



THE INSTITUTE
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IN ENGLAND AND WALES



THE AUDIT FIRM GOVERNANCE CODE

A PROJECT FOR THE FINANCIAL REPORTING COUNCIL

Audit Firm Governance
Working Group
Chairman: Norman Murray
January 2010

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INTRODUCTION

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

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

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

Background and approach

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

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

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

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

The Working Group decided that for the purposes of the Code, public interest entities should be defined as UK companies listed on the London Stock Exchange's Main Market. This is in line with the definition used in UK legislation to implement EU requirements for audit firm transparency reports. The Working Group recommends that the Code should initially apply to firms which audit more than 20 listed companies.

Intended benefits of the Code

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

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

Features of the Code

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

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

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

The Working Group also appreciates that the audit firms are professional practices and have professional obligations which already include a requirement to act in a way that properly takes the public interest into consideration. The Code refers to these obligations which need to be upheld by all members of a firm's management team and governance structures.

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

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

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

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

The Code in practice

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

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

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

Implementation

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

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

Audit Firm Governance Working Group

January 2010

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

A LEADERSHIP

A.1	Owner accountability principle
	<p>The management of a firm should be accountable to the firm's owners and no individual should have unfettered powers of decision.</p>
	<p>Provisions</p>
A.1.1	<p>The firm should establish board or other governance structures, with matters specifically reserved for their decision, to oversee the activities of the management team.</p>
A.1.2	<p>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.</p>
A.1.3	<p>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.</p>
A.1.4	<p>The firm's governance structures and management team and their members should be subject to formal, rigorous and on-going performance evaluation and, at regular intervals, members should be subject to re-election or re-selection.</p>

A.2	Management principle
	<p>A firm should have effective management which has responsibility and clear authority for running the firm.</p>
	<p>Provision</p>
A.2.1	<p>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.</p>

B VALUES

B.1	Professionalism principle
	<p>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.</p>
	<p>Provisions</p>
B.1.1	<p>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.</p>
B.1.2	<p>The firm should have a code of conduct which it discloses on its website and requires everyone in the firm to apply.</p>

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 who through their involvement collectively enhance shareholder confidence in 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.
	Provisions
C.1.1	Independent non-executives should: 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.
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.
	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 of independent non-executives principle
	<p>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.</p>
	<p>Provisions</p> <p>C.3.1 Each independent non-executive should have a contract for services setting out their rights and duties.</p> <p>C.3.2 The firm should ensure that appropriate indemnity insurance is in place in respect of legal action against any independent non-executive.</p> <p>C.3.3 The firm should provide each independent non-executive with sufficient resources to undertake their duties including having access to independent professional advice at the firm’s expense where an independent non-executive judges such advice necessary to discharge their duties.</p> <p>C.3.4 The firm should establish, and disclose on its website, procedures for dealing with any fundamental disagreement that cannot otherwise be resolved between the independent non-executives and members of the firm’s management team and/or governance structures.</p>

D OPERATIONS

D.1	Compliance principle
	<p>A firm should comply with professional standards and applicable legal and regulatory requirements.</p>
	<p>Provisions</p> <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p>

