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AUDIT FIRM GOVERNANCE SECOND CONSULTATION PAPER

A PROJECT FOR THE FINANCIAL REPORTING COUNCIL

Audit Firm Governance
Working Group
Chairman: Norman Murray
July 2009

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Chairman’s introduction

This consultation paper provides an opportunity to comment on a draft of the Audit Firm Governance Code (the Code) and influence its finalisation. The Code should be of direct interest to everyone who sees audit as playing a vital role in a market economy, including:

- shareholders in public interest entities;
- directors, employees and other stakeholders of those entities including regulators; and
- partners and staff of firms that carry out audits of such entities.

It is important that people with different perspectives look at the draft Code, consider the effects it will have in practice, identify any ways it could be improved and share their insights with the Audit Firm Governance Working Group.

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 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 Audit Firm Governance Working Group (the Working Group) whose members are listed in Appendix 1. 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. The Code is intended to mitigate the risks of market exit and to provide a benchmark against which firms’ current and future governance practices can be measured. For a major public interest entity appointing an auditor, it could also enhance choice by reducing a perceived risk of looking outside the four largest firms.

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 a new global awareness of the widespread economic harm that can follow the failure of systemically important institutions. This is reflected in some of the recent regulatory developments summarised in Appendix 2 including Sir David Walker’s review of corporate governance in the UK banking industry and other financial institutions and the FRC’s review of the Combined Code.

It is to everyone’s benefit that confidence in the major international audit firms has remained strong throughout the recent financial crisis. However, we cannot afford to be complacent and that is why the audit firms’ willingness to embrace the Code is so important. It shows that the firms are aware that the reputations they have built upon their licence to audit are of vital public interest and that one way in which they can maintain public trust in their brands is by being seen as exemplars of best practice governance.

The draft Code

The Working Group is very grateful to the 43 formal respondents to the first consultation paper who sent us letters and who are listed in Appendix 3 and to all those in the UK and elsewhere who have shared their views with us in numerous meetings. The result is a draft Code with the following main features:

- it follows the transparency reporting definition of public interest entities as listed companies;

- it is targeted at shareholders in listed companies and contains principles related to their dialogue with audit firms;
- it 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. Based on analysis published in 2009 by the UK Professional Oversight Board (POB) and reproduced in Appendix 4, the Code will initially apply to eight firms;
- it 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 Combined Code designed for listed companies is of limited applicability to owner-managed firms;
- it recognises the qualities that audit firms are expected to demonstrate as regulated professional practices and summarises these qualities so that they can be more widely appreciated;
- it sets out a very specific role for independent non-executives of audit 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
- it envisages that firms will make Code-related disclosures in transparency reports that supplement the legal requirements set out in Appendix 5.

The way forward

We have performed extensive analysis of the evidence we have received already and sought to respond fairly to the points made, including criticisms of the basic premise of Recommendation 14 that a code would be beneficial. The Code should enable a much better understanding of firms and help them to continue to command the confidence of shareholders and others.

Without wishing to discourage further comments, we will give most attention to new points so that we can finalise the Code as swiftly as possible before the end of the year. In this respect we are particularly interested in comments on the practical implementation issues associated with independent non-executives. We are also aware that in finalising the Code we will need to take account of any relevant points arising from the Walker review and the review of the Combined Code.

In the meantime, we hope that you find the draft Code and the consultation paper interesting and thought-provoking. We look forward to reading your comments.

Norman Murray

Chairman, Audit Firm Governance Working Group

July 2009

1. CONSULTATION PROCESS

1.1 Responding to this consultation paper

What to comment on

We invite comments on the consultation paper, particularly:

- the presentation of issues involved in developing the Code in Section 2;
- anticipated costs and benefits relevant to the assessment in Section 2.3;
- the independence of non-executives and their impact on auditor independence as discussed in Section 2.4; and
- the content of the draft Code in Section 3 and the balance between principles and provisions.

Who should respond?

The Working Group is seeking responses to this consultation paper from representatives of audit firms, investors, listed companies, and any other interested parties.

When to respond

Comment letters should be received, at the latest, by Saturday 10 October 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
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Chartered Accountants' Hall
PO Box 433
Moorgate Place
London EC2P 2BJ
United Kingdom

It would help in the analysis of responses if organisations could provide information on their size and activities and if individual commentators could describe their background and experience.

Respondents should indicate specifically whether their comments are to 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 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 Code;
- demonstrates a practical application of evidence-based policy-making; and
- follows better regulation principles.

The Working Group decided that it needed to carry out two formal consultations:

- the first to gather evidence on key issues to inform its work in drafting a proposed Audit Firm Governance Code; and
- the second to obtain views on a draft Code.

The first consultation paper of October 2008 asked 20 questions on eight consultation issues that were considered crucial to the drafting of the Code. From this first consultation we wanted to understand views of firms, shareholders, companies and other stakeholders on the issues that the Code should address and how it should address them. We have:

- put responses from the 43 respondents listed in Appendix 3 on the ICAEW website referred to in Section 1.1;
- analysed the quality of the arguments as well as the weight of opinion behind different points of view and, where necessary, sought further input through meetings with relevant individuals;
- for each question, summarised the written submissions in Section 4 of this paper and stated the conclusion we reached for the purpose of preparing the draft Code in Section 3; and
- identified areas requiring further analysis that is presented in Section 2 and reflected in the draft Code.

This paper is part of the second consultation phase which will also include other activities to gather views of interested parties. We aim to publish the final Code in late 2009 along with written responses to this consultation.

2. DEVELOPING THE CODE

2.1 Regulated professional partnerships

Comment letters from a number of firms with public interest audit clients noted that the Working Group had assumed that a governance code should be developed. While this was an understandable assumption for a Working Group charged with drafting a code to make, they questioned the benefits of adding a code to the existing regime for regulated professional partnerships carrying out audits. Consistent with the Working Group's intention to carry out evidence-based policy-making, we address this issue by articulating the case for the Code in Section 2.2. But first we acknowledge the strengths of the existing regime.

Each of the three elements of the term 'regulated professional partnership' raises issues about the benefits of subjecting such entities to a governance code.

Partnership: as owner-managed businesses, audit firms generally do not face the agency problems that characterise listed companies where management and ownership are separated. Codes of corporate governance are principally designed to address the risk that managers will pursue their own interests at the expense of earning returns for the benefit of owners. The Combined Code addresses this risk through a unitary board with supporting committees and a substantial presence of independent non-executive directors with wide-ranging responsibilities to shareholders on strategic, operational and compliance matters.

Pressures for audit firms to apply this model are apparent not only in MPG Recommendation 14 that firms comply with the provisions of a Combined Code-style best practice corporate governance guide but also in one of the October 2008 recommendations of the US Treasury Advisory Committee on the Auditing Profession. It called on regulators, investors, companies and audit firms to analyse, explore and enable, as appropriate, the appointment of independent members with full voting power to US audit firm boards. Yet in the absence of significant agency problems arising from outside ownership, some commentators questioned the value of audit firms following a governance code.

Professionalism: partnerships that carry out audits are already subject to professional requirements to take the public interest, and not just the needs of an individual client, into consideration and uphold codes of ethics which in turn means that partners have strong shared values. Corporate governance codes can be seen as injecting norms of behaviour into organisations that would not otherwise have to embody any particular values. The fact that professional practices by their nature have an ethical dimension is another reason for some commentators to question the need for the Code.

Regulation: where experience has shown weaknesses in the operation of professional partnerships in delivering audit quality, the reaction has historically been to impose additional regulatory requirements on audit firms. UK audit firms operate in a highly regulated environment as described in the first consultation paper and on 8 December 2008 the FRC issued the first public reports on individual firms in respect of the Audit Inspection Unit's inspection cycle for the year ended 31 March 2008. To the extent that a governance code is seen as helping to secure further improvements in audit quality, it was unclear to some commentators why regulation and related inspection and enforcement could not be used to realise these improvements.

2.2 The case for the Code

Despite the arguments advanced in Section 2.1, the Working Group believes that the Code will support choice in the listed company audit market by enhancing confidence in the regulated professional partnerships that perform such audits.

The Code can help to relieve shareholders in listed companies of the need to become experts in private partnership agreements, professional ethics, quality control and auditing standards and other regulatory requirements in order to obtain assurance about how audit quality is achieved. Principally for the benefit of people outside the firms, the draft Code summarises in one place the best aspects of partnership, professionalism and regulation. Broadly this is what is achieved by sections A, B, D and E of the draft Code which cover leadership, values, operations and reporting respectively:

- Section A of the draft Code summarises measures to maintain owner accountability under principle A.1 while having effective management under principle A.2. In their governance structures, the firms generally include partners who are not involved in senior management positions to address any potential lack of alignment between management and broader ownership interests;
- Section B summarises the values set out in professional codes of ethics under principle B.1 on professionalism and the spirit of consultation expected in professional partnerships under principle B.3 on openness;
- Section D summarises standards for performance of audit work under principle D.1 on compliance as well as cultural attributes that regulators look for in an audit firm under principle D.3 on people management and regulatory expectations on whistleblowing under principle D.4; and
- Section E on reporting sets out the reporting required for owner accountability and effective management under principle E.1 on internal reporting. It also reflects regulatory expectations, for example UK requirements for firms that audit listed companies to prepare transparency reports as referred to under provision E.4.1 and for limited liability partnerships and companies to publish audited financial statements as reflected under principle E.2 on financial statements, supplemented by principles E.3 and E.5 on management commentary and reporting quality respectively.

At its simplest, the draft Code establishes benchmarks and allows exception reporting which aids efficiency of information generation and processing. Benchmarks should also encourage firms to be proactive and innovative in their governance practices as well as responding to pressures from owners, professional bodies and regulators. To this end, Section F establishes expectations of firms to enter into dialogue about matters related to the Code with the shareholders and directors of their listed company audit clients under principle F.1. This is not an activity that is either a professional obligation or a regulatory requirement, but it is an important means of protecting and developing a firm's presence in the listed company audit market. Principles F.2 and F.3 put corresponding responsibilities on shareholders to support dialogue and informed voting on audit matters.

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 doesn'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 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 partnership model to enhance the confidence that shareholders in listed companies place in the firms that audit those companies. Principles C.2 and C.3 set out the characteristics and rights of independent non-executives that are likely to make them effective in their role.

Decision making: those 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. Reports on the results of inspections will also only be published after completion of due process. However, reassurance about a firm's current performance is more difficult to achieve.

Some of the firms currently refer to partners who 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 could play an important role in enhancing confidence. They 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.

Management of reputational risks: the 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. 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 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.

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 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.

2.3 Assessment of costs and benefits

While the Working Group does not support new regulations which would necessitate a formal regulatory impact assessment, it is appropriate to consider the practical consequences of what is proposed. Now that a draft Code has been produced, the Working Group is looking forward to obtaining specific feedback during the consultation period on benefits and costs. Section 2.2 advanced arguments for the introduction of the Code and anticipated benefits in terms of choice and enhanced confidence in audit firms, principally because it would:

- establish an expectation that firms that audit listed companies will appoint independent non-executives to address issues related to decision making, management of reputational risks, and stakeholder dialogue;
- encourage improvements in governance practice, for example in dialogue between auditors and the shareholders of listed companies; and
- bring together in one place as an aid to good communication various aspects of the regulated professional partnership model of audit firms.

In principle, in all these areas the Code should deliver benefits although it is important to be alert not only to implementation costs but also to risks of unintended consequences which might have offsetting effects. In respect of one source of benefit, namely the summarisation of the existing regulated professional partnership model, the incremental costs should be relatively small. The two main areas where the introduction of the Code would be expected to lead to identifiable incremental costs relate to dialogue with shareholders and the appointment of independent non-executives.

On dialogue with shareholders, there is a need to look not just at how listed companies will discharge their own responsibilities under principle F.1 on firm dialogue but also to ensure that shareholders implement principle F.2 on shareholder dialogue and principle F.3 on informed voting. Moreover, while it is possible to argue that in a comply or explain environment, shareholders are the ones who should monitor the quality of disclosures and adherence to the Code, in practice there will need to be some shared *monitoring* of disclosure to reduce the costs to firms and investors of responsible dialogue.

