ACTING ON AUDIT

An investor stewardship perspective

RAILPEN

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CONTENTS

INTRODUCTION AND RECOMMENDATIONS

High quality and independent external audit plays an important role in serving the public interest. Fundamentally, an audit is the independent examination of an organisation's financial report, in order to obtain assurance that said report is free from "material misstatement, whether due to fraud or error[1]". Therefore, high quality audit can serve the public interest by: reinforcing trust and confidence in the accuracy of financial reporting; reducing the risk of inaccurate information or fraud; and strengthening corporate accountability to investors through increased transparency. This is of clear benefit to investors, both lenders and equity investors, and by extension the beneficiaries they invest on behalf of, such as pension fund members and savers. Companies' employees, suppliers and customers also benefit from accurate information about a company's financial position, and the stability this provides around future expectations.

The important role that audit plays is evidenced by the fact that when audit fails the losses suffered by investors and their beneficiaries, and by a company's employees and pensioners, can be significant. It is easier to quantify the financial materiality of audit to investors by looking at the losses incurred in cases of audit failure, as illustrated by some high profile examples detailed elsewhere in this report. While in each case the board and management were primarily responsible, weaknesses in the audit were identified as a contributory factor.

Since the collapse of Enron and its auditor Arthur Andersen in the early 2000s, there have been major reforms to the regulatory framework governing external audit. These reforms were aimed at: improving audit quality, increasing transparency and accountability, addressing threats to auditor independence, and making the market for audit services more resilient.

Railpen has been thinking about audit issues at both its portfolio companies, as well as the broader framework for audit quality, for some time[2]. However, we recognise that it has been five years since there was a flurry of UK policy initiatives aimed at improving audit quality and that the portfolio companies we speak to about audit issues often note that we are one of few investors to cover this issue. We therefore wanted to undertake a review of audit *as a stewardship issue* to help us understand how better to address this with our portfolio companies, as well as to consider how we can most effectively wield the array of stewardship tools at our disposal.

Building on a series of interviews with key market participants, as well as a review of the academic and policy research base, this report therefore examines the status of the main factors affecting audit quality and auditor accountability, including recent and current policy developments, and explores why they matter to investors and the beneficiaries upon whose behalf we invest.

Such factors are wide-ranging and include the:

- skills, experience and resources of the audit partner and team;
- auditors' independence and the absence of conflicts of interest;
- effectiveness of audit committee oversight;
- quality of public disclosures made by companies, auditors and regulators; and
- use of standards and regulatory requirements.

These factors can be influenced by investors such as Railpen, either by engaging with investee companies and auditors, or by participating in the policy-making process. This report examines the nature and effectiveness of investor stewardship activity on audit related issues to date, and makes recommendations to other participants in the audit quality ecosystem – companies, audit firms, regulators and investors – as to activities they may be able to consider to effect positive change.

> Many of these issues are the subject of intensive industry debate. However, we hope that our report provides a useful contribution to the discussion from an investor stewardship perspective.

1 *Auditor's Responsibilities for the Audit (frc.org.uk)*

2 *Full details of our work in this space can be found at p.28*

The scope of the report

The term "audit" can be used to mean various things – particularly in the rapidly developing world of responsible investment. This report does not cover either internal controls or assurance of sustainability information: we deem these issues to be well covered and understood by others[3]. The primary focus of this report is on the external auditor's core function – conducting an independent assessment of companies' financial statements and related disclosures.

Furthermore, although we recognise that audit quality is an issue in nearly every jurisdiction, we focus our work here on the major markets that most investors are exposed to: the UK, the US and the EU.

Our findings

1. **There are regular audit failures and a high number of 'high risk' audits are considered deficient in major markets.** Despite the considerable efforts that have been made, there continue to be regular audit failures and a worryingly high number of the 'high risk' audits of listed companies in major markets such as the US and UK that have been inspected by regulators are considered deficient. Our research and interviews have highlighted some specific aspects of audit where practice and the policy framework can be improved.

2. **Investors have concerns about the usefulness of audit information they receive and believe there is scope for improvement.** We have heard these concerns regarding the information provided by auditors, audit committees and regulators, both in respect of individual audits and audit firms' overall performance. The strength of these concerns varies between markets but all investors whose views we heard felt that there was scope for disclosures to be enhanced.

3. **There are currently low levels of investor engagement in audit issues.** The reasons for this appear to include a lack of resource as well as a lack of understanding of the impact and technical aspects of auditing.

4. **Extensive efforts are being made on audit reform.** We welcome the recent announcement by the new UK Government that it intends to legislate on audit reform, and we strongly support the ongoing efforts of the FRC, the PCAOB and other national and international audit regulators and standard setters to strengthen the policy framework for audit and ensure that the current framework operates effectively. We also recognise the improvements undertaken by many in the audit industry.

5. **Yet it is clear there is more that needs to be done on all sides if we are to see market-wide material improvements in audit quality.** In this report we make recommendations for activities and initiatives addressed to audit firms, policymakers, companies and investors for them to consider. Taken together, we believe they can contribute to an environment that supports high quality audits. We summarise them in the table below, with links to the sections of the report where the recommendations and rationale are explained in more detail.

3 *For instance, we note the recent Viewpoint from the International Corporate Governance Network (ICGN) on the assurance of sustainability reporting [Microsoft Word - 3. ICGN Investor Viewpoint - The assurance of sustainability reporting.](#)*

What Railpen will do – and what we are asking others to do too

We recognise that investors need to up their game if the outcomes we seek are to be achieved, and that includes Railpen. As a result of the research described in this report we are considering making changes to the way we address audit issues as part of our stewardship activities. These are likely to include:

- Updating our Global Voting Policy to clarify our position on auditor liability and the adequacy of companies' efforts to address previously identified material weaknesses.
- Encouraging portfolio companies to commission their auditor to produce graduated findings.
- Asking portfolio companies to prepare i) a Resilience Statement and ii) an Audit and Assurance Policy (AAP) and share it with us and other interested shareholders.
- Pursuit of escalation activities should our requests to meet the Audit Committee members or auditors at target companies not be met.

We recognise that, although we are a large UK investor with a longstanding history of engaging on audit issues at portfolio companies, our actions alone are not enough to effect the system-wide change we think is needed. We therefore encourage regulators, companies, audit firms and other investors to continue to "act on audit" by undertaking the following additional actions which together we think should raise the quality of external audits:

Issue	Our recommendation	Jurisdiction	Who should take forward?
Insufficient information on assessment of quality of individual audits	Engagement-level Audit Quality Indicators (AQIs) should be published or shared with investors upon request	UK	Audit Committees, Policymakers
	Audit Committees should agree up front with auditors which engagement-level metrics will be used to assess performance / suitability	UK, US, EU	Audit Committees
	Policymakers should publish the name of the company and additional information when reporting on audit quality inspections	UK, US	Policymakers

Issue	Our recommendation	Jurisdiction	Who should take forward?
Need for more informative audit reporting to investors	Regulation around content of going concern statements should be improved	UK, US, EU	Policymakers, Regulators and Standard setters
	Auditors should be required to produce and publish graduated findings in audit reports In the interim, investors should ask for this information to be included in audit reports	UK, US, EU	Policymakers, Audit Committees, Investors, Audit firms
	Audit Committees should publish Resilience Statements and Audit and Assurance Policies (AAPs)	UK	Audit Committees, Policymakers
Limited investor – issuer engagement on audit	Audit Committees should agree to all reasonable meeting requests from shareholders	UK, US	Audit Committees
	Audit partners should attend AGMs and answer shareholder questions Shareholders should flag their intention to ask the auditor a question in advance of the AGM	UK, US	Audit Committees, Auditors
	Investors should publicly affirm their interest in audit issues / commit to attend meetings with Audit Committee chairs Shareholders should seek to i) understand the experience / expertise of external audit team ii) express their preferences for high-quality as opposed to low-cost audits	UK, US, EU	Investors
	Regulators should find additional opportunities to encourage Audit Committees to seek shareholder views	UK, US, EU	Policymakers

Issue	Our recommendation	Jurisdiction	Who should take forward?
Limited investor involvement in regulatory framework for audit	Where this is not already happening, audit regulators should establish an investor-only advisory group	UK, US, EU	Policymakers, Investors
Limited investor – audit firm engagement	Audit firms should hold at least one investor roundtable each year or investor associations and professional bodies should commit to at least annual roundtables	UK, US	Audit firms, Audit and Investor associations
	Audit firm iNEDs should be made available to speak to investors at least once a year (without the presence of audit partners)	UK, US, EU	Audit firms
Culture of audit firms needs further improvement	iNEDs at audit firms should be required, alongside minimum standards regarding the number and role of such iNEDs	US, EU	Policymakers
Limited investor engagement with audit issues generally** **NB this will also be improved indirectly through some of the recommendations above	Audit firms should hold sessions on the nature and function of an audit report for investors Investors should hold sessions for audit firms on what is considered to be decision-useful information	UK, US, EU	Audit firms, Investors Investors, Audit firms
Limited use of investor stewardship tools on audit issues	Investors should review and enhance their voting policies on audit at relevant companies, as well as consider AGM questions and pre-declarations	UK, US, EU	Investors
Need for greater progress on audit market competition	Regulators should formally set out (and publish results of) tests applied to assess satisfaction with competition in the audit market If audit market competition is deemed insufficient, policymakers should revisit the market cap approach	UK, US, EU	Policymakers

We are grateful to those investors, audit committee chairs and members of the audit profession who agreed to be interviewed as part of this research, and to everybody else who has contributed directly or indirectly. We hope that this report is a useful and timely update on the issue and serves both to raise awareness of audit as an important stewardship issue and to provide practical suggestions as to how investors, companies, audit firms and regulators might be able to work together.

If you would like to find out more about Railpen's work in this space, or have any questions about the findings and conclusions in this report, please contact SO@railpen.com.

WHY SHOULD INVESTORS CARE ABOUT AUDIT?

High quality audit has been defined by the CFA Institute as "one that diminishes the ability of a management team to obscure the economic reality, and one which ensures the timely communication of information which could become significant if the future state turns out to be different to reporting date expectations"[4].

This section assesses the available academic literature and other evidence on the benefits to investors (and their beneficiaries) of high quality audits, and the costs associated with audit failure based on an analysis of selected high-profile cases. It also aims to identify the different factors that have the most direct impact on audit quality and, by extension, on the benefits or costs to investors.

Research on the positive case for audit

It is difficult to find quantitative evidence of the positive and direct financial materiality of audit from an investor perspective in academic research. Most of the available research focuses on the impact on companies, for example on the cost of capital[5]. While there is clearly correlation between the two, benefits to the company will not always flow through to its investors and even those benefits are dependent on the quality of the audit undertaken.

The main findings of academic research into the theoretical benefits of high quality audit were summarised in a statement by US SEC's Chief Accountant, Paul Munter[6], in 2021:

"Academic studies demonstrate that assurance provided by an independent auditor reduces the risk that an entity provides materially inaccurate information to external parties, including investors, by facilitating the dissemination of transparent and reliable financial information. Research also shows that an independent, high quality audit improves the credibility of financial statements reducing risk to investors, thereby lowering the cost of debt and the cost of equity for the company. Additionally, companies often benefit in other ways from the services of an independent auditor... audit may also help a company prevent fraud and aid in the evaluation of management".

Evidence on the costs to investors of audit failures

It is easier to quantify the financial materiality of audit to investors by looking at the losses incurred in cases of audit failure, as illustrated by some high profile examples (details below). While in each case the board and management were primarily responsible, weaknesses in the audit were identified as a contributory factor.

This is not intended to be an exhaustive set of case studies – we could have chosen from several others including Parmalat and Satyam – but we thought this selection provided accessible and market-relevant insights into the specific features of the audit process that may have contributed to the failure and, in the earlier cases, helping to explain how audit policy has developed in certain markets.

We also note that the costs of audit failure are borne, not just by investors in a company's equity, but by its bondholders too. However, there is more information publicly available on the losses to equity investors, which is why we focus on these costs in the tables below.

4 *Quoted in the Brydon Report: brydon-review-final-report.pdf*

5 *A helpful summary of some of the academic research can be found in: The Value of Audited Financial Reports - The CPA Journal*

6 *SEC.gov | The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors*

Case study 1

Company, market, year	Enron (US, 2001)
Estimated losses	• Estimated $11bn loss for equity investors (based on equity value before collapse). • Largest US corporate bankruptcy at the time with $63.4bn in assets[7].
Audit-related contributory factors	• Conflict of interest resulting from high levels of non-audit fees. • Failure to gather evidence to enable it to conclude that the financial statements were true and fair. • Failure to detect deliberate misstatements in financial reports.

Case study 2

Company, market, year	BHS (UK, 2016)
Estimated losses	• Estimated £571m pension deficit at the time of the company's bankruptcy[8].
Audit-related contributory factors	• Inadequate supervision, performance and review of the audit engagement. • Independence affected by the value of non-audit fees (which exceeded audit fees by more than three times, four years in a row). • Failure to identify material uncertainties to the company's ability to continue as a going concern. • Failure to challenge management assumptions on future sales growth and revenues[9].

7 *Figures from The Quality of Corporate Financial Statements and Their Auditors before and after Enron (cato.org); George Benston; 2003*

8 *Figure from BHS report (parliament.uk); July 2016*

9 *All findings from the FRC's report on the BHS audit: Microsoft Word - BHS - PFAM - Final - 10 August 2018 (frc.org.uk)*

Case study 3

Company, market, year	Carillion (UK, 2018)
Estimated losses	• Estimated £1.2bn loss for equity investors (based on final half-yearly statements before liquidation) • Estimated £2bn owed to suppliers and creditors. • Estimated £800-900m pension deficit[10].
Audit-related contributory factors	• Failure to gather sufficient appropriate audit evidence to enable it to conclude that the financial statements were true and fair. • Failure to consider evidence suggesting that Carillion's accounting might have been incorrect or unreliable. • Failure to conduct the audit with an adequate degree of professional scepticism and to subject Carillion's management's judgements and estimates to effective scrutiny. • Suggestion that KPMG's approach to the audit was influenced by Carillion's importance as a client[11].

Case study 4

Company, market, year	Wirecard (Germany, 2020)
Estimated losses	• Shareholders claimed for a collective total of €7bn in damages[12]. • Separately, some investors have attempted to sue EY[13].
Audit-related contributory factors	• Objectively inaccurate audit opinions over a period of years. • Grave and repeated failures in internal audit quality controls and professional duties[14].

