Feedback Statement and Consultation

December 2015

Review of the UK Audit Firm Governance Code

Feedback statement and proposed revisions
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Introduction

1. In May 2015 the Financial Reporting Council (FRC) published a review of the Audit Firm Governance Code (“the Code”). Based on feedback to that review, we are now consulting on proposed revisions to the Code.

2. The Code was introduced in January 2010. It applied to firms auditing 20 or more listed companies and was created with the aim of:

   “Provid[ing] a formal benchmark of good governance practice against which firms which audit listed companies can report for the benefit of shareholders in such companies.”

3. We looked at the way firms had adopted the Code and whether it had achieved its intended benefits. These were to:
   
   • Support firms in their objectives of performing high quality audit work that gives confidence to shareholders
   • Benefit capital markets by enhancing choice and helping to reduce the risk of a firm exiting the market
   • 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
   • Strengthen the regulatory regime by achieving transparency and effective governance without disproportionate regulation.

4. The consultation closed at the end of August 2015. We received 22 responses. A list of respondents, and the public responses themselves can be read on our website at https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Audit-Firm-Governance-Code/Responses-to-consultation.aspx

5. The distribution of responses is as follows:

<table>
<thead>
<tr>
<th>Type of respondent</th>
<th>Number</th>
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<tbody>
<tr>
<td>Audit firms</td>
<td>8</td>
</tr>
<tr>
<td>Independent Non-Executives of audit firms</td>
<td>3</td>
</tr>
<tr>
<td>Investors</td>
<td>3</td>
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<td>Professional bodies</td>
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<td>Trade bodies</td>
<td>2</td>
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<tr>
<td>Overseas regulators</td>
<td>1</td>
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<tr>
<td>Other</td>
<td>2</td>
</tr>
</tbody>
</table>
Main messages

6. The vast majority of respondents saw the introduction of the Code as a positive development which has enhanced audit firm governance. All agreed the Code should remain principles-based and operate on a “comply or explain” basis. Audit quality should be central to the Code but the majority of respondents were keen that it also applied to the governance and oversight of the firms’ non-audit businesses – which collectively are larger than the audit service line in all of the firms which apply the Code and may therefore impact on the capacity to provide and/or quality of the audit service line.

7. Audit firms said that the Code was working well and advised against significant changes to the existing provisions or introducing increased prescription.

8. Investors were keen to see enhanced transparency from the firms and clearer guidance about the role and responsibilities of the Independent Non-Executives (INEs).

9. A significant aspect of the Code is the Dialogue Principle, which promotes engagement between audit firms and shareholders in listed companies. Some suggested that the FRC could help to facilitate this dialogue, for example by hosting meetings or setting up groups to discuss matters of shared interest.

10. Investors also sought more monitoring by the FRC of the firms’ application of the Code. Currently, our Audit Quality Review inspectors review the firms’ transparency reports and report on whether or not the content of the report reflects reality. We do not wish to turn the Code into a regulatory tool. However, we can provide more feedback to firms on transparency reports and highlight good practice and we will do so going forward.

11. Respondents pointed to the Code’s lack of visibility. This is particularly acute in the corporate sector and we did not receive any consultation responses from for example, finance directors or audit committee chairs. Informal feedback from audit committee chairs indicates that they trust the firms to implement appropriate governance arrangements under our oversight.

12. Based on the consultation and our earlier fieldwork we intend to make the following changes:
   - Sharpen the Code’s purpose and ensure audit quality is clearly embedded in this;
   - Promote a clear focus on audit quality in the work of the INEs;
   - Strengthen investors’ engagement with the firms;
   - Improve transparency in the firms’ reporting against the Code;
   - Promote the adoption of some aspects of the Corporate Governance Code which we consider to be most applicable to audit firms, on a comply or explain basis; and
   - Promote the adoption of independent challenge within the governance of the firms’ international networks.

13. A new draft Code can be found at Appendix 1 and we welcome comments on the proposed changes. Interested parties are invited to send any feedback to Susan Currie (s.currie@frc.org.uk) by 11 March 2016.
Responses to specific questions

14. The May review asked a number of specific questions about the Code and made suggestions for potential changes. The feedback to each of these is set out below.

