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IN ENGLAND AND WALES



AUDIT FIRM GOVERNANCE

FEEDBACK STATEMENT ON DRAFT CODE CONSULTATION

A PROJECT FOR THE FINANCIAL REPORTING COUNCIL

Audit Firm Governance
Working Group
Chairman: Norman Murray
January 2010

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Summary

In this feedback statement the Audit Firm Governance Working Group (the Working Group) summarises the main issues arising from responses to its second consultation paper issued in July 2009. The statement:

- presents and explains the main changes made in finalising the Audit Firm Governance Code (the Code);
- provides further suggestions on disclosure that are not included in the final Code; and
- notes issues considered by the Working Group that did not result in changes to the draft Code.

The final Code is available for download on www.icaew.com/auditfirmgovernance where there are also details of how to obtain printed copies.

Overall, the analysis of responses can be summarised as follows:

- the draft Code received broad support and while some areas of it were commented upon, much of it attracted little or no comment;
- investors and other respondents made suggestions for strengthening the draft Code primarily in relation to enhanced disclosure which in their view would make it more effective by increasing their understanding and/or helping them engage in dialogue with the audit firms;
- audit firms had concerns, primarily in respect of independent non-executives; and
- changes have been made to the draft Code to address a number of suggestions and concerns and they are shown in the mark-up of the draft Code in Section 2.

1. Introduction

1.1 Background to the project

The Audit Firm Governance project is the result of Recommendation 14 of the October 2007 report of the Market Participants Group (MPG) which stated 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.'

The MPG was established by the UK Financial Reporting Council (FRC) to advise it on its work on 'Choice in the UK Audit Market'. In turn, the ICAEW was invited by the FRC to support the follow-up to Recommendation 14 by drawing up a code and for this purpose formed the independent Working Group.

The significance of this project has grown since the MPG made Recommendation 14 and, in particular, since October 2008 when the Working Group published its first consultation paper. There is now a global awareness of the widespread economic harm that can follow the failure of systemically important institutions. This is reflected in recent regulatory developments including Sir David Walker's final recommendations in his November 2009 report *A review of corporate governance in UK banks and other financial industry entities* and the FRC's December 2009 review of the Combined Code on Corporate Governance.

Although confidence in the major international audit firms has remained strong, they cannot afford to be complacent and that is why their willingness to embrace the Code is so important. It will show that each firm is aware that the reputation it has built upon its licence to audit is of vital public interest and that one way in which it can maintain public trust in its brand is by being seen as an exemplar of best practice governance.

1.2 Respondents to the second consultation paper

The Working Group is:

- grateful to the 48 respondents who commented on the second consultation paper; and
- thankful to all those who have shared their views with us in numerous meetings.

Overall, during the course of the project, the Working Group received a substantial amount of input from a range of commentators to both the first evidence gathering consultation paper and to the second consultation paper on the draft Code. The Working Group is pleased with the quality and the comprehensiveness of the feedback it has received.

Compared to the first consultation paper, the second attracted responses from more institutional investors and from a wider group of interested parties including regulators. While fewer audit firms responded to the second consultation paper, probably due to the number of firms to which the Code will apply, all eight firms to which the Code will apply submitted responses.

Forty-four responses to the second consultation paper have been placed on the public record on www.icaew.com/auditfirmgovernance and the names of these respondents are provided in the Appendix. The Working Group also received four private responses, two from audit firms and two from individuals. All 48 responses were reviewed and analysed.

1.3 Analysis process

Although respondents were generally content with the draft Code, the Working Group received a number of suggestions for changes and additions to the draft Code.

While there is always a temptation to make numerous changes to a proposed document to reflect suggestions from commentators, the Working Group has tried to exercise restraint. While there was a need to address some issues raised by investors and by the audit firms, in general, respondents to the second consultation paper did not indicate that a substantial number of changes were needed to the draft Code.

When considering possible changes to the draft Code, other than minor drafting improvements, the Working Group applied the following tests:

- Does the proposed change address an issue that is not already substantially covered by the draft Code?
- Is a change to the draft Code the most appropriate way to address the issue concerned?
- Would the proposed change enhance investor confidence in the audit firms?
- Would any proposed change restrict an audit firm's ability to apply the Code in a manner suitable to its own particular circumstances?

As a result of applying these tests, the Working Group dealt with material in responses in one of the following ways. It either:

- decided not to act on it, but to refer to it in this feedback statement. Such matters include the definition of a public interest entity and the threshold of more than 20 listed companies; or
- included it in this feedback statement as being material that should not be forgotten by any future review or matters that the audit firms may wish to consider as potential enhancements to their governance practices and disclosures; or
- included it in a new appendix to the Code; or
- reflected it in changes to the draft Code.

The Working Group only made a limited number of changes to the draft Code and these are shown in Section 2 of this feedback statement.

1.4 Main features of the draft and final Code

The central part of the second consultation paper was the draft Code. The main features of the draft and final Code are that it:

- follows the transparency reporting definition of public interest entities as listed companies;
- is targeted at shareholders in listed companies and contains principles related to their dialogue with audit firms;
- contains a recommendation that the Code should not be implemented through regulation and that only firms that audit more than 20 listed companies should be expected to report on their application of the Code;
- is a cousin of the Combined Code, rather than its offspring. It follows the structure of principles and provisions, the philosophy of comply or explain, and the wording of the Combined Code in a limited number of areas. However, it recognises that a code designed for listed companies is of limited applicability to owner-managed audit firms;
- recognises the qualities that audit firms are expected to demonstrate as regulated professional partnerships and summarises these qualities so that they can be more widely appreciated;
- sets out a very specific role for independent non-executives within the firms in addressing threats that the firms face in spite of their strengths as owner-managed and highly

regulated professional practices. This includes being a witness to how a firm is run, a safeguard of a firm's reputation especially in unregulated areas of its business, and a channel for dialogue with stakeholders; and

- envisages that firms will make Code-related disclosures in the transparency reports that are now required by UK regulation as a result of the EU Statutory Audit Directive.

2. Mark-up of the draft Code

INTRODUCTION

The ~~is~~ Audit Firm Governance Code (the Code) is intended to ~~assist in promoting~~ continuing confidence and choice in the market for the audit of listed companies and should be relevant to everyone who sees audit as playing a vital role in a market economy.

The primary purpose of the Code is to provide a formal benchmark of good governance practice against which firms which audit listed companies can report for the benefit of shareholders in such companies. The Code is also expected to be helpful to other stakeholders, including:

- directors, particularly audit committee members, with responsibilities for the appointment of auditors;
- regulators with responsibilities for confidence in audit quality; and
- partners and employees of audit firms.

Background and approach

The market for large audits in the UK is dominated by four firms and the risk of the withdrawal of a major firm is a matter of continuing concern to the UK Financial Reporting Council (FRC) and many others.

The Code is the result of a recommendation made in October 2007 by the Market Participants Group set up by the FRC to advise it on its work on 'Choice in the UK Audit Market'. The recommendation was that 'every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice governance guide or give a considered explanation.'

The FRC invited The Institute of Chartered Accountants in England and Wales (ICAEW) to draw up the recommended code and the ICAEW formed its independent Audit Firm Governance Working Group (the Working Group) under the chairmanship of Norman Murray (Chairman of Cairn Energy PLC) to carry out and complete this work.

The Working Group has sought to discharge its responsibilities in a proportionate way that secures wide support for the Code and demonstrates a practical application of evidence-based public policy making. To this end, the Working Group has conducted two wide-ranging formal consultations: the first to gather evidence on key issues to inform drafting of the Code; and the second to obtain views on a draft of the Code.

