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Financial Reporting Council
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Dear Sirs

Audit Firm Governance Code: a review of its implementation and operation

We are pleased to respond to the consultation questions posed in the recently issued report on the implementation and operation of the Audit Firm Governance Code. Our responses are set out in the attached Appendix, but we also have some other observations.

When the Code was initially issued, we did not believe that it was really necessary. We do recognise that at the time the Code was issued, questions were being asked of auditors following the banking crisis, and the FRC perhaps needed to be seen to do something to address this, at least with regard to the larger audit firms. However, we are extremely concerned by the suggestion that the scope of the Code should be extended more widely, for instance to any audit firm which undertakes the audit of Public Interest Entities (PIEs).

This would place an increased burden on mid tier and smaller firms which audit such entities and would be completely disproportionate; moreover it would increase the risk of such firms deciding to exit the listed company audit market entirely, further increasing market concentration. Against the requirements of the Audit Directive and Regulation, which will already significantly – and disproportionately – increase the burden on smaller auditors of PIEs, any wider imposition of the Code may well be the straw that breaks the camel's back. It is already clear that one of the intended benefits of the Code – that of enhancing choice – has failed, as there has been no discernible increase in competition outside the Big Four whatsoever since the Code was issued.

In our opinion, what may be appropriate for a Big Four firm which undertakes the audit of systemic financial institutions and has hundreds of partners may be totally inappropriate, burdensome and unnecessary for a mid tier firm which may audit a few PIEs and a number of other quoted companies none of which pose any significant systemic risk. If imposed, it is vital the Code retains sufficient flexibility to allow it to be applied by firms in ways which reflect not only their governance structure but also their size and the type of companies they audit.

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We hope our comments are useful to you. If you have any questions on the contents of this letter, then please contact either Sir Michael Snyder or Tessa Park.

Yours faithfully



Kingston Smith LLP

1. Do you agree that the purpose of the Code should be redefined as proposed in the Report?

Whilst much of the Code was based on sensible principles – for instance that firms should ensure they perform quality work and provide for good quality regulatory compliance – as noted above we did not believe that the Code was really necessary when it was issued, and were concerned about the additional regulatory burden that would be imposed on firms.

In particular, the requirement to appoint non-executives was of concern. The partnership model under which accountancy firms operate is completely different from the business model of a listed company, which is likely to be owned by a variety of different shareholders, including institutional investors, who are not directly involved in running the business.

The partnership model, in contrast, provides for long term investment by the partners, and it is entirely within the interest of the partners to ensure that the work performed is of good quality and that the firm complies with regulatory requirements. For a listed company, the appointment of non-executive directors is important to protect the interests of shareholders, but there usually are no external shareholders in an accountancy firm; the business is owned and operated entirely by its partners. The principal reason for appointing non-executives therefore does not apply.

The FRC has proposed that the purpose of the Code, going forward, should be primarily for the promotion of high quality statutory audit in the interests of shareholders and in accordance with law and regulation. We agree that this should be its purpose, as clearly high quality statutory audit is in the interests of stakeholders, whether the company subject to audit is listed or not. We do however note that stakeholders are not limited to institutional investors, and remain concerned that the FRC puts the views of investors ahead of those of other stakeholders.

We also agree that the purpose of the Code should encompass preventing an audit firm failure.

We do have some concerns with whether additional provisions in respect of the public interest should be included in the Code. In our opinion, the current reference to the protection of the public interest when setting out the role of the INEs is sufficient.

As the FRC itself notes, defining the public interest is fraught with difficulty. More importantly, however, an auditor has no obligation to the general public in performing their work. Performing good quality audit work and complying with applicable professional and ethical standards and regulation is undoubtedly in the public interest, but that does not mean that the auditor should have any additional responsibilities in the public interest, either within the Code or other regulation.

In addition, given the changes to regulation for auditors of PIEs as a result of the Audit Directive and Regulation, we do not believe that now is the time for changes to the Code in this respect. Rather, the FRC should wait until the impact of the Audit Directive and Regulation, both on firms and the FRC itself, is clearer.

2. Has the Code achieved its purpose?

We do recognise that the Code may have assisted firms in improving their governance procedures, subject to our above comments on the necessity of INEs. Similarly it may have assisted the reporting by firms, although in both cases (as the report itself notes) it is impossible to quantify how

much of any improvement is due to the Code rather than measures a firm may have taken for other reasons, e.g. following the banking crisis or as a result of AQR recommendations.

