



PROPOSED REVISIONS TO THE AUDIT FIRM GOVERNANCE CODE CONSULTATION DOCUMENT

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ICAEW welcomes the opportunity to comment on Proposed Revisions to the Audit Firm Governance Code Consultation Document published by the Financial Reporting Council in August 2021, a copy of which is available from this [link](#).

ICAEW welcomes the opportunity to provide views to the FRC on the Proposed Revisions to the Audit Firm Governance Code. We strongly support the Code and its role in promoting public confidence in audit, however, we believe changes to the Code in isolation will not restore confidence. Our key concerns about the proposals are:

- Unclear expectations – it is unclear who will decide what is in the ‘public interest’, and how. More generally, expectations of Independent Non-Executives (INEs) are poorly defined and in places unreasonable.
- Excessive prescription – this reduces the Code’s ability to be proportional, scalable and flexible and sits uncomfortably with the ethos of ‘comply or explain’.
- ‘Code creep’ – the Code needs to keep to its clear purpose.
- Competition concerns – there may be an adverse impact on competition and choice in PIE and FTSE 350 audit markets.
- Lack of integration – there is a lack of integration with wider reform measures.

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KEY POINTS

1. We strongly support the Audit Firm Governance Code (the Code) and its objective of improving governance at the largest audit firms as a means of promoting public confidence in audit. This is a vital objective. There is much work for the FRC, as an improvement regulator, and the profession to do in taking forward BEIS's proposals for audit and corporate governance reform, and the Code can play an important role in helping to deliver those necessary reforms.
2. Effective corporate governance in any entity comprises a number of key players. In this instance, audit committees, potential investors and ultimately shareholders, are the key stakeholders for this Code. Such stakeholders need to have trust in the audit system overall and receive insightful information about individual firms to ensure they can make decisions based upon factors such as the culture of the firm, the nature in which the audit firm will add value and the quality of its audit process. However, investor engagement, in particular, cannot be taken for granted. Reform needs to be undertaken in a holistic manner to restore trust, ensure the UK and its companies remain an attractive destination for investment and encourage sustained and constructive engagement. The Code is an important part of the picture for reform, but it is not the complete picture.
3. We recognise that where possible the FRC should be taking action now, ahead of legislation, that revising the Code is an action it can take, and that revisions are desirable to support operational separation. But we are not convinced that making the proposed changes now, in isolation, will achieve the desired objective. Our key concerns about the proposals are:
 1. Unclear expectations – it is unclear who will decide what is in the 'public interest', and how. More generally, expectations of Independent Non-Executives (INEs) are poorly defined and in places unreasonable.
 2. Excessive prescription – that reduces the Code's ability to be proportional, scalable and flexible and sits uncomfortably with the ethos of 'comply or explain'.
 3. 'Code creep' – the Code needs to keep to its clear purpose
 4. Competition concerns – there may be an adverse impact on competition and choice in PIE and FTSE 350 audit markets.
 5. Lack of integration – there is a lack of integration with wider reform measures.
4. These concerns need to be addressed and a compelling, cohesive package of measures presented that achieves enhanced audit committee and investor engagement. A cohesive plan is needed for communication aimed at supporting audit committee and investor choice – risk focused AQR reports and the Audit & Assurance Policy form part of this, alongside the Transparency Report. Until there is a clear plan for these vital communications, it is too early to make changes to the Code.

Unclear expectations – it is unclear who will decide what is in the 'public interest', and how. More widely, expectations of Independent Non-Executives (INEs) are poorly defined and in places unreasonable

5. We are concerned about a lack of clarity in a number of the proposed revisions. These include clarity around the meaning of public interest and its application beyond audit practices, clarity around the distinction between Board and management and clarity around the role of INEs and, in the case of operationally separated firms, Audit Non-Executives (ANEs). What is meant in this context by the public interest is not adequately explained in the consultation. It will be for INEs to properly 'assess' the public interest. Even with a degree of further guidance it is difficult to understand how they are expected to do this.
6. INEs play a crucial role and have made a strong and positive impact in the governance of firms since they were introduced. It is vital that firms can recruit and retain the best individuals to this role. The lack of clarity around what is expected of them, coupled with

requirements that in some cases are unreasonable, may deter potential applicants and could adversely affect the quality of governance.

7. A balance is required between providing the high degree of clarity needed to enable revisions to achieve the desired outcomes, without resorting to a level of prescription that reduces the ability of firms to apply these revisions in a suitably flexible way. The FRC should make every effort to achieve this balance when finalising the revised Code.

