SECTION 4: AUDIT, RISK AND INTERNAL CONTROL

The primary client of a company's Auditor is the shareholder. Investors rely on a high-quality audit, where the Auditors are fully independent and have exercised professional scepticism and judgement, to enable them to form a clear and accurate view of the financial health of the company.

Individual accountability here is key: if a named partner, or the Chair of an Audit Committee, has been involved in presiding over poor audit practices elsewhere, then investors should expect that the individual is not involved on an Audit Committee or involved in the audit at or of another firm.

In 2021, the UK Government launched a major consultation on audit reform,[24] bringing together the recommendations of the Kingman Review,[25] the Competition and Markets Authority statutory audit market study,[26] and the Brydon Review.[27] Though the Government had committed in the 2022 Queen's Speech[28] to bring forward an Audit Reform Bill, this legislation was not included in the 2023 King's Speech.

A set of draft regulations to create a series of "new corporate reporting requirements for very large UK companies" were laid in Parliament on 19 July 2023, but these proposals were withdrawn on 16 October 2023, after a consultation with companies raised concerns about imposing additional reporting requirements. Instead, the Government will pursue options to reduce the burden of red tape, while remaining committed to wider audit and corporate governance reform, bringing legislation in this area when Parliamentary time allows.[29]

Nevertheless, the FRC published in May its Minimum Standards for Audit Committees[30], which are applicable – for now on a voluntary basis – to companies with a Premium Listing on the London Stock Exchange, and which are included within the FTSE 350 index. The goal is to enhance performance and ensure a consistent approach across audit committees within the FTSE350, while

[24] Department for Business, Energy and Industrial Strategy 'Restoring trust in audit and corporate governance – Consultation on the government's proposals', Department for Business, Energy and Industrial Strategy (2021) <Restoring trust in audit and corporate governance (publishing.service.gov.uk)>.

[25] Sir John Kingman 'Independent Review of the Financial Reporting Council', Department for Business and Trade, Financial Reporting Council and Department for Business, Energy & Industrial Strategy (2018) <Independent Review of the Financial Reporting Council (publishing.service.gov.uk)>.

[26] Department for Business, Energy & Industrial Strategy 'Market study on statutory audit services: summary of responses', Department for Business, Energy & Industrial Strategy <Market study on statutory audit services: summary of responses to the 2019 consultation (publishing.service.gov.uk)>.

[27] Sir Donald Brydon 'Assess, assure and inform: improving audit quality and effectiveness – final report of the independent review', Department for Business and Trade and Department for Business, Energy & Industrial Strategy (2019) <Independent Review into the Quality and Effectiveness of Audit (publishing.service.gov.uk)>.

[28] Prime Minister's Office 'The Queen's Speech 2022', Prime Minister's Office (2022) <Lobby Pack (10 May 2022) (publishing.service.gov.uk)>.

[29] Department for Business and Trade 'Burdensome legislation withdrawn in latest move to cut red tape for businesses', Department for Business and Trade (2023) <https://www.gov.uk/government/news/burdensome-legislation-withdrawn-in-latest-move-to-cut-red-tape-for-businesses>.

[30] Financial Reporting Council 'Audit Committees and the External Audit: Minimum Standard', Financial Reporting Council (2023) <https://media.frc.org.uk/documents/Audit_Committees_and_the_External_Audit_Minimum_Standard.pdf>.

the FRC aims to support the delivery of high-quality audits and reinforce public trust in the financial reporting process.

Recommendations from the Brydon Review, that investors may wish to consider, include:

- For the Directors' Risk Report to be published in good time for shareholders to comment, as well as for a formal invitation to be issued to shareholders to express any requests regarding where they would be particularly keen for an Auditor to focus on in the audit plan.
- A standing item to be added to AGM agendas for questions to the Chair of the Audit Committee and to the Auditor.

THE EXTERNAL AUDITOR

The role of the external Auditor is to provide an independent opinion of a set of financial statements in order to show whether these give a true and fair value of the company. There should be regular turnover in use of an external Auditor to ensure that they remain impartial and are able to exercise professional scepticism.

RISK AND INTERNAL CONTROL

Risk management must be a prominent consideration at any company. In addition to an external audit, an effective, robust and well-resourced internal audit has a central role to play in supporting boards to better manage and mitigate the risks the company faces. Firms should focus on risk in the context of the business strategy, the firm's size and global footprint, as well as its assets, liabilities and the wider political and regulatory environment.

It is the internal Auditor's task to provide an annual internal opinion on the state of the organisation's arrangements in relation to risk management, governance and internal control. This function may also include an advisory or consultancy function, where they support management in improving systems and controls.

Cybersecurity

The move to home working during and after Covid-19, alongside the current geopolitical situation, has increased cybersecurity risks. These risks can arise not only from the technology itself but also from the people using it and the processes supporting it. It includes risks to information (data security) as well as assets, and both internal risks (for example, from staff) and external risks (such as hacking). Investors need to ensure that companies are managing these threats appropriately, by having governance and oversight structures in place and reporting on potential breaches and solutions.

