

**BY EMAIL: [s.currie@frc.org.uk](mailto:s.currie@frc.org.uk)**

Ms S Currie  
Financial Reporting Council  
8<sup>th</sup> Floor  
125 London Wall  
London  
EC2Y 5AS

Date: 17 August 2015

Tel: 020 7220 5000 Ext 5019

Dear Ms S Currie

## **AUDIT FIRM GOVERNANCE CODE – A REVIEW OF ITS IMPLEMENTATION AND OPERATION**

I am writing to comment on the above consultation on behalf of RPMI Railpen, the investment monitoring arm of the Railways Pension Trustee Company Limited, the corporate trustee of the UK railway pension funds with approximately £21 billion of assets under management and 350,000 beneficiaries, from the perspective of a long term pension fund asset owner.

We are long standing supporters of better corporate governance and consider external audit to be one of the pillars of good governance. We have an obvious interest in the requirements governing the audit and the auditor's report as users of companies' accounts. It follows that we wish to see robust external audit from the perspective of a major pension fund investor and we believe that the governance of audit firms has ramifications in terms of audit quality, effectiveness and reporting.

We welcomed the introduction of the Audit Firm Governance Code back in 2010 and replied in detail to the ICAEW's prior consultation on 6 October 2009 and I attach a copy of our response for reference as some of our suggestions and emphases remain relevant. For example, we suggested six years ago, and continue to suggest today, that some sort of monitoring body should be set up, possibly under the auspices of the FRC, to overcome the absence of a mechanism to report beyond the firm.

It follows that we now welcome the FRC's current review, which is very appropriate at this stage five years since the Code's launch, and we agree with the FRC that the Code itself should more sharply define the public interest, particularly by explicitly recognising the importance of audit quality. There was a perception on the part of many investors prior to the Code that the internal governance of audit firms concentrated on revenue optimisation from audit and non-audit services rather than on audit quality and transparency. This was exacerbated by the limited contact between investor and auditors of listed companies.

Nevertheless we believe that the introduction of the Code has been helpful both in terms of the wider public interest and the narrower benefit to the investment community. The major structural change in relation to Section C of the Code through the introduction of independent non-executives (INEs) at all firms to which the Code applies has certainly been helpful but more needs to be done in terms of clarifying the role and accountability of INEs and defining

the public interest more specifically. With this in mind, we strongly support the stated primary purpose of the Code to work for the benefit of shareholders, and agree with 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.

We also welcome the increased contact between investors and the audit firms which was close to non-existent prior to 2010. We at RPMI Railpen have attended stakeholder meeting of most, if not all, of the major firms and have had private meetings with INEs which we have found helpful. However, we would agree that such meetings are not attended by a wide range of investors beyond what might be termed the usual suspects with an interest in audit and accounting matters but in our experience audit firms and their INEs are making a genuine attempt to reach out to stakeholders like us. The real question is whether this is sufficient and whether more needs to be done to reach out to investors.

We acknowledge that this is a major challenge for audit firms and regulators. It may be helpful to draw a parallel with engagement between audit committee chairmen and investors which until recent years was extremely rare and in marked contrast with the well established channels of communication between remuneration committee chairmen and investors. This is gradually changing as a wider range of investors appreciate the need for improved contact. We would expect a similar trend in relation to investor engagement with audit firms particularly with developments such as mandatory re-tendering and enhanced auditor reporting that should give rise to substantive issues for discussion.

We believe that in reviewing the implementation and operation of the Code, the FRC, professional bodies, audit firms, companies, investors and other stakeholders need to understand that retaining and increasing public trust in audit will be a challenging task that will need continuous efforts on the part of stakeholders to sustain and nurture. With this in mind, we feel that it would be helpful to bring the Code closer to the UK Corporate Governance Code 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.

We set out our detailed response to your questions in the attached appendix. I hope that our comments in the appendix and this covering letter are helpful. Please contact me if they need clarification or you feel that we can otherwise be of assistance.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Frank Curtiss".