D.2	Risk management principle
	A firm should maintain a sound system of internal control and risk management over the operations of the firm as a whole to safeguard the owners' investment and the firm's assets.
	Provisions
D.2.1	The firm should, at least annually, conduct a review of the effectiveness of the firm's system of internal control. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.
D.2.2	The firm should state in its transparency report that it has performed a review of the effectiveness of the system of internal control, summarise the process it has applied and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in its financial statements or management commentary.
D.2.3	In maintaining a sound system of internal control and risk management and in reviewing its effectiveness, the firm should use a recognised framework such as the Turnbull Guidance and disclose in its transparency report the framework it has used.
D.3	People management principle
	A firm should apply policies and procedures for managing people across the whole firm that support its commitment to the professionalism, openness and risk management principles of this Audit Firm Governance Code.
	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	Financial statements principle
	A firm should publish audited financial statements prepared in accordance with a recognised financial reporting framework such as International Financial Reporting Standards or UK GAAP.
	Provisions
E.2.1	The firm should explain who is responsible for preparing the financial statements and the firm's auditors should make a statement about their reporting responsibilities.
E.2.2	The firm should report that it is a going concern, with supporting assumptions or qualifications as necessary.
E.3	Management commentary principle
	The management of a firm should publish on an annual basis a balanced and understandable commentary on the firm's financial performance, position and prospects.
	Provision
E.3.1	The firm should include in its management commentary its principal risks and uncertainties, identifying those related to litigation, and report how they are managed in a manner consistent with the requirements of the applicable financial reporting framework.
E.4	Governance reporting principle
	A firm should publicly report how it has applied in practice each of the principles of the Audit Firm Governance Code excluding F.2 on shareholder dialogue and F.3 on informed voting and make a statement on its compliance with the Code's provisions or give a considered explanation for any non-compliance.
	Provision
E.4.1	The firm should publish on its website an annual transparency report containing the disclosures required by Code Provisions A.1.2, A.1.3, C.2.1, D.1.3, D.2.2 and D.2.3.

E.5	Reporting quality principle
	A firm should establish formal and transparent arrangements for monitoring the quality of external reporting and for maintaining an appropriate relationship with the firm's auditors.
	Provision
E.5.1	The firm should establish an audit committee and disclose on its website information on the committee's membership and terms of reference which should deal clearly with its authority and duties, including its duties in relation to the appointment and independence of the firm's auditors. On an annual basis, the firm should publish a description of the work of the committee in discharging its duties.

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 C.1 on the involvement of independent non-executives refers to the three areas of decision making, management of reputational risks and stakeholder dialogue, where independent non-executives can build on the strengths of 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

Those with an interest in the quality of an audit firm's work will be aware that the involvement of regulators is largely after the event and that reports on the results of inspections will only be published after completion of due process. Reassurance about a firm's current performance is difficult to achieve.

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 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 can be a witness to a firm's commitment to the public interest.

Management of reputational risks

The ability of a firm to maintain its presence in the listed company audit market is dependent to a significant degree on the benefits to its reputation of being subject to effective audit regulation. However, ineffective regulation and non-audit business, much of it subject to little regulatory supervision, can have a significant adverse impact on a firm's reputation and the sustainability of its audit business. There are also risks associated with audit and non-audit work performed by other firms in the same network.

Whole firm procedures performed by audit regulators and improved international regulatory co-ordination can be expected to mitigate some of these risks 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 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

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

to the firm's leadership. Even the best-run audit firm may find it easier to respond to issues in a constructive fashion where they are raised through independent non-executives.

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

APPENDIX 2

Independence considerations

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

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

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

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

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

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

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

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

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

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

APPENDIX 3

Working Group members and terms of reference

Members of the Audit Firm Governance Working Group

Norman Murray (Chairman)	Chairman, Cairn Energy PLC
Jan Babiak	Non-Executive Director, Logica plc (from 1 January 2010) Partner, Ernst & Young LLP (retired 31 December 2009)
Anthony Carey	Partner, Mazars LLP
Richard Delbridge	Senior Independent Non-Executive Director, Tate & Lyle PLC
John Griffith-Jones	UK Chairman and Senior Partner, KPMG LLP (UK)
Archie Hunter	Non-Executive Director and Chairman of the Audit Committee, The Royal Bank of Scotland Group plc
Huw Jones	Director of Corporate Finance, M&G Investment Management
Guy Jubb	Investment Director, Head of Corporate Governance, Standard Life Investments
Professor Sir Andrew Likierman	Dean, London Business School
Andrew Moss	Group Chief Executive, Aviva plc
Richard Murley	Managing Director, Rothschild
Jeremy Newman	Chief Executive, BDO International
Observer	Chris Hodge, Head of Corporate Governance Unit, FRC
Project Director	Robert Hodgkinson, Executive Director, Technical, ICAEW
Project Manager	Jonathan Hunt, Head of Corporate Governance, ICAEW

Terms of reference

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