Excessive prescription – that reduces the Code’s ability to be proportional, scalable and flexible and sits uncomfortably with the ethos of ‘comply or explain’

8. As indicated above, we are concerned about excessive prescription. Proportionality, scalability and flexibility are essential given the significant differences between audit firms. These include differences in structure and relationships with global networks, as well as in size. A ‘one size fits all’ approach is therefore unlikely to be workable. Indeed, we strongly believe such an approach would lead to a ‘lowest common denominator’ approach in firms, increasing the risk of homogeneity in the audit product and jeopardising the possibility of innovation in that product, something Sir Donald Brydon attached great importance to in his review into the quality and effectiveness of audit.
9. Given the subjective nature of many of the proposals and the iterative way they have been developed, clarity is needed around how the regulator will assess whether the desired outcomes have been achieved. Rightly, given these differences, the Code takes a ‘comply or explain’ approach. That is important, as not all the provisions will be appropriate in all circumstances – in particular, to those firms applying the Code for the first time. Prescription exacerbates these issues and sits uncomfortably with the ethos of ‘comply or explain’. If all firms that come under the Code have to behave exactly the same way, where is the choice for audit committees and shareholders?

‘Code creep’ – the Code needs to keep to its clear purpose

10. The existing Code has a clear purpose, which we support: promoting audit quality; securing the firms’ reputations; and reducing failure risk. The revised Code extends beyond this core purpose and its focus needs to be restored to what it needs to achieve. In particular, it is unclear how a firm is expected to define the ‘public interest’ and reflect that in its decision making. The consultation document notes that there was only ‘some support’ for this change and doesn’t explain why it was necessary to move away from an objective to secure the firms’ reputations, which is a more straightforward articulation of the public interest.
11. The revised Code extends its scope beyond the UK entity. Although it makes sense for INEs and ANEs to have an awareness of risk and controls in the firm’s network outside the UK and to draw on this information in discharging their duties, it does not seem to sit comfortably with their responsibilities to expect them to ‘assess the potential impact on the UK firm’. INEs are not in a position to assess global governance standards and, as worded, this requirement may simply be unworkable.
12. The revised Code also more explicitly applies to the whole firm. This seems to run contrary to the purpose of ring-fencing and the concept of operational separation, which the Big 4 firms are already embarking upon; we might have expected a firmer link between the Code and the audit practice. The ambiguity here illustrates how the purpose of the Code has expanded beyond securing audit quality and resilience.
13. Indeed, basing the Code on the Corporate Governance Code may be problematic given the differences between partnerships and corporates. It may also exacerbate confusion about the roles played by non-executives. Finally, it may diminish its scalability: the Corporate Governance Code applies only to premium listed companies, with other more proportionate frameworks available for other reporting entities.

Competition concerns – there may be an adverse impact on competition and choice in PIE and FTSE 350 audit markets

14. We are concerned that the burdens associated with applying the Code for the first time may deter audit firms from entering or remaining in the PIE or FTSE 350 audit markets. This could directly militate against the competition objective we expect ARGA will have in any proposed legislation and may frustrate market opening measures. Good governance is vital for challenger firms and transparency about this is important to support sound selection decisions by audit committees and shareholders. But the Code should be designed to facilitate market opening rather than acting against it and so a proportionate approach here is key. Revisions to the Code should be considered alongside other parts of the reform package.

Lack of integration – there is a lack of integration with wider reform measures

15. We also have concerns about the timing of the consultation and its proposed changes. Further revisions to the Code may well be needed following the outcome of the BEIS reform consultation and consideration of audit reform in Europe. The consultation acknowledges this and pledges to keep abreast of any developments. However, the consultation also concedes that consequential changes to the Code may be needed, once the Government's response to the White Paper is known. Such an approach will not ensure that efficient and tangible improvements to governance and quality are made.
16. Audit firms are facing major capacity challenges and are implementing a number of new and revised auditing standards, including the quality management standards, ISA 315 and others, which we expect to have a strong and positive impact upon governance and quality issues. We understand that some of the proposed changes result from audit firms requesting greater clarity around operational separation and the need for timely maintenance. We welcome an attempt to provide such clarity and maintenance.
17. However, changes to audit firms in isolation are unlikely to achieve the stated objective of promoting public confidence in audit. A 'whole' system approach to reform is needed, with a new regulator and changes across the corporate reporting system. Audit quality is not just about auditors, but about other players in the system. We encourage the FRC to integrate changes to the Code with the wider changes to the corporate reporting system to provide them with the best chance of promoting public confidence in audit.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: How appropriate do you feel that the revised purpose of the proposed 2022 Code is?

