



Quoted Companies Alliance

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Dear Sir John,

Arrangements for auditor procurement and remuneration

We welcome the opportunity to respond to your supplementary questions regarding the arrangements for auditor procurement and remuneration, as part of your independent review of the Financial Reporting Council.

The Quoted Companies Alliance *Financial Reporting Expert Group* has advised on this response; a list of Expert Group members can be found in Appendix A.

Overall, we believe that changing the appointment of auditors would represent a major change in the relationship between companies, their shareholders and auditors, which needs to be carefully considered. As companies are owned by their shareholders, it is they to whom auditors are responsible. If another body were to be responsible for appointing auditors, it would follow that the auditors would be accountable to the new body. We therefore do not believe that this would sufficiently address the issue identified.

However, if the government were to proceed, we would urge that such an arrangement be limited to listed entities on the FTSE 100, as this is where the largest risk lies. Expanding this to all public interest entities and all listed entities regardless of size would be highly disproportionate.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Tim Ward".

Tim Ward
Chief Executive

The Quoted Companies Alliance is the independent membership organisation that champions the interests of small to mid-size quoted companies.

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Q1 Notwithstanding the important role played by audit committees, as well as the formal requirement for shareholder approval, can present arrangements risk auditors being too close to company management, and insufficiently incentivised to pose suitable scepticism, objectivity and challenge?

There is always a risk that auditors have a close relationship with management of a company. This is inherent in the development of client relationships to enable open and effective communication between the auditor, management and those charged with governance (e.g. audit committees).

However, if the current system's checks and balances, as established in the underlying ethical framework of the IESBA Code of Ethics¹ and the FRC Ethical Standard, are functioning properly the risk will be reduced to a level where auditor independence, objectivity and integrity is not compromised. If the risk is not reduced to such a level, then the existing ethical arrangements need to be either improved or replaced, so that they are able to function effectively.

The FRC Ethical Standard's overarching requirements are to ensure that auditors are objective, independent and have integrity, and that measures are in place to restrict the tenure of an auditor of a listed company or public interest entity (PIE). This was introduced with the aim of preventing auditors becoming too close to management.

Additionally, the FRC Ethical Standard was enhanced in respect of the provision of non-audit services to listed companies and PIEs as well as the provision of and acceptance of gifts and hospitality to all companies. This has also been included to address the perception of a loss of independence and objectivity.

However, we do not think that the FRC Ethical Standard goes far enough in respect of gifts and hospitality, as it fails to clearly establish what is deemed acceptable other than to apply a 'third party test'. If this matter is to be fully addressed and this perception removed, then the FRC should issue clearer guidance.

Q2 Notwithstanding the FRC's Guidance which states that audit committees must be satisfied that "the level of fee payable in respect of the audit services provided is appropriate and that an effective, high quality audit can be conducted for such a fee", could present arrangements in practice contribute to a situation where audit work is under-priced, under-resourced or cross-subsidised from other work?

Yes – the present arrangements in practice promote an under-priced audit product. This has generally been driven through the operations of the "Big 6" audit firms, as well as companies demanding more assurance from auditors but with reduced costs.

The introduction of the EU Audit Regulation and Directive in respect of PIEs having their non-audit services restricted (as provided by their statutory auditors) will help address this, although we have seen little evidence to the contrary to show this. The intention is to show that audit, which has always been a loss leader, needs to be priced more competitively and even to be costed at a price which produces appropriate cost recoveries.

The loss of non-audit services should drive the cost of audit upwards although it could have reverse consequences especially when developments in audit software, including data analytics, are taken into account. It remains to be seen if this will improve the situation.

¹ <https://www.ethicsboard.org/iesba-code>

Q3 If auditors of some or all major companies of public interest were to be appointed in a different way, by whom could this be done in practice?

Changing the appointment of auditors would be a fundamental change to the nature of companies and the responsibilities of auditors. Companies are currently considered to be jointly owned by shareholders who appoint an auditor to report back to shareholders; auditors are then in turn responsible to the shareholders. If another body were to be responsible for appointing auditors, it would follow that the auditors would be accountable to the new body.

So whilst this would seem like a way to address the issue that has been identified, we do not believe that it would necessarily have the desired impact. It should also be noted that no other audit regulator operates in this manner. For example, the United States' Public Company Accounting Oversight Board (PCAOB) does not appoint the auditors of major listed companies.

