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Dear Shamima

## **Proposed revisions to the Audit Firm Governance Code August 2021**

1. We have pleasure in providing you with our comments on your consultation on revising the UK's Audit Firm Governance Code ("Code" or "AFGC") for firms that perform audits of 20 or more Public Interest Entities<sup>1</sup> ("PIEs") or of one or more FTSE 350 companies.
2. We believe 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, 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 are 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.
3. 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

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<sup>1</sup> As defined in the Statutory Auditors and Third Country Auditors Regulations 2016

on how audit quality should be measured and assessed. We elaborate on this below.

4. The effectiveness of the Code will be proved by how well the audit firms provide good and useful Transparency Reports, whether they are read more widely, and lead to an increased resulting 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. It should be with shareholders in the companies being audited by the firms having to comply with the Code, However, we have concerns with Transparency Reports and provide more detail at 13.5 below in our answer to Q8.
5. 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”. There is a reason for this. **As far as individual (retail) investors are concerned, intermediation (where investors’ shares are held by a nominee) prevents firms and their INEs having any access to those shareholders.** Some audit firms may have the view that their 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. In cases in which we have attended investor engagement meetings, while these events have been well organised, convivial, enjoyable and interesting, we have noticed that they are also heavily choreographed, stage managed and, to a degree, ‘scripted’ with formal presentations on specific topics. Rather like the Transparency Reports, investor events appear all too often to be an opportunity for the audit firm to tell investors what the audit firm wants them to hear..
6. 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 but presently ignores individual investors. Non-institutional investors, represented if necessary by organisations such as us, need including when looking at the dialogue in the round, as mentioned in our answer to Q5. We believe this is vital to the success of the Transparency Report, INE and audit committee communications with company shareholders and a reminder that retail shareholders are an important constituent of stewardship and governance.
7. In the context of the above overall comments, we answer your 12 consultation questions as follows.
8. Q1. How appropriate do you feel that the revised purpose of the proposed 2022 Code is?

- 8.1. We feel the revised purpose is appropriate:
    - 8.1.1. To promote audit quality.
    - 8.1.2. To ensure firms take account of the public interest in their decision-making, particularly in audit.
    - 8.1.3. To safeguard the sustainability and resilience of audit practices and of firms as a whole.
  - 8.2. However, a key component of promoting audit quality will be a collective understanding of what is meant by audit quality. We suggest that the AFGC provides help in this respect such as an agreed definition of audit quality and some guidance on how best to assess or measure it.
  - 8.3. 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.
9. Q2. What are your views on the proposed thresholds for application of the proposed 2022 Code?
- 9.1. 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.
10. Q3. Should the proposed 2022 Code apply to any firm that audits a FTSE 350 company? Please suggest alternatives.
- 10.1. Yes, it should. We have no alternatives to suggest.
11. Q4. What are your views on the proposed effective date of the proposed 2022 Code?
- 11.1. The proposed effective date of accounting periods beginning on or after 1<sup>st</sup> 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.
  - 11.2. 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<sup>st</sup> 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.

12. 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?
  - 12.1. Our view is that it should be essential that auditors and therefore their firms understand shareholders' priorities in the corporate 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 audit partners and their firms to have ongoing dialogue directly with their audit clients' shareholders, 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 successors need 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.
  
13. Q6. To what extent do you support the changes proposed in the areas of partner oversight and accountability to owners?
  - 13.1. We support fully the changes proposed.
  
14. 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?
  - 14.1. We are supportive of the proposals. However, as our knowledge of any detail in the connectivity of any firm's global network and monitoring of its potential to impact a UK firm is limited, we do not have any other suggestions.
  
15. 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.
  - 15.1. We have concerns about the approach taken to people and culture, similar to the concerns we have about people and culture in the companies we invest in.
  - 15.2. 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 them to describe this and provide some coherent evidence is extremely difficult.

