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**Date:** 18 August 2022

Sent via email: AQIs-consultation@frc.org.uk

Dear Ms Hussain,

**Railpen response | Financial Reporting Council (FRC) Consultation Document: Firm-level Audit Quality Indicators (AQIs).**

About Railpen

Railpen is the trading name of Railway Pension Investments Limited, which is authorised and regulated by the Financial Conduct Authority (FCA). Railpen acts as the investment manager for the railways pension schemes and is responsible for c. £37 billion of assets on behalf of over 350,000 members.

Sustainable Ownership is Railpen's approach to incorporating sustainability considerations into the investments it manages on behalf of members. Railpen's work is enabled by the Trustee's related investment belief: "Incorporating and acting upon climate risk and other environmental, social and governance factors is a significant driver of investment outcomes and part of our fiduciary duty."

A well-functioning audit market, that supports high-quality audits, ensures a company's accounts represent a true and fair view of its financial health and is vital to investor decision-making. This is why one of Railpen's core thematic priorities is "audit quality" and why we welcome the opportunity to contribute to this consultation.

Our submission builds on our previous responses on audit issues in the UK, including to the 2021 consultation from BEIS on *Restoring trust in audit and corporate governance*. We have focused our response on those issues and questions where we think we can add most value.

Our response

We support the principle of greater transparency around audit quality metrics to Audit Committees, investors and other stakeholders. We recognise that much of the investor community has not historically been engaged on audit issues and, while we are hopeful that many of the broader reforms proposed by the Brydon Review will help solve the engagement issue, we do not think that lack of current wider investor interest should delay the FRC's current work on AQIs. We are also hopeful that these firm-level AQIs will further encourage investor engagement with audit quality.

We focus here on three aspects: i) the scope and application of the AQI regime, ii) the content of the reporting itself and iii) the publication of this information. Although out of the scope of this consultation, we also offer some thoughts on the publication of engagement-level AQIs and the usefulness of this information to investors.

**A. Scope and application**

We are generally supportive of the proposed scope of the AQI regime. Broadly, we would like to see the regime applied to as many firms – including challenger firms – as possible. We think that it will be important for investors and Audit Committees to see and understand AQIs from challenger firms in light of ongoing concerns about the quality of the audits undertaken by these companies.

Furthermore, although we recognise concerns that some smaller firms may not have sufficient resource to report on the full range of AQIs, we would suggest the FRC strongly encourages as many firms as possible to do so, or perhaps considers introducing a tiered approach. Even where a challenger firm does not currently meet the threshold for reporting (in terms of PIEs or FTSE 350 firms audited), it is likely that being able to demonstrate consistent, useful provision of AQIs will be an additional criterion for Audit Committees considering whether to award an audit to such a firm.

Although we recognise that metrics will differ across audit firms in light of the variety of business models and structures of firms, we support the principle of ensuring the metrics provided are as comparable and consistent as possible. We think that requiring firms to report against the same year end (1 April – 31 March) will be of use to investors.

We note the discussion around the potential cost to firms of providing and publishing these metrics. Given the clear link, as demonstrated by the FRC in its paper, between many of the metrics proposed and audit quality, we would hope that audit firms will already be monitoring these metrics, or have taken meaningful steps to do so. We are therefore hopeful that the additional cost of reporting will be minimal.

**B. Content.**

<u>The importance of context and framing</u>

Investors recognise that it is difficult to get the full picture of an issue, where metrics alone are provided. Supporting narrative provides vital context and can partly mitigate any misinterpretation that may occur from provision of metrics alone. Narrative also aids to prevent an issue being "buried" in the data. The FRC's own Stewardship Code provides space and flexibility for investors to discuss what makes them unique and is a good example of the usefulness of narrative in providing stakeholders with richer insights. We are therefore supportive of the proposal that narrative, as well as metrics, should be provided in firms' reporting of AQIs. We would hope that this narrative would also offer some indication of the direction of travel over time.

For ease of use by Audit Committees and investors, we would hope that the FRC would discourage as far as possible web links to information contained elsewhere. We note the evidence on web user experience that demonstrates that too many 'clicks' in a web journey discourages engagement. In the context of, as noted previously, the need

to further encourage investors to view this information, we think this is worth careful particular consideration.

We would also be supportive of any steps the FRC could take to encourage firms to break down metrics by not just sector or size of the entity, but also by the 'risk-level' of an audit (analogous to the FRC's own concept of "higher risk engagements"). We recognise that *requiring* more segmented information from audit firms – at this stage – may be overly burdensome, but we hope that once the new regime has been embedded, this might be considered.

