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Private and Confidential

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BY EMAIL
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Our ref: 013461/DI/Letter

Dear Sirs

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

We are pleased to have the opportunity to comment on the above document issued by the Financial Reporting Council.

Whilst we believe that the main objective, purpose, and principles-based approach of the current Code remains largely valid, we welcome the FRCs work on assessing the effectiveness of its application and whether it remains relevant in its current form.

Although many of the hot topics facing the profession are similar to those present when the Code was first launched in 2010, there has been some change in focus, particularly, as the document points out, on the subject of Public Interest. We do not believe however, that the Code needs a fundamental rewrite to be fit-for-the-future. The principles-based approach allows firms to apply best practice in a way that suits their own particular organisation and we would urge the FRC to resist any temptation to reduce this flexibility or introduce a raft of more prescriptive recommendations; to do so would effectively treat all firms as if they were the same and ultimately reduce the Code's effectiveness.

We append responses to your detailed questions which where appropriate, have been developed in discussion with, and taking into account the experience of, our independent non-executives.

Should you wish to discuss any aspect of audit firm governance, please contact Simon Michaels, our Managing Partner.

Yours faithfully

BDO LLP

Responses to specific questions**Do you agree that the Code's purpose should be redefined in this way?**

We broadly agree with the FRC's comments in paragraphs 15 and 16 which state that '*...its principal purpose [is] working for the benefit of shareholders in listed companies*' and that '*...[the] purpose of the Code should lie in the promotion of high quality statutory audit in the interest of shareholders and in accordance with law and regulation...*'. In this context, the proposals in paragraph 58, namely:

- Importance of audit quality
- The broader reputation of the firms, including oversight of their non-audit services, and
- Prevention of firm failure

are all sensible derivations of the original purpose. However, the proposal to tie these 3 elements to the 'public interest in paragraph 58 seems unnecessary and might actually restrict future thinking. The concept of the public interest in the context of audit and accountancy practices is intertwined with adherence to all of the relevant professional standards, including those relating to ethical principles.

In a similar vein, the comment in paragraph 67 that '*...ethical principles are paramount and the public interest supersedes all commercial interests of the firm...*' may, in our view, cause similar problems: ethical standards recognise commercial considerations and threats throughout, and incorporate appropriate rules and safeguards to address them. Indeed, an effective ethical code cannot exist without incorporating these commercial threats and attempting to separate them and assert that one should 'supersede' another risks undermining the clarity and authority of the fundamental principles of the Code.

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

The FRC is right to recognise the changing composition of some firms, and in particular the increasing financial importance of consulting practices. We agree with the FRC that a continuing focus by the individual firm's governance structures on audit is critical. We are, however, also of the view that this must be balanced against the fact that threats to the firm's reputation can certainly arise from issues outside the ambit of audit of UK listed entities and indeed from outside the UK.

The current Code's principle C.1 recognises this and states that INEs should '*enhance shareholder confidence in... management of reputational risks including those in the firm's businesses that are not otherwise effectively addressed by regulation*'. In our view this principles-based approach is appropriate and allows firms, including their INEs, to construct the most appropriate governance arrangements reflecting the structure and operations of any one particular firm.

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' is a fundamental and critical aspect of any governance arrangement that is likely to protect audit quality effectively. However, we believe that the current Code and related professional codes and standards, already embrace the concept effectively.

Tone at the top is a high level behavioural concept and including additional detail as to how this should be applied will, in our view, do little to enhance this objective and indeed, at its extreme, risks reducing it to a tick-box process. However, there is probably value in firms better demonstrating how they, as individual firms, have undertaken measures to ensure that the benefits of a strong ‘tone at the top’ ethos have translated to actions at relevant engagement levels. Doing so orally, or in writing, could serve to increase stakeholder confidence in this area.

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

There is little doubt that elements of the Code could be beneficially applied elsewhere in the world. However, differing operating models (both of listed corporates and audit firms), differing cultures, and differing stakeholder needs and concerns, makes this far from straightforward. We believe that whilst there is certainly a benefit in the FRC promoting the Code and showcasing its success in the UK, the best value would result from the FRC continuing to focus on UK regulation, and not going extraterritorial. In our view a Global Audit Firm Governance Code cannot be considered alone, and needs to be considered in the same context as global audit regulation and standards setting.

