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Dear Sir

Second consultation paper on a proposed governance code for audit firms

PricewaterhouseCoopers LLP (PwC) welcomes the opportunity and is pleased to respond to the second consultation paper on audit firm governance issued by the ICAEW in July 2009.

We recognise the importance of good governance for audit firms and support the introduction of a code based on the principle of "comply or explain" as a means of sustaining market confidence in the auditing profession. To be effective, any such code has to be flexible enough to reflect the different governance structures of audit firms and to be practical to apply within the existing regulatory environment. In particular, it is essential that the role of independent non-executives is capable of attracting individuals of the highest calibre.

The creation of an audit firm governance code was a recommendation of the Market Participants Group (MPG) that was set up to promote greater choice in the audit market. Consequently the development of such a code in the UK is a logical next step, and one we welcome. PwC is a leading proponent of good governance, both for our clients and for our own firm, as we believe it is essential for the wellbeing of any organisation. We also recognise that a commitment to a transparent governance code can play an important role in sustaining market confidence in audit quality.

Over recent years, the UK regulatory landscape affecting audit firms has advanced considerably, resulting in greater transparency around audit quality and audit firm governance; examples include audit firm inspection by an external body which then publishes reports on their findings on individual firms and the publication of an annual transparency report by audit firms. As a result we would observe that we already comply with a significant proportion of the proposals in the code on either a voluntary or a regulatory basis. We recognise, however, that UK investors would welcome greater clarity around audit firm governance and acknowledge the role that a code can play in providing this.

Notwithstanding our support for the code, there are certain elements, particularly relating to the proposal for independent non-executives, which we believe the working group should consider further. If the code is to be effective in sustaining market confidence in the auditing profession, it is important that it is practical from an operational perspective and can be fully met by audit firms. Moreover, we believe that refinements are needed to ensure that the highest calibre of individual is

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attracted to the important role of an independent non-executive of an audit firm. We therefore raise these concerns now in the interests of ensuring that the code is able to be applied effectively by audit firms of all sizes.

Independent non-executives

We recognise the important role that independent non-executives could play in advising audit firms on matters of public interest. Indeed, we have frequently considered the possibility of appointing such individuals in the past. However, for this role to be effective in enhancing market confidence, it is important that individuals of the highest calibre are willing to be considered for the role. In this context, therefore, we think that the working group should give further consideration to the proposed role, the proposed rights of the non-executives and the implications that this may have on the need to comply with the strict independence regime within which we are required to operate.

The role of an independent non-executive is crucial in determining both their exposure to liability as a result of the duty of care that they will assume in taking up such a role and the extent to which they will be required to comply with the relevant independence rules. We welcome the flexibility proposed in the code in this regard. The role envisaged in the code establishes an advisory role for the non-executives that need not, in itself, bring them into the "chain of command" of an audit firm. In this context, however, we would encourage the working group to reconsider provision C.3 of the code which provides a right for non-executives to report publicly on areas of fundamental disagreement with the owners of an audit firm. We believe that this right effectively imposes a duty to report on the independent non-executives in certain circumstances which may place them in an invidious position of conflict - between the duties they owe to the audit firm and those owed to the public at large. It may also place the non-executive within the "chain of command" of the audit firm as defined by the SEC¹ (by inference "do what I say or I will publicly report"). This is likely to make them subject to onerous independence requirements which may seriously impair the attractiveness of the role.

In general, we believe that the rights and duties of an independent non-executive in an audit firm should mirror, in so far as they are relevant, those of a non-executive director under the Combined Code. Clearly the key distinguishing feature of a professional services partnership is the fact that it is owned and controlled by its partners, all of whom have invested their capital in the firm and work for it. As such, management is held to account by partners who are independent of management but who work full-time in the firm in client-service roles - in PwC's case through the medium of an elected Supervisory Board. Consequently, in our view the natural remedy for an independent non-executive who has a fundamental disagreement with the management of the audit firm would be to report to the Supervisory Board and, ultimately, to the partnership as a whole, with the right to resign as a last resort. We therefore believe that any additional right to report to third parties is unnecessary, confusing and should be deleted.

On the assumption that the role does not place the non-executive in the chain of command, we believe that there are still significant independence restrictions to which a non-executive, acting in an advisory capacity, will be subject. In this context, it is important to recognise that many auditors

¹ Under the rules of the SEC, an individual would be in the chain of command if he/she was deemed to have "direct management responsibility for the audit" or "oversight of the audit".

of public interest entities will be required to comply with the independence rules established by regulatory bodies outside the UK, in particular with those issued by the SEC. We set out below our understanding of the likely independence issues that will be faced by an independent non-executive under the current proposals.