Investors should encourage companies to explicitly disclose the governance and oversight structures in place to identify and manage these risks, as well as provide timely reporting of any breaches and the measures taken in response.

Cybersecurity should also be an active consideration when selecting a supplier and suitable provisions should be included in contracts. Investors should agree what metrics to use to monitor their suppliers, at a depth and frequency proportionate to their risk.

Artificial Intelligence (AI)

Artificial Intelligence (AI) is likely to be one of the biggest technological leaps in history. It is poised to unlock new business models, transform industries, reshape people's jobs, and boost economic productivity.

AI has the potential to change the investment landscape in three ways:

- Investors will place more value on the quality of a company's AI assets and capabilities.
- Investors themselves will rely far more on AI-based research techniques to support their investment approach.
- Investors will compete head-to-head with the technology sector for AI talent.

Although AI has the potential to generate significant opportunities, it can also generate risks for businesses, including the amplification of discrimination, proliferation of misinformation and privacy violations – particularly in relation to generative technologies.

In addition, AI is likely to be highly disruptive in the employment space, being poised to take jobs away from workers worldwide in the future. Indeed, some large technology companies are already starting to feel the heat from ESG-focused shareholders concerned about job losses due to AI, as well as the potential introduction of discrimination in employment decisions.

Investors should ensure that companies are accountable for their social impacts by aligning with evolving industry good practice. It may be that AI and AI-enabled technologies will be subject to new standards and requirements in the future in order to promote safety, security and equity. Investors will need to ensure that companies are adhering to these standards and requirements.

EVIDENCE BASE

- The key source of information provided by the Auditor is the Audit Report. Investors should pay attention to the following information:
- Evidence of professional scepticism by the Auditor
- The critical accounting policies and principles used
- The level of materiality adopted
- Assumptions and judgements
- The findings of any review undertaken by the FRC's Audit Quality Review Team (and actions taken by the board in response to the findings).

Few investors are experts on audit assumptions and methodologies and there is an ongoing policy debate regarding to what extent investors can expect to be. The key determinant of a high-quality audit is professional scepticism and a willingness to challenge management.

Investors should be prepared to dig deeper and ask questions, including disclosure on areas where the Auditor challenged management and the outcome, or even simply making a request that the Auditor be present at the AGM to answer any questions and present their Report.

On ESG metrics, it is desirable that the sustainability metrics provided by companies be assured.

WHAT DOES GOOD COMPANY BEHAVIOUR LOOK LIKE?

Audit

- The audited accounts represent a "true and fair" view of the state of affairs of the business. This should include its assets, liabilities, financial position and profit or loss – all of which should be prudently assessed to avoid overstating capital.
- The Audit Committee obtains a high-quality audit in the interests of shareholders, allowing for proper accountability between the audit company and the investors. This Committee has arguably the most complex brief of any of the board Committees, as objective and prudent accounts sit at the heart of an effective accountability regime.
- The Audit Committee demonstrates sufficient independence from company management. The Committee should be staffed solely by independent Directors (both from the executive, but also taking into account independence from the external Auditor) and enjoy sufficient relevant experience to carry out its responsibilities to a high standard.
- The Audit Committee Report provides 'colour' and detail. This should not simply mirror the Auditor's Report. It should include the right quality and amount of information to give investors an insight into the audit process, including:
    - Explicit details of the criteria used for Auditor selection and evaluation, including any contractual obligations to appoint audit firms.
    - Details of the audit tender process, including when the audit was last tendered and how the company ensures independence is safeguarded.
    - How the Audit Committee satisfied itself that it got the highest quality audit possible.
    - Any changes to the process and plan of the audit (and reasons for these changes), including any changes to the audit partner and the process carried out by the Audit Committee to agree this appointment.
- The audit tendering process is in line with Regulations[31] and has been rigorous. Any tendering process should enable the Audit Committee to compare the quality and effectiveness of the services provided by the incumbent audit with other audit firms –

[31] The Statutory Auditors and Third Country Auditors Regulations 2016, The Stationary Office <The Statutory Auditors and Third Country Auditors Regulations 2016 (legislation.gov.uk)>.

including those outside the Big Four. The intention to tender the audit contract should be disclosed in advance within the Report and Accounts and the process should focus on audit quality – not costs – including the Auditors' independence and processes to ensure professional scepticism.
- The Audit Committee fully discloses any members' connections with the current or potential Auditor. Committee members should also have recent and relevant financial experience related to audit, accountancy or investor practitioner expertise.
- Additional disclosures clearly cover any the reasons for any Auditor resignation and fully detail all non-audit fees and policy on non-audit work. Where the Auditors supply non-audit services to the company, the Audit Committee should keep the nature and extent of such services under regular and closer review, to ensure objectivity is not compromised. Disclosure of non-audit fees should include:
    - Clear breakdown between the types of services received
    - Tax compliance services are differentiated from tax advisory services
    - Non-statutory acquisition-related services are separated from statutory services.
- Appropriate use is made of third parties for non-audit services (including outside the Big Four). Where the company also uses its Auditors for non-audit work, the rationale must be clearly explained. No more than 50% of the audit fee should be spent on non-audit services.
- The AGM includes a presentation from the Auditor. This happens increasingly rarely, but the PLSA would be keen for this to take place more frequently. Such appearance would give investors the opportunity to directly ask questions and hopefully raise the profile of audit issues.
- Company is looking to apply on a voluntary basis the FRC's Audit Committees and External Audit: Minimum Standard.

