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AUDIT FIRM GOVERNANCE

A PROJECT FOR THE FINANCIAL REPORTING COUNCIL

EVIDENCE GATHERING CONSULTATION PAPER

Audit Firm Governance
Working Group
Chairman: Norman Murray
October 2008



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Chairman's introduction

This consultation paper provides an early opportunity to inform and influence an important project. It considers issues that should interest everyone who sees audit as playing a vital role in a market economy, including:

- partners and staff of firms that carry out audits;
- directors and employees of the firms' public interest audit clients; and
- investors and other stakeholders in those public interest audit clients.

The Audit Firm Governance project is intended to promote continuing confidence in, as well as choice amongst, firms that command public trust in the market for the audit of public interest entities. These are aims that in principle should attract wide support from those concerned with the soundness of capital markets.

The project is a challenging one and to be successful it also needs practical support in the form of knowledge, experience, views and ideas from a wide range of people.

Background

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.'

The UK Financial Reporting Council (FRC) established the MPG to advise it on its work on Choice in the UK Audit Market. In turn, the Institute of Chartered Accountants in England and Wales (ICAEW) was invited by the FRC to support the implementation of Recommendation 14 by drawing up a code. The ICAEW formed the independent Audit Firm Governance Working Group (the Working Group) to carry out this work.

Looking beneath Recommendation 14, the underlying reason for the project is the same as the reason for the establishment of the MPG. 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. This remains the case despite a host of reforms since the collapse of Arthur Andersen in 2002 in the wake of the failure of Enron. In recent years, legislators and regulators have implemented measures to strengthen auditing and independence standards and have established additional independent oversight and monitoring of audit work. The UK has also taken steps to address the liability risks facing auditors and has played a significant role in enhancing the public transparency of firms that audit public interest entities (the firms) with the result that UK firms are often seen as leaders in this area.

Nevertheless, there is still seen to be a need both to reduce the risk of a firm exiting the audit market because it has lost public trust and to reduce the risk of a failure that could trigger such an exit. In part this might be because although the firms see themselves as highly regulated in their audit activities and committed to quality and risk management, their audit practices share operations, brands and reputations with businesses that are subject to little regulation. The planned Audit Firm Governance Code (the Code) is intended to mitigate the risks of market exit and to provide a benchmark against which the firms' current and future governance practices can be measured. For a major public interest entity appointing an auditor, it could also reduce a perceived risk of looking outside the four largest firms.

CHAIRMAN'S INTRODUCTION

Benefits and challenges

The benefits of the Code to the firms, companies and investors are anticipated as including reduced risks of:

- a major firm exit from the audit market with its attendant immediate adverse effects on the functioning of capital markets and its sustained adverse impact on choice for major public interest entities;
- an audit failure that might trigger an exit from the market or otherwise give rise to claims for losses and damage confidence; and
- the loss of a firm's substantial investment in reputational capital.

More generally, if the Code means that directors, particularly audit committee members, and investors can 'sleep better at night' and that investors can engage better with auditors, this should have a beneficial impact on the corporate sector. We also believe that it should be less costly and more effective to achieve the benefits we have identified through a comply or explain regime which relies on market forces than through prescriptive regulation.

On the other hand, despite the potentially significant benefits of the Code and the Working Group's plans for ensuring that the Code is developed in a way that is designed to secure those benefits, we recognise that the project faces a number of challenges. For example:

- there is a danger of an expectations gap. Notwithstanding the ambitious objectives for the Code outlined below, we accept the conclusion from the MPG report that there is no silver bullet in relation to the issue of expanding choice in the large listed company audit market and substantially reducing the risk of the exit of a major firm from that market. The Code, like other recommendations from the MPG, can make a contribution but it is not a panacea; and
- some people, particularly within the firms, may believe that the Working Group is committed to an agenda of applying to firms all of the Combined Code model for corporate governance, for example in relation to having a balance of executives and non-executives (in particular independent non-executives), without considering whether this is necessary in the context of owner-managed firms. While recognising that the listed company governance model provides the principal frame of reference, the Working Group will reflect on all arguments put forward about the application of the Combined Code model and is committed to debate issues such as the potential role of non-executives with equivalent powers and responsibilities to non-executives in listed companies.

International context

The UK has already played a leading role in identifying issues related to governance of the firms. However, the Working Group will need to consider recent, related international developments such as the governance recommendations of the US Treasury Advisory Committee on the Auditing Profession (ACAP). We also note that the International Organization of Securities Commissions (IOSCO) has announced that its Audit Services Task Force will consider the transparency and governance of the firms.

We will seek international input to our consultation process and also consider our work in the context of any potential international response to the current difficult economic environment. The publication and acceptance of an Audit Firm Governance Code could pre-empt more prescriptive initiatives in this area.

Objectives

There is already a considerable amount of information in the public domain about the firms' governance arrangements. This shows that individual governance practices have evolved in the face of changing circumstances. The primary purpose of the Code will be to provide a formal benchmark of good governance practice against which the firms can report on a comply or explain basis. This will help audit committees and shareholders of public interest entities make better informed choices. However, on its own this is not enough. It would be unfortunate if the application of the Code were seen by auditors, their clients and investors as primarily an exercise in compliance and disclosure performed for the benefit of regulators. The Code should not simply be a regulatory cost of doing business to be borne and, if possible, minimised.

Our aspiration is that the Code should over time play three additional roles:

- encouraging changes in governance which are seen as enhancing the way the firms are run;
- enhancing the stature of the firms as public interest entities by giving users of audit services confidence in the firms' governance that allows the firms to stand comparison with the best of their public interest audit clients; and
- underpinning other aspects of the regulatory regime for audit, instilling confidence that the regime will deliver high quality audit without needing to cover every eventuality through costly and distracting detailed regulation.

We hope that directors and shareholders of audit clients will believe that the Code plays these roles. However, this is most likely to occur in practice if the firms see the Code in this way. Therefore, the support of the firms' leaders is important to the Code's success.

The first stage in the process of drafting the Code is to obtain responses to the questions in this first consultation paper. All those with an interest in the vital role of audit in the economy are invited to contribute their knowledge, experience, views and ideas.

I therefore encourage recipients of this consultation paper to respond to some or all of our questions. We also welcome evidence of any specific issues that the firms may need to address through enhanced governance which you think should be considered in the development of the Code.

Your responses will help inform our future work and we look forward to reading what you have to say.

Norman Murray
Chairman, Audit Firm Governance Working Group

1. CONSULTATION PROCESS

1.1 Responding to this consultation paper

Who is asked to respond?

The Working Group is seeking responses to all, or some, of the questions in this consultation paper from representatives of:

- audit firms;
- investors;
- listed companies;
- other public interest entities; and
- any other interested parties.

When to respond

Comment letters should be received, at the latest, by 31 January 2009. Early responses are encouraged.

How to respond

Comments should be sent either:

- by e-mail as a Word file to auditfirmgovernance@icaew.com; or
- by post to:

Robert Hodgkinson
Project Director
Audit Firm Governance Working Group
ICAEW
Chartered Accountants' Hall
PO Box 433
Moorgate Place
London EC2P 2BJ
United Kingdom

We welcome contributions to any of the relevant matters raised in this document from commentators outside the UK.

It would help in our analysis of responses if you could provide us with information on the size and activities of your organisation.

Respondents should indicate specifically whether their comments should be treated as confidential. Standard disclaimers in responses received by e-mail will be disregarded for this purpose. Unless otherwise stated, responses will be regarded as being on the public record.

Web links and future information

This document is available on the websites of the ICAEW and the FRC, where any follow-up documents will appear in due course, as follows:

ICAEW www.icaew.com/auditfirmgovernance

FRC www.frc.org.uk/about/auditchoice.cfm

1.2 Working methods

Its terms of reference call upon the Working Group to ‘develop, consult upon, and publish a code of best practice governance for accountancy firms that audit public interest entities with which they should comply or give a considered explanation for any non-compliance.’ The members of the Working Group listed in Appendix 1 bring experience from a wide variety of backgrounds in the firms, listed companies and the investment, regulatory and academic communities.

The Working Group is committed to discharging its responsibilities in a way that:

- secures wide support for the planned Audit Firm Governance Code;
- demonstrates a practical application of evidence-based policy-making; and
- follows better regulation principles including the completion of a regulatory impact assessment.

The Working Group plans to carry out two formal consultations:

- the first to gather evidence on key issues that will inform our work in drafting the Code; and
- the second to obtain views on a draft of the Code.

This consultation paper is part of the first evidence gathering phase which will also include other research activities. We will seek views from relevant groups and individuals and not rely exclusively on written submissions to this consultation paper. The outputs from our research and engagement activities will be summarised alongside written responses to the consultation questions.

From this first consultation we want to understand views on the issues that the Code should address and how it should address them in the context of the Combined Code model. The consultation will help ensure that the draft Code anticipates the concerns of the firms, companies, shareholders and other stakeholders. We will:

- put all responses on the public record;
- analyse the quality of the arguments as well as the weight of opinion behind different points of view; and
- for each question summarise the evidence and state the conclusion we have reached for the purpose of preparing a draft Code.

We are not taking for granted what the Code should contain and a draft of the Code will be prepared for consultation in spring 2009 with the aim of issuing the Code in late summer 2009.

This paper asks 20 questions on eight consultation issues set out in Section 2 that are crucial to the drafting of the Code. We are aware that these questions raise difficult technical and practical issues specific to the firms of which there may be little widespread appreciation. Therefore we have presented supplementary briefing information in Section 3 to help ensure that commentators are properly informed about the issues involved. Commentators who are less familiar with the issues under discussion are likely to find Section 3 particularly useful.

1. CONSULTATION PROCESS

1.3 Consultation questions

The Audit Firm Governance Working Group is seeking responses from commentators to any or all of the following questions.

It would be helpful, where appropriate, to provide reasons to support your answers.

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?

Risk management

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

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?
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?

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

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?
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?

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?
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?
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?

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?
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?

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?
18. Are there any compelling reasons for departing from 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 firms?
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?

In addition to encouraging recipients of this consultation paper to respond to some or all of our questions, we also welcome evidence of any specific issues that the firms may need to address through enhanced governance which you think should be considered in the development of the Code.

2. CONSULTATION ISSUES

2.1 Stakeholders of firms that audit public interest entities

Codes of governance that originate in the UK and in many other countries are based on the comply or explain approach envisaged in MPG Recommendation 14, the development of which is described in Section 3.1. This approach requires public disclosures by an organisation of how it has applied a governance code and explanations of any non-compliance. It promotes the accountability of an organisation to the stakeholders the code is designed to serve. They can evaluate the disclosures and act on them as they see fit.