Purpose

15. In the consultation, we explored whether the stated purpose of the Code remains valid. That purpose, as set out in the Introduction to the Code, is:

16. “To provide a formal benchmark of good governance against which firms which audit listed companies can report for the benefit of shareholders in such companies.”

17. We stated that we believed that the public interest in the context of the Code rests in:

- Firstly, and of greatest importance, audit quality and the preservation of audit capacity.
- Secondly, the firm’s reputation more broadly; this involves oversight of the firm’s non-audit businesses which now make up 70 - 80% of the major firms’ revenues. Some of these businesses are subject to statutory regulation but the majority are not.
- Finally, prevention of a firm failure.

18. We proposed that the purpose of the Code should be restated in order to reflect this.

Q1 Do you agree that the Code’s purpose should be redefined in this way?

19. Responses to this question were thoughtful and detailed. Respondents from all groups found the existing purpose still to be valid and overall we consider that the three priorities we set out in the consultation properly elaborate what the Code’s original purpose should mean in practice, but there was support for a simplification or clarification of the supplementary aims set out in the original introduction to the Code.

20. There was widespread agreement that audit quality must be central to the Code’s purpose and that the Code should also encompass the governance of work outside of statutory audit.

21. Respondents noted that the Code had not led to enhanced choice in the audit market and that it was not, in any event, an appropriate vehicle to do so. There was, however, support for the proposal that the Code has a role in preventing audit firm failure. In other words there is concern to ensure sufficient audit capacity of appropriate quality.

22. A number of respondents raised concerns about the use of the term “public interest”. The term is often used in relation to audit and accountancy and has a number of different meanings. The European Audit Directive and Regulation introduces a new definition of a “public interest entity”. The chartered accountancy bodies are developing new guidance on “public interest” and its application to non-audit accountancy work.

23. Attempting to define “public interest” solely for the Code risks causing confusion and distracting from the central point we are seeking to make about audit quality. Instead we propose to rephrase the Code’s purpose to incorporate the three key aspects as set out above.
Safeguarding audit quality and capacity

Governance arrangements

24. In the light of high growth rates in consultancy services relative to audit, we asked how the culture within audit could be maintained and whether there should be special governance arrangements to safeguard it.

Q2 Should there be separate governance arrangements for audit? What might such arrangements look like?

25. There was very little appetite for the creation of specific governance arrangements for audit only. Audit firms pointed to the importance of embedding a single ethical culture across all service lines and argued that INEs needed to have visibility of the entirety of the business in order to provide effective oversight and protection of audit quality and capacity.

26. Some investors have expressed concern that INEs’ oversight of non-audit matters could create a conflict of interest. However, this appears to be a minority viewpoint.

27. We agree that the case for governance arrangements specifically for audit is not proven. However, audit quality and the risks to audit, from within the audit practice and elsewhere in the firm, other parts of its network, and from outside the firm, should be at the top of the INEs’ agendas. INEs should report publicly on how well audit quality and capacity is being safeguarded.

Tone at the top

28. An appropriate “tone at the top” is vital for a strong culture of ethics and professionalism to take root and flourish. We asked:

Q3 Should the Code include more detail and impose more requirements on tone at the top and professionalism more generally?

29. There was widespread acknowledgement of the importance of “tone at the top” but mixed views on the extent to which the Code should focus on this. Respondents pointed to the Code’s existing Principles as well as the ethical requirements which apply to all firms of chartered accountants. Investors appeared broadly satisfied with the Code’s existing provisions but indicated a desire for greater transparency around the INEs’ oversight of firms’ management and behaviour.

30. On balance we have decided not to amend the Code to make further references to “tone at the top” but we note the desire for greater transparency and recognition of the importance of culture and people to audit firms. The revised introduction to the Code suggests how this transparency might be achieved.

