

RSM response to AFGC 2022 Consultation (including sections applicable to each consultation question)

1. Application and purpose

Purpose of the Code

Audit is a statutory function in which there is considerable public interest. High-quality, reliable audit depends on well-governed, stable and resilient firms consistently delivering high-quality work. This Code is intended to enhance trust and confidence in audit amongst stakeholders and across the market as a whole.

The Code provides a framework for good governance practice against which firms that audit PIEs can be assessed and report. Its principal objectives are:

- to promote audit quality;
- to ensure firms take account of the public interest in their decision-making, particularly in audit; and
- to safeguard the sustainability and resilience of audit practices and of firms as a whole.

The Code is intended to benefit stakeholders with an interest in the reliable performance of high-quality audit, including:

- investors and shareholders in PIEs;
- audited entities, particularly PIEs, and their partners, employees, suppliers and customers;
- directors, particularly audit committee members, with responsibilities for the appointment of auditors and the effectiveness of audit; and
- regulators.

The Public Interest

The public interest is an abstract concept for which there is no single definition. Its meaning depends on the context. The public interest can be described as being about putting the common good and wellbeing of society above the interests of an individual or a small group of individuals. This meaning resonates across a range of different contexts.

In the context of audit, the consistent performance of high-quality audits is in the public interest because they promote the efficient functioning of capital markets in the UK, lowering the cost of capital. Reliable corporate reporting allows market discipline to work. More broadly, it underpins public trust and confidence in the market economy. Whether or not audit firms are operating in a manner which supports the consistent performance of high-quality audits is therefore a matter of public interest. Other matters of public interest in this context include the ability of companies to find an auditor able to deliver high-quality audit services and the resilience of the audit market as a whole. Independent non-executives have a unique role. They are not directors of the business or responsible for its strategy or performance. Independent non-executives represent the public interest and provide counsel and challenge in respect of a firm's activities from that perspective. This means acting for the benefit of the common good, not necessarily in the interests of the firm's owners (the partners), although those interests may often be aligned. Independent non-executives generally do not have voting rights or make decisions.

An integral part of the role of independent non-executives is to reflect and form views on what the public interest means in the context of audit and the activities of the firm as a whole. It is their job to help the firms to identify where the public interest in its activities is engaged and to ensure the firm is taking the public interest into account in its decision-making and how it operates.

Q.1: How appropriate do you feel that the revised purpose of the proposed 2022 Code is?

We agree with the main objectives of the revised purpose namely promoting audit quality, taking account of the public interest and safeguarding the sustainability and resilience of the audit practice.

Whilst the public interest is defined within the proposed Code with reference to audit it is not so clear how the public interest should be taken into account by the wider firm (to which the Code will apply).

The intention of the 2010 version of the Code was two-fold: to protect (i) the audit firm and (ii) audit quality produced by the firm. There is a clear and comprehensible public interest in both respects, and another in respect of anything done by the wider firm and its network that might affect the audit firm, but this third manifestation of the public interest does not mean that there is a residual public interest in the broader firm and its network *per se*, only in the potential for either to damage the audit firm.

This is an important distinction to appreciate, particularly as regards the obligations of INEs: the scope of those obligations is well understood in so far as the audit firm is concerned and the expectation raised by the revised Code should not include the same depth of involvement in the remainder of the firm – the revised Code gives a greater degree of emphasis on INEs' communication and real-time involvement with management decision-making that would be very difficult to replicate across the whole firm.

Audit firms' resilience and capacity to resist damage occurring in other service-lines is enhanced by modern governance structures (the Operation Separation principles are one means of achieving resilience-proofing but there are others which in their nature and design achieve the same end) and this should be borne in mind when ascribing duties to INEs in this respect.

This understanding is implicit in the consultation: "*An integral part of the role of independent non-executives is to reflect and form views on what the public interest means in the context of audit and the activities of the firm as a whole.*" We support this conclusion but the Code should give more guidance to assist INEs in assessing what it means in practice.

2. Thresholds for application

The Code makes the following assumptions:

- that all firms within its scope are subject to the International Standards of Quality Management (UK); and
- that all firms within its scope are established under the Limited Liability Partnerships Act (2000) or under the Companies Act (2006) and are subject to the associated statutory requirements.

Application Scope

The scope of this Code is firms that audit PIEs. The FRC encourages all such firms to adopt this Code voluntarily and expects firms to apply it once they audit 20 or more PIEs or if they audit one or more FTSE 350 companies. Where the number of PIE audits conducted by a firm applying this Code drops below 10 and a firm does not audit any FTSE 350 companies, it may cease to apply this Code. Firms that do not meet these thresholds and who apply the Code, may choose to apply it in a manner proportionate to their size and the nature of the entities they audit.

Note:

The thresholds we have proposed are based on the current definition of a PIE:

- *entities whose transferable securities are admitted to trading on a regulated market;*
- *credit institutions; or*
- *insurance undertakings.*

The BEIS consultation, 'Restoring trust in audit and corporate governance', proposed extending the UK's definition of PIEs to "include large companies within certain limits regardless of whether they are admitted to trading on a regulated market".

Q.2: What are your views on the proposed thresholds for application of the proposed 2022 Code?

We believe the thresholds are sensible and will help to strengthen audit firm governance. RSM currently voluntarily applies the Code and does so to the full extent of its coverage. Any numerical mechanism bringing firms into scope is bound to be arbitrary but we think that the proposed thresholds represent a proportionate application of obligation.

Q.3: Should the proposed 2022 Code apply to any firm that audits a FTSE 350 company? Please suggest alternatives.

We believe the 2022 Code should apply to any firm that audits a FTSE 350 company. It is hard to articulate any justification for allowing an audit firm not to apply the Code simply on the grounds of the uniqueness of such an appointment among the generality of its client-base – a derogation based on the firm's overall profile would be inappropriate. However, it should be added that the Code needs to be cognisant of the audit market concentration-reduction objective among the FRC's terms of reference, highly likely to be replicated under the nascent ARGAs: that objective will necessarily involve recognition of the need to help smaller firms 'bridge into' active participation in the PIE market, perhaps by extending the regulator's educative function and in that way giving living expression to the 'improvement regulator' and Proportionality narratives that both Kingman and Brydon believed should underscore its activities.

