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# Audit Firm Governance Code

A review of its implementation and operation

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## Executive Summary

1. The major accountancy firms are of great importance to the UK economy, both as major businesses in their own right and through the impact they have on the broader health of the financial system.
2. Adoption of the Audit Firm Governance Code (“the Code”) is not a regulatory requirement, but the firms to which it applies have used it as a catalyst for improved governance of their businesses.
3. This report sets out our key findings and goes on to raise a number of questions. Our principal conclusions are that:
  - The quality of governance in the major firms is of considerable significance to investors and to the health of markets.
  - The firms have taken an important step forward in bringing in Independent Non-Executives. They have brought external challenge into the partnership model. The firms are in the main well ahead of their international comparators in taking this step.
  - However, there is scope for the action already taken to be built upon. The report suggests that the principle of external challenge be adopted in the international network organisations as well as at national level. It is also important as the firms grow their consultancy businesses that this challenge remains focused on the audit practice as well as across the firm as a whole.
  - As regards the Code itself we propose that it should more sharply define the public interest, particularly by explicitly recognising the importance of audit quality.
  - The Code should continue to be sufficiently flexible to allow firms to apply it in ways which best suit their governance structure.

## Introduction

4. The Code was introduced in January 2010. It applies to firms auditing 20 or more listed companies.
5. At the time of its introduction it was recommended that the implementation of the Code be reviewed after four years by the FRC. This report constitutes the first stage of that review. It describes how the Code has been implemented by the firms and discusses the wider context in which the Code operates. It goes on to detail the feedback we have received so far and concludes with a consultation on possible changes to the Code.

6. We have so far spoken with investor groups; with the ICAEW; with the chair of the original working group; and a number of Audit Committee Chairmen. We have also interviewed Independent Non-Executives and members of senior management from all seven firms to which the Code is currently applicable. We would like to thank everyone for their contributions to our review. However, we are conscious that so far our preliminary analysis relies on feedback from a relatively small group of stakeholders and we are interested in views from as many users of audit services and others as possible. Interested parties are invited to send any feedback to [s.currie@frc.org.uk](mailto:s.currie@frc.org.uk) by 28 August 2015.

## Development of the Code

7. In the wake of the collapse of Arthur Andersen, concerns arose about the preservation of an adequate supply of high quality audits in a highly concentrated market. A Market Participants Group (MPG) was formed to suggest market-based solutions.
8. One of its recommendations was for major audit firms to follow a UK Corporate Governance-style Code. The resulting Audit Firm Governance Code, 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.”*

9. Its specific intended benefits 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.
10. It was also thought that the Code would help firms adjust to developments such as regulatory change, falling trust in the profession, technical change and change in firm structures that were happening at the time and continue today.
11. The Code is principles-based, and those firms adopting it are expected to follow these principles. Compliance with each of the Code’s individual provisions is on a “comply or explain” basis. To deliver the expected benefits it includes provisions on governance and transparency under six headings:
- **Leadership** – The management of a firm should be accountable to the firm’s owners<sup>1</sup> and no individual should have unfettered powers of decision.

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<sup>1</sup> Usually its partners

- **Values** – A firm should perform quality work by exercising judgement and upholding values of integrity and objectivity in a way that takes the public interest into consideration.
- **Independent Non-Executives** – INEs should be appointed to provide an external voice in the firms to enhance commitment to the public interest in the firm's governance and decision making.
- **Operations** – Firms should provide for good quality regulatory compliance, risk management, people management and whistleblowing procedures.
- **Reporting** – Good quality public reporting by the firm is encouraged.
- **Dialogue** – Firms should reach out to listed company shareholders as well as the management of the companies and their audit committees.

12. At the time of its introduction the Code applied to eight audit firms:

- Baker Tilly
- BDO
- Deloitte
- EY
- Grant Thornton
- KPMG
- PKF
- PricewaterhouseCoopers

13. BDO and PKF have since merged, leaving seven firms within the scope of the Code. In addition a further firm, Mazars, has adopted the Code.

### **Link to the Corporate Governance Code**

14. In drafting the Code, the original Working Group had regard to the existing principles of the Corporate Governance Code and designed it around a similar structure. Whilst partnerships differ from listed companies and aspects of the Corporate Governance Code are not applicable, there are many provisions in the Corporate Governance Code which can easily be applied to many types of organisation. We discuss later in this report some aspects of the Corporate Governance Code which might translate effectively to audit firms.

### **Purpose and the Public Interest**

15. As part of this review the FRC seeks views on whether the purpose of the Code and the intended benefits remain valid. The Code establishes its principal purpose as working for the benefit of shareholders in listed companies. The FRC supports this. However, the Code also refers to the protection of the public interest in setting out the role of the INEs. It does so without being clear what the public interest is and whether it is synonymous with the shareholder interest. INEs and others have therefore sought clarity on how the public interest is defined, seeking to ensure the Code guides firms and INEs appropriately in their work in the public interest. This lack of clarity should be addressed.