The Working Group decided that for the purposes of the Code, public interest entities should be defined as UK companies listed on the London Stock Exchange's Main Market. This is in line with the definition used in UK legislation to implement EU requirements for audit firm transparency reports. ~~Although t~~The Working Group ~~does not have power to introduce and give effect to regulatory requirements, it has~~ recommends ~~ed to the FRC~~ that the Code should initially apply to firms which audit more than 20 listed companies, ~~and it has also discussed proposals for monitoring with the FRC.~~

Intended benefits of the Code

The Working Group has drafted the Code to serve the interests of shareholders in listed companies to whom auditors address their reports. The Code supports firms in their objectives of performing high quality work that gives confidence to shareholders. It should also benefit capital markets by enhancing choice and helping to reduce the risk of a firm exiting the market for large audits because it has lost public trust. Exit from the market would not only signal the loss of a firm's substantial investment in its reputation, but would also have

adverse effects on the functioning of markets and on the availability of choice for users of audit services. Our aim is that the Code should play four additional roles:

- enhance the stature of firms as highly visible exemplars of best practice governance;
- enrich firms' transparency reports;
- encourage changes in governance which improve the way that firms are run; and
- strengthen the regulatory regime by achieving transparent and effective governance without disproportionate regulation.

Features of the Code

The Code's structure is similar to that of the UK ~~Combined Code on~~ Corporate Governance ~~Code (formerly the Combined Code on Corporate Governance)~~ for listed companies. The Code comprises 20 principles and ~~29-31~~ provisions. Compliance with the provisions helps firms to apply the Code's principles but does not absolve firms from their responsibility to take appropriate measures to apply the principles and embrace the spirit of the Code.

Principle E.4 on governance reporting states that a firm 'should publicly report how it has applied in practice each of the principles of the Audit Firm Governance Code excluding F.2 on shareholder dialogue and F.3 on informed voting and make a statement on its compliance with the Code's provisions or give a considered explanation for any non-compliance.' This is the approach which is summarised in the phrase 'comply or explain'.

While acknowledging that listed company governance codes provide an important point of reference for developing the Code, the Working Group recognises that audit firms are generally owner-managed partnerships, whereas listed companies need to address issues arising from the separation of ownership and management interests. For this reason, the Working Group has been selective in drawing on material from the UK Corporate Governance Combined Code.

The Working Group also appreciates that the audit firms are professional practices and have professional obligations which already include a requirement to act in a way that properly takes the public interest, ~~and not just the needs of an individual client~~, into consideration. Accordingly, the Code makes reference to these obligations which need to be upheld by all members of a firm's management team and governance structures.

Furthermore, the Working Group acknowledges that audit is subject to extensive regulation and so, where appropriate, the Code makes reference to such regulation, for example in relation to standards on auditing, quality control and ethics and transparency reporting disclosure requirements. Firms are expected to integrate disclosures called for by the Code within the transparency reports published on their websites.

One of the key features of the Code, the appointment by the firms of independent non-executives, reflects the belief that regulation is not a substitute for effective governance and that good governance complements regulation in promoting audit quality.

Audit firms often share operations, brands and reputations with businesses that are subject to little or no regulation and this can pose significant risks to the reputation and continued existence of the firm including its audit practice. The Code envisages independent non-executives playing a role in helping to address those risks, as well as enhancing confidence in firms' decision making and ensuring that stakeholder concerns are properly communicated at the highest level.

Although Appendices 1 and 2 do not form part of the Code, they are intended to support implementation of the Code and application of its principles and firms and stakeholders will be expected to have regard to them. Appendix 1 explains the involvement of independent non-executives in the light of the firms' status as regulated professional partnerships. Appendix 2 sets out considerations relevant to the potential impact of independent non-executives on auditor independence. For example, auditor independence considerations are likely to prevent an independent non-executive from having access to audit working papers.

The Code in practice

It would be unfortunate if the application of the Code were seen by firms, listed companies and their shareholders as primarily an exercise in compliance and disclosure performed for the benefit of regulators. Dialogue between audit firms and shareholders is an important feature of the Code. In encouraging shareholders to be proactive, two of the Code's principles, F.2 on shareholder dialogue and F.3 on informed voting, set out what is expected of shareholders. We have had initial discussions ed arrangements for about implementing these principles with shareholder representatives the FRC and institutional investors in the context of measures to be taken by them to enhance dialogue.

The effectiveness of the Code's comply or explain approach also depends on the firms' leadership setting the right 'tone at the top'; and taking the Code to heart rather than seeing it only as a cost of doing business. Audit firms can demonstrate their commitment to good governance and the public interest by ensuring that their reporting does not become boilerplate.

A potentially challenging area of application and reporting arises in relation to the international structures of the major audit firms. Firms that sign statutory audit reports are generally national firms. However, we recognise that where a national firm that applies the Code is part of a regional or an international structure, it will may make sense to look beyond the national firm in considering application of Code principles and compliance with Code provisions. For this reason, disclosures under the Code may be more useful if they do not relate exclusively to the a national firm. applying the Code.

Review of ~~i~~implementation

The Working Group recommends that the Code should apply to financial years commencing on or after 1 June 2010. For this new area of governance, independent monitoring arrangements will need to be established under the auspices of the FRC and a review by the FRC of how the Code has been implemented in practice is recommended to start no later than after four years after its publication.

Experience of applying the Code will be the basis for improving it and thereby further enhancing audit firm governance. It is with these objectives in mind that firms, listed companies and their shareholders are encouraged to give the Code their full support.

Audit Firm Governance Working Group ~~XXX~~ January 2010

Throughout this Code reference to 'a firm' means 'a firm that audits listed companies'.

A LEADERSHIP

A.1	Owner accountability principle The management of a firm should be accountable to the firm's owners and no individual should have unfettered powers of decision.
Provisions	
A.1.1	The firm should establish board or other governance structures, with matters specifically reserved for their decision, to oversee the activities of the management team.
A.1.2	The firm should state in its transparency report how its governance structures and management team operate, their duties and the types of decisions they take.
A.1.3	The firm should state in its transparency report the names and job titles of all members of the firm's governance structures and its management team, how they are elected or appointed and their <u>terms</u> , length of service, meeting attendance in the year, and relevant biographical details.
A.1.4	The firm's governance structures and management team and their members should be subject to formal, rigorous and on-going performance evaluation and, at regular intervals, members should be subject to re-election or re-selection.
A.2	Management principle A firm should have effective management which has responsibility and clear authority for running the firm.
Provision	
A.2.1	The management team should have terms of reference that include clear authority over the <u>whole</u> firm <u>including its non-audit's entire businesses</u> and these should be disclosed on the firm's website.

B VALUES

B.1	Professionalism principle A firm should perform quality work by exercising judgement and upholding values of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour in a way that properly takes the public interest into consideration.
Provisions	
B.1.1	The firm's governance structures and management team should set an appropriate 'tone at the top' <u>through its policies and practices and</u> by publicly committing themselves and the <u>whole</u> firm to quality work, the public interest and professional judgement and values.
B.1.2	The firm should have a code of conduct which it discloses on its website and requires everyone in the firm to apply.

B.2	Governance principle
	A firm should publicly commit itself to this Audit Firm Governance Code.
	Provision
B.2.1	The firm should incorporate the principles of this Audit Firm Governance Code into an internal code of conduct.
B.3	Openness principle
	A firm should establish <u>maintain</u> a culture of openness which encourages people to consult and share problems, knowledge and experience in order to achieve quality work in a way that properly takes the public interest into consideration.

C INDEPENDENT NON-EXECUTIVES

C.1	Involvement of independent non-executives principle
	A firm should appoint independent non-executives who through their involvement, at a minimum , collectively enhance shareholder confidence in the public interest aspects of the firm's decision making, stakeholder dialogue and management of reputational risks <u>including those</u> in the firm's businesses that are not otherwise effectively addressed by regulation.
	Provisions
C.1.1	Independent non-executives should either : have the majority on a body that oversees public interest matters; and/or be members of other <u>relevant</u> governance structures within the firm. They should also meet as a separate group to discuss matters relating to their remit.
C.1.2	The firm should disclose on its website <u>information about the appointment, retirement and resignation of duties of</u> independent non-executives, their <u>duties and the</u> arrangements by which they discharge those duties and the obligations of the firm to support them. Where there is a body that oversees public interest matters, the firm should also disclose on its website the terms of reference and composition of any governance structures whose membership includes independent non-executives on the firm's website.
C.2	Characteristics of independent non-executives principle
	The independent non-executives' should have a <u>duty of care is</u> to the firm, They should <u>command the respect of the firm's partners owners</u> and collectively enhance shareholder confidence by virtue of their independence, number, stature, experience and expertise.
	Provision
C.2.1	The firm should state in its transparency report its criteria for assessing the impact of independent non-executives on the firm's independence as auditors and their independence from the firm and its partners <u>owners</u> .

