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Dear Susan

## **Consultation – Audit Committee Standard**

1. We have pleasure in providing you with our comments on your consultation on the proposed Audit Committee Standard.

### **Introduction**

2. We support the intentions of the FRC to provide a stop gap (the Audit Committee Standard (ACS)) until the government has transformed the FRC into ARGA and given it the power to set minimum requirements for audit committees in relation to the appointment and oversight of auditors as envisaged by the CMA Review and the government response, Restoring Trust in Audit and Corporate Governance.
3. However, one of our main concerns is that the ACS does not sufficiently emphasise shareholders' role in audit committees appointing and overseeing external auditors with the main focus on audit quality. The various audit reviews culminating in the government's Restoring Trust in Audit and Corporate Governance response envisaged engagement between shareholders, auditors and audit committees in this respect. The ACS needs to address this, possibly through articulating how audit committees should proactively make this happen and how Audit and Assurance Policies are produced and ratified by shareholders.
4. We have a number of other material concerns with the ACS as set out below.

## **Our other material points**

### **Name of the standard**

5. The name of the standard should reflect the content applicable to audit committees. Audit committees have a wide range of responsibilities and these are not all covered by the draft ACS. The ACS focuses on tendering, oversight of auditors and audits and reporting. As a result the ACS should be named to reflect its limited coverage of audit committee responsibilities; for example, "Audit Committee Standard 1 – audit tenders, oversight of auditors and audits and reporting".

### **Scope and authority**

6. The scope should not be limited to just FTSE350 companies. The scope should be at least the same as that of the Corporate Governance Code, i.e. companies with a premium listing. Our preference on scope is premium listed companies, standard market companies (as there are plans for the premium and standard markets to be combined into one and when this happens all combined market companies should be within scope if the Corporate Governance Code will apply to all of them), other large companies as to be defined for the new reporting regulations (those with turnover of £750 million or more and with 750 or more employees) or Public Interest Entities (PIEs).
7. The FTSE350 is fluid in terms of its constituents and therefore the scope needs to be wider to capture potential constituents and other PIEs. It does not make sense that the standard applies when a company is a FTSE350 constituent and then does not apply when it is not.
8. Para 2 of the ACS mentions primary legislation bringing ARGAs into being. This draft standard should therefore anticipate the standard's scope and authority when ARGAs have come into being. This will more likely help smooth the transition to the standard(s) when this primary legislation has been passed.

### **Structure and tone**

9. The tone is wrong as it is more applicable to a Code, such as the Corporate Governance and Stewardship Codes. It should be more like auditing and accounting standards and use mandatory language.
10. As a result, it should also be structured like a standard. We suggest it should follow the structure of an auditing standard (ISA (UK)s) with an introduction, objectives, definitions, requirements and lastly a section referring to other relevant explanatory materials.

## **Purpose and/or objectives**

11. The purpose of the standard should be clear. In line with the government's Restoring Trust in Audit and Corporate Governance response, this should be setting out the minimum requirements expected of audit committees in the appointment and oversight of auditors.

## **Tendering**

12. The ACS is too minimalist with regard to the standards required of an audit committee for tendering. We have set out our detailed thoughts on this in the appendix to this response.
13. As a result, the tendering standards should recognise the varying complexities of audit contracts and allow for a minimalist approach for simple audits but also recommend minimum standards for complex audits. The latter will need an executive project team with the required procurement skills for complex long term contracts, overseen in a non-executive way by the audit committee, as suggested in our appendix.

## **Reporting**

14. 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". Other than the non-mandatory wording covered above that should change, this is also too general a requirement that fails to recognise corporate reporting's disclosure problem (too much irrelevant information, not enough relevant information and badly articulated information) and then seek to mitigate the problem. We suggest that audit committee reports are required to include only material matters (material being defined in the same way as for accounting and sustainability standards by IFRS; the primary user/shareholder decisions being how to vote at AGMs on auditor appointment and remuneration and audit committee appointments).

## **About United Kingdom Shareholders' Association (UKSA)**

15. UKSA represents the views of individual investors. UKSA was originally formed to provide individual shareholders with a voice, influence and an opportunity to meet like-minded fellow investors. It is structured as a non-profit making company with annual subscriptions. An elected Chairman and Board of Directors (all volunteers and individuals with a wide range of backgrounds and experience) monitor a regional organisation. Each region benefits from oversight by an elected regional Chairman and Committee.

16. There are many agents and intermediaries in financial markets. Unlike them, UKSA represents solely those people who are investing their own money. UKSA builds relations with regulators, politicians and the media to ensure that the voices of individual shareholders and their interests in the long term public good are reflected in the development of law, regulation, and other forms of public policy. See [www.uksa.org.uk](http://www.uksa.org.uk).

**Next steps**

17. If you wish to clarify any of our comments or discuss our thoughts further, please contact Charles Henderson at [charles.henderson@uksa.org.uk](mailto:charles.henderson@uksa.org.uk).