18. We support the current Code's purpose, which focuses squarely on audit quality and resilience. We agree with the change in focus to PIEs rather than listed companies, which should align the Code with wider reform. However, while we welcome the addition of a reference to the public interest, we believe this needs further consideration. It is unclear why securing reputations – and thereby resilience – has been dropped from the purpose. If the public interest is to be referenced, the Code needs at least to better explain its meaning and how audit firms are expected to decide what is in the public interest. Although the 2022 Code seeks to drive more consistency between firms, the lack of clarity over the definition of the public interest is troubling. For example, the requirement for INEs to report to the FRC if firms are not acting in the public interest could result in inconsistencies in reporting. We also note that the wording included on page 37 with INEs being 'accountable to' the public interest is problematic, as INEs have to determine what the public interest is which leads to a circular debate. As an example, under Section 475 of the Companies Act 2006, with certain exemptions, a company's annual accounts must be audited. However, under Section 516, an auditor may resign, and may for example do so because it does not think the entity has sufficiently high-quality internal controls. Given the need for statutory audit, should the INE or

ANE consider it in the public interest for the firm to continue with the engagement, despite the reservations of partners?

19. If the FRC wishes to continue with this change in purpose, it may need to consider the case for developing, after further consultation, further guidance to support audit firms in developing their own approach to determining what constitutes the public interest.

Question 2: What are your views on the proposed thresholds for application of the proposed 2022 Code?

Question 3: Should the proposed 2022 Code apply to any firm that audits a FTSE 350 company? Please suggest alternatives.

20. We are not convinced of the need for staggered thresholds. We also query the rationale behind the choice of 20 PIEs as the threshold, particularly given that many companies defined as PIEs have small market caps.
21. In addition, we believe there is asymmetry between the thresholds for the Code and the three-tier system of regulatory supervision used by the FRC. For example, performing 20 PIE audits would not necessarily result in a public report from the AQR. This is odd given that consumers should presumably be expected to read the Transparency Report alongside the AQR report in making selection decisions and shows the need to better join up this exercise with the wider reform programme. We would therefore encourage the FRC to consider the various thresholds in the round with a view to aligning them where possible.
22. We agree that where a firm acts for a FTSE 350 company, it should apply the principles of the Code. However, there are significant practical, administrative, and financial burdens associated with applying the Code for the first time, which may deter audit firms from entering the FTSE 350 audit markets. These include substantial financial implications, not only as one-off costs, but recurring expenses, for example the requirements to appoint INEs. We also note that entities move in and out of the FTSE 350, which gives rise to further concerns. Finally, the interaction with any new reform proposals on the definition of PIEs and managed shared audits may also need further consideration.
23. There are two competing key public interest considerations to consider. The first is to ensure well-governed audit firms are performing audits of PIEs and FTSE 350 companies. But the second is to ensure that there is a greater diversity of firms auditing PIEs and FTSE 350 companies, to help improve market resilience and inject greater competition and choice into the market. There is a danger that if the barrier to auditing these companies is set too high, then new entrants will be discouraged from entering the market, which could counteract market opening measures. In addition, to avoid coming into scope, existing audit firms with 19 PIEs or fewer may seek to maintain this level to remain out of the Code's scope. This becomes a hard barrier, with few firms perhaps wanting to cross the threshold. Unless this change is implemented carefully, incrementally and proportionately, it will disincentivise firms from entering or remaining in the PIE market.
24. Those firms who wish to be in the PIE or FTSE 350 audit market usually make an active decision to enter the market, and heavily invest in this as a preliminary step, with some considerable financial risk. Firms who are approaching the threshold are unlikely to be apathetic over whether they cross it. We suggest that the FRC monitors those firms who currently audit 19 PIEs or fewer but do not reach the threshold of 20, as a means of assessing the effect of not attracting new entrants into the market.
25. We note that some smaller firms have already made some of the changes proposed voluntarily.
26. However, a 'softer' barrier or gradualist approach may help to attract other new entrants to the market. It may be helpful to consider giving firms, say, two years to apply the Code once they have reached the thresholds. During this period, firms could explain the actions they are taking to implement the Code. Alternatively, an approach which mirrors that seen in the Stewardship Code could also be helpful for firms. Examples include requiring firms to apply

to the FRC first and the FRC performing early reviews of implementation to facilitate feedback to firms that throws light on FRC expectations.