Monitoring should also generate confidence in the information that shareholders use and create incentives for the development of best practice. The Working Group will be liaising with investor groups and the FRC during the consultation period to develop proposals for proportionate monitoring arrangements. The Working Group is mindful of the risks that:

- without effective monitoring and support mechanisms, boilerplate disclosure and box-ticking may prevail; and
- disproportionate costs of dialogue may put firms and shareholders who implement the Code at a competitive disadvantage.

On independent non-executives, the potential benefits of the proposals are that:

- from a shareholder and public interest perspective, they could help prevent the failure of a firm by facilitating dialogue with stakeholders and increasing confidence in firms generally; and
- insofar as firms are concerned, there is considerable flexibility about how they are deployed subject to a minimum expectation that independent non-executive involvement will be directed at decision making, management of reputational risks, and stakeholder dialogue with the objective of enhancing shareholder confidence in firms.

It is important that the benefits of applying Section C of the draft Code can be secured at a cost that is seen to be proportionate. The principal concerns relate to the following risks:

- structures will be imposed on firms that do not suit the firm's culture and are not seen as adding value overall;
- costs for smaller firms which audit listed companies will be disproportionate; and
- availability of candidates will be unduly limited by concerns about liability or independence.

Structures: provision C.1.1 has been drafted to allow firms considerable flexibility on the location of independent non-executives within organisational structures provided they meet together to discuss public interest matters. The responses to the first consultation paper summarised in Section 4.4 provide a wealth of ideas and also show that a number of firms were starting to think of how they might introduce independent non-executives in ways that would work best for them.

Costs for smaller firms: the issue here is that independent non-executives represent an incremental fixed cost of being in the listed company audit market. There is a real risk of unintended consequences if a code introduced to enhance choice reduces it because it deters firms from entering the listed company audit market or causes firms to exit that market. The problem would be a real one if the firms concerned are capable of doing a good job but a perception is created that they cannot, or are less likely to, do a good job if they do not apply the principles in Section C of the Code.

The Working Group's proposed answer is to set a threshold in terms of listed company audit client numbers for initial application of the Code. We have proposed more than 20 such clients as the threshold to avoid the problem of constraining the growth of the many firms which are some way off that level. The Professional Oversight Board analysis reproduced in Appendix 4 shows eight firms with more than 20 listed company audits. Draft Code principle C.2 also does not specify a minimum number of independent non-executives so as not to exacerbate the risk involved. It emphasises instead the combined qualities of independent non-executives rather than getting into a numbers game.

Availability of candidates: while perceptions about liability may restrict the supply of suitable independent non-executives, it is difficult to address them in advance in a conclusive way. In our first consultation paper we analysed the liability risks that might attach to a non-executive member of a UK LLP and noted that these were comparable to those facing any non-executive director of a listed company. This consultation paper is more specific about the role of independent non-executives and it is not envisaged that they would be partners or LLP members. This should reduce the risk to the individuals concerned, as should the provision of indemnity insurance referred to in draft Code provision C.3.2.

Nevertheless, we acknowledge that it might still be possible for potential candidates for independent non-executive positions to be deterred because of perceived risks of being named in litigation even if such action is without foundation. This would seem to be an issue which can only be progressed through implementation. Ultimately, if some firms find it impossible to attract candidates of appropriate calibre to be independent non-executives at a reasonable cost, that will be a further argument for fresh liability and litigation reform not for dispensing with independent non-executives. The other factor which is most often quoted as limiting availability is independence which is considered in Section 2.4.

2.4 Independence and independent non-executives

In appointing independent non-executives, firms need to consider two independence issues:

- the independence of non-executives from the audit firm and its partners; and
- the impact of independent non-executives on the independence of the audit firm from its audit clients.

These are both important issues. A perceived or actual lack of independence will reduce the value that non-executives bring to their role in audit firms and auditor independence is central to the value that shareholders attach to auditors' opinions.

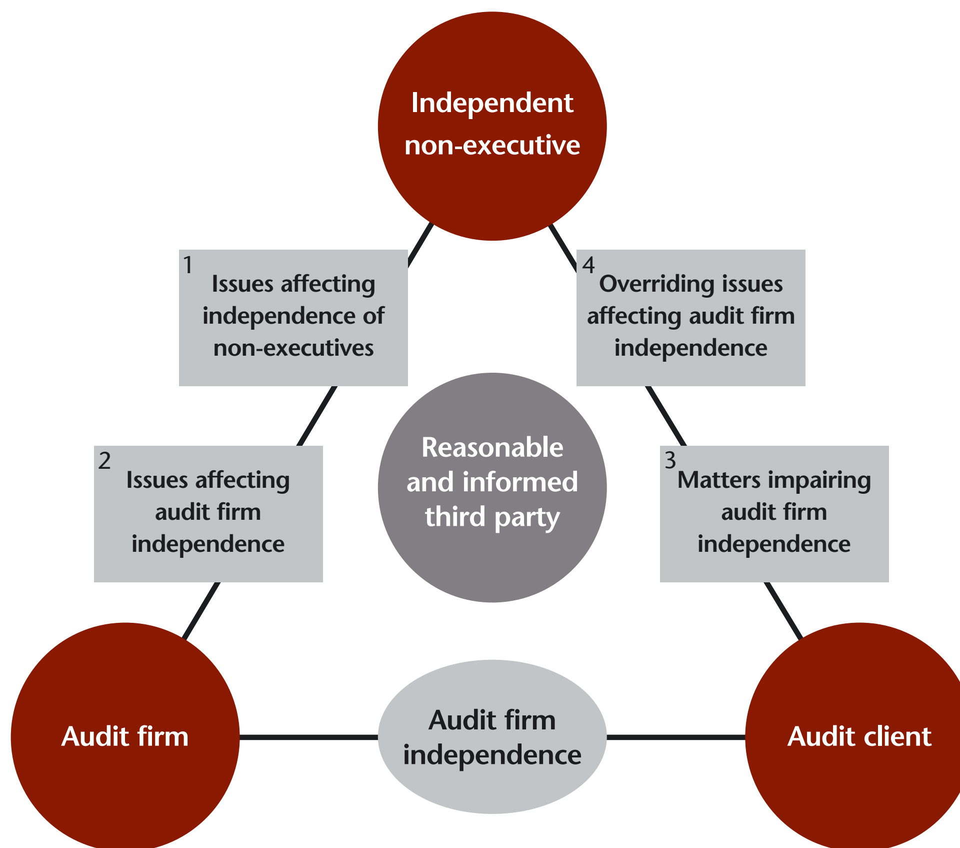
A number of audit firm respondents to the evidence gathering consultation expressed concerns about whether they would be able to find candidates of sufficient quality who would satisfy relevant independence criteria and be prepared to comply with ongoing auditor independence requirements. However, provided that sensible and proportionate independence criteria are in place, the Working Group doubts whether any firm would conclude that it could not, as a practical matter, appoint appropriate independent non-executives. Such a conclusion would raise serious questions about market concentration and its impact on the public interest.

In the interests of allowing appropriate criteria to become established in an area where there is little practical experience, the Working Group makes the following proposals:

- in accordance with draft Code provision C.2.1, firms should state in their transparency report their 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;
- there should be no 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; and
- there should be no initial list of relationships between an independent non-executive and an audit client of a firm, such as being a director or holding shares, which would automatically prevent a firm from being judged to be independent of that audit client.

We also trust that authorities with responsibilities for regulating auditor independence will be prepared to reconsider their application of existing rules to individual non-executives if rules, which were never designed with independent non-executives in mind, appear to be imposing unnecessary restrictions. It would be unfortunate if existing rules frustrated realisation of the benefits of enhanced audit firm governance.

The remainder of this section is concerned with supporting our proposals by analysing independence criteria to be applied in making judgements about the appointment and continuation of independent non-executives. The following diagram summarises the judgements involved which involve four key parties: the audit firm; the audit client; the independent non-executive; and a hypothetical 'reasonable and informed third party' who is referred to in the standards of the UK Auditing Practices Board (APB) and other independence standard setters and regulators.



The diagram shows that there are four key judgements that have to be made by reference to the conclusions that a reasonable and informed third party might reach. The first two relate to relationships between the audit firm and a potential independent non-executive and the second two relate to relationships between the independent non-executive and the entities that the firm audits. After considering each of these judgements in turn, we also cover other conflict of interest issues that firms and independent non-executives will need to manage.

Firms already have in place processes to resolve auditor independence issues that involve appropriate systems and governance structures and expert partners and staff. Therefore where the following analysis refers to judgements being made by the firm and non-executives, it is taken as read that they will be supported by existing processes, systems, structures and people adapted as necessary to deal with additional demands arising from the appointment of independent non-executives.

1. Issues affecting independence of non-executives

Independent non-executives should report for consideration known:

- financial interests in the audit firm, or an entity in which the audit firm or any of its partners have a significant interest;
- business relationships with the audit firm or any of its partners;
- family relationships with the audit firm or any of its partners; and
- past employment relationships with the audit firm.

The independence of non-executives from the audit firm and its partners is analogous to the independence of non-executive directors from the company and its directors, considered by Section A.3.1 of the Combined Code. This sets out seven independence criteria some of which are quite specific as to the number of years involved in 'cooling off periods' and length of service. It is not proposed to copy such requirements directly in to the Audit Firm Governance Code at this stage because there is a need to allow best practice to develop. Independent non-executives are also seen as having a duty of care to a firm but not the full range of fiduciary duties of a director and so copying the Combined Code's independence requirements for non-executive directors may not be appropriate.

It is, however, clear that any relationships or circumstances which may affect, or could be perceived to affect, the independence of non-executives should be considered by firms. A judgement should be made as to whether such relationships or circumstances would impair actual or perceived independence. For example, while independent non-executives will expect to be remunerated, it might well be judged inappropriate for them to derive direct financial gain from the profitability of the audit firm, including having any ownership interest in it.

2. Issues affecting audit firm independence

In order to carry out statutory audits, any audit firm registered in the UK must adhere to the APB's Ethical Standards, as well as the Audit Regulations of the professional accountancy body they are registered with. In addition, for audits of companies with non-UK listings, or affiliates of such companies, foreign auditor independence standards may apply. In the case of US listings, the rules of the US Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board will need to be adhered to. Many interpretations are determined directly by the SEC on the basis of discussions of specific circumstances.

APB independence requirements generally apply to those in a position to influence individual audits, including those considered to be in the chain of command. In discussing the chain of command, the APB states that 'It does not include any non-executive individuals on a supervisory or equivalent board.' Therefore, under APB standards, independent non-executives would generally be outside the scope of the standards' detailed requirements for individuals. However, it is less clear that this is the case under the US rules and this might be a matter that the US authorities decide to consider by way of follow-up to the recommendations of the US Treasury Advisory Committee on the Auditing Profession. In addition, it should be noted that despite the APB position on non-executives, specific circumstances could override the presumption that independence requirements do not apply to them.

Accordingly, firms will need to take steps to ensure that the governance structures on which independent non-executives serve are 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 and compensation or to exercise quality control or other oversight functions. Independent non-executives' contracts might cover these matters and prevent them from receiving feedback on an individual audit assignment. It does not appear that such restrictions would prevent independent non-executives from fulfilling their core functions in relation to decision making, management of reputational risks, and stakeholder dialogue.

3. Matters impairing audit firm independence

If independent non-executives fall within the scope of individuals covered by auditor independence standards, then under UK and US rules they will be subject to a variety of restrictions on financial and other interests in entities that the firm audits and will need to comply with a firm's internal requirements for the notification and divestment of such interests. There is little scope for applying judgement except in respect of deciding how to establish and operate systems to capture information about matters that impair independence and how to enforce them.

4. Overriding issues affecting audit firm independence

Even where independent non-executives are not in the chain of command and are not in a position to influence individual audits, they could have connections with an entity audited by the firm which impairs its independence. As under item 1 above, connections could arise through financial interests in the entity, business relationships, and family or employment relationships, including directorships.

Independent non-executives will need to disclose such relationships and situations to the firm and where such relationships and situations are significant to the independent non-executive or the company audited, consideration should be given as to whether it is appropriate for the independent non-executive to take up or continue an appointment.

It is likely that firms and prospective independent non-executives will be anxious to have certainty about how a reasonable and informed third party might view particular connections, particularly when implementing the Code for the first time. However, the Working Group thinks that it will be important for firms and shareholders to take a measured view of what is in the public interest and to consider the possible unintended consequences of taking early fixed positions on particular issues.

