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Dear Ms Currie

## Audit Firm Governance Code - a review of its implementation and operation

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) consultation on "Audit Firm Governance – a review of its implementation and operation."

### General observations

We continue to support a "comply or explain" Code firmly based on principles and believe that any changes to the Code should only be made if they would increase investors' understanding of the firms' governance and facilitate better communication between investors, other stakeholders and the audit firms.

As we discuss in our response to Question 1, when considering how and in which direction the Code might evolve, we believe that it is relevant to look back at its origins in the recommendations of the Market Participants Group in 2007.

What was subsequently developed and released as "The Audit Firm Governance Code" was identified as a principles-based measure that would, without the need for increased regulation, result in reduced risk of a firm leaving the market without good reason.

The Code also makes clear that the involvement of independent non-executives (INEs) was intended to address three potential threats to continued confidence in an audit firm at that time, namely: decision-making is private, external regulation does not cover all the activities of a firm that could place the reputation of a firm at risk and dialogue between firms and stakeholders was difficult.

Whilst subsequent experience has provided evidence that the presence of INEs within the governance structures of the major firms has not necessarily led to a consistently higher level of engagement between those firms and stakeholders, we do not believe there is evidence that the other original objectives of the Code have not been met. As a result, we are unconvinced that significant changes to the content and status of the Code are required, despite the passage of time since the current Code was first released.

In relation to engagement with stakeholders, we do not believe that further improvements will be achieved by changing the responsibilities and accountability of INEs. Instead, we encourage the FRC and others to consider existing best practice and explore additional

practical initiatives that would help to create wider dialogue between investors and the firms. In this context we make some suggestions in our more detailed response to Question 1.

If greater transparency in reporting by firms is considered necessary, for example around the process for appointing INEs and their terms of appointment, then we support it. However, the consultation paper does potentially suggest a considerable number of additional disclosures and we are concerned that additional disclosure and longer reports run the risk of reducing, rather than increasing, the level of stakeholder engagement.

**The role of INEs**

The appointment of INEs has indeed been of particular benefit. We firmly believe that they should remain accountable to the firm and do not think such accountability conflicts with their existing public interest responsibilities. In this respect, we do not see any merit in trying to define further the concept of public interest in the Code. It is a concept that has different meanings to different people and is influenced by events and the business environment of the time.

Whilst we agree that INEs need to be independent, we do not believe that the role of INEs to challenge management and consider the interests of other stakeholders is necessarily inconsistent with "promoting" the firm, nor does it mean they should be accountable to the FRC. Working with, as opposed to against, the firm's management is not inconsistent with independence and is important if the role of the INE is to be successful.

It is right that the FRC meets regularly with INEs and we would support exploring other ways in which such dialogue can be increased. However, any developments in this regard should stop short of making INEs directly accountable to the FRC. INEs can only function properly if there is a level of trust between them and the firm's executive. Any direct line of reporting to the regulator would harm this relationship.

**Governance of the Audit practice**

We do not believe that there should be separate governance arrangements for audit. At Grant Thornton there is one culture and one set of values throughout the entire firm. In addition, the audit practice often calls on specialist input from other areas of the firm to properly perform audits. Accordingly, we think that to carry out their responsibilities as effectively as possible, in particular their public interest role, INEs should have insight into the governance structure and business of the wider firm. In this way they can help protect the reputation of the firm, advise and challenge across the practice and, importantly, help to ensure that there is appropriate investment in audit by the firm.

We set out other comments and our responses to the specific questions raised in the attached Appendix A. If you have any questions on our response, or wish us to amplify our comments, please contact me or Andrew Vials (T: 020 7728 3199, E: andrew.vials@uk.gt.com).

Yours sincerely

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## Audit Firm Governance Code - a review of its implementation and operation

### Responses to specific questions

**1. Do you agree that the Code's purpose should be re-defined [in this way]?**

No. In short, we believe the Code is still valid in its current form and that its principles-based approach has advanced the quality of audit firm governance. We agree there is room for improvement in the consistency of its application and in the level of engagement between the firms and stakeholders.

When considering how and in which direction the Code could evolve, we believe that it is relevant to look back at its origins in the recommendations of the Market Participants Group in 2007.