16. The FRC proposes that the purpose of the Code should lie primarily in the promotion of high quality statutory audit in the interests of shareholders and in accordance with law and regulation. A quality audit is one that provides a high level of assurance that the financial statements comply with the law and financial reporting requirements or one that gives rise to an auditor's report that communicates the auditor's disagreement or restricted ability to opine. A high quality audit also complies with applicable laws, regulations and professional standards. Some of these professional standards, notably those relating to independence, are unique to audit. In considering the public interest firms should also be mindful of the societal value of audit.
17. The public interest also arises in other types of regulated work undertaken by the firms, for example insolvency, investment business and non-audit work which is required by law or regulation to be conducted by the auditor. Those charged with governance should have effective oversight over those parts of the business.
18. The Code should also promote good quality, soundly managed work outside of statutory regulation. This should be undertaken in such a way as to avoid undermining public confidence in the firm and hence in its audit work.
19. We welcome views on the above expression of the public interest in this context and whether it should be put into the Code. We recognise that defining the public interest is fraught with difficulty, and that there is a multiplicity of views as to its meaning. We also note that the question of public interest is being discussed in other fora, for example in relation to the development of Ethical Standards. We may not therefore reach a final answer through this consultation.
20. In considering wording on the public interest it also should be recognised that the spirit with which the public interest is pursued is as important as the definition. A legalistic and minimalist approach may preserve a firm from regulatory or legal challenge but will not build public confidence.

### **How the Code has been applied**

21. Many of the Code's provisions were already in place when it was introduced. Major audit firms had arrangements covering such matters as leadership, risk management, people development and an internal Code of Conduct.
22. The most significant changes the Code introduced were the provisions on:
  - The appointment of INEs;
  - Dialogue between audit firms and shareholders in listed companies.
23. Details of how each firm has implemented and reported on the Code can be found in the Appendix. Overall there are many similarities in the approach that each firm has taken but also some important differences, notably in respect of the positioning of INEs within the governance structure. This positioning often relates to each firm's broader governance structure and the respective responsibilities and accountabilities of the core executive management team and its oversight body, which is typically elected directly by the partnership.

24. There are two basic models:
- INEs sit on the Board or a similar governing body.
  - INEs sit on a separate public interest committee.
25. EY, due to its global governance structure, has a different approach involving the appointment of INEs at regional level and a global public interest committee.
26. In their transparency reports, almost all of the firms report on their attempts to engage in dialogue with shareholders in listed companies, making references to individual meetings with investors on particular matters; to stakeholder forums; and to informal discussions with institutional investors and others.
27. We understand from firms and investors, however, that these attempts at engagement have not always been successful and that the investor audience for such meetings is limited.

### **Has the Code achieved its purpose?**

28. As noted above the Code sought 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.
29. Underneath this purpose lay a number of objectives which fell into four broad categories:
- Improving firms' governance in order to support the provision of high quality work to give confidence to shareholders and improve the way they are run.
  - Increasing competition and choice in the audit market and helping to reduce the risk of a firm exiting the market.
  - Enhancing firms' reporting and transparency more broadly and enhancing their stature as visible examples of best practice.
30. We are keen to seek views on the extent to which the Code has achieved its stated purpose and delivered the above hoped-for benefits. Our preliminary views are as follows.

### **Governance**

31. The firms have clearly enhanced governance in recent years through the involvement of INEs, the creation of public interest committees and the development of other checks and balances on the way management runs the business. Internal processes for ensuring audit quality have improved at the same time and overall the FRC's inspections have shown the quality of individual audits has also improved. It is not possible to say how much of this is due to the Code, not least because of the extent of regulatory change that has occurred in parallel, but it is reasonable to conclude the impact has been beneficial. In particular, the widespread appointment of INEs and their active involvement in discussion and, in some cases decision-taking, at the highest levels is to be welcomed. Partnerships have many strengths but they can also

be introspective compared to a public company and so the fresh insight and challenge of external non executives is important.