A legitimate further justification for such a 'gradualist' approach is aspiring audit firms' own economic interests, especially given that the widening of the PIE definition may induce firms to feel that they have to compete in the PIE audit market for fear of the market's perception if they do not: some degree of transitional provisioning should therefore be baked into the 2022 Code (allowing something like the approach adopted in the PASE/Section 6 parts of the Revised Ethical Standard 2019), so that smaller audit firms can grow into a degree of compliance with the Code that reflects the level of activity they want to aspire to in the PIE market, and avoiding the initial immediacy of expectation that applies to the largest firms.

The ways in which gradualism can be achieved merits further study by the FRC, a need justified not merely by the revision of the Code but also by the package that will emerge shortly from the downstream work by BEIS on audit reform.

One specific such example is the Code's use of the 'comply or explain' principle which ought to allow for flex in relation to new PIE audit firms' application of regulation.

3. Effective date of application

Effective Date of the Proposed 2022 Code

Subject to the outcome of this consultation, we will aim to publish a final version of the Code in spring 2022. The proposed 2022 Code will take effect from accounting periods beginning on or after 1 January 2023. This will enable Firms applying the Code for the first time to recruit INEs and make other arrangements, and existing Firms to make any necessary adjustments to how their governance operates currently. It will also mean that we should have more certainty over the Government's definition of a PIE.

Q.4: What are your views on the proposed effective date of the proposed 2022 Code?

The Revised Code does not exist in a vacuum – it should be regarded as a complementary part of the overall reform package and its introduction should be phased in as part of the sympathetic implementation of that package.

4. Engagement with Stakeholders

Structure of the Code

The 2022 Code operates on a 'comply or explain' basis. Firms are required to apply the Principles and should describe how they have done so in their transparency reports. Firms should comply with the Code's Provisions or explain in their transparency reports why they have not, the alternative arrangements in place and how these work to achieve the desired outcome and the purpose of this Code. For example, smaller firms might choose to apply some Provisions in a way that is proportionate to their size and resources. The way in which a firm applies this Code, can demonstrate its commitment to good governance that enhances the firm's long-term sustainability and resilience and helps it to achieve the purpose of this Code.

Appendix B - Transparency Reporting

Transparency is key to improving trust and confidence in audit. All firms which audit PIEs are required by regulation to produce annual transparency reports containing, inter alia, information about the operation of this Code within that firm. However, these reports are not widely read and have been described as both compliance and marketing documents of limited interest to stakeholders. At well over 100 pages, reading the reports is also time-consuming.

Our 2019 thematic review into transparency reporting found that, while they generally provide the information required, the reports "are not being read by the intended beneficiaries, principally investors and audit committee chairs and members". The two main problems identified were:

- a lack of awareness amongst these groups that the reports exist; and
- for those that are aware of the reports, a view that they are too long and overly positive to be useful.

Reporting enhances accountability and drives behaviour, helping ensure leadership focus on the key governance and performance issues which the Code covers. Alongside the FRC's firm reports on audit quality, transparency reports should provide stakeholders with important information about each firm's quality processes and initiatives to improve audit quality. Clearly there is more to be done to tailor the reports to the audience and convince audit committee members, finance directors and investors to read and discuss these reports with the firms. Dialogue between stakeholders and the firms is likely to be the most effective way to improve the reports.

Applying the Principles and 'Comply or Explain'

Reporting against this Code should focus on describing how a firm has applied the Principles, in a manner that would enable stakeholders to evaluate how the firm has met purpose of the Code and achieved the desired outcomes. Reporting should cover this in the context of the particular circumstances of the firm.

It is important to report meaningfully when discussing the application of the Principles and to avoid boiler-plate reporting. A firm should articulate what action has been taken and the resulting outcomes. High-quality reporting will include signposting and cross-referencing to those parts of the transparency report that describe how the Principles have been applied. This will help stakeholders with their evaluation of firm policies and procedures.

The effective application of the Principles should be supported by high-quality reporting on the Provisions. These operate on a 'comply or explain' basis and firms should avoid a 'tick-box approach'. An alternative to complying with a Provision may be justified in particular circumstances based on a range of factors, including the size, service lines, history, network and ownership structure of a firm. Explanations should set out the background, provide a clear rationale for the action the firm is taking and explain the impact that the action has had. Where a departure from a Provision is intended to be limited in time, the explanation should indicate when the firm expects to conform to the Provision. Explanations are a positive opportunity to communicate with stakeholders.

Additional provisions relevant to stakeholder engagement

26. A firm should publicly report how it has applied in practice each of the Principles of this Code and make a statement on its compliance with its Provisions or give a detailed explanation for any non-compliance.

34. Independent non-executives should have dialogue with audit committees and investors to build their understanding of the user experience of audit and to develop a collective view of the way in which their firm operates in practice.

Appendix A – Independent Non-Executives

INE accountability to the public interest also means ensuring there is high quality public transparency over their activities and related outcomes, so that they can be questioned and challenged by external stakeholders. This is achieved through stakeholder engagement and transparency reporting.

Q.5: What are your views on the priorities for engagement with investors, audit committee members and other external stakeholders and how could we encourage interaction between these groups and INEs?

In our experience, audit committees are becoming more interested in firm governance and therefore are engaging on how the firm is structured and how it ensures its audits are of a high quality. Being able to give them access to high quality published transparency reporting is important and INE involvement and oversight in the production of the transparency report is key.

There is definitely a role for INEs to engage with audit committees and other stakeholders of clients and contacts to ensure they are aware and understand their views on the role of audit and how the firm is achieving this effectively. This could be achieved through roundtables but also individual interviews with key stakeholders at the business.