**Frank Curtiss**  
**Head of Corporate Governance**  
**RPMI Railpen**

ENCS

**Responses to Questions in FRC Consultation on Audit Firm Governance Code – A Review of its Implementation and Operation**

**Response to ICAEW on Audit Firm Governance Code 2nd Consultation dated 5 October 2009**

# RESPONSE TO AUDIT FIRM GOVERNANCE CODE – A REVIEW OF ITS IMPLEMENTATION AND OPERATION

## Responses to Questions

### Purpose

*“Based on our own observations and the feedback we have received we believe that the public interest in this context rests in:*

- *Firstly, and of greatest importance, audit quality.*
- *Secondly, the firm’s reputation more broadly; this involves oversight of the firm’s non-audit businesses. These now make up 70 - 80% of the major firms’ revenues. Some of these businesses are subject to statutory regulation but the majority are not.*
- *Finally, prevention of a firm failure.*

*In our view the purpose of the Code should be restated to in order to reflect this.”*

<p>1. Do you agree that the Code’s purpose should be redefined in this way?</p>
---

RPMI Railpen supports the stated primary purpose of the Code to provide a formal benchmark of good governance practice against which firms which audit listed companies can report for the benefit of shareholders, and we agree with 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. The importance of the public interest is acknowledged in Principle B.1 of the Code but is not really defined.

It is important to provide clarification on this so that the INEs can understand the full remit of their role. In this respect, it would be helpful if the FRC could provide guidance to assist the audit firms in determining what is expected of the INEs. For the Code to be fully effective, it is vital that firms and INEs are encouraged to think about the public interest in broad and dynamic terms rather than in a narrow and static way which could soon become out of date.

As an investor, we agree with the FRC’s emphasis on audit quality which in our view should be a major focus of the Code. We note that all 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 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.

Although the collapse of a major firm would create a serious problem, it would be unlikely to be at the same level of systemic risk posed by the failure of major banks. Nevertheless the prevention of firm failure is a legitimate area of concern to stakeholders and to regulators in particular and an obvious issue of public interest. The resulting additional concentration of the statutory audit market would be undesirable in our view. The introduction of mandatory retendering is an additional factor that could impact on firm survival or failure.

We would expect 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 expect that the FRC as the regulator would look at this as part of its AQRT inspection regime and other enforcement activities. However, we see some merit in making this an explicit part of the role of INEs.

### **Safeguarding audit quality**

*“It was noted that the direction of travel elsewhere, e.g in banking, has been to work to embed a single ethical culture throughout the organisation and that this may be more difficult if different governance arrangements apply to audit.”*

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

Although the audit businesses of firms are more heavily regulated than their non audit activities, we are not convinced that separate governance arrangements would be helpful. In fact, we believe that governance overall would be significantly weakened if these areas are separated.

We think the existing Principle C.1 of the Code is correct in extending the scrutiny of reputational risks by INEs to cover “those in the firm’s businesses that are not otherwise effectively addressed by regulation”. With separate governance arrangements for audit, INEs would not have a full line of sight over matters arising outside that area that could potentially impact audit quality.

*“We believe that the Code could also be used to help embed firms’ tone at the top and push this tone further down the organisation. The Code already makes reference to the importance of tone at the top but it should be possible to enhance this section, perhaps by including specific requirements for firms to report in more details on how this is cascaded throughout the organisation.”*

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

We acknowledge that the Code’s principles and provisions address the tone at the top and professionalism. However, firms need to be as transparent as possible on how this works in practice.

We believe 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 firm. Provision C.1.1 provides for by stating “They should also meet as a separate group to discuss matters relating to their remit” and greater transparency about how this works in practice would be useful.