For example, it might be argued that an independent non-executive should not be a director or shareholder of any of a firm's audit clients. However, this could have serious consequences for the pool of potential appointees that is available, particularly for the four largest firms. Consequently, we propose that there should be no initial list of relationships between an independent non-executive and an audit client which would automatically prevent a firm from being judged to be independent of that audit client. Firms should instead consider the significance of relationships and exercise judgement in realising the objective of draft Code principle C.2 so that independent non-executives 'collectively enhance shareholder confidence by virtue of their independence, number, stature, experience and expertise.'

Other conflict of interest matters

The detailed consideration of independence issues in this section should not distract firms and independent non-executives from the need to apply ethical business practices in relation to potential conflicts of interest even where these do not raise independence questions. These matters are covered by draft Code provision D.1.3. By reference to a reasonable and informed third party, a firm's governance procedures should help ensure that an independent non-executive is ring-fenced from taking decisions in situations where there is a potential conflict.

There will also be an overall need for independent non-executives to be sensitive to potential conflicts and report them. While the firm should provide appropriate support in identifying and responding to issues, it will remain the responsibility of independent non-executives to comply with relevant requirements, for example insider dealing legislation in relation to information that they might become aware of through their work with a firm.

3. DRAFT AUDIT FIRM GOVERNANCE CODE

INTRODUCTION

This Audit Firm Governance Code (the Code) is intended to promote 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 the Working Group does not have power to introduce and give effect to regulatory requirements, it has recommended 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's Combined Code on Corporate Governance (the Combined Code) for listed companies. The Code comprises 20 principles and 29 provisions. Principle E.4 on governance reporting states that a firm 'should publicly report how it has applied 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 Combined Code.

The Working Group also appreciates that the audit firms are professional practices and have professional obligations which already include a requirement to take the public interest, and not just the needs of an individual client, into consideration. Accordingly, the Code makes reference to these obligations.

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 their transparency reports published on their websites.

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

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.

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 discussed arrangements for implementing these principles with shareholder representatives.

The effectiveness of the Code's comply or explain approach also depends on the firms' leadership setting the right 'tone at the top', 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 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.

Review of implementation

A review by the FRC of how the Code has been implemented in practice is recommended after four years. 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 2009

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 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 firm's entire business 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' by publicly committing themselves and the 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 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 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 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 the duties of independent non-executives, the 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 its terms of reference on the firm's website.

C.2	Characteristics of independent non-executives principle
	Independent non-executives should have a duty of care to the firm, command the respect of the firm's partners 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.

C.3	Rights of independent non-executives principle
	Independent non-executives of a firm should have rights commensurate with their role including a right of access to relevant information and people, and a right to report a fundamental disagreement regarding the firm to its owners and, where such a disagreement cannot be resolved, to report 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 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, 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.

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 the application of its whistleblowing policies and procedures and disclose those policies and procedures on its website.

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 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 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.

F DIALOGUE

F.1	Firm dialogue principle
	A firm should have dialogue with listed company shareholders, as well as listed companies, 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.
	Provision
F.1.1	The firm should disclose on its website its policies and procedures for dialogue about matters covered by the 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.

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.

F.3	Informed voting principle
	Shareholders should make considered use of votes in relation to the appointment of auditors of listed companies.

4. RESULTS OF EVIDENCE GATHERING CONSULTATION

4.1 Stakeholders of firms that audit public interest entities

Question 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?

The Working Group concluded that:

- the balance of comments showed that the Code should be designed primarily to serve those to whom the auditors of public interest entities address their audit reports, which in the case of listed companies means their shareholders;
- while the drafting of the Code would be aimed at such primary stakeholders, others who would benefit from the Code include regulators with responsibilities to protect the primary stakeholders and others who benefit from the audits of public interest entities such as directors and other stakeholders of listed company audit clients, including creditors and employees, and potential shareholders and the wider investor community;
- audit committees would particularly benefit from the Code because of their specific responsibilities to ensure that the audit serves shareholder interests; and
- partners who own and work in a firm, as well as firm employees, could also be indirect beneficiaries of the Code but there would be no compelling reason to produce a code specifically for them.

These conclusions are summarised in the Introduction to the draft Code and are reflected in the draft Code itself, particularly in Section F on dialogue about matters related to the Code with shareholders and directors of their listed company audit clients.

Responses from audit firms provided mixed, sometimes opposing, viewpoints as to which group of stakeholders the Code should primarily serve. Some firms took an internal perspective and believed that the partners and owners should be the primary stakeholders with other stakeholders receiving consequential benefits.

Other firms took an external perspective and believed that shareholders of audit clients and boards and audit committees should be the Code's primary stakeholders. A large firm drew a distinction between these two groups stating that, 'Investors are likely to be more concerned with the wider public interest, whereas audit committees will be more immediately focused on issues which are directly relevant to appointment of their auditor.' One of the largest four firms and a large firm noted that under current ownership and governance arrangements, the interests and needs of the partners and owners are met by other means. One of the four largest firms suggested keeping the primary stakeholder group narrowly defined as this will add clarity.

Investor respondents saw themselves as the primary stakeholder group although they also referred to boards and audit committees.

Companies and their representative bodies, as well as a number of non-executive directors, generally believed that shareholders and audit committees should be the primary stakeholders for the Code. Reference was also made to the 'public interest' and the 'capital markets in general'.

One company respondent stated, 'In our view the driving force behind the proposed code is to safeguard the public interest objective. We therefore rank investors and other stakeholders in the public interest audit clients far ahead of the partners and staff of firms that carry out audits, and also of the directors and employees of the firms' public interest audit clients. We consider that meeting the needs of the clients' investors and other stakeholders is most likely

to result in the long term sustainability of the firm and thus safeguard the interests of others.' While one professional body drew the distinction between internal and external stakeholders and noted that from an internal perspective information for partners should already exist, most professional bodies also referred to shareholders and company directors as the primary stakeholders.

Most respondents who mentioned other stakeholders did not consider regulators to be primary stakeholders as regulators' interests would be served through the regulatory framework. Lenders, creditors, insurers, employees and others were generally not thought to be primary stakeholders and were seen as having the same interests as in any other business.

4.2 Risk management

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

The Working Group concluded that the draft Code should adopt an approach to risk management and internal control in line with:

- the Combined Code with its 'sound system' principle and its 'annual review and reporting' provision as reflected in principle D.2 and provision D.2.1 respectively;
- the Turnbull Guidance which is reflected in draft Code provision D.2.2 and referenced in draft Code provision D.2.3; and
- the Business Review with its reporting of principal risks and uncertainties which is reflected in draft Code provision E.3.1.

A number of firms, including the four largest, referred to the internal control aspects of the Combined Code or the supporting Turnbull Guidance or both. One of the four largest firms said, 'Any Audit Firm Governance Code should follow the principles of the Combined Code in relation to risk management and internal control, as this represents current best practice and there are no issues which differentiate audit firms from listed companies in this regard.' However, where firms commented on the Business Review requirements to disclose principal risks, they reached different conclusions on their relevance and applicability. Firms also referred to existing requirements to report in the annual transparency report on the effective functioning of a firm's internal quality control system and to operate such a system in accordance with the International Standard on Quality Control No.1.

Investors referred to the Turnbull Guidance and the need for alignment with the internal control and risk management aspects of the Combined Code. For example, an asset management company stated, 'Although the ownership structure and governance structures of audit firms is different from those of plcs, we do not see a reason why firms should adopt a different approach to the form and substance of internal controls that are set out in the Turnbull Guidance.' On disclosure, one investment institution stated, 'We believe that the audit firms should be encouraged to explain their processes, in particular identifying their key risks and how they are managed.' Investors generally believed in the importance of the relevant requirements of the Business Review.

Most corporate respondents referred to risk management and internal control in the context of the Combined Code. A large listed company stated, 'The Combined Code provides a good model for audit firms. It provides a principles based approach which can be adapted to each audit firm's own operating model, with appropriate reporting on the effectiveness of its risk management and internal control environment.' Another listed company appeared to make a linkage with the Business Review and wrote, 'A statement of the principal risks faced by and on the quality of systems of internal control operated by an audit firm along the lines of the Combined Code would be appropriate. It is important that they are risks and controls associated with the whole firm and covering all its business lines.'

Professional bodies and others also referred to the adoption of the Combined Code and the Turnbull Guidance or to a general statement that effective management and control are critical to the success and sustainability of every business, including audit firms. One accountancy body also noted that the key asset of an audit firm is its reputation and, therefore, risk management should focus on this.

Question 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?

The Working Group concluded that:

- the issues faced by the firms in discussing their principal litigation and claims risks are not unique; and
- because of the potential financial and reputational impact of litigation and claims on its sustainability, a firm should consider their potential significance to shareholders of its clients in the context of reporting the firm's principal risks and uncertainties and this is reflected in draft Code provision E.3.1.

This was a particularly sensitive topic for audit firms of all sizes which generally believed that, due to the current liability environment, they face unique circumstances and that the Code should not go beyond the current financial reporting requirements for disclosure in a firm's audited financial statements. Among other things, the firms said that they are more susceptible than many other sectors to speculative claims and vexatious litigation, and additional disclosures of information that would not otherwise be in the public domain could have potentially damaging consequences.

Acknowledging the interests of other stakeholders, one of the four largest firms commented, 'We recognise that an audit firm's claims profile and its continued sustainability are relevant to certain stakeholders, particularly companies and regulators, who are keen to ensure that certain professional services, including audit, continue to be available from a sufficient number of providers. However, we believe that the risks of causing damage to the sustainability of an audit firm by publicly discussing its principal litigation and claims risks are the same as for other sectors. Such publicity could have a reputational impact on firms and be attractive to speculative litigants. This serves no one's interests, including audit clients and their shareholders.'

In relation to the disclosure of principal risks, one of the four largest firms also commented, 'We accept however that there are factors which make the management of such risks particularly important for the major audit firms. The risk of litigation is high and the capital base of most firms is low relative to such risks.' They went on to comment that it is appropriate for the Code to require discussion of both what the principal risks and uncertainties are and how the firm seeks to manage them.

Although they were not so convinced of the unique issues facing audit firms, investors who responded to the question did recognise that there are commercially confidential issues that could cause damage to a firm's sustainability if they were disclosed. They nevertheless believed that firms could still make disclosures of principal or key risks. For example, one institutional investor stated, 'Whilst we would not expect firms to disclose matters that should be kept confidential because of legal or other reasons, we would expect an exposition of what the key risks to the firm are and how they are managed. We would also expect firms not to avoid or delay disclosure of matters that might reasonably be considered material.'

While respondents from the corporate sector generally agreed that this is a difficult area with firms facing significant litigation risks, there was some disagreement on whether or not there should be additional disclosures. For example, one respondent wrote, 'Unless there is a specific issue that is material to the financial stability of the firm, litigation matters should remain confidential.' However, a large listed company commented, 'We do not believe that audit firms face issues that are any different from public entities when it comes to litigation and

claims risks – if they are material, it is in the public interest that they should be disclosed. The real issue here is that with so few large firms, the consequences of another large firm leaving the market as a result of litigation or a claim are substantial. This however is not an argument against keeping stakeholders informed of material litigation and claims risk.' Another summed up as follows, 'A fundamental prerequisite for the effective operation of the "comply or explain" principle is a high level of transparency to stakeholders.'

Other views from respondents in the corporate sector included this one from an individual who stated, 'Litigation is a difficult area but in my view if one starts from the need for greater accountability in the public interest then one cannot ignore one of the key risks facing the accountancy firms. Public companies have had to deal with this issue for some time and it is necessary information to assess the viability of any entity exposed to significant litigation.'

Among professional body respondents, a number were not convinced that audit firms face unique issues in discussing and disclosing their principal litigation and claims risks. They did however raise points on confidentiality and the consequences of disclosures beyond current requirements which might impact the sustainability of a firm and thus precipitate an audit firm leaving the market. An accountancy body observed that, 'Arguably, a proposal to discuss a firm's litigation and claims risks might be thought to assist audit committees to help assess general client satisfaction, or dissatisfaction, or the quality of the firm's audits. If so, rather than the current exposure, we would expect the audit firm's past claims experience to be more informative.' They did however recognise that disclosure of past claims experience is a blunt indicator.