Investors, in our experience, are less likely to engage with audit firm governance. It is encouraging that the FRC is considering tackling this on the next revision of the UK Stewardship Code. However, the proposed 2022 Code still places the onus on the INEs of individual firms to engage with investors. We believe this should be done through the FRC, in conjunction with the INEs, or it will not happen.

INEs have found it difficult to engender regular dialogue with investors and with Audit Committee Chairs. Though INEs are content to assume the liaison obligation, they feel that it will only be when investors and ACCs are under a countervailing obligation in the Stewardship Code, establishing mutual expectation of performance, that any meaningful degree of improvement in frequency of dialogue can be achieved.

5. Leadership

A - Leadership

Principles

A. A firm's Management and governance structures should promote the long-term sustainability of the firm. To this end, the Management of a firm should be accountable to the firm's owners.

B. A firm's governance arrangements should provide checks and balances on individual power and support effective challenge of Management. There should be a clear division of responsibilities between a firm's governance structures and its executive Management. No one individual or small group of individuals should have unfettered powers of decision.

C. A firm's Management should demonstrate its commitment to the public interest through their pursuit of the purpose of this Code and regular dialogue with the independent non-executives. Management should embrace the input and challenge from the independent non-executives.

D. The members of a firm's Management and governance structures should have appropriate experience, knowledge, influence and authority within the firm, and sufficient time, to fulfil their assigned responsibilities.

E. The Management 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.

Provisions

1. A firm should establish a Board or equivalent governance structure to oversee the activities of Management.

2. At least half a firm's Board should be selected from among partners who do not have significant management responsibilities within the firm.

3. The Chair of the Board should not also chair parts of the management structure or be the managing partner.

4. A firm's Management and Board should have a clear understanding of their authority, accountabilities and responsibilities. The Board should have clearly defined terms of reference, with matters specifically reserved for its decision, detailing in particular its role in relation to firm strategy, risk, culture and other matters relating to the purpose of this Code. Management should have terms of reference that include clear authority over the whole firm and matters relating to the purpose of this Code. Terms of reference should be disclosed on the firm's website. Terms of reference for international management and governance structures taking decisions that apply to the UK should be disclosed on the UK firm's website in the same way as for UK-based structures.

5. A firm should establish arrangements for determining remuneration and progression matters for members of the Board which support and promote effective challenge of Management.

6. The individual members of a firm's governance structures and Management should be subject to formal, rigorous and ongoing performance evaluation and, at regular intervals, members should be subject to re-election or re-selection.

7. There should be a formal annual evaluation of the performance of the Board and any committees, including the public interest body. A firm should consider having a regular externally-facilitated board evaluation at least every three years.

8. Management should ensure that, wherever possible and so far as the law allows, members of governance structures and independent non-executives have access to the same information available to Management.

9. A firm should disclose in its annual transparency report:

a) the names and job titles of all members of the firm's governance structures and its Management;

b) a description of how they are elected or appointed and their terms, length of service, meeting attendance in the year, and relevant biographical details;

c) a description of how its governance structures and Management operate, their duties, the types of decisions they take and how they contribute to achieving the Code's purpose. If elements of the Management and/or governance of the firm rest at an international level and decisions are taken outside the UK, it should specifically set out how management and oversight is undertaken at that level and the Code's purpose achieved in the UK; and

d) an explanation of the controls it has in place on individual powers of decision and to support effective challenge by Board members, how these are intended to operate and how they work in practice.

Q.6: To what extent do you support the changes proposed in the areas of partner oversight and accountability to owners?

Principles A-E of the proposed 2022 Code are sensible and already apply to RSM UK Audit LLP. Whilst we do not currently comply with all the Provisions of the proposed Code, we cannot see any issues with implementing them.

It should be recognised that the ownership of professional services firms differs from that of corporates in at least one important respect - there are three distinct categories of 'partner' whose functions are different from those of the firm's 'operational partners' (those who provide the firm's services to clients): (i) those whose duties are exclusively (or at least primarily) the management of the firm, (ii) those involved with the firm's governance and compliance with regulation and standards, and (iii) the INEs themselves. This functional differentiation adds to a firm's ability to satisfy not only the Principles but the Provisions beneath them, enabling it to demonstrate explicit fulfilment or at least a persuasive explanation of how compliance is accomplished.

We for our part will have regard to contemporary best practice, adopting any measure that might be fruitful in our context.

6. Global networks

Provisions relevant to global networks throughout the consultation

28. A firm should disclose in its transparency report:

g) a description of how it interacts with the firm's global network, and the benefits and risks of these arrangements, with reference to the purpose of this Code. This should include an assessment of any risks to the resilience of the UK firm arising from the network and any action taken to mitigate those risks.

30. Independent non-executives should have full visibility of the entirety of the business. They should assess the impact of firm strategy, culture, senior appointments, financial performance and position, operational policies and procedures including client management processes, and global network initiatives on the firm and the audit practice in particular. They should pay particular attention to and report in the transparency report on how they have worked to address: risks to audit quality; the public interest in a firm's activities and how it is taken into account; and risks to the operational and financial resilience of the firm.

32. A firm should provide access for independent non-executives to the activities of the global network such that they can assess global governance standards and the impact of the network on the UK firm and the public interest in the UK.

41. Independent non-executives should participate in governance structures operating across the entirety of the firm and pursue the purpose of this Code at the firm-wide level. They should:

- i) monitor the activities of the wider firm and global network for their potential to affect audit quality and the resilience of the audit practice; and
- ii) ensure the firm takes account of the public interest in its wider decision making.

Q.7: What are your views on the proposals to underpin connectivity with the global network and monitoring of its potential to impact on the UK Firm? Do you have other suggestions for how this could be addressed?

We agree that the risks presented to a UK audit firm by its global network should be considered by the firm and its INEs. However, the Code does not appear to allow for variance in the structure and governance of networks. Over time, the largest firms have opted to consolidate their global networks into a small number of legal entities, whereas firms outside the largest tend to be members of a network with very little consolidation.

