BAKER TILLY

First Floor, Quay 2
139 Fountainbridge
Edinburgh
Scotland, EH3 9QG
United Kingdom

T: +44 (0)131 659 8300
F: +44 (0)131 659 8301

www.bakertilly.co.uk

For attention of Susan Currie
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

28 August 2015

Dear Ms Currie,

Joint Group A and APA firms' response to the FRC consultation paper: *Audit Firm Governance Code – a review of its implementation and operation.*

This response is joint between the Group A and the members of the Association of Practising Accountants (we have appended a list of all of the firms which have ascribed to the response[1]), namely the medium sized firms that are active in the mid-tier market, including SMEs[2].

Although the Audit Firm Governance Code is obligatory for only two of our number[3], we have chosen to make this response joint among all of our firms.

Our overall propositions are that:

- high-quality audit needs to be encouraged, not mandated, and care should be taken not to damage the economics of the product's delivery;
- the Code needs to serve proportionate objectives and avoid arbitrary gold-plating of obligations for which no empirical need is shown – better to try to bring the rest of the world up to the UK standard before fine-tuning current norms further;
- the public interest role of INEs is vague, ill-defined, arbitrary, and needs elucidation, and the FRC's suggestions for its expansion (and indeed for many of the possible changes to the Code) cannot be safely risk assessed and assessed for unintended consequences till a workable and comprehensible definition is arrived at;
- although, as a means of stimulating competition, innovation, and addressing market concentration (which carries with it, of course, a risk of exit from the market and a threat to statutory audit itself), the Code has not worked optimally, the original Market Participants Group concluded that addressing competition issues was an important objective for the Code and it should remain so; and
- our firms' clients are mainly in the SME sector. Our aim is to provide a high-quality service at a cost which they can bear. Changes to the Code need to be measured against the desirability of avoiding direct or indirect costs to our clients.

Answers to consultation questions:

---

[1] **Group A** - Baker Tilly, Crowe Clark Whitehill, Haines Watts, Kingston Smith, Mazars, Moore Stephens, Saffery Champness, and Smith & Williamson; **APA** – Armstrong Watson, BHP, Blick Rothenberg, Brebners, Buzzacott, Dixon Wilson, Duncan & Toplis, James Cowper Kreston, Kreston Reeves, Mercer & Hole, Price Bailey, Roffe Swayne, and Shipleys.

[2] In total, we have annual revenues of £1.1bn+, with 12,600 partners and staff in 230+ offices around the United Kingdom.

[3] Baker Tilly and (by voluntary assumption) Mazars. It should be noted that the INEs of both firms have contributed to the joint response.

Q1 Do you agree that the Code's purpose should be redefined in this way [that the public interest, for Code purposes, should be – to foster audit quality; preserve the reputation of the non-audit parts of the audit firm's business; and prevent the firm's failure]?

We agree that there is little clarity in the Code as to what it obliges firms and their INEs to do, and that that should be addressed. We do not think (as the consultation paper tends to imply), however, that the public interest obligations that firms have and those that their INEs have are different: those obligations are simply the two sides of the same coin; the firms' obligations are to achieve audit quality on a sustained basis and a firm's INEs' obligations are to have regard to the processes and procedures the firm uses to do it and to form a view as to their adequacy.

It should not be assumed that the partnership and corporate models are similar, or capable of being treated as if they are. The consultation paper infers that Non-executive directors and INEs are essentially the same thing and serve the same objectives. That is not correct.
There can be little doubt that there is a profound public interest in the maintenance of high-quality audit but there is nothing to suggest that the firms have failed to recognise that in the course of the four years the Code has been in effect: audit firms are heavily focused on audit quality, in terms of the emphasis they lay on the education of staff, and of the degree of resource they consistently apply, and they are mindful of their reputations. Their INEs are conscious of the emphasis that the boards of audit firms lay on both and their INEs already believe that the underlying purpose of the Code is the underpinning of audit quality.

We accept that work needs to be done on the meaning of the public interest but we do not think that this consultation process should be definitive: there is a great deal of discussion at stakeholder level on the topic, including during the process of implementing the recent EU Audit Directive and Regulation and in answer to the DBIS and FRC consultations on implementation, and the FRC should take cognisance of that work before revising the Code in this respect.