*“As noted above only a handful of other jurisdictions have introduced similar governance requirements for audit firms. We believe that there is considerable merit in other major territories introducing their own governance arrangements and also for aspects of the Code to be picked up at network level. However, we recognise that there are challenges in doing so.”*

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

As an international investor, we see the attraction of a global approach whilst noting that the ICAEW back in 2010 quite understandably considered it was premature to roll out the Code worldwide at that stage. However, the structure of global audit network organisations can mean that a UK firm may be affected significantly by decisions taken elsewhere in the network outside the control, or even the influence, of the UK firm. This will be of concern not only to INEs but also to partners and employees in the UK. Given the importance of the global networks, we agree that firms should seek to apply the Code internationally or explain where this is not the case. Investors, regulators and other need to know how consistency in audit quality is ensured and auditing standards applied globally.

Restricting the code solely to the UK will obviously limit its effectiveness and if firms are given discretion to determine the level at which the Code applies, then there will be a lack of comparability which will diminish its value. Both EY and Mazars deserve credit for incorporating aspects of the Code into their international structures and we hope other firms take note.

Nevertheless the adoption of the Code internationally remains a significant challenge for a variety of reasons. The Code operates on a comply or explain basis that is suited to the UK principles-based approach but this does not always readily translate in jurisdictions, such as the USA, that have a strong rules-based approach.

However, noting that the FRC is a UK regulator but not without influence with its peers in other countries, we would suggest that:

- The FRC works with IFIAR to develop a global audit firm governance code.
- The Code requires firms and their INEs to explain in the UK context how they engage with the firm's international network and its constituent firms.

We would encourage the FRC to look at other practical steps or consensus positions that might resonate at an international level. For example, the FRC could seek international consensus that significant audit firms have within their governance structures a minimum number of independent non-executives.

### **Role of the INEs**

*“One area where we believe there may be room for improvement is in the appointment process for INEs. Most are currently appointed by the firm's executive management perhaps with the assistance of recruitment consultants, and their appointment may, or may not, be approved by the wider partnership. Investors have indicated that they would like to have some input into the appointment process although the precise mechanics of any such input remain unclear and may be difficult to achieve in practice. Firms could, however, consider discussing with investors their approach to the appointment process and the key attributes they are looking for in new INEs.”*

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

We agree that it is vital that INEs are perceived as being demonstrably independent and investors, amongst other stakeholders, need to have confidence in the way in which INEs are selected and appointed. We also 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.

We note the two examples in paragraph 77 of the consultation of a firm appointing a serving partner and a firm tendering for the audit of a listed company of which one of its INEs is a NED which are cause for concern. We told the ICAEW in our 2009 response that we felt 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. Then as now we believe this should be explicit and not left to implicit interpretation.

We also have reservations about Principle C.2 which states that the INEs' duty of care is to the firm and C.3 which adds that "they have a right to report a fundamental disagreement regarding the firm to its owners". As we make clear in our opening paragraph above in response to this question, we consider that the 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, the 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.

We also note at some listed companies, the 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 in the event of a serious dispute. It might be worth considering introducing something similar as a best practice suggestion in any revision to the Audit Firm Governance Code.

*6. 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 are not in favour of a prescriptive standard process but it is important that investors have confidence in the appointment process. Provision C.1.2 requires firms to disclose on their website information about the appointment, retirement and resignation of INEs. Such disclosures could be improved and in particular more transparency around the appointment process would be useful. One approach could be to have a nominations committee which could disclose the criteria used to ensure the INEs are independent.

Given that an audit is undertaken for the benefit of the shareholders as main users of the accounts, it seems sensible to take steps to ensure investor confidence. As far as we know, audit firms do not routinely consult investors on the appointment of INEs. Greater transparency in relation to the process would allow interested investors to engage at an early stage if they wish.

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

We have some reservations over giving the FRC a 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.

*“That said there are aspects of the Corporate Governance Code and of corporate governance good practice more broadly which, given the significance of the audit firms to the markets, which may if applied enhance confidence in the Code, and in the role of INEs. For example:*

- *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.”*

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?*

We feel that it would be useful to include all these aspects in the Code and have some specific comments to make on some of them below. However, more generally, we feel that it would be helpful to bring the Code closer to the UK Corporate Governance Code 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.