What was subsequently developed and released as "The Audit Firm Governance Code" (the Code) was identified as a measure that would result in "reduced risk of a firm leaving the market without good reason". The following was presented in support of the recommendation:

> **Conclusions**
>
> Market participants generally agree that that firms should comply with a Combined Code-style best practice corporate governance guide or give a considered explanation, in order to reduce the risk of a firm leaving the market.
>
> Existing regulatory activities (registration and inspection) are focused on audit quality rather than the firms' governance. If through a suitable 'comply or explain' arrangement there can be increased transparency over the firms' corporate governance arrangements this should be less costly than increased regulation.
>
> The principles in the Combined Code are likely still to be relevant but would require modification to fit with the legal form and operating structures of audit firms.
>
> On this basis, having considered the consultation responses, the Group revised the provisional recommendation to refer to a Combined Code-style best practice corporate governance guide.
>
> **Recommendation 14**
>
> **Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.**

It seems clear to us that it was envisaged the fundamental principles underlying the Combined Code for Corporate Governance should form the basis of the Code for audit firms, but adaption would be necessary to reflect the context and structure of audit firms to make its provisions relevant. It also seems clear to us that a successfully implemented code would remove the need for "increased regulation". We believe that these principles still hold good.

Appendix 1 of the Code makes clear that the involvement of independent non-executives (INEs) was intended to address three potential threats to continued confidence in an audit firm at that time, namely: decision-making is private, external regulation does not cover all the activities of a firm that could place the reputation of a firm at risk and dialogue between firms and stakeholders was difficult.

Whilst subsequent experience has provided evidence that the presence of INEs within the governance structures of the major firms has not necessarily led to a consistently higher level of engagement with stakeholders, we do not believe there is evidence that the other original objectives of the Code have not been met. As a result, we are unconvinced that any significant changes to the content and status of the Code are required, despite the passage of time since the current Code was first released.

We do not believe there is any confusion as to the role of INEs, which was fully debated at the time of the development of the Code. They currently have clear accountability to the firm and that is rightly so. However, we do not think that such accountability acts to the detriment of the public interest. Just as is the case with non-executive directors in public companies, their role also encompasses the wider considerations of other stakeholders including, but not limited to, "the public". Accordingly, we do not agree that the Code needs to be explicitly re-focused so as to make the primary role of INEs "to promote the public interest" or to change the current accountability of INEs.

The concept of public interest is already embedded in the Code but the suggestion in the consultation paper is that it should be more clearly defined and given greater focus. We do not agree with this proposition. We acknowledge that, as a professional services firm carrying out statutory audits, we have a public interest responsibility. The ethical standards which govern the audit profession are guided by the need to serve the public interest. Furthermore, at Grant Thornton the recognition of this wider responsibility is specifically incorporated in the terms of reference of our Partnership Oversight Board (POB), the body responsible for standards of corporate governance within the firm and oversight of the executive leadership.

We do not believe that there is anything to be gained by trying to define "public interest". To date there has been no single authoritative definition. The concept will have different meanings to different people and any attempt to establish one definition is likely to give rise to unnecessary and unproductive discussion on the matter. Also, the public interest is not a constant as it is influenced by events and the business environment of the time.

In summary, therefore, we believe that generally the Code has served its purpose well and we think that changes to the Code should be made only if a clear case for so doing has been established. In this context, the FRC notes in its recent annual report that it tries to ensure that its codes and standards are based on principles that promote the exercise of good judgment, rather than on a set of rules. We very much agree with this approach and therefore continue to support a "comply or explain" Code firmly based on principles, rather than any checklist of requirements.

We agree that the level of interaction between INEs and investors is inconsistent across the firms and that there is room for improvement. We encourage the FRC, and others, to consider ways of establishing best practice, perhaps through one of its thematic reviews, and to explore additional practical initiatives that would help to create wider dialogue. One idea that might be worthy of consideration is an "AGM" between the firm's senior management, INEs and institutional shareholders in the firm's major clients at which, within appropriate parameters, the transparency report and governance issues generally might be discussed.

We very much doubt the wider dialogue that is sought will be achieved by changing the Code in the ways proposed in the consultation paper.

**2. Should there be separate governance arrangements for audit?**

No.

We do not believe that there should be separate governance arrangements for audit. Clearly each firm will have its own structure and processes to safeguard the quality of audit but that does not mean that a separate governance structure is appropriate. Such a proposition fails to acknowledge that a distinct ring-fence around audit would be difficult to achieve. For example, the audit function has to rely on specialist expertise from across the wider firm to properly perform audits and governance oversight across the broader spectrum of service areas is helpful in this regard.

