



## Review of the UK Audit Firm Governance Code

ICAEW welcomes the opportunity to comment on the *Review of the UK Audit Firm Governance Code* published by the Financial Reporting Council (FRC) on 8 December 2015, a copy of which is available from this [link](#).

This ICAEW response of 11 April 2016 reflects wide consultation, including with the Corporate Governance Committee whose members are drawn from the business, investment and public practice communities. The Committee informs our thought leadership and policy work on corporate governance issues and related submissions to regulators and other external bodies.

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## MAJOR POINTS

1. We welcome this chance to make comments on the proposed revisions to the UK Audit Firm Governance Code (the Code/ the Draft Code). Our comments reflect our commitment to the continuing success of the Code. We support the FRC's approach of limiting changes, and it is clear that the FRC has taken account of the feedback it has received from the review process. Please contact us if you would like clarification of our comments or if we can provide any other assistance such as facilitating closer dialogue between stakeholders.
2. We have presented our comments in two sections. In this first section we highlight our major points. In the second section we provide more granular comments on the Draft Code in relation to our major points and in relation to other issues.
3. We have concerns about some of the drafting that the FRC is proposing. The positioning of some of the amendments is illogical, some principles now cover more than one topic, and it would also be better to draw attention to new requirements by presenting them separately, for example:
  - the new annual reporting requirement for Independent Non-Executives (INEs) appears in the principle about the involvement of INEs (C.1), but it should be a separate provision attached to the principle about the rights and duties of INEs (C.3) and it should be listed in the governance reporting provision (E.2.1);
  - a new monitoring duty for INEs is included in the compliance principle (D.1) but it should be a separate provision attached to the principle about the rights and duties of INEs (C.3);
  - reordering of principles in section E is unnecessary;
  - rights and duties of INEs should be presented separately (C.3.1-C.3.6); and
  - principle D.1 should not confuse principles with provisions.
4. The ICAEW Working Group which originally developed the Code used the Corporate Governance Code as their starting point, so there has always been a strong relationship between the two codes. However we disagree with the FRC's proposal that firms should consider the key aspects of the Corporate Governance Code and, where appropriate, report on their conclusions. The FRC has not identified which of the Corporate Governance Code's main principles, supporting principles or provisions are key. We also see value in codes being standalone documents which can be understood in isolation.
5. Capturing and sustaining investors' interest in the Code is critical to its effectiveness. Ideally investors would take as much interest in the Code as in the selection of auditors for listed companies, but the very low number of consultation responses submitted by investors demonstrates that there is a long way to go. To help address this one of our suggestions is to extend the Code's reporting requirement to firms' dialogue with the shareholders of listed companies.
6. The visibility of transparency reports is a barometer of the Code's success, but the consultation feedback shows that transparency reports currently have inadequate reach and impact. For this reason we support the addition of viability statements and the new requirement for INEs to report on how they have worked to meet the purpose of the Code, and how audit quality has been safeguarded and the risks to it addressed.
7. Prescribing the number of INEs for a firm's most significant markets will be a barrier to international adoption of the Code. The proposed approach fails to recognise the interconnectivity of markets and obscures the Board's collective responsibility for all markets. The changes also go too far in relation to auditor independence which is an area where there are international variations.
8. The whistleblowing principle should be amended to reflect the emerging best practice of identifying a [Whistleblowers' Champion](#). Champions are responsible for ensuring and

overseeing the integrity, independence and effectiveness of the firm's policies and procedures on whistleblowing, including those policies and procedures intended to protect whistleblowers from being victimised. This oversight role could be played by an INE.

## DETAILED COMMENTS ON DRAFT CODE

### Introduction

9. The Introduction and the Draft Code both include multiple references to public interest. In our view these references are appropriate and a detailed definition of public interest is unnecessary.
10. The description of the purpose of the Code should be consistent throughout. The description used in the Introduction is preferable and A.1.2 and D.1 should repeat this description.

### A. Leadership

11. We disagree with the proposal to change 'management team' to 'management' in A.1.2. Middle managers and supervisors must not be inadvertently brought into scope. The following should continue to apply to the (senior) management team and not to all managers:
  - responsibility and clear authority for running the firm (A.2);
  - supply of information to members of firms' governance structures (E.1); and
  - an annual fair, balanced and understandable commentary on the firm's performance, position and prospects (E.3).
12. We disagree with the proposed approach to the interrelationship between the Code and the Corporate Governance Code in A.1.4, but believe that the Corporate Governance Code's principle A.2 about division of responsibilities, and the related provision A.2.1, should be copied into the Code.

