Ernst & Young LLP
1 More London Place
London
SE1 2AF

Tel: + 44 20 7951 2000
Fax: + 44 20 7951 1345
ey.com

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

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

1st September 2015

Direct line: 020 7951 6174

Email: savarley@uk.ey.com

Dear Ms Currie

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

We welcome this opportunity to comment on the Financial Reporting Council's (FRC's) consultation on *The Audit Firm Governance Code: A review of its implementation and operation.* In particular, we support the Executive Summary conclusion that the Audit Firm Governance Code ("the Code") "should continue to be sufficiently flexible to allow firms to apply it in ways which best suit their governance structure."

Our detailed comments and responses to the specific questions raised by the FRC in the consultation paper are included in Appendix I. We set out below our key observations and more general comments.

Introduction

The Code is, of course, "the result of a recommendation made in October 2007 by the Market Participants Group set up by the FRC to advise it on its work on 'Choice in the UK Audit Market'. The recommendation was that 'every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice governance guide or give a considered explanation.'"

To develop the Code "the ICAEW formed its independent Audit Firm Governance Working Group (the Working Group) under the chairmanship of Norman Murray (Chairman of Cairn Energy PLC) to carry out and complete this work." The Working Group took the UK Corporate Governance Code as its starting point and carried out an extensive consultation exercise with stakeholders (as described in the Introduction to the Code). The Introduction also highlights that, amongst other things, the Working Group:

- "… sought to discharge its responsibilities in a proportionate way that secures wide support for the Code and demonstrates a practical application of evidence-based public policy making."
- "… conducted two wide-ranging formal consultations: the first to gather evidence on key issues to inform drafting of the Code; and the second to obtain views on a draft of the Code."

We agree that it is appropriate, as recommended by the Working Group, for the FRC to review the implementation of the Code four years after it came into effect. However, in carrying out this review it is

important that the conclusions reached by the Working Group are revisited and understood – even if, with hindsight, the FRC believes some of these conclusions no longer hold.

In particular, it is important to be mindful that the Corporate Governance Code operates in a context that has important differences to that of audit firms and partnerships in general. Companies' legislation recognises, amongst other things, that the owners of companies do not always have visibility of the business and so seeks to protect the remote owners. For listed companies within scope of the Corporate Governance Code the remoteness of owners is particularly acute.

With the partnership model, however, owners are not remote but are actively engaged and/or have visibility over the business, which is why some of the provisions of the Corporate Governance Code are not appropriate. This was reflected by the Working Group in the Introduction to the Code where it reports that: "While acknowledging that listed company governance codes provide an important point of reference for developing the Code, the Working Group recognises that audit firms are generally owner-managed partnerships, whereas listed companies need to address issues arising from the separation of ownership and management interests. For this reason, the Working Group has been selective in drawing on material from the UK Corporate Governance Code."

Companies' legislation also recognises that although directors owe a duty of care to the company, they must have regard for wider societal issues when running the company. As we discuss in Appendix I, we believe that this model should also be applied to Independent Non-Executives (INEs).

Key points

- ***The review and consultation process:***
    - Whilst the extent of consultation with different groups of stakeholders is not entirely clear from the consultation paper, the level of consultation and the involvement of stakeholders does appear to us to be significantly less than when the Code was developed. We recognise that the consultation is the "first stage of that [four year post implementation] review" but believe that, as part of the second stage, the finalised proposals to amend the Code need to be exposed for more detailed input from stakeholders and be subject to a full cost-benefit analysis. It would be helpful if the FRC could clarify the next steps in the review process.
    - As noted above, there were reasons why certain Corporate Governance Code provisions were not included in the Code, yet in asking a general question about which Corporate Governance Code provisions to include, there is no reference to the reasoned thought that went before or who the Code is focussed on (i.e. that the Corporate Governance Code is designed to protect the interests of remote owners). As discussed previously, it is important that the conclusions reached by the Working Group are revisited, understood and re-evaluated.
    - We are not sure whether the review has considered all of the principles of the Code. The review of Principle F (Dialogue), and specifically F.3 (informed voting rights principle) does not seem to us to be an in depth review - rather it focusses on what firms do. We believe that the FRC should also consider how stakeholders are using dialogue and voting rights in relation to the appointment and reappointment of auditors and what could facilitate this process.

