



Financial Reporting Council

Audit Firm Governance Code

April 2022

Introduction

The Audit Firm Governance Code (“the Code”) was first published in January 2010. At that time, the Code applied to audit firms (“firms”) auditing 20 or more listed companies. It introduced for the first time the concept of independent non-executives (“INEs”) in firms. INEs are now well established in all of the firms currently applying the Code. The flexibility allowed by ‘comply or explain’ provisions remains an important characteristic of the Code.

The Code was first updated by the FRC in 2016 following a high-level review of its implementation by those audit firms within its scope. It has been updated again in 2022 to take account of the introduction of operational separation of audit practices at the largest audit firms and findings from the FRC’s review of firm implementation against the 2016 Code. The threshold for application of the 2022 Code has been aligned with the rest of the regulatory regime for audit which is based on the audit of public interest entities (“PIEs”) rather than listed companies.

The Code applies to the firm as a whole, not purely the audit practice. It continues to apply in its entirety in firms where the audit practice is operationally-separate from the rest of the firm.¹

The Code makes the assumptions that all firms within its scope:

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

This version of the Code is applicable for financial years beginning on or after 1 January 2023.

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.

¹ As required by statute or agreed voluntarily with the FRC or its successor bodies.

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;
- company directors, particularly audit committee members, with responsibilities for the appointment of auditors and the effectiveness of audit; and
- regulators.

Application Scope

The scope of this Code is firms that audit PIEs.² 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.

Structure of the Code

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.

This Code is organised by theme into five sections, as follows:

- Sections A-C are directed primarily at firms applying the Code and deal with the themes of leadership; people, values and behaviours; and operations and firm resilience.
- Section D is directed primarily at INEs and Audit Non-Executives (ANEs).
- Section E is directed at those firms with operationally separate audit practices and deals with the respective roles and responsibilities of INEs who are independent members of Public Interest Bodies, and the independent members of Audit Boards, known ANEs.

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. The FRC's Principles of Operational Separation were published in February 2021.⁴ Principles 1-10 set out the requirements for the governance of operationally-separate audit practices. These require the largest audit firms to establish a separate Audit Board, with a majority of ANEs, to oversee audit quality and the activities of the audit practice. All four firms had established an Audit Board by the time of publication of this Code.

² As defined in the Statutory Auditors and Third Country Auditors Regulations 2016

³ https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf

⁴ See Appendix C

The Principles of Operational Separation sit alongside this Code in setting a framework for governance and oversight at those firms which are required to apply them.

The creation of Audit Boards with an independent majority will lead to consequential changes to other aspects of firm governance, particularly the role of INEs. This is dealt with in section E.

The Principles and most of the provisions in section D also apply to ANEs in relation to the audit practice in firms with operational separation. It should be remembered that all firms have appointed individuals that act as both an INE and ANE (sometimes referred to as a “double-hatter”). This overlap within an individual’s role helps to ameliorate some of the challenges of distinguishing between the respective responsibilities of the two groups.

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. We would encourage firms to develop their own guidance on public interest as it relates to their specific circumstances.

INEs have a unique role. They are not partners of audit firms or responsible for its strategy or performance. INEs 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. INEs generally do not have voting rights or make decision.

An integral part of the role of INEs 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. Where a firm has ANEs they will focus on public interest in the audit practice only. There are a wide range of stakeholders to consider as part of this exercise; not just audited entities and their shareholders, but the firm’s employees and the wider public. These groups may well have non-aligned and even competing interests. It is the role of INEs and ANEs 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. In doing so they should have regard to the Code and any guidance issued by the firm.

Additional context on INEs and ANEs and their independence can be found in Appendix A.

Information about transparency reporting and ‘comply or explain’ can be found in Appendix B.

A Leadership

Principles

- A. A firm's Management⁵ 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 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 INEs. Management should embrace the input and challenge from the INEs (and ANEs).
- 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, INEs and ANEs, 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 Board⁶ 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, plus the public interest body.⁷ A firm should consider having a regular externally-facilitated board evaluation at least every three years.

⁵ A firm's most senior executives, responsible for running the business.

⁶ A firm's most senior governance body.

⁷ See Provision 29.

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8. Management should ensure that, wherever possible and so far as the law allows, members of governance structures and INEs and ANEs have access to the same information as is 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 relevant⁸ 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.

⁸ Relevant being judged by reference as to the Code's purpose.

B People, Values and Behaviour

Principles

- F. A firm is responsible for its purpose and values and for establishing and promoting an appropriate culture,⁹ 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 INEs 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 standards¹⁰ 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 systems for the promotion and embedding of an appropriate cultures underpinned by sound values and behaviour across the firm, and in audit in particular. INEs should be involved in this review and where a firm has implemented operational separation the ANEs should be involved in the review as it relates to the audit practice. 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 INEs should be satisfied that there is an effective whistleblowing policy and procedure in place and should monitor issues raised under that process.
- 17. INEs 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

⁹ Consistent with the requirements of Provision A.1.1 of the 2019 Revised Ethical Standard for Auditors.

¹⁰ Including ethical and technical standards, and the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour

managing talent, particularly in the audit practice. Where operational separation is in place the ANEs should be involved in this process.

