Re: Audit Firm Governance, Second Consultation Paper, A Project for the Financial Reporting Council

Dear Mr. Hodgkinson and Audit Firm Governance Working Group:

We are writing on behalf of the International Corporate Governance Network (ICGN). The ICGN is a global membership organisation of institutional and private investors, corporations and advisors from 43 countries. Our investor members are responsible for global assets of U.S. $9 trillion. The mission of the ICGN is to meaningfully contribute to the continuous improvement of corporate governance best practices through the exchange of ideas and information across borders. Information about the ICGN, its members, and its activities is available on our website: www.icgn.org.

The purpose of the Accounting and Auditing Practices Committee is to address and comment on accounting and auditing practices from an international investor and shareowner perspective. The Committee through collective comment and engagement strives to ensure the quality and integrity of financial reporting around the world.

http://www.icgn.org/organisation/committee_membership.php?name=AAP

We are pleased to respond to your request for comment to gather views on the Audit Firm Governance Working Group (“Working Group”) Second Consultation Paper entitled, “Audit Firm Governance, Second Consultation Paper, A Project for the Financial Reporting Council” dated July 2009. The Audit Firm Governance project is the result of Recommendation 14 of the October 2007 report of the Market Participants Group (“MPG”): “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.” In accord, we are disappointed that the Working Group decided that public interest entities should be narrowly defined as UK companies listed on the London Stock Exchange’s Main Market and that it has recommended to the FRC that the Code should only initially apply to firms which audit more than 20 listed companies (see page 15 of the Draft Audit Firm Governance Code). We strongly urge you to reconsider this definition and instead adopt a broader definition of a public interest entity consistent with the above-referenced MPG principle. We believe if an entity is considered private, but takes in and manages public money, such entities should be considered to be a public interest entity.

As reference, we attach our letters dated 31 January, 2009 and 6 July 2007, which provided our committee’s viewpoint on the Audit Firm Governance, First Consultation Paper and the Consultation on the Interim Report of the Market Participants Group on choice in the UK Audit Market (the “Report”). This letter provides you with our comments below regarding the Draft Audit Firm Governance Code (the...
“Code”), including comments on the presentation of issues involved in developing the Code in Section 2. Developing the Code, anticipated costs and benefits relevant to the assessment in Section 2.3, the independence of non-executives and their impact on auditor independence as discussed in Section 2.4. Independence and independent non-executives, and the content of the draft Code in Section 3. Draft Audit Firm Governance Code and the balance between principles and provisions.

We strongly agree with the conclusion of the Working Group that the Code should primarily serve the company for the benefit of its investors, the end users of financial statements, subject to the clarification, that the benefit includes the protection of the capital itself, which is the judicial purpose of accounts and audits, ex US.

Our other comments are as follows:

4.1 Stakeholders of firms that audit public interest entities

1. Which groups of stakeholders do you think the Audit Firm Governance Code should primarily serve and in what ways, if any, do they have differing interests?

Comment
We strongly agree with the conclusion of the Working Group that the Code should primarily serve the company for the benefit of its investors, the end users of financial statements.

4.2 Risk management

2. What approach should a Combined Code-style Audit Firm Governance Code adopt to risk management and internal control?

Comment
We strongly agree with the conclusion of the Working Group that the Code should adopt an approach to risk management and internal control consistent with the Combined Code, the Turnbull Guidance, and the Business Review. Effective risk management and internal controls are important factors and should be an integral part of strengthening audit firm governance and transparency.

We consider that Code section D.2.2 would benefit from having a stronger bite. In addition to a stronger linkage to the full Turnbull guidance, we think that they should also be required to disclose their risk management practices and significant business risks that could affect their financial stability, capital and liquidity.

We also agree with the conclusion of the Working Group on page 16 of the Second Consultation Paper that “[i]t would be unfortunate if the application of the Code were seen by firms, listed companies and their shareholders as primarily an exercise in compliance and disclosure performed for the benefit of regulators.” In light of this potential issue, we recommend that D.1 be renamed from “Compliance principle” to “Best Practice principle’ and that section D.1 of the Code be amended so that it reads as follows: “A firm should comply with the letter and spirit of professional standards and applicable legal and regulatory requirements.”
3. To what extent do the firms face unique issues in discussing their principal litigation and claims risks without causing damage to the sustainability of the firm?