- ***Governance and oversight:***
    - It seems to us that the concepts of governance and regulation have been used interchangeably in parts of the consultation and overall the review seems to be pervaded by a regulatory, rather than a standards, outlook. A 'comply or explain' governance Code will, of course, not necessarily provide a solution to perceived regulatory issues but can complement regulation. This point attracted comment from the original Working Group which stated that: "One of the key features of the Code, the appointment by the firms of independent nonexecutives, reflects the belief that regulation is not a substitute for effective governance and that good governance complements regulation in promoting audit quality."[1]
    - We note from para 36 that firms have given the FRC "strong arguments" to explain why they have adopted particular models of governance but that the FRC believes that "the firms will not meet the Code's objective of creating investor confidence in governance unless they explain well why their model has been chosen and why it makes more sense for their firm than the alternatives."
    - We agree that there is scope for improvements in the way that firms describe their approach to governance and believe that provision A1.2 of the Code should be expanded to require a discussion of the governance of the wider network, why the firm has adopted particular structures and how the firm has satisfied itself that its governance structure has contributed to the safeguarding of audit quality.
    - We believe that firms could do more than put Transparency Reports on the website but ultimately it is incumbent on investors to read and challenge them. We also feel that greater granularity from the FRC, as a standard setter, and investors as to how firms – in particular, network firms - could improve their Transparency Reports would be helpful.
    - The consultation appears to take a narrow view of what constitutes governance in places and could be read as asserting that fresh insight and challenge principally comes from INEs. As we reported to stakeholders in Volume 1 of the EY UK Transparency Report 2014: "EY is unique amongst all the large audit firms in its governance arrangements. Through the process of global integration completed several years ago, our UK Board and management (the UK team) is subject to oversight from higher levels of Area (EMEIA) and Global leadership. The UK team is subject to regular review of its actions and its performance across all areas of business activity and benchmarked relative to comparable firms elsewhere in the world. Whilst decision making is primarily local, the regular review process provides another level of informed challenge to intended decisions and plans. And to reinforce the importance of engaging with the challenges that are made, the remuneration of the UK team requires concurrence at an Area level."

      This approach applies to all our service lines, but there are particular features that apply to the audit practice. For instance:

        - Certain kinds of decisions on audit engagements require prior approval at an EMEIA or Global level so that we obtain globally consistent outcomes where the fact patterns are the same

[1] Introduction to the Code

- The audit engagements that are selected for our internal quality inspections are approved at an EMEIA level so as to avoid an inappropriate population being selected
- Our UK Audit Independence team is accountable to Global Independence Leadership and its decisions are subject to their review.

We do not believe that the series of checks and balances creates inconsistency between the making of strategic decisions and compliance with national regulation. Indeed, compliance with national regulation is a component of strategic decision making for all businesses that have cross border activities. We are also of the view that EMEIA oversight would function as an additional route for regulatory engagement in the event of a crisis at a national level.

- ***The Public Interest***
  - We agree that the societal value of the audit (and audit related work) should be at the heart of the Code. The role of the Code and the "independent" element of the governance structure must be to provide a level of assurance that audit firms remain focused on that principle goal.
  - We therefore think that it would be helpful for the FRC to bring the definition of the "Public Interest" into the Code and in doing so balance the responsibilities of INEs. Clearly, INEs must owe a duty to the firms they work with, but they must also be satisfied that the firm appropriately recognises the societal role it plays and its obligations to wider stakeholders. Being explicit on this point would we believe strengthen the Code and provide helpful clarity to INEs and potential INEs.

- ***The location of INEs***
  - We are concerned that the FRC sees risks in having decision-making and governance arrangements for UK-based firms taking place "overseas", as the governance duties of UK listed multinational firms are often undertaken by non-UK residents. It may be that we have misunderstood the thrust of the point being made here but describe below our concern based on the language currently used.
  - As a study of the composition of FTSE100 companies' boards demonstrates, at least 10 FTSE100 companies have 50% or more non-UK resident directors on their boards and at least 30 FTSE100 companies have three or more non-UK resident NEDs.
  - We can find no reference in the UK Corporate Governance Code to expecting only individuals who are UK based to serve as NEDs. Given the FRC's interest in aligning the Corporate Governance Code and the Code (as discussed at paragraph 82) it would seem to us anomalous to have reservations about individuals who are not UK based serving as INEs. It also seems inconsistent with the Government's and FRC's focus on encouraging diversity in Boards.
  - Audit firms do, of course, have a unique public interest role in respect of UK statutory audits. Therefore, the issues seems to us to be one of knowing and, if necessary, being able to hold accountable any non-resident INEs, rather than implying that only UK-based individuals

should undertake UK governance duties. This is an issue that was addressed by the Financial Services Authority in their approved persons regime[2].