An individual respondent, who advocated the establishment of a Public Interest Board (PIB) was not convinced that, 'public disclosure of litigation and claims risks is actually necessary. It might be sufficient for the PIB to take the litigation and claims risks into account when assessing whether the firm was properly upholding its public interest objectives.'

Question 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?

The Working Group concluded that:

- it was right to focus on risk management and internal control of the firm as a whole insofar as the financial and reputational impact of the non-audit business could be significant to the sustainability of the firm's auditing of listed companies and this is reflected in draft Code principle D.2; and
- the cost implications of risk management may be a concern for smaller firms and the Working Group was conscious of this in making its recommendation as noted in Section 2.3 on the initial application of the draft Code.

The four largest firms and a number of other firms supported the 'whole firm' approach. One of the four largest firms noted that, 'The reputation and credibility of the audit firm is dependent on the professionalism and integrity demonstrated in all its business functions, including tax and advisory services.' Another of the four largest firms stated that their own risk management and internal control processes were only fully understood when viewed from a whole firm perspective and suggested that the Code should reflect this business reality rather than require the creation of an artificial layer of governance reporting related solely to audit.

By way of contrast, while accepting that the Code may have requirements in this area, a large firm started their comments by stating, 'risk management and internal control are of primary interest to owners, and so in our view reference in an Audit Firm Governance Code to risk management and internal control is not appropriate.' A mid-tier firm also representing views of some other similar firms noted that 'the extension of the Code to the firm as a whole is unnecessary and disproportionate, and likely expensive.' They were concerned about potential interference with the business models of mid-tier audit firms if the Code were to be applied across all their business activities.

Investors indicated that risk management should focus on the firm as a whole with most respondents noting that there are substantial risks in other parts of an audit firm's business. Stating that the Code should also apply to the non-audit business, one institutional investor commented, 'It is worth stressing that this is important and that reporting on risk management and quality control on a firm wide basis is entirely appropriate. As audit practices within firms share operations, brands and reputation with other lines of business that are often lightly regulated, the Code should extend to non-audit business given the significant business risks that they run.'

All but one of the corporate respondents believed that risk management should be about the firm as a whole. Reflecting the view of others, an individual commented, 'I believe that any Code must apply to the firm as a whole and not just the audit practice as it is the poor governance of other aspects of the firm that could taint the name of the audit firm and therefore affect public confidence.' Another commented, 'What the public interest is looking for is reassurance about the firms' activities as a whole – more tone at the top/business culture reassurance than specific comfort that the firm has a well run audit practice.' The one dissenter believed that the Code should be restricted to the audit and financial assurance services practice but controls over the standard of financial reporting should extend to the whole firm.

Professional body and other respondents commented on the whole firm approach. One noted, 'The firm as a whole would also be synonymous with the UK entity presenting financial statements and a transparency report.' Mindful of smaller firms and their possible exit from the smaller end of the public interest entity (PIE) audit market, one accountancy body said, 'We would be concerned, however, if those firms with only a few PIE clients were expected to comply with a firm wide governance code, and perhaps need to change their whole business governance model when only a small proportion of their revenue is derived from PIE clients.'

4.3 International structures of firms

Question 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?

The Working Group concluded that in the case of a UK registered audit firm that is part of a regional or international structure, the Code should:

- not specify a level at which the Code as a whole is applicable; but
- call instead, as in the introduction to the draft Code, for UK firms to consider and explain circumstances where the UK firm looks beyond itself in applying the Code's principles and in complying with its provisions.

This issue is made more complicated by the fact that the larger audit firm networks are currently developing new and varied regional and international structures. However, the audit firms believed that the Code should allow a firm some discretion to determine the level at which it applies the Code provided it explains why a particular level has been chosen. One of the four largest firms commented, 'the principle should be that the Code applies to the firm which conducts audits in the UK or to a firm which controls the UK audit firm.'

A mid-tier firm noted that the Code would not be enforceable outside the UK unless other jurisdictions voluntarily adopted it and commented, 'The key messages of which stakeholders need to be apprised are that the firm operates a common audit methodology and that quality assurance systems make the application of that methodology as uniform as can be achieved between jurisdictions. No audit network is presently able to give a level of assurance of complete uniformity but the obverse is that they work very hard at identifying non-uniformity and addressing it.'

The views of investor respondents varied in terms of how much discretion firms should be allowed to exercise. For example, one representative body stated, 'we do not agree that individual firms should be given discretion to determine the level at which the Code applies. This would result in a lack of comparability in the reports produced and not help improve investors' awareness of auditing firms outside the Big Four so that they can clarify their preferences between auditing firms.' By contrast, another representative body said, 'It would seem reasonable for firms to have this discretion, and we agree that each firm should be required to report not only at what level the Code applies but also why this is appropriate.'

One institutional investor, noting the danger of being overly prescriptive as well as the importance of seeing the extent of consistency in audit quality and the application of international accounting standards, suggested, 'give a little more emphasis to the desirability of a cross-border approach. We favour the application of the Code at the highest level and support steps to create a regional or international approach.' An international investor organisation commented, 'There should be only one Audit Firm Governance Code that applies globally to every firm, and every affiliate within that firm, that audits public interest entities. The issue should be one of scalability as appropriate for the size of the audit firm in question as opposed to whether or not the Audit Firm Governance Code should be applicable at all or at differing, lesser levels.'

With a minimum starting point of application of the Code to the activities of UK firms, some corporate respondents believed that discretion should be given to firms. One commented, 'emphasise the "comply or explain" principle and any firm would wish to explain its global structure to instil confidence and trust in the market.' Another hoped that, 'the Code would encourage the international firms to consider whether the principles of the code should be replicated internationally.' On this latter theme, a large listed company commented, 'It is the role of the senior governing body in any audit firm to set the highest standards for the professional performance and conduct of their firm. These standards should apply to all entities, wherever in the world and whatever the business line, as a matter of good commercial practice, but also to support the integrity of its audit and assurance practice under the Code. One is not incompatible with the other.'

Question 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?

The Working Group concluded that the Code should contain principles and/or provisions covering:

- a firm's dependence on, and exposure to the risks of, other network members; and
- how it ensures consistent quality and application of auditing standards.

However, rather than introduce standalone principles into the draft Code to reflect these conclusions, the Working Group chose to see these issues as being covered by principle D.1 on compliance and principle D.2 on risk management. Supporting provision D.1.2 articulates the specific expectations of respondents in relation to reliance on other network members by reference to current auditing standards and extends this provision to include standards related to reliance on other auditors not in the same network.

The responses to this question highlighted some disagreement between audit firms with some in favour of principles and provisions of the type suggested in Question 6 and others not. One of the four largest firms said, 'Consistent quality and governance across an international network are critical to an audit firm's ability to deliver services of the requisite quality to many of the UK's listed companies. It is therefore important that the Audit Firm Governance Code should establish principles for the establishment and monitoring of network wide policies.' Another of the four largest firms was somewhat less in favour and commented, 'we believe

that information about our dependence on, and exposure to, risks of other network members is of legitimate interest to our regulators but may harm the interests of a number of stakeholder groups if the information was circulated more widely.' Noting the transparency report disclosures in relation to how they ensure consistent quality and application of auditing standards across their network, this firm concluded, 'However, if the AFGC is to cover these areas we believe that it should set out the principles rather than provisions because not all audit firms and networks are the same.'

The remaining two of the largest firms were not in favour and both made reference directly or indirectly to existing transparency report requirements. One firm's interpretation of the question led them to say, 'We do not believe that the Audit Firm Governance Code should contain principles or provisions regarding how the international networks should be governed. This implies an element of extra territorial application which in our view is not appropriate unless such elements can be developed on an international basis. In our view the descriptions of the relevant arrangements in the Transparency Reports already provide the market with sufficient information to assess whether or not in their view such arrangements are adequate, although this disclosure could be further enhanced if required.' The other firm, in not supporting the idea, believed that such requirements are duplicative and would 'sit uneasily in a Governance Code.'

The majority of other audit firm respondents disagreed with principles and provisions of the type suggested. References were made to: descriptions of network structures in the transparency report; auditing standards for group auditors; extraterritoriality; and the inherent limitations of a UK code. A large firm commented, 'We believe that there is a limit to what it is possible for a UK Code to impose in this area.' A mid-tier firm saw other problems, 'Given the increasing prevalence of spurious "holding out" claims against firms in relation to their international networks or network members we regard this as dangerous and unhelpful territory. The requirements for disclosure of international arrangements in the transparency reports of firms are in our view adequate information for stakeholders.'

A mid-tier firm also representing the views of some similar firms made some suggestions. They stated that the Code 'should contain only high-level principles, obliging the firm to disclose (i) the key features of the common audit methodology, (ii) how quality assurance systems are validated, (iii) how the application of auditing standards is accomplished worldwide, and (iv) that, the network's "flag state" being the UK, it is required to publish annually a transparency report covering these sorts of issues. Beyond that, a Code might say how the network assesses, on the basis of self-certification and any other available evidence, any perceived risks applying either to the firm supplying supporting audit work or opinion or the jurisdiction within which it operates. We believe this should be a permissive entitlement, however, not an obligation.'

Investor respondents generally supported the suggestions in Question 6. One respondent said, 'Investors will expect these issues to be addressed and on balance we would support the inclusion of principles covering them.'

There was also general agreement from the corporate respondents. Two audit committee chairmen believed that this is a major risk area for the firms and two large listed companies noted the need for consistent application of standards. For example, one listed company respondent stated, 'The consistent application of the highest standards adopted across a firm's business lines and its geography are vital to assure the firm's reputation for integrity. This is also one of the key features looked for by Audit Committees of companies with multi country international businesses when selecting an audit firm.'

Another company stated, 'A UK audit client needs to know that the approach taken by its auditor is consistent across the jurisdictions in which it provides the audit service. While it would be ideal for the Code to apply to a firm as a whole, we accept that this may lead to issues of extra-territoriality of UK compliance. We believe however that where it is not possible for an audit firm to apply the Code across its whole business, it is incumbent on the UK part of that firm to disclose to its client the procedures it has in place to ensure that where elements of an audit are provided by other parts of the firm, they are performed following principles consistent with those required by the UK part of the firm under the Code. To the extent that an audit firm is not able to do this, it would raise questions about the quality of the audit being provided.'

Professional bodies and other respondents were generally in favour of a principle only approach to dependence on, or exposure to the risks of, other network members. One thought it reasonable as 'this might be useful in highlighting risks which could affect sustainability and more importantly how they are dealt with. Should there be issues concerning such information being detrimental to confidentiality/commerciality then this could be explained.'

One professional body stated, 'It is vital that the Code recognises that, although not directly under the control of the firm, risk assessment properly extends to the potential impact of risks in network structures. Such risks are a particular feature of the auditing profession and are of interest to stakeholders. The Code should acknowledge that a basic description of network arrangements is required in transparency reports. The matter of consistent quality and application of auditing standards by other network members is best considered as part of the more-specific audit quality reporting as it is within the scope of AIU reports.'

4.4 Governance structures and independent non-executives

Question 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?

The Working Group concluded that:

- the balance of comments received clearly showed that, in principle, the Code should support the appointment of independent non-executives by the firms; and
- further analysis of the role of independent non-executives, as set out in Sections 2.2, 2.3 and 2.4, was needed in order to address the issues raised about distinguishing their role from that of corporate non-executive directors and to provide a basis for the principles and provisions included in the draft Code, particularly in Section C.

Responses from audit firms varied. The firms that have either formally appointed independent non-executives, or who commented that they are thinking about this matter, were more positive. A large firm that has already appointed two independent non-executives commented that they fulfil a useful advisory role in questioning and influencing decisions and bringing different experiences to bear. Noting that part of the traditional role of a listed company non-executive director is taken on by the firm's partnership council and expressing some concerns about potential expectation gaps for an independent non-executive in an audit practice, they concluded, 'We support and encourage the appointment of independent non-executives but recognise that the role will develop over time and that therefore the code should not be prescriptive regarding the number, roles and responsibilities of the non-executives.'