Comment
We agree with the conclusion of the Working Group that audit firms do not face litigation issues that are so unique to them that they could not discuss their principal litigation and claims risks. We also do not believe disclosure of such claims in accordance with generally accepted accounting principles would affect the sustainability of the firms in a negative fashion. We strongly urge the inclusion of a stronger provision in Code section E.3.1 requiring disclosure of such litigation. In addition, Code section E.3.1 should also be amended to add a provision that reaffirms the fundamental right to access public courts of law for dispute resolution and not permit audit firms to require mandatory, private arbitration and mediation. Private litigation is an important investor protection that supplements regulatory activity to ensuring accountability and confidence in the financial markets.

4. Do you agree that the Audit Firm Governance Code should focus on risk management and internal control of the firm as a whole including its non-audit business and, if not, what alternatives would you propose?

Comment
We agree with the conclusion of the Working Group that the Audit Firm Governance Code should focus on risk management and internal control of the firm as a whole, including its non-audit business. We also believe the audit firms should focus on, and provide transparent disclosures on their key indicators of audit quality.

It is interesting to note the comment on page 27 of the Second Consultation Paper of a mid-tier firm also representing views of some other similar firms that ‘the extension of the Code to the firm as a whole is unnecessary and disproportionate, and likely expensive’ as they were concerned about potential interference with the business models of mid-tier audit firms if the Code was applied across all their business activities. Again, we urge the Working Group to explore the following critical issues affecting the auditing profession. These issues include the questions of:

- Whether or not an “audit only firm” is a more appropriate business model for the profession than the current model which combines the federally and state regulated auditing function that serves the investing public, with the non regulated consulting services that serve businesses and other who acquire such services.
- The quality of international auditing standards applicable to audits of global international public companies including the independence of the process by which they are established and enforced, including auditor oversight.
- Conflicts and questions of independence that arise from the auditor being paid by the very company they audit and whether there might be a better mechanism for achieving the goals of having an independent audit.

With respect to the above-referenced concern about cost, given the trillions of dollars in investor losses we strongly believe the benefits will outweigh the costs of adhering to the Code. As aptly noted by well known columnist Floyd Norris in a September 11, 2009 New York Times article titled “Accountants Misled Us Into Crisis”, Mr. Norris states, “The accountants let us down. That is one of the clear lessons of the financial crisis that drove the world into a deep recession.”
4.3 International structures of the firms

5. In the case of a UK firm that is part of a regional or an international structure, should the Audit Firm Governance Code specify the level at which it is applicable or should the firm be given some discretion to determine the level at which it applies the Code, explaining why this level has been chosen?

Comment
We urge the Working Group to revisit this issue as we do not agree with the conclusion of the Working Group on this issue. We strongly believe there should be only one Audit Firm Governance Code that applies globally to every firm, and every affiliate within that firm, that audits public interest entities. The issue should be one of scalability as appropriate for the size of the audit firm in question as opposed to whether or not the Audit Firm Governance Code should be applicable at all or at differing, lesser levels.

6. Do you think that the Audit Firm Governance Code should contain code principles and/or code provisions covering an audit firm’s dependence on, and exposure to the risks of, other network members and how it ensures consistent quality and application of auditing standards?

Comment
We agree with the conclusion of the Working Group that the Code should contain principles and/or provisions covering a firm’s dependence on, and exposure to the risks of, other network members; and how it ensures consistent quality and application of auditing standards. We believe the operating procedures and governance of a firm should require it to disassociate itself from a firm or network of firms, when affiliates within the network are not required to maintain a quality control system that ensures high quality audits that provides investors reasonable assurance as to the accuracy of financial statements and disclosures.

4.4 Governance structures and independent non-executives

7. In principle, do you think that the Audit Firm Governance Code should support the appointment of independent non-executives by the firms and, if so, what might it say on the number or proportion of non-executives and their position, role and responsibilities in a firm’s governance structure?

Comment
We agree with the conclusion of the Working Group that the Code should support the appointment of independent non-executives directors by the audit firms as it relates to the establishment of an independent board of directors. Audit firms should ensure that they sufficiently empower their independent directors to exercise informed influence. This will be challenging if they constitute only a small proportion of the Board. We believe the Code is right to recommend a majority of them on the body that oversees public interest matters, or other relevant involvement in the governance structures of the firm.
8. Other than matters related to auditor independence, are there any barriers, regulatory or otherwise, to the appointment of independent non-executives to firms?