International context

31. All of the major UK audit firms are part of international networks and have varying degrees of autonomy within each of the global structures. Only a handful of other jurisdictions have introduced similar governance requirements for audit firms; notably the Netherlands, which has gone beyond the UK in requiring the creation of supervisory boards to oversee the management of the national firms.
Q4  Do you agree that the concept of the Code should be spread elsewhere in the world? How might this be achieved?

32. Respondents were broadly in favour of the promulgation of the Code internationally but noted the difficulties of doing so. Some queried the extent to which the UK could exert influence. Others suggested that the correct route to promote the idea of a governance Code for audit firms was via the International Forum of Independent Audit Regulators (IFIA).

33. We do not intend to include specific provisions in the Code about its international adoption. However, we believe that INEs and others at the firms with public interest responsibilities should consider carefully how best practice in governance can be rolled out across their networks. The FRC will also promote the adoption of aspects of the Code at network level.

34. The effectiveness of governance at national level also requires careful attention if the firm adopts a more global approach to the organisation and governance of its business. Those that have or intend to do so may have decision-making executive structures that do not fit with nationally based governance arrangements. However, some national markets are of overwhelming importance to the firm and problems in them, including in audit, can imperil the entity as a whole. That is particularly true in the US and UK. In these circumstances the firms need to determine and report on how their global governance arrangements promote audit quality, ensure audit capacity and deliver independent challenge to their partners in major, strategically significant countries, and how key people in governance will effectively engage on audit matters with national regulators. We believe it is particularly important that issues in major markets are not addressed by a single INE working at an international network level. A lone voice is not sufficient and the INE needs to have direct influence on the national partners. At least two, and ideally three, INEs in an international governance structure should have a special responsibility in relation to each of the network’s most significant two or three audit markets, including the UK, and should take part in relevant national governance and/or oversight arrangements.

Role of the INEs

35. INEs are the most visible aspect of the Code and we asked a number of specific questions about their role and responsibilities.

Q5  How might the independence of INEs be protected and demonstrated?

36. The firms broadly considered that existing provisions were adequate. Investors asked for additional safeguards in relation to INEs’ appointment and reporting.

37. In the review paper the FRC highlighted two matters:
   - A serving partner being appointed as an INE; and
   - An INE serving as a NED with a company during an audit tender process involving the firm concerned.

38. We have amended Appendix 2 to the Code to address these issues.

Q6  Should the firms follow a standard process in appointing INEs, including all such positions being publicly advertised? What engagement, if any, should investors in audited entities have in an audit firm’s appointment of INEs?
39. The majority of respondents were not in favour of a standard appointment process. There was, however, recognition that improved transparency would enhance confidence in the process and we consider that the firms could provide more details of this in their public reporting.

40. Investors remain keen to have some input into the choice of INEs. We believe there is scope for dialogue with investors on the qualities of INEs that the firm might look to appoint (rather than the individual candidates). At least one audit firm has already engaged in such dialogue.

Q7 Should the FRC or any other regulator have a role in the appointment of INEs; perhaps a right of veto?

41. There was very little support for the FRC having a right of veto over the appointment of INEs and it is not a role we wish to take on. We would, as part of our ongoing dialogue with the firms’ management and INEs, be happy to discuss the qualities and skill sets which might be appropriate to the role.

Corporate Governance Code

42. In the review we identified a number of aspects of the Corporate Governance Code and of corporate governance good practice more broadly, which might be “carried over” to audit firms:

- The inclusion in firms’ transparency reports of a viability statement providing an assessment of longer term solvency and liquidity
- Term limits on INEs’ appointment
- Transparency around the remuneration of INEs
- A requirement for at least one INE to have recent and relevant financial experience
- An independent Chairman
- Greater consideration of diversity
- A formal role for INEs on remuneration, nomination, risk and/or audit committees

Q8 Which of these, if any, should be incorporated into the Code? Are there any other aspects of the Corporate Governance Code which should also be considered?