C.3	Rights of independent non-executives principle
	Independent non-executives of a firm should have rights consistent commensurate with their role including a right of access to relevant information and people to the extent permitted by law or regulation , and a right to report a fundamental disagreement regarding the firm to its owners and, where ultimately this such a disagreement cannot be resolved and the independent non-executive resigns , to report this resignation publicly.
	Provisions
C.3.1	Each independent non-executive should have a contract for services setting out their rights and duties.
C.3.2	The firm should ensure that appropriate indemnity insurance is in place in respect of legal action against any independent non-executive.
C.3.3	The firm should provide each independent non-executive with sufficient resources to undertake their duties including having access to independent professional advice at the firm's expense where an independent non-executive judges such advice necessary to discharge their duties.
C.3.4	The firm should establish, and disclose on its website, procedures for dealing with any fundamental disagreement that cannot otherwise be resolved between the independent non-executives and members of the firm's management team and/or governance structures.

D OPERATIONS

D.1	Compliance principle
	A firm should comply with professional standards and applicable legal and regulatory requirements.
	Provisions
D.1.1	The firm should establish policies and procedures for complying with applicable legal and regulatory requirements and international and national standards on auditing, quality control and ethics, including auditor independence.
D.1.2	The firm should establish policies and procedures for individuals signing group audit reports to comply with applicable standards on auditing dealing with group audits including reliance on other auditors whether from the same network or otherwise.
D.1.3	The firm should state in its transparency report how it applies policies and procedures for managing potential and actual conflicts of interest.
D.1.4	The firm should take action to address areas of concern identified by audit regulators in relation to the firm's audit work.
D.2	Risk management principle
	A firm should maintain a sound system of internal control and risk management over the operations of the firm as a whole to safeguard the owners' investment and the firm's assets.

Provisions

D.2.1	The firm should, at least annually, conduct a review of the effectiveness of the firm's system of internal control. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.
D.2.2	The firm should state in its transparency report that it has performed a review of the effectiveness of the system of internal control, summarise the process it has applied and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in its financial statements or management commentary.
D.2.3	In maintaining a sound system of internal control and risk management and in reviewing its effectiveness, the firm should use a recognised framework such as the Turnbull Guidance and disclose in its transparency report the framework it has used.

D.3 People management principle

A firm should apply policies and procedures for managing people across the whole firm that support its commitment to the professionalism, openness and risk management principles of this Audit Firm Governance Code. ~~and a culture of, quality work and professional judgement and values in a way that properly takes the public interest into consideration. They should cover recruitment, development, objective setting, performance evaluation, remuneration, progression and other forms of recognition.~~

Provisions

D.3.1	<u>The firm should disclose on its website how it supports its commitment to the professionalism, openness and risk management principles of this Audit Firm Governance Code through recruitment, development activities, objective setting, performance evaluation, remuneration, progression, other forms of recognition, representation and involvement.</u>
D.3.2	<u>Independent non-executives should be involved in reviewing people management policies and procedures.</u>

D.4 Whistleblowing principle

A firm should establish and apply confidential whistleblowing policies and procedures across the firm which enable people to report, without fear, concerns about the firm's commitment to quality work and professional judgement and values in a way that properly takes the public interest into consideration.

Provision

D.4.1	The firm should report to independent non-executives on <u>issues raised under the application of</u> its whistleblowing policies and procedures and disclose those policies and procedures on its website.
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E REPORTING

E.1	Internal reporting principle The management team of a firm should ensure that members of its governance structures, including owners and independent non-executives, are supplied with information in a timely manner and in a form and of a quality appropriate to enable them to discharge their duties.
E.2	Financial statements principle A firm should publish audited financial statements prepared in accordance with a recognised financial reporting framework such as International Financial Reporting Standards or UK GAAP. Provisions
E.2.1	The firm should explain who is responsible for preparing the financial statements and the firm’s auditors should make a statement about their reporting responsibilities.
E.2.2	The firm should report that it is a going concern, with supporting assumptions or qualifications as necessary.
E.3	Management commentary principle The management of a firm should publish on an annual basis a balanced and understandable commentary on the firm’s financial performance, position and prospects. Provision
E.3.1	The firm should include in its management commentary its principal risks and uncertainties, identifying those related to litigation, and report how they are managed in a manner consistent with the requirements of the applicable financial reporting framework.
E.4	Governance reporting principle A firm should publicly report how it has applied in practice each of the principles of the Audit Firm Governance Code excluding F.2 on shareholder dialogue and F.3 on informed voting and make a statement on its compliance with the Code’s provisions or give a considered explanation for any non-compliance. Provision
E.4.1	The firm should publish on its website an annual transparency report containing the disclosures required by Code Provisions A.1.2, A.1.3, C.2.1, D.1.3, D.2.2 and D.2.3.
E.5	Reporting quality principle A firm should establish formal and transparent arrangements for monitoring the quality of external reporting and for maintaining an appropriate relationship with the firm’s auditors.

Provision

E.5.1	The firm should establish an audit committee and disclose on its website information on the committee's membership and terms of reference which should deal clearly with its authority and duties, including its duties in relation to the appointment and independence of the firm's auditors. On an annual basis, the firm should publish a description of the work of the committee in discharging its duties.
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F DIALOGUE

F.1	Firm dialogue principle A firm should have dialogue with listed company shareholders, as well as listed companies and their audit committees , about matters covered by this Audit Firm Governance Code to enhance mutual communication and understanding and ensure that it keeps in touch with shareholder opinion, issues and concerns.
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Provision

F.1.1	The firm should disclose on its website its policies and procedures, including contact details , for dialogue about matters covered by this Audit Firm Governance Code with listed company shareholders and listed companies. These disclosures should cover the nature and extent of the involvement of independent non-executives in such dialogue.
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F.2	Shareholder dialogue principle Shareholders should have dialogue with audit firms to enhance mutual communication and understanding, and with listed companies in relation to their appointment of auditors.
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F.3	Informed voting principle Shareholders should have dialogue with listed companies on the process of recommending the appointment and re-appointment of auditors and should make considered use of votes in relation to such the appointment recommendations of auditors of listed companies.
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New appendix shown as mark-up to last seven paragraphs of Section 2.2 of the second consultation paper.

APPENDIX 1

Involvement of independent non-executives

~~However, the most important aspect of the draft Code which reinforces and supplements what regulated professional partnerships will achieve on their own without a governance code is Section C on independent non-executives.~~ Independent non-executives offer a governance solution to three potential threats to continued confidence in an audit firm: decision making is private; regulation does ~~not n't and shouldn't~~ cover all activities which put a firm's reputation at risk; and stakeholder dialogue to manage major threats to survival is difficult. Principle C.1 on the ~~role involvement~~ of independent non-executives refers to the three areas of decision making, management of reputational risks and stakeholder dialogue, where independent non-executives can build on the strengths of ~~the regulated professional partnerships model~~ to enhance the confidence that shareholders in listed companies place in the firms that audit those companies.

Reference to these core areas is not meant to prevent a firm from involving independent non-executives in other areas, such as the development of strategy. However, an independent non-executive is not the same as a member of an advisory board and may not fulfil the same role as a director on a corporate board.

~~1-~~ Decision making:

~~T~~hose with an interest in the quality of an audit firm's work will be aware that the involvement of regulators is largely after the event ~~rather than real time and that -r~~ Reports on the results of inspections will ~~also~~ only be published after completion of due process. ~~However,~~ ~~R~~eassurance about a firm's current performance is ~~more~~ difficult to achieve.

Some ~~of the~~ firms ~~currently~~ refer to ~~partners-owners~~ who ~~are members of sit on~~ governance structures and who are not in management positions as non-executives. However, the involvement of people who do not have executive responsibilities in the firm and who are independent of the firm and its ~~partners-owners~~ could play an important role in enhancing confidence. For example, tThey could help bridge the gap between a firm saying that it has a culture that is committed to working in the public interest and proving it by allowing outsiders to see the firm's leadership at close quarters ~~and in real time~~ making decisions that show that the firm does not pursue other interests to the detriment of the public interest. In short, independent non-executives can be a 'witness' to a firm's commitment to the public interest.

