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**The Investment Association**

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Susan Currie  
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27 August 2015

Dear Susan

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

The Investment Association represents the asset management industry in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £5 trillion (€5.6 trillion) of assets, which are invested in companies globally. In managing assets for both retail and institutional investors, our members are major investors in companies whose securities are traded on regulated markets. Therefore, they have an interest in the requirements governing the audit and the auditor's report as users of companies' accounts.

Investors value high quality audits and see them as the product of the standards governing audit firms. In the context of the current consultation, although the situation has improved recently, investors have had concerns that firms' internal governance may be more disposed towards maximizing revenues as opposed to audit quality and transparency. Also there was a disconnect between major shareholders and the auditors of listed companies in that auditors tended not to engage much with major shareholders.

The introduction of the Audit Firm Governance Code (AFGC) in 2010 provided a framework to help address these concerns in that it assisted audit firms establish governance structures involving Independent Non-Executives (INEs), and facilitated investors' engagement with the firms that apply the Code. This also helped enhance our understanding of audit firms and their approaches to governance, and enabled us to provide feedback.

***The Code's purpose.*** We support the AFGC's stated purpose as "working for the benefit of shareholders in listed companies" (paragraph 15), and the FRC's proposal that this should be

through the promotion of high quality statutory audits and the increased emphasis on the public interest. Whilst the AFGC has contributed to the governance framework of the main audit firms, we still consider there are matters that should be addressed as set out in this response. Nor has the AFGC necessarily achieved all of its underlying objectives (set out in paragraph 29) in that:



- Whilst the Code has helped differentiate the firms from each other, it has not addressed choice in the market or reduced the risk of a firm exiting the market. Whilst we would expect the FRC through its enforcement activities to check that firms make contingency arrangements, if the AFGC is to continue to have choice as an underlying objective (some of our members have questioned this) then we believe the AFGC should specify that this is part of the oversight role of the INEs.
- The firms have sought to provide the transparency expected in the AFGC, but it would be helpful if they adopted a more tailored approach and clearly and concisely disclosed how they have fulfilled each of the provisions of the Code or explained where not. Investors would particularly like more transparency around the roles and work of the INEs as set out below. Moreover, the transparency reports are central to the firms' accountability. The firms should seek to identify those investors that have significant holdings in their audit clients and ensure that the reports are sent to them.

***The role of the INEs.*** We supported the appointment of INEs to provide fresh insight and challenge. However, we have some concerns about the current text of the AFGC which states that the INEs' duty of care is to the firm (C.2) and that "they have a right to report a fundamental disagreement regarding the firm to its owners" (C.3).

We consider the INEs' duty of care should be to the public, as opposed to the firm, and that AFGC provision C.2 is incompatible with the public interest objective now being emphasised. Nor do we consider that a right to report a fundamental disagreement to the firm's owners, the partners, is sufficient. INEs should have remedies to address concerns/disagreements particularly if factors are impacting audit quality. Such remedies should involve escalation to the regulator and not just to the firm's owners. The INEs role as regards a firm's partners is to influence them so as to ensure they adopt a culture that will deliver quality audits.

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 AFGC to have an independent evaluation, albeit some of the firms have done this voluntarily. We consider there should be a requirement in the AFGC for a periodic externally facilitated evaluation.

***Position of INEs.*** The firms have positioned the INEs in different ways, for example, as part of the oversight board; as a separate advisory board; or as part of the global board with a representative in the UK. How the INEs are positioned can be critical to the effectiveness of the AFGC in practice. We agree that the FRC should not necessarily prescribe a firm's organisational structure but are concerned that sometimes the INEs can seem divorced from the real governance and management of the firm. The AFGC should introduce a requirement for the firms to disclose why they have adopted their particular model and why this is considered effective. In this context, we welcome the FRC's proposal to meet regularly with each firm's board and public interest committee, as well as with senior partners and the INEs.

It would also be helpful if the FRC provided guidance to assist firms in determining what is expected of their INEs.