More generally, we think it is wrong to "compartmentalise" a firm in the way discussed in the paper. At Grant Thornton there is no separate set of values or culture for the audit practice. The firm has one culture and shares one set of values. Accordingly, we believe that to carry out their responsibilities as effectively as possible, in particular their public interest role, INEs should have insight into the governance structure and business of the entire firm. In this way they can help protect the reputation of the firm, advise and challenge across the practice and importantly help to ensure that there is appropriate investment in audit by the firm.

INEs clearly need to be sufficiently informed to be able to fulfil their duties properly and the suggestion that one of the INEs has recent relevant financial experience certainly has merit. However, we are not convinced that the argument for such a change is overwhelming. From our own practical experience, INEs with a broader range of experience can bring invaluable independent challenges to the firms, unburdened by any influence from or previous exposure to existing structures, standards and processes within the profession.

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

No.

We believe that the Code's principles and provisions regarding tone at the top and professionalism are already fit for purpose. At Grant Thornton our approach to quality and ethics is consistent across the practice and our transparency report explains how the values and principles are cascaded throughout the firm. To operate with two cultures or two classes of excellence would be illogical and difficult to sustain; our governance structure helps ensure that this is not the case.

The paper notes 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 into the work being done on every engagement or to the behaviour of individual partners and staff". In this regard, every effort is made to avoid instances of poor quality work or behaviour and practices and safeguards continue to evolve and improve. However, on occasion there are lapses from the high standards set by firms but this does not in our view translate into a wider issue regarding the tone at the top. Whilst it might be appropriate for the FRC to highlight current best practice in reporting on this area, we are concerned that adding further specific requirements to the Code would have little impact and risk becoming boiler-plate.

**4. Do you agree that the concept of the Code should be spread further throughout the world?**

As we note above, the Code has achieved significant advances in audit firm governance. However, the adoption of the Code internationally remains a significant challenge and it would not seem practical to export it in any binding way. Different jurisdictions have a variety of regulatory structures and models for audit and a number of countries have

developed their own codes. Some models are based more on rules-based regulation than "comply or explain".

Of course, wherever possible, the FRC should take the opportunity to promote the Code through international bodies such as IFAC.

**5. How might independence of INEs be protected and demonstrated?**

We agree that INEs need to be independent and need to be seen as such. We believe that this is currently the case. Independence is firmly embedded in the current code.

The first of the two instances referred to in the consultation paper is unfortunate and if the FRC wishes to make a specific prohibition in this regard we would not object, although we believe that the existing principles in the code should be adequate to avoid such situations.

In paragraph 79 of the paper the FRC notes that "it is important that INEs are not seen to act as advocates for the firms rather than as guardians of public interest". We think that this is the wrong emphasis. Clearly, out and out advocacy at the expense of other responsibilities would not be appropriate but we do not believe that the role of INEs to challenge management and consider the interests of other stakeholders is necessarily inconsistent with promoting the firm. INEs will only be prepared to act in this way if they have done the appropriate level of due diligence and are satisfied that the organisation has appropriate values and high standards of corporate governance. Working with, as opposed to against, the firm's management is not inconsistent with independence and is important if the role of the INE is to be successful.

**6. Should the 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 firms appointment of INEs?**

No.

We do not think there should be a standard process for the appointment of INEs. The individual characteristics and circumstances of firms vary and no one model will be appropriate for all. We do think it is important that investors have a wider engagement with the overall process, for example by expressing their views as to the appropriate attributes of an INE. There should also be appropriate transparency around the process. However, INEs are ultimately accountable to the firm and, after appropriate consultation with institutional investors, the firm should be responsible for their appointment. The key therefore is greater dialogue between firms and investors to allay any concerns in this area. We encourage the FRC to explore ways in which this might be achieved.

**7. Should the FRC or any other regulator have a role in the appointment of INEs; perhaps a right to veto?**

No.

We do not think this is appropriate and are concerned by the implication in the paper that INEs are currently not good enough. In this context it is worth noting that for those firms which provide corporate finance or investment business services, the appointment of INEs requires FCA approval under the 'fit and proper' test. Accordingly, we do not think that

there is an issue here that needs to be fixed, but accept that wider dialogue between investors and the firms would increase transparency and understanding of the appointment process.

**8. Which [of these, if any, ]should be incorporated into the Code? Are there any other aspects of the Corporate Governance Code which should also be considered?**

The principal purpose of the Corporate Governance Code is to protect investors who put money into businesses. The same does not apply to audit firms. Accordingly, while some of the concepts in the corporate code are relevant to the audit firm code we are not in favour of just importing a "shopping list" of measures from the corporate code. Each should be considered on its merits. The risk of boilerplate language and increasingly lengthy reports also needs to be considered.