We also question whether having the auditors of major companies of public interest appointed would run counter to the objective of improving competition in the audit market.

That said, if the government were to select this option, we believe that it would not be appropriate for such powers to be given to the FRC. Instead, it may be worth considering establishing an entirely separate body whose sole responsibility is the awarding of such contracts.

Q4 What capability would need to be built up to do this competently? How could this be properly governed?

Please see our comments above.

Creating an equivalent entity similar to the now abolished Audit Commission² would consume a vast amount of resources, so that it could operate effectively. A comprehensive list of all entities to which the new regime would apply would also be required.

There would also need to be an appropriate tendering process which the entity would need to use to assess all audit firms that does not only consider audit fees but audit quality too. We believe that this would ultimately be flawed as the "Big 6" audit firms can access sufficient resources for such an audit client, whereas mid-tier firms may not be able to do so. Without clear guidelines for this function to assess audit firms, it is likely to default to the "Big 6" audit firms and therefore negate any improvement that is sought.

Furthermore, such an approach would remove the purpose of the audit committee to clearly oversee and review the function of the auditors. For example, we question how an audit committee would be able to remove poor auditors other than for reasons of conflict of interest.

We also question how such a system would function effectively to ensure compliance with the EU Audit Regulations and Directive, which are enshrined in UK law. It is particularly complex in terms of who can and cannot be appointed due to conflicts of interests in terms of network firms in EEA states and around the world providing other services to those entities or their subsidiaries or parents. We consider that it would be difficult for this to function in practice, as it is already a major challenge for the existing firms who operate internationally and are part of a network.

² <http://webarchive.nationalarchives.gov.uk/20150421134146/http://www.audit-commission.gov.uk/>

The governance of any body overseeing the appointment of auditors would face the same issues that the FRC currently experiences. The need for independence of the organisation would be paramount. However, it would also need to be able to develop its own engagement mechanism with investors without falling foul of legislation, such as the Transparency Directive or Market Abuse Regulation. Discussions at critical times between these two parties could be very difficult.

Q5 How could this be done in a way which commanded the confidence of users of accounts, such as investors? How could investors' rights of approval over auditor appointments be protected in any new arrangement?

Please see our comments above.

The reason for appointment would need to be publicly disclosed, as well as clear guidelines on how investors could remove an auditor that has been appointed under a contract of a certain length. There would also need to be a feedback mechanism between investors and the body that appoints the auditors, so that this can feed into any regulatory inspection performed by the FRC.

Q6 How would any alternative body take into account the views of the audit committee?

Please see our comments above.

The audit committee, as part of a unitary board, is responsible to shareholders. Placing an additional regulatory burden on companies requiring some directors to serve on an audit committee and for those directors to report to some outside body, fundamentally changes the nature of a company and those directors responsibilities.

The timing of such reporting could also cause regulatory issues in terms of distributing price sensitive information.

Q7 What companies should any new arrangement apply to? Is there case for piloting an alternative approach, for instance in relation to cases where deficiencies in audit have been identified?

As we have already mentioned in our previous answers, we do not believe that this arrangement would be the best solution.

However, if the government were to insist on proceeding, we would note that, if the largest risk is those listed entities on the FTSE 100, then it is to those companies that any new arrangement should apply only. Expanding this to all public interest entities and all listed entities regardless of size would be highly disproportionate.

Alternatively, if the issue relates primarily to those which have been subject to a Public Accounts Committee review, then such an approach should be strictly limited to those where such deficiencies have been identified and take away their ability to appoint auditors independently.

Appendix A

The Quoted Companies Alliance *Financial Reporting Expert Group*

Matthew Howells (Chair)	Smith & Williamson LLP
Rochelle Duffy (Deputy Chair)	PKF Littlejohn LLP
Elisa Noble	BDO LLP
David Ellingham	Bilby Plc
Matthew Stallabrass	Crowe UK LLP
Peter Westaway	Deloitte LLP
Jon Wallis	Grant Thornton UK LLP
Laura Mott	haysmacintyre
Claire Needham	KPMG LLP
Ben Courts	Moore Stephens
David Hough	RSM
Mark Hodgkins	Trackwise Designs plc
Edward Beale	Western Selection Plc