**Oversight and non-audit services.** A particular concern of investors is the potential threat to audit quality from the increase in non-audit services provided by the firms. The significant revenues generated and the nature of the services can affect auditor objectivity and lead the firms to identify themselves with the interests of management rather than those of investors.

The consultation asks whether there should be separate governance arrangements for audit. This would split the governance of the audit business from consultancy and if the INEs' role was limited to audit then matters arising outside that area that potentially impact audit would not come to their attention. Thus our members support the AFGC focusing on the oversight of a firm as a whole including its non-audit services provided this is in so far as these other services impact audit quality.

That said, certain of our members consider that the oversight of the INEs should be limited to the firm's audit and assurance services because giving them oversight of the firm's non-audit business creates an unacceptable conflict of interest.

In summary, whatever arrangements the FRC proposes they should be consistent with the AFGC's purpose. We recommend that the FRC consults further on this aspect with a view to ensuring that the arrangements ultimately adopted in the AFGC have the support of the investor community.

**International application.** Our members invest internationally and want to know how consistency in audit quality is ensured and auditing standards applied globally. Given the importance of the global networks, the AFGC should encourage the firms and their INEs to explain how they engage with the firm's international network. The FRC is a UK regulator and we suggest that it works with the International Forum of Independent Audit Regulators (IFIAR) to develop a global audit firm governance code.

**Appointment of INEs.** Whilst AFGC Provision C.1.2 expects firms to disclose on the website information about the appointment, retirement and resignation of INEs, these disclosures do not appear to be always apparent. We would welcome more transparency around the appointment process. In particular, the AFGC could require a nominations committee which discloses the criteria used to ensure the INEs are independent. Due to the significance of audit firms to the market, the FRC should consider approving the appointment of INEs on the basis they are 'fit and proper persons' for the purposes of the AFGC albeit the process should have a 'lighter touch' than that used by financial services regulators.

**Accountability.** The boards, public interest committees and INEs need to be accountable. With the increased emphasis on the public interest, we consider there should be external monitoring arrangements to ensure the AFGC is implemented, and that disclosures/explanations are adequate. The FRC could set up such a monitoring body to oversee the operation of the AFGC and provide such accountability.

**Remuneration.** The AFGC is silent on remuneration issues. Whilst due to the different underlying framework, 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. This should be addressed in the AFGC.



***Alignment with the Corporate Governance Code.*** We consider that the AFGC should seek to be more aligned with the UK Corporate Governance Code. This could be addressed by introducing a rebuttable presumption that significant developments in the Corporate Governance Code are carried over to the AFGC. This would help deal with areas on which the AFGC is silent albeit there are some issues that would still benefit from an explicit mention in the AFGC, for example as noted above, remuneration. Moreover, just as the Corporate Governance and Stewardship Codes are reviewed every two years, we consider the AFGC should be as well to ensure that it remains relevant and achieves its purpose.

I trust that the above and the attached are self-explanatory but please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

**Liz Murrall**  
**Director, Stewardship and Corporate Reporting**

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

### 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."*

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

The Investment Association supports the AFGC's stated purpose as "working for the benefit of shareholders in listed companies" (paragraph 15), and the FRC's proposal that this should primarily be through the promotion of high quality statutory audits and the increased emphasis on the public interest. What is meant by public interest is not defined in the existing AFGC. We agree it is important that this is clarified so that the INEs are clear as to their role. We also consider it may be helpful for the FRC to provide guidance to assist the audit firms in determining what is expected of the INEs.

We particularly welcome the emphasis on audit quality and agree this should be the main focus of the AFGC. Audit practices within firms share operations, brands and reputations with service lines that are subject to little regulation. We consider that audit quality can be impaired by these non-audit services in that the significant revenues generated and the nature of the services can affect auditor objectivity and lead the firms to identify themselves with the interests of management rather than those of investors. Thus our members support the AFGC focusing on the oversight of a firm as a whole including its non-audit services provided this is in so far as these other services impact audit quality. That said, certain of our members consider that the oversight of those charged with governance, such as the INEs, should be limited to the firm's audit and assurance services because giving them oversight of the firm's non-audit business creates an unacceptable conflict of interest.