43. The majority of respondents who commented saw value in some of the suggested carry-overs, in particular:

- The viability statement which is highlighted also relates to risk management and internal control reporting; and
- The requirement for recent and relevant financial experience; although it was suggested that this should be amended to “recent and relevant audit or assurance experience” whether through work as an auditor, finance director or audit committee member.
- Term limits for INEs, mirroring those in the Corporate Governance Code

44. More broadly the Corporate Governance Code and its principles have served to raise the quality of governance in the UK and we believe that the audit firms should consider carefully whether they could benefit from adopting many of its core provisions to the extent that they can be applied in a partnership. We encourage audit firms to report publicly on their views particularly on the applicability of the other provisions listed above.
**Accountability**

45. The review discussed the question of the accountability of INEs. The Code states that the INEs’ duty of care is to the firm; this co-exists with their responsibility to the public interest. Investors have expressed concern that the INEs may be close to the firm and hence fail to discharge their public interest responsibilities effectively. However, we have seen little evidence of this in practice.

46. To explore the topic further we asked a number of questions on accountability and transparency.

<table>
<thead>
<tr>
<th>Q9</th>
<th>To whom should the boards, INEs and public interest committees be accountable? How should this accountability be discharged, including to the FRC?</th>
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<tbody>
<tr>
<td>Q10</td>
<td>Should the Code include specific provisions on the firms’ Boards and Public Interest bodies engaging with and disclosing certain matters to regulators?</td>
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<tr>
<td>Q11</td>
<td>Is greater transparency sufficient? What else can be done?</td>
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47. Feedback from the majority of respondents acknowledged that in legal and practical terms the accountability of INEs and public interest committees can only be to the audit firm. Transparency appears to be the only realistic way to increase confidence that the firms’ governance structure is working in the interests of investors and the public interest.

48. Concerns were raised about the introduction of additional obligations on firms and their boards/committees beyond those already required by regulation or professional ethics. Investors were keener on this, but on reflection we do not consider a principles-based governance code to be the most appropriate place to put a new requirement of this nature.

49. There is a clear desire amongst investors for greater transparency but, as the original consultation document noted, the firms’ primary vehicle for this – the mandatory annual transparency reports – have a limited audience. Some of the firms cautioned against introducing further disclosure requirements which would lead to more boilerplate and we agree that it is quality, not quantity, of information that we wish to encourage. Most of the firms who apply the Code currently include within their transparency report a separate report from INEs or their public interest committee and many of these are to a high standard. We intend to introduce additional provisions as set out in Appendix A. We would not envisage these adding significantly to the length of the report but should we hope increase investor and other stakeholder interest in it.

**Other issues**

50. Currently the Code applies to firms which audit 20 or more listed companies. Other firms may apply the Code on a voluntary basis, and at least one, Mazars, does so.

51. Increasing the reach of the Code to a wider group of firms may help to raise confidence in the profession as a whole. At the same time, however, we are conscious of the need to ensure that regulation is applied in a proportionate manner.

| Q12 | Should the Code be applied to a wider group of firms? |
52. The feedback showed a divergence of opinion between respondents from the audit firms and the accountancy profession on the one hand, and investors on the other. The majority of respondents from the firms and the profession argued that the current population of firms covered by the Code was appropriate and that extending it to a larger group would be disproportionate. Investors, whilst recognising the proportionality argument, showed broad support for the adoption of the Code by all firms auditing listed companies.

53. Applying the Code, and in particular appointing effective INEs, can be a time-consuming and expensive process. We need to balance the governance improvements which we believe adoption brings with the avoidance of the imposition of additional regulatory burdens on firms which may be quite small in comparison with the current population applying the Code.

54. On balance, therefore, we do not intend to lower the current threshold for the application of the Code, but we would urge firms which do audit listed companies or other PIEs\(^1\) to consider applying aspects of the Code on a voluntary basis and to report on this publicly.

55. The Code was published jointly by the ICAEW and FRC following extensive work by the ICAEW and others.

**Q13 Do you have any comments on the role of the FRC in this context?**

56. The feedback we received during our fieldwork and in response to the review document was that the Code should now be owned by the FRC as the independent regulator and inspector of the firms which apply it, with input from the ICAEW and other professional bodies as required. A number stressed the importance of continuing to engage with the ICAEW and other chartered accountancy bodies and we intend to do so.