10 *All figures from The collapse of Carillion (parliament.uk); 2018*

11 *All findings from the FRC's decision notice on the Carillion audit: Sanctions against KPMG LLP, KPMG Audit plc and two former partners (frc.org.uk); October 2023*

12 *Figure from Wirecard shareholder claims for damages rank behind all creditor claims in landmark insolvency ruling - Lexology; 2022*

13 *For example, Commerzbank sues EY over Wirecard fallout - FStech Financial Sector Technology; 2023*

14 *APAS findings as reported in: EY's Wirecard audits marred by 'repeated grave' violations of duties, says watchdog (ft.com); April 2024*

Case study 5

Company, market, year	Silicon Valley Bank (US, 2023)
Estimated losses	• Estimated cost to the US Deposit Insurance Fund of $16-20bn[15]. • Research suggests that the contagion effect of the bank's collapse caused significant negative returns in global equity indices[16].
Audit-related contributory factors	• Still under investigation but allegations include failure to identify material uncertainties to the company's ability to continue as a going concern, including large unrealised losses on Treasury bonds. • It has been suggested that KPMG's long tenure as the company's auditor (29 years) may have contributed to a lack of diligence[17].

How different factors can affect audit quality

Much of the academic research focuses on the relationship between audit quality and specific features of the audit process or the policy framework of law, standards, reporting requirements and enforcement.

For example, one paper compares insights and views of auditors and investors on audit quality[18] and ranks different factors by their perceived impact on quality. Some of the factors that were ranked highly by the investors included: the expertise, resources and training of the audit engagement team; the size and reputation of the audit firm; auditor independence and scepticism; and the track record of the audited entity.

Some research identifies threats to audit quality such as the predominance of consulting income over auditing income at firm level undermining the public service ethos, the lack of competition and de facto oligopoly of the Big 4 audit firms (PWC, Deloitte, KPMG and EY) and the absence of pressure as "outsiders (including investors) cannot distinguish superior from mediocre auditing services"[19]. Other papers identify beneficial factors such as the independent oversight of audit (as opposed to self-regulation by the audit profession which was the norm before Enron)[20].

Together, the academic research and case studies mentioned in this report highlight features of the audit process, audit market and regulatory framework that can negatively impact the effectiveness of the audit and the reliability of the information received by investors. These features are explored in more depth later in the report but include:

- the skills, experience and resources of the audit partner and team;
- the auditors' independence and the absence of conflicts of interest;
- the ethics and culture of the audit firm;
- the effectiveness of audit committee oversight;
- the quality of public disclosures made by companies, auditors and regulators;
- the use of standards and regulatory requirements;
- market incentives to provide high quality services, such as competition; and
- the possibility of meaningful sanctions in the case of audit failure.

Action by investors can influence some of these factors at both a company and market wide level, but a bigger influence is the regulatory framework within which both auditors and companies operate.

This is why a growing number of investors believe that it is worthwhile participating in the policy-making process and attempting to influence that framework as part of their public policy advocacy[21]. Railpen itself has done and continues to do so in relation to audit and other systemic issues[22].

15 *Figure from Material Loss Review of Silicon Valley Bank (federalreserve.gov); 2023*

16 *The domino effect: Analyzing the impact of Silicon Valley Bank's fall on top equity indices around the world - ScienceDirect; 2023*

17 *KPMG's 29-year SVB stint stirs independence debate | CFO Dive; March 2023*

18 *Understanding Audit Quality: Insights from Audit Professionals and Investors (thecaq.org); 2016*

19 *'Why Do Auditors Fail? What Might Work? What Won't? by John C. Coffee: SSRN; 2019.*

20 *Public Oversight and Reporting Credibility: Evidence from the PCAOB Audit Inspection Regime'; Brandon Gipper et al; ECGI; 2019: finalgipperleuzmaffett_1.pdf (ecgi.global)*

21 *The ICGN Systemic Stewardship & Public Policy Advocacy Toolkit | ICGN provides investors with useful guidance on when and how to undertake public policy advocacy.*

22 *Details of Railpen's audit-related activities can be found on page 28 of this report. Details of our broader public policy advocacy can be found in our 2023 Stewardship Report.*

HOW IS AUDIT REGULATED?

As with many other corporate governance issues, the policy and regulatory framework is fundamental to the effectiveness of external audit.

This section identifies the main elements of this framework around the provision of audit services to listed companies and other so-called 'public interest entities'[23], and describes briefly how it has been developed. The focus is particularly on the UK, US and EU in line with most UK and US investors' allocations.

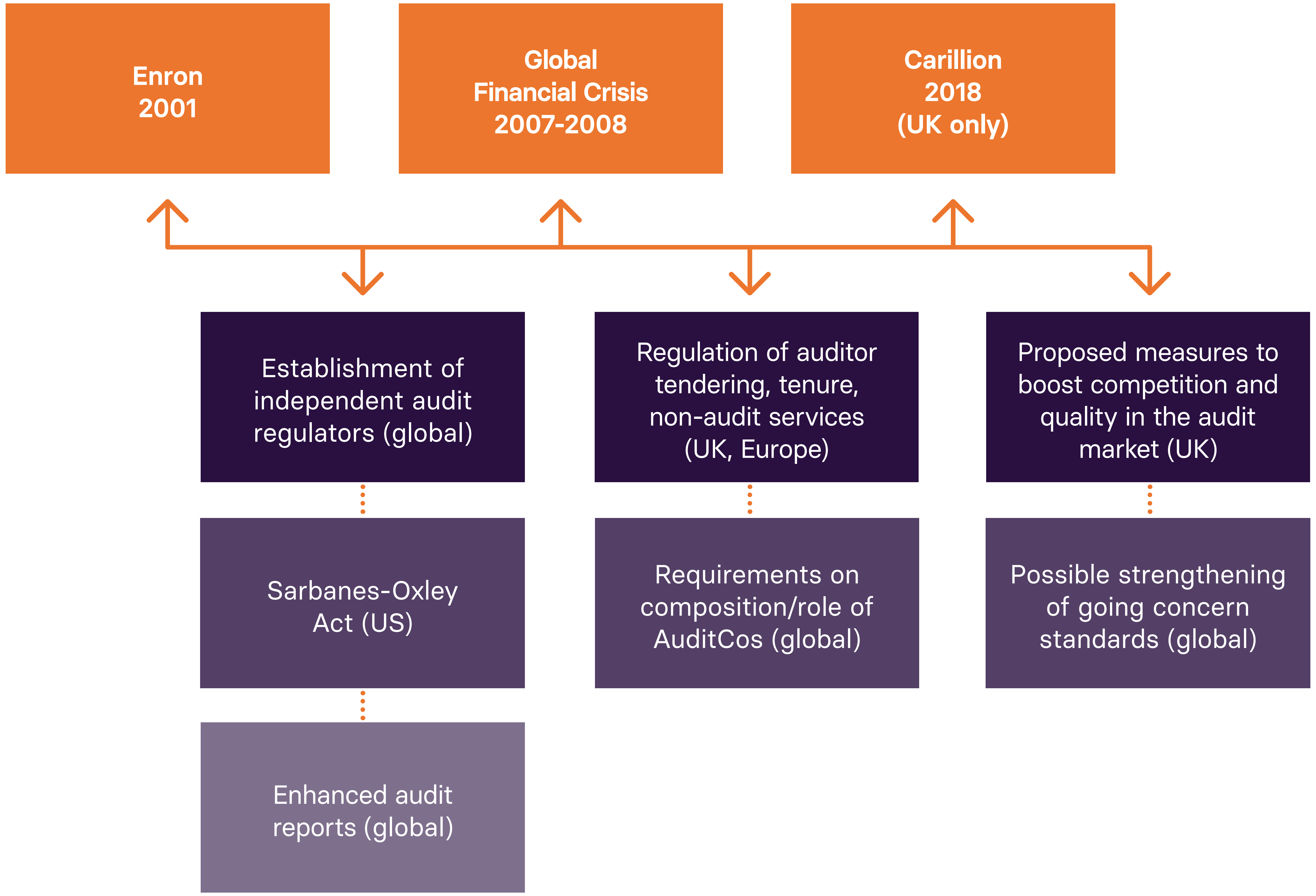
Corporate scandals have led to significant recent policy developments

There have been significant developments in the policy framework for audit in all major markets since the turn of the century. The audit profession is now subject to formal regulation and independent standard-setting, oversight and enforcement in varying degrees. In addition, the relationship between companies and the external auditor – and in particular the role of the audit committee – is now much more heavily prescribed.

Policymakers have various tools at their disposal when developing a regulatory framework. These include setting and enforcing rules and standards; intervening in the operation of the market, for example to encourage competition; requiring public disclosures; and providing shareholders and others with legal rights. All these tools and more have been used during this period.

The two main events that instigated these developments were the collapse of Enron and subsequently its auditor (Arthur Andersen) in 2001-02 and the global financial crisis of 2007-08. In the UK specifically there were further policy developments following the collapses of BHS and Carillion in 2016 and 2018 respectively, the current status of which are described later in this section.

23 The exact definition of a 'public interest entity' (or equivalent term) differs between markets. In the UK the current definition includes all entities whose transferable securities are admitted to trading on a regulated market as well as unlisted credit institutions and insurance undertakings. It has been proposed that this should be extended to cover some other large unlisted companies.



The collapse of Enron and Arthur Andersen led to the 2002 Sarbanes-Oxley Act in the US, which increased the requirements on auditors to inspect companies' internal controls. It also prompted the creation of independent audit regulators such as the Public Company Accounting Oversight Board (PCAOB) in the US and the Financial Reporting Council (FRC) in its current form in the UK. There are now over 50 such regulators globally, including in all major markets, that typically set and enforce standards and have powers to carry out inspections and sanction individual auditors and audit firms.

A second wave of regulation and policy changes followed the global financial crisis in the late 2000s. The response varied between markets but in the EU and UK it included, for example, mandatory auditor rotation, restrictions on the provision of non-audit services and increased reporting obligations, as well as regulation of the composition and role of the audit committees. Global and national standard-setters introduced enhancements to the standards for auditor reports. In addition, more attention also began to be paid to the governance of the audit firms, for example with the publication of the first governance code for audit firms in the UK in 2010.

While there have been significant changes in the policy framework in all major markets during this period, there are also significant differences between them. These differences are covered in greater depth in the Appendix, but here we note that there is a greater degree of consistency between the UK and EU frameworks than with the US framework, as many of the reforms introduced in the first two markets were made at a time when the UK was still a member of the EU.

In general terms, the policy framework in the UK and EU is more comprehensive, but the US framework goes further in some respects. Specifically, auditors in the US have responsibility for assessing companies' internal controls over financial reporting (through the Sarbanes-Oxley Act) which is not currently the case in the UK or EU.

Progress so far

Issue	Evidence of impact achieved? (UK)	Evidence of impact achieved? (US)
Audit quality[24]	26% of inspected audits in 2022/23 carried out by Tier 1 firms classified by FRC as needing improvement.	46% of inspected audits in 2023 classified by PCAOB as having deficiencies.
Audit firm fines[25]	2023/24: £48.2m (£33.1m after the application of settlement discounts)	2023: $11.85m
Non-audit services	The share of total income from the provision of non-audit services to audit clients fell for all Big 4 firms between 2016 and 2021 (ranges from 7% to 12% in 2021)	Non-audit fees average 10-11% of the fees paid by US public companies to audit firms (no change)
Big 4 share of the audit market for audit	2021: audited 98% of FTSE350 audit fees	2023: audited 88% of large accelerated filers[26]
Audit firm rotation	Between 2018 and 2022, 131 FTSE350 companies changed auditors. On aggregate the smaller audit firms gained 13 audits during that period.	No available data

On audit quality

Many of the policy measures taken over the last fifteen years or so have been intended, either directly or indirectly, to lead to improvements in the overall quality of audit. However, it is hard to make a definitive assessment of the extent to which they have succeeded in this aim as limited academic research has been undertaken. What seems clear to us is that any improvements in audit quality so far – and the latest FRC report "welcome[d] the work that the largest four firms have undertaken over the past few years that has resulted in the improvement of in their delivery of high-quality audits"[27] - have not yet been sufficient to meet the increased expectations on auditors.

Recurring audit deficiencies: regulatory findings

Both the PCAOB in the US and the FRC in the UK continue to report high levels of inspected audits containing deficiencies and requiring improvements - 46% and 26% in the US and UK respectively in 2023 (it should be noted that the regulators use different definitions when calculating these percentages). We should note that figures are specific to audits that have been selected for inspection, the criteria for which contains an element of risk-based selection, i.e. higher risk audits are more likely to be selected. However, both the PCAOB and FRC use different sampling methods during selection. So considering the nature of how they are selected, to quote the FRC, "it is important not to extrapolate our findings or assessment of quality to the whole population of audits".

24 To note that the FRC and the PCAOB use different classification models and sampling methodologies so the number of audits rated as deficient or needing improvement in the two markets are not directly comparable.

25 It should be noted that audit-related fines in a given year often relate to the audit undertaken of a specific entity in previous years.

26 'Large accelerated filer' is defined by the SEC as a company whose public float exceeds $700m.

27 Quality gap widens among Tier 1 audit firms, says FRC | ICAEW

Common deficiencies identified in the US by the PCAOB[28] in its most recent report included:

- that risks of material misstatement (for example, in relation to expected credit losses) were not appropriately assessed and related controls were not tested; and
- failures to properly test accounting estimates, including fair value measurements, resulting in deficiencies in many financial statement accounts.

The findings most frequently identified in the UK by the FRC[29] included:

- that audit teams did not adequately evaluate and challenge management's assumptions on impairment assessments and credit loss provisions;
- failure to obtain sufficient audit evidence on revenue recognition; and
- shortcomings in procedures for journals testing and inventory valuation.

A recent report on the market for audit services in the EU[30] covering the period 2019-2021 found that the deficiencies that were most commonly identified by national audit regulators related to:

- insufficient audit procedures and failure to improve methodologies in line with new legislation and standards;
- failure to perform timely engagement quality reviews;
- insufficient risk assessment and testing of internal controls; and
- poor documentation and data security.

Regulatory review findings

As already noted, there continue to be high-profile audit failures, including those discussed in the previous section, as well as widespread deficiencies in audits inspected by regulators.

The PCAOB reported that approximately 46% of the 2023 audits it reviewed had one or more deficiencies, up from 40% in 2022 and 34% in 2021[31]. The most recent report from the FRC[32] found that 26% of inspected audits carried out by Tier 1 audit firms[33] required more than limited improvements (compared to 33% in 2020). Four percent of inspected audits required significant improvements, although none of these were FTSE350 companies. As noted above, the PCAOB and FRC findings are not directly comparable.

Both the PCAOB and FRC highlight that there is a significant difference between the performance of the Big 4 firms and the other firms whose audits they inspect which has a distorting effect on the headline figures. The PCAOB found that on aggregate 26% of inspected audits conducted by the Big 4 only had deficiencies, the same percentage as in 2022; while the FRC noted a widening gap between the Big 4, whose results have either improved or are broadly stable, and smaller Tier 1 firms whose results have declined.

While welcoming the apparent levelling out in terms of the performance of the Big 4 firms, Railpen's view is that the percentage of their inspected audits requiring improvement remains higher than we would like, especially considering that many would have been selected for inspection as they were considered high risk.