The meaning of public interest does not become any clearer through mere repetition of use and the Code, and indeed the revision consultation paper, is sprinkled with the term. When used objectively, its use should be confined to widely agreed and closely definable matters of collective responsibility. Collective responsibility features significantly in the FRC's own definition of PI:

"The various groups of society which constitute the public include investors, creditors, savers, insurance policy holders, pension scheme members, employees, consumers, suppliers, clients of professional accountancy and actuarial advice and taxpayers. Those groups benefit from a well-functioning and stable economy in which their individual and collective interests are respected. A well regulated system of corporate governance and reporting (supported by corporate governance, stewardship, accounting, auditing, actuarial and ethical codes, standards and guidance; the inspection and review of the application of those standards; the disciplining of any culpable failures and the oversight of the professional bodies) contributes to such a well-functioning and stable economy."

It is worth noting that audit is only one part of the public interest in matters of investment, so it follows that, when the consultation paper says that, *"Investors are clear that they want the Code and INEs to focus on audit quality, and to reinforce the importance of independence and professional scepticism"*, it should also be clear that investors' wishes in these regards are not unlimited in scope: the firms are already subject to exacting obligations, particularly in terms of ethical standards and there is little, if any, empirical evidence of a culture of unethical behaviour.

Investors need to distinguish between independence and professional *objectivity*. They are not the same thing and continual, confused, use of independence is unhelpful in establishing the proper scope of respective stakeholders' duties in the public interest: auditors bring a necessarily objective view to their work. To the extent that independence is not a flawed and limited concept so far as the delivery of statutory audit is concerned, it is preserved adequately by operation of the ethical standards already

and representations that it is not are not supported by evidence: independence obligations are not open-ended.

We need a broader debate about the meaning of public interest in the context of statutory audit than the current Code revision exercise is likely to produce. We would agree with the proposition, though, that "*the purpose of the Code should lie primarily in the promotion of high quality audit in the interests of shareholders and in accordance with law and regulation*" (para 16) but we do not think that shareholders' interests are unlimited and that the obligations of firms and their INEs are predicated solely on those interests: there must be rational limits to the firms' and INEs' obligations and that is where a broader debate should be focused. We therefore support the text of para 19[4].

We take issue with the terms of para 17, "*The public interest also arises in other types of regulated work undertaken by the firms, for example, insolvency, investment business, and non-audit work which is required by law or regulation to be conducted by the auditor. Those charged with governance should have effective oversight of those parts of the business*". This proposition tends to confuse different arguments: whereas the firm's obligation to act in the public interest is enshrined in statute in the practice of audit and insolvency and obliges the firm to act independently, there is no such obligation in investment business and certain other non-audit services, for good reason – practice in those areas often oblige the firm to act as the client's advocate whereas practice in audit and insolvency requires the firm not to act as an advocate.

We take issue with para 18 too, "*The Code should also promote good quality, soundly managed work outside of statutory regulation. This should be undertaken in such a way as to avoid undermining confidence in the firm and hence in its audit work*". It should be borne in mind that we are dealing with an *Audit Firm* Governance Code, and although INEs doubtless have regard to the governance of the non-audit parts of the business, the degree of their accountability in those areas should not be as extensive as it is to a firm's audit business

Still on this broad theme of the extent and meaning of the public interest, we note the suggestion in the consultation paper that it would be desirable for the international networks to which UK audit firms belong to subscribe to the Code. Our counter-proposition is that the way to internationalise Code-like obligations is through the offices of the International Forum of Independent Audit Regulators (IFIAR), not through the networks. It is not the responsibility of networks to predict what the public interest means in a global context, given that there is no currently viable and commonly accepted meaning even in the UK, and it would be close to impossible to enforce the meaning internationally in any event.

We note too (at paras 29 (has the Code achieved its purpose?), and 56), that it is suggested that some of the Code's objectives "*particularly around competition, may be beyond the scope of a governance code*". Para 58 then suggests that the public interest should be redefined in a way that allows any reference to addressing market concentration to elide. We would wholly oppose a redefinition of public interest that allowed such an important original objective to be abandoned and we wonder if the consultation paper has been brought to the specific attention of the Competition and Markets Authority. We cannot imagine that such an abandonment would be met with equanimity by the CMA, given its recent recommendations and how it sought to have the FRC reflect a competition imperative in its own terms of reference. It cannot, surely, be contended that in the measurable instance of addressing market concentration that the Code has been a success.

Q2 Should there be separate governance arrangements for audit? What might such arrangements look like?

The advent of the Code has seen the effective implementation of separate governance arrangements for audit already: INEs' principal focus has, not unnaturally given the Code is audit-focused, been the

[4] "*We may not therefore reach a final view through this consultation.*"

audit practice of the firm. That does not mean that the rest of firms' practices have not been subject to their own governance arrangements – indeed, these have been broadly similar to those to be found in relation to the audit practice.