- ***The future of the Code***
    - We agree that the FRC should own the Code going forward but we believe that it should sit in Codes and Standards alongside the UK Corporate Governance Code i.e. as part of the FRC's work as a governance standards setter.
    - We agree with the conclusion in the Executive Summary of the consultation paper that: The Code should "continue to be sufficiently flexible to allow firms to apply it in ways which best suit their governance structure"[3]. As discussed above, if there are concerns firms need to provide better explanations.

We hope that you find our comments helpful. We should be happy to expand upon and discuss any points in more detail, so please do not hesitate to contact me if you would like any further information.

Yours sincerely,

Steve Varley

UK Chairman

[2] See PS09/14 and CP08/25
[3] Page 1, para 3, bullet point 5

Appendix I: Responses to specific consultation questions

Purpose

- ***Firstly, and most importantly, is the stated purpose of the Code still valid?***

  In our view some of the benefits of the Code have been secured and others not. In particular:

  - the choice of auditor has not yet been enhanced;
  - we do not think the Code per se is a suitable tool for enriching Transparency Reports and, as a 'comply or explain' governance code[4], we do not see it directly strengthening the regulatory regime[5];
  - we do not think that the provisions of the Code will *prevent* firm failure or that INEs should be held to account for failure. The Code makes a helpful contribution to that outcome but we believe that prevention of failure to be too high an expectation, particularly as this a corporate governance Code rather than regulation.

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

  As an overarching comment, we assume that, as part of its review, the FRC has gone back to look at why the Code's purpose was defined in the way that it was in 2010? It seems to us though that the FRC's proposed redefined purpose of the Code, as set out in para 16, is very narrow and regulatory in its focus, whereas a corporate governance code should also be about both the success of a business and the protection of its owners.

  We support the proposed redefinition of the public interest discussed is para 16 to 18. We are, however, uncertain about the interconnections between this redefinition and the reference in para 58 to what the FRC believes the public interest rests on. It would be helpful to have clarification as to which expression of the public interest represents the decided view.

  More broadly, we would like to see the overarching importance to the public interest of people and culture – the latter being dependent on the tone set from the top - being highlighted.

  We would also caution that confusion could be caused by a definition of public interest in the Code that is different to the definition used for professional ethics purposes (including in the new ICAEW guidance on acting in the public interest). As the term 'public interest' can be emotive, perhaps a different phrase could be used in the Code (e.g. wider societal interest).

  Whichever term is decided upon, it is also important that references are used consistently i.e. the objective of improving clarity is not fully captured by the current references to:

  - "societal value"
  - "public confidence"
  - "public disquiet"

[4] Para 2
[5] Para 9

- "accountable to the public"

Whilst we recognise that these phrases are used within the text of the Consultation and not the draft Code text, the phrases reintroduce concepts present in earlier representations of the public interest and are open to a number of interpretations as to their scope and scale. If they are not capable of having principle based boundaries placed around them then we recommend that such terms are not introduced into the Code itself.

Safeguarding audit quality

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

We agree with the FRC's summary in para 60 regarding how the public interest arises in audit firms. As the FRC highlights, audit firms are "major employers and contribute significant to the UK economy", so we also believe that the Code should acknowledge that it is in the public interest that we are successful and grow.

We note from para 62 that some INEs have "compared the culture of the consultancy business in [their firms] negatively with that of the audit practice…". We would be keen to understand the basis for asserting that integrity, scepticism and independence do not apply "to the same degree" in consultancy work.

While we acknowledge that the application of scepticism and independence is different in audit, we believe it would be wrong to conclude that these values are of lesser importance outside of audit because they are unnecessary ingredients for the safe and effective delivery of all the professional services we provide.

On the contrary, we have a single ethical culture, a single set of values that we deploy to all our service lines (not just audit) and annually conduct quality review programmes in each service line. Also, as you will be aware, all of our partners are subject to the ethical requirements of ICAEW and this reinforces both the outlook of partners and our oversight of them.

For these and other reasons referred to in this response, we consider it would be unwise to allow any partner to believe they might be able to conduct themselves to a different standard of values by virtue of falling outside an audit ring fence. Indeed, it would also be inconsistent with their duties as Associate Members of ICAEW and with our responsibility for overseeing their conduct.