- 15.3. Key components of culture in an organisation are the values it espouses and the behaviours it encourages and rewards. The FRC ran a series of seminars on organisational culture during the week of 21<sup>st</sup> June 2021. All the main issues surrounding organisational culture were well explored and debated by the panels at each session and there is little that we can add here. One important observation made in the first session was that organisations often claim to espouse one sort of behaviour but actually encourage and reward 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.
- 15.4. Some of us agree that remuneration is a key driver of behaviour, linked closely to the practice of why financial reward is given. 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 very well paid.
- 15.5. However, others believe that remuneration is not a key driver of behaviour and incentive schemes can sometimes lead to unintended adverse consequences. An audit firm's remuneration policy needs to take into account the conflict between providing audit quality from an investor perspective and providing an audit that the company is happy to pay for, which are often not the same thing. There should also be mechanisms to determine if the pay people receive seriously disincentivises rather than motivates them and take steps to resolve this. Another mechanism to consider is to impose penalties to deter people from unwanted behaviour, for example reductions in remuneration for non-compliance.

- 15.6. The problem of encouraging appropriate behaviour and culture within audit firms is doubly complex due to confusion over who 'the client' really is. Many businesses have tried to focus on 'customer satisfaction' and the nurturing of long term customer relationships as a means of mitigating a culture of overly-aggressive selling and corner-cutting with service. The difficulty in audit is that while, in principle, the customer/s should be the shareholders, in practice, the customer-relationship is with the company and mainly its financial management who engage the auditor and pay 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 challenging or application of serious professional scepticism. The management will also require "their" auditors to help them keep their reporting compliant and therefore them safe. It is also hard to see a client selecting the bid from the auditor who bids the highest price while offering the programme of work that is clearly the most thorough and is designed to ensure the most effective questioning and challenging on behalf of the real client, the shareholders.
- 15.7. Ideally, we would like to see a third party (perhaps the regulator) involved in the selection and appointment of auditors. This would help to overcome the current conflict of interests which jeopardises the ability and willingness of auditors to apply professional scepticism and approach their work with the interests of the shareholders as their primary objective. Resistance to this idea from several quarters suggests that it is unlikely to be adopted in the short term. Nevertheless, it remains our view that this would be the single most powerful measure for improving audit quality.
- 15.8. Current changes requiring the large audit firms to have at least one INE with responsibilities relating purely to the audit part of the practice are a step in the right direction. We would very much like to see the FRC maintaining a close relationship with these individuals, working with them to explore ways in which auditor independence and culture can be monitored and managed and generally holding them to account,
- 15.9. We hesitate to provide additional improvement suggestions as this 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.

- 15.10. Whistleblowing is an area where problems are known to exist, not least in the anecdotal evidence that suggests it is usually not worth someone's effort to whistleblow. We do not agree with the BEIS consultation conclusion not to follow the Brydon Review recommendation on whistleblowing. 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 with a view to 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 may need 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.
- 15.11. With regard to investor engagement events, we have already mentioned in Paragraph 5 above that we believe that these events, enjoyable as they are, often fail to address issues that are of interest to investors. In Appendix 1, we provide an example of where a question on culture was dealt with and shortly afterwards there was a press story that contradicted the answer provided. There is therefore a serious need to consider how investor engagement events can be made more useful for both the auditors and those they serve.
- 15.12. Lastly, we question the quality and usefulness, as you have done, of Transparency Reports. We think these should focus on:
- 15.12.1. how firms have met the purpose of the Code
  - 15.12.2. how they ensure audit quality or explain what they are doing to improve it
  - 15.12.3. what key or material decisions they have taken in the reporting period and how they have taken the public interest into account
  - 15.12.4. how they have safeguarded the sustainability and resilience of the audit practice and firm as a whole, and
  - 15.12.5. how they have complied with the principles and provisions of the Code or explained non-compliance or alternatives, including non-relevancy.