We find it difficult to separate governance arrangements from firms' ethical ones: irrespective of whether we are talking about audit practice, insolvency practice, corporate finance, accountancy services, or any other service-lines, the tone-at-the-top is the same and it is driven by firms' appreciation of good ethical behaviour. Whereas it is true (and we pointed it out above in any event) that professional independence does not apply to non-statutorily reserved areas of practice as it does to statutory audit, that is not to say that there are no governance strictures around the framework of delivery of those services.

We therefore do not accept that those aspects of the Code require to be extended across the non-audit service-lines and nor we do not accept that INEs will wish to be regarded as the guardians of the reputation of firms: to do so places them in the wholly invidious position of having too broad a scope of duty and of having to be involved in management's affairs to the extent that the Code's principles obliging them to avoid involvement in management would be vitiated – this would be a logical nonsense.

We therefore advocate that the Code should continue to apply principally to firms' audit practice.

Q3 Should the Code include more detail and impose more requirements on tone at the top and professionalism more generally?

If any finessing of the ethical codes and standards is thought necessary, it can be left to the revision consultations which we understand we should expect later this year.

We think it is an empty exercise to prescribe in revisions to the Code what tone at the top means and to prescribe more specifically what firms have to do in order to demonstrate that it (a) has one, and (b) how it cascades it through the firm. That is not to say that these things should not be done but the case for the kind of 'statist' solution suggested by the consultation paper is simply not made out and represents a disproportionate application of regulator-strength.

The FRC's engagement with audit firms should have demonstrated by now that, whereas mistakes can happen through imperfect human performance (as they can in any field), they are virtually always a function of error, not a lack of integrity. This is important to bear in mind.

Q4 Do you agree that the concept of the Code should be spread elsewhere in the world? How might this be achieved?

This is an issue of only marginal concern to most of our firms but as we said in our response to Q1 above, we believe that any obligation to replicate the Code across other jurisdictions is a matter for IFIAR, not firms' international networks.

Debate in the US context would be a good starting point.

Q5 How might the independence of INEs be protected and demonstrated?

We noted the consultation paper's correlation (in para 75) of INEs with members of corporate advisory boards, adding that what distinguishes INEs from that role is their public interest role. We stress again that it is in no-one's interest for the scope of that role to remain undefined and indeterminate: that simply causes expectations to run amok and store up disputes for the future. What we need is an open debate on INEs' responsibilities beyond those they owe to the owners of the firms.

We already have independence-in-fact: we do not believe that, in the sense of relationships between the INE and entities audited by the firm to which he or she is appointed, there is thought to be any issue – such relationships are eschewed.

Insofar as independence between the INE and the audit firms, we believe that the models now adopted by the firms satisfy both letter and spirit of the Code and do not need further specification, though we would have no particular objection should it be drafted for further consultation.

We have real difficulty, however, with para 79 of the paper (INEs should not be seen as advocates of the firm, only as guardians of the public interest). INEs feel that, provided they are satisfied with the firm's actions in support of audit quality, they should not be precluded from explicitly saying so: indeed, giving that kind of qualitative assurance (or not) is precisely what one would expect them to say in Transparency Reports. Though it would not be advocacy, para 79 suggests the INE should not be allowed to make an observation of that kind. That cannot be right.

There is a danger that one tries to provide too much in a comply or explain Code when challenge (presumably by investors) about INEs' independence is better addressed through the three-dimensional contact and meaningfulness of contact and discourse that INEs have with stakeholders: trust is earned, not mandated.

Q6 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 firm's appointment of INEs.

Our belief is that the questions whether an audit firm should be obliged to advertise publicly all INE posts, and whether investors should take part in the selection process, ought to predicated on the degree to which the audit firm is engaged in the PIE sector: in other words, the process ought to be calibrated according to a criterion geared to the number of fully listed audit clients the firm serves.

Firms should not be required to follow a standardised process and there is no need for all such positions to be publicly advertised: audit firms (certainly our own) are not public bodies and should not be treated as such.

Similarly, we are not persuaded that there is a need for investors of audited entities to have any appointment-engagement in this regard - we do not imagine they would want it in any case.

Q7 Should the FRC or any other regulator have a role in the appointment of INEs; perhaps a right of veto?