In the case of a UK company listed on the Main Market of the London Stock Exchange, the Combined Code on Corporate Governance (the Combined Code) summarised in Appendix 2 is designed to serve shareholders, particularly institutional investors who also have obligations under the Combined Code.

The driving force behind the establishment of codes of corporate governance is the need to protect the interests of shareholders when there is a separation of ownership from control. However, such codes also benefit others. The Combined Code helps to reinforce the UK's enlightened shareholder value approach, whereby directors of companies also need to have regard to other interests referred to in section 172 of the Companies Act 2006.

In the UK, almost all the larger firms identified in the analyses prepared by the Professional Oversight Board (POB) and reproduced in Appendix 3 are currently owned by people who are actively involved in the business whether as members of a Limited Liability Partnership (LLP) or as partners in a partnership. Thus although a few firms use a company structure, accountability to external owners is not the significant issue that it is for listed entities that are subject to corporate governance codes. This could change if, at some time in the future, regulation of audit firm owners and management voting rights is relaxed to make it easier for them to raise significant amounts of external capital. However, that is a separate debate and there is currently no presumption of change.

The question arises as to who the stakeholders are whose interests should be taken into account in developing an Audit

Firm Governance Code. The introduction of such a code would not alter the members' or partners' rights as owners, nor the fact that the firm's management is accountable to them for the overall success of the business. In addition to the owners of firms (be they members or partners) and as well as the capital markets in general, the two external groups most commonly mentioned as stakeholders of the firms are:

- shareholders in public interest entities that are audited by the firms; and
- directors of public interest entities including their audit committees.

Both these external groups have reasons to focus on all of the following:

- the sustainability of their audit firm;
- audit quality; and
- issues related to choice of firms including how the firms are governed and how they differentiate themselves.

In this context, the Audit Firm Governance Code could be seen as helping to ensure that directors of, and investors in, public interest entities have a greater understanding of and more confidence in the governance of firms that audit public interest entities. The Code would support a trend whereby shareholders, who are the ultimate beneficiaries of the work of auditors of listed companies, are in the future likely to take an interest in the governance of the firms in two ways. Firstly by direct engagement with auditors and secondly through the audit committee of listed companies in which they invest as this is the board committee that is most closely involved in the evaluation, appointment and re-appointment of the audit firm.

As with other governance codes, the Audit Firm Governance Code could also be seen to benefit others, being the wider stakeholders of both public interest entities and the firms. Wider stakeholders might include lenders, creditors, insurers and employees. Regulators are also likely to take an interest in the application of the Code.

Consultation question on stakeholders of firms that audit public interest entities

It would be helpful, where appropriate, to provide reasons to support your answers.

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?

2.2 Risk management

The origin of the request to develop the Audit Firm Governance Code is Recommendation 14 of the final report of the MPG. This Recommendation falls under a report objective entitled ‘reduced risk of a firm leaving the audit market without good reason’.

Effective risk management and control are critical to the success and sustainability of every business. Consequently, these processes and their disclosure are significant issues to:

- help ensure the sustainability of an audit firm and reduce the risk of it leaving the audit market; and
- provide listed company directors and shareholders and others with insight into firms to assist them in making evaluations of the firms for the purposes of appointment or re-appointment.

In the context of listed companies, Main Principle C.2 of the Combined Code calls for a ‘sound system of internal control’ and its related Code Provision refers to a review, undertaken at least annually, with related reporting to shareholders. The FRC’s guidance on internal control, often referred to as the Turnbull Guidance, which supports these aspects of the Combined Code enhanced the attention paid by boards to wider aspects of listed company risk management and internal control processes and related disclosures. The statutory business review has also required listed companies to disclose their principal risks, in addition to making the disclosures required by accounting standards in relation to provisions and contingencies.

Firms that audit public interest entities place considerable emphasis on the quality of their work and have standards, systems and processes to manage risk and quality control,

particularly in their regulated businesses. While each firm has its own detailed approach, the overall objective is to have an effective quality and risk management framework underpinning the consistent application of professional standards to the services provided to their clients. Regulators, such as the FRC’s Audit Inspection Unit (AIU) and the US Public Company Accounting Oversight Board (PCAOB), look at these matters as part of their inspection visits.

Two issues might be seen as needing particular attention in applying listed company experience of risk management and disclosure to the firms, both in their highly regulated audit practices and in their less regulated businesses:

- Unless information is already in the marketplace, disclosures additional to those required by accounting standards of major risks related to actual or potential liability claims could result in the crystallisation of claims and impact the sustainability of a firm. This could result in limitations on such disclosures as it is likely that the firms will not be willing to disclose some litigation issues for reasons of commercial confidentiality and uncertainty. Yet this is the area that may pose the greatest threat to a firm’s sustainability and so be of considerable interest to stakeholders.
- Stakeholders have an interest in the management of the principal risks to the sustainability of the firm as a whole, not just risks in the audit business. They may wish for information on a firm’s overall culture including its ‘tone at the top’ and on its non-audit business if a major failure in this part of a firm might threaten the audit business.

Consultation questions on risk management

It would be helpful, where appropriate, to provide reasons to support your answers.

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

2. CONSULTATION ISSUES

2.3 International structures of the firms

There is a presumption that listed entities subject to the Combined Code are, from a corporate governance standpoint, independent and self-contained with the board acting as agents running the company on behalf of its shareholders. However, the Audit Firm Governance Code will apply to many UK firms that are members of international networks of firms.

The major international audit practices have traditionally been organised as networks of separate, nationally owned firms. National firms have predominated because the regulation of audit has been organised nationally and the UK regulatory regime is described in Section 3.2. International networks of national firms have been a pragmatic response to the need to perform audit and other assignments for international clients. Auditing standards require signing partners to take responsibility for the adequacy of the work on international clients but audit committees of such clients will, at a minimum, be interested to understand how consistency in audit quality and application of auditing standards is ensured around the world.

Network agreements cover matters such as the use of the network brand, the development and use of a common audit methodology, arrangements for cross-referrals of client work and international quality assurance systems. The central organisation in each of the networks generally does not provide services to clients as this work is undertaken by the individual network firms.

Networks are currently undergoing significant change with a number of networks bringing national firms together into new regional multi-jurisdiction firms, although there are currently very few firms structured as a single international entity.

Where the firm that signs an audit report is governed by a regional, multi-jurisdiction structure or a single international structure, rather than being part of a traditional network, an issue for consideration is the level at which the Code should be applied. It could be argued that the Code should be implemented by the national firm signing the audit report.

Alternatively, if a firm is principally governed at a regional or international level and the national firm no longer has its own complete governance structure, application of the Code at a higher level may be more appropriate. The latter option brings possible extra-territoriality implications were a UK originated code to apply to other national firms. There may be a third option of allowing a choice to determine the level at which to apply the Code.

As detailed in Section 3.3, under Article 40 of the EU Statutory Audit Directive 2006, firms will soon have to publish transparency reports and some firms have already voluntarily published such reports. The Directive recognises the importance of networks by requiring the following information: 'Where the transparency reporting auditor belongs to a network, a description of the network and the legal and structural arrangements of the network'.

The Directive simply requires a description and does not establish any expectations regarding network governance arrangements. However, this is an area which might need to be covered by the Code if it is to be seen to serve the interests of the firms' stakeholders.

Consultation questions on international structures of the firms

It would be helpful, where appropriate, to provide reasons to support your answers.

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?
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?

2.4 Governance structures and independent non-executives

The Combined Code, like many international corporate governance codes and requirements for listed companies, expects there to be independent non-executives on a board and that they form the membership of important board committees covering audit, remuneration and nomination matters.

Although there is no presumption that the Combined Code model for independent non-executives is entirely appropriate for the Audit Firm Governance Code, the role of such individuals and the benefits they bring to companies are set out in the Higgs Report and summarised in Section 3.4. Many of these benefits might also apply to the firms, working on the assumption that, as in a corporate setting, non-executives would act as part of the board in the interests of the entity and not as representatives of any particular stakeholder or interest group.

UK law implementing the EU Statutory Audit Directive requires that, for an audit firm, more than half the owners' voting rights and over half the management in terms of votes have to hold an audit qualification.

The larger firms generally have a two-tier governance structure with:

- a form of partnership board or council, with supporting audit and other committees, that represents the interests of the partners and whose membership includes individuals elected by the partners with others appointed by an individual who may be described as the CEO or the managing partner; and
- a management board selected and headed by the CEO or the managing partner who is elected by the partners.

Brief information on audit firm governance practices and developments is provided in Section 3.5. It could be said by some firms that their current governance structures already reflect to some extent the principles of the Combined Code because the majority of the partners on their partnership board or council are not members of their executive management board and these individuals participate in partnership board or council committees such as audit, remuneration and nomination committees.

Nevertheless, the question of whether there should be an injection of independent non-executives as understood under the Combined Code needs to be addressed by the Working Group. There may be alternative structures, boards or committees from where potential independent non-executives could perform their role which might include oversight of governance and public interest matters. One of the six largest UK firms has recently appointed two independent non-executives to its management board.

In the UK, issues related to appointment of non-executives on boards of firms were highlighted before the MPG reported in October 2007 and they now need further consideration.

As described in Section 3.6, on 6 October 2008 the US Treasury Advisory Committee on the Auditing Profession (ACAP) published its final report. One of its recommendations is that regulators, investors, companies and the audit firms 'analyze, explore, and

enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms'. In their comment letters to ACAP on its draft report, while generally being positive about the value provided by independent board members, the US audit firms expressed concerns related to partnership law, auditor independence rules and liability risks, noting that these create obstacles to attracting appropriate independent board members.

As described in Sections 3.7 and 3.8, for potential non-executives the issues related to auditor independence and liability in the UK are somewhat different to those in the US. The UK LLP affords much protection from personal liability so that with carefully drafted contracts for services the issues appear to be more manageable in the UK.

The auditor independence regime in the UK has fewer detailed rules than in the US. Nevertheless, there may be particular problems with the current US auditor independence requirements as they apply to a UK firm in relation to clients registered with the US Securities and Exchange Commission (SEC). The US rules are complex and it is recommended that respondents read Section 3.7.

Requirements which attach paramount importance to auditor independence above all other considerations long predate the work of the MPG and ACAP on audit firm governance. Public policy often has to balance a number of different considerations and in the medium-term it is possible that independence rules might need to be adjusted to reflect the belief that independence and good governance are both important. If this were to be the case, it might make it easier for the largest firms to appoint individuals to bring an external perspective at the highest level without falling foul of auditor independence requirements.

Consultation questions on governance structures and independent non-executives

It would be helpful, where appropriate, to provide reasons to support your answers.

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

2. CONSULTATION ISSUES

2.5 Scope of firms to be covered

Recommendation 14 of the MPG's final report states 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.' Consequently, the Audit Firm Governance Code will most definitely not need to be applied to all firms that perform statutory audits, only to certain firms that audit public interest entities.