57. In response to feedback around the need for more visible monitoring of the firms’ application of the Code, the FRC commits to publish regular reviews of transparency reporting. As part of this we will highlight where we see best practice and innovation. Our Audit Quality Review function will continue to monitor whether the firms’ public statements on their application of the Code match what is seen in practice.

58. The FRC will also continue to act as a convenor of meetings with INEs from all the firms and to meet with INEs from individual firms on a regular basis.

**Next steps**

59. Any comments should be sent to Susan Currie (s.currie@frc.org.uk) by 11 March 2016.

60. We intend to issue the revised Code in **June 2016**.

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\(^1\) Public Interest Entities as defined by the EU Audit Regulation which broadly comprises listed companies and unlisted banks and insurers.
APPENDIX – PROPOSED REVISIONS TO THE UK AUDIT FIRM GOVERNANCE CODE

INTRODUCTION

The UK Audit Firm Governance Code (the Code) is intended to assist in promoting continuing confidence 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.

Purpose

When the Code was introduced in 2010, its primary purpose was to provide a formal benchmark of good governance practice against which firms which audit listed companies could report for the benefit of shareholders in such companies. Five years on, this purpose is still valid but should be amplified to encompass three specific aspects of good governance:

- Firstly, and of greatest importance, audit quality and the preservation of audit capacity.
- Secondly, the firm’s reputation more broadly; this involves oversight of the firm’s non-audit businesses. Some of these businesses are subject to statutory regulation but the majority are not.
- Finally, prevention of audit firm failure.

The Code is also intended 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 genesis of the original Code was 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 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 (formerly Chairman of Cairn Energy PLC) to carry out and complete this work. The Audit Firm Governance Code was published jointly by the ICAEW and FRC in January 2010. It included 20 principles and 31 provisions and operated on a “comply or explain” basis. It applied to firms auditing 20 or more listed companies. Many of the provisions codified requirements and practice already in place from other sources, but it introduced two new concepts:

- The appointment of independent non-executives within governance structures of audit firms; and
- Dialogue between audit firms and investors in listed companies.

In line with a recommendation made at the time of the Code’s publication, during 2014-15 the FRC carried out a review of its implementation and operation. That review found that the Code had been adopted by all firms within its scope (and at least one outside of it). Firms had implemented the Code in different ways, with a particular diversity in the positioning of independent non-executives within governance structures. The FRC sees value in each of the different approaches and does not intend to introduce prescription in this area. However, firms should report publicly on why they have adopted a particular approach and how that approach serves the public interest by helping to ensure audit quality and capacity.
Our review of the Code did not suggest that it required a major rewrite. However, a number of issues were identified:

- The Code itself has insufficient visibility.
- The Dialogue principle has not worked as well as hoped. Firms have reached out but investors have not always had the time or resource to engage with them. In addition, firms have not always engaged on those issues of most interest to investors;
- Investors are not clear about the role which independent non-executives (INEs) play and have concerns about their independence.
- There are aspects of the Corporate Governance Code which could usefully be incorporated into the Code on a comply or explain basis.

Following the review we have made a number of changes to the Code, to highlight the importance of transparency and to introduce some additional provisions from the Corporate Governance Code. The principles remain unchanged.

To facilitate better implementation of the Dialogue principle, the FRC will work to help facilitate improved engagement between firms and investors. It is hoped that this will improve the level and extent of dialogue, but it must be stressed that this is intended to supplement and not replace the firms’ direct interaction with shareholders in listed companies.

Transparency is key to addressing the other matters identified in the review. All audit firms which audit listed companies are required to produce annual transparency reports containing, *inter alia*, information about the operation of the Code within that firm. These reports are not widely read and have previously been described as compliance documents of limited interest.

