CRUF
CORPORATE REPORTING USERS' FORUM

18 November 2021

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

Via email: afgcreview@frc.org.uk

Dear Shamima,

Re: Proposed Revisions to the Audit Firm Governance Code

The Corporate Reporting Users' Forum (hereinafter referred to as CRUF) is delighted to respond to the FRC's consultation document on the proposed revisions to the Audit Firm Governance Code (Code or AFGC).

The CRUF was established in December 2005 and we have been holding regular meetings since. The CRUF UK has prepared this comment letter based on discussions within CRUF UK.

Responses to the questions raised in the consultation that relate to the issues that concern investors are set out below. As always, we do not seek to reach a consensus within the CRUF but to reflect a broad spectrum of users' views. Our comments are based on our professional experience as users of annual reports.

Overall comments

The CRUF believes most shareholders look to the audits of annual financial statements to underpin their confidence and trust in the companies they are invested or interested in, their management and the accounts they report. It appears that most of the thousands of audits each year are conducted at an adequate quality level and many are certainly good. However, we are mindful of recent public examples of potentially inferior quality audits and of the conclusions from the FRC's 2020 and 2021 summaries of prior year audit inspections that firms are still not consistently achieving the necessary level of audit quality and that further progress is required. We also recognise that BEIS is looking into restoring trust in audit and corporate governance. We welcome the FRC's resulting move to tighten up the UK's Audit Firm Governance Code with the emphasis on audit quality.

The Code needs to define what audit quality means in the context of its purpose, principles and provisions. It also needs to provide or point to guidance on how audit quality should be measured and assessed. We welcome the FRC's publication, on November 16, of 'What makes a good audit' and look forward to assessing whether this defines audit quality and provides relevant guidance.

The effectiveness of the Code will be proved by how well the audit firms provide meaningful and useful Transparency Reports, and whether these are read more widely and lead to an increased dialogue between audit firms and their stakeholders. As you mention in Appendix B to the Code, this dialogue should be the most effective way to improve Transparency Reports. We believe that the most important conversation should be with shareholders in the companies audited by firms that have to comply with the Code, However, we have some concerns with Transparency Reports and provide more detail below in our answer to Q8.

You mention at the end of page 11 of your consultation document "anecdotal evidence suggests limited appetite, in particular among investors, for engagement on governance matters with Firms or their INEs". We believe this is not the case and one issue may be that interested individual investors are intermediated through, for example, nominee accounts preventing firms and their INEs gaining access to those shareholders.

Some may have the view that audit firms' engagement with audit committees is sufficient and therefore direct engagement with shareholders is not needed, especially where there is a good dialogue between an audit committee and its shareholders. However, audit committees may also have an intermediation issue with their shareholders. Other reasons may include stakeholders' experiences of such engagements leading them to believe that they are presentational, stage managed and unlikely to produce any substantive changes where needed and, as a result, not worth their while.

In respect of dialogue with investors, your consultation suggests, in relation to the deletion of the old Code Principle F.1 and the revised Code Provision 34, such dialogue will be looked at in the round, as the Stewardship Code and standards for audit committees are developed (as proposed in section 4 of the consultation). The Stewardship Code is limited to institutional asset managers and asset owners and will exclude individual investors. We would like serious consideration to be given to non-institutional investors, including through organisations like the CRUF, when looking at the dialogue in the round (see answer to Q5). We believe this is vital to the success of the Transparency Report, INE and audit committee communications with company shareholders. It is also a reminder that retail shareholders are an important constituent of stewardship and governance.

In the context of the above overall comments, please find below our answers to your 12 consultation questions.

CRUF's responses to the consultation questions

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

We feel the revised purpose is appropriate:

- To promote audit quality;
- To ensure firms take account of the public interest in their decision-making, particularly in audit; and
- To safeguard the sustainability and resilience of audit practices and of firms as a whole.

However, a key component of promoting audit quality will be a collective understanding of what is meant by audit quality. We are keen that that the AFGC should provide help in this respect such as an agreed definition of audit quality and some guidance on how best to assess or measure it. We welcome the FRC's publication, on November 16, of 'What makes a good audit' and look forward to assessing whether this defines audit quality and provides relevant guidance.

We believe the Code is sufficiently explanatory on how firms should determine public interest, sustainability and resilience in the context of its purpose, principles and provisions.

