](#)), worth repeating in the context of this consultation:

18. Any regulatory scrutiny applied to audit committees must be risk-based and proportionate, bearing in mind that the appointment and monitoring of external auditors is only one of the Committees' responsibilities. ICAEW believes that the proposal that a representative from the regulator should observe all (or a random sample) of audit committees' meetings is unrealistic. Such omnipresence on the part of the regulator could undermine Committee chairs and discourage other independent non-executive directors (INEDs) from joining.
19. ICAEW would argue that in most situations, a risk-based approach will deliver both more effective regulation and stronger audit committees. The support of the regulator is likely to be welcomed by most audit committees as they embrace whatever measures emerge from the CMA's market study, especially if these include potentially complex mechanisms such as mandatory joint audit or market share caps. Persuading audit committees of the advantages of any reforms will be key to successful and timely implementation.
20. The regulator should be able and willing to impose strong interventions on audit committees when justified, but needs a range of powers, including, but not limited to, a power of real-time observation. If process or quality issues have been established, an appropriate regulatory response may be to observe audit committee meetings. We would, however, expect this power to be used sparingly and only as a temporary measure until the regulator is sufficiently assured that the Committee is working well and understands its responsibilities. Public reprimands or direct statements to shareholders may also be appropriate alternatives in some circumstances. Where there are significant concerns, the regulator may have a greater interest in overseeing changes in the membership and leadership of audit committees.
21. Risk-based regulators rely upon strong information flows. Some compulsory reporting could serve as a salutary reminder to audit committees that their responsibility to protect fully the interests of shareholders is subject to regulatory oversight. However, there is also a significant risk that, over time, reporting is reduced to meaningless boilerplate language. Proportionality is key to maximising the potential advantages and minimising the potential disadvantages of reporting. Dependent upon its frequency, routine reporting throughout audit engagements could be debilitating for audit committees, auditors and the regulator. The introduction of targeted reporting at key stages of the tendering process would be more acceptable.
22. ICAEW agrees with the CMA that during the tender selection process, audit committees should be able to demonstrate that they have: prioritised independence and challenge; made decisions independently; managed conflicts of interest so as to maximise choice; and given fair consideration to challenger firms. We also agree that during the audit engagement, audit committees should be able to demonstrate that they made interventions to assess quality beyond seeking management feedback. However, rather than requiring all audit committees to report on all of these points on a routine basis, we suggest that the regulator occasionally asks specific audit committees to evidence their performance in these areas. A targeted approach would yield a far more accurate picture for the regulator, and is also more likely to generate goodwill through dialogue. If audit committees actively seek support from the regulator, then this will be an important demonstration of success.
23. One of the recommendations arising from Sir John Kingman's Review of the FRC is for auditors to report viability or other serious concerns, and in some circumstances the new regulator will be the appropriate recipient of these in extremis reports. It may also be

appropriate and helpful for audit committee members to be able to make similar reports to the regulator, either on record or anonymously. audit committee members may wish to report – and the regulator may wish to be informed about – serious and material disagreements which arise in the tripartite relationship between audit committees, company management and audit firms.

24. If reporting were on a proportionate, exceptional basis, we see no reason why the scope should not cover all PIEs. However, the more onerous procedures implied in the proposed Remedy could take significant resource and, if adopted, should be limited to the FTSE 350 at most, until time has evolved to assess and refine the process.