We are concerned that Principles 32 and 41 which relate to INEs in relation to the global network are very broad and set expectations on firms and on INEs which will be difficult to fulfil outside the Big 4. In particular, the responsibility of the firm to provide access to, and the INEs to monitor, the activities of the global network are imprecise but arguable give rise to regulatory obligations which in turn might bring about legal ones and an extended liability to civil damages for failure to comply. 'Activities' is not specified and opens the firm and the INEs up to responsibilities they may not be able to fulfil. Moreover, the consequences for the attractiveness of INE appointments need scarcely be stated.

People, Values and Behaviour

B - People, Values and Behaviour

Principles

F. A firm is responsible for its purpose and values and for establishing and promoting an appropriate culture, that supports the consistent performance of high-quality audit, the firm's role in serving the public interest and the long-term sustainability of the firm.

G. A firm should foster and maintain a culture of openness which encourages people to consult, challenge, contribute ideas and share problems, knowledge and experience in order to achieve quality work in a way that takes the public interest into consideration.

H. A firm should apply policies and procedures for managing people across the whole firm that support its commitment to the purpose and Principles of this Code.

Provisions

10. A firm's Board and Management should establish the firm's purpose and values and satisfy themselves that its purpose, values and culture are aligned. If a firm's purpose and values are established at an international level, the firm should ensure it has the ability to influence that decision-making process and the ability to tailor the output for the UK.

11. A firm should have a code of conduct which it discloses on its website and requires everyone in the firm to apply. The Board and independent non-executives should oversee compliance with it.

12. A firm should promote the desired culture and a commitment to quality work, professional judgement and values, serving the public interest and compliance with professional standards and applicable legal and regulatory requirements, in particular through the right tone at the top and the firm's policies and procedures.

13. A firm should establish policies and procedures to promote inclusion and encourage people to speak up and challenge without fear of reprisal, particularly on matters relating to this Code and the firm's values and culture.

14. A firm should introduce meaningful key performance indicators on the performance of its governance system, and report on performance against these in its transparency reports.

15. A firm should assess and monitor culture. It should conduct a regular review of the effectiveness of the firm's system for the promotion and embedding of an appropriate culture underpinned by sound values and behaviour across the firm, and in audit in particular. Independent non-executives should be involved in this review. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the purpose of this Code, it should take corrective action.

16. A firm should establish mechanisms for delivering meaningful engagement with its people. This should include arrangements for people to raise concerns in confidence and anonymously and to report, without fear, concerns about the firm's culture, commitment to quality work, the public interest and/or professional judgement and values. The independent non-executives should be satisfied that there is an effective whistleblowing policy and procedure in place and should monitor issues raised under that process.

17. Independent non-executives should be involved in reviewing people management policies and procedures, including remuneration and incentive structures, recruitment and promotion processes, training and development activities, and diversity and inclusion, to ensure that the public interest is protected. They should monitor the firm's success at attracting and managing talent, particularly in the audit practice.

18. Independent non-executives should use a range of data and engagement mechanisms to understand the views of colleagues throughout the firm and to communicate about their own roles and the purpose of this Code. One independent non-executive should be designated as having primary responsibility for engaging with the firm's people.

19. A firm should disclose in its annual transparency report:

a) a description of how it engages with its people and how the interests of its people have been taken into account in decision-making; and

b) a description of how opportunities and risks to the future success of the business have been considered and addressed, its approach to attracting and managing talent, the sustainability of the firm's business model and how its culture, in particular in the audit practice, contributes to meeting the purpose of this Code.

Q.8: How supportive are you of the approach taken to people and culture in section B of the proposed 2022 Code? Please include any suggestions for how we could improve it further.

RSM is very supportive of the approach taken to people and culture: people are at the heart of our businesses and are the key to delivering high-quality audits.

7. Operations and Resilience

C - Operations and Resilience

Principles

I. A firm should promote a commitment to consistent high-quality audits and firm resilience in the way it operates. To these ends, a firm should collect and assess management information to evaluate the effectiveness of its policies and procedures and to enhance its operational decision-making.

J. A firm should establish policies and procedures to identify, assess and manage risk, embed the internal control framework and determine the nature and extent of the principal risks the firm is willing to take while working to meet the purpose of this Code.

K. A firm should communicate with its regulators in an open, co-operative and transparent manner.

L. A firm should establish policies and procedures to ensure the independence and effectiveness of internal and external audit activities and to monitor the quality of external reporting.

Provisions

20. A firm should assist the FRC and its successor bodies to discharge its duties by sharing information openly.

21. A firm should take action to address areas of concern identified by regulators in relation to the firm's audit work, leadership and governance, culture, management information, risk management and internal control systems.

22. A firm should develop robust datasets and effective management information to support monitoring of the effectiveness of its activities, including by independent non-executives, and its ability to furnish the regulator with information. Note: AQIs are one example.

23. A firm should establish an audit committee and disclose on its website its terms of reference and information on its membership. Its terms of reference should set out clearly its authority and duties, including its duties in relation to the appointment and independence of the firm's auditors. Where a firm's audit committee sits at an international level, information about the committee and its work should be disclosed by the UK firm as if it were based in the UK.

24. A firm should monitor its risk management and internal control systems, and, at least annually, conduct a review of their effectiveness. Independent non-executives should be involved in the review which should cover all significant controls, including financial, operational and compliance controls and risk management systems.

25. A firm should carry out 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 in the UK. Independent non-executives should be involved in this assessment.

26. A firm should publicly report how it has applied in practice each of the Principles of this Code and make a statement on its compliance with its Provisions or give a detailed explanation for any non-compliance.

27. A firm should explain who is responsible for preparing the financial statements and the firm's auditors should make a statement about their reporting responsibilities in the form of an extended audit report as required by International Auditing Standards (UK) 700/701.