However, as a means of increasing competition the Code has undoubtedly failed, and the report itself admits this. There has been no discernible reduction in market concentration over the period the Code has been in operation; whilst, as a result of measures such as mandatory retendering, competition for audits within the Big Four appears to have increased, there is no evidence whatsoever that competition has increased more widely. This is despite the Competition and Markets Authority's enquiry into the larger listed audit market. As we have commented before, there may be many reasons for this, not least the misperception by certain (although we accept not all) institutional investors that 'only a Big Four firm will do'.

We note that the FRC does not comment on whether anything could be done to improve the Code in this respect. In our opinion, because of external factors such as the attitude of certain investors and the 'alumni effect' increasing competition by means of the Code would be extremely hard to achieve. We remain of the opinion that the only method to increase competition that would actually work would be to introduce shared audit, but that is outside the scope of this consultation.

3. To whom should Independent Non-Executives (INEs) owe a duty of care or be accountable?

We do not agree that the duty of care of the INEs as currently set out in the Code – i.e. to the firm – is incompatible with the public interest. As noted above, the partnership model is completely different from the business model for a listed company subject to the Corporate Governance Code and therefore requires a different type of governance.

We do not believe that formal accountability outside the firm is either necessary or desirable and have commented on this further below; in this context we also do not see why an audit firm, or its INEs, should have any additional obligation to explain publicly why their governance model has been chosen. The governance of a firm which is required to prepare an annual Transparency Report is available to the public in that report and therefore we do not agree that any further public explanation is required. Indeed the report itself notes that those firms that apply the Code include additional disclosures on their compliance with it in their Transparency Reports.

We note that the FRC is not convinced that transparency reporting is drawing wider attention to the firms' governance arrangements. Perhaps the solution to this is for firms, or the FRC, to draw the attention of stakeholders to the existence of the transparency reports, rather than impose any additional regulatory requirements which may result in the duplication of information that is already publicly available.

4. Should there be separate governance arrangements for audit?

We believe that firms place a great deal of focus on the governance of their practice as a whole and that there is therefore no specific need for a separate governance structure for their audit practices. Many firms will already have a structure for their audit practices in any event, for instance regional heads of audit reporting to a national head of audit, depending of course on the size of the firm. The responsibilities of these individuals will normally be clearly defined.

We do not believe that it should be necessary to 'ring fence' audit practices, regardless of the growth of the consultancy operations of a firm. We would agree that the responsibility of INEs is to the firm as a whole, and therefore needs to encompass good governance of the firm as a whole, not simply its audit practice. We entirely agree that a single ethical culture needs to be embedded

throughout a firm and that this would be more difficult were there to be separate governance arrangements for audit.

5. Should the Code include more detail and impose more requirements on tone at the top and professionalism more generally?

We agree that tone at the top and professional behaviour is important, indeed it is vital. However, we do not believe that any changes are required in this respect either to the Code or to the Ethical Standards for Auditors, except as otherwise required for instance as a result of the Audit Directive and Regulation.

We do not believe that there is any real evidence that firms do not take this seriously; their business, and the livelihood of their partners, depends on it. We therefore note with concern the comment that 'There is evidence from AQR inspections that firms can have a strong tone at the top and high quality processes but that these do not always translate to the work being done on every engagement or to the behaviour of individual partners and staff'.

It is difficult to see how the FRC, or the AQR, proposes to address this; the fact that an individual audit engagement might not always be conducted entirely satisfactorily is simply a fact of human nature and that human beings may 'have a bad day'. It is impossible for a firm to ensure that all its audits are conducted perfectly at all times by all partners and staff. If the firm's internal processes are effective, then poor quality work will be identified, for instance as a result of cold file reviews, and appropriate action taken to address deficiencies.

6. Do you agree that the concept of the Code should be spread elsewhere in the world? If so, how might this be achieved?

We believe that this would be difficult to achieve in practice and depending on the regulatory environment in a particular jurisdiction the Code may not be suitable. We also cannot see how it could be mandated in other jurisdictions. We believe that multi-national audit firms take their international governance very seriously and are entirely aware of the need to ensure audit quality, and compliance with relevant regulations, on a global basis.

7. How might the independence of Independent Non-Executives (INEs) be protected and demonstrated?

As we have commented elsewhere in this letter, the role of an INE of an audit firm is very different from that of a non-executive director of a listed company.

We do not believe there is any particular evidence that there is an issue with the independence of INEs and the report itself notes that firms and INEs took independence seriously. The Code would therefore not appear to need to be changed significantly in this area although we can see that additional clarity in some respects, for instance where there is a linkage between an INE and an audit client, would be useful.