Comment
We do not concur with the conclusion of the Working Group that further consideration be given to liability concerns and independence issues. With respect to comments from the audit firms on these issues, we believe that the provision of indemnity insurance referred to in Code section C.3.2 addresses the potential liability concern. We also believe that qualified candidates will be available to serve on the boards of independent public accounting firms that audit public companies. We do not believe changes should be made that would lessen the independence of audit firms, or create incentives to unduly focus on profits to the detriment of their customers, the investing public.

9. What other governance structures and models are there that provide for independent oversight which might be considered by the Audit Firm Governance Working Group?

Comment
We believe 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. To incent the highest level of audit quality and audit firm governance and transparency, Part A DIRECTORS, Main Principles of the Combined Code on Corporate Governance published by the FRC in June 2008 should be adopted by audit firms.

Scope of firms to be covered

10. In order to determine which firms the Audit Firm Governance Code applies to, should the definition of a public interest entity be based upon the narrower listed company market definition used for transparency reporting purposes or the wider definition used by the AIU or some other definition?

Comment
We strongly urge you to revisit this issue and adopt a broader definition of a public interest entity, that includes (i) entities whose transferable securities are admitted to trading on a regulated market or an exchange-regulated market (i.e., including the Main Market of the London Stock Exchange and companies listed on AIM), (ii) credit institutions, (iii) insurance undertakings, and (iv) other entities of public relevance because of the nature of their business, their size, or the number of their employees. If an entity is considered private, but takes in and manages public money, then we believe such entities should be considered to be a public interest entity.

11. Do you think that a distinction should be made between firms that would be required to apply the Audit Firm Governance Code and firms that would be encouraged to apply it on a voluntary basis and, if so, where should that distinction be drawn?

Comment
We believe no distinctions should be made between firms. Every audit firm that audits listed, public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation. In the absence of a regulatory requirement for
adoption of the Code and some meaningful oversight mechanism, we sincerely hope audit firm clients will vote with their “feet” in favor of audit firms that elect to follow the Code provisions and principles.

4.6 Implementation and monitoring

12. Based on the assumption that the comply or explain approach will apply, to what extent do you think that the implementation of the Audit Firm Governance Code should be ‘left to the market’ because owners of the firms and shareholders and directors of listed companies can be relied on to ensure that the firms apply the Code and make appropriate explanations of non-compliance?

Comment
To ensure good faith implementation of the Audit Firm Governance Code, some type of meaningful oversight mechanism needs to be put in place. We support the Audit Services Task Force of the International Organization of Securities Commissions (IOSCO) which on 27 May 2008, announced that it will expand the scope of its work to include the transparency and governance of audit firms, including the intersection of governance with both firm viability and audit quality.

13. What need, if any, do you think there will be for?
- Audit regulations to require the firms to make comply or explain disclosures in relation to the Audit Firm Governance Code?
- A regulatory or other body to monitor and to check either compliance with the Audit Firm Governance Code or the appropriateness of explanations of non-compliance?
- Involvement of auditors appointed by the firms?

Comment
We do not agree with the conclusion of the Working Group on this issue. In a best case scenario situation, ideally the audit firms will view meaningful audit firm disclosures as a competitive advantage that increases investor confidence in audit quality. However, in a real world scenario, some appropriate level of oversight, including regulation, is needed to ensure that both the letter and the spirit of the Audit Firm Governance Code are being fulfilled.

14. Can you suggest any potential deregulatory measures to eliminate possible duplication that could be linked to the implementation of the Audit Firm Governance Code?

Comment
Creation of the Audit Firm Governance Code and its implementation should be viewed as a continuous improvement project. Effective investor protection enhancing regulations should be strengthened, and ineffective, unduly burdensome regulations should be under consideration for revision or eventual elimination.

4.7 Reporting and communication

15. What measures should be taken in relation to how and where the firms disseminate information about their application of the Audit Firm Governance Code so as to enhance its usefulness?

Comment
We urge the Working Group to continue to monitor audit firm reporting and communicating under the Code to ensure meaningful public disclosure and transparency. We strongly encourage the Working
Group to develop a well thought out education and outreach plan. Such a plan should include provisions for communicating with investors, as well as audit firms, as part of the Audit Firm Governance Code audit firm implementation plan to enhance its usefulness.

16. Should the Audit Firm Governance Code call for disclosure of specific matters, such as major changes in governance practices, responses to specific concerns raised by the AIU, and any other matters?

