



Financial Reporting Council

# **FRC Audit Firm Governance Code**

## **Feedback Statement**

April 2022

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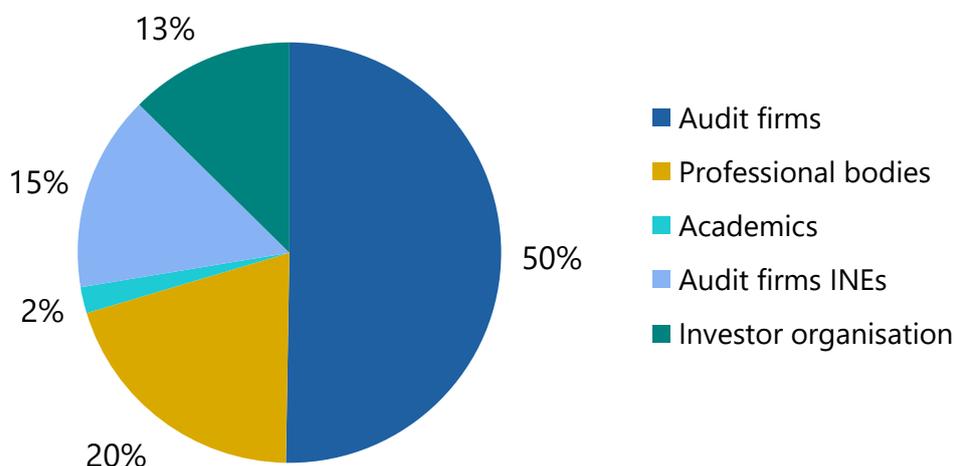
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# Introduction

1. On 26 August 2021 we published our [consultation] on revisions to the Audit Firm Governance Code. The consultation followed a review of the operation of the current Code and input from stakeholders.
2. The proposed changes were intended to:
  - strengthen the Code in those areas where we had identified gaps in the 2016 Code or weaknesses in firm implementation;
  - provide greater clarity in areas where stakeholders tell us the 2016 Code is insufficiently precise or detailed;
  - reflect recent developments in good governance practice;
  - eliminate or reduce overlap with requirements based in law, regulation or standards;
  - align the Code with the language and intent of the new International Standards on Quality Management (UK); and
  - establish the boundaries between the responsibilities of Independent Non-Executives (INEs) and Audit Non-Executives (ANEs) in firms with operationally separate audit practices, currently the "Big Four"
3. The consultation closed on 18 November 2021, and we received 20 responses to it. The breakdown of those responding was as follows:

## Responses by type



4. In addition to the written consultation, we have engaged with stakeholders in a number of different fora. The feedback from these discussions largely matched that of the written responses.

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## Summary of responses

5. The majority of responses were broadly supportive of the proposed changes. Where concerns were raised, they typically focused on:
  - The definition of “public interest” in the light of the revised Code’s heightened focus on the concept;
  - Scope and in particular its proposed extension to any firm which audits one or more FTSE350 companies;
  - The respective responsibilities of INEs and ANEs;
  - Comply or explain and the extent to which firms which explain will be put at a disadvantage by either the market or the regulator; and
  - Global aspects and their impact on UK INEs.
6. Some responses queried the rationale for issuing a revised Code at this time, given the Government’s proposals following the *Restoring Trust in Audit and Corporate Reporting* White Paper. We have decided to do so as we do not believe that the proposed legislative changes impact significantly on the Code other than in relation to scope and Managed Shared Audit, both of which are discussed later in this paper.

### Public Interest

7. Although the consultation did not include a specific question on public interest, many responses referenced it, often in the context of the proposed revised purpose of the Code. There is a greater emphasis in the revised Code on the concept of public interest and in particular the role of the INEs in representing the public interest and considering what this means in the context of the firm’s audit and non-audit work.
8. There were concerns that INEs had insufficient guidance to enable them to discharge their public interest responsibilities and that they should be given additional guidance to enable them to do this effectively.
9. The “public interest” is an abstract concept which continues to evolve and for which there is no single definition. The Code highlights matters which would be relevant for consideration of the public interest in the context of audit firms: for example, whether the firm is operating in a manner which supports the consistent performance of high quality audit, the ability of companies to find an auditor capable of delivering a high quality audit and the resilience of the audit market as a whole.
10. The Principles of the Code also provide signposts to how one might structure a consideration of the public interest – for example those sitting under the sections on Leadership, Operations & Resilience and People, Values & Behaviour.
11. We do not intend to provide a detailed definition of the public interest. It is as noted above an abstract concept. It is also a dynamic concept – new developments can raise additional matters which impact the public interest, and we are keen that firms and INEs consider all relevant factors holistically and in a way which is meaningful for the particular features of their organisation rather than adopting a checklist approach. We also expect the concept of the public interest to be further debated as the Government’s proposals for reform of corporate governance and audit progress through the legislative process and this will provide further insight to this area.
12. In recognition of the appetite for additional guidance in this area we have however expanded the relevant parts of the Code to assist INEs and ANEs in their consideration of public interest matters. We would also encourage firms to develop their own material to assist INEs, ANEs and others in their governance function.
13. In response to feedback querying the extent to which public interest considerations apply outside of the audit practice we would highlight the following:

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- Although statutory audit may make up less than 25% of the business of the largest firms, their status as trusted brands relies heavily on their reputation as auditors;
  - The importance of whole firm culture irrespective of operational separation;
  - The public interest in audit firms themselves as significant economic entities; and
  - That threats to the resilience of an audit firm may arise outside of the audit practice, given that some services provided by firms, such as corporate finance advice, are inherently risky.
14. The Code will continue to apply to the firm as a whole, but section E recognises of the specific circumstances of firms with operational separate audit practices.

