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Dear Sir

Audit Firm Governance Consultation Document

We are pleased to respond to the consultation paper on Audit Firm Governance issued by the ICAEW in October 2008. Good governance is essential to the wellbeing of any organisation. PricewaterhouseCoopers LLP (“PwC”) has therefore long been a leading proponent of good governance for our clients, both in the private and public sectors, and for our own firm. We therefore support the focus now being placed on the governance of audit firms and, where we disagree with statements made in the consultation paper, it is precisely because we consider the subject so important that we have made our comments.

By way of background, PwC, like other professional services organisations in the UK, and generally elsewhere in the world, is a partnership, owned and controlled by the partners, all of whom have invested their own capital in the firm and who work in it, depending on it for their livelihood. If the firm does not make a profit, the partners do not get paid. If the firm makes a loss, the partners have to contribute additional capital. If the firm were to become insolvent, the partners lose all their capital. It follows, therefore, that the partners have enormous “skin in the game”. They also have a great understanding not just of the firm and the accounting profession, but also of the issues facing the markets in which our clients operate. The partners therefore have every incentive to wish to see the firm prosper in both the short and long term, and have the knowledge and skills to bring this about. Indeed, it is hard to imagine any group of people more heavily incentivised to see good management and good governance than the partners in a large audit firm.

The size of PwC – some 800 partners, employing approximately 15,000 people and with an annual turnover in excess of £2.1bn - requires sophisticated management and governance structures. PwC operates a two tier Board structure. The Executive Board is responsible for developing and implementing the policies, strategy, direction and management of the firm. It is chaired by our Senior Partner and Chairman (“The Chairman”), who is elected by the whole partnership. The Chairman appoints the other Executive Board members, all of whom are partners in the firm. Each Board member has responsibility and accountability for a specific aspect of our business.

We also have a Supervisory Board, which is independent of the Executive Board, and which is elected by the partners, usually for a term of three years. It is chaired by one of the elected members. Its meetings are held monthly, or more frequently if necessary, and are attended by the Chairman as an ex officio member.

The Supervisory Board provides the Chairman with guidance on matters of actual or potential concern to the partners. It is charged with considering, reviewing and giving guidance to the Executive Board on any matter it, in its entire discretion, considers to be of concern to partners having regard to the interests of the firm as a whole. It is also responsible for approving the firm’s Annual Report, for the admission of new partners, for overseeing the process of electing the Chairman and for checking that our policies on partner remuneration are being properly applied. It acts as a check and balance on the executive in much the same way as non-executives on a unitary board.

The Senior Management Remuneration Committee is a subcommittee of the Supervisory Board. It sets the Chairman’s profit share and approves his recommendations for the profit shares of the other Executive Board members.

The Audit Committee is a subcommittee of the Supervisory Board that has responsibility for reviewing the policies and processes for identifying, assessing and managing risks within the firm. It oversees the management of those risks, including financial control, compliance and independence. It also reviews the firm’s financial statements and considers the scope, results and effectiveness of internal and external audit, including reviewing the external auditor’s independence and their non-audit services and fees.

The Strategy, Governance and International Committee of the Supervisory Board has responsibility, inter alia, for monitoring strategy setting and implementation.

We also have an Advisory Board which does not form part of the formal governance arrangements for the firm. It comprises senior people from different aspects of business and professional life, drawn from both the public and private sector. Its role is to provide an external perspective on the firm’s business strategy. Because of the advisory nature of this Board, its members are not subject to either UK or international auditor independence restrictions, thus enabling us to attract the quality and experience we believe can add value to our organisation.

These structures have been developed over many years, with a great deal of careful thought and, indeed, are product of our experience of operating different governance structures in

our predecessor firms. They comply with all the generally accepted principles of good governance. They do not easily fit into the Combined Code which, of course, was developed for companies with publicly traded shares, owned by investors who may well have no other connection with the company. It is for this reason that we consider any Code for audit firms should be drawn up ab initio, rather than by modifying the Combined Code, as in the case with many other recently developed governance codes, for example, the “Lambert” code of governance for universities (2003). Of course, a code for audit firms would no doubt draw on the Combined Code which has served UK business so well over the past 15 years.

