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FAO - Shamima Hussain

November 17, 2021

Dear Sir or Madam

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the consultation regarding the "Proposed Revisions to the Audit Firm Governance Code" (the Code). Grant Thornton believes in the need for strong governance in the audit market, particularly from those who seek to audit Public Interest Entities (PIEs) and are therefore supportive of the Code.

The ongoing public scrutiny of the auditing profession requires that audit firms need to demonstrate the highest governance standards. We generally believe the proposed revisions to the Code are positive and will lead to a strengthening of audit firm governance. We do however have several observations and some concerns over specific provisions.

The introduction of International Standards on Quality Management (UK) 1 (ISQM 1) provides an opportunity for the alignment of the Audit Firm Governance Code. Both are seeking to improve the quality of audits or reviews of financial statements, or other assurance or related services engagements including those in the Public Interest. We strongly recommend that the FRC fully aligns the Code to ISQM 1 where relevant.

Our detailed response is set out in the attached appendix. Our key observations are:

- 1) We believe the number of PIE audits a firm performs before being within the scope of the Code should be reduced significantly. Where firms wish to audit in the PIE market they should have adopted or be adopting the Code before they are appointed as auditors to more than just a few PIE clients. The Code has been developed in a "Comply or Explain" structure which allows for firms to explain how they will meet the requirements of the Code whilst still moving into the PIE market, therefore we don't believe reducing the number of PIE audits to a lower level before the Code is adopted would be a barrier to entry to smaller firms.
- 2) The role of the Independent Non-Executive (INE) is being expanded and this increased involvement in the firm's policies and processes could result in INEs being seen to act as "Management". INEs need to be positioned to ensure they can provide challenge and advice to the firm whilst having clarity over who they are responsible to and for what. It is important that if there is a change in expectations of INEs this is fully reflected in the FRC's Audit Firm Monitoring and Supervision program.

- 3) We agree that INEs need to obtain information in respect of the network. We do not, however, believe that INEs need to be part of a global board. The response taken by INEs should be proportionate to the nature of the network and the legal and operational relationship to the UK firm. The proposals should be very clearly aligned to the requirements in ISQM 1 (UK).
- 4) We do not believe that the proposals in provision 18 that “One independent non-executive should be designated as having primary responsibility for engaging with the firm’s people” is required or helpful. This may not be the most effective way of a firm’s INEs operating and is likely to increase the risk of the INE acting as management.

Yours faithfully



Fiona Baldwin
Head of Audit
Grant Thornton UK LLP

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

We believe that the revised purpose of the 2022 Code more appropriately reflects the current expectations of an audit firm and the environment in which the audit profession operates. Whilst the FRC have sought to “align the Code with the language and intent of the new International Standards on Quality Management (UK) 1”¹ (ISQM 1), we recommend that the Code should be more fully aligned to ISQM 1. Two areas where further alignment is required are:

- a) How the UK firm interacts, including INE interaction, with the network should be flexible and designed around the risks this relationship brings. The current proposal that INEs move towards a more formal relationship and even a role on a global governance board may not be appropriate, or even legally possible, in some networks. ISQM 1 specifically considers networks and the Code should be aligned to this.
- b) In respect of principle J and provision 24 we believe the wider definition of “Internal control” is not required. The “reasonable assurance” declaration in ISQM 1 is sufficient and should be the basis for review.

This closer alignment would be consistent with the Code’s primary purpose concerning the “protection of the audit practice and the promotion of audit quality”²

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

The Code was created in 2010 to improve the governance in place at the largest audit firms with the aim of promoting public confidence in audit.

“Confidence in audit means having confidence in the Firms’ capabilities and in their commitment to delivering high quality audit on a consistent basis. Firms that are well governed are more likely to meet expectations for high-quality audit. The Code plays an important role in this by establishing minimum expectations around governance at Firms.”³

We would agree with the consultation which notes that, whilst there may be costs associated with applying the code, the FRC believe these are outweighed by the considerable benefits as noted on page 8 of the consultation, i.e.

- a) Improved governance and, by extension, resilience;
- b) Firms gaining an external perspective from the INEs; and
- c) Putting firms in a stronger position to take on additional PIE audits in the future.

It is therefore appropriate to expect those firms who are wanting to audit PIE entities to comply with the code or explain why they do not. The threshold of 20 PIEs seems highly inconsistent with these wider objectives.

In recent years, there have been several high-profile audit resignations by Big 4 firms, where the audit engagement has moved to a smaller firm, which is not subject to the current Code and would not be subject to the proposed 2022 Code. We believe that failure to reduce the threshold to a lower level in these market conditions will undermine the purpose of the AFGC and would not be in the public interest.