28 *Spotlight-staff-preview-2022-inspection-observations.pdf (pcaobus.org) staff-update-2023-inspection-activities-spotlight.pdf (pcaobus.org); August 2024*

29 *Annual review of Audit Quality (frc.org.uk); July 2024*

30 *Report on Audit Market Monitoring 2020 (europa.eu); March 2024*

31 *Staff-update-2023-inspection-activities-spotlight.pdf (pcaobus.org)*

32 *Annual review of Audit Quality (frc.org.uk); July 2024*

33 *The list of Tier 1 firms varies depending on the number of public interest entities audited but in the July 2024 report included the Big 4 (Deloitte, EY, KPMG and PWC) plus BDO and Mazars.*

The apparent decline in standards at the smaller audit firms inspected by the PCAOB and FRC is also a cause for concern, with PCAOB Chair Erica Y. Williams recently commenting:

"These inspection results point to some small signs of movement in the right direction. Still, overall deficiency rates are unacceptable, and firms must do better. Now is the time to double down on efforts to improve and deliver the audit quality investors deserve[34]."

There is no equivalent information on audit quality at the EU level, although some national regulators do report on the subject. A 2022 European Commission report included the results of a survey that found that "Overall, the large majority of the audit committee representatives (more than 97%), auditors (more than 89%) and users (about 75%) considered the audit reform to have improved or left unchanged the quality of the statutory audit work"[35].

Level and severity of sanctions on audit firms

Another potential indicator of audit quality is the number and severity of fines and other sanctions imposed on audit firms. In the UK the total value of all financial sanctions imposed on audit firms by the FRC in 2023-24 was £48.2m prior to the application of any settlement discounts[36], the highest figure in any single year, while in the US the total fines issued by the PCAOB in 2023 ($11.85m) eclipsed the record set in the previous year[37]. The value of fines in 2023 alone in the US equalled that of all fines issued in the five-year period 2017-2021.

However, these findings need to be qualified. The increasing frequency and severity of sanctions may in part simply reflect the fact that some audit regulators now have greater powers than was previously the case, and there is a time lag between the actions of the audit firm and the completion of enforcement action. In addition, standards against which individual audits are assessed have been strengthened and in some markets the auditors' range of responsibilities have been increased creating more potential areas for non-compliance.

On auditor independence and rotation

One of the main strands of the reforms in the UK and EU was a series of actions intended to reduce risks to the independence and objectivity of individual audits. This included measures to restrict non-audit fees (both absolute value and some specific non-audit services) and to increase audit tendering and rotation (including mandatory audit firm rotation every 10-20 years depending on national regulations). In the case of tendering and rotation, it was also hoped that this would stimulate improvements in audit quality.

To date, US regulators have not followed suit with equivalent regulation on these matters. A requirement for audit partners to be rotated every five years was introduced as part of the Sarbanes-Oxley Act in 2002. Also, in 2011, the PCAOB issued a concept release in which it sought views on whether to also introduce mandatory audit firm rotation, but no further action was taken[38]. We note that the CII supports competitive bidding every five years[39].

34 *PCAOB Posts 2023 Annual Inspection Reports Alongside Staff Observations and New Charts To Boost Transparency | PCAOB (pcaobus.org)*

35 *Study on the audit directive 200643ec as-EV0120603ENN.pdf; European Commission; 2022*

36 *Annual Enforcement Review 2024 (frc.org.uk); July 2024*

37 *Accounting firms hit with record US fines over audit failures (ft.com); November 2023*

38 *It should be noted that Railpen remains sceptical as to whether audit partner rotation is sufficient, owing to its own experiences of conversations with audit firms and audit committees around the likelihood that a new audit partner will feel comfortable asking the challenging questions to the extent she or he may lose a long-standing corporate client of the firm.*

39 *Corporate Governance Policies (cii.org)*

Audit vs. non-audit fees

In the US the Sarbanes-Oxley Act[40] prohibits the external auditor from providing certain specified non-audit services. For the last 20 years non-audit fees – which require pre-approval by the audit committee – have averaged 10-11% of the fees paid to the auditor by US registered and listed companies every year[41].

In Europe, non-audit fees consistently averaged 19% of the total fees paid to the auditor in the five years to 2016 when the EU restrictions were implemented. Since then the figure has fallen to 11% (as of 2021)[42].

There is no recent equivalent data on the level of non-audit fees in the UK, but anecdotal evidence from our interviews with investors suggests that this is no longer seen as a major issue by many UK investors. This appears to be supported by data from the FRC which shows that the share of total income from the provision of non-audit services to audit clients fell for all Tier 1 firms between 2016 and 2021, ranging between 7% to 12%[43].

Audit firm rotation

There is clear evidence of increased auditor rotation in the UK, as is to be expected given this is mandatory, but it does not seem to have significantly affected the Big 4 firms' dominance of the UK listed sector. Between 2018 and 2022, 131 of the FTSE 350 changed auditors and in most cases the new auditor was one of the Big 4 firms[44]. On aggregate the smaller firms gained only 13 audits during that period. Measured in terms of total audit fees, the Big 4 accounted for 98% of the FTSE350 audits in 2021.

Most of our interviewees felt that it was too early to say whether increased rotation will have the desired impact on audit quality, or what the effect on audit fees will be. However, anecdotal evidence from conversations with companies and Audit Committees generally indicates that the experience of being audited by a new firm can provide useful additional insights. It should be noted that some investors shared a concern (also expressed in Railpen's global voting policy)[45] that mandatory tendering and rotation should not be used as an excuse to cut fees at the expense of quality. Overall, FTSE350 audit fees increased by 13% in 2022 but this may not be related to auditor rotation[46].

The most recent EU-wide market report on the market for audit services[47] covers the period up to 2021 and does not contain comprehensive data on the extent of auditor rotation[48]. However, that report shows that the Big 4 firms were also dominant in many European markets, although to a lesser extent than in the UK. The Big Four accounted for 86% of revenue from audits of public interest entities across the EU.

Similarly, at the time of writing there appears to be no current information on the extent of auditor rotation in the US, but the most recent data also shows the Big 4 remain dominant. In 2022 they audited all but six S&P 500 companies[49].

The quality of information available to investors

As on other issues, investors need clear, comparable and consistent information on audit to help inform their analysis and decision-making. There are three main sources of information on audit that are available to investors:

- Companies (primarily the audit committee report);
- Audit firms (audit reports on individual audited entities and firm-level disclosures); and
- Regulators (market-level disclosures).

While the volume of information provided by each of these sources has undoubtedly increased as a result of the policy reforms described above, views from interviewees differed as to whether this has been matched by an increase in clarity and usefulness. While UK investor interviewees were typically more positive about the quality of information than their US and EU counterparts, all investors felt that there was still room for further improvement. This is discussed in more detail later in the report.

40 *Commission Adopts Rules Strengthening Auditor Independence (sec.gov); 2003*

41 *Twenty-Year Review of Audit and Non-Audit Fee Trends (harvard.edu); 2022*

42 *Audit Fee Trends in Europe: 2010 – 2021 | Audit Fee Trends in Europe: 2010 - 2021 - Audit Analytics; 2022*

43 *Competition_in_the_audit_market.pdf; FRC; 2022*

44 *FRC Ibid*

45 *A summary of the global voting policy as it relates to audit can be found on page 28. The full policy is at Voting Policy 2024 (railpen.com)*

46 *Audit_market_and_competition_developments_-_a_snapshot.pdf; FRC; December 2023*

47 *Report on Audit Market Monitoring 2020 (europa.eu); March 2024*

48 *The report states that 19% of audit committees surveyed reported that the auditor had changed in the previous ten years but some of these changes could have preceded the new rules coming into effect.*

49 *Audit Fee Trends of S&P 500 (ideagen.com); August 2023*

Future audit developments in the UK and US?

UK

Following the collapse of BHS and Carillion in 2016 and 2018 respectively, the UK Government at the time commissioned three reviews addressing different aspects of audit: the Brydon review of the quality and effectiveness of audit[50]; the Competition and Markets Authority review of the market for statutory audit services[51]; and the Kingman review of the Financial Reporting Council[52].

After the completion of these reviews the then Government published proposals for a wide-ranging package of reforms[53], including:

- The creation of a new regulator - the Audit, Reporting and Governance Authority (ARGA) - with stronger powers over companies and auditors[54];
- Measures to boost competition and resilience in the audit market, including the power to mandate operational separation between auditing and consulting services within firms;
- Extending existing audit requirements to large private companies;
- Requiring listed companies and other public interest entities to publish Resilience Statements statements, material fraud statements and Audit and Assurance Policies; and
- Strengthening internal control requirements for listed companies.

While the package was broadly supported, to date the legislation required to effect the proposed reforms has not been implemented. The previous Government did not find Parliamentary time to enact the legislation required to make some reforms law, and in October 2023 it withdrew draft regulations containing planned reporting requirements on companies.

In July 2024 the incoming Government included legislation to implement audit reform in the King's Speech identifying the laws it intends to introduce in this Parliament. At the time of writing it is not clear whether this legislation would be identical to that which was previously proposed, or whether the withdrawn regulations will be implemented.

Some of the proposed reforms listed above are discussed in more detail in later sections of the report.

US

The PCAOB maintains an active work programme. At the time of writing, this includes:

- Proposed amendments to its rules and reporting forms to require audit firms to report on specified firm-level metrics[55];
- Proposed revisions to standards related to the auditor's responsibility for considering a company's non-compliance with laws and regulations[56];
- Proposals to improve audit procedures that involve technology-assisted analysis of information[57]; and
- A project (currently under development) to consider the auditor's evaluation and reporting of a company's ability to continue as a going concern in response to changes in financial reporting, the auditing environment, and stakeholder needs[58].

50 *Independent Review into the Quality and Effectiveness of Audit (publishing.service.gov.uk); December 2019*

51 *Statutory audit services market study: Final report (publishing.service.gov.uk); April 2019*

52 *Independent Review of the Financial Reporting Council (publishing.service.gov.uk); December 2018*

53 *Restoring trust in audit and corporate governance: government response to consultation on strengthening the UK's audit, corporate reporting and corporate governance systems (publishing.service.gov.uk); May 2022*

54 *In particular, Railpen is supportive of proposals that ARGA's authority over the preparers of financial statements should be expanded beyond those who are chartered accountants.*

55 *2024-002-Firm and Engagement Metrics (pcaobus.org); April 2024*

56 *PCAOB Release No. 2023-003 - NOCLAR (pcaobus.org); June 2023*

57 *PCAOB Release No. 2023-004 - Technology Assisted Analysis (pcaobus.org); June 2023*

58 *Going Concern | PCAOB (pcaobus.org)*

HOW ARE INVESTORS ADDRESSING AUDIT ISSUES?

This section describes the range of stewardship tools potentially available to investors and assesses the extent to which they are currently being used. It also explores how investors have historically devoted relatively little stewardship resource to audit-related activities, at least in the UK[59], and considers some potential reasons for this.

In broad terms, stewardship tools available to investors on audit issues can be grouped into five categories[60]:

- The use of voting (and other ownership rights) at and around the Annual General Meeting (AGM);
- Engagement with investee companies (and their auditors) on individual audits;
- Engagement with audit committees and the audit profession on broader audit issues;
- Class actions; and
- Participation in the policy-making and standard-setting process.

The first two categories have the potential to directly affect the value of the investors' individual investments and portfolio, either through influencing company behaviour or informing decisions around whether to invest, or remain invested, in a company.

While the benefits of the other categories are less direct, in principle at least they have the potential to deliver systemic benefits. One outcome could be that more weight is given to the concerns and priorities of investors in the conduct and oversight of individual audits. Another is that the policy framework would give more weight to investor views and greater emphasis to audit quality and accountability.

However, in order to achieve either of these outcomes it would likely require the combined effort of a sufficient number of investors, and the good will of other parties. This does not mean individual investors should not pursue stock-specific activities on audit, but system-wide change in addition to company-specific changes usually requires some level of collaboration and potentially engagement with policymakers and regulators.

59 80% of the interviewees for this project were UK-based. Furthermore, much of this chapter is also based on investor disclosures. While the sample of 20 investors whose disclosures were reviewed was more balanced – roughly one-third from each of the UK, North America and other markets – the disclosures by investors that are signatories to the UK Stewardship Code are typically more informative than those that are not, leading to a UK bias in our commentary here.

60 The main focus of this research has been on stewardship, but it is also open to investors to build audit factors into their investment decision-making processes, for example when screening potential investments. One of our investor interviewees stated that they will always review the track record of potential investee companies to identify whether there were any red flags such as previous financial reporting and control failures or unexpected and unexplained auditor changes. Information on how Railpen assesses audit when taking investment decisions, in addition to its overall stewardship approach, is on page 28.

The use of voting and ownership rights at AGMs

Voting

Voting at company AGMs is an important stewardship tool as it provides shareholders with the opportunity to provide either support for, or public sanction of, corporate behaviour on key issues.

Railpen believes that the most impactful voting takes place alongside, and is aligned with, thoughtful engagement.

Shareholders are typically provided the right to vote to approve the appointment of the auditor (and the fees paid to them) on a regular basis, although this varies depending on the market. The most significant difference in the markets covered in this report is that shareholder votes to ratify the appointment of the auditor are binding in the UK and EU but only advisory in the US.

Shareholders also have the right to a binding vote on the appointment or reappointment of audit committee members in their capacity as directors. This is consistent across markets, but the frequency with which the vote takes place can vary. For example, while all UK listed companies and most of the S&P500 companies in the US[61] hold annual director elections this is not yet common practice in most EU markets.

As part of the research for this project, we analysed the most recent voting policies of a sample of twenty investors from different markets for references to audit issues. Most of the policies reviewed set out the circumstances in which the investor might vote against an auditor's appointment, the auditor's fee or the election of the audit committee chair (and in some cases other board or committee members as well). Railpen's own voting policy[62] also provides this information.

Voting policies can also reflect other differences in the regulatory framework between markets, for example the absence of legal requirements for auditor rotation and restrictions on non-audit fees in the US. These differences may explain why the UK and EU investors in the voting policies sample typically took a stronger line on these issues than those from the US, and why some US investors addressed the topic differently in their North American and European voting policies[63]. In addition, a perceived lack of publicly disclosed information about the auditor or the audit in the US could be an impediment to investors developing proxy voting policies on this issue.

That said, within the voting policies reviewed, there are frequently occurring reasons provided for considering a vote either against the auditor or the audit committee chair. These include where:

- there are concerns about the company's financial policies and processes – vote against the audit committee chair (and potentially other board or committee members);
- previously identified material weaknesses have not been addressed or disclosures are inadequate – vote against the audit committee chair;
- the audit firm's tenure is considered excessive – vote against the auditor and sometimes audit committee chair; and
- there are considered to be excessive non-audit fees or other concerns about independence – vote against the auditor and sometimes the audit committee chair.

61 2023_us_spencer_stuart_board_index.pdf (spencerstuart.com)

62 Railpen's 2024 Global Voting Policy can be found at Voting Policy 2024 (railpen.com).

63 Railpen usually applies a consistent approach across markets on audit issues, given its importance to ensuring investors have a true and fair picture of a portfolio company's financial health.