27. A number of audit firms we have spoken to would value greater clarity around what the FRC considers to be the most important aspects of the proposals and the way these interact with the 'comply or explain' requirement. Firms welcome the opportunity to consider the principles of the Code, but we believe pressure to comply with them immediately may be counterproductive.
28. Where firms are close to the thresholds, providing additional support and guidance as a transitional measure could also be considered.

Question 4: What are your views on the proposed effective date of the proposed 2022 Code?

29. It is too early. It would be better to wait for the outcome of other connected parts of the reform package – including the powers and operation of ARGA, the Audit and Assurance Policy, and market opening measures – and then make changes to the Code in a holistic and coordinated way.
30. Following publication of a final version of the Code in Spring 2022, the proposed effective date of 1 January 2023 would only give some firms eight months to put procedures in place, for example, for 31 December year ends, as the Code will apply during the year and not just at the firm's year end. This represents a significant challenge for some firms.
31. This represents a significant amount of work to undertake, especially in addition to other changes required for the new and revised quality management standards as well as the implementation of new auditing standards. Confirmation over whether all elements of the Code need to be in place by this date or whether firms can start implementing some of the areas of the Code during their first accounting period commencing after this date, under the 'comply or explain' basis, may help. If the timing is to remain as intended, the FRC should provide assurance to firms that where aspects of the Code are not complied with initially, and instead firms take the explain approach, firms will not be unduly criticised as a result.
32. Recruiting high-calibre INEs can be time consuming. The 'comply or explain' element may need to be used in these cases, especially in year one of implementation. Firms that are newly in scope need time to implement changes and it is likely they will have to explain why they are not yet compliant along with the actions that they are taking to remedy this. Firms may benefit from confirmation that using the explain element in this manner would be acceptable as a transitional arrangement.

Question 5: What are your views on the priorities for engagement with investors, audit committee members and other external stakeholders and how could we encourage interaction with INEs?

33. Greater interaction between investors, audit committees and INEs is crucial. There is little value in maintaining the Code unless audit committees and investors find Transparency Reports useful. Audit firms and the FRC stress the importance of transparency, but note concerns about engagement by users with their current transparency reports. Adding more information to such reports, in the interest of serving multiple stakeholders, will likely only exacerbate this problem. Engagement with audit committees and investors is vital not only here, but also in the context of the Audit and Assurance Policy and market opening measures. The reforms need to be approached in a coordinated and cohesive manner so that these key stakeholders receive information they can use to make informed choices.
34. We agree that achieving meaningful engagement with users is not solely the gift of audit firms, but a two-way dialogue. Users need to be convinced of the value of such engagement. Nevertheless, encouraging engagement between stakeholders is important and we agree with the need to focus on the actions of these other groups, too.

Question 6: To what extent do you support the changes proposed in the areas of partner oversight and accountability to owners?

35. Clarity is needed around the distinction between Board and management and the role of INEs.
36. In larger firms, given the number of partners, it is feasible to have different representatives on different boards. However, within smaller firms, in theory there may be several different boards in operation but in practice it may be the same individuals on each board with partners who perform multiple roles.
37. The provisions are prescriptive and may be challenging to implement. Clarity is needed over the implementation timescales and the way implementation will be assessed by the FRC. Some firms may also value support from the FRC in this implementation. There are major differences in structures between firms and we believe proportionality and flexibility are key to successful implementation.

Question 7: What are your views on the proposals to underpin connectivity with the global network and monitoring of its potential to impact the UK Firm? Do you have other suggestions for how this could be addressed?

38. Some understanding of how the international network is governed and what impact this has on the UK firm is important. We understand that some firms with international networks are already addressing this with international representatives on different country company boards. However, caution is needed as a detailed understanding of the impact of these other jurisdictions on UK audit may not always be possible. In particular, the word 'assess' in the proposed Code in relation to global governance is concerning. This territorial reach beyond the UK may be simply unworkable. INEs are not in a position to assess global governance standards, but leadership should have a role in understanding the global network and assessing the risk on the UK firm with INEs overseeing the Board. The proposals do not reflect how the global firms operate, the views of the global networks and the autonomy of UK firms. Any attempts to extend the Code to non-UK parts of the network could pose legal challenges.
39. As with firm structures, there are major differences in relationships with global networks between firms and, again, we believe proportionality and flexibility are key to successful implementation and to foster an innovative, resilient and diverse audit market.