32. There are, however, important aspects of the governance of the firms that warrant further consideration.
33. The role of the INEs certainly needs to be better understood by stakeholders. They are not directors comparable to NEDs on a public company unitary board. Nor do they share the rights and powers of partners. They are influential, often powerfully so, but are not capable of pushing through decisions. Investors must not be allowed to misunderstand their authority.
34. Similarly there is confusion about the INEs' purpose and to whom they are accountable. This needs to be clarified. We believe their role is to promote the public interest – hence, our focus on defining the public interest more clearly as proposed above.
35. Currently, the Code states that INEs' duty of care is to the firm. Some have suggested this is incompatible with the public interest. Others have suggested INEs should also be accountable to shareholders or to the FRC. We welcome the dialogue INEs have with the FRC. But that does not make them formally accountable to the FRC. We do not appoint them or approve their appointment. Nor can they be appointed by shareholders or audit clients. However, even if formal accountability outside the firm is not possible we believe boards, public interest committees and INEs should regard themselves as being accountable to the public and conduct themselves accordingly. That means ensuring there is high quality public transparency of their role and work so that they can be questioned and challenged and that if there is evidence of public disquiet they should respond to this. We welcome views on this.
36. As noted above the firms have adopted different public interest / governance structures in response to the Code, reflecting different organisational models. These are also permitted by the comply or explain basis of the Code. The FRC does not believe the Code should be prescriptive. However, the firms will not meet the Code's objective of creating investor confidence in governance unless they explain well why their model has been chosen and why it makes more sense for their firm than the alternatives. The firms have given the FRC strong arguments as to why they have adopted particular models but at present their public explanations are somewhat limited in this regard.
37. There are also certain features of governance that the FRC would wish to see in any structure. These concern governance at an international level and a high degree of focus on audit.
38. The major firms in the UK are entities within international networks. These networks enhance the firms' ability to work together with overseas partners to audit multinational business to a consistent standard. The network organisations have considerable influence over how the firms are run and have the ultimate sanction of removing a firm's brand. They exist both to raise standards and to protect national firms from contagion from litigation elsewhere in their world. Some investors therefore see their



role as ambiguous. Whether or not that is true they are certainly powerful and, as the firms globalise, will become more so.

39. Although there are a number of international bodies which are influential in standard setting and sharing national best practice in this area, the regulation of statutory audit itself remains on a national level. The network entities conduct no audit work themselves and hence are not subject to direct regulation. Nor have they generally developed governance structures of the kind envisaged in the Code, including INEs. The FRC therefore believes that it is imperative that the network organisations review whether their governance is fit for purpose and whether they should adopt some provisions of the Code. We are raising this with the network firms.
40. We do not, however, wish any such review to lead to a reduction of the quality of governance at national level. Audit will continue to be led and executed by national firms under national law and regulation. We strongly believe that even if greater globalisation takes place firms should ensure there is at national level a governance structure that can protect and account for both the performance of the firm as a whole and the performance of the audit division in relation to the protection of the public interest. To that end, we believe the firms should consider creating specific governance structures for their audit (and, perhaps, assurance) practices. Such structures should be in addition to the wider governance of the firm and should not replace it; for example, we believe that INEs should sit at the firm level as well as being part of audit-specific arrangements.
41. The FRC maintains a close dialogue with the management of each firm at senior partner and regulatory partner level covering the results of inspections and risk to the public interest. As noted above, we also meet INEs. We propose that in future the FRC should hold regular meetings with each firm's Board and public interest committee in addition to its ad hoc meetings with senior partners.

#### *Increasing choice and reducing the risk of a firm exiting the market*

42. A key driver in the development of the Code was concern about choice in the audit market and, post-Andersen, the risk of another audit firm failure. It was hoped that the existence of a governance code for major audit firms would help give large companies the confidence to consider a wider range of potential auditors and hence mitigate the concentration seen in this market<sup>2</sup>.
43. There is no indication, however, that the existence of the Code has had an impact on concentration in the audit market. Non-Big Four firms have not to date increased their market share within the FTSE 350.
44. Since the issue of the Code, the Competition and Markets Authority (CMA; formerly the Competition Commission) has conducted an investigation into the audit market for

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<sup>2</sup> Over 90% of FTSE 350 audits are conducted by the "Big Four" audit firms (Deloitte, EY, KPMG and PwC).

large companies and has proposed a number of remedies to address what it found to be adverse effects on competition. In its report the CMA made only a passing mention of the Code and it did not feature in any of the remedies.

45. Whilst there is little evidence that the existence of the Code has affected the structure of the audit market, improved governance structures may reduce the risk of a firm failing. Management and INEs should be better placed to identify potential issues before they become life-threatening. In addition, in the event that a crisis did occur, the presence of INEs provides regulators and others with a route to engage with the firms at a senior level in the event of a concern about the quality or integrity of a firm's executive management.
46. Firms are already required, under the statutory requirements for transparency reporting, to provide a description of their internal quality control system and a statement on the effectiveness of its functioning. We believe that the effectiveness of internal control requires strong leadership focus and that there is a case for the Code to be more specific about best practice and reporting in this area as in the guidance sitting alongside the Corporate Governance Code. Specifically we believe the firms should give clear assurances that they have addressed risk and make a longer term viability statement as now required of listed companies.

#### *Transparency reporting*

47. The Code states that firms should report on their compliance with it, or explain their non-compliance, in their transparency reports. Transparency reporting came into force in the UK in 2010, via a Statutory Instrument implementing one aspect of the Statutory Audit Directive.
48. Transparency reports are mandatory for all firms which audit one or more listed companies. This is a much wider population than is affected by the Code; around forty UK firms in total are required to produce transparency reports.

The FRC has previously reported on the quality of transparency reporting<sup>3</sup>. Those firms which apply the Code include additional disclosures on their compliance with it and several provide a reconciliation of these disclosures against each of the relevant Code provisions. Most also include a separate report from the INEs and/or the firm's public interest committee. Despite this we are not convinced that transparency reporting is drawing wider attention to the firms' governance arrangements.

