

6th Floor
2 London Wall Place
London
EC2Y 5AU

T (020) 7429 4100
F (020) 7248 8939
W macintyreHUDSON.co.uk



Shamima Hussein
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

By Email: afgcreview@frc.gov.uk

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Dear Financial Reporting Council

Proposed revisions to the Audit Firm Governance Code

We welcome the opportunity to comment on the Financial Reporting Council's (FRC) proposed revisions to the Audit Firm Governance Code ('the Code').

About us

We are a firm of chartered accountants, tax, and business advisers. From offices across the UK, we provide a full range of financial and business services to enterprises and individuals helping them to achieve growth and long-term success.

In the context of this consultation and other ongoing audit reforms, MHA MacIntyre Hudson is a challenger firm. We are currently auditor to two FTSE 350 entities and, because of the proposals in this consultation, we would be required to adopt the Audit Firm Governance Code in full as set out on page 8 of the consultation.

MHA MacIntyre Hudson is a United Kingdom member of Baker Tilly International. The views expressed in this letter are those of MHA MacIntyre Hudson.

For more details on our firm please visit <https://www.macintyreHUDSON.co.uk/>.

General observations

We are very supportive of the aims of the Audit Firm Governance Code (the Code) to improve governance at the largest audit firms, with a view to enhancing public confidence in audit. We summarise some general observations regarding the proposals below, before responding to the questions included in the consultation document.

Timing of the proposals

Whilst we appreciate that a cyclical review of the Code is due and we can understand that the FRC is keen to make progress ahead of the introduction of ARGAs, we do not necessarily believe that now is the time to revisit the Code in isolation of the developments arising from the recent BEIS consultation and wider changes which are likely to come in the next few years.

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We are particularly concerned that adoption of the code for new firms, such as ours, will be particularly challenging on the timeframe set out in the proposals. Firms are already facing significant challenges arising from implementation of the revised international quality standards and the major revisions to ISA 315 which require fundamental changes to our audit methodology by the end of 2022.

Nature of the code

It is not clear whether the code is intended to be prescriptive in the actions that firms are required to take or whether it is intended to provide a framework for firms to comply with. Although the principles in each section set out a useful framework, the provisions are then highly prescriptive regarding how firms go about implementing those principles.

Comply or explain

It is not clear in the proposals how the regulator will assess compliance with the code and, in particular, whether outcomes have been achieved by individual firms. We appreciate that the Code is established on the basis of “comply or explain” which permits some flexibility; however, it is unclear whether any of the provisions in the Code are “must haves” from the regulator’s perspective and in which areas more flexibility may be appropriate depending on a firm’s circumstances. This will be very important for firms transitioning to the Code when establishing their arrangements in the first year of adoption as it is unrealistic to expect full compliance immediately.

Lack of proportionality and flexibility

There is a wide diversity of firms to which the code will apply if the proposed changes to the scope are implemented and there is no one-size fits all answer to audit firm governance. The code does not take account of the proportionality and flexibility which is required to take account of differences between the firms to which it applies, or to the global networks of which those firms are members. A firm like ours will have a very different structure, relying on a smaller number of partners in key managerial and supervisory roles than, say, a Big 4 firm and it is essential that the code is flexible and proportionate in requirements around governance arrangements. Likewise, the structures and relationships with global networks will be very different with some more or less global operations and others which are a collective of highly independent firms with relatively little global direction or limited global requirements.

What is meant by “public interest”?

There is a lack of clarity in the definition of “public interest” and whether this concept is to be applied across all the activities of a multi-service professional services firm or just the audit practice, bearing in mind that what is in the public interest can be very different from what is of interest to the public.

Impact on the audit market and competition

There is a tension between what is in the public interest with regard to an individual FTSE 350 audit, addressed by the proposed change in scope to the Code, and what is in the public interest within the wider audit market where the proposals may negatively impact competition.

There is a very real risk that the burdens associated with applying the Code for the first time, in addition to other regulatory burdens already present, may deter audit firms from entering the PIE or FTSE 350 audit markets, or may even lead to firms deciding to leave the market. There has been precedence for this in other jurisdictions, most notably in the Netherlands where the market reaction to increased regulation was such as to reduce the number of firms in the PIE market, restricting competition and choice. It is imperative that proposed changes to the Code, alongside additional burdens associated with the BEIS consultation and audit reform, do not negatively impact on competition in the audit market.