We believe that the firms should revise their transparency reports to include content which is of greater relevance to investors, regulators and other stakeholders. In particular, firms applying the Code should include the following:

- A separate report from the independent non-executives and/or public interest committee; several firms already do this. This report should include an explanation of how the independent non-executives or committee has overseen the UK audit practice in particular, as well as the wider UK business more generally, over the reporting period.
- An explanation of why the firm has chosen to position its independent non-executives in the way that they have and how they believe that this serves the public interest by helping to ensure audit quality and capacity.
- A statement of how the firm has worked during the year to fulfil the Code’s purpose, defined as:
  - Audit quality and the preservation of audit capacity
  - The firm’s reputation more broadly, including oversight of non-audit businesses
  - Prevention of firm failure.
- Details of any provisions from the UK Corporate Governance Code which they have adopted within their own governance structures and a consideration of whether there are any others it might adopt in the future.

A report on the work of the firm’s Board including performance against any KPIs in place.

For our part the FRC will commit to conducting regular reviews of transparency reports with a view to increasing their visibility. As part of this we will highlight best practice and innovation in audit firm governance.
As noted above, we have made some minor changes to the Code to align it more closely with the Corporate Governance Code. We have not introduced further provisions because we recognise that, as the original Working Group concluded, there are significant differences between owner-managed businesses such as audit firms and listed companies. However, we would encourage firms regularly to review their governance against the provisions of the Corporate Governance Code and to consider introducing certain aspects (for example, the separation of Chairman and Chief Executive) within their own governance structures.

The major audit firms operate in a globalised world and all are members of international networks. We encourage UK audit firms to promote the Code and in particular the concept of independent challenge within the governance structure, within their networks. If they move towards fully globally managed structures, in which national governance arrangements become less appropriate or subordinate to global control, they should also consider and report on how such governance arrangement protect the public interest in audit in the most significant national markets, bearing in mind that audit regulation remains the preserve of national authorities. The FRC will promote the concept with networks and via IFIAR.

Financial Reporting Council

December 2015
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. In doing so the firm should explain how its governance structure provides oversight of both the firm as a whole and the audit practice with a focus on ensuring this Code’s purpose, to promote audit quality and secure audit capacity, is achieved. If the governance of the firm rests at a global level it should specifically set out how oversight of audit in major jurisdictions of potential risk to the whole within the firm network, including the UK, is undertaken and the Code’s purpose achieved.

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 terms, length of service, meeting attendance in the year, and relevant biographical details.

A.1.4 The members of a 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. In reviewing governance the firm should consider both the provisions of this Code and key aspects of the Corporate Governance Code, where appropriate, and report on its conclusions.

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 whole firm including its non-audit businesses and these should be disclosed on the firm’s website.

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2 Relevant being judged by reference as to the Code’s purpose.
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 through its policies and practices and by publicly committing themselves and the whole 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 maintain 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 to the governance structure who through their involvement collectively enhance shareholder confidence in by meeting the purpose of the Code the public interest aspects of the firm’s decision making, stakeholder dialogue and management of reputational risks including those in the firm’s businesses that are not otherwise effectively addressed by regulation. They INEs should report in the firm’s transparency report particular on their involvement on how they have worked to meet the purpose of the Code and in particular on how audit quality has been safeguarded and the risks to it addressed.

Provisions

C.1.1 Independent non-executives should number at least three: have the majority on a body that oversees public interest matters; and/or be members of other relevant governance structures within the firm. They should also meet as a separate group to discuss matters relating to their remit. -They should pay particular attention to and report on risks to audit quality and how they are investigated and addressed. Where the firm adopts an international approach to its management it should have at least two and ideally three INEs with specific responsibility to focus on each of the firm’s most significant markets and to take part in governance arrangements for these markets.

C.1.2 The firm should disclose on its website information about the appointment, retirement and resignation of independent non-executives; their duties and the arrangements by which they discharge those duties; and the obligations of the firm to support them. The firm should also disclose on its website the terms of reference and composition of any governance structures whose membership includes independent non-executives.
C.2 Characteristics of independent non-executives principle

The independent non-executives’ duty of care is to the firm. They should command the respect of the firm’s owners and collectively enhance shareholder confidence by virtue of their independence, number, stature, experience and expertise. At least one independent non-executive should have competence in accounting and/or auditing, gained for example from a role on an audit committee, in a company’s finance function or an audit firm.

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 owners.