- 15.13. We would like to see Transparency Reports that are business reports that cover this focus, based on the AFGC, and are 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 to Appendix B.
16. 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?
- 16.1. No.
17. Q10. Do you think that the proposed 2022 Code is clear enough about the role INEs play in the Firms?
- 17.1. 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 and 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.
18. 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.
- 18.1. We have no further comments.
19. 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.
- 19.1. We believe the proposals make sense and do not have enough insight to know if any difficulties may arise from what is proposed.
20. **UKSA (UK Shareholders' Association)** is the oldest shareholder campaigning organisation in the UK. We are a not-for-profit company that represents and supports individual shareholders who invest in the stock market.
21. There are many agents and intermediaries active in financial markets. Unlike them, we are an organisation solely representing people who are investing their own money.



22. UKSA was formed to provide private shareholders with a voice, influence and an opportunity to meet like-minded fellow investors. It is structured as a non-profit making company with annual subscriptions. An elected Chairman and Board of Directors (all volunteers and individuals with a wide range of backgrounds and experience) monitor a regional organisation. Each region benefits from oversight by an elected regional Chairman and Committee.
23. We build relations with regulators, politicians and the media to ensure that the voice of individual shareholders is reflected in the development of law, regulation, and other forms of public policy. See [www.uksa.org.uk](http://www.uksa.org.uk)
24. **ShareSoc (UK Individual Shareholders Society)** is the UK's largest retail shareholder organisation, acting in all areas of the UK stock market. It is a not-for-profit company.
25. ShareSoc is dedicated to the support of individual investors (private shareholders as opposed to institutional investors). We aim to make and keep investors better informed to improve their investment skills and protect the value of their investments. We won't shirk from tackling companies, the Government or other institutions if we think individual shareholders are not being treated fairly. See [www.sharesoc.org](http://www.sharesoc.org)
26. UKSA and ShareSoc have a combined membership of 22,000. Individual investors should always be in the minds of regulators as they own 15% of the UK stock market and 25% of AIM companies (source: <https://www.sharesoc.org/investor-academy/advanced-topics/uk-stock-market-statistics/> ).
27. If you wish to clarify any of our comments or discuss our thoughts further, please contact Charles Henderson at [charles.henderson@uksa.org.uk](mailto:charles.henderson@uksa.org.uk) and Cliff Weight at [cliff.weight@sharesoc.org](mailto:cliff.weight@sharesoc.org).

Yours sincerely

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## **Proposed revisions to the Audit Firm Governance Code August 2021 – UKSA and ShareSoc response**

### **Appendix 1 – example of investor engagement event where contradictory cultural messages were received**

1. In 2019 we attended an event with one of the Big Four firms at which an investor raised a concern about culture within the firm. His comments were firmly rebutted by one of the senior audit partners who commented that he had worked for the firm for many years and did not recognise the behaviour to which the investor referred.
2. Less than forty-eight hours later an article appeared in the Weekend FT magazine giving a damning account of sexism, homophobia and persecution of whistle blowers within all four of the Big Four auditors. The firm in question was mentioned specifically – as were others.
3. We wrote to the firm about this. The firm responded to us commenting:
  - 3.1. 'Going back to your note, at XXX we are acutely aware that the FT article did indeed reference deeply disappointing allegations of poor conduct across all of the Big Four, including a case from XXX in the UK.
  - 3.2. While we did not get into the specifics of this article at our event back on Thursday, please know that (our firm) takes incidents of sexual harassment, homophobia and/or bullying seriously, incredibly seriously.'
4. While it was good to receive a response from the firm concerned, it does prompt some questions, including:
  - 4.1. If they knew the article was about to be released, why did they deny any awareness of poor behaviour within the firm at the meeting?
  - 4.2. Why did they not admit that unflattering comment was about to appear in the FT and that they would be taking serious steps to address the issues raised?
  - 4.3. Why not suggest that there would be a separate meeting arranged at a date to be agreed to discuss the issues and remedies with investors?
5. In the light of this, it was not surprising some seven months later to find the same firm at the centre of a major audit scandal in which large numbers of investors suffered serious losses.