Lastly, whilst the Code has helped differentiate the firms from each other, it has not addressed choice in the market or reduced the risk of a firm exiting the market. We would expect the FRC through its enforcement activities to check that firms make contingency arrangements, but if the AFGC is to continue to have choice as an underlying objective (some of our members have questioned this) then we believe the AFGC should specify that this is part of the oversight role of the 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?*

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

If there were separate governance arrangements for audit, it would split the governance of the audit business from consultancy and if the INEs' role was limited to audit then matters arising outside that area that potentially impact audit would not come to their attention. Thus our members support the AFGC focusing on the oversight of a firm as a whole including its non-audit services provided this is in so far as these other services impact audit quality.

However, as noted above certain of our members consider that the oversight of the INEs should be limited to the firm's audit and assurance services in that giving them oversight of the firm's non-audit business creates an unacceptable conflict of interest.

In summary, whatever arrangements the FRC proposes they should be consistent with the AFGC's purpose. We recommend that the FRC consults further on this aspect with a view to ensuring that the arrangements ultimately adopted in the AFGC have the support of the investor community.

*"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?*

The Investment Association supports the principles based approach in the AFGC and that it is applied on a comply or explain basis. Specifically as regards 'tone at the top' we consider it can be important for the INEs to meet without the Executive so that they can discuss freely their assessment of 'tone at the top' and the professionalism of the firm in general. We note that the AFGC already provides for this in Provision C.1.1 but more transparency over what happens in practice would be appreciated.

*"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?*

The Investment Association's members invest internationally and want to know how consistency in audit quality is ensured and auditing standards applied globally. We understand that currently only EY operates a global structure but has only one INE in the UK – albeit he is considered an effective INE. Given the importance of the global networks, the AFGC should encourage the firms and their INEs to explain how they engage with the firm's international network. The FRC is a UK regulator and we suggest that it works with the International Forum of Independent Audit Regulators (IFIAR) to develop a global audit firm governance code.

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

## 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?*

The Investment Association supported the appointment of INEs to provide fresh insight and challenge. Provided the INEs are empowered and exercise informed influence, this should improve audit firm governance and transparency, and thus audit quality. It is important that the INEs' independence is secured and can be demonstrated. Whilst we have not identified any conflicts arising that were not addressed, we agree with the Consultation Paper that the AFGC should address:

- A firm appointing a serving partner as an INE. Although not specifically covered in the AFGC, its Appendix notes the need for careful consideration if the appointment of a former partner is being considered.
- A firm tendering for the audit of a listed company of which one of its INEs is a NED. The NED should not participate in the selection of the audit firm and should resign from the INE position should the firm be appointed.

We also have some concerns about the current text of the AFGC which states that the INEs' duty of care is to the firm (C.2) and that "they have a right to report a fundamental disagreement regarding the firm to its owners" (C.3).

We consider the INEs' duty of care should be to the public, as opposed to the firm, and that AFGC provision C.2 is incompatible with the public interest objective now being emphasised. Nor do we consider that a right to report a fundamental disagreement to the firm's owners, the partners, is sufficient. INEs should have remedies to address concerns/disagreements particularly if factors are impacting audit quality. Such remedies should involve escalation to the regulator and not just to the firm's owners. The INEs role as regards a firm's partners is to influence them so as to ensure they adopt a culture that will deliver quality audits.

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?*

In a corporate board the independence of the non-executives can be assured in that they can be appointed and removed by outside shareholders. Some would consider the audit firms' current ownership structure may be a barrier to the effective oversight by audit firms INEs. A number of parties have looked into audit firm ownership rules: the FRC consulted on the matter in May 2008 and the European Commission in November 2008. No changes were proposed as a result and it appears unlikely that there will be any changes to the ownership structures in the medium term.