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<sup>3</sup> <https://www.frc.org.uk/Our-Work/Publications/Professional-Oversight/Transparency-Reporting-by-Auditors-of-Public-Inter.pdf>

49. Details of the firms' most recent disclosures on their implementation of the Code are given in the Appendix. In general terms we found that the firms provided detailed and informative disclosures around Leadership, Values, INEs and Dialogue and that these disclosures were often framed in the context of the Code.
50. Disclosures around the Operations and Reporting principles were also detailed, but were sometimes less easy to locate and often did not make direct reference to the Code.
51. Most of the stakeholders we have spoken to felt that there was useful information in the transparency reports but also a lot of boilerplate and that they had become dull compliance documents which were not widely read. Some blamed the Statutory Instrument, arguing that its provisions encouraged tick-box compliance-focused reporting. Others pointed to internal templates set at network level which are required to be followed and which leave little room for national firms to develop their own reporting.
52. It is important to note that the requirements of the Statutory Instrument are intended to provide the minimum criteria on which firms should report. There is nothing to prevent firms from providing additional information and indeed we would encourage firms to do so.
53. A number of stakeholders suggested that the FRC could invigorate reporting and increase the visibility of the Code by highlighting particular disclosures by firms in our own publications. We will consider how we can best do so without turning the Code into a "comply" rather than comply or explain document.

## **Specific Questions**

54. In the light of the above a number of questions are set out below on which we would welcome views.

### *Purpose*

55. Firstly, and most importantly, is the stated purpose of the Code still valid?
56. The Code's objectives are wide. Some of them, particularly around competition, may be beyond the scope of a governance code. It is also clear that some aspects, notably the interaction between firms and investors, have been less successful than was hoped
57. Feedback from stakeholders highlighted the following:
  - The public interest must be central to the Code and the work of the INEs. Any changes to the Code should reinforce this.
  - The role of the INEs was seen as very important but there was a lack of clarity as to what this role should actually involve. A number of INEs noted that they had been

unclear as to their responsibilities when appointed and that it took some time to “find their feet” and grow into the role. There appears to be an appetite among INEs, firms’ management and in particular investors for greater clarity on the purpose of the Code and the role of the INEs in particular. The existing purpose may be too broadly stated. This is tempered by some reluctance on the part of the firms and INEs to have their role too tightly prescribed by the FRC.

- Investors are clear that they want the Code and INEs to focus on audit quality, and to reinforce the importance of independence and professional scepticism.

58. Based on our own observations and the feedback we have received we believe that the public interest in this context rests in:

- Firstly, and of greatest importance, audit quality.
- Secondly, the firm’s reputation more broadly; this involves oversight of the firm’s non-audit businesses. These 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.

59. In our view the purpose of the Code should be restated in order to reflect this.

Do you agree that the Code’s purpose should be redefined in this way?
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### *Safeguarding audit quality*

60. There is a public interest in many of the services provided by the audit firms as well as in the firms themselves; they are major employers and contribute significantly to the UK economy. However, the public interest arises most acutely in their audit work.

61. Audit, as a mature market, has remained a relatively stable source of firms’ revenue for many years. That contrasts with the high growth rate in many firms’ consultancy practices. In some firms less than a quarter of their revenue is now derived from audit. This has led to some concern amongst regulators, INEs and investors alike about the impact on the firms’ culture and future strategy; concern which has been heightened by the acquisition of consulting businesses by some audit firms. The management of the firms continue to state the importance of audit to their business but there is a question as to how long this can continue given the growth in consultancy work.

62. Some INEs compared the culture of the consultancy businesses in the firm negatively with that of the audit practice and others queried how long the firm could survive in its current form without splitting into two. Audit quality depends on the firm promoting integrity, scepticism and independence from clients. These values do not apply to the same degree to consultancy work.

63. One way of safeguarding audit quality, the culture associated with the audit practice and the importance of audit within the wider business might be to ring fence the audit

practice to some extent. This could include the creation of separate audit-only governance structures that are specific to audit and the introduction of specific responsibilities for INEs in relation to audit quality.

64. Firms and INEs were sceptical of this suggestion, arguing that in order to preserve and enhance audit quality, INEs should actually focus on the firm as a whole. This is because as a threat to the reputation of audit business is more likely to arise outside of audit where some work (eg corporate finance) is inherently risky. Concerns were also raised that separating governance arrangements in this way risked encouraging the separation of the audit business's culture and that of the consultancy practice. Further, if INEs found their role limited to oversight of the audit practice, there is a risk that public interest matters arising outside of that area will not come to their attention.
65. It was noted that the direction of travel elsewhere, eg in banking, has been to work to embed a single ethical culture throughout the organisation and that this may be more difficult if different governance arrangements apply to audit.