More specifically we would suggest:

- As opposed to one of the INEs having recent and relevant *financial* experience, it should be relevant *audit* experience in that the INE needs to understand the operation of an audit practice, its risks and the professional standards expected of auditors.
- 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.

We also consider 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 below); and provisions whereby the INEs should stand down where there are conflicts (see question 5 above). Any revisions to the 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?*

We note that there is an issue in reporting and wider accountability in terms of Code compliance. As we observed in 2009 in our response to ICAEW, it is not obvious to us how "comply or explain" could work without some sort of external monitoring framework and we recommended setting up an institutional monitoring group with some investor representation, possibly under the auspices of the FRC, to review progress and to publish an annual report on its findings. We stand by this recommendation which would give the Code greater credibility and would also strengthen the position of independent non-executives themselves. We continue to fear that the Code will otherwise suffer from the absence of a mechanism to report beyond the firm.

*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 informal dialogue could be very helpful and to the mutual benefit of all parties. We also see some merit in adding a requirement to the Code for audit firms to submit a report to the regulator. The existing transparency reports provide limited insight on how audits are performed but 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 AQR 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". It is thus important that there is transparency as to their role and effectiveness so that they can be challenged. The firms should seek to set KPIs to measure the success of the INEs. Also currently, boards, public interest committees and INEs are not required in 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. However, our suggestion in answer to question 8 above on the rebuttable presumption that significant developments in the UK Corporate Governance Code should be carried over, mutatis mutandis, to the Audit Firm Governance Code would cover many of these additional points without the need for frequent revision of the Code.

We would observe more generally that making the Code more effective is not only about greater transparency and more extensive disclosure. Investors and others would also gain from better communication and engagement. As we say in our response above 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. This is likely to be much more effective in supporting better governance than requiring disclosure of success measures or KPIs although the data from such metric can be helpful in facilitating dialogue.

#### **Other issues**

*"Increasing the reach of the Code to a wider group of firms may help to raise confidence in the profession as a whole, but we are also conscious of the need to ensure that regulation is applied in a proportionate manner."*

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



In principle, we consider any audit firm that audits listed public interest entities should have to comply with the provisions of the Code or give a considered explanation. As an investor in private equity and other unlisted investments, we see the case in principle for an extension to a wider group of firms that do not audit listed companies. We also note that some of these audit firms that are not subject to the Code have appointed INEs which is certainly welcome and to be encouraged.

However, 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 audit 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.

*“The Code was published jointly by the ICAEW and FRC following extensive work by the ICAEW and others. The feedback we have received to date is that the Code should now be owned by the FRC as the independent regulator and inspector of the firms which apply it, with input from the ICAEW and other professional bodies as required. The FRC will also continue to act as a convener of meetings with INEs and to meet with INEs individually about matters of concern.”*

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

We agree that the FRC should own the Code and is well placed to do so.

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

We would refer again to our suggestion that it would be helpful to bring the Code closer to the UK Corporate Governance Code 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. However, some major issues would benefit from an explicit mention in the Code even with the rebuttable presumption in place.

For example, the Code is silent on remuneration issues. As we say in our covering letter, that the internal governance of audit firms concentrated on revenue optimisation from audit and non-audit services rather than on audit quality and transparency. Whilst not all the principles and provisions in the UK Corporate Governance Code on remuneration are likely to be relevant to audit firms, remuneration structures are important for an assessment of the incentives that operate within a firm particularly when the firm concerned audits public interest entities. It would be helpful if they were explicitly addressed in the Code.



**COPY FOR YOUR  
INFORMATION**

Mr R Hodgkinson  
Project Director  
Audit Firm Governance Working Group  
ICAEW  
Chartered Accountants' Hall  
Moorgate Place  
London EC2P 2BJ

5 October 2009

Dear Robert

**AUDIT FIRM GOVERNANCE SECOND CONSULTATION PAPER:  
PROPOSED AUDIT FIRM GOVERNANCE CODE**

I am writing to comment on the Audit Firm Governance Second Consultation Paper on behalf of rpm Railpen Investments, the investment monitoring arm of the Railways Pension Trustee Company Limited, the corporate trustee of the UK railway pension funds with approximately £18 billion of assets under management and 350,000 beneficiaries.