~~2-~~ Management of reputational risks:

~~T~~he ability of a firm to maintain its presence in the listed company audit market is dependent to a significant degree on the benefits to its reputation of being subject to effective audit regulation. However, ineffective regulation and non-audit business, much of it subject to little regulatory supervision, can have a significant adverse impact on a firm's reputation and the sustainability of its audit business. There are also risks associated with audit and non-audit work performed by other firms in the same network.

'Whole firm procedures' performed by audit regulators and improved international regulatory co-ordination can be expected to mitigate some of these risks ~~but they -~~ ~~However, significant risks~~ are likely to persist in relation to lightly regulated or unregulated non-audit work ~~performed in domestic as well as international markets.~~ Although an audit firm can manage these risks intelligently and conscientiously, it is only to be expected that there will be less confidence in how it is doing this in the absence of explicit independent external regulatory oversight. The presence of independent non-executives within an audit firm could help

address reputational risks including those in the firm's businesses that are not otherwise effectively addressed by regulation. In short, independent non-executives can be an additional 'safeguard' of a firm's reputation.

3. Stakeholder dialogue:

An audit firm's continued ability to maintain confidence in its audits of listed companies depends on good two way communication between the firm and stakeholders whose views are vital to the firm's sustainability. They include not only shareholders of listed companies but also regulatory, judicial and government bodies. In an audit firm, independent non-executives have a potentially important contribution to make. They could initiate dialogue and prompt candid feedback in a way that may be more difficult for partners-in-owners of a firm and provide a sounding board for, and collect external perspectives about, issues facing a firm. Independent non-executives could also be a valuable channel of communication for those wishing to raise issues about a firm while fearing that this might trigger confrontation if reported to a regulator or a defensive response if communicated to the firm's leadership. Even the best-run audit firm partnership may find it easier to respond to issues in a constructive fashion where they are raised through independent non-executives.

Independent communication channels are likely to be most important when events occur which pose a major threat to a firm's reputation. They could be a safety valve that helps prevent a firm from being forced to exit an audit market. At such times, the leadership of a firm is likely to be preoccupied with day-to-day survival. In the heat of a crisis it may also be impractical to set up new lines of communication quickly enough and this strengthens the case for firms to make arrangements as a matter of course so that they are prepared for potential adversity. In short, independent non-executives can be a channel for dialogue with stakeholders.

APPENDIX 2

Independence considerations

Code Principle C.2 identifies the independence of an audit firm's independent non-executives as a characteristic which enhances shareholder confidence. This appendix provides background information to help firms and independent non-executives in their consideration of independence issues related to independent non-executives.

A firm applying the Code will need to address two independence issues:

- auditor independence: relationships between an independent non-executive and an entity that a firm audits may prevent a firm from acting as auditor of that entity or otherwise reduce confidence in the firm's independence; and
- non-executive independence: relationships between an independent non-executive and a firm and its owners may be inconsistent with Code Principle C.2 on characteristics of independent non-executives.

In addressing both issues a firm will need to consider financial interests and business, family and employment relationships entered into, and notified to the firm, by independent non-executives. Restrictions that a firm places on such relationships will need to be made clear during the search, recruitment and appointment process and kept in view throughout the period of service of an independent non-executive. The appointment of independent non-executives will also require firms to extend and adapt existing processes that address auditor independence issues.

In relation to auditor independence, there are extensive national regulatory requirements and the importance of complying with these requirements and their impact will be affected by how a firm involves its independent non-executives. If independent non-executives are not seen to be in the firm's chain of command, then there will be less onerous restrictions on the financial interests and business, family and employment relationships that an independent non-executive can have with an entity audited by a firm.

Whether a particular firm's arrangements mean that an independent non-executive is in the chain of command will depend on specific facts and circumstances. In the view of the Working Group, it should be possible for a firm to apply the Code's principles and comply with its provisions on independent non-executives without placing them in the chain of command. To this end it will be important that an independent non-executive is not in a position to influence individual audits. This would include having no actual or apparent ability on individual audits to evaluate audit partner performance or to exercise quality control or other oversight functions. Independent non-executives' contracts might cover these matters and prevent them from receiving feedback on individual audits or having access to audit working papers unless appropriate safeguards are applied.

The Working Group is also aware that firms develop their own policies on auditor independence with the aim of helping to ensure compliance with different national requirements. Where a firm develops its own criteria for independent non-executives to support compliance with auditor independence requirements, Code Provision C.2.1 calls on a firm to state those criteria in its transparency report.

In relation to non-executive independence from a firm and its owners, a number of relationships that may cause concern will already be precluded because of auditor independence requirements. However, because there are no specific requirements which define non-executive independence, Code Provision C.2.1 also calls on a firm to disclose its

criteria for assessing whether its independent non-executives are independent from the firm and its owners.

In developing criteria, a firm is expected to reflect the views of a reasonable and informed third party. Therefore, firms should not exclude individuals from consideration as potential independent non-executives simply on the basis that independence issues might arise in the future. However, a proposal to appoint a former partner, for example, would need to be subject to careful consideration.

Once appointed, independent non-executives will need to be sensitive to potential conflicts of interest, report them and ensure that they exclude themselves from any related decisions. They will also need to comply with relevant requirements such as insider dealing legislation in relation to information that they might become aware of through their involvement with a firm.

New appendix shown as mark-up to Appendix 1 to the second consultation paper.

APPENDIX 3

Working Group members and terms of reference

Members of the Audit Firm Governance Working Group

Norman Murray (Chairman)	Chairman, Cairn Energy PLC
Jan Babiak	<u>Non-Executive Director, Logica plc (from 1 January 2010)</u> <u>Partner, Global Climate Change & Sustainability Services Leader, Ernst & Young LLP (retired 31 December 2009)</u>
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	Dean, London Business School
Andrew Moss	Group Chief Executive, Aviva plc
Richard Murley	Managing Director, Rothschild
Jeremy Newman	Chief Executive, BDO International
Observer	Chris Hodge, Head of Corporate Governance Unit, FRC
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.

3. Areas of change from the draft Code

3.1 Involvement of independent non-executives

Because of its innovative nature, Section C.1 of the draft Code dealing with the involvement of independent non-executives attracted a range of comments from respondents.

The Working Group concluded that:

- there was agreement with the core roles of independent non-executives;
- a number of respondents were concerned about whether independent non-executives would, in practice, be members of substantive governance structures relevant to their core roles;
- reference to the core areas was not meant to prevent a firm from involving independent non-executives in other areas; and
- more disclosure was required to enable investors to assess the substantive nature of the involvement of independent non-executives.

In the second consultation paper, the core roles of independent non-executives were set out in the last seven paragraphs of Section 2.2, not as part of the draft Code. The relevant text has now been substantially incorporated in a new Appendix 1 to the Code and the Introduction states that firms and stakeholders are expected to have regard to its contents even though Appendix 1 does not form part of the Code.

The Working Group added the word 'relevant' to Provision C.1.1 to ensure independent non-executives participate in governance structures that are relevant to their role. A sentence was included in Appendix 1 to make it clear that the role of independent non-executives can extend beyond the three core roles.

The Working Group expanded Provision C.1.2 to enhance disclosure about the appointment, removal and resignation of independent non-executives and about their duties and the composition of governance structures in which they participate.

The involvement of independent non-executives was seen by many as the most significant part of the Code.

Audit firms were concerned about duty of care, independence, confidentiality and right to report issues related to independent non-executives. These matters are dealt with in Sections 3.2 to 3.5 respectively.

Firms were appreciative of the draft Code's flexibility as to where independent non-executives could be placed within a firm's governance structures. One of the four largest firms commented, 'We consider that our independent non-executives will contribute most effectively by sitting on our firm's board and other governance structures.'

