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RE: FRC Proposed Revisions to the Audit Firm Governance Code Consultation

The Investment Association (IA)¹ welcomes the FRC's intention to revise the Audit Firm Governance Code. Our members are supportive of the FRC's work, appreciate its extensive outreach to the investor community and look forward to working with it as it transitions to the Audit, Reporting and Governance Authority (ARGA) and helps to implement reforms to corporate governance and audit in the UK.

Investors rely on the quality and robustness of the audited information companies report to the market when making investment decisions and holding company management and boards to account. High quality and effective audits are vital to ensure market trust and confidence in the information companies report. Audit firms are therefore an integral part of the UK market, and their conduct and governance, insofar as they improve resilience and audit quality, is critical to the efficient functioning of the market.

The IA is therefore supportive of the move to update the Code to ensure it reflects current expectations of audit firms and continues to drive improvements to audit quality and audit market resilience. We have provided specific answers to the individual questions raised by the consultation in the annex of this letter. In particular, it is helpful at this time to clarify expectations of Big Four firms following operational separation - in places, we call on the Code to go further in recognising the implications of operational separation.

2021 has already witnessed extensive engagement on audit from investors, headlined by responses to the BEIS consultation on *Restoring Trust in Audit and Corporate Governance* (henceforth, 'the BEIS Consultation'). The IA's [response](#) welcomed the Government's overarching objectives and highlighted audit quality and audit market resilience as key

¹ The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.



priorities. We are pleased to see the proposals to address these issues in the Audit Firm Governance Code.

The IA strongly supports the revised purpose of the Code. The continued focus on audit quality, supplemented by more explicit ties to serving the public interest and building resilience mirror the key messages from our response to the BEIS Consultation. Audit quality has been a key concern for members for a number of years: in 2020 and 2021 the IA published its [Shareholder Priorities](#), which included audit quality as one of four key priorities for investors.

We would expect that the Audit Firm Governance Code may need further revisions once the dust has settled on the broader audit reforms. However, we believe that this is an appropriate time to revise the Code so as to sufficiently consider the implications of operational separation and what that means for governance at the firm-wide level, as well as bringing the Code in line with the regulatory framework regarding public interest entities.

We hope to continue to work with the FRC to improve the audit market and, ultimately, restore trust in audit and corporate governance.

Your sincerely,

Andrew Ninian
Director – Stewardship and Corporate Governance



Annex – Consultation Questions

Q1: How appropriate do you feel that the revised purpose of the proposed 2022 Code is?

The IA believes that the revised purpose of the proposed Code is appropriate.

Audit quality is a key concern for investors and we support its continued inclusion in the purpose of the Code. Our response to the BEIS *Restoring Trust in Audit and Corporate Governance* (the ‘BEIS Consultation’) stressed that the quality of audit should form the backbone of the proposals. Audit quality has featured as a part of the IA’s Shareholder Priorities for UK plc for the past two years. Investors rely on the quality and robustness of the audited information companies report to the market when making investment decisions and holding company management and boards to account. High quality audits are vital to ensuring the markets trust and have confidence in the information companies report.

We also welcome the requirement for firms to take account of the public interest in their decision-making. The BEIS Consultation focused on the importance of restoring public trust in the audit. We were supportive of extending the definition of public interest entities across large private companies and we are supportive of audit firms explicitly considering the public interest in their work.

We agree with the decision to reframe objective three in a more positive way and align the purpose with the two overarching objectives of the FRC’s monitoring and supervisory regime. Our response to the BEIS Consultation noted that investors are concerned with the lack of competition and resilience in the UK audit market. The failure of a Big Four firm would be devastating to this balance. It is helpful to focus on sustainability and resilience to encourage a more consistent day-to-day approach to building a resilient firm.

Q2: What are your views on the proposed thresholds for application of the proposed 2022 Code?

The IA supports the proposed thresholds.

We agree that the application of the Code should be linked primarily to the audit of Public Interest Entities, in line with the regulatory framework. We further agree with the need for stability and therefore support setting the threshold for starting to apply the Code higher than the threshold for stopping.

The consultation document outlines three main benefits to applying the proposed 2022 Code: governance and resilience; the perspective of INEs; and putting firms in a stronger position to take on additional PIE audits in the future. We echo these benefits. In addition, wider and more long-term adoption of the Code by smaller firms will improve transparency into the governance and approach of these firms. This will, in turn, make those firms more attractive to potential PIE clients, further supporting competition in the market overall.

Q3: Should the proposed 2022 Code apply to any firm that audits a FTSE 350 company? Please suggest alternatives.

Yes. Given the size and importance to the economy and the public interest of FTSE 350 companies, the IA would expect any firm that audits a FTSE 350 company to apply the Code.

Q4: What are your views on the proposed effective date of the proposed 2022 Code?



The IA is supportive of the Code coming into effect for accounting periods beginning on or after 1 January 2023. We agree with the rationale provided by the FRC. As a matter of best practice, we would welcome firms adopting the new Code on a voluntary basis ahead of this timeline.

Q5: 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?