Question 8: How supportive are you of the approach taken to people and culture in section B of the proposed 2022 Code? Please include any suggestions for how we could improve it further.

40. We agree that the focus on people and culture is crucial and that this is a top priority for many firms. A major challenge is the attractiveness of the profession and having an overall focus on people first will be key to attracting and retaining talent within audit.
41. Where this section is problematic is, again, in relation to the expectations on INEs. The revised Code needs to draw a clearer distinction between executive and non-executive management. We do not believe it is appropriate to expect INEs to 'assess and monitor' culture as provision 15 states and question why the expectation is identical for INEs and firms in this regard. It is for firms to 'assess and monitor' culture and report on this to INEs so they can discharge their duties effectively.

Question 9: Are there any matters you believe we should include in section C that do not currently feature and/or can you suggest other improvements to how the proposed 2022 Code approaches operational matters and resilience?

42. We agree that engendering a positive relationship between firms and the FRC will be constructive for both parties and reflects principles of interaction with regulators already in place with the FCA and PRA. However, it is unclear at present how the FRC will approach compliance with the Code and the extent to which this will respect the 'comply or explain'

ethos. The prescriptive nature of a number of the changes suggest that there may be an expectation these are rigidly complied with, even though some of the provisions may not be appropriate to firm circumstances.

Question 10: Do you think that the proposed 2022 Code is clear enough about the role INEs play in the Firms?

43. No. Firms value what INEs have brought to their roles. INEs have been important in helping achieve enhancements in audit quality and resilience. Unfortunately, the proposed Code is unclear on what is expected from INEs and in some places may be unreasonable. It uses phrases that suggest INEs should be 'assessing' the firm and that they should 'have full visibility of the entire business'. We believe this terminology will exacerbate the confusion about the role played by INEs. Ultimately, we worry that such confusion and concern about expectations may be counterproductive and diminish the attractiveness of the INE role.
44. We also note that some of the proposed drafting in the Code is based on the Corporate Governance Code. This is problematic given the differences between partnerships and corporates. We are concerned there may be confusion about the role played by INEs and the consultation document is unclear and even excessive in its expectations for their role. As discussed above, we also have concerns in this context about the requirements to assess the public interest under Principle N.

Question 11: What are your views on the proposals for strengthening the status and role of INEs? Please include any suggestions for other ways to increase their impact and effectiveness.

45. Caution is required around the suggested role of INEs and careful thinking is needed on whether they can fulfil roles such as participating in nomination committees and involvement in remuneration reviews. They are not decision makers but should instead oversee management in this area. There is a line between management and INEs which needs to be more fully recognised and the difference between non-executives in a corporate entity and a partnership, for example with regards to voting rights, needs to be understood. We suggest the role of INEs needs significant further consideration.

Question 12: What are your views on the proposed boundaries between the responsibilities of INEs and Audit Non-Executives? Please give examples of any potential difficulties you foresee with what is proposed

46. Firms working on operational separation have also told us that they have been able to recruit excellent ANEs who bring challenge and focus to the role.
47. However, this question is symptomatic of the problems introduced by the proposed revisions – the proposed boundary is not clear enough and there is still considerable confusion between the role of INEs and ANEs that the Code does not address appropriately. One aspect is the mutual reliance needed between INEs and ANEs, which is wrought with challenge.
48. The changes resulting from operational separation are likely to differ between firms and this will have to be adjusted further when the Code comes into place. In addition, those firms bringing in INEs for the first time will likely have to implement significant structural changes within their firms which may be challenging.
49. With the introduction of the ring-fence, it might have been expected that this revision of the Code would focus its core scope on the ring-fenced firm. Instead, the proposed Code appears to widen its remit more explicitly to the whole firm, while then rather awkwardly appending incremental requirements for audit INEs. This fails to take into account the work Big 4 firms are undertaking with operational separation. While some provisions clearly need to apply at the whole firm level, it hasn't been articulated how the proposed changes reconcile with the original purpose of the Code, which is specifically to secure audit quality and resilience. Although resilience is a firm wide concern, it is in the context of the audit that

it becomes a matter of public interest. There is a real danger here of ‘code creep’ far beyond the audit practice.

50. Finally, we note calls for greater clarity around the independence criteria.