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

We believe that the proposed thresholds for application of the Code, which are firms that perform audits of 20 or more PIEs or of one or more FTSE 350 companies, are reasonable. It is also helpful to provide thresholds for the disapplication of the Code, which are where PIE audits drop below ten and a firm does not audit any FTSE 350 companies.

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

Yes. We have no alternatives to suggest.

Question 4: 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 likely to mean most implementations of the revised Code will not be reported on in Transparency Reports until the middle to end of 2024, which is three years away.

As the revised Code is a tightening up of the existing Code, it would seem implementation could be earlier. We would suggest an effective date of accounting periods ending on or after 31 December 2022, bringing the Transparency Reports forward into 2023. If this proves a problem for firms new to the Code (including, for example as you point out in your consultation document, any problems with their recruitment of INEs), the Code could have a one year transition period for new firms where they explain their non-compliance in their first year if required.

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?

Our view is that it should be essential that auditors and their firms understand shareholders' priorities in the reporting of the companies they are invested in and, therefore, in the audits of those corporate reports. In our view, the only way to ensure this is for auditors and their firms to have ongoing dialogue directly with the shareholders of the audited entities, including with and through audit committees and boards. This dialogue should make every effort to include individual shareholders or beneficial owners of shares in companies. The FRC (and its successor) needs to be mindful that its Stewardship Code does not include this category of shareholder or beneficial owner. Any developments of Audit and Assurance Policies and of audit standards for audit committees, following the BEIS consultation, will need to address this requirement.

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

We fully support the changes proposed.

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?

We are supportive of the proposals. However, as CRUF participants' knowledge of the detail of connectivity within global network – and of the potential impact on a UK firm – is limited, we do not have any other suggestions.

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.

We have concerns about the approach taken to people and culture, similar to the concerns we have about people and culture in the companies whose reports we use and/or we invest in.

Organisational culture is often difficult to define and even more difficult to measure. People tend to know and assess whether a culture is good or bad intuitively over long periods of time. Trying to get audit firms to describe this and provide some coherent evidence is extremely difficult.

Key components of culture in an organisation are the values it espouses and the behaviours it encourages and rewards. This sounds simple but, as the FRC's series of online seminars on organisational culture (21st - 25th June 2021) noted, organisations often claim to espouse and value certain specific behaviours while actually encouraging and rewarding very different behaviours. In professional services firms (such as audit) it is common to claim that integrity, impartiality and high standards of professional competence are key values within the firm and that these drive the way in which it operates. However, the pay and promotion systems within the firm usually reward those who sell and/or retain the most business. They can also encourage aggressive and conflicted behaviour in this area which often ends up going unchallenged and unpunished.

The problem of encouraging appropriate behaviour and culture within audit firms is doubly complex due to confusion over who the 'client' really is. While, in principle, the customer/s should be the shareholders, in practice, the customer relationship is with the company due to its key role in engaging the auditor and paying the fees. This creates an environment in which all the incentives are for the auditor to keep the client company happy by avoiding any awkward challenges or the application of serious professional scepticism.

Current changes requiring the large audit practices to have at least one INE with responsibilities relating solely to the audit part of the practice are a step in the right direction. We would like to see the FRC maintaining a close relationship with these individuals and working with them to foster and promote a strong culture of auditor independence, in which the shareholders are seen as 'the client'.

As we have indicated, organisational culture is often difficult to define and measure. Improvement requires a thoughtful process to determine what information may be available to indicate good and bad audit cultures and how this could be collected and reported. Examples may include information about whistleblowing incidents, reasons for leaving firms provided in exit interviews, how partner remuneration is determined, how audit fees are determined, employee surveys, promotion criteria for all levels and the basis for being appointed or sacked as auditors. More tangible aspects should include a statement setting out who the audit is for (primarily shareholders), a statement on the quality the audit firm aspires to and how the culture of the firm aligns itself with those aspirations. In reality, these soft aspects are difficult to measure but at least would establish the official view of the auditor for readers to assess.