While being cautious not to rule out the possibility of introducing independent non-executives in some form, an alternative view from one of the four largest firms was, 'We have given considerable thought to this issue over the years, but have always ended up concluding that the obstacles to a major audit firm being able to appoint external directors with appropriate and relevant experience and expertise are insurmountable.' They cited restrictive auditor independence requirements such that 'The type of people who could add real value to the firm are simply not able to be members of either of our governing boards.' By way of comparison, a large firm stated in their response to Question 8, 'Matters related to auditor independence are not immaterial, nor in our view are they insurmountable.' This difference in opinion may be due to the relative sizes of the two firms.

Firms of all sizes raised a number of matters including:

- partners of firms can get the comfort they need as owners from existing governance structures;
- codification of existing practices, including the appointment of non-management partners to governance structures would be a suitable alternative to the appointment of independent non-executives from outside the firm;
- the rigorous work of the AIU protects the interests of shareholders and other stakeholders in public interest audit clients;
- problems with UK and non-UK auditor independence rules, as well as liability, deter firms from appointing independent non-executives;
- there are unresolved practical issues associated with the appointment, number, accountability and role of potential independent non-executives; and
- there is a need for flexibility regarding the governance structures where independent non-executives may be involved given that this is an untested area where developments are better left to learning from experience rather than imposition through a code.

With few exceptions, mid-tier audit firms had issues with independent non-executives. In addition to points made above, a mid-tier firm representing the views of some other such firms said that 'the business model on which most firms are predicated is not designed to accommodate, nor needs to accommodate the participation of non-executives appointed to oversee their PIE-audit activities. They may have only a handful (if that) of PIE clients and were they to be obliged to re-model their systems on the lines of the Code, the degree of interference with the way they deliver non-PIE audit and non-assurance services would be grossly disproportionate to any benefit derived.'

One mid-tier firm saw the matter differently. Commenting that they saw 'merit in firms having independent directors within their governance structures and have had initial discussions on the matter', they suggested that this 'is in line with our view that independent directors make a substantial contribution to the boards of listed companies, in terms of providing challenge and support on, for example, strategic and oversight issues. We would very much welcome the views of institutional investors and audit committees on the benefits of firms appointing independent directors.'

The majority of investors supported the appointment of independent non-executives, generally seeing this as a positive step with some recognising that there are issues to be addressed. One respondent warned of 'the danger that such appointees could be used as a way of creating the form of good governance, without the substance,' noting that before the corporate governance reforms of the 1990s, non-executives served on boards as a way to add to the status of the company rather than to perform a governance role. It was recommended that such a danger be guarded against in respect of independent non-executives joining audit firms.

An international investor organisation gave strong support to the appointment of independent non-executives and a UK respondent supported the related recommendation of the US Treasury Advisory Committee on the Auditing Profession regarding the potential appointment of 'independent members with full voting powers to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms.' However, one respondent was wary of replicating the traditional listed company non-executive given the ownership structure of audit firms and suggested that the appointment of non-executive directors would be of questionable value.

While expressing some doubts and difficulties, a major institutional investor stated, 'However, we believe that independent directors may be able to play an important governance role.' Not seeing independent non-executives in audit firms playing the same role as non-executive directors of listed companies under the Combined Code, this investor, elsewhere in their response, was less concerned with the mechanics of the appointment and guidelines on numbers but was interested in 'proposals for fuller public interest reporting by the audit firms and for a variety of fora to develop dialogue between interested users of the audit firms' work and the audit firms themselves.'

A majority of corporate respondents supported the appointment of independent non-executives with an audit committee chairman stating that he strongly believed that they were 'a prerequisite of making the Code credible' and suggested that 'most should not come from an accounting background to widen the experience base for the governance of the firms.' An individual who is currently a non-executive of an audit firm and another individual who was a previous non-executive chairman of a smaller audit firm as well as a major representative body all supported the proposal, noting that the non-executives must have power. A similar point was made by some investors. Those who have experience of acting in the capacity of a non-executive in an audit firm believed that there should be a sufficient number of independent non-executives, as one notes, so that, 'there is no danger of a single non-executive feeling marginalized or isolated and to give real force to any serious challenge that needs to be independently re-enforced.'

An audit committee chairman stated that, 'these individuals, if suitably chosen, should bring their experience to each business and would supplement operating boards of in-house executive directors or partners which tend to have a narrower view.' He concluded, 'A balanced supervisory board with equal executive and non-executive members and an independent Chairman might help to preserve the hard-earned reputation of each firm as a valuable, independent, ethical body.' Another respondent, noting the owner-managed nature of the firms compared to that of a listed company commented that the role an independent non-executive would play is less clear than for a listed company non-executive director. A corporate respondent, who also recognised some difficulties, suggested that these individuals could 'act as a reviewer of the governance practices of the audit firm and to have their views made available to the executive of the firm. In particular they could act as the principal conduit for the output from any internal audit function, thereby presenting a form of independent scrutiny that is ultimately in the interests of the governing body of the audit firm and their stakeholders.'

A non-executive director, who previously held a senior position in one of the four largest firms commented, 'I am a firm believer in the value of non-executive directors and the independent challenge they can bring. But audit firms may have different levels at which they might seek non-executive input. They might appoint non-executives to the supervisory board of the LLP, or to its executive/management board, or its audit practice board. They could be formal non-executive directors in the conventional sense or work as an advisory group. In a large firm, they could conceivably work at all levels and be of both types.'

Another respondent strongly advocated the development of a public interest board whose members should be independent of the firm. However, a professional body, which supports non-executive directors in listed companies had 'strong reservations about the need for them in an oversight function where a supervisory board is providing oversight and the members of that board are seasoned professionals used to exercising independence of thought. Clearly, non-executive directors may bring other insights to the board and the Code should not stand in the way of their appointment.'

An accountancy body noted, 'Audit is a highly specialised and regulated profession and we question whether someone outwith the audit profession would add to the technical aspects of the business. In relation to more general oversight of audit, there is already external oversight exercised by the AIU. A non-executive of the wider accountancy firm might be perceived as bringing further independent, "public interest" oversight to the audit firm and would, therefore, need to be independent and able to review process and controls at a high level across the firm.'

A European representative body observed that the appointment of non-executives would constitute a major change for many audit firms in many EU member states and that 'it is not immediately apparent where independent non-executive directors would fit in the legal and organisational structures of trans-national organisations and practices. The context of international associations of member firms across a number of countries is very different to that of a firm in one particular jurisdiction.' However, their response went on to say, 'It should be noted that many firms have already implemented some forms of involvement of "non-executives" eg, through "public boards" and seem to benefit from the experience.'

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

The Working Group concluded that in order to ensure that any explanation of non-compliance with Code provisions on independent non-executives could not be justified on grounds of impracticality alone, it was necessary to:

- give some further consideration to concerns about liability as set out in Section 2.3; and
- provide further analysis of independence issues as set out in Section 2.4.

A number of commentators, particularly from the audit firms, placed great emphasis on independence problems. The larger the audit firm, the greater the perceived barriers and complications, with some audit firm respondents saying there was a need to consider the regulatory environment globally as many of their clients are listed outside the UK. When directly answering the question, other commentators covered:

- liability issues for independent non-executives;
- the potentially disproportionate cost burden on smaller firms;
- the balance between risk to the individual's reputation and the financial reward for the work of an independent non-executive;
- voting rights problems in respect of statutory requirements for the ownership of firms; and
- limits to the pool of candidates of sufficient calibre and expertise to act as independent non-executives in audit firms.

Solutions to any potential liability problems for independent non-executives included the use of insurance and as one respondent suggested, 'at the very least, we would envisage that the PIB members would require liability insurance and an indemnity from the audit firm.'

An individual who is now in the corporate sector but with long experience of the accountancy profession in different roles commented, 'some way needs to be found to allow people of significant standing and experience to sit on boards of firms and monitor governance without any financial liability or the debarring of the taking part as directors of major companies which may be clients. I have suggested a model of a supervisory board of independent and partner members. Such a Board would have no direct influence on individual transactions or opinions. The FRC if it supports the concept should find a way of excluding such independent members from the risk of financial liability or independence rules in relation to clients.'

Question 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?

The Working Group concluded that it would be appropriate to recognise that:

- comments from firms questioning the need for any form of independent oversight on top of audit regulation and partnership governance arrangements showed that further analysis was needed to support a key aspect of the draft Code and this is provided in Section 2.2;
- a variety of governance structures might enable independent non-executives to exercise oversight of areas covered by the Code and draft Code provision C.1.1 allows for alternative structures; and
- any structures would need to provide for appropriate appointment procedures, terms of reference, allocation of resources, referral of relevant matters and reporting and such issues are covered by draft Code provisions A.1.3, A.1.4, C.1.2, C.3.3 and C.3.4.

A number of audit firms referred to existing national regulatory models as offering forms of independent oversight. Some were prepared to countenance extension of these models to provide enhanced oversight, for example through extension of the AIU's work. One of the four largest firms commented, 'Given the extent of existing regulation, we do not consider that any further oversight is desirable, necessary or appropriate. The combination of audit regulation, the firm's own governance arrangements and the transparency which now exist are both appropriate and sufficient.'

Some firms also stated that they already have some form of informal group or advisory board comprised of outsiders that operates behind the scenes. These individuals currently have no responsibility for governance and one of the four largest firms noted, in response to an earlier question, that these bodies are 'established simply to provide high level advice which the firm may choose to accept or not.' However, some acknowledged that such groups could provide a starting point for developing independent oversight. The largest firms presented several forward looking ideas including:

- the inclusion of outsiders on a firm's audit committee;
- the formation of a risk committee outside the formal governance structure enabling the participation of external people who would not be subject to audit independence restrictions;
- an advisory committee composed of independent, external members, together with for example the Chief Executive and Chairman of the firm, having a clear charter to focus on risk management and quality providing insight on matters of concern to stakeholders; and
- independent non-executive directors on some form of public interest board.

One institutional investor stated in its overall comments, 'We believe that there is a real opportunity to develop an imaginative solution to the widely held perception that the audit profession is insufficiently accountable and as a result has a tendency towards a lack of independence. Such a solution might initially meet resistance but most change does – the Combined Code itself is widely accepted and adhered to, having met scepticism and even hostility as it was developed. However, if the initiative prevents further prescriptive regulation, including a tightening of the ethical standards, even those who oppose such a change must prefer it [to] that threat.'

Suggestions from investors to encourage high governance standards included:

- more public debate concerning the regulators' findings;
- assessment of the firms' governance arrangements by an advisory forum selected by stakeholders including interested investors;
- public meetings where interested parties could assess the audit firms' governance arrangements in open dialogue;
- a governance committee with a majority of independent members that tests the audit firm's management on its governance arrangements and reports separately to stakeholders; and
- a board committed to public interest objectives as provided for by the Reuters Trust model.

Suggestions from corporate respondents included:

- a supervisory board of independent members and partners in the firm;
- a monitoring group to ensure adherence to the Code and to help spread best practice across firms; and
- a governance oversight committee with an independent chair and a majority of outside members.

A current non-executive in an audit firm commented on the development of the non-executive role stating, 'The introduction of non-executives into partnership structures will need time and experience to evolve in the most productive way and being too prescriptive might cause genuine operational difficulties for many firms. That said, if, in the future, greater adherence to a Combined Code style of governance is required, a compromise route – leaving the Audit Firm freedom to elect its own senior management, whilst demonstrating the independence and thoroughness of its risk management organs – might be to set up a Public Interest Committee within the Audit Firm, charged with the overview of risk control and conflicts policy and monitoring. It might be appropriate for an independent non-executive, particularly one with an accountancy qualification, to chair the Public Interest Committee, with other non-executives also sitting on that committee.'

Suggestions from professional body respondents included a public interest board and an independent public review board specifically charged with responsibility for overseeing and reporting on the quality, sustainability and independence of a firm's audit practice.

4.5 Scope of firms to be covered

Question 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?

The Working Group concluded that the listed company definition which is used for transparency reporting purposes in the UK should be used for the purposes of defining public interest entities and drafting the Code. Consequently, in a UK context, the Code is drafted primarily to serve the shareholders of UK companies listed on the Main Market of the London Stock Exchange.