The IA understands the importance of engagement between audit firms and investors, audit committee members other external stakeholders. The IA has previously helped facilitate engagement between investors and INEs through annual meetings with the IA's Company Reporting and Auditing Group (CRAG), as well as supporting dialogue with audit committee members through meetings between CRAG and the Audit Committee Chairs' Independent Forum.

While those meetings provided an opportunity for investors and auditors/audit committee members to engage, there were concerns that meetings with INEs served mainly as a means by which Audit Firms could comply with the Code, rather than as an opportunity for discussion of material information. Members noted a lack of substantive information from these meetings, with discussions reflecting on process rather than detail of the INEs role in challenging management to ensure a quality audit product. There was a sense among investors that comments from shareholders were not always heeded. Subsequently, CRAG determined that it would be more beneficial to focus on material audit issues (topics from the last year include audit reform, climate change accounting and reverse factoring) than to continue engagement for engagement's sake.

We echo the need to find solutions to improve engagement between the parties. Limited appetite for further engagement speaks to the lack of material conversations at these meetings in the past. This is why, in our response to the BEIS Consultation, we emphasised the need to create more hooks through which investors could engage on the audit. This means more transparent audit committee reports, more transparency around audit firm practice and how the INEs challenge management to ensure a quality audit product. This transparency will give investors the information they need to guide their engagement.

We think it is logical to further tackle this issue through the next revision of the Stewardship Code and the introduction of standards for audit committees that focus on material issues on audit quality and the role that INEs have played. This timeline will also allow the proposals put forward by BEIS to be adopted, which should create further hooks for engagement which could be referenced in the Code.

Q6: To what extent do you support the changes proposed in the areas of partner oversight and accountability to owners?

The IA supports placing explicit responsibility on boards for oversight and challenge of management. In meetings with INEs, our members have expressed concern that the board does not take a sufficiently critical approach to the work of the partners and would welcome more oversight, more challenge and more transparency regarding that challenge. We expect boards to be active participants in improving the firm. As with our position on improving audit quality, we expect the board so challenge management where necessary. As with Provision 5, this should be supported through arrangements for determining reward and progression.



We welcome Provision 2 that the majority of the Board should be partners without significant management responsibilities.

Q7: 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?

The IA strongly supports proposals to underpin connectivity with the global network. In our response to the BEIS Consultation, we noted the global nature of audit firms and called on the Government to consider the international reach of its proposals given this. We welcome the FRC's consideration of this matter in the Code.

In particular, the Big Four audit firms are international and often responsible for the audit of global groups, many of which will have a holding company listed on the UK market. We agree that where decisions are made outside the UK firm, the same level of disclosure and transparency should apply as if that body sat at the UK level. We also support INEs having access to information on what is happening at the global level so as to be in a position to assess the impact on the UK firm.

Q8: 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.

While we are supportive of the approach to people and culture in Section B, we believe there needs to be greater recognition of the impact of operational separation. The section on people and culture focuses on the firm as a whole. While this is a worthy endeavour, there should also be more focus on the culture within the audit function of the firm – this may differ significantly from the approach at the firm as a whole. It would be helpful to understand how the culture differs or where there are similarities across the firm and how the leadership of the audit business are seeking to embed and uphold a particular culture.

Q9: 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?

It would also help if firms were required to disclose the nature of their policy outreach. It would be helpful to understand how firms directly lobby government as well as their work with public bodies, investor committees and NGOs – whether through participation and collaboration or through secondments. This would bolster transparency around lobbying efforts and any actual or potential conflicts of interest that exist. This is a key area that is vital to the public interest but is not addressed by the Code.

Q10: Do you think that the proposed 2022 Code is clear enough about the role INEs play in the Firms?

Yes.

Q11: 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.

The independence of INEs is fundamental to improving audit firm governance. We believe that the proposals are a step in the right direction towards greater transparency and



increased accountability. Measures such as the right to attend Board and Committee meetings and to embed INEs in other governance structures are important improvements.

However, some members are still concerned about the true independence of the INEs given their appointment by the audit firms and the lack of real mechanisms to hold underperforming INEs to account. This risks making the INEs indebted to the audit firm and leaves them protected from repercussions where their independence is in doubt. While this may be beyond the scope of the current consultation, the FRC may wish to consider whether appointments should be made by an external body. This would need to be balanced with the benefits of the auditors appointing the INEs, to ensure that the appointed INE is a good cultural and operational fit with the rest of the Board.

Otherwise, to further improve accountability, the FRC may also wish to consider establishing a body by which investors and other stakeholders could raise concerns around INEs that are not adequately fulfilling their roles as set out by the Code. This would provide a better overview of the market view on individual INEs and further accountability in their retention and appointments.

In line with the Corporate Governance Code (provision 10), it would also be helpful for firms to provide a clear explanation of how it considers the INEs have delivered their role with genuine independence and challenge.

As with the UK Corporate Governance Code, we support the introduction of a recommended maximum tenure for INEs of nine years.

Q12: 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.

The Code could stand to be clearer on the boundaries between executive partners, NED partners and INEs. The IA understands from conversations with a number of audit firms that it is not always clear how INEs interact with the existing governance structures of partnerships – for instance, where the firm has executive partners, NED partners and INEs, the Code could be clearer on how the three interact and what value they are expected to bring to the governance structure.