Should there be separate governance arrangements for audit? What might such arrangements look like?
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66. Regardless of the precise nature of the governance arrangements in place, if audit quality is to be safeguarded there needs to be an appropriate "tone at the top" and a strong culture of ethics and professionalism in place. There is evidence from AQR inspections that firms can have a strong tone at the top and high quality processes but that these do not always translate to the work being done on every engagement or to the behaviour of individual partners and staff.
67. The importance of the "tone at the top" and the responsibilities in this regard of the leadership of audit firms are reflected in the FRC's Ethical Standards for auditors. The FRC is currently reviewing these standards and considering how the ethical principles set out within them can be reinforced and clarified. This includes the responsibility of the senior management of the firm to instil the necessary culture and behaviours throughout the firm so as to ensure that compliance with the ethical principles is paramount and the public interest supersedes all commercial interests of the firm. Proposed changes to these standards will be consulted on in due course.
68. We believe that the Code could also be used to help embed firms' tone at the top and push this tone further down the organisation. The Code already makes reference to the importance of tone at the top but it should be possible to enhance this section, perhaps by including specific requirements for firms to report in more detail on how this is cascaded throughout the organisation.

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

69. All of the major audit firms are part of international networks and the UK national firms have varying degrees of autonomy within each of the global structures.
70. As noted above only a handful of other jurisdictions have introduced similar governance requirements for audit firms. We believe that there is considerable merit in other major territories introducing their own governance arrangements, and also for aspects of the Code to be picked up at network level. However, we recognise that there are challenges in doing so.

Do you agree that the concept of the Code should be spread elsewhere in the world? How might this be achieved?
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71. In the case of some firms, notably EY, the UK partnership has limited ability to influence the future direction of the firm, with most strategic decisions being taken at a regional or global level. At the same time the regulation of audit and auditors is the responsibility of national authorities.
72. In the case of EY INEs are appointed at a global level and only one is UK-based. Mazars, which applies the Code voluntarily, has appointed INEs at a European level and neither of them is UK-based.
73. We have no criticism of current INEs but we do see risks in having decision-making and governance arrangements for UK-based firms conducting UK statutory audits taking place overseas. We will give further thought to this issue in the coming months.

#### *Role of the INEs*

74. INEs, even if they sit on the management board, are not direct equivalents of NEDs at a corporate. Their public interest responsibilities are unique in this context.
75. Given that INEs do not correspond exactly to NEDs, “Independent Non-Executive” may not be the right term. Corporates often have advisory boards comprised of external individuals who provide advice to the board as well as fulfilling an ambassadorial role. We considered whether INEs, particularly those who do not sit on the firm’s main Board, were similar to advisory board members, but what makes INEs unique is their public interest responsibility.
76. Investors stressed the importance of INEs being, and being seen to be, independent. The existing Code notes the need for any firm which applies it to address two independence issues:
- The relationship between the INE and an entity audited by the firm
  - The relationship between the INE and the firm itself and/or its owners (ie its partners)
77. We found that firms and INEs took independence seriously and, where a potential independence issue arose, would take steps to ensure that appropriate safeguards were in place. However a small number of situations which are not directly addressed by the Code currently have arisen, for example:

- A firm appointed a serving partner as an INE. This is not explicitly addressed by the Code although it does note the need for careful consideration if the appointment of a former partner is being considered.
- A firm tendered for the audit of a listed company of which one of its INEs also served as a NED. The INE took no part in the selection of the audit firm and resigned from the INE position when the firm was appointed.

78. We believe that the Code should be amended to address these situations and will address these specific issues in a future draft.

79. If INEs are to enhance public and shareholder confidence in their audit firms, their independence needs to be considered more broadly. It is important that they are not seen to act as advocates for the firms rather than as guardians of the public interest. In this context we would also note that there is a view that the wider partnership acts as a check on the executive leadership taking a wrong turn, and therefore INEs' interaction with the firm's partners as a whole should not be neglected. This interaction can help to safeguard the public interest.

80. One area where we believe there may be room for improvement is in the appointment process for INEs. Most are currently appointed by the firm's executive management, perhaps with the assistance of recruitment consultants, and their appointment may, or may not, be approved by the wider partnership. Investors have indicated that they would like to have some input into the appointment process although the precise mechanics of any such input remain unclear and may be difficult to achieve in practice. Firms could, however, consider discussing with investors their approach to the appointment process and the key attributes they are looking for in new INEs.

How might the independence of INEs be protected and demonstrated?

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 into an audit firm's appointment of INEs?

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

81. The provisions of the Code differ from and are in most respects less demanding than those of the Corporate Governance Code. We believe it would not be appropriate to import the Corporate Governance Code wholesale to audit firms because the risks and governance issues affecting owner-managed businesses are quite different to those which have large numbers of external shareholders.