C.3 Rights and duties of independent non-executives principle

Independent non-executives of a firm should have rights consistent with their role including a right of access to relevant information and people to the extent permitted by law or regulation, and a right to report a fundamental disagreement regarding the firm to its owners and, where ultimately this cannot be resolved and the independent non-executive resigns, to report this resignation publicly.

Provisions
C.3.1 Each independent non-executive should have a contract for services setting out their rights and duties.

C 3.2 Independent non-executives should be appointed for specific terms and any term beyond nine years should be subject to particularly rigorous review.

C 3.3 The duties of an independent non-executive should include, but not be limited to, oversight of the firm’s policies and processes for:

- maintaining and promoting audit quality and preserving capacity;
- preserving the firm’s reputation; and
- contingency plans or other safeguards for preventing firm failure.

C.3.4 The firm should ensure that appropriate indemnity insurance is in place in respect of legal action against any independent non-executive.

C.3.5 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.3.6 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. Operations should be conducted in a way that preserves audit quality, capacity and the reputation of the firm. The independent non-executives should be involved in monitoring each of the matters below.

Provisions

D.1.1 The firm should establish policies and procedures for complying with applicable legal and regulatory requirements and international and national standards on auditing, quality control and ethics, including auditor independence.

D.1.2 The firm should establish policies and procedures for individuals signing group audit reports to comply with applicable standards on auditing dealing with group audits including reliance on other auditors whether from the same network or otherwise.

D.1.3 The firm should state in its transparency report how it applies policies and procedures for managing potential and actual conflicts of interest.

D.1.4 The firm should take action to address areas of concern identified by audit regulators in relation to the firm’s audit work.

D.2 Risk management principle

A firm should maintain a sound system of internal control and risk management over the operations of the firm as a whole to safeguard the owners’ investment and the firm’s assets.

Provisions

D.2.1 The firm should, at least annually, conduct a review of the effectiveness of the firm’s system of internal control. The review should cover all material controls, including financial, operational and compliance controls and risk management systems as well as promotion of appropriate standards and values within the firm.

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 The firm should confirm a robust assessment of the principal risks facing it – including those that would threaten its business model, future performance, solvency or liquidity. This should reference specifically the sustainability of the audit practice within the UK. In maintaining a sound system of internal control and risk management and in reviewing its effectiveness, the firm should use a recognised framework such as the Turnbull Guidance and disclose in its transparency report the framework it has used.

D.3 People management principle

A firm should apply policies and procedures for managing people across the whole firm that support its commitment to the professionalism, openness and risk management principles of this Audit Firm Governance Code.

Provisions

D.3.1 The firm should disclose on its website how it supports its commitment to the professionalism, openness and risk management principles of this Audit Firm Governance
Code through recruitment, development activities, objective setting, performance evaluation, remuneration, progression, other forms of recognition, representation and involvement.

D.3.2 Independent non-executives should be involved in reviewing people management policies and procedures.

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 issues raised under 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 Governance reporting principle

A firm should publicly report how it has applied in practice each of the principles of the Audit Firm Governance Code excluding F.2 on shareholder dialogue and F.3 on informed voting, and make a statement on its compliance with the Code’s provisions or give a considered explanation for any non-compliance.

Provision

E.2.1 The firm should publish on its website an annual transparency report containing the disclosures required by Code Provisions A.1.2, A.1.3, C.2.1, D.1.3, D.2.2, and D.2.3.

E.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 fair, balanced and understandable commentary on the firm’s financial performance, position and prospects.
E.3.1 The firm should confirm that it has carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The directors should describe those risks and explain how they are being managed or mitigated. The firm should include in its management commentary its principal risks and uncertainties, identifying those related to litigation, and report how they are managed in a manner consistent with the requirements of the applicable financial reporting framework.

E.4 Governance reporting principle

A firm should publicly report how it has applied in practice each of the principles of the Audit Firm Governance Code excluding F.2 on shareholder dialogue and F.3 on informed voting and make a statement on its compliance with the Code’s provisions or give a considered explanation for any non-compliance.

E.4.1 The firm should publish on its website an annual transparency report containing the disclosures required by Code Provisions A.1.2, A.1.3, C.2.1, D.1.3, D.2.2 and D.2.3.

