Financial Reporting Council

Consultation: Firm-level Audit Quality Indicators

RESPONSE FROM:

United Kingdom Shareholders' Association and ShareSoc

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Financial Reporting Council Consultation

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1. Introduction

1. UKSA and ShareSoc welcome the opportunity to provide the Financial Reporting Council with our comments on their consultation on firm-level Audit Quality Indicators (AQIs).

Definition of audit quality

2. We understand from its various recent publications[1] that the FRC has a definition of high quality audits as audits that:

   2.1. provide investors and other stakeholders with a high-level of assurance that financial statements give a true and fair view;

   2.2. comply with both the spirit and the letter of auditing regulations and standards;

   2.3. are driven by a robust risk assessment, informed by a thorough understanding of the entity and its environment;

   2.4. are supported by rigorous due process and audit evidence, avoid conflicts of interest, have strong quality management, and involve the robust exercise of professional judgement and professional scepticism;

   2.5. challenge management effectively and obtain sufficient audit evidence for the conclusions reached; and

   2.6. report unambiguously the auditor's conclusion on the financial statements.

3. While we generally agree with this definition, we have some issues with it. The first is (and this may be just semantics) that we would look for good quality, as opposed to bad quality, audits; not high or low quality. As a result we would change the word high to good in front of quality.

4. The second is with the idea of avoiding conflicts of interest. Conflicts of interest should be managed, not necessarily avoided, in a way that aligns the auditors' interests with those of its primary audience, members of companies they report to. As a result they will always have a conflict of interest with the management of companies and therefore should focus on shareholders' interests being theirs and not managements'. Also, any conflicts with key stakeholders of companies other than their shareholders should be mitigated against. If financial

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[1] FRC AQR What Makes a Good Audit_November2021 p6 and FRC Audit Quality Inspection and Supervision Public Report 2022 - Tier 1 Firms Overview_July 2022 p3

statements give a true and fair view, this will be sufficient for investors and therefore should also be sufficient for other stakeholders. Auditors should never be answerable to other stakeholders; only to shareholders, who have the power to appoint and remove them.

5. Lastly, AQIs should derive from trying to measure good quality audits and therefore relate to the definition of good quality audits. We notice that this AQI consultation does not start with the definition of good quality audits and suggest it should.

Measuring audit quality

6. We recognise how difficult it is to measure audit quality, which is why we suggest that AQIs should focus on the definition of a good quality audit. Good quality audits tend to be instinctively obvious to shareholders from reading annual reports and audited financial statements and feeling that they have a high level of assurance that what they are reading is reasonably accurate and understandable and not obfuscated by too much irrelevant information. This is then validated over time provided no scandals or questionable accounting or material omissions come to light in subsequent periods.

7. Your proposed AQIs will only be worth reporting if they evidence any component of a good quality audit as defined.

8. Providing AQIs at the firm level is also more efficient for the main users of audits as they will provide a more holistic and balanced view of the quality of audits a firm provides. The quality of individual audits is far too granular to be useful.

UKSA and ShareSoc offer to FRC

9. We are supportive of the FRC's drive to improve audit quality and would like to offer relevant FRC staff our availability in any post consultation phase of your firm-level AQIs project and in helping to clarify investor/reporting user views and perspectives. Please contact Charles Henderson at charles.henderson@uksa.org.uk or Dean Buckner at dean.buckner@uksa.org.uk and Cliff Weight at cliff.weight@sharesoc.org if you wish to take us up on this offer.

2. About UKSA and ShareSoc

10. UKSA and ShareSoc represent the views of individual investors. Between us we have over 23,000 members. In addition to our own members, 6 million people own shares or have investment accounts with platforms in the UK.

11. The Office for National Statistics estimates that at the end of 2018 UK-resident individuals held 13.5% of the UK stock market, up by 1.2% from 2016 and moving away from the historical lows of 10.2% in 2008. In 2020, the Financial Times estimated that 15% of the UK stock market is held by individual shareholders. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes. See https://www.sharesoc.org/investor-academy/advanced-topics/uk-stock-market-statistics/

UKSA (United Kingdom Shareholders' Association)

12. 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.

13. There are many agents and intermediaries in financial markets. Unlike them, UKSA represents solely those people who are investing their own money. UKSA and ShareSoc work together to build 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

ShareSoc (UK Individual Shareholders Society)

14. ShareSoc is a not for profit company. It is dedicated to the support of individual investors (private shareholders as opposed to institutional investors). It aims to make and keep investors better informed to improve their investment skills and protect the value of their investments. It engages with companies, the Government or other institutions if we think individual shareholders are not being treated fairly.

15. ShareSoc actively campaigns to seek redress for private shareholders in cases where they have been the victims of unfair or unscrupulous treatment by companies and / or the financial services industry. See www.sharesoc.org

3. <u>Answers to your numbered questions</u>

Scope and application

Question 1. Do you agree that the firms reporting their AQIs should be aligned to the scope of the revised 2022 Audit Firm Governance Code? If not, what scope would you prefer and why?