We are long standing supporters of better corporate governance and consider external audit to be one of the pillars of good governance. It follows that we have an interest in robust external audit as a major pension fund investor and we believe that the governance of audit firms has ramifications in terms of audit quality and effectiveness as well as choice. We responded to your earlier consultation in February of this year. We welcome this opportunity to comment on the latest paper and the proposed governance code itself, which we broadly welcome, and we provide some suggestions below on how to strengthen it.

We believe the draft code has the potential to make a significant contribution and it builds helpfully upon existing professional ethics and regulation. We acknowledge that a partnership structure presents somewhat different challenges to those inherent in listed companies where ownership and management are separated and we recognise that the code should be seen as a cousin of the Combined Code rather than a direct sibling.

Although we welcome other aspects of the code on leadership, values, operations and reporting, we agree with your paper's observation that the most important aspect of the draft code is the Section C on independent non-executives. Through their involvement they can, in principle, enhance confidence in a firm's decision making processes, stakeholder dialogue and the management of reputational risks in the firm's businesses that are not otherwise effectively addressed by regulation. This appears to apply to non-audit work as well which is necessary in our view. From an investor perspective, an initiative to address audit firm governance and risk is rather more useful than moves to limit or cap the liability of a listed company's external auditors.

However, we acknowledge that there is an issue in reporting and wider accountability in terms of code compliance. It is not obvious how "comply or explain" could work without some sort of external monitoring framework and we recommend that an institutional monitoring group with some investor representation is set up, possibly under the auspices of the FRC, to review progress and to publish an annual report on its findings. This would give

/.....Cont'd

the code greater credibility and would also strengthen the position of independent non-executives themselves. We feel that the code will otherwise suffer from the absence of a mechanism to report beyond the firm.

We also acknowledge that investors have a role to play in developing dialogue and consider principles F.2 and F.3, on shareholder dialogue with audit firms and informed voting on external auditor appointments respectively, to be sound in concept. In practice, however, audit committees have the direct relationship with the external auditor rather than shareholders and will also have a due diligence role of their own to play and a need to engage with shareholders in what is a triangular relationship.

We have some reservations in relation to the draft code on the independence of independent non-executives and the absence of a definition of independence. The consultation paper acknowledges the obvious risks posed by an actual or perceived lack of independence. It identifies the need for firms to ensure the independence of non-executives from the firm and its partners and also the need to preserve independence of the firm itself from its audit clients but is anxious not to lay down any prescriptive definitions of independence to be included in the text.

Whilst we accept that the introduction of independent non-executives is a first step in evolutionary process, we feel that implicit expectations on independence at the outset are not enough. 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. The code would be greatly strengthened if it identified some minimum threshold of this type. Certainly firms would help themselves if they could explain how non-executives are not in any position to influence individual audits, and the existence of basic independence requirements would give this substance.

We welcome the provisions underpinning Principle C.3 on the rights of independent non-executives. However, we feel confidence in them could be strengthened further still if there was some sort of disclosure requirement in Principle C.1 on the extent to which they are integrated into the governance structure of the firm and whether they actually serve on a deliberative body. We feel that an advisory board model is unlikely to be strong enough and would do little to improve risk management within the firms.

We also consider that Principle D4 should make clear that the whistleblowing policies and procedures should be under the auspices of the independent non-executives and that Provision D4.1 should be strengthened to say specifically that the independent non-executives should have sight of all issues raised and how they have been dealt with. The provision is expressed more vaguely in its present form.

I hope you find these comments helpful and I would like to acknowledge the openness of the Working Group in its willingness to engage with investors and other stakeholders.

Yours sincerely

**Frank Curtiss**  
**Head of Corporate Governance**