28. The transparency report should be fair, balanced and understandable in its entirety. A firm should disclose in its transparency report:

- a) a commentary on its performance, position and prospects;
- b) how it has worked to meet the legal and regulatory framework within which it operates;
- c) a description of the work of the firm's audit committee and how it has discharged its duties;
- d) confirmation that it has performed a review of the effectiveness of the system of internal control, a summary of the process it has applied and the necessary actions that have been or are being taken to remedy any significant failings or weaknesses identified from that review;
- e) a description of the process it has applied to deal with material internal control aspects of any significant problems disclosed in its financial statements or management commentary;
- f) an assessment of the principal risks facing the firm and explanation of how they are being managed or mitigated; and

g) a description of how it interacts with the firm's global network, and the benefits and risks of these arrangements, with reference to the purpose of this Code. This should include an assessment of any risks to the resilience of the UK firm arising from the network and any action taken to mitigate those risks.

Q.9: Are there any matters you believe we should include in section C that do not currently feature and/or can you suggest other improvements to how the proposed 2022 Code approaches operational matters and resilience?

[We feel that section C is comprehensive and therefore have no further suggestions.](#)

8. Independent Not-Executives

D - Independent Non-executives

Principles

M. A firm should appoint independent non-executives to the governance structure who through their involvement collectively enhance the firm's performance in meeting the purpose of this Code. Independent non-executives should be positioned so that they can observe, challenge and influence decision-making in the firm. *Note: Firms are increasingly giving INEs a participating observer role on governance committees.*

N. Independent non-executives should provide constructive challenge and specialist advice with a focus on the public interest. They should assess and promote the public interest in firm operations and activities as they relate to the purpose of this Code, forming their own views on where the public interest lies.

O. Independent non-executives should maintain and demonstrate objectivity and an independent mindset throughout their tenure. Collectively they should enhance public confidence by virtue of their independence, number, stature, diverse skillsets, backgrounds, experience and expertise. They should have a combination of relevant skills, knowledge and experience, including of audit and a regulated sector. They owe a duty of care to the firm and should command the respect of the firm's owners.

P. Independent non-executives should have sufficient time to meet their responsibilities. Independent non-executives should have rights consistent with discharging their responsibilities effectively, including a right of access to relevant information and people to the extent permitted by law or regulation, and a right, individually or collectively, 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.

Q. Independent non-executives should have an open dialogue with the regulator.

Provisions

29. Independent non-executives should number at least three, be in the majority on a body chaired by an independent non-executive that oversees public interest matters and be embedded in other relevant governance structures within the firm as members or formal attendees with participation rights. If a firm considers that having three independent non-executives is unnecessary given its size or the number of public interest entities it audits, it should explain this in its transparency report and ensure a minimum of two at all times. 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 at an audit firm. Independent non-executives should meet regularly as a private group to discuss matters relating to their remit. Where a firm adopts an international approach to its management and/or governance it should have at least three INEs with specific responsibility and relevant experience to focus on the UK business and to take part in governance arrangements for this jurisdiction. The firm should disclose on its website the terms of reference and

composition of any governance structures whose membership includes independent non-executives, whether in the UK or another jurisdiction.

30. Independent non-executives should have full visibility of the entirety of the business. They should assess the impact of firm strategy, culture, senior appointments, financial performance and position, operational policies and procedures including client management processes, and global network initiatives on the firm and the audit practice in particular. They should pay particular attention to and report in the transparency report on how they have worked to address: risks to audit quality; the public interest in a firm's activities and how it is taken into account; and risks to the operational and financial resilience of the firm.

31. A firm should establish a nomination committee, with participation from at least one independent non-executive, to lead the process for appointments and re-appointments of independent non-executives (and Audit Non-Executives), to conduct a regular assessment of gaps in the diversity of their skills and experience and to ensure a succession plan is in place. The nomination committee should assess the time commitment for the role and, when making new appointments, should take into account other demands on independent non-executives' time. Prior to appointment, significant commitments should be disclosed with an indication of the time involved. Additional external appointments should not be undertaken without prior consultation with the nomination committee.

32. A firm should provide access for independent non-executives to the activities of the global network such that they can assess global governance standards and the impact of the network on the UK firm and the public interest in the UK.

33. Independent non-executives should have regular contact with the Ethics Partner, who should under the ethical standards have direct access to them.

34. Independent non-executives should have dialogue with audit committees and investors to build their understanding of the user experience of audit and to develop a collective view of the way in which their firm operates in practice.

35. Firms should agree with each independent non-executive a contract for services setting out their rights and duties. Independent non-executives should be appointed for specific terms and have a maximum tenure of nine years in total.

36. The firm should provide each independent non-executive with the resources necessary to undertake their duties including appropriate induction, training and development, indemnity insurance and access to independent professional advice at the firm's expense where an independent non-executive judges such advice necessary to discharge their duties.

37. The firm should establish, and disclose on its website, well defined and clear escalation procedures compatible with Principle P, for dealing with any fundamental disagreement that cannot otherwise be resolved between the independent non-executives and members of the firm's Management and/or governance structures.

38. An independent non-executive should alert the regulator as soon as possible to their concerns in the following circumstances:

- the independent non-executive believes the firm is acting contrary to the public interest; or
- the independent non-executive believes the firm is endangering the objectives of this Code; or
- the independent non-executive initiates the procedure for fundamental disagreements.

39. A firm should disclose in its annual transparency report:

a) information about the appointment, retirement and resignation of independent non-executives; their remuneration; their duties and the arrangements by which they discharge those duties; and the

obligations of the firm to support them. The firm should report on why it has chosen to position its independent non-executives in the way it has; and

b) its criteria for assessing whether independent non-executives are: i) independent from the firm and its owners; and ii) independent from its audited entities.

Additional provisions for INEs elsewhere in the consultation

11. A firm should have a code of conduct which it discloses on its website and requires everyone in the firm to apply. The Board and independent non-executives should oversee compliance with it.

