



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

ICAEW welcomes the opportunity to comment on the *Audit Firm Governance Code: A review of its implementation and operation* published by the Financial Reporting Council (FRC) on 21 May 2015, a copy of which is available from this [link](#).

This ICAEW response of 28 August 2015 reflects wide consultation, including with the Corporate Governance Committee whose members are drawn from the business, investment and public practice communities. The Committee informs our thought leadership and policy work on corporate governance issues and related submissions to regulators and other external bodies.

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MAJOR POINTS

1. The Audit Firm Governance Code (the Code) was issued in 2010 with the overarching objective of improving the level of public trust in audit. It sought to do this by improving the governance of firms with significant presence in the UK listed audit market. It adopted a non-regulatory approach, recognising that the diversity of structures of the major international audit network firms makes a flexible application more suitable.
2. The Code has stimulated significant improvements to the governance of firms, with all major firms having appointed independent non-executives (INEs) and disclosed information publicly on governance. The Code has had influence internationally, with some aspects adopted by firms and in codes outside the UK, and the Code has affirmed the UK's reputation for innovation in audit and governance.
3. In reviewing the implementation and operation of the Code, we believe that the FRC, professional bodies, audit firms, companies, investors and other stakeholders need to recognise that maintaining and enhancing public trust in audit is challenging. It requires ongoing effort and collaboration between stakeholders to create an environment that supports engagement and trust. We see this as a way the Code can serve the public interest. As evidenced by our role in establishing the Code, ICAEW has a significant contribution to make.

The focus of the consultation

4. We welcome the FRC's review of the Code's implementation and operation and believe that it should be guided by two principles.
5. Firstly, a key priority for this review should be to foster the right environment for engagement between audit firms and their stakeholders. Changes to the Code have a role to play in this but we advise setting a high hurdle for such changes. Most energy should be directed towards understanding and addressing the root causes of why audit firms, investors and others are not engaging with each other to the degree that was hoped when the Code was launched.
6. Secondly, we believe that it supports public trust in audit firms if they are subject to broadly the same governance regime as the companies they audit. We therefore recommend that there should be a presumption that significant developments in the UK Corporate Governance Code should be carried over to the Audit Firm Governance Code. However, this presumption can be rebutted in cases where the real differences between partnerships and companies make it impractical or inappropriate.

A new context for the Code

7. Since the Code was published, a significant development has been the introduction of mandatory audit tendering at least every 10 years, following a report by the UK Competition Commission, and the finalisation of a package of measures on audit reform by the European Union. Anticipating these requirements, many listed companies have been putting their audits out for tender recently.
8. In this more competitive regime, audit committees are much more keenly interested in audit quality. The FRC should consider what scope there is for audit firm governance to support innovation and help audit committees better differentiate between audit firms.

Improving stakeholder communications

9. The FRC notes that attempts by firms to engage with investors have not always been successful and that the investor audience for such meetings is limited. Our own informal feedback, supported by a report from the CCAB ('Audit Quality and Transparency', available from tinyurl.com/ccabaudq), is that audit committees and investors do not generally refer to

Transparency Reports. The same CCAB report finds that while investors support the objectives of the Code, they are sceptical that disclosures in Transparency Reports will be useful. There is a useful role for the FRC here in identifying the root causes of investors' lack of engagement with these disclosures. We suggest there is a need for better supporting institutions to bring together audit firms, members of the investor community, company executive and non-executive directors and broader society in ways that are credible to the regulator and serve the public interest.

10. In establishing new institutional arrangements, as the owner of the Code, the FRC would need to agree these arrangements. However, it wouldn't need complete ownership, and could utilise the support and expertise of other organisations, such as ICAEW. In this context, there are a variety of precedents. As a starting point, we note the effectiveness of the Audit Firm Governance Working Group, which brought together stakeholders with an interest in audit to understand the issues and draft the code. Similarly, the ICAEW-convened Audit Quality Forum has been effective in hosting conversations between stakeholders on ideas to foster better audit quality. In another industry, the Guidelines Monitoring Group, which oversees the Walker Guidelines for Disclosure and Transparency in Private Equity, has proved beneficial. Imaginative approaches should be considered with a view to kickstarting better two-way communication and understanding between firms and stakeholders. For example, the FRC might establish a permanent group to encourage dialogue and host ongoing debate on areas of concern on a regular basis. In doing this, we urge the FRC to think about helping stakeholders engage with firms as a whole, rather than just with INEs.
11. Better audit firm governance is of interest not only to investors but also to partners and employees within audit firms and across their international networks. Positioning the Code as useful to them may help stimulate higher quality engagement and more useful disclosures, as well as building support for the Code's principles.

