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Ms S Currie
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Dear Ms Currie

Audit Firm Governance Code – A review of its implementation and operation

Legal & General Investment Management (LGIM) is one of Europe's largest fund management companies and a major global investor. LGIM manages £715 billion in assets for over 3,000 clients¹. We offer investment expertise across a range of capabilities from index-tracking, active fixed income, multi-asset solutions, liquidity management and commercial property to LDI and broader risk-management solutions.

As a long term investor and primary user of companies' accounts, we support the FRC's mandate to review the Audit Firm Governance Code in order to protect the integrity of the quality of audits conducted by audit firms and to clarify areas of definition such as the public interest. This will strengthen the Code's purpose and provide improved guidance for all stakeholders.

Our submission to the questions in the information request follows this letter. We are available to discuss any of the issues highlighted in this submission.

Yours sincerely

Sacha Sadan
Director of Corporate Governance

¹ As at 30 June 2015. Includes notional derivative positions.
Authorised and regulated by the Financial Conduct Authority

**RESPONSE TO FRC CONSULTATION ON AUDIT FIRM GOVERNANCE CODE –
A review of its implementation and operation August 2015**

Purpose

1) Do you agree that the Code' s purpose should be redefined in this way?

LGIM supports the Audit Firm Governance Code's stated purpose as "working for the benefit of shareholders in listed companies" and the FRC's proposal that this should primarily be through the promotion of high quality statutory audits and the increased emphasis on the public interest.

In addition, we also agree that the "public interest" needs to be clarified so that Independent Non-Executives (INEs) can understand the full remit of their role. Therefore, it would be helpful if the FRC could provide guidance to assist the audit firms in determining what is expected of the INEs.

As an investor, we agree with the FRC's emphasis that of "greatest importance" is audit quality. This should be a major focus of the Audit Firm Governance Code. We note that all audit firms provide significant non-audit services that, unlike audit, are often subject to little regulation. These non-audit services can potentially affect auditor independence in that the significant revenues and the nature of the services may lead the firms, whether intentionally or not, to identify themselves more closely with the interests of management rather than those of investors. It follows that we believe the Audit Firm Governance Code should focus on the oversight of a firm as a whole including its non-audit services to the extent that these other services could impact on audit quality.

The prevention on an audit firm failure is a legitimate area of concern to stakeholders and to regulators in particular and an obvious issue of public interest. Furthermore, the additional concentration of the statutory audit market is undesirable in our view which is why mandatory retendering is an important factor in protecting the integrity of the market.

We would expect audit firms to have contingency plans or so-called "living will" arrangements in place which would certainly be in the public interest, not to mention the partners and owners of firms themselves. We would expect the FRC as the regulator to look at this as part of the AQRT inspection regime and other enforcement activities. However, we also see some merit in making this an explicit part of the role of INEs.

Safeguarding audit quality

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

We do not believe that there should be separate governance arrangements for audit because this adds complexity and weakens governance. Furthermore, this makes oversight by the INEs more difficult as their role will be limited to audit only and are less attuned to matters arising outside that potentially could impact audit quality.

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

We support the Audit Governance Code's principles and provisions which addresses the tone at the top and professionalism issues. However, we believe audit firms need to be more transparent and include better disclosure to demonstrate how it works in practice.

We also believe that it is important for the INEs to meet without the Executive so that they can discuss freely and in confidence their own assessment of the tone at the top and the professionalism of the audit firm. Although this point is in provision C.1.1, we would welcome better disclosure on the process and outcomes of the discussions.

International context

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

Given that we invest internationally, we would like to see the Audit Governance Code being applied worldwide to gain assurance that audit being conducted is consistent and of a high quality. Therefore, restricting the Code solely to the UK will limit its effectiveness and if firms are given discretion to determine the level at which the Audit Governance Code is applied, there will be a lack of comparability which will diminish its value.

We support both EY and Mazars for incorporating aspects of the Audit Governance Code into their international structures and hope other firms follow their lead.

Nevertheless, we understand that the adoption of the Audit Governance Code internationally remains a significant challenge for a variety of reasons. For example, the Code operates on a 'comply or explain' approach which is principle-based and appropriate in the UK whereas in the US, there is a stronger rules-based framework applicable to these types of issues.

Therefore, we would suggest that the FRC works with the IFIAR to develop a Global Audit Firm Governance Code. Furthermore, in the context of the UK, the Code should require the firms and their INEs to explain how they engage with the firm's international networks and its constituent firms.

Role of the Independent Non-Executives (INEs)

5) How might the independence of INEs be protected and demonstrated?

LGIM supports the appointment of INEs to provide fresh insight and challenge to the operation of audit firms. This adds integrity to the process and we share the FRC's view as expressed in paragraph 79 of the consultation document, that it is important that INEs are not seen to act as advocates for the firms rather than as guardians of the public interest.

However, this is only effective if INEs are empowered and exercise the informed influence to improve audit firm governance and transparency.

Additionally, there are a few issues which we would like to raise with the Audit Firm Governance Code.

Firstly, an audit firm appointing a serving partner as an INE and a firm tendering for the audit of a listed company of which one of its INEs is a NED are causes for concern. We believe that an independent non-executive should not be a recent former partner of the firm and similarly should not be a serving director on the board of a major audit client. This creates a conflict and should be avoided.

Secondly, we also have reservations about Principle C.2 which states that INEs duty of care is to the firm and in Principle C.3 that "they have a right to report a fundamental disagreement regarding the firm to its owners." This is because we consider that the INEs' duty of care should be to the public rather than the firm. We also consider that a right to report a fundamental disagreement to the firm's owners (or partners) is insufficient. INEs should have the power to go beyond this and such remedies should involve escalation to the regulator and not just to the firm's owners, particularly if there is an impact on audit quality.