Yours sincerely

Charles Henderson, Chairman, UK Shareholders' Association

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## APPENDIX – Tendering

### Audit fees for a sample of FTSE 350 companies

Company	# A. C. members	£m. Fees 2020	£m. Fees 2021	£m. Fees 2022	Estimated 10 year contract value £m
BP plc	6		43.7	47.0	450
Rolls Royce	4	13.0	13.5		130
AstraZeneca	4	13.6	20.8		160
M&S	3		2.4	2.5	25
Babcock Int'l.	4		6.0	7.1	65
QinetiQ	5	0.9	1.2		10
Hill & Smith	5	1.4	1.5		15

1. We have carried out a brief analysis of spend on audit services by a small and random sample of FTSE 350 companies for the last two years of reporting. This is shown above. The spend includes work on the statutory audit and spend on non-audit work provided by the auditor. The latter is typically relatively small at 10 - 20% of the total fees paid to the auditor (presumably as a result of the regulatory constraints on auditors doing non-audit work).
2. The analysis, limited though it is, highlights two important features of the procurement of audit services by FTSE 350 companies:
  - 2.1. Because most audit contracts are let for ten-years (the maximum period for which they can be let before they must be retendered) the contract values, particularly for FTSE100 companies, can be very substantial. This assumes that auditors are rotated every time there is a retendering. If the auditor is not rotated and left for the regulatory maximum period of 20 years, then these contract values will be even more substantial. Although in this scenario, we would assume the contract for the second ten years of an incumbent auditor would be renegotiated. The BP audit contract, for example, is estimated to be in the region of £450 million over ten years (potentially £1 billion or more over 20 years). The Rolls Royce contract is estimated to be worth over £100 million (excluding non-audit work) over ten years. Even among FTSE 250 companies there are some with significant audit contracts – for example, Babcock International with an estimated spend of £65 million over ten years.
  - 2.2. The estimated size of audit contracts varies very significantly from £450 million or more for the likes of Shell and BP to £10 – £15 million for companies like QinetiQ and Hill & Smith.
3. The importance of these observations is:
  - 3.1. It is not very satisfactory to try and take a ‘one-size-fits-all’ approach to setting a minimum standard for the procurement and management of audit services. Good practice principles in tendering may be similar regardless of

contract value. However, the complexities of managing the audit contract will be very different for larger FTSE 100 companies compared to many of the smaller FTSE 250 companies.

- 3.2. The table shows that the audit committee typically consists of between four and six people. In most cases the members of the audit committee may have little procurement experience.
- 3.3. The Draft Standard states in para 6: *'Audit Committees may, of course, make use of the entity's employees for research and evaluation'*. Given the size and complexity of many audit contracts (even at FTSE 250 level), it is not appropriate to give the impression that the members of the audit committee can lead the tendering process as part of their normal day to day activities in the same way as executive management would be able to. For many companies it would be appropriate to have a project team overseeing the tendering process. The project team should have strong procurement input and appropriate stakeholder representation. In many cases it would be appropriate to have a professional project or contract manager overseeing day to day management of the contract once it has been let. This ought to be someone with sound experience of managing contracts for complex services. The audit committee would then be responsible for the oversight of the audit tender project team, making the decisions on the team's recommendations and ultimately on the final candidates for the board decision and subsequent ratification by shareholders. This will also allow the audit committee to act in a non-executive way, as it should.
- 3.4. The fact that external audit contracts are typically let for ten-years (with the usual early termination clauses on both sides) adds significantly to the complexity of buying and managing the service. On a ten-year time horizon it is very difficult to set a service specification that will not change significantly over the life of the contract. If nothing else, there are certain to be changes in service needs on the client side. It is important that these changes are monitored and well-managed by the client if the contract is to achieve value for money.
- 3.5. The draft standard makes no reference to contract 'variations'. Yet the potential impact of 'variations' on any contract cannot be ignored. Any 'variation' to the original contract needs to be negotiated. The bargaining position of the client in these circumstances is invariably weak. The supplier nearly always has the upper hand. It can be very difficult to control costs and even harder to ensure that value for money continues to be achieved. It is a truism that suppliers who 'low-ball' when bidding for contracts do so in the certain knowledge that they will be able to make up any shortfall in the profitability of the basic contract by charging handsomely for the variations. Buyers need to plan and manage carefully to ensure that variations are

minimised and the costs associated with them are tightly controlled. Again, this is not something that most audit committee members are likely to be able to do on an 'ad hoc basis' using light-touch oversight.

4. Further comments on the draft standard are:

4.1. The Draft Standard states baldly (para 8): '*The selection criteria should be transparent and non-discriminatory*'. This statement is misleading. The whole point of the selection criteria is that they should seek to discriminate so as to ensure that the best bid wins the contest. The guidance should therefore be amended with the following qualification (or similar): '*the selection criteria must not discriminate in a way that distorts competition by inappropriately penalising certain bidders or by giving others an unfair advantage*'.