¹ Page 3 - Consultation document – Proposed Revisions to the Audit Firm Governance Code – FRC - August 2021

² Page 2 - Consultation document – Proposed Revisions to the Audit Firm Governance Code – FRC - August 2021

³ Page 2 - Consultation document – Proposed Revisions to the Audit Firm Governance Code – FRC - August 2021

Furthermore, we strongly believe in a lower threshold for adoption of the code because

- a) Those firms wishing to enter the market should be developing and improving their governance to allow them to demonstrate to stakeholders their commitment to quality;
- b) Compliance with the code is a key to improving trust and so is key to all PIE auditors; and
- c) The code is a comply and explain code allowing smaller firms/new entrants to explain if they are not fully compliant. This also allows companies appointing audit firms to assess their quality in a more transparent manner.

We would propose the threshold for the adoption of the code should be:

- a) Five PIE audits; and/or
- b) One or more FTSE 350 company

This threshold takes account of the potential situation of the occasional PIE entity entering a firm's client base without the firm wanting to operate in the PIE market. The threshold however is set so that, once a deliberate decision to enter the PIE market, the firm should adopt the Code. This is consistent with the proposal in the BEIS consultation to separate the role of confirming audit firm eligibility for the statutory auditors of PIE entities and non-PIE entities.⁴ We believe the level of five audits or one FTSE 350 is a strong indicator of intent.

The FRC notes that currently there are 35 firms that audit PIE entities and on the current basis there could be over 500 PIE entities audited by firms that do not apply the code, or over 25% of all PIEs⁵. As detailed above, we believe that failure to reduce the threshold means the proposed measures are unlikely to meet the aim of increasing confidence in the PIE audit market.

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

We agree that the proposed 2022 Code should apply to any firm that audits a FTSE 350 company, reflecting the focus on the public interest. We also suggest that the FRC consider whether other entity audits such as pension schemes, local authorities and limited liability partnerships ought to be considered when determining which audit firms should be covered by the proposed 2022 Code.

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

The proposed effective date of accounting periods beginning on or after 1 January 2023 is considered appropriate, as it allows sufficient time for firms to make the necessary arrangements. As the Code is a Comply or Explain code firms can explain any changes that they have not managed to implement or are in the process of being implemented. A short extension, six months, could be given for first time adopters especially if the threshold for compliance is lowered.

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?

We support the proposed consultation on tackling stakeholder engagement in the next revision of the UK Stewardship Code and the introduction of standards for audit committees. We acknowledge that dialogue with INEs may be beneficial to raising awareness of the public interest focus of audit firm. The benefit and frequency of any dialogue needs to be carefully weighed against the workload of the INEs and the willingness of different stakeholder groups to engage with Audit Firms in this area.

⁴ Chapter 9 – “Restoring trust in audit and corporate governance, Consultation on the government's proposals” – Department for Business, Energy & Industrial Strategy – March 2021

⁵ Based on 1,1811 PIE and 35 firms less 10 that are expected to adopt the code - Page 8 - Consultation document – Proposed Revisions to the Audit Firm Governance Code – FRC - August 2021

As noted on page 11 of the consultation “anecdotal evidence suggests limited appetite, in particular among investors, for engagement on governance matters with Firms or their INEs”. We believe outside of the ‘Big 4’ this a particular issue which is likely to require concerted action across the audit market with an active role from the FRC to improve the level of engagement, particularly to assist non Big 4 firms, in this area.

Accordingly, we suggest that dialogue with INEs should be managed via an annual opportunity for stakeholders to meet with INEs.

We would welcome a proposal that the firms provide copies of their Transparency Reports to all audit committee chairs of the firms ongoing PIE audit clients. This is a process that we now adopt.

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

In general, we support the changes proposed in the areas of partner oversight and accountability to owners, although several areas need careful interpretation. The requirement that the majority of the Board should be partners without significant management responsibilities needs to be properly defined, i.e., what does ‘significant’ mean in this context? In practice, most partners who may become Board members are likely to have management responsibilities, which could be deemed significant. This needs careful assessment as, particularly in smaller firms, this requirement can restrict the full use of the talent the firm has.

We note the proposal for audit firms to put in place arrangements for determining the reward and progression of Board members to support and promote effective challenge need further consideration. Creating a separate process for Board members purely in respect of management challenge is, we believe, too narrowly focused. We consider board members should be focused, and rewarded, based on the delivery of their entire role including challenge of management, firm resilience and the delivery of quality by the firm.

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?

We agree with the proposal that INEs have access to the network information which is relevant to their role in assessing the impact on the UK firm. The approach taken to INE involvement needs to be adapted to the circumstances of the network to UK firm relationship. We don’t, for example, believe that a global INE structure is required to deliver good governance in the UK.

Structures and processes to meet these requirements are, we believe, likely to vary considerably depending on the structure of the network and the relative level of influence the network has over the UK firm.

The focus of the approach to INE involvement should be tailored to support how the risks associated with ISQM 1 in this area are mitigated. Without careful consideration there is an ongoing risk of INEs moving into, or being seen to move into, a management role.

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.

We are supportive of the approach taken to people and culture in section B of the proposed 2022 Code, although there are several areas where the users of the Code would benefit from further guidance.