E.4 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.

E.4.1 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.

E.5 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.

E.5.1 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.5.2 The firm should state whether it considers it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to its ability to continue to do so, with supporting assumptions or qualifications as necessary.

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.

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 and their audit committees, about matters covered by this Audit Firm Governance Code to enhance mutual communication and understanding and ensure that it keeps in touch with shareholder opinion, issues and concerns.

Provision

F.1.1 The firm should disclose on its website its policies and procedures, including contact details, for dialogue about matters covered by this Audit Firm Governance Code with listed company shareholders and listed companies. These disclosures should cover the nature and extent of the involvement of independent non-executives in such dialogue.

F.2 Shareholder dialogue principle

Shareholders should have dialogue with audit firms to enhance mutual communication and understanding.

F.3 Informed voting principle

Shareholders should have dialogue with listed companies on the process of recommending the appointment and re-appointment of auditors and should make considered use of votes in relation to such recommendations.
APPENDIX 1

Involvement of independent non-executives

Independent non-executives offer a governance solution to three potential threats to continued confidence in an audit firm: decision making is private; regulation does not cover all activities which put a firm’s reputation at risk; and stakeholder dialogue to manage major threats to survival is difficult. Principle Code Provision C.1-3.3 on the involvement duties of independent non-executives refers to their role in helping the firm meet the purpose of the Code three areas of decision making, management of reputational risks and stakeholder dialogue, where independent non-executives can build on the strengths of regulated professional partnerships to enhance the confidence that shareholders in listed companies place in the firms that audit those companies.

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

Decision making

Some firms refer to owners who are members of 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 owners could can play an important role in enhancing confidence. For example, 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 making decisions that show that the firm does not pursue other interests to the detriment of the public interest. In short, independent non-executives could be a witness to a firm’s commitment to the public interest.

Management of reputational risks

Whole firm procedures performed by audit regulators and improved international regulatory co-ordination can be expected to mitigate some of these risks but they are likely to persist in relation to lightly regulated or unregulated non-audit work. 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 to address reputational risks including those in the firm’s businesses that are not otherwise effectively addressed by regulation.

In short, independent non-executives can be an additional safeguard of a firm’s reputation.

Stakeholder dialogue

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 could be a channel for dialogue with stakeholders.
APPENDIX 2

Independence considerations

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

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

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

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

In relation to non-executive independence from a firm and its owners, a number of relationships that may cause concern will already be precluded because of auditor independence requirements. However, because there are no specific requirements which define non-executive independence, Code Provision C.2.1 also calls on a firm to disclose its criteria for assessing whether its independent non-executives are independent from the firm and its owners. This should include any term limits which the firm applies. Where an independent non-executive has served for longer than this term, or nine years, whichever is shorter, this should be disclosed in the firm's transparency report.

Being in a position to influence the conduct or outcome of an individual audit engagement would include having an actual or apparent ability on individual audits to evaluate audit partner performance or to exercise quality control or other oversight functions. Independent non-executives' contracts might cover these matters and prevent them from receiving feedback on individual audits or having access to audit working papers unless appropriate safeguards are applied. This should not preclude independent non-executives from oversight of a firm's processes – for example by sitting on a remuneration committee – provided that they are unable to influence the compensation of any individual and/or recuse themselves from any situations where this might arise.

In developing criteria, a firm is expected to reflect the views of an objective, reasonable and informed third party. Therefore, firms should not exclude individuals from consideration as potential independent non-executives simply on the basis that independence issues might arise in the future. However, a current partner or member of staff should never be considered independent for these purposes and a proposal to appoint a former partner or employee, for example, would need to be subject to careful consideration.
Once appointed, independent non-executives will need to be sensitive to potential conflicts of interest, report them and ensure that they exclude themselves from any related decisions. For example, an independent non-executive who also sits on the board of a company which is considering appointing the audit firm as auditor, should recuse himself from any involvement in the tender process on either side.

Independent non-executives will also need to comply with relevant requirements such as insider dealing legislation in relation to information that they might become aware of through their involvement with a firm.