Examples of investor voting policies on audit

Audit topic	Example of voting sanctions
Concerns about audit quality or the company's financial policies	"We will not support the re-election of members of the audit committee where there are concerns over accounting and auditing practices at the company… or the reappointment of the auditors when there are concerns over the competency of the audit partner"[64]. (Aviva Investors)
Insufficient information	"We are likely to vote against the re-election of the Chair of the audit committee where the audit committee report fails to provide meaningful information to assist shareholders understand how the audit committee operates and the issues it addresses"[65]. (NEST)
Length of tenure of audit firm and audit partner	"LGIM will not support the reappointment of the external auditor if it has served as auditor for more than 20 consecutive years. Within this timeframe, we expect the lead audit partner to be subject to refreshment at least every five years"[66]. (LGIM)
Tendering frequency and firms' ability to tender	"USS will vote against or abstain where… the external auditor has been in place for over 10 years without a competitive tender being undertaken… There should be no Big 4 only restrictions in audit firm tenders and companies should resist the imposition of such requirements by lenders or others"[67]. (USS)

64 Policies and documents - Aviva Investors 2024

65 Responsible Investment with Nest Pensions | Nest Pensions; February 2024

66 UK Corporate Governance and Responsible Investment Principles policy document (lgim.com); February 2024

67 How we vote (uss.co.uk); 2024

Audit topic	Example of voting sanctions
Replacement of previous auditors	"We will not support the appointment of an auditor if the previous auditor was replaced without explanation"[68]. (NBIM)
Audit fee reductions	"Fee reductions raise issues about potential reductions in audit quality. Unless there is a clear rationale for the fee reduction, the appointment and remuneration [of the auditor] resolutions are unlikely to receive our support"[69]. (Railpen)
Non-audit fees	"We generally ratify the auditors recommended by the company unless the non-audit related fees for services provided by the auditors are excessive and exceed 50-percent of the total audit fees paid"[70]. (CalPERS)
Limiting the auditor's liability to the company	"AllianzGI does not support proposals that limit auditor liabilities as they could potentially reduce shareholders' ability to recover any losses incurred"[71]. (Allianz GI)

68 Global voting guidelines 2023 (nbim.no)

69 Voting Policy 2024 (railpen.com)

70 CalPERS Proxy Voting Guidelines; 2023

71 Policies and reporting | Allianz Global Investors (allianzgi.com); 2024

It is generally not possible to identify reliable data on audit-related voting outcomes across the UK, US and EU as most published reviews of previous AGM seasons do not include an analysis of votes on auditor appointments or identify votes against audit committee members when analysing director elections.

One exception is the reviews that used to be carried out by the Pensions and Lifetime Savings Association (PLSA), based upon data from Minerva Analytics, which published dissent levels on audit related resolutions at FTSE350 companies (see table below).

The PLSA noted that "investors have traditionally paid less attention to audit issues, so analysis here applies a different threshold for significant dissent [to the 20% threshold which is the standard definition in the UK] …as audit and reporting resolutions typically pass with near anonymity, a 5% threshold for significant dissent can be considered to indicate real concerns among the investor community.[72]"

More recent evidence suggests that the appointment of the auditor usually receives significant levels of votes in favour from shareholders in the UK and US. In the UK, the Investment Association's public register[73] records that only eight companies received votes of more than 20% against the appointment of the auditor in the five years from 2019 to 2023. In the US only two S&P500 companies received equivalent levels of votes against in 2022[74]. By contrast, levels of support were much lower in other markets where investors have greater concerns about the independence and competence of auditors[75].

FTSE 350 dissent over Audit and Reporting

	Resolutions attracting more than 5% dissent	Companies affected	Resolutions defeated
2013	70	46	0
2014	82	51	0
2015	49	32	0
2016	46	34	0
2017	48	31	0
2018	48	39	1
2019	48	35	0

Figure 1 FTSE 350 dissent over audit and reporting resolutions. Source: PLSA (2019)

Recommendations

- Investors should review and, where necessary, enhance their voting policies to ensure that sufficient weight is given to audit issues. Such issues could include: auditor tenure; audit vs. non-audit fees; auditor liability; audit fee reductions.
- Investors should stand ready to engage on audit issues with portfolio companies and, where their expectations are not met, consider applying a voting sanction or other escalation measure.

AGM participation

Investors are free to make public statements at AGMs in most markets, usually in the form of a question to those members of the Board and senior company management present at the meeting[76]. In many major markets the external auditor's participation in the AGM is also encouraged (but not usually mandated) so that they are available to answer any questions that participating shareholders might have.

In the Netherlands, where market practice has evolved further, it is now common practice for the auditor to present the main points of their report at the AGM. This is done before the company presents the financial results, after which there is a Q&A session with both the company and the auditor[77]. The Dutch professional body for accountants (NBA) has issued guidance to members on the performance of external auditors at general meetings[78].

72 *PLSA-2019-AGM-Voting-Review.pdf.*

73 *The Public Register / The Investment Association (theia.org)*

74 *Shareholder Votes Against Auditor Ratification 2022 (ideagen.com). According to the same source, only seven percent of US companies received votes against of more than five percent, lower than the equivalent figures reported by PLSA.*

75 *For example, Allianz GI stated in its Stewardship and Sustainability Report 2022 that it voted against 46% of auditor appointment resolutions in China in 2022: Sustainability and Stewardship Report 2022 | AllianzGI*

76 *Railpen's statements at AGMs can be found at AGM Statements (railpen.com).*

77 *Eumedion's report on the 2024 Netherlands AGM season states that auditor presentations were becoming more informative although the quality pf those presentations varied considerably: Evaluation-AGM-season-2024-DEF.pdf (eumedion.nl); July 2024*

78 *NBA-handreiking 1118: Het optreden van de externe accountant in de AvA*

Eumedion, the Dutch corporate governance and sustainability platform for institutional investors, is currently campaigning for the auditor's presentation to be circulated in advance for the benefit of those shareholders unable to attend the AGM and is also proposing that auditors and audit committee chairs should be available in advance of the AGM where shareholders seek clarification of information in either of their reports[79].

Some interviewees were sceptical about the benefits of the auditor giving a presentation at the AGM on the grounds that it was unlikely to include information not already in the audit report and because most institutional investors do not attend AGMs. However, some felt that the prospect of more direct exposure to shareholders might make auditors think more carefully about the content of, and primary audience for, their report. It was also suggested that an auditor's presentation at AGMs could further enhance investors' understanding of the importance of the external audit and support future dialogue.

Recommendations

- Audit partners should attend AGMs and be available to answer shareholders' question as a matter of course. Regulators should consider making this a mandatory requirement in markets where it is not already the case.
- Shareholders who wish to ask questions to the auditor or audit committee chair should notify the company in advance of the AGM and attend the meeting in person wherever possible

Engagement with investee companies and their auditors on individual audits

Evidence suggests that engagement with individual investee companies, or their auditors, on audit issues is sporadic at best, but this may be partly explained by the nature of the subject matter. To quote from the Investor Forum's report on the December 2023 dialogue between investors and audit committee chairs in which Railpen participated:

"Neither investors nor companies necessarily require or seek regular communication, but efforts could be made to establish more open lines of communication, so that they are available for use when necessary"[80].

Engagement with companies

Based on the responses from interviewees as well as the Investor Forum research cited above, it appears that engagement with individual companies on issues related to their audit does not happen to any great extent, at least not in the UK.

This impression is reinforced by the stewardship disclosures of the sample of investors whose voting policies and stewardship disclosures were reviewed. Of those who provided data on their engagement activity in their most recent stewardship disclosures, only two identified audit as an engagement topic. They reported that it accounted for four percent and seven percent of their governance engagements respectively.

The asset managers that were interviewed stated they typically will try to engage with audit committee chairs only if there are specific reasons for doing so, for example regarding an unexpected auditor change or known control failures. One noted that if there were 'second order' issues then they might ask that the audit committee chair to join their annual meetings with the company, but this was not the norm.

The asset manager interviewees said that where they did ask to meet the audit committee chair this request was normally granted, but that is not the experience of all investors – including some asset owners. Audit committee chairs that were interviewed said that in their experience such requests were unlikely to be granted unless they came from an 'anchor investor'. They went on to note that requests were very rare, and that when they attended investor roadshow events they were rarely, if ever, asked questions.

79 *Railpen has previously been supportive of a proposal in the Brydon Review that a mandatory standing item should be added to the AGM agenda for questions to be put to the senior audit partner and the Audit Committee Chair, although this proposal was not adopted by the then UK government: railpen-response_beis_08-07-2021.pdf (azureedge.net).*

80 *Audit & Assurance Dialogue: Ensuring Robust & Reliable Information for All Stakeholders'; The Investor Forum; 2024*

The relatively low level of engagement raises questions about investor appetite to engage on audit-related issues. When this was discussed with investor interviewees, various reasons were suggested for this. The main ones were:

- limited resources meant other considerations had to be given priority;
- while still far from perfect, improvements in audit practice and reporting meant that the level of concern on some audit issues – for example, non-audit fees – was lower than was once the case (at least in the UK);
- lack of access or the absence of opportunities to engage on the issues that matter most to investors deterred them from attempting to engage; and
- insufficient understanding of audit, which meant that they either did not know what questions to ask or they placed insufficient weight on it as a risk factor.

A couple of interviewees suggested that investors should have an obligation to engage with companies on audit issues where they had a significant holding. The majority disagreed, arguing that requiring engagement for engagement's sake would not be a productive use of either party's time and that engagement needed to be 'decision useful'.

In addition to engaging on a one-to-one basis, where multiple investors share concerns about audit-related issues at a specific UK company they could in principle make use of the existing forums for collective engagement. For example Railpen, in its response to the UK Government's consultation on audit reform[81], had previously suggested the Investor Forum could be such a vehicle.

Recommendations

- Audit committees should commit to meeting all engaged shareholders upon reasonable request.
- Investors should publicly affirm their interest in audit issues and set out the circumstances in which they would seek to engage with the audit committees of portfolio companies.

Engagement with auditors on individual audits

In principle there may also be opportunities for investors to engage directly with auditors about individual audits. One audit firm interviewee said they welcomed input from investors to the planning of individual audits, but there had been only limited take up of the offer for them to do so. This might be caused by a lack of awareness that the opportunity exists but may perhaps also reflect an unwillingness to contribute on the part of investors.

Another audit firm interviewee confirmed that direct engagement between auditors and investors on individual entities was rare but noted that engagement after the audit had been commenced would be of limited value to the investor as the auditor would be very restricted in what they could say.

It should be noted that companies may not welcome attempts by investors to engage directly with their auditor. Audit committee chair interviewees believed they should be the sole or primary conduit for investor engagement on individual audits. This is consistent with comments from audit committee chairs in previous discussions with Railpen, and consistent with the publicly expressed preferences of Railpen and many other investors[82].

81 *Railpen-response_beis_08-07-2021.pdf*

82 *See Railpen's response to the FRC's 2023 consultation on the Minimum Standard for Audit Committees for further details: railpen-response_frc-auditco-standards_feb-2023.pdf (cdn-suk-railpencom-live-001.azureedge.net).*

Engagement with audit committees and the audit profession on broader audit issues

Investors can also engage either with companies on issues that are not related to their specific investments or with the audit profession (either one or more firms or professional bodies) with the aim of sharing insights, promoting a clearer understanding of investors' concerns and priorities and, in the case of the audit firms, helping investors better form an assessment of their culture and capabilities.

Engagement with the audit firms and professional bodies can be carried out by individual investors as well as through collective mechanisms. One of the audit firm interviewees said that they find one-on-one discussions with investors to be more informative than collective ones, although that refers to engagements initiated by the audit firm itself. As noted above, attempts by individual investors to initiate such discussions about a specific company might not always be welcomed by the company under discussion.

The UK interviewees also identified some current or previous mechanisms through which investors could engage collectively with audit committee chairs or audit firms. These included:

- various forums for discussions between investors and audit committee chairs, including the meeting hosted by the Audit Committee Chairs Independent Forum (ACCIF) and the Investor Forum in late 2023; and
- open meetings for investors hosted by individual audit firms which audit partners and independent non-executives[83] from the firm attend. Some firms hold these annually but it seems not all of them do so.

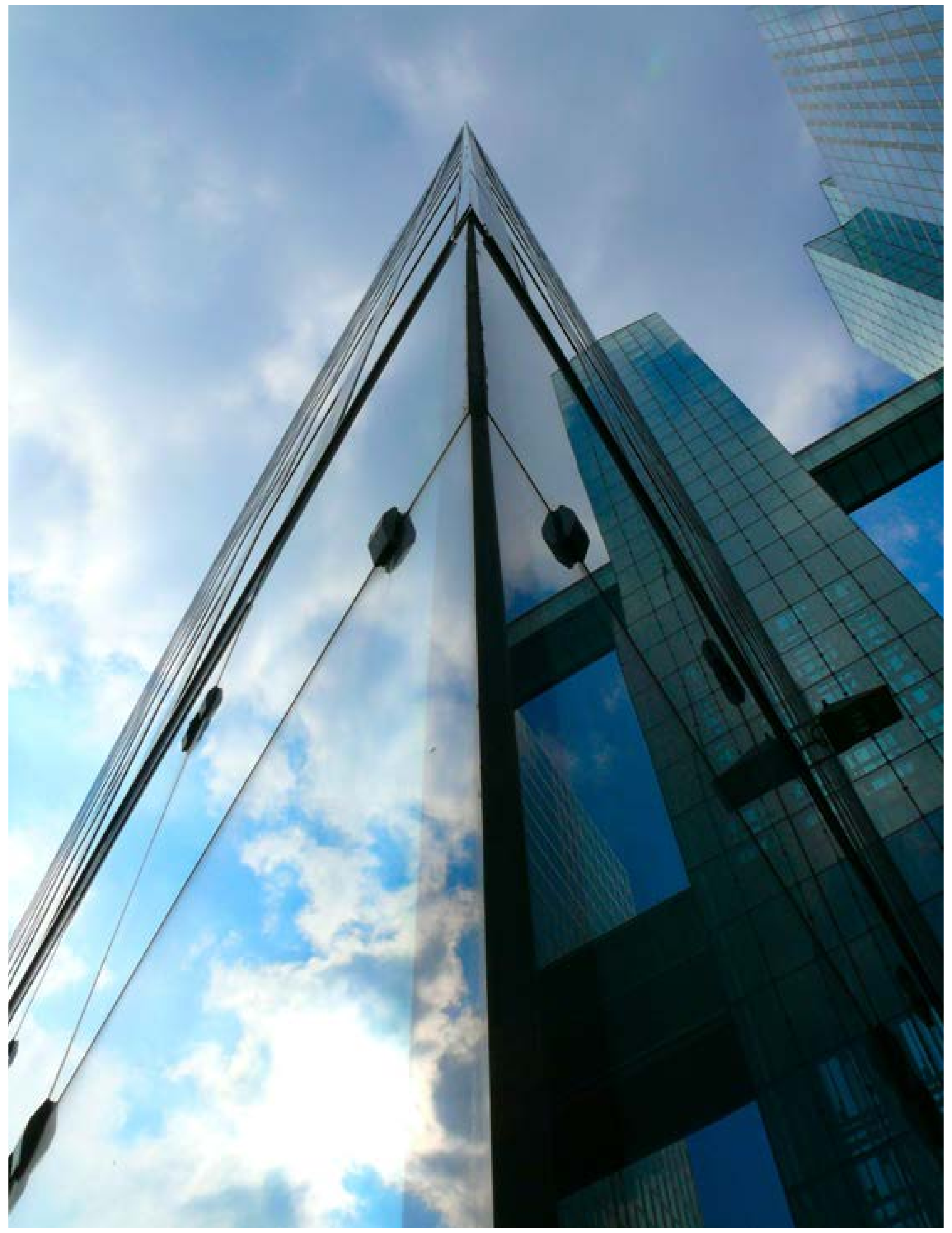
In the Netherlands, Eumedion has regular meetings with the Dutch professional audit body and considers that it plays a positive role in ensuring the audit firms understand investors' views. It was suggested during the interviews that it might be useful for similar discussions to take place involving the equivalent bodies in other markets[84].

