

# Audit committees and the external audit

## KPMG Audit Committee Institute

The Financial Reporting Council (FRC) has issued [Audit Committees and the External Audit: Minimum Standard](#) as a direct response to the Government's consultation on Restoring Trust in Audit and Corporate Governance, which expressed the intention to grant statutory powers to ARGA (the Audit, Reporting and Governance Authority) for mandating minimum standards for audit committees in relation to the Appointment of, and oversight over, external auditors.

The stated objective of the new Standard is to enhance performance and ensure a consistent approach across audit committees within the FTSE350. By setting out clear expectations and guidelines, the FRC aims to support the delivery of high-quality audits and reinforce public trust in the financial reporting process.

The Standard will apply to FTSE350 companies and is now available to audit committees on a voluntary basis ahead of the anticipated legislation that will make compliance with the standard mandatory.

The Standard is to be followed on a comply or explain basis, for now, so if a company does not wish or is unable to apply a particular provision this can be dealt with via an explanation in the audit committee report.

While the Standard is largely drawn from existing guidance and best practice, the voluntary adoption period is intended to allow audit committees to familiarise themselves with the requirements and proactively enhance their practices.

Companies which are not within the FTSE 350 index are not required to apply this Standard. However, those companies which aspire to join the FTSE 350 may wish to do so in order to minimise disruption in the event that they succeed in doing so. Even where a company has no plans to grow to that size, if it is subject to mandatory tendering and rotation of audit firm appointments, it may wish to apply the Standard anyway – the provisions are examples of good governance.

### Scope

The Standard addresses only those audit committee responsibilities that relate to the external audit.

- The appointment of the auditor and the tendering process associated with that appointment;
- The ongoing oversight of the audit and the auditor;
- Reporting on the work the audit committee has done in respect of the audit and on compliance with the Standard.

The focus on the external audit is in keeping with the Government and CMA's intentions. An audit committee's other responsibilities – including those relating to internal audit, risk management and internal controls – will continue to be covered by the Corporate Governance Code and related guidance.

### The Standard

The vast majority of the Standard's content is taken from existing FRC publications including the Corporate Governance Code, Guidance on Audit Committees and Audit Tenders: Notes on Best Practice. However, new text has been included primarily to reflect the Government's / FRC's focus on diversity in the audit market.

The FRC believe there is a strong public interest in audit market diversity, and in the market as a whole having sufficient resilience, capacity and choice.

While audit committees cannot directly control the supply of audits, the FRC believe they do – as the buyers of audits – influence supply, and are crucial to realising a well-functioning audit market.

New provisions in this area include:

- Companies should manage their relationships with audit firms to allow them sufficient choice in a future audit tender and to take account of the need to expand market diversity and any market opening measures that may be introduced.
- The audit committee should communicate with any eligible audit firms that are unwilling to tender to understand why they are unwilling to tender and whether there is anything that could be done to change that.
- The audit committee should ask any eligible audit firms that are unwilling to tender how such action is in the public interest.
- The audit committee should remind eligible firms that refuse to tender that they may as a result be ineligible to bid for non-audit services work.

Other notable provisions include:

- Clarification that the tendering process should be led by the audit committee and not by executive management.
- The choice of auditor should be based on quality, including independence, challenge and technical competence, not price or perceived cultural fit.
- All members of the audit committee should be involved throughout the tender process, not just attending the audit firms' final presentations.
- The audit committee should consider running a price-blind audit tender.

## Practical application

Most FTSE350 audit committees will already be following much of the Standard as it draws heavily on existing best practice guidance. However, as drafted, the Standard does not provide the precision, objectivity, or clarity usually associated with a Standard. As such, it is unclear whether ARGAs will be able to enforce compliance in practice.

Furthermore, we would urge audit committees to look beyond the Standard when discharging their duties. Particular attention should be given to both section 489A(4) of the Companies Act 2006 and Part 5 of the CMA's Statutory Audit Services Order 2014 which articulate the audit committee role differently, and in some respects go further than the FRC Standard.

- Paragraph 4 of the new Standard requires that the audit committee approve the remuneration of the external auditor. Part 5 of the CMA's Statutory Audit Services Order 2014 (and paragraph 6 of the Standard) goes further in requiring that the audit committee negotiates the audit fee.
- Paragraph 7 of the new Standard requires that the tender process should not preclude the participation of 'challenger' audit firms "*without good reason*". By contrast, section 489A(4) of the Companies Act 2006 requires that the audit committee must carry out the selection procedures in accordance with Article 16(3) of the Audit Regulation, which states that the tender process '*cannot*' preclude the participation of non-Big 4 firms.

*"The organisation of the tender process [must] not in any way preclude the participation in the selection procedure of firms which received less than 15 % of the total audit fees from public-interest entities ... in the previous calendar year".*

## Expectations beyond the Standard

From our discussions with audit committee chairs, we believe there are a number of additional issues, not addressed in the Standard, that are important elements of an audit committee's role in relation to the external audit.

- **Skills and experience:** Effective oversight of audit starts with an 'audit competent' audit committee i.e., one with both financial literacy and appropriate experience in audit.

As an aside, one of the emerging themes from our recent Global audit committee survey is that as the committee's role and responsibilities have expanded and evolved beyond the core oversight role, the skill sets of many audit committees have changed, or are in the process of changing. As audit committees look to add members with experience in IT, cybersecurity, climate and other areas critical to the business, many audit committees (50 percent) are now noting that they are relying on just one or two members to do the 'heavy lifting' in the oversight of audit and financial reporting.

- **Oversight of management:** Management, including the Chief Financial Officer and finance function, also have a role to play in ensuring a high-quality audit. Audit committees have a responsibility to ensure:
  - management provides quality and timely information to the auditor during the audit.

- management are open to challenge during an audit and respond promptly to queries and information requests.
- management understand and fully promote the public interest purpose of the audit.

— **Audit process:** As noted in the recent FRC paper, '[What Makes a Good... Environment for Auditor Scepticism and Challenge](#)', a well-planned audit reaps many benefits, including ensuring that audit efforts are directed at the most significant areas where there is an increased need for scepticism and challenge.

The audit committee's role in ensuring that appropriate plans are in place for the audit is vital, including consideration of whether the planned levels of materiality and proposed resources to execute the audit plan, are consistent with the scope of the audit engagement.

— **Communication:** Audit committees should agree the formal and informal means of communication with the auditors at the start of the audit, including the plan for how any unexpected matters arising can be escalated in a timely manner. Such communication provides a strong foundation for establishing an effective working relationship between the auditor, management, and the Audit Committee.

Audit Committees should also set clear expectations and boundaries of what is desired of an auditor to deliver a good quality audit, such as the extent of constructive challenge that stakeholders expect to see between the audit firm and the audited entity's management, including how this would best be achieved and evidenced.

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