The Working Group recognised that many of the respondents who expressed a preference for the AIU definition did so because it would help to ensure that the scope of any requirements to apply the Code would be limited to a small number of firms. However, the Working Group thought that the issue of the number of firms which is considered under Question 11 could be addressed on its own merits and should not influence the definition of a public interest entity. It sees the transparency reporting definition as having the following advantages:

- ease of understanding: the AIU definition of public interest entities refers to 11 different categories of UK entity of which 10 have related size tests;
- clarity of the Code: listed companies have a clear group of primary stakeholders, namely shareholders, unlike the AIU definition which includes pension schemes, friendly societies, building societies, open-ended investment companies, unit trusts, Lloyd's syndicates and mutual life offices; and
- alignment with better regulation principles: use of the transparency reporting definition means that disclosures under the Code can be made in a transparency report and the Code does not need to impose a new reporting obligation on firms that would not otherwise make governance disclosures.

There were mixed opinions from the audit firms about how to define public interest entities. Overall, a slight majority opted for the wider definition used by the AIU with the others choosing the narrower transparency reporting definition. Investor respondents preferred a wide applicability for the Code and thus most chose the AIU definition which includes AIM companies. There was a balance of opinion among corporate respondents, while the majority of professional body and other commentators who responded to this question opted for the transparency reporting definition. There were no proposals for other definitions.

Question 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?

The Working Group concluded that:

- there is no compelling argument at this stage for establishing a regulatory requirement for firms to adopt the Code; and
- although the absence of regulatory requirements means that there is no need to establish a regulatory threshold for the application of the Code, for example by reference to a number of listed company audits, it is still necessary to establish expectations as discussed below in relation to Question 13 regarding the number of firms adopting the Code to help avoid an undesirable reduction in choice in the listed company audit market.

Respondents' views on the population of firms that might be required to apply the Code were linked to their answers to Question 10 on the definition of a public interest entity. They were also influenced by a widespread recognition of the need to ensure that the route chosen for implementing the Code does not create an additional barrier to entry into the audit market for public interest entities or force some smaller firms to exit that market. For this reason there was widespread acceptance of a need to limit the number of firms that would initially be expected or required to apply the Code to no more than the nine largest firms, being those firms that the AIU visits on an annual or 18 to 24 month cycle and where their scope of work covers whole firm procedures as well as audit file reviews.

Nevertheless, despite this broad consensus, a variety of positions were taken by different firms. For example, one of the four largest firms that supported a transparency reporting definition of public interest entities commented, 'The proposed "comply or explain" nature of the Audit Firm Governance Code makes it in our view appropriate for all audit firms within the scope.' This firm clearly anticipated that explanation of non-compliance would be effective and went on to say that 'application of the code will be proportionate to the size and circumstances of each audit firm. Smaller audit firms may be constrained by resources and scale (and any guidance should avoid erecting further barriers to entry into the larger audit market) and larger firms may be constrained by their multinational nature and obligations to differing statutory frameworks.'

Another of the four largest firms commented, 'Our understanding is that any Code will be a voluntary Code, that is no firm will be required to comply with it although, of course, there would be strong encouragement to do so and, in practice, all the large audit firms would almost certainly adopt the Code. If, as this question implies, some firms will be "required" to follow the Code, then this must become a matter of regulatory imposition.'

There were some stronger responses from both investor and corporate respondents, such as the view that there should be 'no threshold below which compliance would be voluntary' and, 'No distinctions should be made between firms. Every audit firm that audits listed, public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.' On the other hand, another investor recognised the dilemma raised by such positions and suggested, 'It is important that such an obligation does not become a barrier to entry to auditing larger quoted companies for smaller firms. At the same time, an element of compulsion may be necessary to obtain the necessary specific gravity for the initiative. Certainly the big four should be required to apply the Code; perhaps all firms which audit a FTSE 350 firm should be obliged to apply the Code, with those who audit other main market or AIM firms encouraged to do so.'

One investor representative organisation, which started by suggesting the need for a body responsible to ensure that disclosures are made in accordance with the Code, concluded that 'on cost benefit grounds, we accept that it may be appropriate to introduce a threshold within that definition so that only firms that audit entities of a certain size or firms that audit a certain number of public interest entities fall within the Code's scope. It would be open to firms outside this scope to apply the Code on a voluntary basis.'

4.6 Implementation and monitoring

Question 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?

The Working Group concluded that:

- there should be some degree of reliance on market participants, in particular shareholders and directors of listed companies, to ensure that firms apply the Code and make appropriate explanations of non-compliance with any of its provisions; but
- in recognition of the potential costs faced by individual market participants in pursuing questions, there should also be some mechanism as discussed below in relation to Question 13 to deal with market participants' concerns about compliance and the appropriateness of explanations.

Most of the audit firms suggested that implementation of the Code should be left to the market, with some placing particular emphasis on the role of audit committees and boards of listed companies. Two of the four largest firms did not wish to see any formal monitoring by an independent body, citing this as 'entirely unjustified' or 'bizarrely bureaucratic'. Another respondent said that it should be left to public interest entity clients with no regulatory involvement. Another of the four largest firms was more qualified in its views, suggesting that it should initially be left to the market and only if this is not working should the position be reconsidered.

A mid-tier firm stated, 'We believe it is important that the implementation of the Audit Firm Governance Code has credibility with the primary stakeholders (investors and audit committees) and thus believe significant weight should be given to their views in determining the process to be adopted in monitoring individual firms' implementation of the Code. Subject to their views, there may be merit in leaving it to the market, at least initially, with, institutional investors, their representative bodies or others raising appropriate issues with individual firms. There may, in addition, be benefit in the FRC, or one of its associated bodies, being asked to undertake an overall review of the quality of reporting after a period of, say, three years by which time a settled pattern of reporting should have started to emerge. In addition, we would expect the Audit Inspection Unit and/or the relevant professional body to have regard to issues disclosed when undertaking their review of firms regardless of whether or not they are formally required to monitor implementation.'

Attaching significant weight to investors' views, as suggested by this last contribution, is significant because almost all the investor respondents did not believe that implementation should be left to the market. A number of these respondents believed that some designated organisation should be involved in the monitoring of the Code's implementation. An international investor organisation stated, 'Without any type of enforcement or implementation oversight, it is human nature for firms to take the path of least resistance. To ensure good faith implementation of the Audit Firm Governance Code, some type of meaningful oversight mechanism needs to be put in place.' On the matter of an oversight body, some referred to the FRC, possibly to establish an independent monitoring group, and others suggested the AIU.

One investor respondent also increased expectations by stating that a comply or explain statement 'should be considered as an important part of the auditor engagement process. Investors should request that consideration of this matter is reported by audit committees in their annual reports and, if not, or if the statement provokes material concerns which are not properly addressed in discussion with the relevant companies or audit firms might lead to selected votes against the re-appointment of auditors or members of the audit committees

or even against the report and accounts.' This respondent went on to suggest that 'audit committees themselves would need to develop a mechanism, probably via their chairs, to aggregate their collective views effectively – both to set the standards and to enforce the explanations of non-compliance.'

Corporate respondents referred to involvement of market participants and board and audit committee members, as well as the firm's own external auditors, given that auditors also have a role in relation to the Combined Code. Some others referred to the involvement of the FRC in monitoring, either through existing mechanisms, such as the AIU, or through a new monitoring body.

Question 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?**

The Working Group concluded, primarily on cost-benefit grounds considered further in Section 2.3, that:

- encouragement from the FRC, rather than audit regulations, should initially endorse a recommendation repeated in the introduction to the draft Code that the eight largest firms that audit more than 20 listed companies should be expected to apply the Code and to make comply or explain disclosures in relation to the Code;
- a regulator should not be required to monitor and to check either adherence to the Code or the appropriateness of explanations of non-compliance since these are matters which would in the main be better judged by market participants but that market participants should be supported by appropriate monitoring arrangements, proposals for which will be developed during the consultation period as noted in Section 2.3; and
- there should be no requirements for auditors appointed by firms to perform work on the firms' adherence to the Code.

Most audit firm respondents believed that there should be no additional regulatory burden on them, that AIU reviews of firm wide procedures represent sufficient monitoring in the areas that might be covered by the Code and that the role of their external auditors on governance matters should be voluntary.

One of the four largest firms said that it did 'not consider that stakeholders require an extension of the scope of regulatory work to cover an assessment of compliance with the Code and any related disclosures.' A large firm noted that there should be no reference to the Code in law or regulation and that market expectations will be sufficient to generate change if needed. However, it also noted that 'external monitoring or assurance should be allowed to evolve if desired by stakeholders so there should be no such requirement in the Code or law or regulations.' In other quarters there was an acceptance that such a position may need to be reviewed by the FRC at some stage in the future after the Code has bedded in and if a voluntary undertaking by firms to implement the Code on a comply or explain basis does not prove effective.

A number of investors took a contrary position to the firms' with one commenting, 'in a real world scenario, some appropriate level of oversight, including regulation, will be needed to ensure that both the letter and the spirit of the Audit Firm Governance Code are being fulfilled.' Another respondent recommended that audit regulations should require that firms make comply or explain disclosures, and that there should be a body responsible for ensuring that the regulation is implemented.

One investor summarised its position on all the issues raised in Question 13 as follows, 'We would prefer that further regulation or a regulatory body are not needed to enforce this Code. However, there may be merit in an independent assessment by a body put together by stakeholders of the various firms' audit output. This body could engage at a high level with the management of the various firms and focus stakeholders' concerns with the firms. Some sort of public forum, available to any interested party, where the management of audit firms are called to account on their governance regime might also have a role to play. We believe that auditors appointed by firms may have a useful role to play. However, we suspect that they might be so conflicted as to play the role poorly either by being satisfied with defective governance arrangements or disclosures as part of industry group think or by not signing off on acceptable governance practice to obtain a competitive advantage. It may be that stakeholders might be able to provide a better independent challenge than the firms and their auditors.'

Of the corporate respondents, some said 'yes' to all three elements of Question 13: regulatory requirements, regulatory monitoring and auditor involvement. One wanted regulatory requirements and auditor involvement but not regulatory monitoring, while another specifically supported regulatory monitoring, suggesting that the FRC set up an independent monitoring group. Another suggestion favoured the involvement of a firm governance committee with independent members. Accountancy bodies generally did not support regulatory requirements and monitoring or auditor involvement.

Question 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?

The Working Group concluded that:

- because no new regulation was proposed in the introduction of the Code, there was no immediate scope for eliminating duplication of regulation; and
- some perceptions of duplication might arise because of the need to refer in the Code, albeit at a high level, to matters that are already addressed by regulation but this was proposed, for reasons further explained in Section 2.2, so that the Code would provide a short and coherent summary of audit firm governance as a whole, rather than just those elements not covered by regulation.

Respondents in all categories were generally cautious about, or saw no opportunity for, deregulatory measures. Some suggested it was too early and that this may be a matter to address when the Code regime is further developed. In commenting that it saw no scope for deregulation, one of the four largest firms stated, 'We do not consider that the introduction of an Audit Firm Governance Code will or should reduce the extent or cost of our existing governance arrangements. Nor do we believe it would be possible or appropriate to reduce audit firm regulation as a result of the introduction of a Governance Code.'

Audit firms and others referred to the need to avoid duplication of existing regulations, some noting that the Code and existing regulation should complement each other. For example, another of the four largest firms stated that, 'rather than identifying deregulatory measures which are likely to be difficult to change, the solution lies in avoiding duplication in the first place by ensuring that the AFGC covers only those areas which are not already covered by law, regulation and/or oversight.'

An international investor organisation struck a more positive note about how regulation might develop, saying, 'Creation of the Audit Firm Governance Code and its implementation should be viewed as a continuous improvement project. Effective investor protection enhancing regulations should be strengthened, and ineffective, unduly burdensome regulations should be under consideration for revision or eventual elimination.'

4.7 Reporting and communication

Question 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?

The Working Group concluded that within the context of a comply or explain statement in relation to the Code, as reflected in draft Code principle E.4 on governance reporting, it should:

- support the integration of Code-related disclosures in a firm's annual published transparency report so as to provide context for the descriptions required under the relevant legislation and this is what is achieved by provision E.4.1 of the draft Code;
- facilitate shareholder awareness of, and access to, a limited amount of other governance information on its management team, code of conduct, procedures related to independent non-executives, whistleblowing and dialogue with shareholders through the firm's website and this is reflected in draft Code provisions A.2.1, B.1.2, C.3.4, D.4.1 and F.1.1; and
- it should not anticipate problems that might not materialise by being prescriptive about communicating specific information to specific people or setting deadlines for the production and dissemination of information.