As discussed in Section 3.9, there are at least two different definitions of public interest entity that are used in the UK for different regulatory purposes. The first definition is used to identify the population of firms that fall under the AIU's inspection regime. The second is for the purposes of implementing the transparency report requirements of the Statutory Audit Directive in the UK. It only covers listed entities on the Main Market of the London Stock Exchange and excludes companies listed on AIM. This is also the proposed definition to be used by the Consultative Committee of Accountancy Bodies (CCAB) in its exposure draft consultation paper entitled *Voluntary Code of Practice on Disclosure of Audit Profitability* issued on 30 September 2008.

The AIU's definition of a public interest entity is far wider because it refers to a number of sectors outside the listed company sector, such as charities and pension schemes. However, the application of size tests to these other sectors means that only a small number of additional firms fall within the AIU's definition.

Were the additional sectors referred to in the AIU definition to be included in the definition without size tests, then it is likely that the number of firms auditing public interest entities would be much higher.

In setting the definition to be applied by the AIU, the Professional Oversight Board (POB) introduced a size test consistent with the reference to major public interest entities in its remit. There is no such reference to major public interest entities in MPG Recommendation 14. If the Working Group wanted to consider a definition that included reference to non-listed sectors, it may need to consider some form of threshold, be it based on a size test or a numerical threshold (such as 10 public interest entities), above which firms would be required to apply the Audit Firm Governance Code and below which application would be voluntary.

Even if the Working Group settled on a definition based on the listed company market, it might still conclude on cost-benefit grounds that reporting on a comply or explain basis against the Code should only be mandatory for firms with public interest entities above a certain size or for firms with a certain number of public interest entity audits. For example, the analyses in Appendix 3 of 33 larger registered audit firms indicate that 24 firms have Main Market listed company audits but only 10 firms have five or more such audits.

The Working Group is also mindful of the fact that MPG Recommendation 14 is a result of the FRC's Choice in the UK Audit Market project. Therefore the definition of the firms to which the Audit Firm Governance Code applies needs to be set with an awareness of its potential effect in discouraging demand for, and supply of, services provided by new market entrants. Such matters will need to be considered as part of the Working Group's regulatory impact assessment work.

Consultation questions on scope of firms to be covered

It would be helpful, where appropriate, to provide reasons to support your answers.

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?
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?

2.6 Implementation and monitoring

Best practice comply or explain governance codes are generally seen as an efficient market-based alternative to regulation. The implementation of such a code by firms requires consideration of the regulated environment in which the firms operate, in order to prevent duplication of effort.

Firms' audit practices, especially those that audit public interest entities, operate in a highly regulated environment. Section 2.3 referred to the new transparency reporting requirements as described further in Section 3.3. This builds on a regime in which firms are regulated on how audits are conducted and on the quality control of audit work and are subject to regular external inspection. Public reports on audit inspections of the largest firms are to be published by the FRC's independent AIU. Firms that audit public interest entities are subject to regulation via the Audit Regulations of the registering bodies, known as Recognised Supervisory Bodies (RSBs) as well inspection by the monitoring units of the RSBs and by the AIU. A summary of the UK regulatory environment for registered audit firms is set out in Section 3.2.

The audit quality monitoring work of the AIU and the Audit Firm Governance Code could be seen as complementary. An appropriate code of governance that would set a clear benchmark for expectations and help strengthen the tone at the top within the firms may help to ensure an appropriate focus on audit quality. If such a code was drafted along similar lines to the Combined Code, there is also unlikely to be much duplication or overlap. For example, there would be no need for such a code to cover standards of performance for audit work and related quality control which are already adequately covered by regulations.

When considering the monitoring of the implementation of any governance code the respective roles of regulators and market participants are important. In the case of listed companies to which the Combined Code applies, enforcement is achieved through:

- the Financial Services Authority (FSA) which in its Listing Rules requires publication of comply or explain disclosures and which checks the existence but not the content of a listed company's corporate governance disclosures;
- shareholders and their agents and advisers who assess comply or explain disclosures and then take whatever action they feel is needed; and
- the auditors of listed companies who have limited involvement in reviewing compliance with 9 out of the 48 provisions in the Combined Code.

When monitoring the implementation of the Audit Firm Governance Code, one option might be to leave it to market participants, in particular to the audit committees and shareholders of public interest entities, as well as to the members or partners of a firm. There may be other options such as giving a role to external auditors appointed by a firm or designating a separate monitoring group to review implementation. While there is no presumption of a role for the AIU, it may wish to consider the governance disclosures made by a firm when undertaking its inspections of audit quality.

Consultation questions on implementation and monitoring

It would be helpful, where appropriate, to provide reasons to support your answers.

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?
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?
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?

2. CONSULTATION ISSUES

2.7 Reporting and communication

In the UK, the firms that audit public interest entities already engage in public reporting which is extensive by comparison with other jurisdictions. As LLPs, the largest UK firms publish audited financial statements and they make transparency disclosures under a voluntary UK reporting regime that was established some five years ago. This reporting is due to be supplemented by:

- new reporting on the results of AIU audit quality monitoring on a firm-by-firm basis, as described in Section 3.2;
- the formalisation of transparency reporting as a consequence of implementing the Statutory Audit Directive, as described in Section 3.3; and
- prospective new disclosures of audit profitability as a result of MPG Recommendation 2 as described in Section 3.6.

The comply or explain disclosures that will result from the introduction of the Audit Firm Governance Code will therefore enter a crowded reporting landscape. While comply or explain reporting can be seen as inherently efficient because it will enable users such as shareholders and audit committees to focus on exceptions from benchmark governance practices, there are a number of risks associated with the new reporting, including risks associated with:

- boilerplate disclosures which fail to differentiate between firms;
- poor explanations of non-compliance which are not properly evaluated and acted on by stakeholders;
- important governance developments not being reported or brought to stakeholders' attention in a timely manner; and
- inconsistency between firms about the location of the new disclosures.

Careful drafting of the Code can help to reduce these risks. In particular, the Code could explicitly call for disclosure of specific matters not covered by other requirements, such as major changes in governance practices or other matters such as responses to specific concerns raised in reports by the AIU.

It is also worth considering ways in which the usefulness of the disclosures resulting from the Code could be enhanced by establishing expectations about how and where firms describe how they have applied the Code. Disclosures could also be made more accessible, for example by:

- updating information on an ongoing basis on firms' websites;
- making information about the Code and the firms' application and compliance readily available to readers of audit reports; and
- providing links to comply or explain disclosures from a firm's financial statements, transparency reports and AIU reports.

In addition, it might also be possible to establish expectations that the firms will proactively communicate their application of the Code through:

- communications to client audit committees;
- meetings with investors as part of a two-way communication process; and
- open public meetings.

Consultation questions on reporting and communication

It would be helpful, where appropriate, to provide reasons to support your answers.

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?
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?

2.8 Areas to be covered by the Code

The Working Group's terms of reference set out in Appendix 1 are based on MPG Recommendation 14 which, as reproduced in Section 3.1, refers to '...a Combined Code-style best practice corporate governance guide...' Therefore, in developing the Audit Firm Governance Code, the Working Group could logically be expected to start with the Combined Code, as summarised in Appendix 2, and identify areas in the Combined Code which will generally be expected to be applicable to the firms and those which will not. There may also be matters that are not in the Combined Code that are of relevance to the firms.

Nevertheless, caution about starting with the Combined Code might be justified for the following reasons:

- the Combined Code has developed to meet the needs of companies where there is a separation of ownership from control and the governance challenges are different from those which face the firms;
- the major firms have a partnership ethos, arising from the fact that all the partners are owners and stewards, which is different from that of a listed company;
- the Combined Code assumes a unitary board model whereas the major firms generally have a two-tier structure with a management board and a supervisory body;
- as firms increasingly become international, it might be inappropriate to impose a UK governance model; and
- some of the principles of the Combined Code, for example in Part B on remuneration, might simply not be legitimate concerns in relation to privately owned businesses.

Counterarguments in favour of aligning with the Combined Code are that:

- as major stakeholders in the firms to which the Audit Firm Governance Code is likely to apply, UK shareholders and listed company audit committees are familiar with the Combined Code;
- some firms already benchmark their governance practices against the Combined Code and apply those aspects of the Combined Code which they consider to be appropriate;
- some audit firms are increasingly organising themselves on a corporate model;
- the Combined Code structure of main and supporting principles and related detailed provisions provides sufficient flexibility to reflect the specific circumstances of the firms; and
- a presumption in favour of applying the Combined Code is likely to provide a useful challenge and could prompt innovation in firms' dialogue with the investor community and in the constructive use of meetings to promote engagement.

Notwithstanding the arguments presented above, it would also seem appropriate for the Working Group to learn from the experience of other sectors outside the listed company sector that have adapted the Combined Code or developed an alternative governance code.

Consultation questions on areas to be covered by the Code

It would be helpful, where appropriate, to provide reasons to support your answers.

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?
18. Are there any compelling reasons for departing from 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 firms?
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?

3. SUPPLEMENTARY BRIEFING INFORMATION

3.1 Market Participants Group Recommendation 14

The FRC's Choice in the UK Audit Market project followed the publication of a study by Oxera that was jointly commissioned by the FRC and the then Department of Trade and Industry (DTI) entitled *Competition and Choice in the UK Audit Market*. The Audit Quality Forum had suggested that the DTI and the FRC commission such research in its *Shareholder involvement – Competition and Choice (interim report)* of July 2005.

In October 2007, the FRC published the final report of the MPG that had advised the FRC on its Choice in the UK Audit Market project. Recommendation 14 of the final report states '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.' Further background information on the development of this recommendation is set out below.

FRC May 2006 Discussion Paper

The FRC's initial discussion paper on its Choice in the UK Audit Market project:

- described the importance of audit to the UK economy;
- summarised key features of the competitive environment in the audit market; and
- discussed risks to the public interest that may arise from the level of choice in the market.

The paper considered three broad types of opportunities for mitigating any confirmed risks, namely to:

- promote increased choice, such that there would be more audit firms participating in the market for the audit of large public companies;
- reduce the risk of an existing large firm leaving the market; and
- reduce the costs of disruption in the event of a large firm leaving the market.

Recommendation 14 can be seen as falling under the second heading.