15. A firm should assess and monitor culture. It should conduct a regular review of the effectiveness of the firm's system for the promotion and embedding of an appropriate culture underpinned by sound values and behaviour across the firm, and in audit in particular. Independent non-executives should be involved in this review. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the purpose of this Code, it should take corrective action.

16. A firm should establish mechanisms for delivering meaningful engagement with its people. This should include arrangements for people to raise concerns in confidence and anonymously and to report, without fear, concerns about the firm's culture, commitment to quality work, the public interest and/or professional judgement and values. The independent non-executives should be satisfied that there is an effective whistleblowing policy and procedure in place and should monitor issues raised under that process.

17. Independent non-executives should be involved in reviewing people management policies and procedures, including remuneration and incentive structures, recruitment and promotion processes, training and development activities, and diversity and inclusion, to ensure that the public interest is protected. They should monitor the firm's success at attracting and managing talent, particularly in the audit practice.

18. Independent non-executives should use a range of data and engagement mechanisms to understand the views of colleagues throughout the firm and to communicate about their own roles and the purpose of this Code. One independent non-executive should be designated as having primary responsibility for engaging with the firm's people.

22. A firm should develop robust datasets and effective management information to support monitoring of the effectiveness of its activities, including by independent non-executives, and its ability to furnish the regulator with information. Note: AQIs are one example.

24. A firm should monitor its risk management and internal control systems, and, at least annually, conduct a review of their effectiveness. Independent non-executives should be involved in the review which should cover all significant controls, including financial, operational and compliance controls and risk management systems.

Appendix A - Independent Non-Executives

Status and Accountability of Independent Non-Executives (INEs)

All of the largest audit firms in the UK are limited liability partnerships (LLPs). They are owned, managed and run by the firm's partners (although each firm has slightly different arrangements). LLPs do not have shareholders and they do not have boards of directors, including non-executive directors, in the same way as public companies. As owner-managed businesses, the potential for conflicts of interest between the owners and managers of the business is lower than at public companies. Conversely, there is a higher risk that they do not adequately consider the needs of their stakeholders.

Legally, only partners can hold certain offices or carry out certain functions, including making key decisions about firm strategy and direction. INEs are not directors and do not have fiduciary duties to the firm's partners. Nor are they accountable for the performance of the business or responsible for setting strategy. INEs are therefore not the same as the independent non-executive directors on a public company board.

INEs are selected, appointed and remunerated by their firm. The Code states that INEs owe a duty of care to the firm. This means they must act in good faith and with reasonable care and diligence in exercising their responsibilities. While we do not believe that INEs should answer to the partnership in each and every other respect, a duty of care is appropriate and compatible with their public interest remit.

INEs (and Audit Non-Executives) should regard themselves as being accountable to the public interest. To the extent that the regulator acts as a proxy for the public interest, there should be an expectation of openness, cooperation and candour in the relationship between INEs and the regulator for mutual benefit. INEs play an important role as an additional lens into the firms while recourse to the regulator can reinforce the influence of INEs with senior management. The Code seeks to clarify this relationship in Principle Q and Provision 38.

In practice, since 2019, the FRC has met with INEs in their firm groups on a regular basis as part of its firm supervisory activity. It also has an opportunity to meet the preferred candidates for INE roles prior to appointment.

INE accountability to the public interest also means ensuring there is high quality public transparency over their activities and related outcomes, so that they can be questioned and challenged by external stakeholders. This is achieved through stakeholder engagement and transparency reporting.

An independent mindset

An overarching requirement for an effective INE is having an independent mindset and demonstrable objectivity in discharging the role. INEs should not become advocates or champions for the firm. Their role is as guardians of the public interest.

The risks that, over time, an independent non-executive might become less independently minded are not easy to address in a Code. Nevertheless, Principle O seeks to emphasise the importance of these characteristics, while Provision 35 sets a maximum tenure of 9 years to guard against threats to independence.

Independence

Independence is a characteristic which the FRC believes enhances stakeholder confidence in the way audit firms are governed and run.

Principle O and Provision 39 deal with the independence of INEs (and Audit Non-Executives). Firms are expected to establish and publish criteria, against which an INE's (or an Audit Non-Executive's) independence will be assessed. These criteria must cover two separate and distinct independence issues, namely, whether an INE is independent from the firm itself; and whether they are independent from the firm's audited entities.

Accordingly, a firm will need to disclose in its transparency report the relationships with the firm itself and with its audited entities that it considers would compromise INE independence, including by reference to requirements from UK and overseas regulators and the International Code of Ethics. It should also disclose any other measures it has in place to safeguard INE independence, for example limits on INE tenure.

A 'covered person' is defined in the UK Ethical Standard for Auditors as "*a person in a position to influence the conduct or outcome of the engagement*". The definition goes on to state that "*An independent non-executive appointed by a firm to act in a public interest role on a governance or oversight body of the firm is not a covered person*". Thus, INEs (and Audit Non-Executives) are not

'covered persons' for the purposes of UK audits and are not subject to the full range of restrictions, for example on their investments, that apply to an audit partner.

INEs (and Audit Non-Executives) can therefore oversee a firm's processes – for example by sitting on a remuneration committee – provided that they are unable to determine 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. For example, a current partner or employee should never be considered independent for these purposes and a proposal to appoint a former partner or employee would need to be subject to careful consideration. A firm should think carefully about possible situations in which a conflict of interest might arise in order to reach a view on whether an individual would be truly independent but should not exclude individuals from consideration as potential INEs simply on the basis that independence issues might arise in the future.

Once appointed, INEs 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 INE who also sits on the board of a company which is considering appointing the audit firm as auditor, should recuse themselves from any involvement in the tender process.

INEs 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.

Q.10: Do you think that the proposed 2022 Code is clear enough about the role INEs play in the firms?