Whistleblowing is another area where problems exist, not least in the anecdotal evidence that suggests it is usually not worth someone's effort to whistleblow. We oppose the BEIS consultation conclusion that the Brydon Review recommendation on whistleblowing should not be followed. In most, if not all, cases of serious problems in companies and audits (and other areas), people will not be incentivised to whistleblow in the public interest. It takes very brave and altruistic people to do so. The Government needs to review whistleblowing, the current problems with whistleblowing regimes and the protection it could bring to public interest by making sure that whistleblowers get the support (e.g. access to specialists in the area concerned), protection (e.g. legal protection) and compensation they need. This may mean that the FRC needs to review its requirements of audit firms' whistleblowing mechanisms and whether they are fit for purpose in the context of our concern, which in turn may require further changes in the AFGC.

Some CRUF participants agree that remuneration is a key driver of behaviour. Performance-related pay is specifically designed to drive behaviours that firms want to encourage. We also recognise that remuneration structures may result in unintended behaviours. For this reason it would be helpful for the regulator to collaborate with firms and their audit INEs to monitor and identify good practice in remuneration systems for auditors. Auditors who demonstrably perform their role with skill and excellence on behalf of the shareholders should be well paid.

However, others do not accept that remuneration is a key driver of behaviour but do recognise that remuneration packages may drive unintended adverse consequences. In one way pay should be determined according to what an appropriately independent body of people in an organisation think the work is worth. If the people receiving that pay are seriously dissatisfied, so as to make them disincentivised, there should be mechanisms to resolve this. Another approach to consider is the imposition of penalties to deter people from poor behaviour, for example reductions in remuneration for non-compliance.

With regard to investor engagement events, a number of our participants believe that while these are usually enjoyable and instructive, they suffer from the same malaise as Transparency Reports (discussed below). They tend to be an opportunity for the audit firm to promote itself and the way it would like to be seen. They provide little real scope for investors to raise difficult or

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awkward issues with the audit firm and even less opportunity for such issues to be explored and discussed – either at the event or by way of follow-up.

Lastly, we question the general quality and usefulness, as you have done, of Transparency Reports. We think these should focus on:

- how firms have met the purpose of the Code;
- how they ensure audit quality or explain what they are doing to improve it;
- what key or material decisions they have taken in the reporting period and how they have taken the public interest into account;
- how they have safeguarded the sustainability and resilience of the audit practice and firm as a whole; and
- how they have complied with the principles and provisions of the Code or explained non-compliance or alternatives, including non-relevancy.

We would like to see Transparency Reports that are business reports that cover this focus based on the AFGC, not marketing and sales documents or superficial tick-box compliance reports. We can see that Appendix B to the Code goes some way to alleviate our concerns with Transparency Reports. To ensure consistency and comparability, you may want to consider adding further guidance on the content that should be included in a good Transparency Report.

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?

No.

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

Yes. However, we are mindful that, after the Code was introduced in 2010, one of the drivers for its revision in 2016 was its focus on audit firm resilience and viability. INEs had diverging views on what their role was. This may only be tested by asking all INEs what they think their role is and what it requires to see if there is any divergence in views. If there are, these divergences should be resolved.

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.

We have no further comments.

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 the proposals make sense and we do not have enough inside knowledge to foresee whether any difficulties will arise from what is proposed.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF was set up in 2005 by users of financial reports to be an open forum for learning about and responding to the many accounting and regulatory changes that affect corporate reporting. In particular, participants are keen to have a fuller input into the deliberations of accounting and auditing standard setters and regulators. CRUF participants include buy and sell-side analysts, credit ratings analysts, fund managers, investors and corporate governance and ESG professionals. Participants focus on equity and fixed income markets. The Forum includes individuals with global or regional responsibilities and from around the world, including Australia, Canada, France, Germany, Hong Kong, India, Japan, New Zealand, South Africa, UK and USA.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. In our meetings around the world, we seek to explore and understand the differences in opinions of participants. The CRUF does not seek to achieve consensus views, but instead we focus on why reasonable participants can have different positions. Furthermore, it would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative. This response is a summary of the range of opinions discussed at the CRUF meetings.

Participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. Accordingly, we sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum and not as representatives of our respective organisations. The participants in the Forum that have specifically endorsed this response are listed below.

Signatures

Charles Henderson
UK Shareholders' Association

Peter Parry
UK Shareholders' Association

Sue Milton
UK Shareholders' Association

Jeremy Stuber

Jane Fuller
FSIP