

Standard Life Investments

Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Standard Life Investments
1 George Street
Edinburgh
EH2 2LL

phone: 0131 245 6813

fax: 0131 245 6463

email: guy_jubb@standardlife.com

www.standardlifeinvestments.com

By email to s.currie@frc.org.uk

28 August 2015

Dear Sirs

Audit Firm Governance Code – A Review of its Implementation and Operation – May 2015

Standard Life Investments is a leading global asset manager with assets under management of £250 billion as at 30 June 2015. In fulfilling our responsibilities on behalf of our clients we place due reliance on the audits of financial statements undertaken by auditors in the UK and elsewhere. Accordingly, we have an interest in ensuring that not only are audits conducted to a high standard of quality but also the audit firms are governed in an appropriate manner in order to uphold such high standards, consistent with the public interest. Therefore, we welcome your Review and the opportunity to comment on it.

We believe that the Audit Firm Governance Code ('the Code'), which was issued in 2010, provides a useful framework to assist the audit firms in governing their activities in an appropriate manner. We support strongly the principles based comply or explain approach that is used. Since the Code's inception, we have engaged, unilaterally and collectively, with many of the audit firms that apply the Code. In general, these meetings have enhanced our understanding of the audit firms and their respective approaches to governance. Importantly, it has enabled us to provide feedback to the firms, when appropriate.

Notwithstanding the above, we believe there is ample scope to strengthen and improve the governance of audit firms and we believe that this is particularly important due to the potential threats to audit quality arising from the very significant increase in advisory services provided by the so-called audit firms. We believe it is important that the FRC's Review should not underestimate the implications of this increase and the trend, which suggests that the provision of audit services will continue to be increasingly marginalised in most, if not all, of the audit firms that apply the Code.

Our principal recommendations and comments are as follows:

- There should be a more structured approach to reporting and transparency by the audit firms in their transparency reports so that their compliance with the Code's Principles, in general, and the Code's Shareholder Dialogue Principle, in particular, can be monitored and evaluated effectively (1.3 and 6.4).
- The FRC should provide guidance to the audit firms to assist them in determining what is expected of their Independent Non-Executives (INEs) and how they should be positioned organisationally, which we believe is of paramount importance to promoting effective governance that is consistent with maintaining high quality audits (4.2 and 6.2).
- The scope of the Code should extend to those parts of the audit firms that provide assurance services (6.1).
- The Code should encourage the audit firms and their INEs to explain how they engage with the firm's international network. Also, the FRC should work with IFIAR to develop a Global Audit Firm Governance Code (6.3).
- The FRC should set up a monitoring body to oversee the operation of the Code and be the body of supervisory accountability to help ensure the Code is applied effectively and achieves its purpose. It should consider whether its Audit Quality Review Team has a role to play in this regard (6.5).

Before we comment on the specific questions posed in the Review we should like to address a number of the topics raised in the Review.

1. Development of the Code

1.1 We support the aim of the Code, as referenced in paragraph 8 of the Review. We believe it is important that the audit firms should have a formal benchmark of good governance practice against which they can report 'for the benefit of shareholders in listed companies'. Also, in principle we support the proposed increased emphasis on the public interest: we shall comment on this later in our submission.

1.2 We believe that the specific intended benefits referenced in paragraph 9 of the Review, continue to be relevant and appropriate. It may be sensible to introduce some recognition in the Code of the implications or audit firm governance of audit tendering and rotational requirements, which are a significant development since the current Code was published.

1.3 With a few notable exceptions, in our opinion the audit firms have performed poorly in fulfilling the Shareholder Dialogue Principle. We note that 'firms should reach out to listed companies shareholders' but in our experience a number of the firms, including their INEs, have failed to reach out regarding their governance and much of the engagement that has taken place has been a consequence of us reaching out to the audit firms. We have witnessed some improvement over the last year or so but nevertheless the appetite for dialogue by the audit firms seems very patchy.

Therefore, we recommend improved transparency by the audit firms in their transparency reports such that they provide sufficient and meaningful information about their dialogue processes and consequential activities in order that the substance of compliance with the Code's Shareholder Dialogue Principle can be monitored and evaluated effectively. In this regard, we should emphasise that we believe it is beneficial for the audit firms and their INEs to have both collective and 1:1 dialogues with major investors in UK listed companies.