The Principles and Provisions in Section D make the role of the INEs clear. However, we think that the role of the INEs, as envisaged, will have become too broad and correspondingly more difficult to fulfil and to evidence:

- the INEs are expected to decide what the public interest means in the context of audit and also the activities of the firm as a whole: that opacity makes their 'accountability to the public interest' quite difficult for them to be able to understand, far less fulfil. See also our answer to Question 1;
- responsibility for assessing the activities of the global network opens INEs up to reputational, regulatory, and legal liability which they may not wish to undertake. See more detail in our answer to Question 7; and
- placing too heavy an onus on INEs to engage with investors is unrealistic – they generally do not want to engage. See also our answer to Question 5.

Q.11: What are your views on the proposals for strengthening the status and role of INEs? Please include any suggestions for other ways to increase their impact and effectiveness.

As commented above, we believe that some of the proposals make the INE role too broad. Although there has been an obligation on INEs to have regard to matters arising out of the firm's non-audit service functions since the 2010 version of the Code, the degree of emphasis which that obligation will receive in the 2022 one suggests a degree of interrogative proactivity on INEs' part that was never previously intended: the public interest in relation to the practice of statutory audit is simple to identify but much less so in relation to non-statutory work.

We are comfortable with the additional proposals that INEs should:

- have the opportunity to influence decision-making;
- maintain and demonstrate objectivity and an independent mindset throughout their tenure;
- have sufficient time to meet their responsibilities; and
- have an open dialogue with the regulator.

9. Operational Separation

Operational Separation of Audit Practices

The CMA Review of 2019³ recommended an operational split between the audit and non-audit practices of the largest audit firms in the UK. The Government consulted on proposals to implement operational separation in March 2021 as part of its wider consultation on *Restoring Trust in Audit and Corporate Governance*. It will apply initially only to the four largest audit firms: Deloitte LLP, EY LLP, KPMG LLP and PwC LLP.

These four firms are working with the FRC to implement operational separation on a voluntary basis ahead of legislation, if implemented. They have submitted proposals for applying the FRC's Principles of Operational Separation. Principles 1-10 set out the requirements for the governance of operationally-separate audit practices. These require the firms to establish a separate Audit Board, with a majority of independent Audit Non-Executives, to oversee audit quality

E - Operational Separation

Principles

R. Where a firm applies the Principles for Operational Separation, has established an Audit Board with a majority of Audit Non-Executives and is subject to regulatory monitoring of these arrangements, Audit Non-Executives will fulfil the responsibilities of independent non-executives under this Code in so far as these relate to the audit practice. A firm's independent non-executives will focus on representing the public interest in high quality audit at the firm-wide level as well as on the public interest in firm activities in non-audit parts of the business and the risks posed by these non-audit activities to the audit practice.

S. Independent non-executives should rely on Audit Non-Executives to provide independent oversight of audit quality plans, audit strategy and remuneration in the audit practice. Audit Non-Executives should rely on the independent non-executives to monitor activities at the firm-wide and network levels for their potential impact on the audit practice.

Provisions

40. Audit Non-Executives should have the same obligations regarding time commitment, independence and objectivity, and the same overarching rights and responsibilities under this Code as independent non-executives. They should focus their attention on the audit practice in accordance with the Principles for Operational Separation. The Audit Board should have the authority to act independently of the firm-wide public interest body.

41. Independent non-executives should participate in governance structures operating across the entirety of the firm and pursue the purpose of this Code at the firm-wide level. They should: i) monitor the activities of the wider firm and global network for their potential to affect audit quality and the resilience of the audit practice; and ii) ensure the firm takes account of the public interest in its wider decision making.

42. Independent non-executives and Audit Non-Executives should maintain open dialogue, consult on matters of public interest and share information with one another to the extent this is relevant for the audit board's oversight of the audit practice and/or the effective discharge of the independent non-executives' responsibilities at the firm-wide level. They should inform one another in the event they invoke the procedure for fundamental disagreements.

Appendix C - Principles for Operational Separation

Objectives, Outcomes and Regulation

FRC Objectives:

- Objective 1: Improve audit quality by ensuring that people in the audit practice are focused above all on delivery of high-quality audits in the public interest.
- Objective 2: Improve audit market resilience by ensuring that no material, structural cross subsidy persists between the audit practice and the rest of the firm.

In pursuing these objectives, we will seek to ensure that audit remains an attractive and reputable profession and increases deserved confidence in audit.

Desired outcomes:

- Audit practice governance prioritises audit quality and protects auditors from influences from the rest of the firm that could divert their focus away from audit quality.
- The total amount of profits distributed to the partners in the audit practice should not persistently exceed the contribution to profits of the audit practice.
- Individual audit partner remuneration is determined above all by contribution to audit quality, taking account of the degree of difficulty and risk of the audits.
- Audit practice financial reporting is transparent to the regulator and public, allowing effective monitoring of audit practice performance and financial resilience.
- The culture of the audit practice supports audit quality and the public interest by encouraging ethical behaviour, openness, teamwork, challenge and professional scepticism/judgement.
- Auditors should act in the public interest and work for the benefit of shareholders of audited entities and wider society; they are not accountable to audited entities' executive management and are not (nor viewed as or considered to be) consultants.

Regulation:

- Firms will need to demonstrate to the FRC that they are delivering these outcomes, consistent with these principles.
- Firms should provide regular management information for the audit practice to FRC, including financial statements, audit quality indicators and other information which indicates whether these outcomes are being delivered.
- FRC will publish annually an assessment of whether firms are delivering these objectives and outcomes.
- FRC will seek backstop powers to require firms to deliver these outcomes as part of the forthcoming audit reform legislation.