Comment
We applaud and encourage the continuation of providing information on the governance structures of an audit firm structured as an LLP or listed entity contained in the annual report published by audit firms on their respective website. Such disclosures should continue to include key indicators of audit quality, information on risk management, quality, responsibility, the regulatory environment and partner remuneration policies as well as financial statements and a report to partners or members. We recommend expanding the requirement and require the disclosure of key performance indicators to foster greater audit quality. Audit firms should disclose minimum qualifications required to assist other audit firms in building these skill sets. Possible other key performance indicators that should be disclosed are continuity of staffing per engagement, and percent of training dollars spent on staff compared to the fees received for the audit.

4.8 Areas to be covered by the Code

17. Are there principles and provisions in the Combined Code which you think are particularly relevant or inappropriate for application to the firms and are there major issues of relevance to the firms that are not included in the Combined Code?

Comment
We do not agree with the conclusion of the Working Group that the principles and provisions in the Combined Code related to ‘Directors’, ‘Remuneration’ would be particularly inappropriate if applied to audit firms. As we stated previously, Part A DIRECTORS, Main Principles of the Combined Code on Corporate Governance published by the FRC in June 2008 is particularly relevant and important and should be adopted by audit firms to include independent directors on audit firm boards. http://www.frc.org.uk/corporate/combinedcode.cfm. We do not agree with the Paper that Part B of the Combined Code on remuneration is not a legitimate concern for audit firms. Remuneration structures are critically important for rendering an effective assessment of the incentives that operate within a firm, and these are particularly important when the firm concerned audits public interest entities. We urge the Working Group to revisit this issue.

18. Are there any compelling reasons for departing from the Combined Code structure of preamble, principles and provisions?

Comment
We agree with the conclusion of the Working Group to follow the Combined Code structure of preamble, principles and provisions.
19. Can you provide examples, whether or not derived from the Combined Code, from other non-listed company sectors where you think that appropriate governance codes have been developed, giving information on their potential relevance to the firm?

Comment
We agree with the conclusion of the Working Group that lessons could be drawn from material not derived from the Combined Code.

20. Do you have any other observations about matters not covered by earlier questions that you think would be useful to the Working Group in drafting the Audit Firm Governance Code?

Comment
While we think it is appropriate to reference auditor independence in Code section D.1.1, more work needs to be done by the Working Group on this issue as we believe effective auditor independence rules and enforcement should be an integral part of the Audit Firm Governance Code. Auditor independence is critical to the credibility of an audit.

In addition, the Audit Firm Governance Code should also incent the improvement of audit quality via fraud prevention and detection. It is important that changes recommended for the auditor report will result in an acknowledgement of an auditor’s responsibility to detect fraud, rather than merely a statement of limitations on their obligations.

Other significant issues that warrant further consideration by the Working Group include the following:

- The quality of international auditing standards applicable to audits of global international public companies including the independence of the process by which they are established and enforced, including auditor oversight.

- Conflicts and questions of independence that arise from the auditor being paid by the very company they audit and whether there might be a better mechanism for achieving the goals of having an independent audit.

Conclusion

In closing, we appreciate the diligent work of the UK Financial Reporting Council commissioning the Institute of Chartered Accountants in England and Wales in developing a draft Code and working to implement a final Audit Firm Governance Code. This initiative provides a useful contribution to the international debate on audit firm governance and therefore we have copied our response to the Public Company Accounting Oversight Board (PCAOB) of the U.S. Securities Exchange Commission (SEC), the U.S. Government Accountability Office (GAO), the International Organization of Securities Commissions (IOSCO), and the European Commission.

Thank you for the opportunity to contribute to the Audit Firm Governance Code. If you would like to discuss any of these points, please do not hesitate to contact Carl Rosen, our Executive Director, at +44 207 612 7098 or Carl.rosen@icgn.org. Thank you for your attention and we look forward to your response on the points above.
Yours sincerely,

Christy Wood
Chair of the ICGN Board of Governors

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Co-Chair, ICGN Accounting and Auditing Practices Committee

Cc: Daniel L. Goelzer, Acting Chair, Public Company Accounting Oversight Board (PCAOB)
    Mary Schapiro, Chairman, Securities Exchange Commission (SEC)
    Gene Dodaro, Acting Comptroller General of the U.S.
    M. Jean-Pierre Jouyet, Chairman of the Presidents Committee of International Organization of Securities Commissions (IOSCO)
    Jose Manuel Barroso, President of the European Commission (EU)

Attachments: