The City of London Law Society

THE CITY OF LONDON LAW SOCIETY

COMPANY LAW COMMITTEE

Response to FRC consultation in respect of the Draft Minimum Standard for Audit Committees

Introduction

The views set out in this response have been prepared by a working party of the Company Law Committee of the City of London Law Society (the "**CLLS**"). The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This working party is made up of senior and specialist corporate lawyers from the CLLS who have a particular focus on issues relating to company law and corporate governance.

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Summary

We welcome the opportunity to comment on the proposed draft minimum standard (the "**Standard**") to apply to audit committees of FTSE 350 companies in relation to the appointment and oversight of auditors. We note that the Standard is proposed in anticipation of the Government's intention to give ARGA the power to set minimum requirements on audit committees in relation to such appointment and oversight. We also note that it is stated at paragraph 2 of the draft Standard that subject to appropriate powers being granted by legislation, the Standard is to become "mandatory". We are not clear what this means. Our principal concern arising from this lack of clarity is that audit committees will be uncertain as to the extent of their requirement to comply with the Standard's provisions. As identified below, many of the provisions in the draft Standard are unclear in their scope or may set aspirations that are not necessarily within the audit committee's powers to achieve. In such a scenario it would be inappropriate for audit committee members potentially to be subject to penalties being applied to them personally for failure to comply. A regime which leads to separate liability amongst directors also potentially undermines the principle of collective board responsibility and should be avoided. We assume this will be considered in more detail when the legislation reflecting ARGA's enforcement powers is introduced.

We agree that the current compliance regime in respect of the UK Governance Code (the "**Code**") (i.e. the "comply or explain" approach) is a tried and tested basis and we think this would be a suitable "mandatory" basis for the Standard i.e. companies and their audit committees should comply with the Standard or explain their reasons for not doing so. If any of the provisions in the Standard are intended to be mandatory in the sense that companies and their audit committees must comply with them, we

think these should be specifically identified and limited in scope. The drafting for any such provisions should provide sufficient detail and clarity so directors are clear as to the expectations on them and the standard of behaviour they need to achieve in order to discharge their responsibilities such that enforcement is a proportionate response for non-compliance. For example, we cannot see any basis why or how audit committees should be required to take responsibility for audit market diversity, albeit recognising that this may be a legitimate aspiration to seek to achieve. The Standard would benefit from the inclusion of some examples – possibly in the form of guidance paragraphs interspersed, if relevant, between any "mandatory" rule-type provisions, as in the Financial Conduct Authority's Handbook. In the case of audit market diversity, for example, it may be that, in line with existing FRC guidance, the Standard is in fact envisaging matters within companies' powers, such as their ability to seek, where possible, to avoid engaging a firm for non-audit work where this would prevent the firm from tendering for the audit. This could be dealt with in a guidance paragraph.

Detailed Comments

Scope & Authority

We note from paragraphs 1 and 3 it is proposed the Standard should apply to companies included within the FTSE 350 index. We assume this means only UK incorporated companies, but this should be clarified. We do not disagree with this approach in principle but would note that such inclusion is not usually within the gift of listed companies, as it is primarily linked to market capitalisation rather than purely aspiration. As a result, there will be a range of companies that will be involuntarily joining and leaving the index on a regular basis. The Standard should therefore contain transitional provisions such that it would only apply to companies that have been included in the index for more than a fixed period, say 12 months, which would enable them to organise their affairs over that time in order to able to seek to comply with the Standard.

As referred to above, we recognise the Standard is designed to set minimum requirements on audit committees in relation to the appointment and oversight of auditors. We are concerned that labelling the Standard as a "Minimum Standard for Audit Committees" is misleading, as there are a number of other requirements which apply to audit committees, many of which are derived from the Code or legislation, which are rightly not reflected in the Standard. We also note that the Standard specifically covers tendering, oversight and reporting, which is not reflected in the scope section (or in paragraph 5).

Responsibilities

We note the Standard sets out that its focus is on a variety of identified audit committee responsibilities. As most of these are derived from existing guidance and legislation, we think it should be clearer that these are subject to compliance in accordance with the Code's requirements or applicable legislation, and that the Standard does not and is not intended to introduce a further set of responsibilities which are mandatory or subject to a separate enforcement process. In relation to "new" proposals (i.e. the first, third and fifth bullet points), it should be clearer that the mechanisms for compliance in this connection are set out in the subsequent sections of the Standard. We think "fair" should be deleted before "choice" in the first bullet point as the extent of the choice is determined by the later provisions of the Standard.