In a September 2006 briefing paper for a stakeholders' meeting, the FRC refers to responses to the May 2006 discussion paper. The following are the audit firm governance-related extracts from the briefing paper:

- Paragraph 61: Whilst recognising that the firms already have the incentive to ensure that their operations are of a high quality, it was suggested that firms could do more to avoid catastrophic failures in all areas of their activities. For example: '[Firms] need to have in place effective governance and oversight of their global business activities enabling them to review their internal controls over risks more generally to ensure that they manage properly the risk of regulatory or other prosecutorial action for work done outside the ambit of audit and assurance engagements. In the UK context, such an outcome could, for example, be achieved by encouraging the UK firms' partnerships to adopt the Combined Code on Corporate Governance as it bears on how the firms are organised and administered'. [Financial Services Authority]
- Paragraph 64: It was suggested that companies could monitor and influence the quality control procedures of their auditors. For example: 'The Big Four firms have already increased their transparency by publishing annual financial statements, and the proposals for the full application of the Combined Code [to the firms]...could further encourage this. Audit committees of client companies should in any event be expected to review their auditors' annual report annually and discuss concerns with the audit partner'. [Financial Services Authority]
- Suggested steps to achieve Objective B.1: Reduced number of claims against audit firms – UK firms could adopt the Combined Code on Corporate Governance as it bears on how firms are organised and administered.

Responses to the May 2006 discussion paper and the stakeholders' meeting indicated a strong preference for market-led solutions and the MPG was established in October 2006 to provide advice on possible actions that market participants (companies, investors and audit firms) could take to mitigate the risks arising in the market for audit services to public interest entities in the UK.

MPG April 2007 Interim Report

The MPG published its interim report and provisional recommendations in April 2007. The wording of provisional Recommendation 14 in the interim report was: 'Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.'

Responses were received from institutional investors, companies and representative bodies as well as from the firms and other market participants, including individual non-executive directors.

44 responses were placed on the FRC's website. Of the 30 which commented on Recommendation 14, there were 25 that were broadly in agreement. Although, in broad terms, 17 suggested adapting the Combined Code and 5 urged the development of a new code a general conclusion was that a Combined Code-style document was the way forward. This conclusion is reflected in revised Recommendation 14 in the MPG's final report.

MPG October 2007 Final Report

In October 2007, the MPG published its final report. Recommendation 14 is noted in the overall 'Findings and Recommendations' section which states: 'In reducing the value of meritorious claims against audit firms, it was noted that the firms themselves have strong incentives to govern their affairs in such a way as to minimise risks. However, the Group considered that users of audit services should be given information about the firms' corporate governance arrangements and that these should comply with standards equivalent to those of public companies.'

The MPG also reported that:

- 'the responses to the Group's interim report demonstrated broad support for the interim recommendations...which are substantially unchanged from the provisional recommendations.
- the recommendations set out actions that could be taken by market participants working collectively and enabling actions by regulators to allow the market to work more efficiently.
- the Group evaluated a wide range of possible actions to increase choice of auditors. In its evaluation the Group sought to identify possible actions which would, when combined with others, contribute to increased choice whilst at least maintaining audit quality, at a cost which is proportionate to the likely benefits and at a cost which is lower than any alternatives offering equivalent benefits.'

It should also be noted that Recommendation 14 is linked to Recommendation 5 on transparency which states: 'The FRC should continue its efforts to promote understanding of audit quality and the firms and the FRC should promote greater transparency of the capabilities of individual firms.' The context for Recommendation 5 is the selection of auditors of public interest entities and the need to reduce the perceived risks to directors of selecting a non-Big 4 firm and to make boards more accountable to shareholders for their auditor selection decisions.

3. SUPPLEMENTARY BRIEFING INFORMATION

3.2 Regulation of UK registered auditors

Audit firms in the UK work in a highly regulated environment. The Professional Oversight Board (POB) is the body with overall responsibility for audit regulation in the UK.

Overview

The Companies Act 2006 implements the EU Statutory Audit Directive of 2006 and provides the legislative framework for the statutory audit of companies in the UK. The law governing statutory audit in the UK is implemented through the Audit Regulations of the professional bodies, known as Recognised Supervisory Bodies (RSBs), which are able to register firms to conduct audit work in the UK. These Regulations require firms to comply, *inter alia*, with the International Standards on Auditing (UK and Ireland) (ISAs), Ethical Standards and Quality Control Standards for auditors issued by the Auditing Practices Board.

Ethical Standards set independence standards for firms relating to audit engagements and deal with such matters as long associations with clients and non-audit services provided to audit clients. ISAs set out the basic principles and essential procedures with which auditors must comply by virtue of the Audit Regulations in the conduct of their audit work. As well as covering matters directly related to the conduct of an audit, ISAs also cover how a firm should communicate with other audit firms and those charged with governance at the audit client. The International Standard on Quality Control (ISQC1) covers such matters as having a system of quality control and the leadership responsibilities for audit quality in the firm.

Before a firm can become a registered auditor it has to demonstrate to an RSB that it is properly controlled in accordance with the Audit Regulations. 'Properly controlled' means that the majority of voting rights in the firm are in the hands of individuals who hold a legally recognised audit qualification or other firms who are themselves registered auditors.

The audit practices within the firms are required to undergo periodic inspections by the AIU of the POB and/or the monitoring unit of the RSB with which they are registered. The Audit Registration Committees of the RSBs receive periodic inspection reports from the AIU and/or their own monitoring units and have powers to impose conditions or restrictions on a firm's continued registration or to withdraw a firm's audit registration.

UK registered audit firms may also be required to register with and be subject to inspection by other national audit regulators such as the US PCAOB.

Scope of the AIU's work

All firms which undertake listed or other major public interest audits are within the scope of the AIU's work. However, where a firm undertakes no more than 10 such audits the AIU restricts its work to the review of one or more such audits and, in effect, delegates the review of firm-wide policies and procedures to the monitoring unit of the relevant RSB. Nine firms are currently subject to full scope AIU inspections, of which the six largest are currently visited annually and the other three firms every 18 to 24 months. Some 30 to 40 other firms are subject to periodic AIU reviews of individual audits as well as inspections by the RSB's own monitoring unit.

AIU inspections of the nine major firms with more than 10 listed or other major public interest audits comprise reviews of the firms' policies and procedures supporting audit quality and the quality of selected audits of listed and other major public interest entities. They include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. The AIU's reviews of individual audits place emphasis on the appropriateness of significant audit judgements exercised in reaching the audit opinion as well as the sufficiency and appropriateness of the audit evidence obtained.

The AIU reviews the firms' policies and procedures relevant to audit quality in the following areas:

- leadership, strategy and communications;
- performance evaluation, promotions and remuneration;
- other human resource matters;
- client risk assessment and acceptance/continuance;
- consultation and review;
- audit quality monitoring;
- independence and ethics; and
- audit methodology.

Its reviews of the firms' leadership, strategy and communications cover the firms' culture and 'tone at the top', published transparency reports and other information. The AIU does not, however, review or express an opinion on the governance structure of the firm, the structure used to manage its operations or the process for selecting the managing partner, chairman or members of the governing body.

AIU reporting arrangements

Revised arrangements for reporting on the results of AIU inspections were announced in December 2007. The new reporting arrangements reflect the outcome of extensive consultation with stakeholders by the POB and are designed to meet increased expectations regarding the transparency of inspection findings in a cost-effective manner.

The AIU will continue to report privately to the RSBs on the overall findings of its reviews of firms' policies and procedures supporting audit quality and its reviews of individual audits at the nine audit firms subject to full scope inspections. However, it will also issue high level public reports on the findings of each such inspection undertaken. The first such public reports, in respect of the AIU's inspection cycle for the year ended 31 March 2008, are expected to be published on the FRC website towards the end of 2008. In each of the previous three years, the AIU published a public report on the main themes and issues arising from its inspections without naming the specific firm or firms at which those issues arose.

The AIU will also report formally to audit engagement partners on the high-level findings of all reviews of individual audits which commenced after 1 January 2008. Firms may provide copies of these new letter-style reports to the directors of the clients covered by individual reviews and the POB expects that this will happen as a matter of routine.

3. SUPPLEMENTARY BRIEFING INFORMATION

3.3 EU transparency report requirements

Article 40 of the EU Statutory Audit Directive of 2006 contains the requirement that a firm which issues an audit report on one or more public interest entities at any time during the financial year of the audit firm should publish on their websites an annual transparency report. The report has to be placed on the firm's website within three months of the end of the firm's financial year.

There has been a voluntary UK regime for reporting transparency information since 2003. However, the requirements of Article 40 have now been implemented into UK regulation by The Statutory Auditors (Transparency) Instrument 2008 (the Instrument) that was issued by the POB on 3 April 2008. The regulations have been made under powers delegated by the Government under the Companies Act 2006 to the POB.

The requirements apply in respect of any financial year of a relevant firm starting on or after 6 April 2008. The regulations set the legal requirements on auditors of public interest entities to provide specific information about themselves and, for example, their systems of quality control and their independence procedures and practices. The requirements follow closely the requirements of the Statutory Audit Directive, from which they are derived. The POB has stated that it will monitor the way in which the firms meet their obligations in practice.

In respect of governance, the Directive simply requires a description and does not establish any expectations regarding network governance arrangements.

Disclosure requirements

The Instrument's disclosure requirements call for:

- a description of the legal structure and ownership of the transparency reporting auditor;
- a description of the network and the legal and structural arrangements of the network, if any, to which a transparency reporting auditor belongs;
- a description of the governance structure of the transparency reporting auditor;
- a description of the internal quality control system of the transparency reporting auditor and a statement by the administrative or management body on the effectiveness of its functioning;
- a statement of when the last regulatory monitoring of the performance by the transparency reporting auditor of statutory audit functions took place;
- a list of public interest entities in respect of which an audit report has been made by the transparency reporting auditor in the financial year of the auditor;
- a description of the transparency reporting auditor's independence procedures and practices including a confirmation that an internal review of independence practices has been conducted;
- a statement on the policies and practices of the transparency reporting auditor designed to ensure that persons eligible for appointment as a statutory auditor continue to maintain their theoretical knowledge, professional skills and values at a sufficiently high level;
- information about the basis for the remuneration of partners; and
- financial information for the financial year of the transparency reporting auditor to which the report relates, which shows the importance of the transparency reporting auditor's statutory audit work.

In respect of the requirement for financial information, it should be noted that many large firms are LLPs and, as such, have been permitted to adopt International Financial Reporting Standards (IFRS) from January 2005. Moreover, subject to some modifications, the accounts and audit requirements of the Companies Acts 1985 and 2006 apply to LLPs.

3.4 Independent non-executives

Non-executives, particularly independent non-executives, play a key role in many of the requirements of the Combined Code, such as the requirements for board committees. Chairmen are also expected to be independent non-executives on appointment and a special role is assigned to the senior independent director. The concept of independent non-executives has been widely adopted, for example in the public and not-for-profit sectors as well as in some larger private companies.

The late Sir Derek Higgs' report in 2003 on the *Role and Effectiveness of non-executive directors* highlighted the role of non-executive directors and noted some of the benefits that such individuals can bring to an organisation.