Lastly, we also note at some listed companies, the independent Non-Executive Directors have the right to obtain independent professional advice at the company's expense. This is a reserve power that would only be used in exceptional circumstances but reinforces independence and empowers the NEDs. Therefore, it is worth considering introducing something similar to the Audit Governance Code in line with best practice.

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 firm' s appointment of INEs?

We are not in favour of a prescriptive standard process in appointing INEs. However, it is important that investors have confidence in the appointment process.

Whilst provision C.1.2 requires firms to disclose on their website information about the appointment, retirement and resignation of INEs, we believe that these disclosures need to be improved. One approach could be to have a nominations committee which could disclose the criteria used to ensure the INEs are independent. This gives investors a better insight on the dynamics of the board and the individuals appointed.

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

We do not believe the FRC should have a right of veto over the appointment of INEs. Although there is an apparent parallel with the FCA in respect of financial services companies, we think it is more important that investors have confidence in the process by which INEs are appointed. However, if the authorities impose this then we would propose a lighter touch regime than that of the financial services regulators.

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?

All the points raised should be included in the Audit Governance Code. However, we believe that the UK Corporate Governance Code and the Audit Governance Code can be brought closer together with a rebuttable presumption that significant developments in the UK Corporate Governance Code should be carried over *mutatis mutandis* to the Audit Firm Governance Code.

For example, as opposed to one of the INEs having recent and relevant financial experience (as highlighted in the UK Corporate Governance Code), it should be recent and relevant *audit* experience which would be more beneficial to the Committee as they are able to understand the operation of an audit practice, its risks and the professional standards expected of auditors.

In addition, the viability statement in the transparency report on the firm's long-term liquidity and solvency should be made jointly by management and the INEs and not just the INEs on their own.

We also consider that there are other aspects of the partnership structure that may weaken the implementation of the Code, for example, there are no safeguards to ensure the independence of the chair; clawback arrangements for remuneration (see question 14) and provisions whereby the INEs should stand down where there are conflicts. Any revisions to the Audit Governance Code should consider these aspects.

Accountability

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

Audit firms are not listed, nor do they have outside shareholders with whom they engage and who can vote against company management if they are unable to resolve their issues through dialogue.

Therefore, in terms of accountability, it is important that an external monitoring framework is put in place to ensure the Audit Governance Code is implemented and that disclosures/explanations under the "comply or explain" approach are meaningful and not boilerplate language. One process which will help discharge accountability is setting up an institutional monitoring group with some investor representation to ensure that the Audit Governance Code is applied effectively and achieves its purpose.

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

We believe that some type of dialogue may be helpful and to the mutual benefit of all parties. In addition, we see some merit in adding a requirement to the Audit Governance Code for audit firms to submit a report to the regulator. The existing transparency reports provide a limited insight into how audits are performed and do not really report as to whether audits are effective. Similar to companies reporting in Audit Committee reports and the auditor providing its perspective in the audit report, transparency reports could report on the firm's assessment of audit quality which could then be reviewed in the context of the AQRT report.

11) Is greater transparency sufficient? What else can be done?

The consultation notes that although the INEs are influential, they are "not capable of pushing through decisions". Therefore, it is important that there is transparency to their role and effectiveness so that they can be challenged and carry more weight in the decision making process.

The audit firms should seek to set Key Performance Indicators (KPIs) to measure the success of the INEs. Also currently, boards, public interest committees and INEDs are not required by the Code to have an independent evaluation although some firms have done this voluntarily. We feel there may be merit in a requirement for a periodic externally facilitated evaluation, like external board evaluations.

Lastly, making the Audit Governance Code more effective is not only about greater transparency and more extensive disclosure. We believe that the market would also gain from better communication and engagement. As highlighted in our response to question 9, setting up a stakeholder monitoring group on a permanent basis with some investor representation would be useful and would facilitate better communication to the market. This is likely to be much more effective in supporting better governance than requiring disclosure of success measures or KPIs although the data can be helpful in facilitating dialogue.

Other issues

12) Should the code be applied to a wider group of firms?

In principle, we consider that any audit firm which audits listed public interest entities should have to comply with the provisions of the Audit Governance Code, or give a considered explanation as to why it doesn't. Furthermore, as a firm with investments in a wide range of assets, we also see the case in principle for an extension to a wider group of audit firms that do not audit listed companies. In some of these audit firms that are not subject to the Audit

Firm Governance Code, they have also appointed INEs which is certainly welcome and to be encouraged.

On cost benefit grounds, it may be appropriate to introduce a threshold within that definition so that only firms that audit entities of a certain size or firms that audits a certain number of public interest entities fall within its scope. However, we are concerned that only applying it, say, to firms that audit more than 20 listed companies or other public interest entities could result in an unintended "cliff edge" for firms that find themselves just below the threshold and impact the market. Hence we would not support such a rigid threshold.

13) Do you have any comments on the role of the FRC in this context?

We agree that the Code should be owned by the FRC.

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

We believe that the UK Corporate Governance Code and the Audit Governance Code can be brought closer together with a rebuttable presumption that significant developments in the UK Corporate Governance Code should be carried over mutatis mutandis to the Audit Firm Governance Code.

Although the underlying frameworks are different, there are some areas of the UK Corporate Governance Code which can be applied to the Audit Governance Code. For example, the Audit Governance Code does not discuss remuneration. However, incentive structures are important for an assessment of the behaviours that operate within the audit firm and therefore affect audit quality and scope.