82. That said there are aspects of the Corporate Governance Code and of corporate governance good practice more broadly which, given the significance of the audit firms to the markets, which may if applied enhance confidence in the Code, and in the role of INEs. For example:

- The inclusion in firms' transparency reports of a viability statement providing an assessment of long term solvency and liquidity
- Term limits on INEs' appointment
- Transparency around the remuneration of INEs
- A minimum number of INEs per firm
- 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

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?
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### *Accountability*

83. The question of accountability, particularly in the context of INEs, was raised on a number of occasions. If INEs were the direct equivalents of NEDs at a corporate then their role would be to represent, and be accountable to, the owners of the business ie the wider partnership. However INEs, even if they sit on the management board, are not the direct equivalents of NEDs. In particular, there is a lack of clarity as to whom INEs are accountable. The Code states that the INEs' duty of care is to the firm and yet their responsibility is to the public interest. One INE indicated that he saw his line of accountability as being to the regulator.

84. As the UK's lead audit regulator we meet directly with INEs both collectively and individually. We find this valuable and feedback from INEs indicates that they also welcome this direct dialogue with us. However the Code does not currently require INEs to engage directly with the FRC or to "whistleblow" to us or other regulators. We welcome views on the extent to which such a duty might be reflected in the Code.

85. One way to encourage accountability is through greater transparency. Despite some of the negative feedback we have received about transparency reports, including their limited audience, we believe that there are ways in which reporting in this way can drive accountability.

86. Transparency reports could be enhanced by the inclusion of success measures or key performance indicators of some sort and a report of the firm's performance against them. It has also been suggested that INEs should report specifically on what they have done during the year to discharge their public interest responsibilities. This might be via the transparency report or in a separate letter to the FRC which we would publish.



87. The firm's management might also be asked to confirm that in their opinion the Transparency Report is "fair, balanced and understandable" similarly to governance reporting by listed companies.
88. As noted above transparency reports could include of a viability statement concerning the firm's long-term liquidity and solvency. The statement could be made jointly by management and INEs.

To who should the boards, INEs and public interest committees be accountable? How should this accountability be discharged, including to the FRC?

Should the Code include specific provisions on the firms' Boards and Public Interest bodies engaging with and disclosing certain matters to regulators?

Is greater transparency sufficient? What else can be done?

#### *Other issues*

89. Currently the Code was created for firms which audit more than 20 listed companies and has been adopted by the seven largest audit firms plus one other. There are around 40 other firms which audit listed companies.
90. Increasing the reach of the Code to a wider group of firms may help to raise confidence in the profession as a whole, but we are also conscious of the need to ensure that regulation is applied in a proportionate manner.

Should the Code be applied to a wider group of firms?

91. The Code was published jointly by the ICAEW and FRC following extensive work by the ICAEW and others. The feedback we have received to date is 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. The FRC will also continue to act as a convenor of meetings with INEs and to meet with INEs individually about matters of concern.

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

Do you have any further comments on any of the issues raised in this report?

**APPENDIX – IMPLEMENTATION OF THE CODE BY FIRM**

	<b>Leadership</b>	<b>Values</b>	<b>INEs</b>	<b>Operations</b>	<b>Reporting</b>	<b>Dialogue</b>
<b>Baker Tilly</b>	<p>Baker Tilly in the UK is made up of a number of limited liability partnerships. The audit business is contained within Baker Tilly UK Audit LLP.</p> <p>The main governance body for Baker Tilly UK Audit LLP is the Management Board. The Board is elected by the members of the LLP from candidates approved by the Baker Tilly UK Group.</p> <p>Day to day management of Baker Tilly UK Audit LLP is done by the Audit Management Team</p>	<p>On its website Baker Tilly details its five core values. It also links to its Code of Business Conduct</p>	<p>Baker Tilly’s two INEs sit on a Public Interest Committee along the with firm’s Ethics Partner.</p> <p>This is a relatively new arrangement; for the first three years of operation Baker Tilly’s INEs (which at the time included the current Ethics Partner) sat on the Management Board of Baker Tilly UK Audit LLP.</p> <p>Describing the Ethics Partner as an INE was criticised by the AQR and following this, Baker Tilly changed its approach.</p> <p>Although the INEs no longer sit on the Management Board they do attend meetings where they will contribute to the discussion of ethical/risk/quality issues but do not take part in the decision-making.</p>	<p>The firm’s transparency report addresses the matters listed under the Operations principle although they are not described in those terms</p>	<p>The firm’s public reporting covers the Code’s Reporting principles although it does not provide a specific statement on the firm’s compliance or otherwise with the Code’s provisions, although there is a statement concerning the PIC’s commitment to the Code</p>	<p>In its 2014 transparency report Baker Tilly UK Audit LLP lists engagement with external stakeholders, including shareholders, as being amongst the duties of the INEs</p>