A number of firms recognised that independent non-executives could bring benefits. One of the four largest firms stated, 'High quality audit firm governance is in the interests of all stakeholders. We wholly support the concept of appointing INEs to focus on improved audit firm governance. We believe that INEs can make a valuable contribution to effective audit firm governance because they can bring different perspectives about the risks and opportunities an audit firm faces as it strives to provide quality services.' They went on to say that, 'The fact that a firm has INEs participating in governance should, in and of itself, help to enhance the confidence of shareholders and other stakeholders.'

Some of the largest firms expressed concerns that due to audit independence issues they may have difficulty in recruiting high calibre individuals. One of the four largest firms, in seeing

the role more in an advisory capacity, noted, 'The role of an independent non-executive is crucial in determining both their exposure to liability as a result of the duty of care that they will assume in taking up such a role and the extent to which they will be required to comply with the relevant independence rules. We welcome the flexibility proposed in the code in this regard.' This contrasted with the view of a mid-tier firm which commented, 'We also support not being prescriptive as to where in the governance structure independent non-executives should sit but regard it as important for reasons of credibility with stakeholders that they do form part of it and do not have merely advisory roles.'

Investors generally wanted independent non-executives to be empowered and to exercise informed influence. It was felt that the Code could be strengthened further if there was additional disclosure of the extent to which independent non-executives are integrated into the governance structure of the firm and whether they actually serve on a deliberative body.

One institutional investor noted that an advisory board model is unlikely to be strong enough and that non-executives should serve on a deliberative body. This latter point was also brought out by respondents in the corporate and other categories who wanted non-executives to be involved at the highest levels within a firm. Some investors felt that confidence in independent non-executives could be strengthened further still if there was some disclosure requirement in Principle C.1 about the extent to which they are integrated into the governance structure of the firm and whether they actually serve on a deliberative body.

All categories of respondents appeared to be supportive of the three core roles of independent non-executives set out in Section 2.2 of the second consultation paper, particularly the emphasis placed on public interest matters. A few were concerned that the roles were a little vague and that they should be similar to the role of a non-executive director in a corporate setting. However, one institutional investor representative body noted that independent non-executives 'cannot exactly mirror the responsibilities and role of those sitting on listed company boards. We believe that the role will evolve over time and that as this is happening individual firms should make special efforts to report on the role and activities of their non-executives.'

3.2 Duty of care

Principle C.2 of the draft Code stated that independent non-executives should have a duty of care to the firm and this prompted requests and suggestions for clarification.

The Working Group concluded that:

- the duty of care of an independent non-executive should be to the firm; and
- anyone with a duty of care to the firm who is a part of the management team and governance structures should have regard to the firm's professional obligations to act in a way that properly takes the public interest into consideration, as referred to in Principles B.1 and B.3.

In the final Code, the duty of care is re-emphasised with clearer wording in Principle C.2 and it is also referred to in the Introduction. The Introduction was also revised to include wording that emphasises the public interest obligations placed on individuals.

Audit firms were of the opinion that the duty of care of the independent non-executives was to the firm or to the firm and its owners. This was an important issue for the firms especially when the firms were also concerned about the application of draft Code Principle C.3 and the right of an independent non-executive to report publicly. Some firms made reference to the duty of care that a director has to a company.

An institutional investor, which is also a major listed company, believed that independent non-executives would strengthen audit firm governance and stated that, 'It would be appropriate

for the final Code to reinforce that they do not owe a duty of care to an audit firm's clients or to the client's shareholders.'

Another institutional investor suggested that 'the principle should be expanded to read "a duty of care to the firm, having regard to its public interest responsibilities and the objective of audit quality". This reflects the point made in the consultation document on reputations and the license to audit being of vital public interest, as well as the prospect that not all non-executives may be subject to the same professional requirements to take the public interest into consideration.'

3.3 Independence

In relation to Section C.2 of the draft Code on the characteristics of independent non-executives, respondents raised practical concerns about the independence criteria applicable to non-executives and the impact of auditor independence requirements.

The Working Group concluded that:

- it should be possible for a firm to apply the Code's principles and comply with its provisions on independent non-executives without placing them in the chain of command for the purposes of auditor independence requirements;
- when deciding who is eligible to be an independent non-executive, it would be important in the first instance to have regard to the practical impact of auditor independence requirements before applying criteria for a non-executive's independence from the firm because these requirements would effectively address many of the concerns expressed by commentators; and
- it was inappropriate for the Working Group to develop criteria for independence from the firm but that careful judgement was necessary when considering individuals as possible independent non-executives.

To outline and clarify such matters, the Working Group added a new Appendix 2 to supplement the text of Principle C.2 and Provision C.2.1. As is explained in the Introduction, Appendix 2 does not form part of the Code but firms and stakeholders are expected to have regard to its contents.

One of the four largest firms commented, 'Independence is the foundation of the audit profession.' An international investor body commented, 'Auditor independence is critical to the credibility of an audit.'

In their responses to the draft Code, the issue of auditor independence was raised by audit firms with varying degrees of concern. Firms, particularly those which audit companies registered with the US Securities and Exchange Commission (SEC), noted that the US independence rules for auditors are stringent. One firm stated that, 'Approximately 25% of FTSE100 companies are SEC-registered' and thus implied that for the firms that audit one or more of these companies, there may be particular problems in finding independent non-executives.

The issue of whether an independent non-executive is in the 'chain of command' for auditor independence purposes was important to the firms and their responses on this issue were wide-ranging. Some assumed a pessimistic worst case scenario; other comments noted that there would be problems even on the assumption that the role need not place a non-executive in the chain of command; others were requests for clarification.

While agreeing with the scope of the role of an independent non-executive as envisaged in the second consultation paper, one of the four largest firms noted, 'However, an INE who is sufficiently involved in the audit firm so as to impact its governance would most likely be in the "chain of command" as considered, defined and implemented for independence purposes.' The firm continued, 'we do not believe that an INE could occupy the governance role

envisaged by the draft Code and, at the same time, have a qualifying financial interest, business relationship or employment relationship with any of our audit clients.’

This firm also stated that although UK auditor independence requirements no longer saw non-executive individuals on a supervisory or equivalent board as being in an audit firm’s chain of command, the standards of the International Federation of Accountants ‘do not include any such provisions for INEs.’

However, a US-based auditor representative body observed that, ‘The manner in which a firm elected to incorporate INEs into its governance structure would determine whether, based on a fact-based analysis, the INE would be in the firm’s “chain of command”.’

Another of the largest four firms while also being less pessimistic on the chain of command issue, commented, ‘On the assumption that the role does not place the non-executive in the chain of command, we believe that there are still significant independence restrictions.’ They went on to refer to regulation, particularly US regulation covering employment, business and financial relationships with clients.

Another of the largest four firms commented, ‘We would welcome greater clarity around the independence issues and would ask the Working Group to have further discussions with the relevant authorities both in the UK and elsewhere (particularly in the US).’

The final largest four firm noted that there were general considerations regarding independence but went on to say, ‘However, we are confident that if these matters can be dealt with, well-chosen individuals with appropriate experience could bring value and strength to our business and enhance the overall credibility of auditing in the UK, to which we are fully committed.’

In relation to independence rules, especially arising from the US, a large firm recommended that ‘the Committee and investors be open to ideas promoted by firms that they believe will help them to apply the principle of the Code in a way which does not restrict their ability to make suitable independent non executive appointments.’

An audit regulator in the public sector commented that it ‘endorses the working group’s analysis of the benefits of the independent non-executive role and the issues affecting their independence. It seems to us that the key principle is that the firms should be able to demonstrate that those individuals are not involved in the chain of command of individual audits, influencing neither their conduct nor the opinion issued.’

Turning to the independence of non-executives from an audit firm, an institutional investor commented, ‘We believe that an independent non-executive should not be a recent former partner of the firm and similarly should not be a serving director on the board of a major audit client. The code would be greatly strengthened if it identified some minimum threshold of this type. Certainly firms would help themselves if they could explain how non-executives are not in any position to influence individual audits, and the existence of basic independence requirements would give this substance.’