2. Link to the Corporate Governance Code

2.1 We are comfortable with the linkage of the Code to the UK Corporate Governance Code. We recognise the importance of respecting the distinctive attributes of partnership governance but we recognise the benefits of designing the Code around a similar structure to the UK Corporate Governance Code and we would not wish to depart from this. The Code should be reviewed more regularly in the future, as is the case with the UK Corporate Governance Code.

We recommend that the FRC undertake to review the Code every two years, as it does with the UK Corporate Governance Code and the UK Stewardship Code. This will help to not only maintain and improve the Code's relevance but also ensure that its purpose – and whether it is achieving its purpose – is kept under regular and effective scrutiny such that improvements can be made in a timely manner.

3. Purpose and the Public Interest

3.1 We support the FRC's proposal that 'the purpose of the Code should lie primarily in the promotion of high quality statutory audit in the interest of shareholders and in accordance with law and regulation'. Also, we support the proposal that the Code 'should promote good quality, soundly managed work outside of statutory regulation'. However, we believe the Code should focus on audit and assurance work and not other advisory services provided by the firm. As previously mentioned, the purpose of the Code is primarily the promotion of high quality audits, not public confidence in the firm. In our opinion, 'public interest' does not equate with 'public confidence in the firm'.

3.2 We share the FRC's recognition that defining the public interest 'is fraught with difficulty' but we support its concept in the context of the Code and share the recognition referenced in the Review 'that the spirit with which the public interest is pursued is as important as the definition'.

3.3 We note the reference in the Review to the public interest arising in other types of regular non-audit work undertaken by the firms but we are not convinced that it is right that those charged with governance (in the context of the Code) should have effective oversight over those parts of the business. Indeed, we believe that to do so creates an unacceptable conflict of interest for those charged with audit firm governance, whose purpose should lie primarily in the promotion of high quality audits. As we shall discuss later, we believe that those who are charged with the governance of the audit firms under the provisions of the Code should focus on the governance of the audit and assurance activities undertaken by the firm and have remedies to address their concerns, if and when they consider that the non-audit and assurance work being undertaken is prejudicial to audit quality and the public interest. A suite of such remedies might involve escalation, and ultimately include a duty to communicate the concerns to the FRC (see 6.2).

4. How the Code has been applied

4.1 We note the reference stating that 'many of the Code's provisions were already in place' but we are not convinced that that was the case.

4.2 We believe that the positioning of the INEs is very, very important and critical to the effectiveness of the Code in practice. We are concerned that some INEs have been positioned organisationally so remotely from the audit practice that it is difficult to accept they are having much of an impact on the audit firm's governance. It sometimes appears that they are divorced from the governance and management of the firm. Also, that said it is important that the Code and its stakeholders do not expect too much of the INEs and recognises the inherent limitations of non-executive roles and responsibilities.

We recommend that the FRC provide guidance to the audit firms to assist them in determining what is expected of their INEs. This does not have to be enshrined in the Code per se but could take the form of an authoritative guidance statement.

4.3 We note the different approach taken by EY, as reference in paragraph 25 of the Review. We believe the EY model is intrinsically interesting but question whether its effectiveness is more of a function of the individuals concerned rather than the structure adopted.

4.4 We note the reference to transparency reports and their role in informing shareholders and others of the firms' activities. However, we are not convinced that the distribution of these reports is well managed.

We recommend that further research is undertaken to determine the effectiveness of the distribution of transparency reports and appropriate action is undertaken in accordance therewith.

4.5 We are concerned that the existence of the Code is not well known – particularly amongst audit committee members and the institutional investment community.

To promote greater awareness of the Code and reinforce its relevance to high quality audits we recommend that the FRC take steps to encourage reference to it in the enhanced audit reports that are now prepared for UK listed companies. Consideration should be given to how the application of the Code and its relevance to the reporting entity can be communicated in such reports.

5. Has the Code Achieved its Purpose?

5.1 In paragraph 29 of the Review it is referenced that a number of objectives fell into four broad categories. However, we could only find three such categories listed.

Referring to these three categories by exception:

- On balance, the Code has improved firm's governance but our conviction in this regard based on the evidence available is patchy, especially when viewed on a firm by firm basis.
- The Code has failed totally to increase competition but it has helped to differentiate the firms in the eyes of this investor. With hindsight, the Code might not be the best way of achieving this policy objective.
- It is not obvious that formal reporting by the firms has improved but informal relationship engagement by the firms has developed usefully over the life of the Code. For example, a number of the firms have held workshops for investors to explain how they conduct audits. That said, we are critical about compliance with the Shareholder Dialogue Principle (see 1.3).