	<b>Leadership</b>	<b>Values</b>	<b>INEs</b>	<b>Operations</b>	<b>Reporting</b>	<b>Dialogue</b>
<b>BDO</b>	<p>BDO's Leadership Team functions as the main Board of the firm. The Leadership Team is appointed by the Managing Partner and approved by the Partnership Council. It comprises seven executives as well as BDO's two INEs.</p> <p>Oversight of management is provided by the Partnership Council, which comprises twelve elected partners plus the Senior and Managing Partners and two representatives from the Leadership Team, who may attend at the invitation of the Managing Partner.</p> <p>BDO also has a Public Interest Committee (PIC), consisting of the INEs and the Ethics Partner. The role of the PIC is to consider public interest matters which</p>	<p>In its transparency report BDO lists its core values in the context of the culture of the firm. The firm makes reference to an internal code of conduct, the whole of which does not appear to be on its website, although there is a page discussing the values in more detail.</p>	<p>BDO was the first firm to appoint INEs, doing so in 2008 (ie two years before the Code was published). Currently there are two INEs, both of whom sit on the Leadership Team.</p> <p>INEs also sit on BDO's Public Interest Committee, together with the firm's Ethics Partner.</p> <p>One of the INEs sits on the firm's Risk &amp; Quality Committee.</p>	<p>BDO's transparency report covers the relevant issues under the Code's Operations principle</p>	<p>BDO's public reporting covers the Code's Reporting principles</p>	<p>The firm reports that its representatives have met informally with listed companies and their shareholders. Partners have also met with institutional shareholders in an attempt to understand their needs</p>

	<b>Leadership</b>	<b>Values</b>	<b>INEs</b>	<b>Operations</b>	<b>Reporting</b>	<b>Dialogue</b>
	affect the firm and enhance stakeholder confidence in the public interest aspects of the firm's activities					
<b>Deloitte</b>	<p>Deloitte's primary governance body is the Board of Partners, which determines the firm's strategy, provides oversight of management and protects partners' interest. The Chairman, CEO, INEs and eleven elected partners all sit on the Board of Partners.</p> <p>Implementation of the firm's strategy and policy, and its day to day management, is the responsibility of the Executive Group</p>	In its transparency report Deloitte refers to the values of "integrity, respect, fairness, objectivity and accountability". Deloitte's "Ethics Code" is available on its website	<p>Deloitte's INEs all sit on the Board of Partners. Through their role on the Board of Partners the INEs are involved with all aspects of the firm's management and governance. An INE attends every audit committee meeting and an INE sits on the Board subcommittee which considers FRC and PCAOB reports on the firm.</p> <p>In addition to their role on the Board of Partners, the INEs also form a separate Public Interest Oversight Board which considers governance and ethical issues and forms a channel for communication with external stakeholders. One of Deloitte's three INEs has now stepped down; a replacement will be appointed</p>	Deloitte's transparency report covers its arrangements, policies and procedures for each of the provisions of the Operations part of the Code.	Deloitte's public reporting covers the majority of the Code's Reporting principles although its 2014 transparency report did not provide a specific statement on its compliance or otherwise with each of the provisions of the Code	Over the past few years Deloitte has organised stakeholder forums to discuss audit quality and governance and regulatory issues. The firm also reports separate discussions with "key investors" and other market participants

	<b>Leadership</b>	<b>Values</b>	<b>INEs</b>	<b>Operations</b>	<b>Reporting</b>	<b>Dialogue</b>
<b>EY</b>	<p>EY in the UK is controlled by EY Europe. A UK Board remains and has authority for operational management in the UK. It is appointed by the Europe Executive (effectively the EY Europe Board).</p> <p>The Europe Executive is advised by the Europe Advisory Council, which is elected by partners within the European region</p> <p>Co-ordination of EY's global strategy is done at network level by EY Global. There is exists a Global Executive and a Global Advisory Council (GAC)</p>	<p>EY's transparency report discusses its three core values and its Global Code of Conduct, which is available on its website</p>	<p>EY has appointed INEs on a global basis, with four (formerly five) non-executives from across the world sitting on the GAC.</p> <p>One of the INEs is UK-based and it is him who will engage with the FRC on audit-related matters</p> <p>EY globally recently established a Governance Working Group and one recommendation from the Group was to set up a separate Public Interest Sub-Committee on which all INEs will sit</p>	<p>EY's transparency report covers the topics set out under the Operations principles, although it is not structured in this way</p>	<p>EY's public reporting covers the majority of the Code's Reporting principles although its application of the internal reporting principle is not explicit. Its 2014 transparency report does not provide a specific statement on its compliance with each of the provisions of the Code.</p>	<p>EY reports meeting regularly with stakeholders, including investors. In its transparency report specific examples of investor engagement are given</p>
<b>Grant Thornton</b>	<p>Grant Thornton's principal leadership and governance bodies are the National Leadership Board (NLB), which is an executive body</p>	<p>Grant Thornton's values are described in the terms of its Code of Conduct – this can be found on</p>	<p>Grant Thornton has three INEs. They sit on the firm's POB and least one INE sits on all POB standing and <i>ad hoc</i> subcommittees.</p>	<p>The firm's transparency report sets out the details of its policies and procedures under each of the Operations principles.</p>	<p>The 2014 transparency report appears to cover the provisions under the Code's</p>	<p>Grant Thornton reports that its Head of External Professional Affairs chairs a global body consisting of investor and auditor</p>

