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Dear Mr Hodgkinson,

**Re: FEE Comments on ICAEW/FRC Second Consultation Paper on Audit Firm Governance**

- (1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the Second ICAEW/FRC Consultation Paper on Audit Firm Governance (the Consultation Paper). We commend the FRC and ICAEW for enhancing this debate with the publication of a second Consultation Paper.
- (2) We have noted the Second Consultation Paper with interest. Even though the Consultation Paper is written within a UK context it includes some elements that may merit wider reflection. We provide our initial reactions on the proposed Code from this wider European perspective with specifically a focus on implications and challenges if such a code or similar initiatives were introduced in other European jurisdictions. The issues addressed in the Consultation Paper are fundamental and complex in nature. The debate in FEE and in some of its Member Bodies on these issues is still at an early stage and, consequently, it would be premature for FEE to express any detailed opinions or definitive positions.
- (3) We understand that the primary purpose of the Code is to provide a formal benchmark of good governance practice against which firms that audit listed companies can report for the benefit of shareholders in such companies and other stakeholders. However we have certain observations to make in relation to introducing such a code and its potential pan-European implications as indicated above.

*Intention of the Code*

- (4) We note that the proposed Audit Firm Governance Code is intended to promote continuing confidence and choice in the market for the audit of listed companies. The underlying reason for the project to develop the Code is that the market for the audit of public interest entities is dominated by four firms and the risk of a major firm leaving that market is a matter of continuing public concern. The Chairman's introduction indicates that the Code is intended to mitigate the risks of market exit and to provide a benchmark against which firms' current and future governance practices can be measured. He also indicates that for a major public interest entity appointing an auditor, it could also enhance choice by reducing a perceived risk of looking outside the four largest firms. The Consultation Paper also indicates in general the expected benefits brought by a further improvement of governance practices for example in dialogue between auditors and the shareholders and other stakeholders of listed companies. The Consultation Paper, however, also acknowledges that independent non-executives represent an incremental fixed cost of being in the market for auditing listed companies. We note that the objective of the Code is to encourage firms to adopt governance arrangements, and to communicate information on those arrangements, so as to enhance the confidence of shareholders and others in the way that all the firms covered by the Code, i.e. not only the largest firms, are run and thereby enhancing choice.

*Entering the market of audits of listed companies*

- (5) On page 10 it is stated in relation to the costs for smaller firms that "there is a real risk of unintended consequences if a code introduced to enhance choices reduces it because it deters firms from entering the listed company audit market or causes firms to exit that market". We agree that there is a potential risk that the compliance costs associated with the Code will form a further barrier, in addition to the requirements imposed by the Statutory Audit Directive, for those smaller audit firms that will not initially be expected to follow the Code. In this way the Code risks entrenching, rather than reducing, the concentration of firms in the audit market. We acknowledge that the implications of the Code for smaller firms may depend on the specific jurisdiction that would apply the Code and may differ between jurisdictions, depending on the organisation, concentration, and the size of the audit market in each jurisdiction.
- (6) Although the main part of the Code creating the above-mentioned barrier is part C on independent non-executives, there may also be an additional cost involved in part F on Dialogue.

### *Considerations regarding implementation*

- (7) We wish to observe that in our view the intention of the suggested Code for firms is different from good “corporate governance” in a general sense since it seems pre-dominantly oversight driven.
- (8) We see a risk of overregulation and an increase of bureaucratic burdens given the existence of the Statutory Audit Directive, the EC Recommendations and the public oversight systems already in place. We think there would be benefits in understanding how the different current requirements are being implemented in Member States, particularly with regard to transparency reports and independence.

### *Structure of the Code*

- (9) We agree with the intention of the Audit Firm Governance Working Group that drafted the proposed Code to be selective in applying the provisions of the Combined Code so as to prepare a tailor made code for audit firms. We note that there has been tailoring but we still have questions that may need to be addressed. We acknowledge that the Markets Participants Group in its 14 October 2007 report requested that “Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation”. Therefore, the Consultation Paper states in relation to the structure of the Code that “the Code’s structure is similar to that of the UK’s Combined Code on Corporate Governance for listed companies” (page 16 first paragraph). Notwithstanding the request of the Markets Participants Group one can question if basing the structure on the Combined Code gives the best structure considering that audit firms are quite different from other (non-audit) commercial companies, as evidenced by the FEE Paper Trans-national Organisations and Practices within the Accountancy Profession of April 2008<sup>1</sup>. If one would have started from a blank sheet of paper a different structure of the Code might have resulted that does not suggest that audit firms are very much like other commercial companies in terms of governance structures.