4.2. The Draft Standard states (para 13): '*The Audit Committee should consider running a price-blind tender*'. While this approach to tender-evaluation can be appropriate when buying physical products, it is fraught with difficulty when it comes to buying complex services such as audit.

4.3. One of our views is that assessing the price of individual bids is a vital part of ensuring that the winning bid offers value for money. In the case of buying professional services this can be a complex exercise. Pricing should be reviewed in the context of the programme of work that the supplier is proposing. Factors to consider are:

4.3.1. What are the different levels / grades of staff that the auditor is planning to allocate to the contract?

4.3.2. What is the fee rate that will be charged for each level / grade?

4.3.3. How many hours (say, annually) is the auditor proposing will be required by each level or grade of staff to complete the programme of work they have outlined in the proposal?

4.3.4. Does the proposed level of input look sufficient to complete the proposed programme of work?

5. Our other view is that if the FRC decides price-blind tenders are better practice, it should recommend them more emphatically (using a mandatory tone as we have suggested for standards in our main responses). However once an audit firm has been selected and prior to awarding the contract, the price needs to be considered. We have set out above some of the factors to be considered. The standard should then remind audit committees what to consider if the price cannot be agreed after a price-blind tender, such as reverting to its second choice auditor.

6. If the level of input looks low, this may suggest that a supplier is 'low-balling'.
7. Expenses should also be considered. Entities should consider what is acceptable/unacceptable when reclaiming expenses. On a £100million contract expenses could easily come to between £10m and £15m depending on the amount of overseas travel.
8. There are some good specific points that are mentioned in the Draft. For example, the suggestion (paragraph 9) that as part of the tender evaluation process Audit Committees should scrutinise public reports published by the FRC and, where relevant, overseas regulators on the quality of each firm's audit. Similarly, (paragraph 16) the suggestion that the Audit Committee should check whether the company's audit has been subject to a review by the FRC and, if so, discussing with the auditor its response to the findings and the action it has taken to address specific issues.
9. There appears to be no reference in the Minimum Standard (or the other supporting documentation on tendering) to the issue of contract terms and conditions. The supplier's terms and conditions of sale are invariably written to ensure maximum advantage to the supplier. The buyer's terms and conditions of purchase will seek to ensure maximum advantage to the buyer. Buyers should always try to ensure that the audit contract is covered by their terms and conditions of purchase. If they do not have specific terms and conditions for the purchase for professional services they may opt to use the supplier's terms and conditions of sale. However, these should always be checked carefully by the buyer's legal team and anything that is considered unduly onerous should be amended or negotiated out. This is not a point of detail. It is simple good practice. We understand that the contract will usually take the form of an audit engagement letter, initially produced, in a standard format for all their audit clients, by the auditor. The project team needs to be allowed to amend this appropriately as suggested here.
10. With regard to the ongoing management of the audit contract, and certainly for larger contracts, the day to day management of the contract should be the responsibility of a professional project or contract manager (as mentioned in 3.3 above). The role of the project or contract manager should be to provide day-to-day oversight of the audit contract on behalf of the Audit Committee. This is likely to include:
  - 10.1. Providing a single day to day point of contact between the audit partner / team and the entity (the customer).
  - 10.2. Planning and organising regular audit review meetings for the Audit Committee



- 10.3. Working with the Audit Committee to develop and implement performance metrics; producing monthly performance and cost control reports for the Audit Committee; developing, agreeing and implementing value-for-money indicators.
- 10.4. Dealing with queries and issues raised by the audit team and, where appropriate, referring these up to the Audit Committee.
- 10.5. Reviewing the auditor's own assessments of the quality of the audit and its quality assurance systems more broadly and reporting back to the Audit Committee on these.
- 10.6. Canvassing material stakeholders, including shareholders/investors, to obtain their feedback on their satisfaction with the contract and its performance.

## **Conclusion**

11. The draft Minimum Standard is superficial in many areas. We accept that it is a *minimum* standard but too much of the content in the Standard is simply 'minimalist'.
12. Some of the supporting documentation needs serious review. The Best Practice Guide to Tendering was written (and last updated) before Carillion and the other audit scandals which have driven the demand for audit and corporate governance reform. The FRC has done (and continues to do) excellent work to ensure that standards of audit are consistently higher than they were, say, five years ago.
13. We accept that the standard should not be repeating what is stated in the 'Best Practice Guide to Tendering' and the 'Audit Quality - Practice Aid for Audit Committees'. Unfortunately, it is not appropriate to tack the Minimum Standard onto these documents. The Minimum Standard needs to be drafted so that it works as a minimum standard for Audit committees. In conjunction with this the supporting documents need to be redrafted and updated so that, together, they form a coherent suite of documents for use by audit committees. However, as the Draft Minimum Standard notes (paragraph 15): '*External audit is a public interest function.*' This, therefore, is a document which is not just of interest to Audit Committees. It is a vital document for all stakeholders with an interest in the external audit.