There were two suggestions for how engagement between investors and the profession in the UK – a jurisdiction of particular interest to Railpen given our role as a UK asset owner – could be improved that were supported by several interviewees:

- reinstate regular meetings between investors and the audit firms' independent non-executives and audit non-executives without the presence of audit partners. Investors who had participated in similar meetings in the past had found them useful as they gave insights into each firm's culture and the extent to which there is appropriate acknowledgement of the shareholders as the true client, while the independent non-executives that were interviewed said they would welcome more engagement with investors[85];
- dialogue between investors and audit firms could take the form of forward-looking discussions on systemic and strategic issues such as changing business models and the impact of economic instability on the resilience of companies and investments. Sharing insights could be beneficial to both sides when subsequently developing audit plans and constructing portfolios. It was suggested that consideration be given to this engagement happening at sectoral level, leading to a greater degree of specificity.

Recommendations

- Audit and investor associations and professional bodies in each market should identify and develop mechanisms for more effective engagement between investors and the audit profession on audit and systemic issues, with the objective of having at least annual roundtables.
- Audit firms should provide investors with an opportunity to meet independent non-executives (and audit non-executives in the UK) without the presence of audit partners at least annually.



83 *The role of independent non-executives is to "provide constructive challenge and specialist advice with a focus on the public interest" (UK Audit Firm Governance Code). Current practice and policy discussion about their role is summarised on page x.*

84 *In the UK this might perhaps also include the newly created Centre for Public Interest Audit which is supported by the Institute of Chartered Accountants of Scotland (ICAS) and the Institute of Chartered Accountants in England and Wales (ICAEW): CPIA Home*

85 *The UK Audit Firm Governance Code includes a 'comply or explain' provision which states that "INEs should have dialogue with audit committees and investors to build their understanding of the user experience of audit and to develop a collective view of the way in which their firm operates in practice": FRC Audit Firm Governance Code_April 2022*

Class actions against auditors

Another form of collective action that is potentially available to investors is to take a class action against an audit firm where audit failures have contributed to a loss of shareholder value. The ability to do so will depend on the legal rights and restrictions in the market in question. In 2013 it was estimated that twenty countries permitted class actions against auditors, including some EU countries such as Italy and Poland[86].

In the UK the consensus is that there is little prospect of successfully bringing a class action against the auditor because of the Caparo judgment[87] (1990) in which the court ruled that the only duty of care the auditors owed was to the governance of the firm and that three factors had to exist for there to be a duty of care to other parties including shareholders: proximity, knowledge of who the report would have been communicated to and for what purposes it would have been used.

In the US, it is considered to have become more difficult to bring a class action following Supreme Court rulings that require plaintiffs to prove that auditors knew, or should have known, that their clients' financial statements contained errors[88]. This may partially explain why in recent US class actions the audit firm is usually only one of multiple defendants (for example, the Silicon Valley Bank lawsuit[89]), if included at all.

One potentially interesting new development in the US is the SEC's intervention in a class action against AmTrust and its auditors[90] in February 2024, calling on the courts to reverse a previous ruling that the auditor's alleged false certification of the financial statements was not material to investors.

Investor participation in the policy process

Shaping the policy and regulatory framework for external audit practices can be a resource-efficient way to achieve stewardship impact. Investors' engagement with the policymaking process on audit issues is mostly undertaken through i) formal appointment to various advisory and governance groups, or ii) by responding to consultations. To date, there has been relatively limited iii) proactive investor policy advocacy on audit – although this report hopes to make a contribution in this respect.

Advisory groups

In the US, the PCAOB has two advisory groups in which investors can participate. Those interviewees with knowledge of these groups felt that they had value and had helped to involve more investors in the policy process than was previously the case.

The role of the Investor Advisory Group is to provide the views of investors on the PCAOB's regulatory agenda. The Standards and Emerging Issues Advisory Group advises the PCAOB on existing and proposed standards and emerging issues "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports". Unlike the Investor Advisory Group, other stakeholders as well as investors are represented on this latter group. Both groups include some international members, which to us seems a positive development given the extensive allocations of non-US investors to US companies.

Unlike the PCAOB, the FRC in the UK does not currently have an advisory group that is purely concerned with the views of investors[91], although it has a proactive stakeholder engagement programme and engages regularly with both the investor representative bodies and individual investors. In addition, six of the 21 current members of its Stakeholder Insight Group[92] could be broadly described as investors.

At an international level the IAASB and IESBA standard-setting process is advised by a Stakeholder Advisory Council[93] which includes investors. The work and membership of both IAASB and IESBA is overseen by the Public Interest Oversight Board[94] that also has investor representation

Recommendations

- Where this is not already happening, audit regulators should consider establishing an investor-only advisory group.

Consultations

Both the PCAOB and FRC issue regular consultation documents on various audit-related issues, as do organisations such as IAASB (International Auditing and Assurance Standards Board) and IESBA (International Ethics Standards Board for Accountants) at international level and other regional and national regulators.

Broader policy initiatives previously referred to in this paper, such as the previous UK Government's proposals for audit reform, have also sought feedback from investors and other stakeholders.

It is unclear how many institutional investment practitioners regularly take up these invitations to respond.

86 *Knives out for auditors as class actions go global | Reuters (2013). I have not been able to find a more recent estimate.*

87 *Caparo v Dickman Case Summary (lawteacher.net)*

88 *Investor Lawsuits Against Auditors Are Falling, and That's Bad News for Capital Markets - HBS Working Knowledge; 2019*

89 *SVB shareholder suit cites KPMG's 'silent' audit | CFO Dive; March 2023*

90 *Audits matter.' AmTrust shareholders get US SEC backing in bid for appellate redo on BDO claim | Reuters; February 2024*

91 *The then Government endorsed the Brydon Review's recommendation to establish an Audit Users Review Board but the intention was that the Secretariat would be provided by the Investment Association rather than having formal links to the FRC. At time of writing, there is no evidence that such a body has been established.*

92 *Stakeholder Insight Group (frc.org.uk). The role of the Group is to "share their perspectives on key opportunities and potential areas of focus for the FRC, and… on key areas of concern and emerging risks relating to accounting, reporting, auditing and governance issues".*

93 *Stakeholder Advisory Council | International Foundation for Ethics and Audit*

94 *PIOB (ipiob.org)*

Summary of Railpen's current audit-related activities

Although we are not complacent – one of the reasons we commissioned this report was to understand where we could improve our own work – Railpen already considers the materiality of a high-quality external audit to long-term company performance and has undertaken several stewardship activities related to audit as a result. These activities are summarised below[95].

Investment process

Railpen considers audit related issues on an ad-hoc basis for prospective investments within its fundamental equities portfolio.

Railpen also includes several audit-focused data points into the initial quantitative screen for its governance and conduct-focused exclusions process (a process that is carried out annually to identify, engage with, and potentially exclude, those companies whose governance and behaviour are of particular concern. For more information on Railpen's governance and conduct-focused exclusions process, see page 42 of our 2023 Stewardship Report.)

Voting

Railpen has published policy lines on audit related issues in its Global Voting Policy which apply across all companies that Railpen invests in where it holds voting rights. Railpen's 2024 Global Voting Policy states that:

- **Auditor independence and rotation:** "Railpen will vote against the re-appointment of the auditors if the tenure of the audit firm is greater than fifteen years. We [Railpen] will typically vote against the re-appointment of the audit committee chair if the external audit firm tenure is greater than thirty years."
- **Level of audit to non-audit fees:** "The non-audit fees paid to the company's statutory audit firm should not exceed good local market practice, in the absence of exceptional circumstances, which must be clearly explained."
- **Significant decreases in audit fees without a clear rationale:** "We [Railpen] will carefully scrutinise instances where there has been a significant reduction in audit fees, including in the wake of a tender process. Unless there is a clear rationale for the fee reduction, the appointment and remuneration resolutions are unlikely to receive our support."
- **Disclosure:** "Where a company provides inadequate disclosure on audit or adopts policies and practices that are not aligned with shareholders' interests as outlined above, Railpen will consider withholding support for the reappointment and setting of fees of the external auditors and/or the re-election of audit committee members."

In 2023 Railpen voted against 19% of management resolutions related to audit at companies for which it holds voting rights. The most common reasons for voting against a resolution were excessive auditor tenure, or a significant year on year reduction in audit related fees without an appropriate rationale provided.

Engagement with portfolio companies

Railpen has engaged with companies in its portfolios, particularly those in the US, where there is excessive audit tenure. Even where audit tenure has not yet become an issue, Railpen shares its global voting policy lines and stands ready to answer questions from portfolio companies on its positions on audit related issues.

One example of such engagement was with a European investment firm that specialises in private markets. We began investing in the company in 2020 and held early discussions with executive to flag our concerns about auditor tenure among other issues (we consider an audit firm that has been in place for more than 15 years to be at risk of not being able to exercise the professional and independent judgement that shareholders need).

Although engagement was constructive in the first two years, we did not feel able to support the vote on auditor appointment at the 2021 and 2022 AGMs. In September 2022, we were invited to an in person meeting with board directors at which they made a commitment to tender for an auditor in the next year.

Following this commitment, we voted to support on the auditor appointment at the 2023 AGM. We also met again in 2023 with a board member for an update, including on the auditor tendering process. As detailed in its 2023 annual report[96], Partners Group concluded the process for selection of a new auditor at the end of 2023, with the new auditor to begin its responsibilities in 2025.

Policy consultations

Although it has a finite resource for responding to policy consultations within its stewardship activities, given the materiality of a high-quality audit and its historic interest, Railpen has fed its views into some UK policy consultations covering audit specifically, as well as broader consultations relevant to audit. Recent Railpen responses, all of which are publicly available on its website, include:

- FRC UK Corporate Governance Code consultation (September 2023): available here.
- FRC consultation on Audit Committee Standard (February 2023): available here.
- FRC consultation on Firm level Audit Quality Indicators (August 2022): available here.
- The Department for Business, Energy and Industrial Strategy's (BEIS) consultation on restoring trust in audit and corporate governance (July 2021): available here.

95 *For more information on Railpen's approach to investment stewardship, please see our 2023 Stewardship Report.*

96 *PGHN Annual Report 2023 (partnersgroup.com)*

WHAT ACTION IS BEING TAKEN TO IMPROVE AUDIT QUALITY?

This section summarises some of the major factors affecting audit quality which are i) the subject of current policy activity in at least one of the UK, US or EU markets ii) where a need for further action was identified by interviewees and/or iii) where deficiencies have been highlighted in recent reports from regulators and others.

As previously noted, there is a recent history of extensive policy activity in the UK and elsewhere to improve the quality of the external audits of companies. Although views amongst the investor, corporate and audit communities differ on some of the specific elements or proposals, there is general consensus that, while progress has been made, some further reforms are needed.

Evidence from the US shows broad support for the PCAOB's current work programme, but some of our interviewees noted concerns that the programme's impact could be muted as a result of anticipated resistance from the audit profession and corporates to some elements of the programme.

Most of the policy debate focuses on various aspects of the following issues[97]:

- The availability and quality of information on individual audits for investors;
- The effectiveness of Audit Committee oversight of the external audit process;
- The need to address recurring external audit issues; and
- Assessing and improving firm-level quality, capabilities and culture.

Availability and quality of information on individual audits

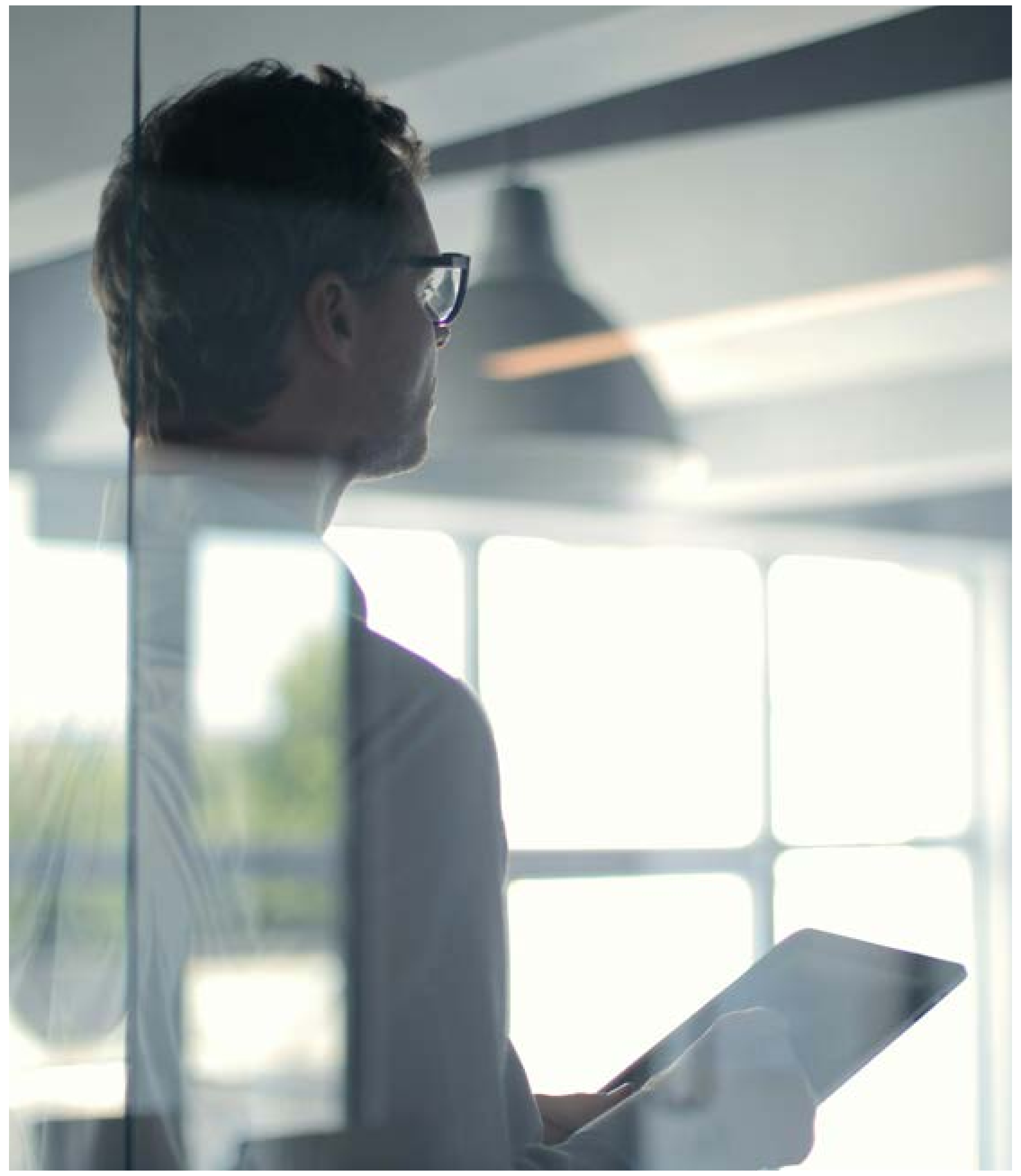
As with every other business-relevant issue, investors are keen to receive decision useful information on audit issues from companies. Although the quality of information on individual audits has generally improved in recent years – particularly in the UK – there remain some areas for possible future improvement.