The comments below are extracts from various sections of the Higgs Report that highlight the role of a non-executive director and some of the benefits that such individuals can bring to an organisation. It should however be remembered that the Higgs Report is set in the context of a listed company with a unitary board.

- A board is strengthened significantly by having a strong group of non-executive directors with no other connection with the company. These individuals bring a dispassionate objectivity that directors with a closer relationship to the company cannot provide.
- A major contribution of the non-executive director is to bring a fresh perspective acquired through their relative distance from day-to-day matters, combined with wider experience acquired elsewhere. This is the basis for questioning and challenging the accepted thinking of the executive.
- Questioning does not only serve to raise specific concerns, it can also prompt stronger executive performance. Skilful questioning can be penetrating and demanding. The response can both reassure the non-executive director and stimulate reflections and actions that contribute to more effective executive performance. Executive directors especially value informed and constructive debate with non-executive directors.
- Much of the effectiveness of non-executive directors depends on exercising influence rather than giving orders and requires the establishment of high levels of trust.
- All non-executive directors must be willing and able to challenge, question, speak up, inquire and probe. They should have sufficient strength of character to seek and obtain full and satisfactory answers within the collegiate environment of the board.
- The composition of a board sends important signals about the values of the company.
- The non-executive director role is complex and demanding and requires skills, experience, integrity, and particular behaviours and personal attributes. The personal attributes are founded on: integrity, probity and high ethical standards; sound judgement; the ability and willingness to challenge and probe; and strong interpersonal skills.
- In addition to the requirements placed on all directors, the role of the non-executive director has the following key elements:
 - Strategy: non-executive directors should constructively challenge and contribute to the development of strategy.
 - Performance: non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives, and monitor the reporting of performance.
 - Risk: non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.
 - People: non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.

3. SUPPLEMENTARY BRIEFING INFORMATION

3.5 Firm governance practices and developments

Information on the governance structures of a firm structured as an LLP or listed entity may be found in the annual report published by that firm on its website. Some of the smaller firms that are LLPs file their annual report at Companies House, but have yet to publish the information on their website.

Additional information on governance structures can be found on firms' websites where they have, in advance of formal implementation of Article 40 of the EU Statutory Audit Directive, published a transparency report. There has been a voluntary UK reporting regime for such information since 2003.

The larger firms generally have a two-tier governance structure with:

- a form of partnership board or council, with supporting audit and other committees, that represents the interests of the partners and whose membership includes individuals elected by the partners with some others appointed by the CEO or managing partner; and
- a management board selected and headed by the CEO or managing partner who is elected by the partners.

Some firms have indicated that their current governance structures already reflect to some extent the principles of the Combined Code.

There is additional information in each annual report which usually includes 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. The firms do not generally have non-partners on the management board or on the supervisory body although it should be noted that:

- the firms are likely to explain this on the basis that they are ultimately private businesses; and
- all the firms have partners with formal oversight roles who are not part of the executive management team.

Partners both work in and own their firms and although individuals in oversight roles represent non-management owners of the business, in a wider context such individuals are unlikely to be seen as being able to meet the expectations of independence that would be applied to non-executive directors on the board of a listed company.

Details of the governance of major US audit firms, the global networks and global governance are set out in Section V of the final ACAP report which can be found on the following web link: www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf

3.6 Regulatory developments

A number of recent and current regulatory developments are relevant to the work of the Audit Firm Governance Working Group in addition to MPG Recommendation 14 described in Section 3.1 and EU transparency report requirements covered by Section 3.3.

United States Treasury Committee

On 6 October 2008, the ACAP appointed by the Department of the Treasury published its final report that contained a number of recommendations designed to increase investor protection and enhance the sustainability of a strong and vibrant public company auditing profession.

The Co-Chairmen of ACAP were Arthur Levitt and Donald Nicolaisen, respectively a previous Chairman (1993–2001) and a previous Chief Accountant (2003–2005) of the Securities and Exchange Commission. In addition to work carried out by the full Committee, there were three sub-committees on Human Capital, Firm Structure and Finances, and Concentration and Competition. The work of the Firm Structure and Finances sub-committee is of most relevance to the Audit Firm Governance project.

In their Co-Chairs' statement Arthur Levitt and Donald Nicolaisen state that 'How auditing firms are structured, their governance, their finances, and their reporting to the public and to investors affect not only how they function but also the market's perception and acceptance of the profession.'

Independent board members

In the final report, the introduction to the Firm Structure and Finances section of the report notes that: 'In addressing the sustainability of the auditing profession, the Committee sought input on and considered a number of matters relating directly to auditing firms, including audit quality, governance, transparency, global organization, financial strength, ability to access capital, the investing public's understanding of auditors' responsibilities and communications, the limitations of audits, particularly relating to fraud detection and prevention, as well as the effect of litigation where audits are alleged to have been ineffective. The Committee also considered the regulatory system applicable to auditing firms.'

The Firm Structure and Finances section makes a number of recommendations that are addressed to regulators, the auditing profession, and others. Of specific interest to the Audit Firm Governance Working Group is Recommendation 3: 'Urge the PCAOB and the SEC, in consultation with other federal and state regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms.'

While recognising the multiple challenges that instituting a governance structure with independent board members might entail, including compliance with state partnership laws and independence requirements, insurance availability for such directors, and liability concerns, the Committee 'believes that enhancing corporate governance of auditing firms through the appointment of independent board members, whose duties run to the auditing firm and its partners/owners, to advisory boards with meaningful governance responsibilities (possible under the current business model), and/or to firm boards could be particularly beneficial to auditing firm management and governance. The Committee also believes that such advisory boards and independent board members could improve investor protection through enhanced audit quality and firm transparency. The Committee is particularly intrigued by the idea of independent board members with duties and responsibilities similar to those of public company non-executive board members.'

3. SUPPLEMENTARY BRIEFING INFORMATION

3.6 Regulatory developments (continued)

Preservation and rehabilitation mechanism

The Concentration and Competition section of the ACAP report considers the importance of the viability of the larger firms and the negative consequences of the loss of one of these firms on the capital markets due to issues arising out of firm conduct, such as civil litigation, federal or state regulatory action or criminal prosecution, or economic events. In the event that the existence of a larger audit firm is threatened then a streamlined governance mechanism might be a practical necessity.

The report notes that it is critical to have a process in place to respond quickly to crisis events. As well as recommending that the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality, ACAP recommended (Section C: Recommendation 2(b)) that there is a need to 'Establish a mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm. A first step would encourage larger auditing firms to adopt voluntarily a contingent streamlined internal governance mechanism that could be triggered in the event of threatening circumstances. If the governance mechanism failed to stabilize the firm, a second step would permit the SEC to appoint a court-approved trustee to seek to preserve and rehabilitate the firm by addressing the threatening situation, including through a reorganization, or if such a step were unsuccessful, to pursue an orderly transition.'

International Organization of Securities Commissions (IOSCO)

On 27 May 2008, the Audit Services Task Force of the IOSCO Technical Committee announced that it will expand the scope of its work to focus on a number of audit-related issues. One of these is the 'transparency and governance of audit firms, including the intersection of governance with both firm viability and audit quality.' The Task Force is comprised of securities regulators from around the globe and is looking at these audit-related issues from an investor protection perspective.

EU ownership of firms

The EU Statutory Audit Directive of June 2006 requires all audit firms to be owned and managed by a majority of registered auditors approved in any EU Member State. The previous regime required nationally registered auditors. The deadline for transposition of the Directive into Member State law was June 2008. The Directive does not specifically define what a majority means in relation to voting rights. Consequently, Member States can require EU auditors (an approved and registered auditor in any EU Member State) to hold a majority of anything between 51% and 100%. The Directive does however set at 75% the maximum requirement which a Member State can stipulate in relation to the composition of the management body of a firm which must be represented by EU auditors.

Against this background, the European Commission commissioned Oxera Consulting to conduct an independent study to examine whether a relaxation of these ownership restrictions to allow external investment into firms would have a positive impact in terms of concentration and choice in the audit market. The study, *Ownership rules of audit firms and their consequences for audit market concentration*, broadly concluded that restrictions on access to capital represent one of several factors relevant to the concentration debate. Other factors include reputation, the need for international coverage, international management structures, and liability risk.

The study also noted that the decision-making processes in large firms indicate that alternative ownership structures are unlikely to impair auditor independence in practice and that specific conflicts of interest could be dealt with through the establishment of appropriate safeguards.

UK consideration of changes to audit firm ownership rules

In May 2008, the FRC published for comment a discussion of the possible effects on auditor choice of changes to audit firm ownership rules. This was in response to the MPG recommendation that: 'The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.' At the time of writing there has been no further statement from the FRC on this issue.

This development arises from MPG Recommendation 1.

UK reporting on audit profitability

The Consultative Committee of Accountancy Bodies (CCAB) has formed a working group to develop guidance on the voluntary disclosure of the financial results of work on statutory audits to help potential new entrants and others to assess the viability of the supply of these services. A consultation paper was issued on 30 September 2008 for comment by 31 December 2008.

This development arises from MPG Recommendation 2.

UK updating of the FRC Guidance on Audit Committees

Following consultation earlier in the year, in October 2008 the FRC published a revised edition of its Guidance on Audit Committees (formerly known as the Smith Guidance). While boards are not required to follow this guidance, it is intended to assist them when implementing the relevant provisions of the Combined Code.

The main changes to the guidance are that:

- audit committees are encouraged to consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning; and
- companies are encouraged to include in the audit committee's report information on the appointment, reappointment or removal of the auditor, including supporting information on tendering frequency, the tenure of the incumbent auditor and any contractual obligations that acted to restrict the committee's choice of auditor.

These developments arise from MPG Recommendations 8, 9 and 15.

UK appointments from more than one network

In May 2008, the FRC published for consultation draft guidance on considerations relevant to the use of firms from more than one network. The FRC's intention was that this would help audit committees to appoint auditors for individual components of a group based on how best to achieve audit quality for each particular component and for the group as a whole.

The guidance was revised following consultation and incorporated into the updated FRC Guidance on Audit Committees published in October 2008.

This development arises from MPG Recommendation 7.

3. SUPPLEMENTARY BRIEFING INFORMATION

3.7 Auditor independence and independent non-executives

UK requirements for auditor independence would be relevant to the appointment of independent non-executives by UK firms and related regulatory requirements in the US may also impact UK firms because of their SEC registered clients. We have endeavoured to distil complex, technical matters relating to the UK and US auditor independence requirements into the summary table set out below.

Applicable requirements

UK In order to carry out statutory audits any firm registered in the UK with one of the RSBs must adhere to the Auditing Practices Board's (APB) Ethical Standards (ES) and the Audit Regulations of their RSB.