In our view, separating the governance structure for audit from the governance structure of the rest of the firm is not the answer. A ring fence would be entirely impractical when personnel from service lines, other than audit, undertake work in support of audits and it could also detract from the focus on and investment in audit quality. In our view, the focus should be on strengthening or increasing the transparency of the governance of the whole audit firm, ensuring there is sufficient investment in audit and significant risk management resources and controls. We also believe that INEs need to retain a broader view of firms to fulfill their public interest responsibilities.

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

  As noted previously, we would like to see the overarching importance to the public interest of people and culture – the latter being dependent on the tone set from the top - being highlighted in the Code.

  Tone from the top is of course fundamental to the delivery of high quality audit but it is ultimately intangible and what matters is not what is communicated but what is heard. Rather than including requirements on how 'tone from the top' is cascaded within a firm, we therefore think it would be more useful for the Code to have a provision addressing the disclosure by firms of the metrics they use to measure the effectiveness of its tone from the top communications. We note that many of the firms have already started to make disclosures of this nature

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

  We do not feel qualified to agree or disagree that the concept of the Code should be spread elsewhere in the world. We suggest that a detailed study of the regulations, the business and professional environments, the socio-political factors and the oversight regimes pertaining to audit firms and a full cost benefit analysis would be necessary before one could conclude on the merits of this proposal.

  As you will be aware, though, EY has chosen to develop certain policies and procedures at a global level and supplement these with country-specific policies and procedures to take account of higher requirements or local specificities. However, mandating the application of the Code on an extra-territorial basis could create conflicts with domestic legislation and could prompt a proliferation of divergent Codes. We suggest that the FRC asks IFIAR to consider developing a high-level international Code that could create an overarching international framework.

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

  We agree that the role of INEs needs to be better understood by some stakeholders. The preamble of the Code sets out the role of the INE's – in doing so though it does not include a duty of care. We assume the FRC gone back to understand the Working Group's rationale for including such as duty?

  Specifically as regards independence, though, it would be helpful to understand why the FRC believes that protection is not currently provided by provision C.2 of the Code.

  Under The Companies Act 2006, a director of a company (including a NED) has a duty to act in the best interests of the company and ultimately the members but in making decisions he/she must have regard for a number of external "public interest" matters[6] including:

  - the impact of the company's operations on the community and the environment

[6] CA2006, section 172

- the need to foster the company's business relationships with suppliers, customers and others; and
- the desirability of the company maintaining a reputation for high standards of business conduct.

This provision illustrates that a duty to a company and responsibilities to wider stakeholders are not mutually exclusive.

If the FRC considers it appropriate to make changes to provision C.2 of the Code then we would suggest aligning the INE requirements with those of directors though the introduction of a similar duty to have regard for public interest matters whilst still owing a duty of care to the firm.

Beyond that, we believe that the independence of INEs is taken very seriously. For example, the conduct of the INE and of the firm cited in the second example in paragraph 77 clearly reflects that independence was considered and it is not clear to us that the Code requires further changes.

- ***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 agree that it would be helpful for firms to be more transparent about how INEs are appointed and the attributes the firms are looking for in new INEs.

  Including such information in firms' Transparency Reports would give stakeholders an opportunity to review and engage directly with the individual firms if they have concerns with respect to the process.

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

  We do not believe that a case has been made for a process that is substantially different to the appointment of NEDs by listed companies. We also believe that without a formal approval process (similar to the FCA/PRA's approval of individuals), the FRC would be opening itself up to legal risk by becoming involved in, or having a right of veto over, the appointment process. If however the FRC believes it needs a formal power in this regard, it would be clearly acting in a regulatory capacity and such a requirement should not form part of a governance Code.

  As discussed above, we agree that there should be greater transparency over the process to appoint INEs and the criteria that firms are looking for and clearly such transparency would also enable the FRC to raise concerns with individual firms.

- ***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 Corporate Governance Code was the starting point for the original Working Group and a significant amount of work was done to consider which provisions to include in the Code, including consultations with the FRC. Has the FRC gone back to ascertain why the Group

chose not to include particular provisions of the Corporate Governance Code? We believe it is important to reflect the considered conclusions of the Working Group when revisiting the extent to which there should be read across between the Corporate Governance Code and the Code.