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<sup>1</sup> <http://www.fee.be/fileupload/upload/TOPs%20080409%20Clean195200826176.pdf>

*Independent non-executives*

- (10) One of the key features of the Code is the appointment of non-executives. Part C of the Code addresses independent non-executives and principle C1 addressing the involvement of independent non-executives states: A firm should appoint independent non-executives who through their involvement, at a minimum, collectively enhance shareholder confidence in the public interest aspects of the firm's decision making, stakeholder dialogue and management of reputational risks in the firm's businesses that are not otherwise effectively addressed by regulation. The involvement of non-executives would constitute a major change for many audit firms in many Member States outside the UK. It is also not immediately apparent where independent non-executives would fit in the legal and organisational structures of trans-national organisations and practices. It should be noted that certain firms have already implemented some form of involvement of non-executives e.g. through "public boards" and seem to benefit from the experience. It may be helpful to survey the outcome of such experiences.
- (11) We note that the Code in principle C1 mandates the appointment of non-executives by stating "a firm should appoint independent non-executives" be it in a "comply or explain" context. From a pan-European point of view an obligation would be too demanding and a recommendation or encouragement would be more appropriate.
- (12) Although we realise that the formulation of the role of the non-executive may be on purpose very general, so as to leave flexibility to the individual audit firm, we are concerned that the Code does not clarify what the role of independent non-executives is. The term "involvement" is in our view very vague. We believe that the Code would be more helpful if further guidance were given. Principle C3 indicates that independent non-executives should have rights commensurate with their role without indicating what the role is. Another example is C.3.1 where it is stated that "each independent non-executive director should have a contract for services setting out their rights and duties", this would mean that the role and involvement may differ for every non-executive and every audit firm concerned. The objective of enhancing stakeholder confidence in the governance structures of audit firms could be made more difficult if those stakeholders do not have a clear understanding of what to expect from non-executives and what their rights and duties are intended to be. It would be helpful if the Code could stimulate the audit firms to explain the extent and degree of involvement of their independent non-executives. We, however, appreciate that the Code cannot go in too much detail and needs to leave sufficient room for the relatively new concept of independent non-executives in audit firms to evolve. Regarding independence, it is unclear whether the independence requirements will be as pervasive as the requirements for the partners in an audit firm, or be less onerous. On the one hand, one can assume that the non-executive director would not be required to be an owner (partner) in the audit firm, but the involvement in governance would raise the issue of the extent of independence required.

- (13) Provision C.1.2 states that “the firm should disclose on its website the duties of the independent non-executives, the arrangements by which they discharge their duties and the obligations of the firm to support them”. We believe, within the context of the proposed code, it may be helpful if there would be a requirement to disclose on a comply or explain basis whether the independent non-executives have fulfilled their duties as described on the required website disclosure.
- (14) Principle C3 refers to public reporting in case disagreement cannot be solved. This right needs to be formulated in a more specific way. We do not support public reporting per se, however, if public reporting were required, it should be confined to specific incidents. If the Combined Code structure is followed, one would assume that the non-executive directors would report to the owners, in other words, the partners of the audit firm in many instances. However, reporting to the owners in a listed company normally assumes a degree of public reporting, whereas, this need not be the case when reporting to the owners of an audit firm.
- (15) We commend the introduction of the whistle blowing principle in the Code and acknowledge the role independent executives could play in this respect. However, the liability of the non-executive director would need to be further clarified, especially if such whistle blowing would involve the passing on of audit client information. In any case, the personal liability of the non-executive director is very unclear, given the governance role that the non-executive director is expected to be engaged in. This is not made easier in those jurisdictions where audit firms are still required to practise as unlimited partnerships.

#### *Scope and level of application*

- (16) The Code applies to firms which audit more than 20 listed companies, which means that the eight largest UK firms are covered. In the analysis of the reactions to questions 10 to 13, no specific reference is made to introducing a minimum size in relation to the audit firm itself other than through the number of 20 listed companies which as such implies a certain size of the audit firm. We recommend to include the size of the audit firm itself as an additional criterion in particular considering that in the future the number of 20 may be lowered with as result that more audit firms may fall within the scope and have to apply the Code.

- (17) The Code does not specify a level at which the Code as a whole is applicable but calls for UK firms to consider and explain circumstances where the UK firms looks beyond itself in applying the Code's principles and in complying with its provisions (4.3 International structures of firms, question 5). In this respect we refer to the findings of the FEE study published in April 2008 on Trans-National Organisations and Practices within the Accountancy Profession. This Study identifies the different structural models of trans-national organisation and practice in the profession that have developed in response to the internationalisation of business. It also highlights the significantly different degrees of trans-national coordination and integration pursued by individual organisations within the profession. These findings indicate that the scope of application of any code would not be self-evident in particular also given the differences in legal structure in the various Member States. It would be helpful if some further guidance would be provided in particular since many of the international structures have their legal basis in the UK and therefore they may be (unintended) implications outside the UK. The Consultation Paper itself acknowledges already the complexities for the scope application that are created by the new integrated structures of certain firms that cover several countries. Another possibility would be to restrict the Code to firms that actually carry out the audit and to scope out their related firms and holding structures. In this respect we refer to our detailed comments set out in our letter to the first Consultation Paper of 22 January 2009.
- (18) The Code supports the integration of Code-related disclosures in a firm's annual published transparency report. We believe that the transparency reports of audit firms auditing public interest entities (Article 40 of the Statutory Audit Directive) already provides significant disclosures by audit firms. It should be recalled that this Article requires Member States to introduce very detailed transparency reporting at a national level for auditors of public interest entities, covering governance and operational matters and also, where a firm belongs to a network, a description of the legal and structural arrangements in the network.

For further information on this letter, please contact Ms Saskia Slomp, Technical Director (e-mail: [saskia.slomp@fee.be](mailto:saskia.slomp@fee.be), tel: 0032/2/285.40.74).

Yours sincerely,



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President