Many audit firm respondents emphasised the importance of their mandatory transparency reports. Referring to disclosures arising from the Code, one of the four largest firms said that a firm could 'either incorporate disclosures into their transparency reports or make them available alongside the transparency report.' Other responses also mentioned the annual reports and corporate responsibility reports that firms may publish as possible places for inclusion of information relating to adoption of the Code.

Some audit firm respondents believed that the Code should not be specific in this area with one commenting that there should be no requirement as to method of communication in the Code. Another of the four largest firms commented, 'We consider this is a matter for the audit firm itself.' It went on to say, 'We would not wish to see any further imposition on how firms should communicate with their stakeholders.'

There was however general support for use of the web as the medium for the dissemination of information. A number of responses referred to frequency of update: one said annually, one suggested annually with interim disclosure on an exceptional basis, and a mid-tier firm suggested that firms 'should update on a regular basis, noting when particular sections of the report were last updated.'

While there was a wide range of comments from the other groups of respondents, use of the web was consistently favoured provided that the information is easy to find. There were also comments that disclosures need to be meaningful and that high quality reporting would help ensure that comply or explain did turn into 'comply or else'.

Other comments endorsed ideas for easy to follow links to each firm's Code-related disclosures on the websites of appropriate oversight bodies and in audit reports provided by the firms to their clients. There were also a number of suggestions for more demanding requirements for Code-related information, for example that firms should file statements with the FRC within 6 months of their year end. A large listed company commented that 'As a public entity, we feel it would be appropriate for such information to be included as part of (a) the declaration of independence provided by the audit firm to an audit committee as part of an audit and (b) as part of the supporting information provided by a public entity to its shareholders when recommending the appointment or reappointment of its auditor.'

A major representative body in the corporate sector suggested, 'It is important that the main audience of corporate governance disclosures – the directors and shareholders of public interest entities (as well as other stakeholders) – have access to information on the corporate governance status of audit firms. It should certainly be presented to audit committees as part of the auditor selection process. Auditors should immediately publicise any changes in their governance status (relative to the issues defined in the code), both to their clients and to the market as a whole. A central website – possibly maintained by the FRC – could provide a central repository of information on the governance status of audit firms.'

Question 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?

The Working Group concluded that it should:

- establish an overall principle for a balanced and understandable commentary on the firm's financial performance, position and prospects as reflected in principle E.3 of the draft Code to help obviate the need for a burgeoning disclosure checklist;
- avoid the proliferation of specific disclosure requirements, for example covering major changes in governance practices and specific concerns raised by the AIU and focus instead on the application of the Code's principles and the explanation of any non-compliance with Code provisions;
- establish provisions for a limited number of specific disclosures within firms' transparency reports relating to governance and management structures, their individual members, independence judgements, conflict management and internal control which are reflected in draft Code provisions A.1.2, A.1.3, C.2.1, D.1.3, D.2.2 and D.2.3; and
- set expectations in areas which would be considered in any planned review of the effectiveness of the Code, for example in relation to reporting for the benefit of shareholders and avoidance of boilerplate, which is achieved through the introduction to the draft Code.

There was an almost unanimous dislike among the firms of the suggestion that the Code might call for disclosure of specific concerns raised by the AIU. One of the four largest firms commented, 'Unless the AIU's concerns relate directly to the Code's other provisions we believe that the firm's response is best made in the context of their public report and we see no reason to duplicate this information elsewhere.' A mid-tier firm suggested, 'We would prefer to avoid mixing up the AIU reports and disclosures under the Code. There are different scopes and objectives to each. Firms already have an opportunity to respond to the public AIU reports through the accompanying letter.'

On the other non-AIU matters referred to in Question 16, there was some disagreement among the firms. Within the four largest firms, one stated, 'It would clearly be beneficial if major changes in governance practices were communicated on a timely basis and we would support such a requirement in the Code.' By way of contrast, another wrote, 'We do not see any need for any further Code provisions in these respects.'

This latter firm was particularly concerned about duplication of information which is already available, such as in the transparency report, and believed the suggestions in this question would be counterproductive. Other firm respondents had other views, with a large firm commenting, 'We agree that major changes in governance practices should be disclosed, and these would ordinarily be covered in the audit firm's Transparency Report.' A mid-tier firm commented that there is 'merit in exploring whether disclosures under the Code could be combined with firms' transparency statements as the scope and objectives are far closer. We would support any sensible amalgamation of the two in order to reduce what you quite rightly refer to as the 'crowded reporting landscape' for firms.'

Investor respondents were generally positive about calls for specific disclosures. A major investor representative body commented, 'The audit firms have already made efforts to improve the reporting on risk management, quality, and other matters. We would encourage audit firms to go further and adopt a plc approach to reporting, including a business review that contains meaningful information on key risks and uncertainties and Key Performance Indicators. If this was done annually it would allow stakeholders to continuously monitor performance and improvements. We also believe that as part of this they should report on any concerns raised by the AIU.' Another representative body had some concerns noting, 'Good disclosure is desirable but must be relevant and proportionate. We are not certain if this can be codified.'

Corporate respondents were generally positive about calls for specific disclosures. A large listed company commented that, 'In general audit firms should take a similar approach to that adopted by public companies when assessing what information might be "price sensitive". If they believe any key stakeholders would or should be interested in a disclosure they should make the presumption that such information be disclosed. Therefore a "presumption of disclosure" for certain "stakeholder sensitive" issues could be adopted within the Code.' An audit committee chairman commented that, 'The members of the supervisory board should use their professional judgement regarding the issues to be raised each year in their external report. If changes to governance practices or AIU responses are considered material to the ongoing activity of the business then the auditor and board members should ensure they are suitably disclosed.'

Professional bodies and other respondents yielded some mixed responses ranging from being positive about the suggestions for disclosure in Question 16 to saying, in the case of an accountancy body, 'We do not favour the creation of a list of specific disclosures. A principles-based disclosure culture should ensure that significant matters (which would include major changes in governance practices) are addressed.' Another accountancy body, specifically referring to the AIU point, stated, 'A firm is expected to address any specific concerns so the matter will either have been dealt with or will be revisited in the next AIU inspection. Therefore, we do not see a need to require disclosure of AIU concerns in an AFGC report because these are publicly available elsewhere. However, firms would be able to disclose such matters if they wish.'

4.8 Areas to be covered by the Code

Question 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?

The Working Group concluded that:

- audit firms differ from listed companies that are subject to codes of corporate governance such as the Combined Code because as partnerships they are owner-managed businesses and are not characterised by the agency problems that arise when there is a separation of ownership from control;
- while it is possible to apply much of the Combined Code to audit firms without much alteration, it is not clear that doing this would help to address important issues rather than being a box-ticking exercise;
- principles and provisions in the Combined Code related to 'Directors', 'Remuneration', 'Relations with shareholders' and 'Institutional shareholders' would be particularly inappropriate if applied to audit firms without substantial adaptation and so they are largely condensed into Section A.1 of the draft Code on owner accountability, Section A.2 on management, Section D.3 on people management and Section F on dialogue;

- principles and provisions related to 'Accountability and audit' are directly applicable to audit firms and are largely transferred to the draft Code in principle D.2 on risk management, principle E.2 on financial statements, principle E.5 on reporting quality and their supporting provisions; and
- major issues of relevance to the firms that are not included in the Combined Code's principles relate to professional values (dealt with in Section B.1 of the draft Code on professionalism and B.3 on openness), independent non-executives (dealt with in Sections C.1 to C.3) and legal and regulatory requirements (dealt with in Section D.1).

Audit firm respondents argued that the Combined Code was not the right place to start in developing the Code. While acknowledging that principles of good governance apply to major audit firms as much as to other organisations, one of the four largest firms stated, 'the significant differences between a partnership and a company with external investors mean that it is not appropriate to devise an Audit Firm Governance Code by adapting the Combined Code.' A large firm strongly recommended that the Working Group start afresh commenting, 'One reason is because the Combined Code is written for corporate owners, who have different needs to those seeking to understand how audit firms safeguard their public interest responsibilities.'

A number of the big firms indicated that they had already considered aspects of the Combined Code. One of the four largest firms stated that 'most major audit firms would be able to comply with much of the Combined Code; indeed we believe that [the firm] already does. However, there are a number of principles and provisions which are either irrelevant or inappropriate to be applied to audit firms given their different nature to public companies.' In their responses firms made various suggestions, some of which were consistent, as to which parts of the Combined Code are relevant.

Many investor, corporate, professional body and other respondents also commented that the Combined Code is not the best starting point, even though there are specific parts that they thought to be relevant. As one respondent said, 'Any similarities with the Combined Code should be as part of the design of the new Code and not an express objective of the new Code.' Nevertheless, some respondents thought that the principles of the Combined Code would be a good starting point for the Code and some of these suggested that the Working Group should consider on a case-by-case basis the applicability to audit firms of the provisions in the Combined Code.

Going further, one audit committee chairman stated, 'As regards areas to be covered by the Code, it should be aligned with that of the Combined Code. That is what stakeholders perceive as best governance practice, regardless of the constitutional fact that firms are in the main partnerships and LLP's and not companies. Explanation could be given in the report as to the division between owner supervision and management, the role of the governance board and their global structure.' One professional body also took the minority view and stated that the Combined Code is the appropriate starting point for the Audit Firm Governance Code.

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

The Working Group concluded that:

- a structure of introduction, principles and provisions should be followed without distinguishing between main and supporting principles of which the Combined Code has 17 and 26 respectively compared to 20 principles in the draft Code; and
- the Code should, certainly initially, contain fewer provisions than the Combined Code, which currently has 48 compared to 29 in the draft Code, because regulatory requirements obviate the need for provisions and a principles-based code should encourage learning from which best practice provisions can subsequently emerge.

Nearly everyone from all categories of respondent agreed that the structure of preamble (or introduction), principles and provisions is appropriate. A number of respondents agreed with the sentiment that the Combined Code is well respected and its structure has proven to be effective and is understood by many of the stakeholders that are to be affected by the new Code.

However, there was some scepticism about whether the Code should contain provisions. In particular, a mid-tier firm suggested that 'a Code should set out only a series of principles given that the regulation-tapestry already in force will give effect to many, if not all, of those principles.' In addition, an accountancy body hoped that the Code would 'be based solely on principles, at this stage, and that provisions are not included. The detailed provisions and a requirement to "comply or explain" could be introduced if felt necessary at a later stage (say, after 3-5 years) after the initial implementation has bedded in and been subject to formal review.'

Question 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?

The Working Group concluded that lessons could be drawn from material not derived from the Combined Code. For example:

- the Walker report on private equity provides ideas on monitoring for a code which is not rooted in legislative and regulatory requirements and future consideration of monitoring arrangements is noted in Section 2.3;
- the International Standard on Quality Control No. 1 issued by the International Auditing and Assurance Standards Board is reflected in Section D.1 on compliance;
- the Reuters Trust Principles which apply to a business that gathers and disseminates information and news reports (rather than audit reports) and are designed to serve report users. These have been helpful in framing Section C of the draft code on independent non-executives; and
- the IOSCO Credit Rating Agency Code applies to businesses that provide credit ratings (rather than audit reports) and is designed to serve ratings users and, as a consequence, the idea that the IOSCO Code should be incorporated into internal codes has been helpful in framing provisions B.1.2 and B.2.1 on codes of conduct.

Respondents provided several useful examples of codes in different sectors of the UK economy, a number of which were variations on the Combined Code. We also received suggestions about non-UK and international codes.

One corporate respondent cautioned against over-reliance on other codes in saying that 'any Audit Firm Governance code should be created from first principles based on the objectives of such a code.' However, others felt that there were solutions that were transferable to audit firms, including a corporate respondent who considered that, 'a public interest board is an alternative approach better suited to address the concerns that are behind the call for a corporate governance code for audit firms.'

Question 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?

The Working Group concluded that it was appropriate to reflect answers to this question in the following areas:

- the Chairman's introduction to this consultation paper notes the need to learn from current studies into the governance aspects of the financial crisis and the benefits of meetings, rather than relying purely on written submissions;
- Section 2.1 acknowledges the point made by a number of audit firms that they are already subject to significant regulation and regulatory oversight;
- Section 2.2 considers the case for the Code in the context of the existing body of audit regulation and oversight;
- Section 2.3 introduces the idea of recommending a threshold of more than 20 listed company audits to encourage small audit firms to stay in the market for the audit of listed companies; and
- the introduction to the draft Code in Section 3 refers to the firms as potential exemplars of best practice governance and proposes a post-implementation review of the Code.