5.2 We recommend a more structured approach to reporting and transparency. We suggest, by way of example, that the firms that apply the Code should have regulatory reporting requirements similar to listed companies, such that significant events and changes, including the appointment of INEs are reported to the market using the Regulatory News Service (RNS). The FRC should consult as to what market disclosures would be useful.

5.3 We recommend that the objective relating to competition and choice in the audit market be reviewed and re-calibrated so that it is fit for purpose and not just aspirational.

6. Governance

6.1 We recommend the scope of the Code (and thereby the INEs) should extend to those parts of the firm that provide assurance services, which are intrinsically aligned with audit services. Such services, which are akin to audits, are becoming increasingly important to shareholders and, we believe, the public interest.

6.2 We support the FRC's view that the Code should not be prescriptive in respect of the organisational models adopted by the firms. That said, we are firmly of the view that firms should consider creating specific governance structures for their audit and assurance practices, as mentioned in paragraph 40 of the Review. Indeed, we believe that such positioning is of paramount importance to maintaining high quality audits. Participation by the INEs in the wider governance of the firm should be supplementary to their involvement in the governance structures of the audit and assurance practices. This aspect is especially important in the light of the increasing significance of non-audit services provided by most, if not all, of the firms. We would assert that there is an inherent conflict of interest between INEs who are responsible for audit and assurance practices and those who have responsibility for the whole firm, notwithstanding that there is a common interest in maintaining the reputation and integrity of the whole firm, its network and brand. For example, such conflicts arise in exercising oversight of the processes to determine whether the firm should resign as auditors when there is the prospect of lucrative but prohibited non-audit services on offer from the audit client. We believe it is very, very important that the Code's provisions and the messaging from the FRC regarding this issue is unambiguous.

We recommend that the FRC develop guidance, separate from but aligned to the Code, to assist firms and their INEs regarding organisational models.

6.3 We support the comments in the Review that highlight the importance of effective governance within and throughout the international networks and we wish the FRC success in its endeavours to improve the status quo through its engagement with the network firms. However, we are somewhat sceptical as to whether the FRC's engagement, of itself, is sufficient and will be successful.

Therefore, in addition to the activities being undertaken by the FRC in this regard, we recommend that:

- The Code should encourage the firms and their INEs to explain how they engage with the firm's international network and its constituent firms with a view to ensuring high standards of governance are applied by the networks and their member firms.
- The FRC work with IFIAR to develop a Global Audit Firm Governance Code. Such a code could be developed in consultation with International Corporate Governance Network (ICGN) to help ensure it is likely to enjoy the support of the global investment community.

6.4 We support the view that firms and their INEs should seek to achieve 'high quality public transparency' standards.

To this end, we recommend that the Code provide that each firm should provide a clear and concise explanation of how they have fulfilled the provisions of the Code. Clearly, meaningful explanations and not boilerplate ones should be encouraged.

6.5 We recognise the confusion regarding the accountability of INEs, which is referenced in the Review. That said, mindful inter alia that the FRC is the regulator of the audit firms, we question seriously whether it is appropriate that they should be accountable directly to the FRC. To do so may compromise the objectivity of the FRC and the INEs.

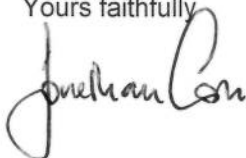
To address this, we recommend that the FRC set up a monitoring body – possibly reporting to its Codes and Conduct Committee - to oversee the operation of the Code and be the body of supervisory accountability. It should comprise a majority of asset owners and asset managers but be chaired by a senior member of the FRC. Such a body would provide a focus for accountability and help to ensure that the Code is applied effectively and achieves its purpose. Also, it could have responsibility for developing the best practice guidelines recommended elsewhere in this letter as well as some of the functions referenced in the questions set out in the Review and addressed in the attachment to this letter.

In addition, the FRC should consider whether there is a role for its Audit Quality Review Team to contribute to the monitoring of the Code's effectiveness.