A mid-tier firm noted that, ‘In order to ensure the independent non-executives command the confidence of key stakeholders in the firm, and in the capital markets more widely, we do believe certain minimum criteria should be laid down as benchmarks against which to assess their independence. We do not, for instance, consider that an independent non-executive should be a director of a substantial audit client of the firm. We naturally would also not regard a former partner of the firm as independent.’ However, a professional body commented, ‘We believe it is important to have experience of the professional services sector and it is with experience that a person begins to have the confidence to challenge the rest of the board and sustain that challenge where necessary. Length of service with the firm should not necessarily be seen as inappropriate. The key point is effective performance, which is dependent on the non-executive being independent of mind.’

Several other respondents believed that certain officers of a client should not be an independent non-executive of a firm. For example, an audit regulator from the public sector commented that ‘while recognising the working group’s reluctance to specify an initial list of relationships between a non-executive and a firm or its partners which would automatically prevent non-executives from being judged to be independent, we consider that there are some relationships that could clearly be ruled out as unacceptable. For example, it would seem to us to be unacceptable for the Chairman or Chairman of the Audit Committee of a firm’s client to serve as an independent non-executive member on that firm’s board of governance. As an active stakeholder we would certainly want to proscribe some relationships.’

3.4 Confidentiality

Principle C.3 of the draft Code referred to independent non-executives’ right of access to information and people and respondents asked for clarification of the interaction of this right with the confidentiality requirements placed on audit firms.

The Working Group concluded that an independent non-executive’s right of access to relevant information and people should not override the firm’s professional and legal obligations in relation to confidentiality.

To clarify this matter, the Working Group included additional wording in Principle C.3.

Some audit firms had concerns about confidentiality and data access in the context of an independent non-executive’s right of access to relevant information and people.

One of the four largest firms had concerns about the extent to which the Code may conflict with client confidentiality and data protection laws in some countries. It believed that this could impact the level at which it might adopt the Code, either in the UK or at a European level, commenting that, ‘It is our understanding that it is intended that neither the independent non-executives nor the dialogue with shareholders should be concerned with individual client situations.’

The Working Group noted that, for example in some European countries, there are clear rules about what data on individual client matters may or may not be made available to individuals on a governance structure as well as national laws and regulations about confidentiality of client data that are specific to auditors.

Another of the four largest firms anticipated that the contract for services setting out the rights and duties of an independent non-executive would include provisions ‘regarding confidentiality similar to those under which the partners and staff of the firm operate.’

3.5 Right to report

Principle C.3 of the draft Code referred to independent non-executives having a right to report publicly a fundamental disagreement and respondents raised concerns about potential unintended consequences of this right.

The Working Group concluded that the right to report publicly should be a measure of last resort related to the resignation of an independent non-executive.

The Working Group clarified these matters by revising the wording in Principle C.3 to supplement disclosure of a resignation on a firm’s website as set out in the new text in Provision C.1.2, referred to in Section 3.1.

While most audit firms had significant concerns about public reporting especially as they saw a link to the duty of care issue covered in Section 3.2, one of the four largest firms stated, 'We agree with the provisions of C.3 that the independent non-executive should have the right to report fundamental disagreements to the owners and, in circumstances where the disagreement cannot be resolved, to report publicly. We agree that this takes the form of a right, rather than a duty, and that it applies only to the most serious unresolved disagreements.'

Other firms linked the matter to the duty of care of independent non-executives to the firm and not to other stakeholders. One of the four largest firms commented that it was 'not clear how such duty (and the duty of care expressed in Principle C2) should or could be balanced against the right to report publicly in the event of unresolved fundamental disagreements.' Another respondent believed that this was a potential 'nuclear option' and could result in unintended consequences if a non-executive felt obliged to use the option in order to comply with the Code, even if that meant severely damaging the reputation of a firm in the process.

Other firms commented on the matter more in the context of the Combined Code on Corporate Governance and the resignation of listed company directors. This included large and mid-tier firms, some of whom believed that public reporting should be an exceptional event after all other avenues had been explored.

One of the four largest firms commented that, 'An audit firm would want to avoid an INE having to resign because, among other things, the fact of the resignation would be public and could well adversely impact on an audit firm's reputation. Furthermore, INEs do not need rights in this regard which go beyond the requirements of the Combined Code for NEDs and listed companies. This is because audit firms are already subject to independent regulatory oversight and public reporting which cover audit firm governance and which could easily be extended to include oversight of INE resignations. To enhance shareholder and stakeholder confidence yet further, we would also support a right for the INE to provide a copy of their resignation statement in confidence to our independent regulators.'

Another of the four largest firms commented that in their view 'the natural remedy for an independent non-executive who has a fundamental disagreement with the management of the audit firm would be to report to the Supervisory Board and, ultimately, to the partnership as a whole, with the right to resign as a last resort. We therefore believe that any additional right to report to third parties is unnecessary, confusing and should be deleted.'

One auditor representative body commented that 'INEs' right to report publicly under the Code would seem to be intended to mean that INEs have a duty of care to other stakeholders. This existence of a duty of care to stakeholders besides the owners of the firm may impede the open sharing of relevant information between U.S.-based member firms and UK firms (and perhaps other countries as well) due to a concern that information provided to INEs in the conduct of their duties may adversely impact the firm.'

A non-executive director of a listed company commented that, 'The issue of public reporting by one individual is an extremely sensitive one and I would like to see more guidance given that an individual would only report either to the firm or to the public at large after having deliberated with his fellow non executive directors and having taken advice from outside the firm.'

3.6 People management

Principle D.3 of the draft Code on people management caused some respondents to suggest changes to make this aspect of the Code more effective.

On the basis that audit firms are people businesses, the Working Group concluded that:

- Principle D.3 should be clearer by being shorter and explicitly linked to other principles in the Code;

- there should be an explicit disclosure requirement covering aspects of people management that are relevant to the application of other principles in the Code; and
- there should be an expectation that independent non-executives should have some involvement in this area.

The Working Group extensively redrafted Section D.3 by:

- making Principle D.3 shorter and linking it to the principles on professionalism (B.1), openness (B.3) and risk management (D.2);
- moving text from draft Principle D.3 into the new Provision D.3.1 on disclosure; and
- adding a new Provision D.3.2 for the independent non-executives to be involved in this area.

An individual who is Chief Financial Officer of a FTSE 100 company and previously a partner in one of the four largest firms commented that ‘the most important Principle in the Audit Firm Governance Code is D.3, the ‘People Management Principle’, as everything in a professional services firm comes back to the quality of people, their development, training, supervision and evaluation leading to their motivations around progression, recognition and remuneration.’ He believed that some of the Code’s Principles ought to be interlinked and that independent non-executives have an important role to play in this area. He also felt that ‘D.3 - being the most important principle in my view - should have guiding provisions rather than inviting simply a policy statement which likely would become boilerplate’.

A professional body also believed that Principle D.3 was one of the most important principles as professional services firms are people businesses and a key matter is the quality of people. In the context of the people management principle, they commented that, ‘There could be a greater emphasis that the professional principle in B1 applies not only to the audit practice but to any services provided by the firm in its other divisions.’

3.7 Dialogue

Section F of the draft Code addressed the importance for audit firm governance of dialogue between audit firms and shareholders and prompted a range of suggestions from respondents.

The Working Group concluded that:

- even though audit firms cannot report on Principles F.2 and F.3, it is important to retain these in the Code as investors should contribute to audit firm governance by being involved in dialogue with firms;
- the involvement of audit committees needed to be emphasised;
- there should be a point of contact in a firm to whom investors would refer in the event that they wished to discuss the firm’s application of the Code; and
- the process for appointing and re-appointing auditors would be better referred to in Principle F.3 rather than Principle F.2.

The Working Group included audit committees in Principle F.1 and added reference to contact details in Provision F.1.1. It moved text from Principle F.2 to Principle F.3 and added references to re-appointment and process so that Principle F.3 now relates to the process for the appointment and re-appointment of auditors.

Audit firms welcomed the proposed requirements for firms to engage with the investor community. One of the four largest firms stated, ‘We consider open discussion and dialogue between auditors, investors and audit committees to be an important aspect of ensuring that the auditing profession understands the needs of key stakeholders.’