8. Should firms follow a standard process in appointing INEs, including all such positions being publicly advertised? What engagement, if any, should investors in audited entities have into an audit firm's appointment of INEs?

We do not see any particular issue with INE positions being publicly advertised, but do not believe that there should be a standard process, simply because the governance processes in place at

firms subject to the Code differ. This will be even more pronounced if the scope of the Code is widened.

We do not believe institutional investors should have any input into the appointment of an INE of an investee's auditors as this is a matter for the governance of the firm. It is in any case difficult to see how this could be achieved in practice. The key attributes that a firm looks for in INEs could perhaps be included in the Transparency Report, which investors could then refer to. We are concerned that any input of institutional investors to the selection of INEs could be used to indirectly pressurise investees into selecting particular firms as auditors, not least given the ongoing misperceptions some have about mid tier firms.

9. Should the FRC or any other regulator have a role in the appointment of INEs, perhaps a right of veto?

No, we do not believe the FRC or any other regulator should have a role in the appointment of INEs. This is a matter for the firm. The FRC may draw any issues it perceives regarding INEs to the attention of the firm, for instance any issues identified at an AQR visit, but it is not appropriate for the FRC to be able to exercise a power of veto in advance. This is simply another example of the FRC seeking to take on more powers rather than acting as the oversight body it is meant to be.

10. Which if any of the aspects of the Corporate Governance Code referred to in the report should be incorporated into the Code? Are there any other aspects of the Corporate Governance Code which should also be considered?

We believe that it would be appropriate for at least one INE to have recent and relevant financial expertise as that will be helpful in understanding the business model of an audit firm. We can also see that it might be helpful from an independence perspective for INEs to be subject to term limits. However, we do not believe there is any need for the other suggestions to be incorporated into the Code and particularly do not believe there is any need for there to be a minimum number of INEs per firm. The number of INEs should be proportionate to the size of the firm which would not necessarily be the case were a minimum number to be imposed.

11. To who should the boards, INEs and public interest committees of firms be accountable? How should this accountability be discharged, including to the FRC?

The Code states at present that INEs have a duty of care to the firm and a responsibility to the public interest. We believe that there is no particular need to vary this. We do not believe INEs should be specifically accountable to the FRC or have any duty to 'whistleblow'. The ongoing dialogue that INEs have with the FRC, together with addressing any issues identified during AQR inspections, should suffice.

12. Should the Code include specific provisions on the firms' Boards and Public Interest bodies engaging with and disclosing certain matters to regulators?

Please see our answer to the above question.

13. Is greater transparency sufficient? What else can be done?

Increased transparency, i.e. additional disclosures in the Transparency Report, would be a better route than some of the suggestions made by the FRC (e.g. minimum number of INEs) although we do not believe that it should be necessary. In the event any additional governance disclosures (e.g. a viability statement) are to be included in the Transparency Report, this should be restricted to

those firms that are subject to the Code, rather than extended more widely, e.g. to all firms that are required to prepare a Transparency Report.

14. Should the Code be applied to a wider group of firms?

No, we do not believe that the Code should be applied to a wider group of firms. As noted in our introductory remarks, we believe that this would be disproportionately onerous for those firms which may audit only a very few listed entities, or even only one. As also noted, many such entities are relatively small, straightforward companies regardless of their listing, and pose little to no genuine systemic risk. Any wider application of the Code may well, as noted in our introductory remarks, lead to at least some smaller firms deciding to exit the market for the audit of listed companies entirely, further restricting choice and increasing market concentration.

Since the Code exists largely because of concerns about the public interest, its application should be restricted to those firms which audit significant numbers of listed entities where there is genuine risk in the event either of an audit failure or the failure of the audit firm. The report itself notes the need to ensure that regulation is applied in a proportionate manner and we would therefore urge the FRC to maintain the application of the Code only to those firms that audit 20 or more listed companies. If any other firm wishes to apply the Code voluntarily, they are of course free to do so, as Mazars have done.

15. Do you have any comments on the role of the FRC in this context?

We note that the proposal is that the FRC should now take on ownership of the Code, it having initially been published jointly by the FRC and ICAEW. We can see the reason for the FRC taking ownership of the Code in the context of its position as oversight body for the profession, but would urge the FRC to specifically consult with the professional bodies on proposed changes to the Code, including this consultation.

16. Do you have any further comments on any of the issues raised in this report?

We have no further comments to make.