US There are two sets of US auditor independence requirements which may apply to UK firms that audit US listed companies or affiliates, being:

- SEC Regulation S-X Rule 2-01; and
- PCOAB rules. These are a combination of PCAOB-written rules, the American Institute of Certified Public Accountants (AICPA) Rule 101 and interpretations thereof, and the rules of the now-defunct Independence Standards Board.

Together the above are referred to as the US Rules.

Summary

Overall, the issues are broadly similar, although the US Rules are complex and constructed differently from those in the UK.

| Auditor independence issue | Impact on potential non-executives |
|---|--|
| <p>Scope of individuals covered by detailed prohibitions on financial interests, business and family relationships, dual employment, provision of non-audit services to audited entities, etc.</p> | <p>UK</p> <p>The ES impose various requirements and prohibitions on audit partners and others in a position to influence an audit. The latter are generally deemed to include those in the 'chain of command' which is defined as 'All persons who have a direct supervisory, management or other oversight responsibility over either any audit partner of the audit team or over the conduct of audit work in the audit firm. This includes all partners, principals and shareholders who may prepare, review or directly influence the performance appraisal of any audit partner of the audit team as a result of that partner's involvement with the audit engagement. It does not include any non-executive individuals on a supervisory or equivalent board.' The last sentence of the definition was recently inserted by the APB into the revised ES and takes effect for audits of periods beginning on or after 6 April 2008. Non-executives would not be included in the chain of command and therefore, unless they have some form of direct link, they would not be affected by the detailed requirements of the ES.</p> <p>US</p> <p>As with the UK, the key concern is whether any potential external non-executive serving on a supervisory board or committee would be included within the scope of individuals required to adhere to the detailed requirements of the SEC and the PCAOB that prohibit various individuals:</p> <ol style="list-style-type: none"> (1) having business or employment relationships with clients; or (2) having financial interests (including investments and loans) in audit clients; or (3) providing certain non-audit services (known as non-attest services) to the audit clients although this prohibition is unlikely to be relevant to non-executives and so is not considered further. <p>A client in this context is taken to be an SEC registrant.</p> |

| Auditor independence issue | Impact on potential non-executives |
|----------------------------|--|
| | <p>Employment restrictions</p> <p>The employment restrictions in (1) above would only be likely to be relevant if the potential non-executive were to be a shareholder in the audit firm or otherwise derive financial gain which varied with the audit firm's financial results. Consideration would need to be given to the terms of any contract with a non-executive to avoid the impression that this was a professional employment contract which would put the individual within the scope of the client employment restrictions.</p> <p>Other restrictions</p> <p>The other restrictions in (2) above would apply to people in the 'chain of command'. The US does not specifically exclude non-executives in definitions of the chain of command. However, it is currently believed that non-executives would not be considered to be 'partners, principals, shareholders, and employees of an accounting firm' (assuming they have no shares in the accounting firm) and therefore they would not, prima facie, be within the chain of command.</p> <p>However, the SEC could conclude that they were included in the chain of command in particular circumstances if there was an impression of interference. As well as the detailed requirements, there is an overall requirement for the auditor to be, and appear to be, 'capable of exercising objective and impartial judgement on all issues encompassed within the accountant's engagement.'</p> <p>The AICPA definition of covered person for the purposes of other restrictions refers simply to 'individuals' and so non-executives would not necessarily be excluded from the definition. This is relevant as the AICPA definition has been adopted by the PCAOB.</p> <p>Conclusion</p> <p>Although it is not completely clear that non-executives would automatically be excluded from the scope of individuals covered by detailed restrictions, a board or board committee is not likely to be involved in direct supervision or technical consultation on an individual audit.</p> <p>To ensure that non-executives are not considered to be in the SEC chain of command or included within the AICPA covered persons:</p> <ul style="list-style-type: none"> • non-executives should not be shareholders in, or otherwise derive direct financial gain from, the profitability of the audit firm; • any board or committee they serve on should, as well as having no direct involvement in specific audits, clearly have no ability, nor appear to be able, to evaluate individual audit partner performance/ compensation or exercise quality control or other oversight on individual audits; • any non-executive's contract for services would have to clarify that he or she is not employed and should prevent them from receiving feedback on an individual audit assignment. |

3. SUPPLEMENTARY BRIEFING INFORMATION

3.7 Auditor independence and independent non-executives (continued)

| Auditor independence issue | Impact on potential non-executives |
|--|---|
| <p>Requirements relating to influencing individual audits</p> | <p>UK</p> <p>No person who is a director of, or significant shareholder in, an audit client of an audit firm could be appointed as a non-executive of that audit firm.</p> <p>In addition, a potential non-executive on a board (or committee) of an audit firm, while not deemed to be in the chain of command for APB ES purposes, could be considered to be capable of influencing the audit for the purposes of the Audit Regulations.</p> <p>For example:</p> <ul style="list-style-type: none"> • N is a non-executive on the board of audit firm A. • N is also a director of a bank B. • B is owed a large amount of money by C, which is an audit client of A. <p>If A is considering qualifying C's financial statements, with a possible detriment to B's ability to get its money back, a scope for undue influence on A's audit of C's financial statements is created.</p> <p>Thus, in addition to ensuring that its board does not include anyone with a significant connection to an audit client as a director or significant shareholder, in these circumstances an audit firm might reasonably be concerned to ensure that it would not include someone with a more indirect potential conflict.</p> <p>Practical implementation</p> <p>The Audit Regulations, while precise in so far as they go, by and large leave it to individual firms to determine how to apply these requirements.</p> <p>This is not a new type of problem. Listed companies often have to deal with similar problems in relation to conflicts of interest. Possible interpretation by the firms could involve the establishment of control mechanisms set up specifically for any non-executives who might have a potential conflict of interest along the lines that a company director uses when faced with a conflict of interest in the boardroom. In these circumstances, non-executives would make formal disclosures of interests and potential conflicts. The governance arrangements would also have to ensure that a non-executive be ring-fenced from taking decisions on situations where there is a significant conflict.</p> <p>US</p> <p>Similar considerations apply to those summarised above for the UK independence requirements.</p> |

3.8 Liability issues and independent non-executives

Most of the larger UK firms are now legally structured as Limited Liability Partnerships (LLPs). This section addresses issues related to the potential appointment of non-executives from the perspective of the liability to the individual in such a role in an LLP. It does not address the liability of the LLP or liability issues specific to the activity of audit.

We conclude that following the introduction of the Limited Liability Partnerships Act 2000 (LLP Act), the issue of personal liability is of less significance in the UK than it appears to be in the US. The LLP Act draws on principles enshrined in the legislative treatment of companies. The essential feature of an LLP is that it combines the organisational flexibility and tax status of a partnership with limited liability for its members who are often referred to as partners. The UK LLP has been described as a corporate shell with a limited liability wrapper for its members.

Limited liability is possible because an LLP is a legal person separate from its members. As a separate legal entity, the LLP is, in many ways, more closely akin to a company than to a partnership. Independent non-executives in an LLP are likely to face the same or similar liabilities as company directors and the role of a non-executive director role in a listed company and a potential non-executive in an LLP may not be significantly different.

Although a firm in the US may also be structured as an LLP (depending upon the laws of the state of incorporation), a US LLP is often more akin to a traditional partnership that, while giving some protection against trading failure, retains unlimited liability for professional failure.

Duties

The duties of a non-executive appointed by an LLP, who does not become a member of the LLP, will primarily be found in his or her contract for services and may, depending on the nature of his or her role and the terms of the contract itself, be supplemented by the general law, such as the law on fiduciary duties.

A non-executive who becomes a member of the LLP will be subject to statutory duties and obligations set out in the Companies Acts 1985 and 2006 and the Insolvency Act 1986; and will usually be subject to fiduciary duties such as the duty:

- to act in good faith and in what the non-executive regards to be the best interests of the LLP;
- to have no conflicts of interest; and
- to make no secret profits.

There is scope for common law/contractual duties to be excluded or varied in the contract for services agreement between an individual and the LLP; or in the terms applicable to a non-executive if he or she is a member.

As for companies, any duties of a non-executive implied by the common law or arising from a contract for services would usually be owed to the LLP rather than individual members. No direct duties would normally be owed to creditors. Therefore it is usually only the LLP itself or its liquidator that could enforce any claim for breach of duties or contract against a non-executive.

Liabilities

The liability for non-executives appears to largely depend on what may be included in a contract for services between the non-executive and the LLP with the potential for protection of a non-executive through indemnities and Directors and Officers (D&O) cover. Care must be taken to ensure that he/she falls within the definition of 'insured'.

3. SUPPLEMENTARY BRIEFING INFORMATION

3.8 Liability issues and independent non-executives (continued)

As a separate legal entity, it will usually be the LLP that contracts with a client. A liability incurred by an LLP must be met from the assets of the LLP. To the extent that members have contributed to those assets, a member risks losing that amount. In the event of the liquidation of the LLP, as there is no share capital, a member's liability to make a contribution to the LLP's assets is limited to such assets as the member has agreed with the other members in the LLP that he/she will contribute. Members are thus generally liable to the extent of their capital in the LLP and it is possible for a member to have no capital in the LLP.

Non-executives who are members of the LLP also face the possibility of personal liability in the event that the LLP goes into insolvent liquidation. Non-executives who are not members may face such liability if they become shadow members.

Should an individual member be negligent in the work that he/she carries out for a client, there are two possible areas of liability: contract and tort. Because the LLP is a separate legal entity with which the client will usually have contracted, a claim in contract will usually only lie against the LLP. A member may, however, become personally liable in tort to a client. A client may be able to bring such a claim if the member has assumed a personal duty of care to the client. Such a liability could also arise for a non-executive who is not a member of the LLP; but in either case it is highly unlikely that a non-executive would act in a client-facing role where this would be a possibility.

3.9 Definitions of public interest entities

Because MPG Recommendation 14 refers to ‘every firm that audits public interest entities’, the population of audit firms to which the Code will apply will be determined by the definition of public interest entity that is adopted.

The Executive Summary of the MPG final report states: ‘Public interest entities means entities that are of significant public relevance because of the nature of their business, their size or number of their employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings’.

There are at least two further more specific definitions of public interest entities currently in use in the UK.

Audit Inspection Unit

The AIU is part of the FRC’s POB and is responsible for the monitoring of the audits of all listed and other major public interest entities. The POB is responsible for approving the AIU’s work programme and, in particular, determining which audited entities fall within the ‘major public interest’ category and therefore within the scope of the AIU’s work.

The scope of the AIU’s inspections is the audit of all entities with listed securities (both equity and non-equity securities) and other entities in whose financial condition there is considered to be a ‘major public interest’. This is a broad definition of public interest entity to which are attached some ‘size’ criteria.