It is also important to be mindful that the Corporate Governance Code operates in a context that has important differences to audit firms. Companies legislation recognises, amongst other things, that the owners of a company do not have complete visibility over the business and the Executive Directors and so their interests need protecting (e.g. by a minimum number of Non-Executive Directors on the Board and an independent Chairmen). In audit firms, however, the owners are directly engaged and have visibility over the business. For that reason, many of the provisions of the Corporate Governance Code do not directly translate to partnerships or the need to safeguard the public interest rather than the owners' interest and need careful consideration.

We are not convinced, however, that making these matters Code requirements would have a material effect on the confidence in the Code. Moreover, any provision in the Code considered for inclusion has to be subject to the test of how it would enhance the audit quality of the firm.

Accountability

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

  As discussed above, we believe that the duties of INE's could be clarified by including a s.172 CA 2006 type provision that requires an INE to have regard to public interest matters while still owing a duty of care to the firm.

  Having a duty of care to the firms is not a novel concept in that, as we also discuss above, it exists with respect to the role of directors in public companies – albeit that the common law duty of care and skill is codified in the CA2006 *Duty to exercise reasonable care, skill and diligence*. Hence, we do not see it as inappropriate for INEs of firms to be expected to act with care whilst discharging their duties. For example, INEs and NEDs have access to highly confidential information which they should use with care and keep confidential.

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

  We agree that the FRC's engagement with the INEs is a helpful process and support the current informal arrangements being incorporated in the Code.

  We strongly support whistleblowing schemes and protection. However, such whistleblowing arrangements are generally not extended to directors by virtue of the duties placed on them by the Companies Act 2006. Under the Prudential Regulation Authority and Financial Conduct Authority's approved persons regimes there is "no duty on an approved person to report such information [under Statement of Principle 4] directly to the regulator concerned unless he is one

of the approved persons responsible within the firm for reporting matters to the regulator concerned."[7] We believe that this is a sensible approach.

Our instinct though is that our current arrangements would enable INEs to discuss whatever they consider appropriate with the regulators and, in the event of disagreement with management about disclosure, for the INE to resign; making whatever external statements they feel appropriate. This feels to us a more appropriate approach given the INEs position in the organisational hierarchy and the FRC might wish to consider enshrining a formal statement of reasons for an INE's resignation within the Code.

- ***Is greater transparency sufficient? What else can be done?***

  The EY Transparency Report already includes KPIs and an INE report. Whilst it is a matter for the INEs, in our view, we think that the INE report is best focused on matters that inform shareholders about the INEs' thoughts and conclusions from their oversight of audit quality and the firms' reputation more generally – an output based report. We see limited merit in in an input based approach that documents process and focusses on what the INEs have done rather than what they have found/concluded.

  We agree though, that there is scope for improvements in the way that firms describe their approach to governance and believe that provision A1.2 of the Code should be expanded to require a discussion of the governance of the wider network, why the firm has adopted particular structures and how the firm has satisfied itself that its governance structure has contributed to the safeguarding of audit quality.

  We would encourage the FRC to continue to review Transparency Reports and to gather views of users as part of that acivity. We believe that such a review would help promote innovation and could also be a helpful process for the FRC to reflect the views of users.

  We are not clear about the merits of a viability statement by audit firms. Whereas in in a corporate context the viability statement is intended to help creditors and shareholders understand the specific risks by entities in the context of their diverse business models, the major audit firms all have essentially the same business model and are all exposed to a catastrophic loss of confidence. Given that, rather than looking to a viability statement modeled on the Corporate Governance Code we think that this Code should require a statement in the firms' Transparency Report about their continued commitment to remaining an audit firm.

Other issues

[7] APER 4.4.5G

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

  This question is best answered by stakeholders and those firms which would be subject to the Code for the first time, it its scope were to be extended. We would note, however, that extending the Code to cover the 40 or so firms that audit a listed company does not, in our view, feel like proportionate regulation, given the disproportionate cost to a firm that only audits one or two listed companies. We assume that any extension of scope would be supported by a full cost-benefit analysis.

- ***Do you have any comments on the role of the FRC in this context?***

  We agree that the Code should be owned by the FRC. In particular, as a governance code, we believe that it should fall under the responsibility of Codes and Standards.

- ***Do you have any further comments on any of the issues raised in this report?***

  We believe that the FRC's final proposals should be evidence-based and subject to full cost-benefit analyses.