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Dear Robert,

Audit Firm Governance – Consultation

I set out below our responses to your consultation and apologise for their lateness. I hope you will find them relevant and constructive.

By way of pre-amble I should state that the NAPF is keenly interested in the audit profession and played an active role in the MPG in 2007. In addition we have participated in the discussions over the years on the effectiveness of the Combined Code and in the development of codes for private equity and hedge funds. All three codes have helped improve governance and we anticipate that your initiative will perform a similar role for audit firms.

That said, we feel that the Combined Code does not provide a relevant template given the different ownership structures which apply. For the same reason, the “comply or explain” regime, which is seen to offer flexibility and accountability (and which is being called into question as I write), will be hard to police in the absence of third party scrutiny (through the AGM for PLCs). In the public market the explanation all too often fails to address properly non-compliance. Audit firms may well choose simply to “comply” because their clients and investors would be concerned about non-compliance and this would dilute the value of the proposed Code.

In our comments below we have addressed the questions from the perspective of institutional investors and thus ignored the potential impact of the Code on smaller audit firms.

Our responses are as follows:

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?

NAPF: The Governance Code should primarily address the needs of the equity investors who are responsible for re-appointing auditors and setting their fees. That is the line of accountability and to add other stakeholders would be to risk confusion and dilute its effectiveness.

Risk management

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

NAPF: The Turnbull and Smith guidance provide a good framework and we are not certain that the audit firm business model is so different as to require special treatment.

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?

NAPF: Audit firms share this concern with other service sector businesses, who already make public statements on their principal risks. We doubt if there are "unique issues" and would encourage audit firms to apply similar standards as other services

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?

NAPF: Yes.

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?

NAPF: The basis of the Code is flexibility/comply or explain and we would therefore avoid prescribing its application to international structures. There are however separate issues around the international structures which will tend to attract more attention as a result of the introduction of the Code and we expect that firms will develop standards to address these.

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?

NAPF: See 5. above. Investors will expect these issues to be addressed and on balance we would support the inclusion of principles covering them.

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?

***NAPF:** Given the ownership structure of audit firms, the appointment of NEDs would seem to be of questionable value from a governance perspective. Individual firms may choose to follow that route because of their structure or history (eg where a firm is the result of a series of mergers, or business management is seen to be weak). We would however encourage firms to review periodically, and with the help of an outside agency, the effectiveness of their governance model and to publish the results of that review.*

8. Other than matters related to auditor independence, are there any barriers, regulatory or otherwise, to the appointment of independent non-executives to firms?

***NAPF:** No view.*

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?

***NAPF:** the Reuters Trust model worked well for many years and may provide some useful guidance.*

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?

***NAPF:** We prefer a wider definition. Pension funds are increasingly investing in assets outside the quoted sphere and should be able to rely on high standards of governance.*

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?

***NAPF:** It is hard to draw a line and indeed we think it would be a mistake. We draw your attention to the NAPF Guidelines for AIM companies where we describe the Combined Code as the standard to which all companies should aspire, but we recognize that it is inappropriate for many given their size and complexity. We recommend that shareholders apply a "sliding scale" when assessing AIM companies' governance. Would something similar work for audit firms?*

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?

***NAPF:** Given our reservations about comply or explain in this context, we question whether "the market" will work effectively. The Combined Code forms part of the Listing Rules, which gives it relevance to public companies and yet standards of compliance vary considerably. The FRC should at the least conduct a regular analysis of compliance standards and should consider whether the Combined Code should be amended to include specific reference to the Audit Firms Governance Code in the guidance to audit committees.*

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?

NAPF: See 12. above.

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?

NAPF: No view.

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?

NAPF: It would be helpful if reporting were to be standardized so as to permit easier comparisons between firms. The initiative would benefit from an annual review of progress in order to identify what is and is not working.

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?

NAPF: Good disclosure is desirable but must be relevant and proportionate. We are not certain if this can be codified.

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?

NAPF: The Combined Code was as you know designed to address the governance problems of listed companies: accountability to shareholders, balance of the board, remuneration being among the most important principles. We are not convinced that this translates well into the audit firm structure except at the highest level of principle. You will have studied the work of the Walker and Large committees on private equity and hedge funds, which will provide some possibly more relevant ideas. At the highest level shareholders want reassurance on the integrity and independence of audit firms, so are interested in the checks and balances around the provision of services and the arrangements for tackling conflicts of interest, for example.

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

NAPF: No

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 firms?

NAPF: See 17. above

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?

NAPF: See introductory remarks.

I apologise again for the late submission of this response and hope that you will find it helpful as you consider the development of the Governance Code.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'David Paterson', with a stylized, cursive flourish at the end.

David Paterson
Head of Corporate Governance