Promoting better audit firm governance internationally

12. The structure of international 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 is of concern not only to INEs but also to partners and employees in the UK. Therefore we share the FRC's vision of better audit firm governance internationally.
13. Adoption of the Code outside the UK remains a significant challenge. Many markets, for example the US and China, do not use comply or explain codes. EY and Mazars deserve credit for incorporating aspects of the Code into their international structures, as had been anticipated by the Audit Firm Governance Working Group in 2010. Other countries have also developed their own codes. However, we recognise that the conditions necessary to make comply or explain work effectively do not in general exist internationally (see 'When is comply or explain the right approach?', available from tinyurl.com/icaewcore).
14. Therefore, as well as promoting the Code internationally, we suggest focusing on key aspects of the Code that might be implemented at an international level via regulation. For example, the FRC could seek international consensus that significant audit firms have within their governance structures a minimum number of independent non-executives. It is notable that UK firms registered with the US Public Company Accounting Oversight Board have successfully introduced independent non-executives even though such a measure had previously been seen as unworkable by the Advisory Committee on the Auditing Profession established by the US Treasury. We encourage the FRC to consider other practical steps that might resonate at an international level.

RESPONSES TO SPECIFIC QUESTIONS

15. For ease of reference, we have numbered each of the boxed questions sequentially and, where appropriate, have annotated them to provide context.

Q1. Do you agree that the Code's purpose should be redefined in this way?

This question asks whether the public interest should be placed at the heart of the Code, with the public interest in this context resting in:

- (1) audit quality,*
- (2) the firm's reputation more broadly, and*
- (3) prevention of a firm failure.*

16. The purpose of any code is to set out good practice. Accordingly the Code, by its nature, has the public interest at its core. In addition, Code Principle B.1, the Professionalism principle, states explicitly that a firm should perform quality work 'in a way that properly takes the public interest into consideration'.
17. As a result, we do not agree with the proposals in paragraph 67 of the consultation paper, which states that 'the public interest [should supersede] all commercial interests of the firm.' While we agree that compliance with ethical principles is paramount for professional accountants and firms of accountants, we do not agree that the public interest is an additional requirement over and above this. Rather, we view the public interest as being served by professional accountants complying with ethical principles.
18. While audit quality, the firm's reputation more broadly and prevention of a firm failure are important, we think the public interest goes beyond these three issues. What constitutes the public interest is, in part, based on social norms which change over time. For example, we see an important current facet of the public interest for accountancy firms as being restoring trust in business, for example in relation to tax. For the Code to be most 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. While there may be some benefit in highlighting specific current public interest issues in the Code, we think that firms should distil relevant issues from dialogue with investors and other stakeholders, rather than see them hardwired into the Code.

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

19. As a separate service line facing its own particular risks and regulations, audit will require careful management and will already have its own processes to safeguard audit quality. In that sense, audit should have separate governance arrangements.
20. However, we do not support separate code regimes for audit and the rest of an audit firm. Code Principle C.1, the Involvement of independent non-executives principle, 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'. This rightly recognises that INEs should consider threats to the firm's reputation that arise outside the UK listed audit practice as well as ensuring that the firm is maintaining and enhancing audit quality and having regard to the public interest in everything it does.

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

21. We believe that the Code principles and provisions adequately cover tone at the top and professionalism. A key priority for this review should be to encourage the right environment for engagement between stakeholders to ensure that the existing principles and provisions are effective. This goes beyond the FRC's Ethical Standards, to include ISQC 1 and auditing standards, as well as supporting regulatory arrangements such as audit inspection. In recognition of this, we advise the FRC to set a high hurdle for changes to the Code, by

introducing changes only where the benefits clearly exceed related costs. Accordingly, we would not include more detail in the Code but would focus on fostering better dialogue between stakeholders.

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

22. The structure of international 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 is of concern not only to INEs but also to partners and employees in the UK. Therefore we share the FRC's vision of better audit firm governance internationally.
23. Adoption of the Code internationally remains a significant challenge. Many markets, for example the US and China, do not use comply or explain codes. EY and Mazars deserve credit for incorporating aspects of the Code into their international structures, as had been anticipated by the Audit Firm Governance Working Group in 2010. Other countries have also developed their own codes. However, we recognise that the conditions necessary to make comply or explain work effectively do not in general exist internationally (see 'When is comply or explain the right approach?', available from tinyurl.com/icaewcore). Accordingly, we think there may be more effective ways of improving the governance of international audit network organisations.
24. As well as promoting the Code internationally, we suggest focusing on key aspects of the Code that might be implemented at an international level via regulation. For example, the FRC could seek international consensus that significant audit firms have within their governance structures a minimum number of independent non-executives. It is notable that UK firms registered with the US Public Company Accounting Oversight Board have successfully introduced independent non-executives even though such a measure had previously been seen as unworkable by the Advisory Committee on the Auditing Profession established by the US Treasury.
25. Even without prescribing the activities of INEs or additional disclosures by the firm and without any reference to the Code, a requirement for INEs would deliver many of the objectives of the Code. In addition, it might provide added protection and comfort to UK INEs, firm management, partners and employees that the UK firm is better protected from risks arising internationally. We encourage the FRC to consider other practical steps that might resonate at an international level.