6.6 We note that 'the FRC maintains a close dialogue' with the firms covering the results of inspections and the proposal that in future the FRC should hold regular meetings with each firm's Board and Public Interest Committee in addition to its ad-hoc meetings with senior partners. In addition to the factors mentioned in 6.5, we believe that such meetings may supplant the dialogue that firms are supposed to have with shareholders.

Accordingly, to help mitigate these concerns we would propose that the recommended monitoring body take responsibility for maintaining dialogues with the management of each firm and with each firm's Board and Public Interest Committee.

Yours faithfully



 Guy Jubb
Global Head of Governance & Stewardship
Standard Life Investments

Attached: Questions and Responses

Standard Life Investments Limited

FRC Audit Firm Governance Code – A Review of its Implementation and Operation - May 2015 ¹

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]

We agree that the Code's purpose should be redefined in the way proposed. However, we disagree with the proposal that those charged with governance (in the context of the Code) should have effective oversight of the firm's non-audit businesses. In our view, this creates an unacceptable conflict of interest for those charged with audit firm governance. We recommend that the FRC develop best practice guidelines to assist those charged with audit firm governance to take appropriate action in the event the firm's reputation is – or is potentially at risk (see section 3 and 6 of our letter).

In addition, we recommend that the Code's objective pertaining to competition and choice in the audit market be reviewed and re-calibrated so that it is fit for purpose. See section 5 of our letter.

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

Yes. The governance arrangements can be designed to fit the circumstances of the firm. They could, for example, comprise a governance council chaired by one of the INEs which would have responsibility for overseeing and reporting on the implementation of the Code. Having separate arrangements for audit will help to ensure the Code's purpose is achieved and manages conflicts of interest.

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

In general, no. However, if it was felt that this aspect of the Code should be strengthened then perhaps it could provide that the INEs should meet separately without any partners or executives present and when doing so assess the tone at the top and professionalism more generally.

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

We support the comments in the Review that highlight the importance of effective governance within and throughout the international networks. However, we are somewhat sceptical as to whether the FRC's engagement with the network firms to improve the status quo is, of itself, sufficient to be successful. Therefore, to enable implementation of the concept we recommend that the FRC work with IFIAR to develop a Global Audit Firm Governance Code. Furthermore, that the UK Code should require the firms and their INEs to explain how they engage with the firm's international network and its constituent firms (see paragraph 6.3 of our letter).

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

The Code could provide that the firms set up a nominations committee which should report in the transparency report about its activities and explain the criteria they use to determine the independence of their INEs.

¹ These responses to the questions posed in the Review should be read in conjunction with our letter dated 28th Aug 2015.

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?

We do not believe it is appropriate for the firms to follow a standard process or to engage the investors in audited entities. However, we are supportive of consideration being given in the Code to firms having a nominations committee, whose activities would be transparent (see Q5 above). Furthermore, we recommend that the firms that apply the Code should have regulatory reporting requirements similar to listed companies, such that significant events and changes, including the appointment of, retirement or resignation of INEs, are reported to the market using the Regulatory News Service (RNS) (see paragraph 5.2 of our letter).

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

In view of the importance of the public interest, being placed at the heart of the Code, we think it is appropriate that the FRC should approve the appointment of INEs on the basis of their being 'fit and proper persons' for the purposes of the Code. This approach is similar to that used for other regulated financial services companies but given the nature of audit firms and their inherent risks we believe that the approval process should have a 'lighter touch' than that used by regulators for, say, banks and insurance companies, where the inherent public interest risks are very different.

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 (1) the inclusion in firms' transparency reports of a viability statement providing an assessment of long term solvency and liquidity; (2) term limits on INEs' appointment; (3) transparency around the remuneration of INEs; (4) a minimum number of INEs per firm; (5) a requirement for at least one INE to have recent and relevant financial experience; (6) an independent Chairman; (7) greater consideration of diversity; (8) a formal role for INEs on remuneration, nomination, risk and/or audit committees; (9) a statement that the firm's Transparency Report is, in management's opinion, 'fair, balanced and understandable'.]

We would support including all the specified aspects into the Code, subject to the following comments:

- In respect of at least one of the INEs having relevant expertise, it should be relevant audit experience rather than just relevant financial experience. This is important to understanding the audit practice and its risks as well as the professional standards expected of auditors.
- We would be supportive of there being an independent Chairman if that was in respect of the firm's governance oversight body responsible for overseeing the implementation of the Code but we do not consider it appropriate that the audit firm, as a whole, should have an independent Chairman.
- We are uncertain as to what is meant by 'greater consideration of diversity', but we would be supportive of the nominations committee (see our responses to previous questions) being required to provide an account of the consideration it gives to the different dimensions of diversity.