Of course, it is recognised that companies are already having to deal with challenges associated with a broader increase in reporting requirements and expectations from regulators and investors. Any further audit-related requirements need to be proportionate and targeted.

The quality of audit reports

The quality of audit reports was highlighted as one of the main issues for investors in the interviews. While recognising that there had been improvements (at least in some markets) since the standards to be followed in these reports were enhanced in the early 2010s, investor interviewees felt that, in all markets, many of these reports still failed to meet the test in auditing standards (highlighted in the Brydon report[98]) of providing information that was 'decision useful'. In relative terms, the quality of audit reports was considered to be higher in the UK than in the US and EU.

Most of the interviewees from companies and some from the audit profession disagreed with the view that audit reports were deficient. They considered it was primarily a lack of understanding on the part of investors that prevented them identifying decision useful information in audit reports[99], although some conceded that there was room for improvement. We welcome the decision by the Institute of Chartered Accountants in England and Wales (ICAEW) to initiate a project that aims to identify how audit reports might be made more useful.



97 *Other linked issues mentioned by interviewees were i) the desire from some investors for external auditors to review and provide assurance on companies' internal controls over financial reporting in the UK (in the same was as they do in the US under the Sarbanes-Oxley legislation) and ii) proposed enhanced responsibilities for auditors in the UK and US relating to fraud and non-compliance on the part of the audited entity – this would require the auditor to actively obtain assurance that the financial statements are free from material misstatement, whether due to fraud or error, arising from non-compliance with laws and regulations.*

98 *Independent Review into the Quality and Effectiveness of Audit (publishing.service.gov.uk)*

99 *We note that a recurring theme in our research was also whether investors' concerns about the quality of information primarily reflected inadequacies in the information being provided or shortcomings in their own ability to interpret that information. Although we do not seek to provide a definitive answer here, we would suggest that – like most things – the truth probably lies somewhere in the middle.*

Do the requirements for audit reports need to be enhanced?

The specific issue raised most frequently by interviewees in relation to audit reports was the perceived inadequate reporting on what are referred to as Key Audit Matters (KAMs) in the UK or Critical Audit Matters (CAMs) in the US[100].

This was a cause of concern for investors in the UK and US, but particularly in the US where the CII and PCAOB's Investor Advisory Group are asking PCAOB to revise its standards[101]. Evidence suggests that audit reports prepared using PCAOB standards typically identify fewer CAMs (one or two[102]) compared to those prepared using international auditing standards (an average of four KAMs in FTSE100 audit reports[103]). As of August 2024, the PCAOB's Investor Advisory Group was evaluating examples of CAMs and intends to publish a report containing the most decision-useful examples later in the year[104].

On a related issue, the Kingman report recommended that the UK's FRC should make graduated audit findings mandatory by requiring auditors to express an opinion on key management estimates and judgements in the accounts and to describe them on a range from cautious to optimistic[105]. The report noted that investors would find such information useful, as our interviews with investors confirmed.

This recommendation was not addressed directly in the then UK Government's package of proposed reforms[106] but was supported by several UK interviewees. Anecdotal evidence from interviewees suggested that while some UK companies voluntarily ask their auditors to provide them with graduated findings, the number doing so has declined. It has also been suggested that investors ask their companies to agree to request graduated findings.

Recommendations

- Regulators should require auditors to include graduated findings in audit reports and audit committees should in the interim ask that their external auditors present them with findings in this manner in order to enhance their own understanding of the company's position.
- Regulators should review the quality of audit reports as part of their inspection activity and report on their findings periodically.
- In markets where graduated findings are not (yet) mandatory, investors should ask portfolio companies to ensure their auditor includes this information in its audit report

100 KAMs are defined as "those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period." International Standard on Auditing (ISA) 701 (NEW), Communicating Key Audit Matters in the Independent Auditor's Report | IAASB. CAMs are defined as "any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that are material to the financial statements; and involved especially challenging, subjective, or complex auditor judgment." Implementation-of-Critical-Audit-Matters-The-Basics.pdf (pcaobus.org)

101 Auditors Gear Up for Fight as PCAOB Brings Back Critical Audit Matters to Research Agenda (thomsonreuters.com); November 2023

102 Briefing- CAMs (pcaobus.org); June 2023

103 Snapshot 3: Key audit matters (frc.org.uk); August 2022

104 IAG Request for CAMs (pcaobus.org); April 2024

105 Independent Review of the Financial Reporting Council (publishing.service.gov.uk); December 2018

106 One action that was included in the then UK Government's response was to "ask the FRC to explore with investors and other stakeholders whether and how the content of the auditors' report could be improved to provide more information about the work auditors have undertaken on the internal controls over financial reporting".

More informative audit committee reports

Similarly to audit reports, there was criticism of audit committee reports from some investor interviewees, with one interviewee noting that while there were usually extensive details on the process, audit committee reports generally offered less by way of genuine insight.

A particular point made by investors was that these reports typically gave little indication of what the audit committee had done to monitor the quality of the auditor's work, which contributed to doubts about the effectiveness of audit committees' oversight (discussed below). As with audit reports, there was some push back from interviewees based on their experience of serving on or working with audit committees, who argued that the information was there if investors knew what to look for.

There is arguably a role for further regulatory encouragement of audit committees to proactively engage with their shareholders, in recognition of the fact that a company's shareholders are the ultimate client. This is recommended practice in the FRC's Minimum Standard for the Audit Committees of FTSE 350 companies[107], and would better help audit committees understand what shareholders are looking for from their reports[108].

Recommendations

- Audit firms are encouraged to offer awareness-raising sessions for investors on the benefits and insights provided by a good audit report. Investors in turn are encouraged to articulate to audit firms what they consider to constitute 'decision useful' information, including by highlighting good examples and offering awareness raising sessions for audit teams.
- Regulators should set out clearer encouragement and expectations for audit committees to engage with shareholders on how the audit committee reports and to seek shareholder views at key moments in the auditor and audit report lifecycle.

107 *FRC's guidance to audit committees states that the committee's responsibilities include "engaging with shareholders on the scope of the external audit, where appropriate": Audit Committee Minimum Standard (frc.org.uk) (May 2023)*

108 *Such engagement would also support audit committee oversight more broadly.*

Limitations of going concern statements

Of all the reporting provided by auditors, going concern statements are of particular importance because they provide investors and other stakeholders with assurance that the company is financially stable enough to meet its obligations and continue its business for the foreseeable future.

That at least is the intention. Some investors remain concerned about the limited and potentially misleading nature of going concern statements[109] and the quality of auditors' assessment of material risks that inform those statements, citing examples such as Silicon Valley Bank where the auditor gave a clean audit opinion less than a month before the bank failed in March 2023[110].

Research published by the FRC in 2022 also found that 14% of audit reports on FTSE and large AIM companies referred to going concern as a Key Audit Matter. By contrast, only two percent of published going concern statements identified material uncertainties[111]. This begs the question of whether the materiality test in auditing standards relating to going concern statements is currently set at the right level.

The IAASB is proposing targeted revisions to ISA 570 (Going Concern) that are intended to strengthen communications and reporting requirements[112]. The PCAOB is also examining the issue[113] but at the time of writing had not published any detailed proposals.

In the UK it had been proposed to supplement going concern statements with 'resilience statements' which would require companies to take a longer-term and broader view of their ability to continue in business by requiring directors to provide their assessment of the company's prospects over the medium term. At the time of writing it is not clear whether this proposal will be implemented by the new UK Government but many investors, including Railpen, had been supportive of this proposal.[114]

Recommendations

- The IAASB should ensure that its planned updated going concern standard enhances transparency with respect to the auditor's responsibilities and work related to going concern, including by providing greater evidence of how the auditor has evaluated management's assessment of going concern.
- The PCAOB should follow the IAASB example and implement improvements to its own standard at the earliest opportunity.
- The UK Government should proceed with regulations to require certain public interest entities to publish a resilience statement. In the meantime, these companies' audit committees should be encouraged to publish such a statement on a voluntary basis and whether other enhancements are needed.

Identifying companies in Audit Quality Review (AQR) inspection reports

Audit Quality Reviews (AQRs) conducted by regulators such as the FRC and PCAOB are another potentially valuable source of information on the quality of individual audits. However, at present regulators' inspection reports do not disclose their findings on individual company audits, or the basis on which their audit was selected for review (for example, whether it was a risk based or random selection).

In the UK the Kingman report recommended that "the new regulator should work towards a position where individual audit quality inspection reports, including gradings, are published in full"[115]. This was based on feedback from investors that they would find such information useful. In its response the then UK Government indicated that it preferred a voluntary, consensual approach but stated that it would provide ARGA with powers to publish this information without consent if necessary[116]. As with other elements of the proposed reform package, this has not yet been implemented.

In the US the PCAOB's Investor Advisory Group has recommended that the PCAOB should amend its rules to allow it to disclose the names of the public companies whose audit it inspected during the year in its inspection reports[117]. There is no indication to date as to whether the PCAOB intends to act on that recommendation.

Recommendations

- When reporting on their inspection of audit quality, regulators in the US and UK should as a minimum identify the name of the company and could also consider including information on the basis on which its audit was selected and the grading given for each audit reviewed.
- Regulators should also consider going further and publish their reports on each individual audit in full.

109 caq_perspectives-on-corporate-reporting-the-audit-and-regulatory-environment_2023-11.pdf (thecaq.org); Centre for Audit Quality (and other sources)

110 Recent Bank Failures May Indicate Problems with Going Concern Standards, Liquidity Risk Disclosure Rules (thomsonreuters.com); March 2023

111 Snapshot 5: Going concern (frc.org.uk); August 2022

112 Going Concern | IAASB. Consultation on a draft took place in 2023. The revised standard is due to be adopted in December 2024

113 Going Concern | PCAOB (pcaobus.org)

114 In August 2024 the FRC issued a consultation draft of updated guidance to companies on how to prepare going concern statements: Consultation on Guidance on the Going Concern Basis of Accounting and Related Reporting, including Solvency and Liquidity Risk (frc.org.uk)

115 Independent Review of the Financial Reporting Council (publishing.service.gov.uk)

116 Restoring trust in audit and corporate governance: government response to consultation on strengthening the UK's audit, corporate reporting and corporate governance systems (publishing.service.gov.uk)

117 Microsoft PowerPoint - 6. SIDT-Recommendations.pptx (pcaobus.org); June 2023

The importance of effective oversight by the audit committee

Audit quality is enhanced by a fully engaged audit committee that sets the tone and clear expectations for the external auditor and monitors auditor performance rigorously through frequent, quality communications and a robust performance assessment.

The perceived deficiencies in audit committee reports noted above feed into broader perceptions about lack of diligence on the part of some audit committees. These include the view held in some quarters that some audit committees prefer to engage unchallenging auditors[118] and/ or are more concerned about the level of the audit fee than the quality of the audit[119]. Railpen's global voting policy notes that unexplained reductions in audit fees will be viewed as a cause for concern[120] and other investors have noted that the quality of the audit is more important than cost-cutting.

Greater engagement between shareholders and audit committees of investee companies is seen as important. However, investors have experienced difficulties when attempting to engage, as noted earlier in this report. Railpen has previously made suggestions on how engagement might be improved, for example through investor involvement in the audit tendering process[121]. We believe the expectations on Audit Committees around engaging with shareholders in the FRC's Minimum Standard could be further strengthened.

Audit and Assurance Policy

The interviews were conducted in late 2023 and early 2024, after the then UK Government had withdrawn the regulations requiring listed companies to develop and publish an Audit and Assurance Policy. Most UK interviewees, including those from companies and the audit profession, expressed disappointment at this decision.

Many felt that such disclosures could be a catalyst for more engagement as well as being a useful source of information for investors. Anecdotally it has been suggested that some larger companies intend to develop policies voluntarily for their own purposes but are unlikely to publish them. Investors could usefully consider asking companies to do so.

In its response to the UK Government's consultation on audit reform in 2021, Railpen stated that it would also support an annual advisory vote on the Audit and Assurance Policy, noting that:

"The best Audit and Assurance Policies will be subject to continuous and iterative review and conversations with shareholders and other stakeholders should, accordingly, be undertaken on a regular basis. As the audit and assurance market, and hence companies' activities on audit, is likely to develop rapidly in light of regulatory developments, it is also likely that there may be significant changes to an Audit and Assurance Policy in a given year and shareholders should therefore be given the opportunity to have their say on an annual basis[122]*."*

Recommendations

- The UK Government should proceed with regulations to require certain public interest entities to publish their Audit and Assurance Policy every year and should consider also introducing the requirement for a regular advisory vote on the Policy.
- The audit committees of listed companies outside the scope of the regulations should be encouraged to develop and publish an Audit and Assurance Policy on a voluntary basis.
- Regulators should set out clearer encouragement and expectations for audit committees to seek shareholder views at key moments in the auditor and audit report lifecycle

118 Why Do Auditors Fail? What Might Work? What Won't? (columbia.edu); John Coffee; 2019 (and other sources)

119 Although FRC and other data shows total audit fees for listed companies increase year on year this appears to be driven more by market forces and increased regulatory costs on auditors than a desire for better audit quality. See also recent data and comment from the Quoted Companies Alliance in the UK: Audit fees for UK-listed companies up 75% since 2018, study finds (ft.com)

120 Railpen's 2024 Global Voting Policy

121 Railpen's response to FRC Audit Committee Standards; February 2023

122 Railpen-response_beis_08-07-2021.pdf (azureedge.net)

Assessing and improving firm level audit quality and culture

An audit firm's internal standards, capabilities, culture and governance have a significant influence on the quality of individual audits. A lack of sufficient skills and experience in the audit team or the functions within the firm that support it has a direct impact on its capacity to carry out an effective audit, while a culture that encourages and incentivises the wrong behaviours – or leads auditors to think that it is the company that is the client, not shareholders – will undermine independence and professional scepticism.