There are two areas, apart from the provisions relating to communication with investors which clearly do not apply to us, where we may be said not to comply with either the letter or the spirit of the Combined Code, namely, the use of a two tier Board structure rather than a Unitary Board and, separately, the involvement of independent non-executive directors. With regard to Board structure, while we have no fundamental objection to a Unitary Board (and certainly support it in the context of a public company), we consider our two tier model has advantages for a large partnership. In particular, the greater size of a Supervisory Board enables broader diversity of experience and expertise to be brought to the oversight of management than would be possible in a Unitary Board. It also enables the different segments of the partnership to be represented, which is particularly important in relation to matters such as generational issues (ie in recognising that the interests of partners at the start of their career may be different from those towards the end of their career). This is important to the long term health of the firm; typically, more experienced partners will form the Executive Board, younger partners have a direct vested interest in where the firm will be over the following 20 years and beyond. Of course, having a two tier Board structure does not prevent the two Boards meeting together on appropriate occasions.

In relation to independent directors, as noted above, management is held to account by partners who are independent of management but who work full time in the firm in client service rather than management roles. We do therefore have independent (of management), non-executive (their day job is elsewhere) directors. The question is whether firms like PwC would also benefit from the existence of external directors.

There is no doubt we already benefit from external input, through our Advisory Board, through the experience of our partners with their clients and through many informal discussions between senior partners in PwC and chairmen, chief executives, finance directors and non-executive directors of many of the world’s largest companies, and their equivalents in the public, academic and voluntary sectors. We have frequently considered whether we could formalise some part of this by including a number of external people on one or other of our Boards, but people with the relevant expertise and experience are almost certainly all conflicted. We consider both the FRC and the ICAEW Working Parties have very significantly underestimated the significance and impact of the auditor independence restrictions. Furthermore, it does not appear appropriate to us for any member of either our Executive or Supervisory Board to be a shareholder in any of our audit clients, or to be directors of any client of the firm, whether an audit client or otherwise. Therefore, even if the authorities were to agree a relaxation in the independence

rules in respect of external directors, we do not believe it would be appropriate for us to take advantage. In addition, there are at any one time many actual conflicts arising from, for example, M&A activity and while, in theory, it may be possible for directors to recuse themselves from any particular discussion, in practice the conflicts are likely to make such a position untenable.

We have given careful consideration to the idea set out in a consultative paper of including external directors on, say, our Audit Committee. We are certainly prepared to give this further consideration in the light of the discussion following the consultation paper, but currently are not persuaded either that this would improve our present processes or provide an alternative conduit for people with appropriate experience to contribute to the governance of our firm.

As noted above, members of our Advisory Board are not subject to either UK or international auditor independence restrictions. We consider, therefore, that this provides the most effective way for external input to be provided. It may be that this concept can be extended to the formation of a risk committee which sits outside the formal governance structure, thus enabling the participation of external people who would not be subject to the audit independence restrictions. Such a group would need sufficient authority to provide value, and its terms of reference and modus operandi need careful design to ensure its effectiveness. More detailed examination will be needed to determine that it is not possible to construct this in such a way that it meets the objective of bringing an external perspective on the firm's risk management without bringing it into the formal governance structure. It is, however, an idea worthy of such further consideration.

Question 1: Which groups of stakeholders do you think the Audit Firm Governance Code should primarily serve and in what ways, if any, do they have differing interests?

The origins of corporate governance lie in the “agency problem” identified by Adam Smith in *The Wealth of Nations*. Large audit firms are owned by their partners, but managed by a small group of senior partners. Any governance code for such firms must primarily serve the interests of the partners as owners of the business.

Audit is recognised as a public interest function. It is for this reason that it is a regulated function and the public interest is protected through the regulatory process (which has proven to be very effective in the UK), as is the case in other companies with public interest responsibilities, eg bank and insurance companies have great responsibilities to depositors and policy holders which are addressed through law and regulation. Good governance may further enhance the protection of the public interest, but an Audit Firm Governance Code must primarily serve the interests of the partners just as the Combined Code exists to protect shareholders' interests.

We consider that Investors, Audit Committees and Boards have a legitimate interest in understanding the governance arrangements of audit firms and, notwithstanding that an Audit Firm Governance Code must primarily serve the interests of the partners, it may also

assist Audit Committees and Boards in the selection of their auditor and Investors in approving the Board's recommendation.

Question 2: What approach should a Combined Code-style Audit Firm Governance Code adopt to risk management and internal control?

Any Audit Firm Governance Code should follow the principles of the Combined Code in relation to risk management and internal control, as this represents current best practice and there are no issues which differentiate audit firms from listed companies in this regard.

Question 3: To what extent do the firms face unique issues in discussing their principal litigation and claims risks without causing damage to the sustainability of the firm?