Risk and Internal Control

- The Annual Report covers the key elements of the business. It should explain how the company generates value from its key tangible and intangible assets. It should set out the how the board establishes and maintains an effective risk management and internal control framework – including ESG and reputational risks.
- The Annual Report covers emerging risks, demonstrating a dynamic approach to risk assessment. This could include risks from climate and cybersecurity, or tax management (and the potential impact on reputation and brand value). Companies should be communicating what changes have occurred in relation to their risks over the previous year, how it has chosen to respond and the impact so far – including likely impact on the overall business strategy and model.
- Directors state whether they expect the company to meet its liabilities as they fall due over the period of their assessment. This should include drawing attention to any qualifications or assumptions as necessary. This should be as part of an articulation as to whether they

have a reasonable expectation that the company will remain a viable and sustainable enterprise for the foreseeable future.

- Directors articulate their reasons for choosing a specific timeframe. This should follow the FRC's guidance that the length of the period should take account of the board's stewardship responsibilities, previous statements they have made, especially in raising capital, the nature of the business and its stage of development.

Cybersecurity and AI

- Companies have identified their cybersecurity vulnerabilities and have policies in place in case of a cyber-attack.
- Companies have a cybersecurity training policy in place for employees and have adopted best practices to enhance network and device security.
- Companies have implemented robust data anonymization techniques when using AI, which allows businesses to protect data privacy.
- Companies take a zero-trust approach when selecting AI tools and third-party services, by vetting them against corporate privacy and security policies, to ensure the business is not being exposed to risk and vulnerabilities.
- Companies monitor their use of AI and have a governance framework for an acceptable use of AI.

HOW INVESTORS SHOULD CONSIDER VOTING

Investors should note that in most cases, but not always, there are separate resolutions which cover the appointment of external Auditors and the setting or authorisation of the board to set Auditors' fees. This is important because investors may have concerns about the balance between audit and non-audit fees, which need to be considered separately to the appointment of the Auditor alone.

There is a range of resolutions that investors might use as a vehicle to express concerns regarding audit process or outcomes. These include: the vote to appoint or reappoint the Auditor; the vote to give Director's power to agree the Auditor's fee; the vote to approve the Report and Accounts; or the election of the Chair (or other members) of the Audit Committee.

<u>Investors should consider voting against the Annual Report and Accounts</u> and perhaps also the Auditor and/or Audit Committee Chair if there are ongoing concerns in relation to:

- The audited accounts fail to provide a true and fair view of profit or loss, assets or liabilities (for example, they overstate profit or assets or understate likely liabilities such as pension or climate-related liabilities). Please note: if the Auditor is seen to have helped reveal this issue, then their re-election, all other things being equal, should be strongly supported.
- There is ongoing use of alternative performance measures to report on business performance and their use is not transparent and fully justified, or where the reconciliation

to the generally accepted accounting principles accounting numbers if unclear, or where the calculations change regularly in ways that appear to flatter management delivery.
- There is poor disclosure of the strategy and risk exposures or a lack of disclosed review of the company's risk management and internal control systems.
- There is either no viability statement which looks out over multiple years, or one which does not evidently consider a full range of risk factors.
- The climate change assumptions that underlie calculations of relevant and publicly stated asset valuations or business profits are not sufficiently transparent or appear to be inconsistent with science and expert opinions on climate change.
- The company's disclosure on cybersecurity risk – and on steps to mitigate this risk – is particularly poor.

Investors should consider voting against the re-election of the Chair of the Audit Committee and reappointment of the Auditor if:

- The tenure of an external Auditor extends beyond ten years and there has not been a recent tender process and where no plans to put the audit service out to tender are disclosed.
- The Auditor has been in place for more than 20 years.
- The non-audit fees exceed 50% of the audit fees in consecutive years without an adequate explanation being provided.
- There are major concerns regarding the audit process and quality of accounts – particularly a failure to provide a true and fair view (or good visibility over the payment of dividends) and these are not resolved satisfactorily by the board.
- Cybersecurity risks (or any breach responses) are not being sufficiently well managed.

Investors should consider voting against authorisation of Auditors' remuneration (or the reappointment of the Auditor if these resolutions are bundled) if:

- The Auditor's Report fails to address a key issue or is otherwise unsatisfactory.
- Audit fees have been either increased or reduced by a significant proportion (e.g. more than 20%) in a given year without a clear justification.

Investors should consider voting against the re-election of the Chair if:

- There are extreme concerns or persistently poor disclosure in regards to the sufficient auditing of the company.

Investors should consider voting against the re-election of a Director (including re-election of the Chair) if:

- There is evidence of egregious conduct attributable to a particular Director around the development and deployment of AI.