A description of major public interest entities approved by the POB for 2008/9 covers the following:

- all UK incorporated companies with listed equity and/or listed debt;
- AIM or Plus markets companies incorporated in the UK with a market capitalisation in excess of £100 million;
- unquoted companies, groups of companies or limited liability partnerships or industrial and provident societies in the UK which have either group turnover in excess of £500 million or group long-term debt in excess of £250 million and turnover in excess of £100 million;
- unquoted companies or groups which are subsidiaries of foreign parent companies where the turnover of the UK group or company is in excess of £1,000 million;
- private sector pension schemes with either more than £1,000 million of assets or more than 20,000 members;
- charities with income exceeding £100 million;
- friendly societies with total net assets in excess of £1,000 million;
- building societies with assets exceeding £1,000 million;
- open-ended investment companies (OEICs) and unit trusts managed by a fund manager with more than £1,000 million of UK funds under management;
- Lloyd’s syndicates with an underwriting capacity in excess of £250 million; and
- mutual life offices whose ‘with-profits’ fund exceeds £1,000 million.

It is understood that nearly 50 UK firms audit public interest entities as defined by the AIU.

3. SUPPLEMENTARY BRIEFING INFORMATION

3.9 Definitions of public interest entities (continued)

The Statutory Auditors (Transparency) Instrument 2008

The Statutory Auditors (Transparency) Instrument 2008 (the Instrument), issued by the POB, implements Article 40 of the EU Statutory Audit Directive (SAD). The Instrument uses a narrower definition than that of the AIU. It states that:

- ‘public interest entity’ means an issuer
 - (a) whose transferable securities are admitted to trading on a regulated market; and
 - (b) the audit of which is a statutory audit within the meaning of section 1210 of the Companies Act 2006;
- ‘issuer’ and ‘regulated market’ have the same meaning as in Part 6 of the Financial Services and Markets Act 2000 (see sections 102A to 103);
- ‘transferable securities’ means anything which is a transferable security for the purposes of Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments.

The above definition excludes AIM and Plus markets companies as well as unquoted companies, pension schemes, charities, friendly societies, building societies, OEICs, unit trusts, Lloyd’s syndicates and mutual life offices. A major reason for a narrower definition than that of the AIU is that Article 39 of the SAD allows member states to restrict the requirement to auditors of listed companies, thus giving member states some flexibility in determining the scope of transparency reporting.

It is understood that there are over 40 UK firms that audit public interest entities under the narrower definition.

When consulting upon the approach to take for the UK, the DTI supported a narrower definition as follows: ‘One option is to align the scope of the requirement for transparency reports with the scope of independent inspection of audit firms. This has the advantage of simplicity in that we would not create a further classification of audit firms. It is also arguable that those firms which fall within the remit of the AIU should be those which provide transparency reports. However, this option goes further than the Directive strictly requires. The practical effect is small. It is likely to require only a handful of firms to provide transparency reports over and above those strictly required to do so under the Directive. Those firms will have a small role in the audits of public interest entities overall and by definition will not audit fully listed companies. It is difficult therefore to see a significant public interest in requiring them to publish transparency reports. Our inclination is to restrict the scope to the minimum required by the Directive.’

APPENDIX 1

Working Group members and terms of reference

Members of the Audit Firm Governance Working Group

| | |
|-----------------------------------|---|
| Norman Murray (Chairman) | Chairman, Cairn Energy PLC |
| Jan Babiak | Global Climate Change & Sustainability Services Leader, Ernst & Young LLP |
| Anthony Carey | Partner, Mazars LLP |
| Richard Delbridge | Senior Independent Non-Executive Director, Tate & Lyle PLC |
| John Griffith-Jones | UK Chairman and Senior Partner, KPMG LLP (UK) |
| Archie Hunter | Non-Executive Director and Chairman of the Audit Committee, The Royal Bank of Scotland Group plc |
| Huw Jones | Director of Corporate Finance, M&G Investment Management |
| Guy Jubb | Investment Director, Head of Corporate Governance, Standard Life Investments |
| Professor Sir Andrew Likierman | Professor of Management Practice, London Business School |
| Andrew Moss | Group Chief Executive, Aviva plc |
| Richard Murley | Managing Director, N M Rothschild & Sons Limited |
| Jeremy Newman | Chief Executive, BDO International |
| Observer | Chris Hodge, Head of Corporate Governance Unit, Financial Reporting Council |
| Project Director | Robert Hodgkinson, Executive Director, Technical, ICAEW |
| Project Manager | Jonathan Hunt, Head of Corporate Governance, ICAEW |

Terms of reference

To develop, consult upon, and publish a code of best practice governance for accountancy firms that audit public interest entities with which they should comply or give a considered explanation for any non-compliance.

APPENDIX 2

The Combined Code on Corporate Governance

Set out below are the Main Principles of the Combined Code on Corporate Governance published by the FRC in June 2008. Section 1 (parts A to D) of the Code relates to companies and Section 2 (part E) is directed to institutional shareholders.

For reasons only of brevity, the Combined Code's supporting principles and provisions are not included below. Recognising that they are an integral part of the Code, it is recommended that respondents are aware of the full text of the Combined Code which can be found at: www.frc.org.uk/corporate/combinedcode.cfm.

Part A DIRECTORS

| | |
|-----|---|
| A.1 | The board |
| | Every company should be headed by an effective board, which is collectively responsible for the success of the company. |
| A.2 | Chairman and chief executive |
| | There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision. |
| A.3 | Board balance and independence |
| | The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking. |
| A.4 | Appointments to the board |
| | There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board. |
| A.5 | Information and professional development |
| | The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. |
| A.6 | Performance evaluation |
| | The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. |
| A.7 | Re-election |
| | All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board. |

Part B REMUNERATION

| | |
|-----|---|
| B.1 | The level and make-up of remuneration |
| | Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. |
| B.2 | Procedure |
| | There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. |

Part C ACCOUNTABILITY AND AUDIT

| | |
|-----|---|
| C.1 | Financial reporting |
| | The board should present a balanced and understandable assessment of the company's position and prospects. |
| C.2 | Internal control |
| | The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. |
| C.3 | Audit committee and auditors |
| | The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. |

Part D RELATIONS WITH SHAREHOLDERS

| | |
|-----|--|
| D.1 | Dialogue with Institutional Shareholders |
| | There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. |
| D.2 | Constructive Use of the AGM |
| | The board should use the AGM to communicate with investors and to encourage their participation. |

Part E INSTITUTIONAL SHAREHOLDERS

| | |
|-----|---|
| E.1 | Dialogue with companies |
| | Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives. |
| E.2 | Evaluation of governance disclosures |
| | When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention. |
| E.3 | Shareholder voting |
| | Institutional shareholders have a responsibility to make considered use of their votes. |

APPENDIX 3

Professional Oversight Board analyses of the firms

Tables from the POB report 'Key Facts and Trends in the Accountancy Profession', published on 30 July 2008.

FEE INCOME OF MANY OF THE LARGER REGISTERED AUDIT FIRMS YEAR ENDED 2007 (By fee income from audit)

| Firm Name | Structure | Year End | No. of Principals ¹ | No. of Audit Principals | No. of Responsible Individuals ² | Total Fee Income (£m) | Fee Income: Audit (£m) | Fee Income: Non-Audit Work to Audit Clients (£m) | Fee Income: Non-Audit Work to Non-Audit Clients (£m) |
|---|------------------|-------------------------|--------------------------------|-------------------------|---|-----------------------|------------------------|--|--|
| PricewaterhouseCoopers | LLP | 30-Jun-07 | 822 | 264 | 360 | 2,107 | 595 | 431 | 1,081 |
| KPMG ³ | LLP | 30-Sep-07 | 559 | 249 | 317 | 1,607 | 423 | 264 | 920 |
| Deloitte & Touche | LLP | 31-May-07 | 651 ⁴ | 202 | 209 | 1,802 | 339 ⁵ | 255 ⁵ | 1,208 ⁵ |
| Ernst & Young | LLP | 30-Jun-07 | 481 | 153 | 222 | 1,226 | 332 | 166 | 728 |
| BDO Stoy Hayward | LLP | 30-Jun-07 | 226 | 98 | 132 | 286 | 97 | 56 | 133 |
| Grant Thornton | LLP | 30-Jun-07 | 249 | 96 | 106 | 315 | 81 | 40 | 193 |
| Baker Tilly | Partnership | 31-Mar-07 | 269 | 132 | 132 | 187 | 59 | 33 | 95 |
| PKF (UK) | LLP ⁶ | 31-Mar-07 | 95 | 58 | 58 | 130 | 54 | 35 | 42 |
| Mazars | LLP | 31-Aug-07 | 104 | 57 | 59 | 80 | 34 | 9 | 37 |
| Horwath Clark Whitehill | LLP | 31-Mar-07 | 62 | 42 | 42 | 41 | 19 | 10 ⁷ | 12 ⁷ |
| Nexia Smith & Williamson Audit ^{8,9} | Company | 30-Apr-07 | 39 | 33 | 34 | 56 | 14 | 0 | 43 |
| RSM Bentley Jennison | Partnership | 31-Dec-07 ¹⁰ | 68 | 30 | 34 | 64 | 13 | 10 | 42 |
| Tenon Audit | Limited Company | 30-Jun-07 | 4 | 3 | 54 | 13 | 13 | 0 | 0 |
| Moore Stephens | LLP | 30-Apr-07 | 64 | 32 | 32 | 49 | 12 | 4 | 33 |

1 Principals are partners or members of an LLP.

2 Responsible Individuals are those individuals who are able to sign audit reports.

3 Includes both KPMG LLP and KPMG Audit Plc.

4 This includes principles who retired from the firm at midnight on the final day of the financial year.

5 These figures are best estimates for the split of the firm's total fee income.

6 PKF became an LLP on 1 April 2005 (PKF (UK) LLP).

7 These figures are best estimates for the split of Fee Income from Non-Audit Work to Audit Clients and to Non-Audit Clients.