The biggest risk to the sustainability of an audit firm is litigation risk. Unless and until audit liability is in some way capped, the potential liabilities cannot be covered by commercial insurance, captive insurance, partnership capital or any combination. To this extent, audit firms are in an unenviably unique position, and any proposal regarding disclosure of outstanding litigation must be carefully thought through with full consideration given to the potentially damaging consequences of any such proposal.

Question 4: Do you agree that the Audit Firm Governance Code should focus on risk management and internal control of the firm as a whole including its non-audit business and, if not, what alternatives would you propose?

Yes.

Question 5: In the case of a UK firm that is part of a regional or an international structure, should the Audit Firm Governance Code specify the level at which it is applicable or should the firm be given some discretion to determine the level at which it applies the Code, explaining why this level has been chosen?

Given the different structures currently being developed, it would be difficult if not impossible to develop precise requirements over the part or parts of an international structure to which the Code should apply. Therefore, we favour the suggestion that the firm should be given some discretion to determine the level at which it applies the Code, explaining why this level has been chosen. That said, the principle should be that the Code applies to the firm which conducts audits in the UK or to a firm which controls the UK audit firm.

Question 6: Do you think that the Audit Firm Governance Code should contain code principles and/or code provisions covering an audit firm's dependence on, and exposure to the risks of, other network members and how it ensures consistent quality and application of auditing standards?

Regulation already requires firm to disclose information about their international network structures and, separately, its processes regarding its own internal quality control. Not only

would further requirements be unnecessarily duplicative, but also these matters sit uneasily in a Governance Code. Accordingly, we do not support the suggestion that there should be Code provisions in respect of these matters.

Question 7: In principle, do you think that the Audit Firm Governance Code should support the appointment of independent non-executives by the firms and, if so, what might it say on the number or proportion of non-executives and their position, role and responsibilities in a firm's governance structure?

We have given considerable thought to this issue over the years, but have always ended up concluding that the obstacles to a major audit firm being able to appoint external directors with appropriate and relevant experience and expertise are insurmountable. As described above, the auditor independence requirements are so restrictive that the type of people who could add real value to the firm are simply not able to be members of either of our governing boards. Any Code provision requiring the appointment of such individuals risks an expensive and counterproductive box ticking exercise, with inappropriate appointments which add little or no value other than enabling the firm to say it has complied with the Code provision. If clear evidence of how these problems can be overcome can be produced, we would certainly be keen to reconsider our position.

A better focus for the Code would be to think carefully about the role of independent (from management) partners and the role that they should play in the governance of the firm. Such partners are extremely well equipped to act as non-executive directors and have every incentive to hold management to account. At the same time, consideration could be given in the Code to the development of the concept of an Advisory Board which would sit outside the formal governance arrangements of the firm (and without the constraints of the personal auditor independence requirement to which members of the firm are required to comply) but would be there to assist in the development of strategy and policy.

Question 8 Other than matters related to auditor independence, are there any barriers, regulatory or otherwise, to the appointment of independent non-executives to firms?

The issues relating to auditor independence are fundamental and, as already noted, in our view insurmountable. They are so invasive and far reaching that they present a complete barrier to the appointment of directors with relevant expertise and experience. However, they are not the only barriers. A director of a client of the firm in respect of non-audit services would have a potential conflict which in practice is likely to prevent him or her being a director of the audit firm. In addition, some, but perhaps not all, suitably experienced potential external directors would feel unable to join the board of a major audit firm because of potential conflicts of interest that might arise at some time in the future as a result of, say, M&A activity by clients of the firm.

Liability issues also represent a potential barrier, notwithstanding the existence of limited liability partnerships. Whilst, theoretically, it may be possible to protect an external director from liability risk, this is untested in practice and the likelihood is that no commercial insurance would be available.

Question 9: What other governance structures and models are there that provide for independent oversight which might be considered by the Audit Firm Governance Working Group?

Given the extent of existing regulation, we do not consider that any further oversight is desirable, necessary or appropriate. The combination of audit regulation, the firm's own governance arrangements and the transparency which now exist are both appropriate and sufficient.

Question 10: In order to determine which firms the Audit Firm Governance Code applies to, should the definition of a public interest entity be based upon the narrower listed company market definition used for transparency reporting purposes or the wider definition used by the AIU or some other definition?

On the basis that any Code will be beneficial, that is the benefit of the Code's requirements outweigh their costs, it is hard to see why it should not be applied to the widest group of audit firms (and, although outside the scope of this consultation, to other large partnerships such as firms of solicitors as well).

Question 11: Do you think that a distinction should be made between firms that would be required to apply the Audit Firm Governance Code and firms that would be encouraged to apply it on a voluntary basis and, if so, where should that distinction be drawn?