18. INEs and ANEs 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 INE 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 description of how:
 - a) it engages with its people and how the interests of its people have been taken into account in decision-making; and
 - b) 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.

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 INEs (and ANEs), and its ability to furnish the regulator with information.
- 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. INEs 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. INEs (and in firms with operational separation, ANEs) should be involved in this assessment.
- 26. A firm should publicly report how it has applied the Principles of this Code, and make a statement on its compliance with its Provisions or give a detailed explanation for any non-compliance, i.e. why the firm has not complied with the Provision, the alternative arrangements in place and how these work to achieve the desired outcome (Principle) and the purpose of this Code.
- 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.

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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.

D INEs and ANEs

Principles

- M. A firm should appoint INEs to the governance structure who through their involvement collectively enhance the firm's performance in meeting the purpose of this Code. INEs should be positioned so that they can observe, challenge and influence decision-making in the firm.
- N. INEs (and ANEs) 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. INEs (and ANEs) 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. INEs (and ANEs) should have sufficient time to meet their responsibilities. INEs (and ANEs) 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. INEs (and ANEs) should have an open dialogue with the regulator.

Provisions

- 29. INEs should number at least three, be in the majority on a body chaired by an INE 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 INEs 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 INE 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.
- 30. INEs 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 INEs, whether in the UK or another jurisdiction.
- 31. INEs 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 establish a nomination committee, with participation from at least one INE, to lead the process for appointments and re-appointments of INEs (and ANEs), 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 INEs' (and ANEs') 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.

33. A firm should provide access for INEs to relevant information on the activities of the global network such that they can monitor the impact of the network on the operations and resilience of the UK firm and the public interest in the UK.
34. INEs should have regular contact with the Ethics Partner, who should under the ethical standards have direct access to them.¹¹
35. INEs 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.
36. Firms should agree with each INE (and ANE) a contract for services setting out their rights and duties. INEs (and ANEs) should be appointed for specific terms and have a maximum tenure of nine years in total.
37. The firm should provide each INE (and ANE) 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 INE or ANE judges such advice necessary to discharge their duties.
38. 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 INEs (and /or ANEs) and members of the firm's Management and/or governance structures.
39. An INE (and / or ANE) should alert the regulator as soon as possible to their concerns in the following circumstances:
 - the INE or ANE believes the firm is acting contrary to the public interest; or
 - the INE or ANE believes the firm is endangering the objectives of this Code; or
 - the INE or ANE initiates the procedure for fundamental disagreements.

¹¹ Paragraph 1.14 of the FRC's 2019 Ethical Standard for Auditors

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

- a) information about the appointment, retirement and resignation of INEs (and ANEs); 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 INEs in the way it has; and
- b) its criteria for assessing whether INEs (and ANEs) are: i) independent from the firm and its owners; and ii) independent from its audited entities.

E Operational Separation

Principles

- R. Where a firm applies the Principles for Operational Separation¹², has established an Audit Board with a majority of ANEs¹³ and is subject to regulatory monitoring of these arrangements, ANEs will fulfil the responsibilities of INEs under this Code in so far as these relate to the audit practice. A firm's INEs 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. In fulfilling their role ANEs should follow the Principles set out in section D as applied to the audit practice.
- S. INEs should rely on ANEs to provide independent oversight of audit quality plans, audit strategy and remuneration in the audit practice. ANEs should rely on the INEs to monitor activities at the firm-wide and network levels for their potential impact on the audit practice.

Provisions

41. ANEs should have the same obligations regarding time commitment, independence and objectivity as INEs. They should focus their attention on the audit practice in accordance with the Principles for Operational Separation¹⁴. The Audit Board should have the authority to act independently of the firm-wide public interest body.
42. INEs 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.
43. INEs and ANEs 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 INEs' responsibilities at the firm-wide level. They should inform one another in the event they invoke the procedure for fundamental disagreements.

¹² See Appendix C

¹³ As required by Principle 3 of the Principles for Operational Separation

¹⁴ As required by Principle 1 of the Principles for Operational Separation

Appendix A

Independent Non-Executives (INEs) and Audit Non-Executives (ANEs)

Status and Accountability of INEs and ANEs

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 and ANEs are not partners 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 firms. 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 and ANEs 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 ANEs) 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 / ANEs and the regulator for mutual benefit. INEs and ANEs play an important role as an additional lens into the firms while recourse to the regulator can reinforce the influence of INEs with Management. The Code seeks to clarify this relationship in Principle Q and Provision 39.

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 and ANE roles prior to appointment.

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

The risks that, over time, an INE or ANE 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 36 sets a maximum tenure of nine 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 40 deal with the independence of INEs (and ANEs). Firms are expected to establish and publish criteria, against which an INE's (or ANE'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.

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 ANEs) 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 ANEs) 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.¹⁵ 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.

¹⁵ Firms may refer to the third party test in I14 of the 2019 Ethical Standard for Auditors.

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 reporting¹⁶ 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’ Provisions

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 the 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. A firm should explain why has not complied with the Provision, the alternative arrangements in place and how these work to achieve the desired outcome (Principle) and the purpose of this Code.

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.

¹⁶ FRC Thematic Review, ‘Transparency Reporting’

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.

Principles

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:
- 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:
 - 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.

Principles

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).



Financial Reporting Council