Tendering

Much of the content of this section of the Standard is derived from existing guidance. We think this should be made clear and a suitable cross reference to that guidance would be helpful, particularly as the provisions in the Standard are, of necessity, a much shortened overview of the more detailed

requirements. We also note this section currently refers to PIEs whereas the "Scope & Authority" section indicates the Standard only applies to FTSE 350 companies. We think, for consistency, the latter should only be referenced here.

Our other specific comments are as follows:

- It is not clear, in paragraph 6, what "influencing the appointment of an engagement partner" may require. We assume the intention is to recognise that the identity and expertise of the relevant audit partner is an important consideration for the appointment of the auditor and that these are matters on which the audit committee may legitimately have views that should be taken into account by the audit firm;
- We agree, as stated in paragraph 7, that there is a "strong public interest in audit market diversity and the market … having sufficient resilience, capacity and choice". We do not, however, consider it is possible for audit committees to "ensure" that there is a sufficient number of potential independent auditors. We think this is an inappropriate expectation to place on audit committees in a minimum standard with potentially draconian sanctions for breach, especially where a scarcity of candidates might result from regulatory or legislative innovations that companies cannot be expected to know the form of in advance of them being introduced and cannot be expected to know the effect of until it materialises;
- While paragraph 7 further refers to a "sufficient" number of potential auditors, paragraph 11 refers to three or four audit firms (or, in some cases, fewer) being required for a tender process. There is a danger of confusion arising from these inconsistencies;
- We are concerned that, per paragraph 9, there is an implication that choice of auditor should not be based on price or perceived cultural fit. Those are likely to be important factors (as well as quality, independence, challenge and expertise) that a board should rightly consider in relation to the final choice of auditor. Accordingly we think the relevant provision should be amended to "rather than **solely** price or perceived cultural fit";
- Paragraphs 11 and 14 do not recognise that companies may legitimately wish to appoint advisers for non-audit work where those advisers have the appropriate level of expertise and experience of working with that company – the impact on the choice of audit firm should not be the only consideration. Paragraph 11 could be amended to address this concern by the addition of a sentence as follows: "*To support this, audit committees should seek to manage their relationships with audit firms having regard to the desirability of having a sufficient number of potential auditors that are independent, or capable of becoming so, in order to allow for adequate competition and choice in a subsequent tender*";
- We agree that an audit committee should only be obliged to "consider" running a price-blind tender. We think it should be clear that this should only apply in the early stages of a tender and the Standard should recognise, as above, that the price is an important factor for companies to take into account in the final appointment decision; and
- We are concerned that paragraph 14 is very prescriptive as to how audit committees are required to conduct their affairs in relation to the appointment of advisers – it contains requirements for an audit committee to communicate certain understandings or issue specific reminders to their advisers. These should be business matters for a company to consider and decide on if appropriate, rather than being imposed by the Standard.

Oversight of Auditors and Audit

We note that paragraph 16 sets out a number of approaches which an audit committee might consider suitable in connection with reviewing the effectiveness of the external audit. As with other provisions in the Standard, these are limited in scope and presumably reflect that audit committees and auditors will have a common understanding of the intention of these provisions. That said, we do consider it might be helpful to clarify the detail of the fourth bullet point (engagement level AQIs) and the penultimate bullet point (tailored surveys) particularly to identify the relevant individuals or entities to which these relate.

Reporting

We are concerned that requiring the audit committee to report (as per the third bullet point of paragraph 22) on shareholder requests that certain matters should be covered in an audit may lead to this being abused. We recognise that the Government is seeking to encourage shareholder engagement on audits but would note that there is no specific legislation to that effect nor any provisions to address what aspects of an audit a shareholder may or may not request are covered. Accordingly audit committees may be put in a difficult position if they are requested to cover matters which they legitimately consider are inappropriate. The reference to requests may also encourage shareholders to submit requests which do not have a legitimate basis or are not for a purpose related to the function of the audit committee. If wide ranging requests are to be permitted, the audit committee should only be required to report on rejected requests which are legitimate and not frivolous or vexatious in nature. Also, just to note that, as a presentational matter, the fourth paragraph in paragraph 22 should be preceded by a bullet point.

3 February 2023