One of the four largest firms believed it would be helpful for the Working Group to have direct dialogue with stakeholder groups and EU figures rather than simply rely on further written submissions. They also suggested setting a date, say in five years' time, for a review of the Code.

Smaller firms suggested that the Code should not become a disincentive to firms to keep the few public interest entity audits that they currently have or to enter the market and some were concerned that the consultation paper appeared to be drafted on the presumption that there will be an Audit Firm Governance Code and questioned whether it was a good idea.

An institutional investor commented, 'We would encourage firms to be exemplars in their reporting and their governance arrangements. Much corporate reporting is formulaic and bland, frequently not attempting nor succeeding in shedding much light into the real practice within the company. The auditors have an opportunity to show their clients that there are significant benefits to clear, honest, open and informative reporting.'

An investor representative body, noting that the audit market is an international one, believed that efforts to promote improvements should also be made at a supra-national level and that UK audit firms should work with their other network firms to promote good governance across the network.

Other suggestions and comments from respondents covered:

- the need for auditor independence rules and enforcement to be an integral part of the Code;
- arguments for and against the appointment of an independent chairman;
- ownership of the Code and responsibilities for guidance on its interpretation; and
- the need for a PIB to have explicit responsibility for considering the firm's performance management and remuneration systems for partners and non-partners alike, and their impact on audit quality.

Noting, in particular in relation to the financial services sector, that questions were being raised about the effectiveness of corporate governance codes, one respondent recommended that the Working Group be cognisant of these developments in corporate governance.

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	Partner, 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	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, 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

Recent regulatory developments

A number of regulatory developments are relevant to the work of the Audit Firm Governance Working Group. This appendix provides an update on the regulatory developments identified in the evidence gathering consultation paper of October 2008.

United States Treasury Advisory Committee

The US Treasury Advisory Committee on the Auditing Profession issued its final report in October 2008. It contained a number of recommendations designed to increase investor protection and enhance the sustainability of a strong and vibrant public company auditing profession. Two recommendations were of particular relevance to the Audit Firm Governance Working Group being:

- Section B, Recommendation 3: which urged US regulatory authorities and market participants 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.'
- Section C, Recommendation 2(b): which looked to establish a mechanism to assist in the preservation and rehabilitation of a troubled larger auditing firm with reference to a contingent streamlined internal governance mechanism.

No US authorities or market participants have made any public pronouncements of work undertaken to take forward these recommendations. However, in connection with Section B, Recommendation 7, on 16 April 2009, the Center for Audit Quality issued a practice aid 'Voluntary Model U.S. Transparency Report for Audit Firms' based on EU transparency reporting requirements and encouraged US public company auditing firms to publish voluntary annual transparency reports on their websites.

International Organization of Securities Commissions (IOSCO)

The Audit Services Task Force of the IOSCO Technical Committee announced in May 2008 that it would 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.'

Following its 2009 annual conference, IOSCO issued a press release on 11 June 2009 indicating that a consultation report on the 'Transparency of firms that audit public companies' was due to be released in the next few weeks.

EU and ownership of firms

The EU Statutory Audit Directive of June 2006, which requires all audit firms to be owned and managed by a majority of registered auditors approved in any EU member state, does not specifically define what a majority means in relation to voting rights. Consequently, member states can require EU auditors to hold a majority of anything between 51% and 100%.

The European Commission (EC) subsequently commissioned 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 choice in the audit market. The study 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.

In February 2009, the EC concluded a consultation on a number of questions on control structures in firms and the audit market. It is expected that the EC will publish a summary of consultation responses in the second half of 2009.

Bank for International Settlements (Basel)

In December 2008, the Basel Committee on Banking Supervision issued a paper entitled 'External audit quality and banking supervision'. One of four key areas to be addressed was described as follows, 'Major external audit firms have globalised and, as a result, their structures are complex and governance within the firms lacks transparency'. Actions the Committee intends to take include engaging with stakeholders and promoting enhancement of sound audit guidance and practices.

UK reporting on audit profitability

In March 2009, the Consultative Committee of Accountancy Bodies (CCAB) published its 'Voluntary Code of Practice on Disclosure of Audit Profitability'. It applies to any UK audit firm that is subject to independent monitoring by the AIU because it is a 'major firm' as determined by the POB. The CCAB Code took effect for accounting periods beginning on or after 6 April 2009.

UK Guidance on Transparency Reports by Auditors of Public Interest Entities

In June 2009, the POB issued a brief analysis of the information published by seven large audit firms in their separate transparency reports for 2007/2008, prepared on a voluntary basis ahead of UK statutory requirements taking effect for financial years of a relevant audit firm starting on or after 6 April 2008. Appendix 5 provides further details of the requirements.

The POB notes that the 2007/8 reports fall short of the requirements for statutory reports and draws out a number of specific points that it wants firms to consider carefully in finalising their 2009 reports. It also comments on the extent to which the firms have drawn on the Audit Quality Framework, published by the FRC in 2008, in preparing their transparency reports.

Transparency report disclosure requirements include a 'description of the governance structure of the transparency reporting auditor'. On this specific area the POB commented, 'In some cases the description of the UK governance structure is restricted to the main Management Board and a committee of elected partners. Other transparency reports give more detail on the structure, including for example on the role of various sub-committees of the Board. We consider that those firms giving the fuller picture provide the better model.'

UK reviews of financial services and corporate governance

In March 2009, the UK Financial Services Authority published a discussion paper as part of its regulatory response to the global banking crisis in which it noted that, 'it is important that everything possible is done to mitigate the risk of circumstances arising which might lead to one of the "Big 4" having to exit the market for audit services.' In this connection it proposed that 'serious consideration should be given to establishing some form of global supervisory architecture for all significant activities of the major accountancy firms.'

Also, in the first quarter of 2009, the UK Government announced an independent review by Sir David Walker of corporate governance in the UK banking industry and other financial institutions and the FRC also announced a review of the impact of the Combined Code on Corporate Governance. Some of the issues the Walker Review will be addressing may have broader applicability to the rest of the listed sector; others may not. The two reviews will be conducted separately, but the FRC will work closely with Sir David Walker and share relevant research and other evidence. It is expected that consultation papers for both reviews will be published in the third quarter of 2009.

APPENDIX 3

Respondents to the evidence gathering consultation paper

Audit firms

Baker Tilly Management Limited
BDO Stoy Hayward LLP
Buzzacott LLP
Deloitte LLP
Ernst & Young LLP
Grant Thornton UK LLP
Kingston Smith LLP
KPMG Europe LLP
Mazars LLP
Moore Stephens LLP*
PKF (UK) LLP
PricewaterhouseCoopers LLP
Saffery Champness*
Smith & Williamson*
Tenon Group PLC*

* Covered by response from Baker Tilly Management Limited

Investors and their representative bodies

Association of British Insurers
Hermes Equity Ownership Services
International Corporate Governance Network
Investment Management Association
National Association of Pension Funds Ltd
Royal London Asset Management
rpmi Railpen Investments

Companies and their representative bodies

Cable and Wireless plc
CBI
Global Governance Services Limited
Independent Audit Limited
Institute of Directors
Quoted Companies Alliance
Severn Trent 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
Institute of Chartered Secretaries and Administrators
Institute of Internal Auditors – UK and Ireland

Individuals

Beevor, Mr Antony
Durant, Mr Ian
Hooley, Mr Peter
Lothian, Professor Niall
MacDonagh, Mrs Lesley
McLaren, Mr Iain
Mednick, Mr Robert
Percy, Professor J P (Ian)
Smith, Mr Peter
Thomson, Mr Alan
Tweedie, Sir David

APPENDIX 4

Professional Oversight Board analysis of firms

Extracted from the POB report *Key Facts and Trends in the Accountancy Profession* published on 22 June 2009.

Firm Name	Structure	Year End	No. of FTSE 100 Audit Clients	No. of FTSE 250 Audit Clients	Total No. of other clients listed on Regulated Markets	No. of AIM Audit Clients
PricewaterhouseCoopers	LLP	30 June 08	39	73	219[1]	151
KPMG[2]	LLP	30 Sep 08	25	42	193	95
Deloitte[3,4]	LLP	31 May 08	21	61	97	87
Ernst & Young	LLP	30 June 08	16	43	264	66
Grant Thornton	LLP	30 June 08	0	6	81[5]	198[5]
BDO Stoy Hayward	LLP	30 June 08	0	6	30	149
PKF (UK)	LLP	31 Mar 08	0	0	45	49
Baker Tilly	LLP	31 Mar 08	0	0	22	93
Kingston Smith	LLP	30 Apr 08	0	0	12	17
Littlejohn[6]	LLP[7]	31 May 08	0	0	6	19
UHY Hacker Young	Group of Partnerships	30 Apr 08	0	0	5	23
Scott Moncrieff	Partnership	30 Apr 08	0	0	5	3
Nexia Smith & Williamson Audit	Company	30 Apr 08	0	0	4	40
James Cowper	Partnership	30 Apr 08	0	0	4	0
Chiene & Tait	Scottish Partnership	30 Sep 08	0	0	4	0
Moore Stephens	LLP	30 Apr 08	0	0	3	13
Chantrey Vellacott DFK	LLP[8]	30 Jun 08	0	0	3	15
Mazars	LLP	31 Aug 08	0	0	3	37

1 This figure is the number of parent groups that are audited by PwC. It does not include any subsidiaries.
2 Includes both KPMG LLP and KPMG Audit Plc.
3 Figures are as at 31 October 2008.
4 Name changed from Deloitte & Touche LLP as of 1 December 2008.
5 Grant Thornton's figures are as at 31 December 2008.
6 Name changed from CLB Littlejohn Frazer with effect from 31 January 2009.
7 Changed from Partnership to an LLP with effect from 31 January 2009.
8 Changed from a Partnership to an LLP in 2008.

Professional Oversight Board analysis of firms (continued)

Firm Name	Structure	Year End	No. of FTSE 100 Audit Clients	No. of FTSE 250 Audit Clients	Total No. of other clients listed on Regulated Markets	No. of AIM Audit Clients
Saffery Champness	Partnership	31 Mar 08	0	0	2	8
Haysmacintyre	Partnership	31 Mar 08	0	0	2	6
Begbies Chettle Agar	Partnership	31 Mar 08	0	0	2	NA[9]
Horwath Clark Whitehill	LLP	31 Mar 08	0	0	1	16
Tenon Audit	Limited Company	30 Jun 08	0	0	1	11
Menzies	Partnership	31 Mar 08	0	0	1	3
RSM Bentley Jennison	Partnership	31 Dec 08	0	0	0	12
HLB Vantis Audit plc	Plc	31 May 08	0	0	0	8
HW Group	Partnership	31 Mar 08	0	0	0	5
MacIntyre Hudson	LLP	31 Mar 08	0	0	0	4
Armstrong Watson	Partnership	31 Mar 08	0	0	0	1
Cooper Parry	LLP	30 Apr 08	0	0	0	0
DTE Business Advisory	Limited Company	30 Apr 08	0	0	0	0
Johnston Carmichael	Partnership	31 May 08	0	0	0	0

9 Where NA is stated the information is not available.

APPENDIX 5

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.

The requirements of Article 40 were 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 were 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.

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.

APPENDIX 6

List of abbreviations

AIU	UK Audit Inspection Unit
APB	UK Auditing Practices Board
CCAB	UK Consultative Committee of Accountancy Bodies
Code	Audit Firm Governance Code
Combined Code	Combined Code on Corporate Governance issued by the FRC
EC	European Commission
EU	European Union
Firms	Firms that audit public interest entities
FRC	UK Financial Reporting Council
ICAEW	The Institute of Chartered Accountants in England and Wales
IOSCO	International Organization of Securities Commissions
LLP	Limited Liability Partnership
MPG	Market Participants Group established by the FRC
PCAOB	US Public Company Accounting Oversight Board
PIB	Public Interest Board
PIE	Public interest entity
POB	UK Professional Oversight Board
SEC	US Securities and Exchange Commission

APPENDIX 7

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