## Scope

15. Since 2010 the Code has applied to firms auditing 20 or more listed companies. The proposed revision changes the threshold to 20 or more Public Interest Entities (PIEs) or one or more FTSE350 companies.
16. There was broad support for the change from listed companies to PIEs, which mirrors the approach being taken in other regulatory contexts. However, the addition of the FTSE350 criterion was more controversial.
17. Several responses made the argument that bringing any firm auditing a FTSE350 company into the ambit of the Code was a disincentive to challenger firms in a market that is already highly concentrated.
18. Whilst we are mindful that the expansion of the Code's scope to include any FTSE350 auditors may function as a disincentive to challenger firms considering entering this market, the public interest in FTSE350 companies is such that it is important that their auditors have high quality governance. The Code is comply or explain, in respect of the provisions, so in the event of a new firm entering the market they can explain the reasons for a delay in applying a particular aspect.
19. The question of how this will apply in the event of Managed Shared Audit (MSA) was asked by a number of those responding. The revised Code is silent on MSA because at the time of the consultation being issued it was unclear whether the Government was likely to adopt this suggestion in the final legislation. In addition, the market for MSA is likely to take some time to develop and as a result the Code remains silent on MSA.
20. We shall continue to monitor developments in the market and the next iteration of the Code will address MSA as necessary. Given the public interest in the audit of FTSE350 companies we would anticipate that challenger firms that make the strategic decision to participate in MSA would consider how adoption of the Code would support their strategy. However, we will consult on this matter as part of the next update to the Code.

## Respective responsibilities of INEs and ANEs

21. Section E of the revised code applies only to those firms with operationally separate audit practices and introduces the concept of audit non-executives (ANEs). ANEs fulfil a similar role in the governance of the audit practice to that of INEs in the firm as whole. Sections D and E of the revised Code have been amended to stress this point.
22. We received feedback to the effect that the two roles were insufficiently distinct and that it was unclear what was meant by the term "mutual reliance" in the rationale for Principle S of the revised Code.
23. As set out in Principle S, the intention is for ANEs to provide oversight of plans, strategy and remuneration in the audit practice. In effect their role mirrors that fulfilled by the INEs across the whole firm.
24. The ANEs will not have full visibility of the whole firm activities being overseen by the INEs and will rely on updates from the INEs to judge whether there is anything elsewhere in the firm that impacts the audit practice. Conversely, the INEs will rely on the more detailed information considered by the ANEs to form a view on

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whether the audit practice is operating effectively. The common practice of appointing individuals as both INEs and ANEs supports this cross-over and reliance.

25. Some duplication may be inevitable and even valuable, but what is superfluous can be minimised by mutual reliance. The rationale for Principle S has been amended to include suggestions of how this might be accomplished. As well as developing their own guidance on what the public interest means for a firm (see paragraph 11), we encourage the firms with operationally separate audit practices to consider setting out where the boundaries and overlaps sit for their INEs/ANEs in the context of the wider governance structures of the firm (which vary from firm to firm).
26. We would reiterate that operational separation is only an expectation for the very largest firms. Separation may become a legal requirement in due course however there is no current expectation to extend beyond the Big Four.

### Comply or explain

27. Some responses suggested that firms which explain rather than comply with certain provisions of the Code will be placed at a disadvantage in the market as Audit Committees prefer firms to comply entirely and are wary of explanations.
28. We expect that Audit Committees will feel comfortable with a valid explanation from a challenger firm which sets out their intention to achieve full compliance in due course. We will look to address this in separate guidance to Audit Committees.
29. There was a further suggestion that firms explaining non-compliance with provisions rather than complying with them will be criticised by the regulator. We can confirm that this is not the case provided that a full explanation for non-compliance with provisions is provided in the transparency report, and all Code Principles are complied with.

### Global aspects

30. All of the large UK audit firms belong to global networks with varying degrees of cross-border integration. The activities of the rest of the network have the potential to impact the UK firm and hence the UK public interest and so there is an expectation in the revised Code that INEs have regard to internal issues anywhere in the network as well as wider geopolitical matters. This is of particular relevance to considerations on resilience. A problem elsewhere in the network could threaten the UK firm including its audit practice.
31. Some of the responses to the consultation expressed concern that INEs might not be in possession of all relevant facts about the activities of other network firms, particularly if the rest of the UK firm's governance structure is unaware.
32. For the avoidance of doubt, we do not expect INEs to be aware of international matters which have not been shared with the leadership of the UK firm. However, where such a matter does come to the attention of the firm's leadership, we would expect it to be shared with the INEs and ANEs on a timely basis.
33. The revised Code includes two provisions which make direct reference to a firm's global operations. The first of these (Provision 32) has been amended for consistency.

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# Impact

34. Our analysis prior to issuing the consultation indicated that the changes to the scope of the Code would bring an additional three firms within its ambit, one of which already applies it on a voluntary basis.
35. It is difficult to quantify the cost of applying the revised Code especially as the provisions are comply or explain. However, for those firms already applying the current Code we would not expect them to require any new systems or significant additional resource to make the appropriate changes to comply with the revised version.
36. From a qualitative perspective, the impact of the new Code should be an improvement in the governance of the major audit firms, building on the progress already made. It will also link in with other initiatives including the Government's legislative changes and the CMA review.



Financial Reporting Council

**Financial  
Reporting Council**

8th Floor  
125 London Wall  
London EC2Y 5AS

+44 (0)20 7492 2300

[www.frc.org.uk](http://www.frc.org.uk)