Principles	
Governance	
Audit board purpose	
P1	The Audit Board should be responsible for providing independent oversight of the audit practice, with a focus on the pursuit of Objective 1. The firm's most senior governance body should be responsible for providing oversight with a focus on the pursuit of Objective 2.
P2	The Audit Board and the management of the audit practice should establish and promote a culture supportive of the public interest.
Audit Board composition	
P3	The Audit Board should be chaired by and have a majority of Audit Non-Executives (ANEs).
Independence of Audit Board from the firm	
P4	At least one of the ANEs should not be a firm INE ('doubly independent'). The Chair of the Audit Board should be an ANE and may also be a firm INE but should not chair any other governance body in the firm.
Skills of Audit Board	
P5	At least one ANE on the Audit Board should have experience of audit at an appropriate level of seniority, either as a former auditor or consumer of audit services.
Audit Board oversight of Audit CEO and Audit Strategy	
P6	The Audit Board should oversee the firm's audit strategy to ensure that it is consistent with pursuit of the objectives and outcomes set out above. It should be able to require changes where it considers that the strategy is not consistent.
P7	The Audit Board shall be consulted by the Senior Partner of the firm with respect to the appointment of the CEO of Audit and have the opportunity to object to the appointment. The Audit Board may seek the removal of the Audit CEO.
Audit Board oversight of partner promotion and remuneration	
P8	Remuneration of audit partners and audit partner promotion should be overseen by a sub-committee of the Audit Board comprising ANEs only. Admissions of partners will remain a partnership responsibility and subject to the governance procedures of the partnership. However, the selection of candidates to be admitted to the partnership to practice as audit partners will be overseen by the Audit Board.
Other governance matters	
P9	Appointments of individuals to the Audit Board should be subject to a formal, rigorous and transparent procedure.
P10	The Audit Board should have the authority to commission reviews from Internal Audit to support their oversight role.
Scope of the separate practice	
Services within the "ring-fence"	
P11	Statutory audit should be provided by the audit practice. The audit practice may also provide: <ul style="list-style-type: none"> • permitted audit-related and non-audit services to PIE entities audited by the firm; • audit-related and non-audit services to non-PIE entities audited by the firm which are not prohibited; and • services to other entities not audited by the firm that are either: <ul style="list-style-type: none"> ○ included on the "white-list" in paragraph 5.40 of the Ethical Standard 2019, and are commissioned by those charged with governance at the entity, or ○ are non-audit assurance engagements where the recipient of the assurance is a third party (e.g., a regulator, government or lender) separate from the client of the audit firm. These assurance engagements should be performed in accordance with a recognised assurance standard (e.g., ISAE 3000, ISAE 3402, SOC1 etc).
Specialists supporting audit	
P12	Specialists supporting audit (and other permitted services provided by the audit practice) can be located elsewhere in the firm provided their services are supplied and charged to the audit practice on an arms-length basis.
Other "ring-fence" matters	
P13	Partners and staff in the audit practice should spend the majority of their time on work in the audit practice. This does not preclude the secondment of staff to other areas of the

	business (in either direction) or the appointment of audit partners to firmwide leadership roles.
P14	Revenues from audit work should make up at least 75% of the revenue of the audit practice.
Financial	
P15	Transactions between the audit practice and the rest of the firm should be conducted and priced on an 'arms-length' basis. The audit practice should not receive fees for introducing business to other parts of the firm.
P16	The audit practice should produce a separate profit and loss account with overhead absorption on an equitable basis.
P17	As part of its annual assessment of whether firms are delivering these objectives and outcomes, the FRC will assess whether the overall distribution of profits to the partners in the audit practice and to those in the rest of the firm is consistent with their respective contributions to firm profits, with no material, structural cross subsidy persisting in either direction. This assessment will take account of any non-recurring items and investment to improve audit quality. If the FRC's assessment is that a material, structural cross subsidy persists, the firm should produce an action plan to remove the subsidy over a period to be agreed with the FRC.
Remuneration of partners	
P18	Remuneration policies and practices for partners in the audit practice should be designed to reward primarily high-quality work and positive leadership behaviours. The firm should have measures in place to reduce reward in cases of poor-quality work. Partners and staff in the audit practice should not be incentivised for sales passed to other parts of the firm.
Transparency	
P19	Firms should publish information about the governance of the audit practice and the terms on which transactions occur between the audit and non-audit business and the nature of these transactions.
P20	Firms should produce annually a separate profit and loss account for the audit practice to a level which is consistent with the firm's own published statutory financial statements. This profit and loss account should be assured by the firm's auditors. Firms should submit more detailed financial information supporting the profit and loss account to the FRC no later than four months after the financial year end. After an agreed transition period, firms should publish the audit practice's profit and loss account described above in their Transparency Reports. Firms should provide to the FRC their budget for the audit practice and sensitivities for the coming year.
Accountability	
P21	Firms should appoint one individual (or a small number of individuals with clearly defined and non-overlapping responsibilities) from the Senior Management team to be responsible and accountable for ensuring the outcomes and principles for operational separation are delivered, embedded and monitored.
Transitional Arrangements	
P22	Firms should provide a transition timetable to ensure that each of these principles is implemented as soon as practicable and they are met implemented in full by 30 September 2024 at the latest (exact date dependent on each firms' year-end). An implementation plan should be submitted to FRC by 23 October 2020. The FRC will agree a transition timetable including a medium-term plan with a firm. In the first year of submission, the profit and loss account may be done on a 'best efforts' basis. Firms will not be required to publish the profit and loss account during an agreed transition period ending not later than 30 September 2024 (exact date dependent on each firms' year-end).

Q.12: What are your views on the proposed boundaries between the responsibilities of INEs and Audit Non-Executives? Please give examples of any potential difficulties you foresee with what is proposed.

As presently conceived and intended, operational separation is mandated only so far as the largest firms are concerned, and we do not offer any comment on the proposed boundaries between the responsibilities of INEs, on the one hand, and Audit Non-Executives, on the other hand. However, we urge caution to ensure that regulatory drift does not bring about any unintended, unnecessary, and detrimental consequence that is antithetical to important public policy objectives, such as reducing audit market concentration: nascent PIE-audit firms need to be encouraged into the field through proportionate regulation. We counsel that further consultation ought to precede any putative *quo* extension of operational separation outside the largest firms.