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

Whilst AFGC Provision C.1.2 expects firms to disclose on the website information about the appointment, retirement and resignation of INEs, we do not believe these disclosures are always apparent. We would welcome more transparency around the appointment process. The AFGC could also require a nominations committee which should disclose the criteria used to ensure the INEs are independent.

Moreover an audit is principally undertaken for the benefit of the shareholders as main users of the accounts. We are not aware of the audit firms ever consulting investors on the appointment of INEs. Investors may not necessarily have the resource to engage on each INE appointment but more transparency around the process would ensure that investors would have the option 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?*

The Investment Association considers that in view of the significance of audit firms to the market, the FRC should consider approving the appointment of INEs on the basis they are 'fit and proper persons' for the purposes of the AFGC albeit, due to the lesser risks, the process should have a 'lighter touch' than that used by 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?*

The Investment Association considers that it would be helpful to include all these aspects in the AFGC, subject to:

- 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 independent Chairman should be in respect of the firm's oversight body responsible for overseeing the implementation of the AFGC in that it may not be appropriate for the audit firm as a whole to have an independent Chairman.
- 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 AFGC, for example, there are no: safeguards to ensure the independence of the chair; clawback arrangements for remuneration (see question 14); and

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

provisions whereby the INEs should stand down where there are conflicts (see question 5). Any revisions to the AFGC 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?*

As regards accountability, audit firms are not listed, nor do they have outside shareholders with whom they engage and who can vote against company management if they are unable to resolve their concerns through dialogue. To address this issue, we consider it important that monitoring arrangements are introduced to ensure that the AFGC is implemented, and that disclosures/explanations are adequate and do not become standardised or boilerplate. Thus the FRC could set up a monitoring body to oversee the operation of the AFGC and provide accountability. It should be chaired by a senior member of the FRC and help to ensure that the Code is applied effectively and achieves its purpose.

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

A requirement could be added in the AFGC for audit firms to submit a report to the regulator. The existing transparency reports to some extent shed light on how audits are done, but do not tend to convey any 'bad news' and report 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 AFGC to have an independent evaluation, albeit some of the firms have done this voluntarily. We consider there should be a requirement in the AFGC for a periodic externally facilitated evaluation.

Whilst the firms have sought to provide the transparency expected in the AFGC, it would be helpful if they adopted a more tailored approach and clearly and concisely disclosed how they have fulfilled each of the provisions of the Code or explained where not. Investors would particularly like more transparency around the roles and work of the INEs as set out below. Moreover, the transparency reports are central to the firms' accountability. The firms should seek to identify those investors that have significant holdings in their audit clients and ensure that the reports are sent to them.

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

## 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 AFGC or give a considered explanation. On cost benefit grounds, we accept that 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 were concerned that only applying it to firms that audit more than 20 listed companies could result in an unintended "threshold effect" for firms that find themselves just below the threshold and impact the market. We do not agree with 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 convenor 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 Code should be owned by the FRC.

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

The main auditing firms have a key role in the capital markets and on this basis, if they audit public interest entities, then broadly we consider they should be subject to the same corporate governance requirements as other public interest entities. The AFGC fulfils a number of the key elements of the UK Corporate Governance Code. However, we are disappointed that the AFGC is silent on remuneration issues. As noted in the covering letter, investors have had concerns that a firm's internal governance may be more disposed towards maximizing revenues as opposed to audit quality and transparency. Whilst due to the different underlying framework, 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. We believe they should be addressed in the AFGC.

We also consider that the AFGC should seek to be more aligned with the UK Corporate Governance Code. This could be addressed by introducing a rebuttable presumption that significant developments in the Corporate Governance Code are carried over to the AFGC. This would help deal with areas on which the AFGC is silent albeit there are some issues that would still benefit from an explicit mention in the AFGC, for example as noted above, remuneration. Moreover, just as the Corporate Governance and Stewardship Codes are reviewed every two years, we consider the AFGC should be as well to ensure that it remains relevant and achieves its purpose.