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

26. We agree that INEs need both to be independent and to be seen to be independent. A key part of this is ensuring that investors have confidence in the process by which INEs are appointed. However, we would leave it to investors to make their own judgement and communicate it to firms. We think this could be supplemented through new supporting institutional arrangements to help increase engagement and dialogue.
27. We believe there is value in exploring the extent to which INEs' interaction with and reporting to the firm's partners as a whole might provide another means by which INEs can demonstrate their independence (paragraph 79 of the consultation). However, we caution against steps that might be seen as setting INEs in tension with the firm's management. For INEs to be truly effective they must work with, not against, the firm's management. As an example, INEs could capture the views of partners and staff via roundtable or town hall events.
28. In respect of the serving partner appointed as an INE (paragraph 77 of the consultation), Principle C.2, the Characteristics of independent non-executives principle, already precludes such an appointment. The fact that the serving partner's appointment was identified by the FRC's inspection work, rather than being highlighted by investors, underscores the need for

better structures to support more effective engagement between firms, investors and other stakeholders. We do not however think the Code needs to be amended to address this situation.

29. In respect of the INE who was a non-executive director at a prospective audit client (paragraph 77), we view the INE's and the firm's response as responsible and consistent with a principles-based code. We do not think the Code needs to be amended to address this situation.

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?

30. No, we do not think firms should follow a standard process. As noted above, we think it is important that investors have confidence in the process by which INEs are appointed, but we would stop short of prescribing a standard process.

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

31. No, we do not think the FRC or any other regulator should have a role in, or a veto over, the appointment of INEs. Recognising that there are other contexts where a regulator has the right of veto over director appointments, such as the Financial Conduct Authority (FCA) in respect of financial services companies, we think it is important that investors have confidence in the process by which INEs are appointed, and meaningful engagement with firms is a key part of this. However, the Code offers a non-regulatory solution to this issue which the FRC should support before taking new responsibilities for regulatory intervention.

Q8. 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?

This question asks whether there are aspects of the UK Corporate Governance Code which should be brought into the Audit Firm Governance Code, including:

- *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; and*
- *a statement that the firm's Transparency Report is, in management's opinion, 'fair, balanced and understandable.'*

32. We believe that it supports public trust in audit firms if they are subject to broadly the same governance regime as the companies they audit. We therefore suggest a presumption that significant developments in the UK Corporate Governance Code should be carried over to the Audit Firm Governance Code. In rebutting this presumption, the FRC should take account of whether introducing a change will make a real difference without introducing undue complexity and thereby pass a basic cost-benefit test. For example, the issues of nomination, remuneration and risk are areas in which the partners of a firm have a keen interest and are likely to already have strong processes to cover them without their having to be addressed further in the Code.

33. For other aspects of the UK Corporate Governance Code listed for potential inclusion in the Audit Firm Governance Code, there would be specific practical issues to be resolved over how they should be implemented, including whether to apply it to the UK firm only or more widely within the network. Our initial assessment is that the most compelling cases for change relate

to the statements on viability and 'fair, balanced and understandable', recognising the real differences between partnerships and companies.

Q9. To who[m] should the boards, INEs and public interest committees be accountable? How should this accountability be discharged, including to the FRC?

34. We think that it is right that the Code sees boards, INEs and public interest committees as being accountable to the firm's owners (Principle A.1, the Owner accountability principle). Combined with Principle B.1, the Professionalism principle, among others, firms are required to take the public interest into consideration. We therefore view owner accountability as appropriate, when other aspects of the Code are taken into account.
35. In discharging this accountability, we believe that the FRC should give thought to developing better supporting institutions, such as a permanent group that brings together representation from all stakeholders. However, we do not think accountability should be discharged to the FRC. Rather, we see the FRC's role as being the catalyst that encourages better communication between stakeholders. We are keen to help the FRC establish and maintain these new supporting institutions.