Revolution or evolution – a new expectation gap?

It appears that some firms are already implementing many of the proposals as a result of the new international quality management standards along with the move towards operational separation. We are concerned that the changes to the Code are not therefore significantly shifting the dial on audit firm governance in many cases and there is a risk of an expectation gap arising if these proposed changes are presented as being revolutionary rather than evolutionary.

Other parties impacting on audit quality

Audit quality is not simply about auditors and effective change can only be achieved through the combined efforts of all those involved in the financial reporting ecosystem, including regulators, standard setters, boards, audit committees and users of the financial statements. As such, changes to audit firm governance in isolation are unlikely to achieve a significant change in confidence in audit. It is imperative that the changes to the Code are made in the context of wider ongoing audit reforms and changes to corporate reporting as a whole.

Response to Questions

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

We believe that the focus of the current code on audit quality and audit firm resilience are appropriate, and we are disappointed to see resilience removed from the purpose. We do, however, welcome the emphasis on PIEs rather than just listed entities in the proposals. It is also good to see the public interest referenced specifically in the proposals although, as noted above, we believe that further clarity is required as to the definition of public interest in this context.

We note that the 2022 Code seeks to drive more consistency between firms, although we are concerned at the lack of proportionality and flexibility to take account of the diversity of firms which will adopt the new code if the proposed changes to its scope are implemented.

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

We are not clear on the rationale for the choice of 20 PIEs as the threshold. The FRC has a three-tier system of supervision, and it would appear logical that any thresholds for application of the code be more closely aligned to that three-tier system (e.g. firms triggering the 20 PIE threshold wouldn't necessarily receive a public report from the AQR but would be required to adopt the Code).

Where a threshold of 20 engagements is in place, potential new entrants approaching the 20 entity threshold may seek to minimise new work to avoid the need to implement the Code, which again may impact on audit competition by deterring firms from taking on additional PIE engagements. There is plenty anecdotal evidence that this is already the case.

A more flexible approach to the adoption of the code, greater support for potential new adopters and a longer implementation period may make new entrants more amenable.

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

We note that the proposals on page 8 refer to the extension of the scope to firms that audit any FTSE 350 company and highlight that this requirement would bring one firm into the scope of the Code. That firm is MHA MacIntyre Hudson and we currently audit two entities in the FTSE 350.

Given the public interest associated with the largest FTSE companies it is hard to argue that the requirements of the Audit Firm Governance Code should apply to any firm auditing FTSE 350 companies. However, this is an area where the FRC needs to strike a balance between the public interest related to a single entity versus the wider public interest of a more diverse, competitive audit market.

There is a risk that this requirement is likely to prevent further challenger firms entering this part of the PIE Market as the requirements of the Code would likely be considered onerous in the context of a single audit. The same might apply to a firm which only had one FTSE 350 company and whether one audit alone would be sufficient to justify the additional requirements, and costs, of compliance with the Code. As such an audit firm may pull out of the FTSE 350 market if its presence were reduced to a single entity.

It is not clear from the proposals what the impact of managed shared audit, should it be adopted, would be on the need for Code compliance. For example, if a challenger firm was involved in managed shared audits of a single FTSE 350 company, would it be required to comply with the Code? Or would there be a minimum number of such audits which would trigger the need to comply. Also, entities move between segments of the FTSE market, and it is not clear what would trigger the need to comply if an entity were to move into the FTSE 350, nor what would happen should an entity drop out of the FTSE 350

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

We believe that the proposed effective date is too soon.

In our view it would be more appropriate to await the outcome of the BEIS consultation and any associated reforms and legislation (e.g. ARGAs, other competition measures etc.) before finalising the Code.

The implementation period for firms required to adopt the code of the first time is too short. As an example, if the code is finalised in Spring 2022 this would give a firm such as ours, with a March year end, just a year to put appropriate procedures in place. A firm with a December year end would have even less time. Given the pressures over the next year with the implementation of new international quality standards and revised ISA 315 it is unreasonable to expect a firm of our size to also make the changes required to ensure compliance with the Code.