The consultation paper makes no reference to the need or justification for this Question and any support for it would seem to us to amount to extraordinary and disproportionate involvement of a delegated authority in essentially private law relationships. If the FRC supports the suggestion, we would need to see the empirical evidence supporting need or specification of the arguments for and against, before being able to comment meaningfully.

We do not believe that any regulator should have a role in the appointment of INEs – the FRC is an oversight body and in our opinion it should not, so far as possible, be involved in the carrying out of any aspect of firms' operational work.

Q8 Which of [the options in para 82] should be incorporated into the Code? Are there any other aspects of the Corporate Governance Code which should also be considered?

- Our firms will not be willing to include in their transparency reports a viability statement providing an assessment of long term solvency and liquidity: such an obligation, certainly

insofar as the extent to which our firms are involved in PIE work, seems grossly disproportionate;

- For the same reason, we would not wish our INEs to be bound by any externally imposed terms of appointment – transparency is not an absolute and is a factor that needs to be balanced against the fact that measures need to be grossly disproportionate to the size and nature of our audit clientele;
- Similarly, we see no need for transparency around our firms' INEs' remuneration; a minimum number of INEs per firm; a requirement for at least one INE to have recent and relevant financial chairman (though the empirical evidence suggests that audit firms already do make provision for INE appointments of that kind); an independent chairman; greater consideration of diversity; or a formal role for INEs on remuneration, nomination, risk and/or audit committees.

Q9 To whom should the boards, INEs and public interest committees be accountable? How should this accountability be discharged, including to the FRC?

Accountability, and its extent, must turn on the debate about the nature and scope of the public interest. Until the latter is determined, questions of accountability will be abstruse and meaningless.

The Code is already acceptably explicit on matters such as INEs' rights to whistleblow and the concomitant obligation to publish the fact and we counsel against introducing obligations of accountability to the FRC.

Similarly, we do not see empirical need, certainly among our firms, to include in Transparency Reports against KPIs and against what INEs do in a given year of measurement to discharge their public interest responsibilities. Much of the consultation paper is vacuous in these respects, in that, as long as the scope and content of the public interest remain indeterminate, it is impossible to match obligations against it.

Moreover, we counsel against any obligation on the part of firms to have to include in their Transparency Reports confirmation that the Report is 'fair, balanced and reasonable': this is an importation from governance reporting by listed companies and although we believe that Transparency Reports should always be objective in their terms, it would be a disproportionate encroachment of corporate reporting into the operation of private partnerships for this suggestion to be carried through.

Q10 Should the Code include specific provisions on the firms' Boards and Public Interest bodies engaging with and disclosing certain matters to regulators?

As we said above, our firms would be opposed to any suggestion that those which have INEs should have an obligation to report matters (which are not described in the consultation paper anyway) to third parties (presumably, principally the FRC). This would necessarily bring about a formal relationship between the FRC and the INE which we do not think is either necessary or desirable.

Q11 Is greater transparency sufficient? What else can be done?

Any temptation to prescribe further content around the Transparency Report should be resisted as an unwarranted and unnecessary gold-plating of the Code.

Q12 Should the Code be applied to a wider group of firms?

We see neither need nor justification for such a move: when the original Murray working party concluded that only firms with a substantial listed sector audit practice should be brought within the ambit of the Code, that conclusion was manifestly correct and we see no reason for coming to a different conclusion now.

Audit firms with only a few public interest clients might feel compelled, should the Code be extended to them, to exit the listed company market, something which would be inimical to competition and choice.

Q13 Do you have any comments on the role of the FRC [in relation to whether it should 'own' the Code or own it jointly with ICAEW]?

Our firms would continue to support *joint* ownership: the regulatory framework comprises not only the FRC but the RSBs, to which obligations following the implementation of the EU Audit Regulation and Directive are likely to be assigned by the FRC in its (again, likely) role as 'Single Competent Authority'. We think that it is desirable that the Code's parentage should continue to reflect that duality.

Q14 Do you have any further comments on any of the issues raised in this report?

Our firms represent clients drawn from every part of the SME sector. Our duty to those clients is to provide a high-quality service at a cost which they can bear. Any change in the Code's strictures (certainly of the kinds we have commented on above) will have a concomitant cost that would inevitably have to be referred to those clients. We would counsel against the additional financial burdens that might accrue to those companies, as being counter-intuitive to the Growth initiative.

We shall be happy to comment further, or be enjoined in further consultation, in your option.

Yours sincerely,

T M McMorrow

T M McMorrow
Secretary, on behalf of
the Group A and APA firms.