Useful metrics

As investors, we want to be reassured that an audit firm has the right kind of culture in place, which supports the exercise of insightful professional scepticism in the interests of investors, and the appropriate and highly qualified resource required to understand the audited entity. The evidence base for the importance of people and culture to the quality of an audit is well established. We are therefore supportive of metrics that would measure the following:

- Whether the culture supports an ethical, principled approach to audit and avoids groupthink.
  We are supportive of the inclusion of culture survey results in A, but think that this should also include employee feedback around the inclusiveness of their organisation (this is not currently measured under E14). We also think further information – perhaps in the narrative – around the type, and level of use of whistleblowing processes in the organisation would be of interest.

  Furthermore, we think that the staff attrition metric suggested in C10 will be of significant interest to stakeholders. It could be indicative of resourcing pressure, as the FRC's paper notes, but it could also be indicative of broader issues with the culture – which can also impact employee morale.

- Whether auditors have enough time to do a good job.
  It is important that sufficient time is given to individuals to ask the right questions and avoid corner-cutting to meet what can be artificial deadlines. Proposed metric A3b, C9a and C9b appear to be closest to measuring this in a meaningful way. In light of reported concerns from audit firms that some companies deliberately provide information late to avoid challenging questions, it might also be useful to get reporting on what proportion of company-provided information fails to hit agreed deadlines.

- The level of experience of audit teams and the team structure.
  Currently the C8 metric proposed measures partner involvement in audits only. However, we think that C12 is more useful in that it also measures the capacity of managers and audit partners to supervise junior audit staff. More valuable still would be a metric that measures the average level of involvement of the middle-tier of audit practitioners in audits. Although this is a metric that is of use at an engagement level, we think it would also be helpful as a firm-level AQI.

- How auditors are incentivised on audit quality.
  The way in which reward and promotion opportunities are implemented is fundamental to the kind of work carried out. A metric, or supporting narrative,

which demonstrates the link between what has been rated as a high-quality audit and promotion or pay increases, would be valuable. As stated previously, we would hope that this is the kind of issue already being measured by audit firms to guide their reward decisions, so this would not be an unduly burdensome requirement.

- The level of interaction with investors.
  We recognise that the precise link between audit quality and investors is difficult to capture in a metric. However, as it is investors who are an auditor's true clients, we believe it is reasonable to argue that asking firms to disclose the extent of their interactions with investors – either directly or through the Audit Committee – would indicate to what extent an audit has been tailored to a primary audience.

  This information could be provided alongside metric A2 on "audit planning milestones" and could potentially capture whether and to what extent investor feedback was included in the final audit plan, as well as the time spent engaging with investors.

- Whether, where and to what extent specialists have been used.
  As the role of auditors changes to provide assurance over both traditional financial information *and* disclosure and metrics on environmental, social and governance issues, the role of such specialists becomes increasingly important. We would therefore be keen to see metric C11 in the final list of required AQIs. We would also like to see the FRC encouraging audit firms to disclose what kind of specialists were used in the accompanying narrative.

## C. Publication

We support the proposal to tabulate the AQI scores for each firm. We would propose that this information is centralised in one table – with links to the fuller reports elsewhere. We agree that the FRC's website is the most appropriate place for this information.

We think that attestation by a senior partner as to the information's accuracy would be useful in i) incentivising the provision of the right information and ii) ensuring clear accountability.

## D. Engagement-level AQIs

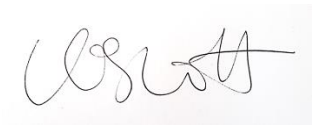
Although outside the scope of this consultation, we want to raise the issue of the publication of engagement-level AQIs. We recognise that these will be of most use to Audit Committees when monitoring and gauging the progress of a specific audit. However, this firm-level information would also be of use to investors and their proxy advisers, when it comes to engaging with – and voting on the audit-related resolutions at – portfolio companies.

We recognise that there may be sensitivities and that the main formal mechanism for investor engagement with the audit is at present through the Audit Committees. However, in reality, it remains challenging for many investors to gain access to a company's Audit Committee Chair or Committee members to discuss the audit.

Although we believe that implementation of some of the Brydon Review recommendations should help break down the barriers, we think that publishing – or in some way making available – engagement-level AQIs to investors would support more thoughtful stewardship on audit issues.

We hope that the information contained in this response has been helpful and would welcome the opportunity to discuss any of the issues above further.

Yours sincerely,



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