	<b>Leadership</b>	<b>Values</b>	<b>INEs</b>	<b>Operations</b>	<b>Reporting</b>	<b>Dialogue</b>
	charged with developing and implementing the firm's strategy; and the Partnership Oversight Board (POB) which oversees the NLB and protects the interests of the partners. The POB consists of eight members elected from the partners, three INEs and three <i>ex officio</i> members	the website	All of the INEs sit on Grant Thornton's newly constituted profit share committee. This does not judge the quantum of an individual partner's profit share but does look at the process and queries any outliers.		Reporting principle, although they are not described in those terms. The key which maps the Code to the transparency report does not include anything under this section	representatives. In addition, one of the firm's INEs meets periodically with representatives of major UK institutional shareholders
<b>KPMG</b>	The main governance body for KPMG in the UK is its Board. The Board consists of the Senior Partner, the Chief Operating Officer /Head of People, the Head of Quality & Risk Management and six Non-Executive members. "Non-Executive" in this context means partners in the firm who are not part of the executive management of the firm.	KPMG has a Code of Conduct which is disclosed on its website. The Code of Conduct sets out KPMG's Values and the "standards of ethical conduct" expected from partners and staff.  The firm's 2014 transparency report also discusses the importance of "Tone at the Top" in providing a focus on quality	KPMG has recently changed its European structure in favour of national firms and has appointed three new INEs as a result. One INE from the previous structure remains.  The INEs do not sit on the Board but instead form a separate Public Interest Committee (PIC). One of the INEs will however usually attend the firm's monthly Board meetings and there are joint Board/PIC strategy sessions.	In its 2014 transparency report KPMG sets out in some detail its key operational arrangements and relevant policies and procedures. The Board confirms that the firm has complied with the provisions of the Code	KPMG publishes its financial statements in its annual report. All other external disclosures referenced under the Reporting principle are made in the annual report or the transparency report. The transparency report confirms that key governance bodies, including the PIC, receive	KPMG reports that members of the PIC and the firm's leadership team meet with investors to discuss audit-related matters as well as the operation of the Code and the priorities of the INEs.

	<b>Leadership</b>	<b>Values</b>	<b>INEs</b>	<b>Operations</b>	<b>Reporting</b>	<b>Dialogue</b>
	<p>Management of the day-to-day activities of the firm is undertaken by the Executive Management Team.</p> <p>There is a separate Public Interest Committee (PIC) consisting of the firm's INEs.</p>		<p>Currently there is no INE representation on any of the firm's other major committees or subcommittees although the PIC meets regularly with the Audit and Risk Committee.</p>		<p>timely and relevant information to allow them to fulfil their duties.</p>	
<b>Mazars</b>	<p>The UK Executive Board is responsible for setting the UK strategy in the context of the firm's international strategy (Mazars being a global integrated partnership).</p> <p>An elected Governance Council reviews certain processes and approves others, It also ensures that the Executive Board has appropriate management structures in place and has identified and is managing major risks.</p>	<p>Mazars' values are set out on its website in a document called the "Mazars Way"</p>	<p>The PIC consists of two INEs. It provides oversight at a group level and also has direct engagement with senior management of the UK partnership</p>	<p>In its transparency report Mazars sets out its policies and procedures under the majority of the Operations principles. The firm's arrangements around whistleblowing are set out on their website</p>	<p>Mazars transparency report appears to cover the provisions under the Code's Reporting principle. The report states that the UK firm complies with the provisions of the Code in all material respects.</p>	<p>Mazars reports regular contact with institutional investors and signals its readiness to engage with institutional investors on matters covered by the Audit Firm Governance Code</p>

	<b>Leadership</b>	<b>Values</b>	<b>INEs</b>	<b>Operations</b>	<b>Reporting</b>	<b>Dialogue</b>
	A Public Interest Committee (PIC) has been created at group level to provide oversight of aspects of the firm's management					
<b>PwC</b>	PwC describes its governance structure as being made up of three main elements: an Executive Board responsible for developing the policies and strategies of the firm and for its direction and management; a Supervisory Board which oversees the Executive Board and represents the interests of the partners; and a Public Interest Body (PIB) focusing on the public interest and reputational issues.	PwC describes its values in terms of quality, ethical behaviour and a culture of partnership with a strong commercial focus. The firm publishes its Code of Conduct on its website	PwC has four INEs (there were previously five but one resigned when PwC gained the audit of a company of which he was Chairman). They sit on a PIB, together with representatives from the Executive and Supervisory Boards. The PIB meets quarterly for all day meetings. INEs form a majority of the PIB's membership.	PwC's 2014 transparency report includes detailed information under each of Code's Operations principles. The Executive Board confirms the firm's compliance with the provisions of the Code.	All external disclosures required under the Code are made in PwC's transparency report and/or its annual report. The firm reports that its governance bodies receive timely and appropriate information to enable them to discharge their duties	The firm reported in 2014 that independent members of the PIB, along with the Head of Assurance, had participated in a meeting with representatives from institutional shareholder organisations and had also met some shareholder representatives on an individual basis





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