The role of INEs

- **How might the independence of INEs be protected and demonstrated?**
- **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?**
- **Should the FRC or any other regulator have a role in the appointment of INEs; perhaps a right or veto?**

We agree that INEs being, and being seen to be, independent is of the utmost importance. The fact that the FRC found that both firms and INEs took independence seriously, and that the two potential issues you raise in paragraph 77 were both satisfactorily resolved, supports the view that in practice this element of the role of INEs is both fully understood, and working well. As such, we question the need for any major overhaul, or further direction, with regards to independence.

It is important that investors have confidence in the process of appointing INEs. However, in our view a prescriptive approach is not necessary, and would further complicate and unnecessarily delay the search for, and appointment of, suitable candidates. The skills required and the necessary appetite to take the responsibilities of the INE seems to us to suggest that the use of professional search is the most effective approach, and that to include more parties in the screening, would both risk deterring good candidates, and make the process unduly cumbersome for the firm.

We believe that the decisions regarding appointment of INEs is a matter for the individual firms and we don’t believe that there is a need for investors of audited entities to be involved in the selection process. Nevertheless, a healthy dialogue between the firms and investors is an important element of the Code, and should there be a particular issue with regards to the appointment of an INE, this should be raised as part of on-going dialogue. Similarly with regards to FRC involvement, our view is that such matters could effectively be raised during regular and on-going dialogue, without the need for any specific or formal regulatory intervention.

The accounting and auditing profession and the firms that comprise it are complex. There may be scope for the Code to recognise more sharply the challenges that this brings to the role of an INE, and the importance for the combined skillsets of any one firm's INEs not only to include valuable experience from outside the profession, but importantly to include adequate familiarity with the way in which the accounting profession operates and its major challenges. We, and our INEs, have suggested before that at least one of the INEs in any firm should have "recent financial experience".

Which of these (See below), if any, should be incorporated into the Code? Are there any other aspects of the Corporate Governance Code which should also be considered?

- **The inclusion in firms' transparency reports of a viability statement providing an assessment of long term solvency and liquidity**
- **Term limits on INEs' appointment**
- **Transparency around the remuneration of INEs**
- **A minimum number of INEs per firm**
- **A requirement for at least one INE to have recent and relevant financial experience**
- **An independent Chairman**
- **Greater consideration of diversity**
- **A formal role for INEs on remuneration, nomination, risk and/or audit committees**

An argument might be made for the Code to evolve in a similar manner to that of the Corporate Governance Code and, if one took that view, there is no reason why each of the above suggestions could not be implemented (and indeed we believe as noted in our answer above, that the relevant financial experience of at least one INE is important). That said, we do express caution in an assumption, or even the appearance of an assumption, that the Code and the role of INEs is synonymous with the Corporate Code and the role of NEDs. We do not believe this to be right or operable, and indeed in the consultation document the FRC recognises this to be the case.

In practice we believe that most of the above suggestions are being appropriately addressed within firms and that with the continuing focus on transparency, this will be apparent.

The suggestion regarding viability is perhaps most interesting. Clearly the subject is of absolute focus within the firms, but public disclosure does have practical issues not least due to the relationship between the UK firm and the wider international network of firms to which it belongs; these complexities could unintentionally be seen to obfuscate the matter rather than add clarity. We also question its relevance in the context of the risks of audit firm failure where we believe that audit quality, risk management processes and professional indemnity insurance are the most important considerations.

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

We believe that the position of the current Code which recognises that INEs are accountable to the firm's owners, combined with the other aspects of the Code relating to professionalism, public interest and stakeholder dialogue, is appropriate.

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

INEs and firms already have the option to discuss matters with regulators and indeed we believe that there already exists a productive dialogue to enable this to take place. We would therefore stop short of introducing formal ‘whistleblowing’ or ‘mandatory dialogue’ type requirements, on the basis that it is unnecessary.

Is greater transparency sufficient? What else can be done?

Transparency is important, but only to the extent that it provides valuable information to the relevant stakeholders. Since the introduction of Transparency Statements, we have seen these evolve from pure regulatory compliance documents to ones which are now substantive documents in their own right providing rich and open information on the operations of the firms and the roles of their INEs. This evolution has been driven by the stakeholders, rather than regulatory requirement and we have confidence in continuing development along these lines.

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

The current extent of adoption feels right, although we would expect additional firms to adopt the Code as the benefits become clear to them.

Do you have any comments on the role of the FRC in this context? (ownership of the Code)

We believe it is appropriate for the FRC to ‘own’ the Code