### C. Independent Non-Executives

13. The involvement of INEs principle (C.1) should expressly state that INEs need to have visibility of the entirety of the business in order to provide effective oversight and protection of audit quality and capacity, and if there are differences between INEs' responsibilities for audit and non-audit services then these should be set out. The Code should also be clear that INEs' duty of care to firms co-exists with their responsibility to act in the public interest.
14. We support the new requirements in C.1 for INEs to report on how they have worked to meet the purpose of the Code, in particular on how audit quality has been safeguarded and the risks to it addressed. However, we would prefer these to be repositioned in C.3 and E.2.1. The reference in the Introduction to public interest committees being responsible for this report is confusing and it should be deleted.
15. We support the Code's objective of helping reduce the risk of firms exiting the audit market, which is especially important due to the risk of contagion between audit firms with mutual clients. However INEs' duties in C.1 and C.3.3 must be limited to preserving the audit capacity of their own firm.
16. Flexibility is important when encouraging international firms to adopt the Code voluntarily. For that reason we do not agree with the prescription in C.1.1 that two or ideally three INEs must be allocated to significant markets. In any event it is unclear what is a significant market, or whether the same INE can cover more than one significant market.
17. The rights and duties of INEs in C.3 should be presented separately with duties coming first. This may help avoid giving the impression that if some rights aren't met then some duties do not apply.

18. There must be confidence in the independence of INEs, and therefore we welcome the new requirement for specific terms for INEs in C.3.2.
19. It may be helpful to clarify in C.3.4 that the reference to legal action relates to legal action taken against INEs in relation to their work as an INE for the firm, and C.3.5 could make clear that the content of any independent legal advice will only be known by the INE as it will be confidential and may also be legally professionally privileged.

#### D. Operations

20. All of the principles are stand alone with supporting provisions, except amended principle D.1 which now includes a cross reference to provisions D.1.1-D.1.4. This is inconsistent and should be amended.
21. The new monitoring obligations for INEs in the compliance principle (D.1) should be included in a separate provision attached to the principle about the rights and duties of INEs (C.3). This would cover monitoring of: policies and procedures concerning compliance with legal and regulatory requirements and international and national standards; policies and procedures for individuals signing group audit reports; reporting on policies and procedures for conflicts of interest; and the firm's action on areas of concern identified by audit regulators.
22. The feedback statement does not detail why the review of people management policies has been removed from INEs through the deletion of D.3.2. This removal seems inconsistent with the new monitoring duties for INEs (D.1) and investors desire for greater transparency around INEs' oversight of firms' management and behaviour as referred to in the feedback statement.
23. The whistleblowing principle D.4 should:
  - make it possible to blow the whistle anonymously as well as confidentially;
  - be clear that the report received by INEs will not undermine anonymity or confidentiality of individual whistleblowers;
  - make it possible to blow the whistle about a wide range of matters, including but not limited to the firm's commitment to quality work and professional judgement and values; and
  - not describe policies and procedures as confidential given that they are to be disclosed on websites.

#### E. Reporting

24. We support the change of language in E.3.1 so that it mirrors the concept of viability statements in the Corporate Governance Code. However the requirement to describe principal risks and explain how they are being managed or mitigated should apply to firms and not to directors.
25. As the following are to be included in transparency reports they need to be listed in E.2.1:
  - the work of the firm's Board, including performance against any KPIs in place as referred to in the Introduction;
  - new INEs report (C.1); and
  - viability statements (E.3.1).

#### F. Dialogue

26. Firms should report on shareholder dialogue because this an area which needs improvement. The information disclosed may throw light on what is important to shareholders and when and how they choose to communicate. Principle E.2 should be amended so that F.2 on shareholder dialogue and F.3 on informed voting are included rather than excluded.

## Appendix 1

27. The reference to INEs witnessing a firm's commitment to the public interest should be deleted and replaced with text that makes it clear that INEs have an active duty to promote the public interest. INEs are not mere spectators, they must take a proactive role.

## Appendix 2

28. We do not agree with the proposed explanatory paragraph about auditor independence. This is a difficult topic which is dealt with comprehensively in specialist literature. Different countries take different approaches to auditor independence which means that international firms need flexibility.

29. The reference to an objective, reasonable and informed third party could be extended in the following ways:

- INEs and firms should think about whether the full range of their relationships and interests could overlap in ways which may lead third parties to question the objective functioning of any single relationship or interest;
- firms should consider whether reasonable and informed stakeholders would regard their choice of INE as contributing to their reputation, particularly in respect of audit work; and
- in cases of uncertainty it is better to take a cautious approach.