Identifying and recruiting high-calibre INEs is likely to be a time-consuming exercise, particularly at a time when a number of firms may be looking to appoint INEs for the first time. This is an area where greater clarity could be provided as to how the comply or explain principle will work for firms adopting the code for the first time, as well as further guidance on first time implementation.

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?

We believe that enhanced interaction with stakeholders is important. It is, however, evidently difficult to engage with some stakeholder groups, in particular investors. If the FRC could crack the holy grail of investor engagement, this would likely be the single biggest achievement arising from the proposed revisions to the Code. We remain sceptical, however, as to whether this can be achieved in practice.

There has been talk about whether transparency reports are proving useful and whether, for example, Audit Committees and investors read transparency reports. Part of the reason for this lack of engagement with transparency reports has been put down to their length and complexity. The proposals suggest that more information should be reported, which would seem on the face of it likely to make such reports even less attractive.

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

The Code, as written, does not really reflect the diverse nature of audit firms, particularly those smaller mid-tier firms which are likely to be required to comply in the future. Much greater clarity is required around the distinction between executive and non-executive roles in smaller firms which may be less well defined, and where individual partners may sit on more than one governance body. Greater clarity is also required as to the role of INEs in effective governance in smaller firms.

As drafted, the provisions in the Code are too prescriptive and may not be appropriate for all firms. We would appreciate greater clarity over the timescale for implementation, as well as a steer as to how the regulator will assess the effectiveness of implementation, in particular what is appropriate in the year of adoption.

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?

In the same way that there is a diversity of firm structures, there are significant differences in how global networks operate and the relationships between member firms and the global network office. Greater flexibility is required in the code to ensure adoption is proportionate to the nature and scale of the firms and networks involved.

Whilst we appreciate that an understanding of how the UK firm interacts with its network, and how the network operates, is helpful but the requirements in this area cannot be too prescriptive as those relationships and interactions will be significantly different between networks. Some networks operate as more or less global operations whereas other networks are much operate with much less direction and prescription from the centre; the requirements of the code need to reflect this level of diversity.

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.

The profession is facing a huge challenge in attracting and retaining talent and it is imperative that all parties work together to address the attractiveness of the profession to the brightest talent. As such, the focus on people and culture is appropriate and is already a priority for most professional services firms.

It is important that the code reflects, however, that culture cannot simply be decided and switched on overnight. Developing culture will take many years and is a journey which is very difficult to measure at any particular point in time – as such it is not clear how firms can demonstrate, or how the regulator will assess, the effectiveness of compliance with the requirements of the code.

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?

We have no comments.

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

We understand from those firms which adopted the current code that the impact of the INE role has been positive. Taking forward the role of the INE is important; however, there are a number of areas where the proposals relating to INEs lack clarity and in our view some of the responsibilities of an INE may be such that they are likely to restrict firms' ability to identify suitable willing candidates for these roles.

The proposals are aligned to the corporate governance code which contributes to the lack of clarity of the role of the INE as partnership governance is very different to that of corporate entities. The role of INEs and how they interact with the responsibilities of the Board and management is unclear and there is too much of the proposed remit of the INE which rightly should be the responsibility of management. It is not clear why the INE would be expected to engage with investors and their ability to fulfil any role in assessing global networks is likely to be restricted.

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.

See also our comments in question 10 above. We believe that the enhanced responsibilities of an INE as set out in the proposals, allied with the lack of clarity in their role and remit, may lead to increased difficulty in recruitment of INEs.

We are concerned that there is a muddying of the water between the responsibility of management and that of the INE. For example, an INE being involved in nomination committees and involvement in remuneration reviews may not be appropriate in a partnership where there are differences to the structures and governance arrangements from a corporate entity. The INE should be overseeing management, and providing effective challenge, rather than making decisions.

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

We believe that the respective roles of INEs and ANEs are not clearly distinguished, and it is not clear how the mutual reliance expected is likely to work in practice. The role of Audit Boards remains unclear.

As noted earlier, the lack of clarity over the public interest, and its application to the audit practice and/or the wider firm, contributes to the difficulties in defining boundaries between the INE and ANE as there will be overlap in the role of the INE with the audit practice and with the whole firm.

Yours faithfully



Dr Paul Winrow

Technical Partner

MHA MacIntyre Hudson