A large firm believed 'that effective engagement between audit firms and the investor community is the most important factor that will govern the Code's success or failure.' They went on to say that if the Code 'were to fail in practice to foster effective dialogue between investors and auditors we believe that most of its potential benefits would be lost. The investor community would lose a valuable opportunity to influence the direction of auditing.'

Another large firm noted that 'in practice there is as yet no established forum for this dialogue' and a mid-tier firm believed that Principles 'F2 and F3 have to have real substance to them in practice. To enhance the possibility of this we believe that:

- when the Code is launched it should be tied into real promotional activity by bodies such as the FRC with the investor community, and a programme should be devised to ensure this activity continues; and
- other bodies representing institutional shareholders should be invited to put flesh on the principles in F2 and F3, similar to the detailed provisions for firms as guidance for their own members.'

While welcoming dialogue with investors and Principle F.1, one of the four largest firms commented, 'However we note that the subsequent provisions of the code in F2 and F3 are requirements that fall on the shareholders of client companies and are therefore not matters within the control of audit firms. Consequently we recommend that these are deleted.'

A listed company commented that audit firms' dialogue with shareholders should reflect 'each individual firm's generic approach to governance structures and does not involve any specific topics regarding their audit clients.'

An institutional investor commented, 'Our chief concern is to make communication, dialogue and engagement between audit firms and listed company shareholders as straightforward as possible.' Another institutional investor acknowledged that investors had a role to play in developing dialogue and considered Principles F.2 and F.3 to be sound in concept. While pointing out that 'audit committees have the direct relationship with the external auditor rather than shareholders and will also have a due diligence role of their own to play and a need to engage with shareholders in what is a triangular relationship.'

Another institutional investor commented 'Overall, we support these principles. We see benefits in increased dialogue and engagement between institutional investors and an audit firm on the basis that it remains informed, focussed, objective and industry or issue generic where possible, rather than relating to a particular audit client/issuer matter. If engagement were to take place on a particular audit client/issuer matter, we believe that it would be legitimate if it related to information which is publicly available. Otherwise we are concerned that discussion on a particular matter may breach the auditors' duty of care to its client, as well as the issuer's communications responsibilities to its shareholders under the Listing Principles.'

3.8 Tone and emphasis

In the Introduction to the second consultation paper, the Chairman of the Working Group invited people with different perspectives to consider the effects that the draft Code would have in practice and, as a result, respondents identified ways in which it could be improved through changes in tone and emphasis.

The Working Group concluded that a number of changes to the tone and emphasis of the Code would make it more effective, particularly for the benefit of investors.

The Working Group made a number of drafting changes to various principles and provisions including:

- adding a reference to audit quality in the Introduction to the Code;

- emphasising the practical application of the Code in Principle E.4, Provision B.1.1 and the Introduction to the Code;
- recognising the need to include reference to the legal and regulatory responsibilities of a firm in addition to compliance with standards in Provision D.1.1; and
- expecting independent non-executives to have an awareness of the issues raised by whistleblowing procedures by amending Provision D.4.1.

An investor representative body noted that audit quality is the product of the values governing audit firms and that many investors were concerned that the firm's internal governance may be more disposed towards maximizing profits as opposed to audit quality and transparency. In this context, an institutional investor commented that although in the draft Code 'general references are made to "quality work", it is unfortunate that "audit quality" is not explicitly mentioned, even once, in the Code.'

The same institutional investor also noted that although the draft Code made reference to legal requirements 'it is rather notable that the provisions focus solely on compliance with standards. We see this as a material weakness in the current drafting of the Code. Audit firms' wider responsibilities and duties in law are of equal if not greater importance to shareholder perceptions and audit quality than pure compliance with standards, which have a narrower and more limiting nature.'

Another institutional investor noted that one of the chief barriers to engagement with the audit firms 'is likely to be ease of access to the relevant information and personnel.' This respondent made a number of recommendations to help matters including 'that the code should ensure that the transparency report and other central documents are easily obtained via the firms' websites' and that, 'The firms should have an initial contact for governance matters who is of sufficient seniority and capability to be able to answer enquiries on the application of the code by the firm and to be able to arrange further meetings and dialogue as necessary.'

While expressing concern that whistleblowing should not involve the passing on of audit client information, an audit representative body stated that, 'We commend the introduction of the whistle blowing principle in the Code and acknowledge the role independent executives could play in this respect.' An institutional investor considered that, 'Principle D4 should make clear that the whistleblowing policies and procedures should be under the auspices of the independent non-executives and that Provision D4.1 should be strengthened to say specifically that the independent non-executives should have sight of all issues raised and how they have been dealt with.'

3.9 Implementation

The draft Code proposed that it be reviewed four years after an unspecified implementation date and respondents made a number of suggestions on these matters.

The Working Group concluded that:

- it was reasonable to expect application of the Code, including the appointment of independent non-executives, to commence for financial years starting on or after 1 June 2010; and
- there should be more flexibility as to the timing of the first formal review of the Code by suggesting that the review should start no later than four years after the publication of the Code.

The Working Group added these matters to the Introduction to the Code.

Although most respondents did not refer to the four year period before a formal review is undertaken, a few respondents did make suggestions including an institutional investor who suggested that 'a review of the Code's implementation could usefully be undertaken after three years rather than the four proposed. This would help firms and other interested parties take stock and ensure that practice is developing in a way that is helping to address the Code's objectives as well as to facilitate the ongoing development of "best" practice.'

Another investor suggested that, 'Given the limited number of firms that will be subject to the Code it would not seem unduly costly for the FRC to invite and make comment on each year's compliance reports rather than wait until the end of four years.'

An individual respondent suggested that 'the formal review period be reduced from 4 to 3 years as I believe clear patterns of reporting and adoption will emerge within the first couple of reporting seasons.'

4. Further suggestions on disclosure

The Working Group noted some interesting suggestions, primarily from institutional investors, in responses to the second consultation paper. While not revising the draft Code for these suggestions, the Working Group decided that the following three suggestions were of sufficient merit to bring to the attention of firms and investors through the feedback statement.

4.1 Reporting by independent non-executives

Firms may wish to ask their independent non-executives to consider preparing an annual report which would be made publicly available.

Several respondents, including institutional investors, a professional body and a non-executive director of a listed company, suggested that an audit firm's independent non-executives should, on an annual basis, prepare their own report which would be made publicly available.

There were various suggestions for the potential content of such a report. For example, an institutional investor, believing such a report would be a useful innovation, commented that the independent non-executives could provide a report 'on how they have conducted themselves during the year to ensure that the provisions of the code have been met or not.' They believed that, without being prescriptive, such a report's content could provide very useful insight into the independent non-executives' role, and 'be a useful additional perspective on the firm's governance and thereby be another useful element in institutional investors' assessment of the firm's quality. It would also be an important basis for discussions between them and institutional investors.'

Other suggestions included reporting by independent non-executives on:

- the discharge of their role and responsibilities under the Code; and
- their role and their views on the firm's application of the Code. The respondent suggesting this wrote that, 'Such reporting will establish their role within the firm and give confidence to the stakeholder community and affirm their role and guard against them being only used for compliance and witness purposes.'

4.2 Setting a governance reporting objective

Firms may wish to set an objective for their disclosures in relation to the Code to help ensure that they provide meaningful information for intelligent readers.

Although the Introduction to the Code already discourages boilerplate, an institutional investor believed that 'there should be a requirement to report meaningfully on the code's provisions. This should include the following provisions:

- to include the necessary detail for a reasonable stakeholder to be able to form an opinion as to how effective the governance arrangements at the firm are;
- to be sufficiently detailed to enable a reasonable stakeholder to engage with the firm with a reasonable knowledge about the firm and its governance arrangements including how it applies and embeds the code in how it carries out its operations.'

4.3 Promoting dialogue with investors

Firms may wish to establish, maintain and use a contacts database of interested individuals.

An institutional investor suggested that, via the governance page on its website, a firm 'should advertise for and collect names and contact details of those at institutional investors and others who wish to be informed about the publication of the firm's transparency report, public meetings on governance and so on. This will enable the firm to provide the necessary information to the interested parties in a way at least partially analogous to how a listed company communicates with its shareholders.'