Reporting on firm-level audit quality

Most of the discussion with interviewees on this topic concerned the availability of audit firm-level information that investors can use to gain insights into the firm's culture and assess the quality of audits undertaken, and that companies can refer to when considering auditor appointments.

There are two main sources that investors and companies rely on for this information:

- The inspection reports published by audit regulators and;
- Annual transparency reports published by the audit firms themselves (in some markets).

Most of the interviewees were broadly content with the information provided in regulators' inspection reports, although (as already noted) some investors expressed the desire that the companies whose audits had been reviewed should be identified. Separately, the argument has been made that "providing a fuller evaluation may encourage investors to place greater confidence in the integrity of the audit regulator and the auditor"[123].

Audit firms typically publish information on their performance against selected audit quality indicators (AQIs) in their annual transparency reports. One of the main criticisms to date has been the lack of consistency between the AQIs selected by each firm which had made it difficult for investors and companies to compare their performance.

In the UK, the FRC has aimed to address this by publishing a set of AQIs in 2022 on which all audit firms within scope must provide them with data[124] which will then be published by the FRC in annual reports[125]. While this is a welcome development it is too early to say whether investors will find these reports useful as the first ones will not be published until 2025.

In the US, the PCAOB published proposed amendments to its rules and reporting forms to require the reporting of specified firm-level metrics in April 2024. The stated aim of these proposals is to "advance investor protection and promote the public interest by enabling stakeholders to make better-informed decisions, promoting auditor accountability and ultimately enhancing capital allocation and confidence in our capital markets"[126].

A few EU countries have also drawn up lists of AQIs for use by audit firms, most notably Germany[127].

Several interviewees supported the suggestion that audit firms should be encouraged or required to report on engagement-level as well as firm-wide indicators, something that Railpen has also called for previously in the UK[128]. Research conducted by the Center for Audit Quality in the US found that "engagement-level metrics are of greater interest [to investors] … audit team experience and years on the engagement are most frequently cited as points of interest because these are associated with the people on the ground who are doing the audit"[129].

The FRC has also highlighted the importance of ongoing training and development for auditors[130]. One specific aspect of this that came up regularly in interviews with investors and the audit profession was the need for auditors to have a clear understanding of the needs and interests of investors. This was felt to be an area where more could be done on both sides to help develop that understanding. As recommended earlier in this report, Railpen believes it would be helpful for both audit firms and investors to offer awareness-raising sessions.

Recommendations

- Regulators in markets where there is currently no mandatory requirement for major audit firms should report publicly on specified firm-wide Audit Quality Indicators should introduce such a requirement.
- Regulators in all markets should also consider requiring audit firms to report on specified engagement level indicators.
- Audit committees should agree with their auditors which engagement level metrics they will use to assess the auditor's performance, and when tendering should specify which indicators they will use to assess candidate firms' suitability.

123 *Why Do Auditors Fail? What Might Work? What Won't? by John C. Coffee: SSRN; 2019. This argument also applies to the provision of engagement level AQIs by audit firms.*

124 *Railpen submitted suggestions for AQIs to the FRC in response to its consultation including that there should be indicators on the level of interaction with investors and how auditors were incentivised to prioritise audit quality: https://cdn-suk-railpencom-live-001.azureedge.net/media/media/jo3li4an/consultation-on-audit-quality-indicators.pdf*

125 *Feedback Statement (frc.org.uk); December 2022*

126 *2024-002-Firm and Engagement Metrics (pcaobus.org); April 2024*

127 *220401-Factsheet-Audit-Quality-Indicators.pdf (accountancyeurope.eu); May 2022*

128 *Railpen has previously asked for the publication by regulators such as the FRC of engagement-level audit quality indicators (AQIs) to complement the audit firm level AQIs already published. Another alternative would be for regulators to place a requirement upon companies to provide such information to their shareholders upon request. Railpen's views can be found at: consultation-on-audit-quality-indicators.pdf (cdn-suk-railpencom-live-001.azureedge.net).*

129 *Caq_perspectives-on-corporate-reporting-the-audit-and-regulatory-environment_2023-11.pdf (thecaq.org)*

130 *What Makes a Good Environment for Auditor Scepticism and Challenge November 2022 (frc.org.uk)*

What is the dominant culture in audit firms?

It is widely recognised that the internal culture of an audit firm – as evidenced by its values and behaviours, rewards and incentives and governance structures – has a direct bearing on audit quality. This has formed part of the policy framework in the UK since 2010 when the first Audit Firm Governance Code was published[131]. The FRC's firm level AQIs also address culture to some extent[132]. Many investors, Railpen included, feel that the key to a positive audit firm culture is recognition that it is the shareholders who are an auditor's real clients, not the company being audited[133].

In the US the PCAOB announced in December 2023 that it was creating a new inspection team to evaluate culture across the largest US firms to enhance its understanding of how audit firm cultures may affect audit quality[134].

The main policy focus to date has been on attempting to reduce the risk that commercial interests lead audit firms to neglect their public interest responsibilities[135], by minimising and managing conflicts of interest and through changes to the firms' governance (for example, the presence of independent non-executives).

Non-audit services and other conflicts of interest

The measures taken in the UK and EU to restrict the provision of non-audit services to the audited client appear to have been quite effective as the data on page 18 shows, with the average level of non-audit fees per client now being roughly comparable with the US (around 10% in all markets), allowing for some differences in how fees are classified. None of the investor interviewees identified this issue as a cause of concern.

However, there remained concerns amongst interviewees that consulting fees continued to be the dominant source of revenue for the major audit firms overall and that this might impact on the culture and integrity of the firms and how they view their public interest responsibilities for audit. Specifically, the concern is that firms would not be willing to challenge the management of audited firms if they perceived that it was not in their broader commercial interests to do so.

Globally, revenues from audit services accounted for only 30 to 35% of total revenues for each of the Big 4 audit firms in 2023[136]. This is consistent with data from the FRC showing that audit fees account for a minority of total firm income in the UK in all Tier 1 firms in 2021[137]. For all the Big 4 firms the share of revenues from audit in the UK was lower than the global figure[138].

Separating audit and consulting operations

One approach to reducing the risk of 'contagion' is operational separation of the audit and consulting arms of the firm. This is not the same as legal or structural separation which would involve splitting into two different firms. Investors and their associations generally support operational separation but some have previously raised concerns about structural separation on the grounds that "it could impact their ability to retain the high quality staff which are vital for an expert, meaningful and thorough audit"[139].

Operational separation is being pursued in the UK even though the proposal to give the FRC legal powers to impose operational or structural separation has not yet been implemented. In 2020 the FRC stated that it expected the Big 4 audit firms to implement operational separation on a voluntary basis by 2024. A report on implementation is expected later this year[140].

Although this is not an active policy debate in other markets, the fact that each firm is part of a global network may constrain the ability of regulators in any single market to mandate legal separation. For example, EY had to abandon its plans to split its audit and consulting businesses in 2023 following apparent opposition from partners in some markets, notably the US[141].

Creating a new corporate auditing profession

Another approach would be to establish a separate corporate audit profession with a more explicit public interest remit and principles governing auditors' behaviour, as recommended by the Brydon Review[142].

Railpen supported the proposal in its response to the Review, noting that in addition to being a means of safeguarding the public interest role "it would be useful in providing opportunities for development and recognition which is specific to corporate audit which should help retain and attract more individuals into the field"[143].

The then UK Government did not take forward this suggestion, and instead proposed that the issues raised in the Brydon report should be addressed through changes to existing standards and guidance. However, some interviewees considered that the idea should be revisited if there was an opportunity to do so in the future.

131 *The Code was most recently updated in 2022: FRC Audit Firm Governance Code April 2022*

132 *Firm-level AQIs Definitions Note (frc.org.uk); March 2023*

133 *Railpen response | Financial Reporting Council (FRC) Consultation Document: Firmlevel Audit Quality Indicators (AQIs); August 2022*

134 *PCAOB Staff Outline 2024 Inspection Priorities with Focus on DrivingImprovements in Audit Quality | PCAOB (pcaobus.org); December 2023*

135 *The introduction to the UK Audit Firm Governance Code explicitly links high quality audit and the public interest: " In the context of audit, the consistent performance of high-quality audits is in the public interest because they promote the efficient functioning of capital markets in the UK, lowering the cost of capital. Reliable corporate reporting allows market discipline to work. More broadly, it underpins public trust and confidence in the market economy". FRC Audit Firm Governance Code_April 2022*

136 *Big Four: revenue by function 2023 | Statista; December 2023*

137 *Competition_in_the_audit_market.pdf; FRC; 2022*

138 *Deloitte: 15% compared to 31%; EY 21% compared to 30%; KPMG 26% compared to 34%; PWC 22% compared to 35%*

139 *BEIS-consultation-CMA-statutory-audit-remedies-PLSA-response.pdf; PLSA; September 2019*

140 *Audit market and competition developments (frc.org.uk); December 2023*

141 *EY calls off global audit and consulting split – for the time being (consultancy.eu)*

142 *Independent Review into the Quality and Effectiveness of Audit (publishing.service.gov.uk); 2019*

143 *Railpen-response_beis_08-07-2021.pdf (azureedge.net); July 2021*

144 *FRC principles for operational separation of audit practices; June 2020*

The role of independent non-executives in audit firms

The internal governance arrangements of audit firms clearly have a significant influence on its culture. One aspect of this is the involvement and role of independent non-executives in the firm's oversight structures. They are a well-established part of audit firms' governance in the UK, although each firm has adopted different arrangements. Since 2020 the Big 4 firms have in addition been required to establish a separate Audit Board, with a majority of Audit Non-Executives, to oversee audit quality and the activities of the audit practice[144]. In the Netherlands it is now a legal requirement for audit firms that audit public interest entities to have independent non-executives on their supervisory boards.

This is currently an active policy debate in several markets, including the US where the majority of the Big 4 firms in the UK have established some sort of arrangements on a voluntary basis. The CII had argued for audit firms to have an independent committee on audit quality which management would report through to the board. The pending PCAOB standard on Audit Quality[145], however, has taken a different approach requiring an external oversight function for audit quality composed of one or more persons, none of whom has a disqualifying relationship with the firm. There have also been calls from audit firms for a more joined-up approach from national regulators in recognition of the fact the firms have global networks[146].

As already noted, it was previously the case in the UK that there were opportunities for investors to engage with the independent non-executives without their executive colleagues being present.

Recommendations

- Regulators, in markets where there is currently no mandatory requirement for major audit firms to have independent non-executives, should introduce such a requirement, setting minimum standards in respect of the number of independent non-executives and their role.

Those investor interviewees who had experience of these meetings said that this had been a useful mechanism for conveying any concerns and gaining insights into the firm's culture, and that they would welcome them being revived.

Increasing competition and capacity in the audit market

Encouraging greater competition

Measures have been taken in the UK and EU to encourage greater competition in the market for audit services provided to listed companies. There were two primary objectives: to raise standards of auditing by encouraging firms to compete on quality rather than price, and to strengthen resilience and capacity by enabling more audit firms to enter the market[147].

The latest data from the UK shows that while there has been some increase in the number of listed company audits being undertaken by 'challenger firms'[148] – in part but not solely due to mandatory auditor rotation – the market continues to be dominated by the Big 4, as is also the case in the US and EU.

One approach to increasing competition is to require shared or joint audits involving one or more challenger firms as well as one of the Big 4[149]. In shared audits, one firm is appointed to perform the audit of the group accounts and some of the components, while another firm audits the other components. In joint audits, two or more firms are appointed to take joint responsibility for the entire group audit.

A few markets currently mandate joint audits, most notably France where they are required for larger listed companies and banks[150]. Most empirical studies do not appear to support the notion that joint audits improve audit quality[151].

In the UK the previous Government stated in 2022 that it would legislate to require UK domiciled FTSE 350 companies either to appoint a challenger firm as its sole auditor or to appoint a challenger firm to conduct a meaningful proportion of its subsidiary audits within a shared audit[152]. As noted, this has not yet been implemented and at the time of writing it is not clear whether it will be included in the legislation proposed by the new Government.

The previous Government had also said that it would give the FRC powers to operate a 'market share cap' if further intervention was felt to be necessary. This would require a proportion of audits to be tendered exclusively for challenger firms, to be based on their capability and capacity. This approach has previously enjoyed some support from investors, including Railpen[153].

145 2024-005-QC1000 (pcaobus.org)

146 PwC pushes to loosen rules on independent board members (ft.com); December 2023

147 Statutory audit market study - GOV.UK (www.gov.uk); October 2018

148 Broadly, challenger firms are those firms outside the Big 4 that have the capacity to undertake audits of public interest entities.

149 The difference between joint and shared audits and the arguments for and against are presented in shared-and-joint-audits.ashx (icaew.com); 2019

150 In 2021 France was responsible for 87% of all joint audits in the EU. Belgium, Croatia, Finland, Ireland and Poland also reported joint audits. Report on Audit Market Monitoring 2020 (europa.eu); March 2024

151 (PDF) Are four eyes better than two? An examination of recent empirical evidence on the impact of joint audits (researchgate.net); Dr Javed Siddiqui; University of Manchester; January 2019

152 Restoring trust in audit and corporate governance: government response to consultation on strengthening the UK's audit, corporate reporting and corporate governance systems (publishing.service.gov.uk); May 2022

153 railpen-response_beis_08-07-2021.pdf (azureedge.net)

In its response to the 2021 BEIS paper, Railpen noted that:

We are sceptical of the benefits of managed shared audit arrangements. We believe that shared audits still run the risk around a lack of co-ordination between the different audit firms and that certain aspects of the audit may be missed or glossed over as a result. We also believe there are issues with a joint audit approach, although at least a joint audit would mean more pairs of eyes.

We welcome the government's statement that a market cap arrangement is still an alternative, although we would encourage serious consideration sooner rather than later. We believe that such an arrangement would be more directly beneficial, not least as it is the attitude of the individuals involved in an audit which is a key determinant of audit quality and such a move could encourage ambitious audit partners or prospective partners to consider at which firms their career goals are most likely to be achieved. This could in turn lead to a greater flow of quality candidates to firms beyond the Big Four[154].

Recommendations

- Regulators in the UK and elsewhere should formally set out the tests they will apply to assess whether they are happy with progress in audit market competition
- If audit market competition (and quality) in relevant markets is deemed insufficient, despite previous reforms, policymakers should revisit a market share cap approach

Improving audit firms' resources and capabilities

Research referenced earlier in the report[155] found that many investors consider the size, skills and experience of the audit engagement team to be the single most important factor in ensuring high audit quality. In recent inspection reports the PCAOB and FRC have both highlighted concerns about audit firm resources and capabilities.