Of the items set out in the consultation document, the case for inclusion in the audit firm code can best be made for those relating to INEs and their involvement in a firm's committees. At Grant Thornton the INEs are involved in a variety of committees including the Risk and Audit Committee, the Remuneration Committee and the Profit Sharing sub-committee. In this respect, we think that the involvement of INEs in the oversight of remuneration is important, unless of course the profit sharing mechanism is formulaic with little discretion involved. The FRC might wish to explore best practice in this regard.

As regards an independent chairman, although the firm is not yet committed, there is currently a proposal to be put before the Members which would enable the appointment of a non-executive chair of our POB.

On other matters, in the current reporting environment we would support the inclusion of a "fair, balanced and understandable" statement in the Transparency Report. The case for a viability statement is perhaps less pressing given the absence of external investors in the firms and the fact that there is to date little experience of such reporting in the corporate world which might provide useful insights into the reporting process.

**9. To whom should the boards, INEs and Public Interest committees be accountable? How should this accountability be discharged, including to the FRC?**

We firmly believe that such committees should be accountable to the firms' owners. This is clearly stated in the existing Code. As we note above, we do not think that such accountability acts to the detriment of the public interest. In this respect, under the professionalism principle in the Code, firms are explicitly required to take public interest into consideration. At Grant Thornton, as is noted above, this is also specifically incorporated into the terms of reference of our POB.

It is right that the FRC meets regularly with INEs and we would support exploring other ways in which such dialogue can be increased. If further action in this area is deemed appropriate then the idea of tripartite meetings between the FRC, a firm's executive and the firm's INEs might be worthy of consideration. However, any developments in this regard should stop short of making INEs directly accountable to the FRC in any way There is no such parallel in the corporate world and INEs can only function properly if there is a level of trust between them and the executive of the firm. Any direct line of reporting to the regulator would undermine this relationship.

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

No.

Firms are required to disclose certain matters to the regulators by law and regulation and they should continue to be required to do so. However, we do not support the inclusion in the Code of specific provisions regarding engagement with, and disclosure of, specified matters to regulators. This runs the risk of the code becoming more in the nature of a regulatory tool, rather than a principles-based governance code.

We believe there is no need for an additional explicit whistle-blowing obligation to be imposed on INEs. If the INEs felt there was a significant issue then in the first instance they would exert pressure on management to resolve the matter to their satisfaction. Ultimately if the matter was not appropriately resolved, then it is highly likely that an INE, in properly fulfilling existing responsibilities under the Code, would in any case wish to bring the matter to the attention of the regulator or other appropriate body.

**11. Is greater transparency sufficient? What else can be done?**

We welcome any input from the FRC as to what additional material might usefully be incorporated in the Transparency Report, although it is important to be mindful of the need to avoid it becoming either too long or too much of a "sales pitch". Specifically at Grant Thornton, it is our intention to include a separate report from the INEs in our 2015 Transparency Report summarising their activities during the course of the year.

However, we are not convinced, given the apparent lack of effective engagement by investors with the Transparency Report at the moment, that increasing the amount of disclosure in that report is the answer. Investors need better understanding of the firms' governance framework and processes, not simply more extensive disclosures. It is likely that investors and others would gain more from better ways of communicating and engaging, rather than just additional disclosures. Better communication between stakeholders is likely to be much more effective in supporting better governance than requiring disclosures of success measures or key performance indicators. The FRC could play a useful role in establishing discussion groups between stakeholders, INEs and the firms and other channels of communication.

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

Not on a mandatory basis.

The Code should apply to all firms auditing public interest entities i.e. those audits that are defined by Audit Regulations as "major audits". We would not object to voluntary adoption of the Code by a wider group of firms but do not believe that this should be mandatory. If consideration is being given to this issue then it might well be worth considering whether it should apply to other professional services firms which also have a public interest role, for example actuarial firms.

**13. Do you have any comments on the role of the FRC [in this context]?**

We agree that, as the independent regulator, it is appropriate for Code to be 'owned' by the FRC. Input from other professional bodies is entirely appropriate and to be welcomed.

One of the overwhelming purposes of the Code is to increase public trust and confidence in audit firms. Although the FRC should own the Code, such trust and confidence can best be established through dialogue between all interested parties. There needs to be buy-in to the Code by all stakeholders including firms and investors. It would be unfortunate if the Code were to be become primarily a regulatory tool, rather than a Code for governance built by consensus, and any proposal to make changes to it should be viewed in this light.