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

We recognise the confusion referred to in the Review regarding the accountability of INEs. To address this and to mitigate conflicts of interest we recommend the FRC set up a monitoring body – possibly reporting to its Code and Conducts Committee - to oversee the operation of the Code and be the body of supervisory accountability. It should comprise a majority of asset owners and asset managers but be chaired by a senior member of the FRC. Such a body would provide a focus for accountability, and help to ensure that the Code is applied effectively and achieves its purpose (see paragraph 6.5 of our letter).

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

Yes, such provisions in the Code would seem appropriate on the understanding that the provisions would be utilised in exceptional circumstances only. Furthermore, the presence of such provisions, whether or not they are enacted serves to strengthen the effectiveness of the Code in general, and the authority of the INEs, in particular. Whilst the provisions referred to in the question may vest with the Boards and Public Interest Bodies, we recommend that they should also lie with the INEs, as well, both individually and collectively. However, we see such provisions as being separate from the 'close dialogue' that the FRC maintains with the firms. We question the proposal that in the future the FRC should hold regular meetings which each firm's Board and Public Interest Committee, since there is a risk that such meetings may supplant the dialogue that firms are meant to have with shareholders. Accordingly, we would prefer that the recommended monitoring body would take responsibility for maintaining dialogues with the management of each firm and with each firm's Board and Public Interest Committee (see paragraph 6.6 of our letter).

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]

We should like to see a more structured approach to reporting and transparency. Furthermore, we support the view that firms and their INEs should seek to achieve 'high quality public transparency' standards. To this end, we recommend that the Code provide that each firm should provide a clear and concise explanation of how they have fulfilled the Code's provisions. Clearly, meaningful explanations and not boilerplate ones should be encouraged (see paragraphs 5.2 & 6.4 of our letter).

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

[Currently the Code is mandatory for firms which audit more than 20 listed companies]

The current basis on which the Code is applied seems effective. In the event a firm which audits listed companies is not subject to the provisions of the Code and does not apply them voluntarily, this should be disclosed in the auditor's report on a factual basis so that the readers of the auditor's report is aware of the status.

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.]

We support the view that the Code should be owned by the FRC. However, we recommend that the FRC set up a monitoring body to oversee the operation of the Code and be the body of supervisory accountability. It should comprise the majority of asset owners and asset managers but be chaired by a senior member of the FRC. Such a body would provide a focus for accountability and help to ensure that the Code is applied effectively and achieves its purpose. It should have a responsibility to report to the FRC – possibly to its Codes and Conducts Committee - if it is concerned regarding the Code's application at a specific firm(s) or if any other matters come to its attention that it believes may be appropriate for regulatory intervention.

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

We would refer you to the following points made in our letter.

a) Although there have been some notable exceptions, in our opinion the audit firms have performed poorly in fulfilling the Shareholder Dialogue Principle (see paragraph 1.3 of our letter).

b) In our opinion 'public interest' does not necessarily equate with 'public confidence in the firm' (see paragraph 3.1 of our letter).

c) Those who are charged with the governance of the audit firms under the provisions of the Code should focus on the governance of assurance as well as audit activities undertaken by the firm (see paragraph 3.3 of our letter).

d) We believe the positioning of the INEs is very, very important and critical to the effectiveness of the Code in practice. We are concerned that currently some INEs have been positioned organisationally such that it is difficult for us to accept that they are having much of an impact on the audit firm's governance. We should like to see the FRC providing stronger guidance to the firms to assist them in determining how the INEs should be effectively integrated into the governance of the firm in such a way that they can have appropriate influence and impact (see paragraph 4.2 of our letter).

e) We are not convinced that the distribution of the transparency reports published by the firms is managed effectively. We recommend that further research is undertaken to address this (see paragraph 4.4 of our letter).

f) To address the Code's invisibility to many of its stakeholders and to reinforce its relevance to high quality audits, the FRC should take steps to promote meaningful references to the Code in enhanced audit reports (see paragraph 4.5 of our letter).

g) The Code has failed totally to increase competition but it has helped to differentiate the firms, which is helpful to understanding their respective attributes (see paragraph 5.1 of our letter).