The PCAOB has previously noted that "deterioration of audit quality may in part be attributable to higher-than-normal staff turnover, use of less experienced staff in general, and the ongoing impact of COVID-19 and related remote work"[156], but comments in its most recent inspection report that "audit firms with strong quality control (QC) systems and centralized structures and processes in place before the start of the pandemic seem to have had a better chance of more quickly righting their ships"[157].

In its most recent assessment of audit quality in the UK the FRC notes that the accountancy and auditing profession worldwide faces ongoing capacity challenges, and highlights factors such as the number of students joining UK accounting bodies, and rapid growth and significant portfolio changes that directly impact audit quality because of insufficient resources[158].

Audit market capacity and the impact on capabilities

The interviews and desk research have identified some specific concerns about the capacity of the audit services market in the UK and the impact of competition and firms' capabilities on audit quality. These include:

- There is a quality gap between audits undertaken by the Big 4 when compared to challenger firms. The FRC's most recent inspection report found that the inspection results for the smaller Tier 1 firms were below those of the Big 4[159], and the PCAOB has observed a similar pattern in the US[160]. This suggests that there may be a trade-off between the two objectives, at least until such time as challenger firms are able to develop their capabilities[161].
- There is evidence that larger audit firms have been 'de-risking' their portfolios with the result that some complex, hard to audit public interest entities have been transferred to smaller firms that may not have the experience, resources or capabilities to perform a high quality audit of these entities[162]. While this may reduce risks for the audit firms, it has the opposite effect for investors.
- There is anecdotal evidence that the Big Four have been retreating from taking work from smaller companies, including ones listed on AIM, leaving those businesses with fewer options when seeking an external auditor[163].
- Recent research commissioned by the FRC shows that there are significant barriers to entry for smaller audit firms wishing to audit public interest entities (which include listed companies), including the ability to recruit and retain staff and economies of scale[164].
- More broadly, concerns have been expressed about capacity constraints because of the increasing demands on audit firms from new standards and regulatory requirements, increasing expectations around independent assurance of non-financial information, the loss of people from the profession and difficulties in recruiting.

154 *Ibid.*

155 *Understanding Audit Quality: Insights from Audit Professionals and Investors (thecaq.org)*

156 *Spotlight-staff-preview-2022-inspection-observations.pdf (pcaobus.org); PCAOB: July 2023*

157 *Staff-update-2023-inspection-activities-spotlight.pdf (pcaobus.org); PCAOB: August 2024*

158 *Annual review of Audit Quality (frc.org.uk); July 2024*

159 *Annual review of Audit Quality (frc.org.uk); July 2024*

160 *Staff-update-2023-inspection-activities-spotlight.pdf (pcaobus.org); August 2024*

161 *FRC notes in its July 2024 report that "both [smaller] firms have takenactions in recent years... to strengthen related firmwide systems and audit quality functions. However, these actions have not yet had the desired impact on the front-line audit teams to improve audit quality"*

162 *FRC ibid*

163 *Audit fees for UK-listed companies up 75% since 2018, study finds (ft.com); February 2024*

164 *Views of firms on entry, growth and exit in the markets for smaller PIEand non-PIE audits (frc.org.uk);*

Remuneration

In 2023, the Chair of the FRC said "there has been a significant increase in profitability at all the audit firms. They have the resources available to increase the pay levels of more junior people that they want to attract into their firms and it's up to them whether they want to do so[165]." There have also been several media reports in recent years comparing the pay for junior auditors (ca. £30-40k per year) to other City professions such as legal and investment banking[166], alongside pay rises that have not kept pace with inflation in recent years.

Railpen has continued to note to its portfolio companies – and express though its voting activities[167] – that the benefits of a high-quality audit outweigh additional costs (within reason). Although how well audit firms pay their junior auditors must remain an issue for the firms themselves, we will continue to make the wider point in our engagements with companies and policymakers.

Recommendations

- Investors should engage with portfolio companies' Audit Committees to understand the experience and expertise of the external audit team.
- Investors should emphasise that while cost restraint can be positive, we would prefer to see money spent on a high-quality, well-resourced audit.
- Audit Committees should share their engagement-level AQIs with shareholders upon request.

165 *Pay junior auditors more if you want to attract staff, watchdog's chair says (fnlondon.com); June 2023*

166 *https://on.ft.com/3r6QD85*

167 *Please see railpen.com/knowledge-hub/engagement/current-voting-records/*

CONCLUSIONS

There have been significant reform efforts from policymakers, but we and others would argue that more needs to be done. There continue to be regular audit failures and a worrying number of 'high risk' audits of listed companies that have been inspected by regulators in major markets such as the US and UK are considered deficient. The causes of this are numerous and varied and we have outlined what we consider to be the most problematic here.

At the time of writing this report, the new UK Government has announced that it will legislate on audit reform, while regulators around the world are making admirable efforts to improve audit quality. However, we would argue that more needs to be done not only by policymakers but also by investors, audit firms, audit committees and others.

As a large institutional investor with a keen interest in audit issues, we at Railpen will continue to do what we can as an individual investor with our portfolio companies. We earlier outlined some of the changes we will make as a response to the research presented here. A well-functioning audit market that supports high-quality audits and ensures a company's accounts represent a true and fair view of its financial health is vital to investor decision-making. We hope that this report is a useful additional contribution to the debate and will provide at least some encouragement to others do what they can to ensure the audit market works in the interests of all stakeholders.

For further information on any of the findings or conclusions in this report, please contact **SO@railpen.com**.

APPENDIX

Topic	UK	US	EU
Auditing standards	National adoption of international (IAASB) standards, with some additional national requirements.	National standards (PCAOB) not derived from IAASB standards.	International (IAASB) standards
Ethical standards	National standards currently being updated to be consistent with IESBA Code. UK professional bodies have all adopted the IESBA Code.	National standards (PCAOB) not derived from IESBA standards.	No EU level standards, apart from a non-binding Recommendation on auditor independence. Major markets have national standards, issued either by regulators or professional bodies. Some currently being updated for consistency with the IESBA Code (e.g. Italy).
Qualifications and training	Provided by professional bodies with FRC oversight. FRC registers PIE auditors directly.	Provided by professional bodies. Licensing requirements for auditors set at State level.	EU law sets minimum requirements to qualify as an auditor. Practice at national level varies.
Oversight/ inspection	Independent regulator (FRC) for public interest entities, delegated to professional bodies for others.	Independent regulator (PCAOB) for audits of public companies and SEC-registered brokers and dealers	National independent regulators for public interest entities. CEAOB has coordination role at EU level.
Published inspection reports	Yes	Yes	Practice varies at national level. CEOAB issues annual pan-EU report based on national data.

Topic	UK	US	EU
Auditing standards	FRC can sanction audit firms and individual auditors, including by: fines; reprimands; restrictions on the nature of work undertaken or clients represented; prohibition from conducting Statutory Audits, withdrawal of practising certificate; and exclusions from membership of a professional body.	PCAOB and SEC "may impose sanctions, including censures, monetary penalties, and limitations on a firm's or an individual's ability to audit public companies or broker-dealers".	EU law requires member states to have effective sanctions which must include the possibility to withdraw the licence to conduct audits.
Competition in the audit market	Proposed reforms included measures to impose some shared audits and market caps if required. *Currently on hold.*	No current policy proposals.	No policy proposals beyond the measures already introduced (e.g. mandatory rotation, shared audits).
Audit firm separation	Proposed reforms included measures to impose operational and/or legal separation if required. Currently on hold. In 2020 FRC stated that it expected the Big 4 to implement operational separation on a voluntary basis by 2024.	No current policy proposals.	No policy proposals beyond the measures already introduced (e.g. ban on provision of some services to audit clients).
Audit firm governance	Audit Firm Governance Code (2022), ethical standards and supervision.	PCAOB pending standard on quality control standard provides some requirements on ethical standards.	No activity at EU level. Ethical standards at national level.
Independent Non-Executives	Audit Firm Governance Code recommends 3 (on comply or explain basis). All Tier 1 firms have some. Big 4 firms also required to have Audit Board with Audit Non-Executives.	Voluntary, all major firms have some. May 2024 PCAOB standard will require external oversight function for firms with over 100 issuer clients.	No EU requirements. Practice varies by country. The Netherlands requires firms that audit PIEs to have an independent supervisory board.

Topic	UK	US	EU
Auditor rotation – audit firm	Mandatory – maximum 10 + 10 years.	Not mandatory.	Mandatory – maximum 10 + 10 years (varies by country).
Audit rotation – audit partner	Mandatory – maximum 5 years (7 in exceptional circumstances only).	Mandatory – maximum 5 years.	Mandatory – maximum 7 years.
Tendering	Mandatory – maximum 10 years.	Not mandatory.	Mandatory – maximum 10 years.
Auditor appointment	Requires shareholder approval.	Shareholder approval not required but voluntary non-binding votes are standard practice.	Requires shareholder approval.
Non-audit services	Capped at 70% of audit fee, some services forbidden.	No cap but some services forbidden and audit committee approval needed for others.	Capped at 70% of audit fee, some services forbidden.
Firm level reporting	Mandatory annual transparency reports for auditors of certain public interest entities.	No mandatory requirements for transparency reports but some audit firms publish US specific reports on a voluntary basis.	Mandatory annual transparency reports for auditors of certain public interest entities.
Audit reports	Extended audit reports mandatory since 2013, contents defined in UK standards.	Extended audit reports introduced in 2017, contents defined in PCAOB standards.	EU adopted IAASB standard for extended audit reports.
Audit committee -composition	Majority independent (Listing Rules) but most are fully independent (UK Corporate Governance Code). At least one member with competence in accounting/auditing (Listing Rules).	Fully independent (Listing Rules and SOX); comply or explain requirement for financial expert (SEC rules).	Non-executives only, at least one with competence in accounting or auditing (under EU law); minimum number of independents varies by country but most minimum 50%.

Topic	UK	US	EU
Audit committee – reports	Reporting requirements specified in the UK Corporate Governance Code and FRC's 'Minimum Standard' for audit committees (2023).	Mandatory audit committee report in annual proxy statement (SEC rules).	No reporting requirements in EU law but some countries require reporting either in the annual report (e.g. France) and/or at the AGM (e.g. Spain).
Auditor liability	Requires shareholder approval to limit liability (by law). Not yet tested for listed companies.	No liability limitations.	No EU level rules, varies by country. In France – unlimited liability, in Germany – cap on liability.
Investor class actions against auditors	Permitted, but in practice difficult due to Caparo judgement.	Permitted.	No common pattern, but examples of class action in several EU countries, e.g. Italy.

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The research undertaken was a combination of desk research and interviews with investors, audit committee chairs and members of the audit profession. The purpose of the interviews was to gain insights into the quality of auditing practice and reporting, the effectiveness of the current policy framework, the activities of other investors and the extent of engagement between investors, auditors and chairs of audit committees at both investee company and market level.

We are very grateful to all interviewees for agreeing to speak to us in their personal capacity, and to everyone else who has directly or indirectly contributed to this report from across the audit, investor and corporate communities. The opinions expressed in this report are those of Railpen and may not reflect the views of individual contributors.

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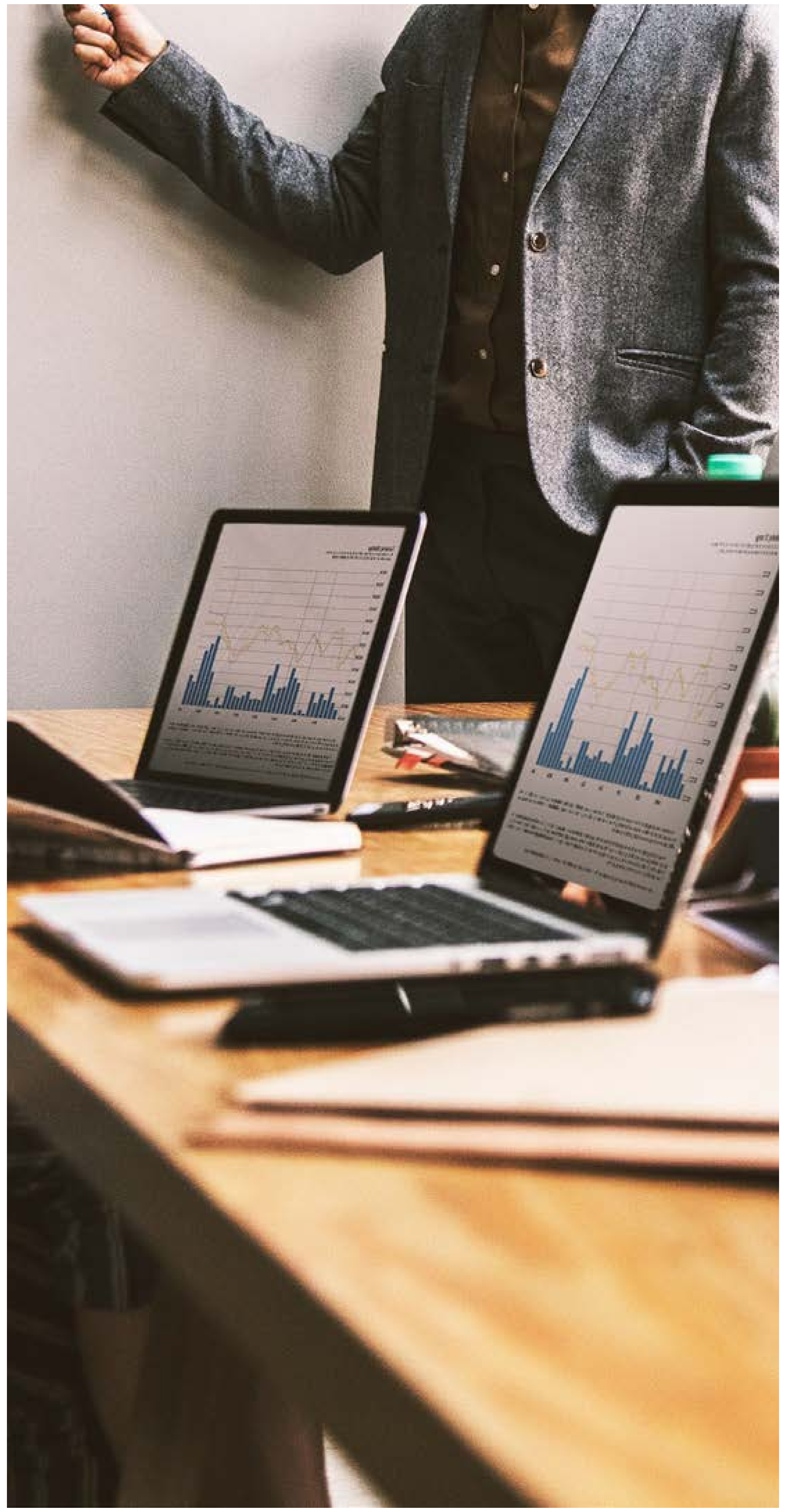
- Liz Murrall (recently retired director of an investor representative body)
- Andrew Ninian (Investment Association)



We hope this has helped you understand a little more about who we are and what we do, but we welcome questions or thoughts.

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