16. No, we do not agree because it is not clear that the Audit Firm Governance Code (AFGC) applies to all Tier 1 (seven largest firms) and Tier 2 (the next five firms) firms out of the 31 firms that audit PIEs.

17. We prefer a scope that includes all audit firms that are likely to be selected to audit FTSE350 and PIE (using the new expanded definition) companies. If this is the same scope of the AFGC, then fine. If not, we suggest the scope should be all firms that have audits within the scope of the Audit Quality Review (AQR) team reviews.

Question 2. Do you agree that the AQIs should include all audit engagements, but segmented between PIE and non-PIE audits? If not, which engagements do you think should be included?

18. Yes, we agree.

19. In agreeing, we envisage each AQI would need to cover total audits, with the data being also segmented between PIE audits and non-PIE audits: ie three lots of information. This is because we would expect a firm providing good quality audits to have AQIs indicating consistent quality across all its audits, its PIE audits and its non-PIE audits.

Question 3. Do you expect any additional costs to be incurred by firms reporting over a period which is not aligned with their financial years? Are there ways to minimise these costs?

20. As we have no insight to any firms' costs of reporting AQIs, we cannot answer this question.

21. However, we would add that we have no issue with audit firms using their financial year and Transparency Report periods to report AQIs. We see no need for firms to use the same 12 months. If reportable AQIs are properly defined and standardised for all reporting firms, they should still be comparable even though covering different periods (similarly to audited financial statements of companies).

Reporting

Question 4. Do you agree that it would be useful to include supporting narrative? Please provide suggestions to ensure that the information is concise and useful for users of audit services.

22. Yes, we agree.

23. We have no suggestions on conciseness and usefulness of any narrative reporting. This is because we expect auditors to be professional and experienced enough to ensure that their reporting is concise and useful themselves. If they do not, they will lose the trust of their audience and only have themselves to blame.

24. However, as a matter of good practice, audit firms should be encouraged to sign up to the 'Plain English Campaign' (PEC) and seek to achieve the PEC's Crystal Mark on their reports . A possible approach to this would be to make it a specific AQI under Section B (Quality Monitoring) for firms to submit a certain percentage (say, 10%) of their audit reports for review by the PEC each year and to publish the results of the reviews.

Question 5. Do you agree with our proposed AQIs? If not, or in addition, do you prefer some of the alternatives presented above? Please explain, using the reference numbers.

25. We agree with AQIs 1, 2, 3a, 4, 5, 6, 8, 9a, 9b, 11 and 13. This is mainly because we can see the links between these AQIs and your definition of a high quality audit (bearing in mind our comments in the introduction). We are not convinced that AQIs 3b, 10 or 14 will be that informative. We accept that AQIs 7 and 12 may also be linked to your definition of a high quality audit.

26. We believe there should be some exploration of potential AQIs that provide information on disciplinary matters that indicate any breach of auditing standards and regulations; on the numbers of audits found to have material gaps in their required documentation and/or evidence; on the quality of the end product, audit reports in terms of their clarity, conciseness and informativeness (see our PEC point above); and on the effectiveness of the governance and leadership of the top level of a firm’s audit department.

27. We also believe there should be some exploration of a potential AQI that provides information on the amount that audit firms involve shareholders of the companies they audit in the planning stages of audits, especially in determining key or material financial statement matters of concern to those shareholders. We understand some audit firms are already doing this (involving investors in determining potential key audit matters) on a trial basis but we recognise this may need to be made more formal. There need to be some mechanisms, such as those envisaged in the audit reform debate like companies audit and

assurance policies, which would enable auditors to ascertain key matters of concern to shareholders.

Question 6. Do you think there are any other firm-level AQIs that we should consider? If so, please explain. (If relevant, please refer to the list of AQIs we have considered but not proposed, in Appendix 1.)

28. Yes, see our answer to Q5 above. Appendix 1 N16 could be developed to show how much time is spent with investors (on average) in the planning stages of audits with explanatory narrative on key matter concerns coming out of these engagements. If this became more common practice, we would also expect these matters to be reported on in audit reports. Also, our suggestion on disciplinary matters indicating breaches of standards and regulations could be considered in developing your Appendix 1 N7 AQI into something that could be informative on audit quality.

29. Some of the most catastrophic audits have occurred where a firm has chosen to audit a company that it should never have taken on as a client. One of the most useful statistics for assessing how seriously an audit firm takes audit quality is, in our view, the rate at which it declines invitations to tender for audits.

30. Accordingly, we recommend that all audit firms be required to publish the percentage of cases (split between PIEs and non-PIEs) where they have been invited to tender for an audit and have declined to do so.

General question

Question 7. Are there any other comments you wish to make about these proposals, including concerning costs, benefits, or impacts not discussed above?

31. Other than our introduction comments, no.