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

36. To the extent that firms are required to disclose certain matters to regulators by law and regulation, they should continue to be required to do so. However, we do not think the Code should be turned into a regulatory tool through the inclusion of specific provisions on engaging with and disclosing matters to regulators.
37. The consultation paper asks this question in the context of INEs. We believe there should be no additional requirement for INEs to whistleblow, although INEs would be likely to exert pressure on management to fulfil their regulatory responsibilities in any case. Principle C.3, the Rights of independent non-executives principle, provides additional safeguards to allow INEs to serve the public interest. We are concerned that additional expectations of INEs as whistleblowers might undermine their ability to work effectively within the governance structures of firms.

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

This question asks whether greater transparency, including in Transparency Reports, is sufficient to achieve the desired level of accountability, or whether additional measures might be needed.

38. Use of the term 'greater transparency' suggests that the solution lies in more disclosures. However, investors need better understanding, not simply more extensive disclosures. It is likely that investors and others would gain more from better communication and engagement. We see a role for the FRC in establishing a permanent forum of stakeholders to encourage these conversations to happen. Better communication between stakeholders is likely to be much more effective in supporting better governance than requiring disclosure of success measures or key performance indicators.
39. Code Provision E.4.1 states that 'the firm should publish on its website an annual transparency report containing the disclosures required by Code Provisions A.1.2, A.1.3, C.2.1, D.1.3, D.2.2 and D.2.3'. In practice, firms have tended to produce extensive disclosures in their Transparency Reports, with a reconciliation showing how those disclosures satisfy E.4.1. This may mean that audit committees are failing to engage with audit firm governance disclosures because they are not seen as separate from the transparency reporting process. To address this concern, it may be worthwhile amending E.4.1 to encourage firms to be innovative in complying with E.4, the Governance reporting principle. This may boost engagement between audit committees and firms on audit firm governance issues.

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

Currently the Code applies to firms which audit more than 20 listed companies.

40. We support measures to encourage a wider group of firms to adopt principles from the Code, even if they stop short of committing themselves fully to the Code. For example, we note some firms have appointed INEs even though they are not subject to the Code. Clearly this should be welcomed. However, we do not think that a wider group of firms should be expected to adopt the Code, given the need to maintain appropriate proportionality.

Q13. Do you have any comments on the role of the FRC in this context?

This question proposes that the Code, having been drafted by a working group convened by ICAEW and published jointly by ICAEW and the FRC, should now be owned by the FRC as independent regulator, with input from ICAEW and other bodies as required. The FRC will continue to undertake meetings with INEs, both collectively and individually.

41. Yes, the FRC should be responsible for updating the Code. However, it is important to think of the Code as only part of the overall objective of supporting public trust in audit firms through good governance. The consultation notes that attempts by firms to engage with investors have generally not been successful and that the investor audience for such meetings is limited. We see a useful role for the FRC here in identifying the root causes of investors' lack of engagement with firms' disclosures and attempts to communicate. We suggest there is a need for better supporting institutions to bring together firms, investors, company executive and non-executive directors and broader society in ways that are credible to the regulator and serve the public interest.
42. We offer our support and expertise in convening and supporting new institutional arrangements. As a starting point, we note the effectiveness of the Audit Firm Governance Working Group, which brought together stakeholders with an interest in audit to understand the issues and draft the code. Similarly, the ICAEW-convened Audit Quality Forum has been effective in hosting conversations between stakeholders on ideas to foster better audit quality. Imaginative approaches should be considered with a view to kickstarting better communication and understanding between stakeholders. For example, the FRC might establish a permanent group to encourage dialogue and host ongoing debate on areas of concern on a regular basis. In doing this, we urge the FRC to think about helping stakeholders engage with firms as a whole, rather than just with INEs. Suitable models may be found in other industries, such as the Guidelines Monitoring Group, which oversees the Walker Guidelines for Disclosure and Transparency in Private Equity.
43. Better audit firm governance is of interest not only to investors but also to partners and employees within audit firms and across their international networks. Positioning the Code as useful to them may help stimulate higher quality engagement and more useful disclosures, as well as building support for the Code's principles.

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

44. We believe that the FRC's review of audit firm governance should:
- focus on improving public trust in audit and identify how all parties, including ICAEW, can help do this.
 - set a high hurdle for changes to the Code by introducing changes only where the benefits clearly exceed related costs, with most energy being directed towards understanding and addressing the root causes of why audit firms, investors and others are not engaging with each other to the degree that was hoped when the Code was launched.
 - consider what scope there is for audit firm governance to support innovation and help audit committees better differentiate between audit firms.
 - look to ICAEW for expertise and practical assistance in convening and supporting better conversations between firms, investors and other stakeholders.

- back up the FRC's vision of better audit firm governance internationally with practical proposals, for example by implementing key aspects of the Code at an international level through regulation.