These include:

- a) Provision 15 envisages that both Management and the Board would be involved in culture monitoring; it would be helpful to understand what form the FRC expects this monitoring to take

and the degree of involvement that the INEs are expected to have: for example, which party defines the scope of the monitoring.

How is the responsibility for the ownership of monitoring shared between Management and the Board and the INEs? Without clearly defined roles for each party for monitoring activity, there is a risk that ownership and ultimate responsibility for assessing and monitoring culture will become obscured, potentially, with INEs taking on a management role.

- b) Provision 18 stipulates that one INE should be designated as having primary responsibility for ensuring engagement with the Firm's people. It is unclear as to whether this refers to people across the whole firm, those in the audit function or those impacting audit quality.

We do not believe that there is a need for one independent non-executive to be designated as having primary responsibility for engaging with the firm's people, nor is it helpful. This may not be the most effective way for an INE to operate and is likely to increase the risk of the INE acting as management.

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?

We are supportive of the proposed provisions in section C. Our observations are

- a) Proposal 24 – In respect of the requirement that the firm should monitor its risk management and internal control systems, we believe this should be amended to be aligned to the requirements of ISQM 1. The requirement to assess internal control systems can lead to a review of controls that are not relevant to the objectives of the Code. The requirement should focus on those controls relevant to the scope of the Code and the “reasonable assurance” scope in ISQM 1.
- b) Proposal 26 – The proposal for a “statement on its compliance” for the firm's compliance with AFGC appears unnecessary as the provision asks for reporting including detailed explanations of non-compliance.
- c) Proposal 27 – This proposal is unclear as to whether a specific disclosure is required in the Transparency report. We don't believe this requirement is required in the Code. ISA 700/701 are clear in the requirements for the audit opinions the firm signs. The requirements of ISAs are clear, subject to separate application based on the individual engagement, and therefore we consider it unnecessary to include in the Code. If the proposal is to have some form of “firm-wide” disclosure we again do not see the value in this. Clarity is required in respect of this proposal with further consultation before any proposals are implemented in this regard.

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

We are supportive of the use of INEs and the proposed focus as set out in Principle N - “Independent non-executives should provide constructive challenge and specialist advice with a focus on the public interest.” The Code does extend the scope and involvement expected of the INEs and this we consider gives rise to three potential issues:

- 1) The increased depth of focus of the INEs e.g., the increase in focus on people could lead to INEs acting as management which would not be consistent with the role of an INE;
- 2) What appears to be a more formal and expanded reporting role to the FRC could lead to the management of firms being less willing to fully engage in an open and constructive dialogue with the INEs; and

- 3) The increased scope and potential lack of clarity in the split of responsibilities between those to the firm and the FRC may make it harder to attract high calibre INEs. Attracting individuals to act as INEs is increasingly challenging due to conflicts of interests and the relevant independence requirements.

The proposed 2022 Code acknowledges that there is no single definition of the public interest and that INEs must form their own view. Given the increased focus of the proposed 2022 Code on the public interest and the expected role of the INE, the FRC needs to provide greater clarity and guidance on this matter, to avoid misunderstanding and differing approaches by the firms.

The consultation notes the role of INE “is to help the Firm identify where the public interest is engaged and make sure the Firm is taking that into account in its decision making.” Whilst we agree that INEs should not be seen as advocates for the firm commercially they need to be able to undertake a role that is consistent with the expectations of INEs in other sectors e.g., under the UK Corporate Governance Rules. INEs need to be able to bring their experience and judgement to challenge and give advice across the firm including on issues of strategy, performance, resources, key appointments, standards of conduct and monitoring of management performance.

The proposed 2022 Code refers to a maximum tenure of nine years for INEs. We believe that to provide flexibility and ensure that the changing skill requirements, that this period should be split into shorter periods of appointment with the possibility of being reappointed.

We believe protection needs to be given to INEs who need to “whistleblow” to the FRC. It is unclear what protection individual INEs have, we would recommend the FRC considers this and refers to this in the Code. Protection could be achieved by requiring/recommending that this is addressed in INEs service contracts.

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.

See comments on question 10.

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.

We agree with the need for close co-operation between the Audit INEs and the firm INEs. The proposal that the “The Audit Board should have the authority to act independently of the firm-wide public interest body” however does not take account of the reason for the existence of both bodies. The firm wide Public Interest Body is only present due to the firm being an audit firm and therefore it is imperative that both bodies work closely together rather than independently.

The consultation notes certain matters as being focused on by the firm INEs some of which appear to be as important to Audit INEs as the wider firm including client acceptance and continuance, risk management, culture and people matters. As written, we don’t believe proposal 41 is appropriate. The requirements for Audit INEs need to align to the areas covered by ISQM 1, which drives audit quality, this includes many of the matters in proposal 41 which are being reserved for the firm wide INEs. This proposal seems to be contrary to the overall principle of Operational Separation.