Our understanding is that any Code will be a voluntary Code, that is no firm will be required to comply with it although, of course, there would be strong encouragement to do so and, in practice, all the large audit firms would almost certainly adopt the Code. If, as this question implies, some firms will be "required" to follow the Code, then this must become a matter of regulatory imposition. This then becomes a different proposition, and we would expect the normal consultation on any proposed regulation by either the FRC or the Government.

Question 12: Based on the assumption that the comply or explain approach will apply, to what extent do you think that the implementation of the Audit Firm Governance Code should be 'left to the market' because owners of the firms and shareholders and directors of listed companies can be relied on to ensure that the firms apply the Code and make appropriate explanations of non-compliance?

We believe any Code which has value will be of considerable interest to Investors, Boards and Audit Committees who will evaluate the extent of compliance and the validity of any explanation of non-compliance. The conclusion of their evaluation will no doubt be a factor in determining the appointment or reappointment of an audit firm. Similarly, the partners in the audit firm will be able to gauge their firm against best practice. There is no case, therefore, for additional regulation.

The appointment of a body to monitor and check compliance appears to us bizarrely bureaucratic and adding cost without any obvious benefit.

Question 13: What need, if any, do you think there will be for:

- **Audit regulations to require the firms to make comply or explain disclosures in relation to the Audit Firm Governance Code?**
- **A regulatory or other body to monitor and to check either compliance with the Audit Firm Governance Code or the appropriateness of explanations of non-compliance?**
- **Involvement of auditors appointed by the firms?**

We do not consider any further regulation will be necessary. As already stated, we believe that the quality of compliance with a Code, or the explanations for variation from the Code, will be of considerable interest to those involved in the appointment and re-appointment process of auditors. We therefore consider that market pressure will be more than sufficient in respect of the Code, such that no further regulation or regulatory body is required.

Since the large audit firms are now LLPs, they are all subject to audit. We would expect the auditor to have the same responsibilities in relation to corporate governance disclosures as is the case for listed companies.

Question 14: Can you suggest any potential deregulatory measures to eliminate possible duplication that could be linked to the implementation of the Audit Firm Governance Code?

We do not consider that the introduction of an Audit Firm Governance Code will or should reduce the extent or cost of our existing governance arrangements. Nor do we believe it would be possible or appropriate to reduce audit firm regulation as a result of the introduction of a Governance Code.

Question 15: What measures should be taken in relation to how and where the firms disseminate information about their application of the Audit Firm Governance Code so as to enhance its usefulness?

We consider this is a matter for the audit firm itself. As already stated, we believe that the subject of audit firm governance will be of interest to both directors and investors when considering the appointment or reappointment of auditors. We would expect, as now and as for public companies, this information to be included within the firm's annual report and accounts which are easily accessible by any and all stakeholders. We would not wish to see any further imposition on how firms should communicate with their stakeholders.

Question 16: Should the Audit Firm Governance Code call for disclosure of specific matters, such as major changes in governance practices, responses to specific concerns raised by the AIU, and any other matters?

We do not see any need for any further Code provisions in these respects. As stated above, these matters will be of interest to those involved in the appointment of auditors but duplicated information which is already available is, far from being helpful, actually counterproductive.

Question 17: Are there principles and provisions in the Combined Code which you think are particularly relevant or inappropriate for application to the firms and are there major issues of relevance to the firms that are not included in the Combined Code?

The principles of good governance apply to major audit firms as much as to other organisations but, as already stated, the significant differences between a partnership and a company with external investors mean that it is not appropriate to devise an Audit Firm Governance Code by adapting the Combined Code.

Question 18: Are there any compelling reasons for departing from the Combined Code structure of preamble, principles and provisions?

See Question 17 above.

Question 19: Can you provide examples, whether or not derived from the Combined Code, from other non-listed company sectors where you think that appropriate governance codes have been developed, giving information on their potential relevance to the firms?

The OECD Principles of Corporate Governance provide a good foundation. Other codes, including the Combined Code itself, will provide useful experience. However, we believe the Code should be kept at a high level of principle to be appropriate and effective.

Question 20: Do you have any other observations about matters not covered by earlier questions that you think would be useful to the Working Group in drafting the Audit Firm Governance Code?

As stated above, we consider a governance code consisting of high level principles to be most appropriate for audit firms. We urge the Working Group to avoid the temptation to over-engineer the code, which we believe would almost certainly reduce its effectiveness.

Yours faithfully

PricewaterhouseCoopers LLP