5. Issues not resulting in changes

Respondents to the second consultation paper made suggestions for changes to the draft Code in a number of areas where, after consideration, the Working Group decided to make no changes. These are set out below.

5.1 Definition of public interest entity

The Working Group recommended in the second consultation paper that, for the purposes of the Code, the definition of a public interest entity should follow that used in regulations requiring the preparation of annual transparency reports. There are links between transparency reports and the Code and therefore the Working Group believed that the definition of a public interest entity for the purposes of this Code should be 'a listed company'. This was further emphasised by the fact that the Code is targeted at shareholders in listed companies and contains principles related to their dialogue with audit firms.

A few respondents felt that the Working Group had been too narrow in limiting the definition of a public interest entity to listed companies. They believed that the definition should be much broader and include other organisations such as mutuals, bodies in the public sector and large private companies.

After consideration of these comments, the Working Group concluded that it did not wish to extend the definition of public interest entity beyond listed companies to include other sectors. This was on the basis that there were similar patterns of concentration in other sectors and so extending the definition would serve little purpose and simply increase complexity.

5.2 Threshold of more than 20 listed companies

In its second consultation paper, the Working Group recommended that only firms that audit more than 20 listed companies should be expected to report on their application of the Code. Based on analysis published in 2009 by the UK Professional Oversight Board, the Code will initially apply to eight firms although other firms may apply the Code if they wish. In establishing the threshold, the Working Group wanted to avoid the problem of constraining the growth of the many firms which are some way off the threshold.

While many respondents did not comment on the issue, and others were supportive of the threshold, some respondents questioned the level at which the threshold was set. Some of these respondents suggested the threshold should be higher while others suggested it was already too high. A few mentioned a 'threshold effect' and the expectations placed on firms below the threshold when, for example, they are on 'tender shortlists' in competition with larger firms who will be applying the Code.

An international investor body believed that there should be no distinction between firms that audit any listed company and that the Code should apply to every such audit firm. Another investor representative body commented, 'The danger that this Code could have become a barrier to entry for new or growing firms was a significant one. However, we believe the Code has been structured in such a way as to address this. Indeed, we consider that firms that are out of scope currently should be encouraged to apply this Code voluntarily so as to further mitigate the issue.'

One of the four largest firms suggested promoting the 'comply and explain' benefits of the Code rather than set an expectation that the Code should only initially be applied by eight audit firms.

After consideration of the comments in the responses, the Working Group concluded that it did not wish to alter the threshold of more than 20 listed companies, noting that:

- the comply or explain basis provides smaller firms with an opportunity to explain to investors, potential clients and others, why they have not complied with any particular provision in the Code and this may provide an opportunity to reduce the immediate impact of additional costs; and
- all firms that audit listed companies will wish to be seen as well governed and, over time, some firms whose number of listed company audit clients falls below the current threshold of more than 20 listed companies may wish to apply the Code with the aim of enhancing investor confidence and competing more effectively in their chosen markets.

5.3 International application

In the Introduction to the draft Code in the second consultation paper, the Working Group commented, 'A potentially challenging area of application and reporting arises in relation to the international structures of the major audit firms. Firms that sign statutory audit reports are generally national firms. However, we recognise that where a national firm that applies the Code is part of a regional or an international structure, it will make sense to look beyond the national firm in considering application of Code principles and compliance with Code provisions. For this reason, disclosures under the Code may be more useful if they do not relate exclusively to the national firm applying the Code.'

Given the varying structures of the audit firms' networks, some firms had pragmatic concerns about the right level for application of the Code and others were concerned about potential unintended extraterritorial consequences. One commented that overseas jurisdictions might 'borrow from the Code without careful thought of how the Code might sit alongside local laws, regulations and practices' and thus how the Code might impact other firms in their networks.

A number of investors and some others acknowledged the interlinking of the firms' networks, but believed that the Code should be applied at the highest possible level.

After consideration of the comments in the responses, the Working Group concluded that it did not wish to alter the wording in the draft Code other than to change 'will' to 'may' to make the Code appear less prescriptive about looking beyond national firms when making disclosures.

5.4 Impact of other governance initiatives

In the latter part of 2009, there were other developments in governance in the UK including Sir David Walker's final recommendations in his November 2009 report *A review of corporate governance in UK banks and other financial industry entities* and the FRC's December 2009 review of the Combined Code on Corporate Governance. The latter reiterated the FRC's commitment to 'comply or explain'.

A number of recommendations in both reports directed at investors, particularly institutional investors, are aimed at increasing the levels of governance activity undertaken by these institutions, although there is no direct reference to dialogue between investment institutions and audit firms. The FRC plans to take responsibility for a Stewardship Code for institutional investors, subject to consultation designed to ensure it can be operated effectively, after which the FRC may delete Section E of the Combined Code which is directed at communication between shareholders and listed companies. This could be seen as supporting the suggestion made by a few respondents that Principles F.2 and F.3 should be removed as firms cannot 'comply or explain' against the related provisions.

However, the Working Group concluded that Principles F.2 and F.3 are important parts of the Code. Until the FRC's Stewardship Code has been operating effectively and the FRC has deleted Section E from the Combined Code, the Working Group believes that it would not be

appropriate to remove Principles F.2 and F.3 from the Audit Firm Governance Code. At the time of finalising the Code the FRC is consulting on some proposed changes to the Combined Code, such as proposals related to risk management and internal control. The Working Group decided not to anticipate any of the proposed changes except that the Code now refers to the UK Corporate Governance Code in recognition of the planned change of name announced by the FRC.

5.5 Cost-benefit considerations

Section 2.3 of the second consultation paper set out an assessment of costs and benefits. In addition to outlining the benefits of the Code, the Working Group noted that the two main areas where the Code would be expected to lead to identifiable incremental costs relate to dialogue with shareholders and the appointment of independent non-executives.

For smaller firms which only audit a few listed companies, the Working Group was aware of the risk of unintended consequences if a code introduced to enhance choice reduced it because it deterred firms from entering the listed company audit market or caused firms to exit that market. The Working Group's proposed answer was to set a threshold of more than 20 listed company audit clients to avoid the problem of constraining the growth of the many firms which are some way off that level. As noted in section 5.2 above, the Working Group did not alter this threshold.

The Working Group received a few comments on costs for smaller firms within the eight firms to which the Code is applicable noting that the incremental costs would be greater in proportion to their revenues than for the larger firms. However, the Working Group believed that:

- responses to the second consultation paper as a whole indicated that its proposed approach was seen as proportionate; and
- the tests set out in Section 1.3 which it has applied in making changes to the draft Code help ensure that the final Code does not impose disproportionate costs.

Appendix: Respondents to the second consultation paper

Audit firms

Baker Tilly Management Limited
BDO Stoy Hayward LLP
Deloitte LLP
Ernst & Young LLP
Grant Thornton UK LLP

KPMG Europe LLP
Mazars LLP
PKF (UK) LLP
PricewaterhouseCoopers LLP
RSM Bentley Jennison

Investors and their representative bodies

Association of British Insurers
Aviva Investors
Governance for Owners
Hermes Equity Ownership Services
International Corporate Governance Network

Investment Management Association
National Association of Pension Funds Ltd
rpm Railpen Investments
Standard Life Investments Limited*

Companies and their representative bodies

CBI
Independent Audit Limited
Institute of Directors

Standard Life plc*
Tate & Lyle plc
Vodafone Plc

Professional bodies

Association of Chartered Certified Accountants
Center for Audit Quality
Chartered Institute of Management Accountants

Fédération des Experts comptables Européens
Institute of Chartered Accountants of Scotland

Regulators and other stakeholders

Audit Commission
Audit Scotland
Auditing Practices Board

Institute of Business Ethics
Trades Union Congress
Wales Audit Office

Individuals

Carcello, Dr Joe
Durant, Mr Ian
Flint, Mr Douglas
Kabureck, Mr Gary
McLaren, Mr Iain

Mednick, Mr Robert
Percy, Professor J P (Ian)
Roberts, Mr Graham
Thomson, Mr Alan

* combined response