8 Nexia Smith & Williamson Audit merged with Soloman Hare on 31 May 2005.

9 Nexia Smith & Williamson changed their name with effect from 1 May 2006.

10 RSM Bentley Jennison's information is provided as at 31 May 2007.

| Firm Name | Structure | Year End | No. of Principals ¹ | No. of Audit Principals | No. of Responsible Individuals ² | Total Fee Income (£m) | Fee Income: Audit (£m) | Fee Income: Non-Audit Work to Audit Clients (£m) | Fee Income: Non-Audit Work to Non-Audit Clients (£m) |
|------------------------------------|-----------------------|-------------------------|--------------------------------|-------------------------|---|-----------------------|------------------------|--|--|
| UHY Hacker Young | Group of Partnerships | 30-Apr-07 | 82 | 45 | 52 | 40 | 10 | 5 | 25 |
| HW Group | Partnership | 31-Mar-07 | 129 | 92 | 93 | 54 | 9 | 6 | 39 |
| Kingston Smith | LLP ¹¹ | 30-Apr-07 | 45 | 39 | 1 | 26 | 9 | 6 | 11 |
| MacIntyre Hudson | LLP | 31-Mar-07 | 46 | 30 | 30 | 24 | 9 | NA | NA |
| CLB Littlejohn Frazer | Partnership | 31-May-07 ¹² | 29 | 16 | 16 | 17 | 8 | 2 | 7 |
| HLB Vantis Audit plc | Plc | 31-May-07 | 3 | 3 | 58 | 8 | 8 | 0 | 0 |
| Chantrey Vellacott DFK | LLP | 30-Jun-07 | 50 | 24 | 24 | 23 | 7 | 2 | 14 |
| Haysmacintyre | Partnership | 31-Mar-07 | 24 | 18 | 22 | 14 | 7 | 3 | 4 |
| Saffery Champness | Partnership | 31-Mar-07 | 53 | 30 | 30 | 32 | 6 | 4 | 21 |
| Menzies | Partnership | 31-Mar-07 | 41 | 22 | 22 | 30 | 5 | 11 | 15 |
| Cooper Parry | LLP | 30-Apr-07 | 21 | 8 | 10 | 14 | 5 | 3 | 7 |
| Scott Moncrieff | Partnership | 30-Apr-07 | 21 | 11 | 11 | 13 | 5 | 2 | 6 |
| Johnston Carmichael | Partnership | 31-May-07 | 40 | 17 | 21 | 18 | 4 | NA | NA |
| James Cowper | Partnership | 30-Apr-07 | 15 | 10 | 10 | 9 | 2 ¹³ | 1 ¹³ | 6 ¹³ |
| Chiene & Tait | Scottish Partnership | 30-Sep-07 | 7 | 4 | 4 | 6 | 2 | 0 | 4 |
| DTE Business Advisory Services | Limited Company | 30-Apr-07 | 11 | 5 | 11 | 6 | 2 | 1 | 3 |
| Jeffreys Henry | LLP | 30-Apr-07 | 8 | 6 | 6 | 5 | 2 | 1 | 2 |
| Armstrong Watson | Partnership | 31-Mar-07 | 35 | 7 | 7 | 18 | 1 | NA | NA |
| Begbies Chettle Agar ¹⁴ | Partnership | 31-Mar-07 | 5 | 4 | 4 | 2 | 1 | NA | 1 |

11 LLP from 1 May 2006.

12 Change in year end therefore, 14-month period.

13 These figures are best estimates for the split of the firm's total fee income.

14 Name changed to Begbies Chettle Agar with effect from 1 April 2006.

APPENDIX 3

Professional Oversight Board analyses of the firms (continued)

CONCENTRATION OF LISTED COMPANIES' AUDITS YEAR ENDED 2007 (By Number of Listed Clients – FTSE 100, FTSE 250, Other Main Market and AIM)

| Firm Name | Structure | Year End | No. of Audit Clients | No. of FTSE 100 Audit Clients | No. of FTSE 250 Audit Clients | No. of Other Main Market Audit Clients | No. of AIM Audit Clients |
|---|-----------------------|-----------|----------------------|-------------------------------|-------------------------------|--|--------------------------|
| PricewaterhouseCoopers | LLP | 30-Jun-07 | 21000 | 39 | 75 | 82 | 141 |
| Deloitte & Touche ¹ | LLP | 31-May-07 | 16843 | 22 | 70 | 206 | 86 |
| KPMG ² | LLP | 30-Sep-07 | 17008 | 21 | 48 | 192 | 113 |
| Ernst & Young | LLP | 30-Jun-07 | 5350 | 19 | 36 | 368 | 21 |
| BDO Stoy Hayward | LLP | 30-Jun-07 | 7035 | 0 | 6 | 30 | 146 |
| Grant Thornton ³ | LLP | 30-Jun-07 | 9000 | 0 | 5 | 75 | 217 |
| PKF (UK) ⁴ | LLP | 31-Mar-07 | 2875 | 0 | 0 | 28 | 53 |
| Baker Tilly | Partnership | 31-Mar-07 | 6392 | 0 | 0 | 26 | 108 |
| UHY Hacker Young | Group of Partnerships | 30-Apr-07 | 1590 | 0 | 0 | 5 | 20 |
| Scott Moncrieff | Partnership | 30-Apr-07 | 473 | 0 | 0 | 5 | 3 |
| Nexia Smith & Williamson Audit ^{5,6} | Company | 30-Apr-07 | 1492 | 0 | 0 | 4 | 34 |
| James Cowper | Partnership | 30-Apr-07 | 306 | 0 | 0 | 4 | 0 |
| Chiene & Tait | Scottish Partnership | 30-Sep-07 | 365 | 0 | 0 | 4 | 0 |
| Moore Stephens | LLP | 30-Apr-07 | 1700 | 0 | 0 | 3 | 14 |
| Chantrey Vellacott | LLP | 30-Jun-07 | 689 | 0 | 0 | 3 | 12 |
| Saffery Champness | Partnership | 31-Mar-07 | 960 | 0 | 0 | 3 | 8 |
| Mazars | LLP | 31-Aug-07 | 2300 | 0 | 0 | 2 | 33 |
| Horwath Clark Whitehill | LLP | 31-Mar-07 | 1995 | 0 | 0 | 2 | 26 |
| Haysmacintyre | Partnership | 31-Mar-07 | 1099 | 0 | 0 | 2 | 6 |

1 Figures reported as best estimates as at 31 October 2007.

2 Includes both KPMG LLP and KPMG Audit Plc.

3 Figures reported as best estimates as at 30 June 2007.

4 PKF became PKF (UK) LLP on 1 April 2005.

5 Nexia Smith & Williamson Audit merged with Soloman Hare.

6 Name changed to Nexia Smith & Williamson Audit with effect 1 May 2006.

| Firm Name | Structure | Year End | No. of Audit Clients | No. of FTSE 100 Audit Clients | No. of FTSE 250 Audit Clients | No. of Other Main Market Audit Clients | No. of AIM Audit Clients |
|-----------------------------------|-----------------|-----------|----------------------|-------------------------------|-------------------------------|--|--------------------------|
| Kingston Smith | LLP | 30-Apr-07 | 1158 | 0 | 0 | 1 | 21 |
| Jeffreys Henry | LLP | 30-Apr-07 | 188 | 0 | 0 | 1 | 18 |
| Tenon Audit | Limited Company | 30-Jun-07 | 1845 | 0 | 0 | 1 | 10 |
| Menzies | Partnership | 31-Mar-07 | 730 | 0 | 0 | 1 | 4 |
| Begbies Chettle Agar ⁷ | Partnership | 31-Mar-07 | 94 | 0 | 1 | 1 | NA |
| CLB Littlejohn Frazer | Partnership | 31-May-07 | 1283 | 0 | 0 | 0 | 21 |
| RSM Bentley Jennison ⁸ | Partnership | 31-Dec-07 | 1450 | 0 | 0 | 0 | 9 |
| HLB Vantis Audit plc | Plc | 31-May-07 | 1601 | 0 | 0 | 0 | 8 |
| HW Group | Partnership | 31-Mar-07 | 1931 | 0 | 0 | 0 | 3 |
| MacIntyre Hudson | LLP | 31-Mar-07 | 1099 | 0 | 0 | 0 | 2 |
| Armstrong Watson | Partnership | 31-Mar-07 | 253 | 0 | 0 | 0 | 1 |
| Cooper Parry | LLP | 30-Apr-07 | 553 | 0 | 0 | 0 | 0 |
| DTE Business Advisory Service | Limited Company | 30-Apr-07 | 183 | 0 | 0 | 0 | 0 |
| Johnston Carmichael | Partnership | 31-May-07 | 329 | 0 | 0 | 0 | 0 |

⁷ Name changed to Begbies Chettle Agar with effect from 1 April 2006.

⁸ RSM Bentley Jennison's information is provided as at 31 May 2007.

CONCENTRATION OF LISTED COMPANIES' AUDITS

| | Big Four Firms (%) | | | | Next Five Firms (%) | | | | Other Firms (%) | | | |
|-------------------|--------------------|----------|----------|----------|---------------------|----------|----------|----------|-----------------|----------|----------|----------|
| | 28/02/08 | 28/02/07 | 31/03/06 | 31/03/05 | 28/02/08 | 28/02/07 | 31/03/06 | 31/03/05 | 28/02/08 | 28/02/07 | 31/03/06 | 31/03/05 |
| FTSE 100 | 100.0 | 100.0 | 99.0 | 100.0 | 0.0 | 0.0 | 1.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| FTSE 250 | 96.0 | 96.8 | 96.4 | 96.8 | 4.0 | 2.8 | 3.2 | 2.0 | 0.0 | 0.4 | 0.4 | 1.2 |
| Other Main Market | 72.3 | 75.4 | 79.0 | 79.3 | 20.1 | 17.7 | 15.0 | 14.1 | 7.6 | 6.9 | 6.0 | 6.6 |
| All Main Market | 79.9 | 82.3 | 84.0 | 83.6 | 14.8 | 12.9 | 11.6 | 11.1 | 5.3 | 4.8 | 4.4 | 5.3 |

APPENDIX 4

List of abbreviations

| | |
|---------------|--|
| ACAP | Advisory Committee on the Auditing Profession (US) |
| AICPA | American Institute of Certified Public Accountants |
| AIU | Audit Inspection Unit (UK) |
| APB | Auditing Practices Board (UK) |
| CCAB | Consultative Committee of Accountancy Bodies (UK) |
| Code | Audit Firm Governance Code (planned) |
| Combined Code | Combined Code on Corporate Governance issued by the FRC |
| EC | European Commission |
| ES | Ethical Standards issued by the APB |
| EU | European Union |
| Firms | Firms that audit public interest entities |
| FRC | Financial Reporting Council (UK) |
| FSA | Financial Services Authority (UK) |
| ICAEW | The Institute of Chartered Accountants in England and Wales |
| IOSCO | International Organization of Securities Commissions |
| ISAs | International Standards on Auditing (UK and Ireland) issued by the APB |
| LLP | Limited Liability Partnership |
| MPG | Market Participants Group established by the FRC |
| PCAOB | Public Company Accounting Oversight Board (US) |
| POB | Professional Oversight Board (UK) |
| RSB | Recognised Supervisory Body |
| SEC | Securities and Exchange Commission (US) |

APPENDIX 5

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