1. Employment Relationships – if the role of an independent non-executive is considered to be a business relationship, he/she may not have a role as “management” of any UK audit client, possibly including a role as a non-executive director. Further, an independent non-executive may not be employed by an audit client in any capacity or serve as a member of a client’s board of directors (or similar body). As it is possible that there may be a perceived conflict of interest should a family member of the non-executive hold such a post this is also likely to be a prohibition. In addition, the perception of a conflict of interest is also likely to extend to a non-executive acting as a promoter, underwriter or voting trustee of an audit client.
2. Business Relationships – a significant supplier/customer relationship between the non-executive’s business and an audit client is also likely to be a conflict of interest issue and prohibited.
3. Financial Relationships – a non-executive and certain of his/her family members would be prohibited from having beneficial ownership of more than 5% of an SEC audit client’s equity securities or having a close family member who controls an SEC audit client. If the non-executive is considered a partner, he/she and any immediate family members would be prohibited from having any financial interest in any audit client, subject only to certain employment-related exemptions.

In considering these restrictions a minimum of a one year “cooling off period” is likely to apply.

The existence of these restrictions, combined with the risk that their other business interests might bring them into a conflict of interest with the firm, will necessarily act as a disincentive for many high calibre individuals who would otherwise be ideally suited for the proposed non-executive role. However, this risk would be significantly higher if the role of the non-executives were to bring them into the chain of command of the firm. The consultation paper indicates (page 11) that the working group *‘trust that authorities with responsibilities for regulating auditor independence will be prepared to reconsider their application of existing rules to individual non-executives if rules appear to be imposing unnecessary restrictions’*. We take our regulatory responsibilities for independence seriously and believe that this reference in the consultation paper does not acknowledge sufficiently the need for us to satisfy the appropriate authorities that we have complied fully with their requirements. Indeed, it would be difficult to justify exempting any individual who is perceived as being in the chain of command from the strict independence requirements that are imposed generally on partners in the firm by internationally accepted best practice. We therefore recommend that the preamble to the code clearly acknowledge the difficulties that independence restrictions will create and recognises the need for flexibility to allow independent non-executives to remain outside the chain of command of a firm.

Scope of the code

As the main driver for the creation of a governance code is to assist in providing greater choice in the audit market we would encourage the working group to promote the “comply and explain” benefits of the code rather than set an expectation that the code should only initially be applied by the top eight audit firms (in effect, creating a barrier to entry for other firms).

This approach will allow audit firms the flexibility to move toward code compliance without being faced with an artificial barrier (e.g. 20 listed company audits as proposed in the draft code) between non and full compliance. It will also allow auditors of public interest entities to determine the appropriate level for their compliance with the code, taking into account the public interest in their audit activities and the costs of complying with the code requirements.

Extraterritoriality

We note that the introduction to the code suggests that, for national firms that are part of a regional or international structure, it will make sense to look beyond the national firm in considering application of the code principles and compliance with the code provisions. As indicated in our response to the first consultation paper, we believe that the principle should be that the code applies to the firm which conducts audits in the UK or to a firm that controls the UK audit firm. Given the different structures adopted by each international network, it would be inappropriate to establish an expectation that this code will be applied more widely. We recognise, however, the importance of disclosing the level at which the code has been applied and the reasons for that choice.

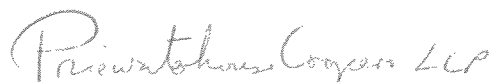
Dialogue

We welcome the proposals in the code that there should be opportunities for dialogue on issues of public interest between the shareholders of audit clients and the audit firm. We therefore support the principle and provision at F1 for audit firms to disclose publicly the arrangements made for that dialogue. However we note that the subsequent provisions of the code in F2 and F3 are requirements that fall on the shareholders of client companies and are therefore not matters within the control of audit firms. Consequently we recommend that these are deleted.

We have attached, at Annex A, some detailed drafting comments on other code provisions.

Please contact Ian Powell or Pauline Wallace if you wish to discuss any particular issues arising from our response.

Yours faithfully



PricewaterhouseCoopers LLP

**FURTHER COMMENTS ON THE DRAFTING OF
THE GOVERNANCE CODE**

C.1 – Involvement of independent non-executives principle

We understand that the anticipated role of a non-executive is as identified in this principle. We suggest, therefore, that 'at a minimum' is deleted as this implies that non-executives are expected to do other unspecified roles.

Whilst audit firms may choose to ask non-executives to take on additional roles we do not consider that the expectation of the code should be that non-executives will take on additional public interest roles not identified in this principle.

D.1 – Compliance principle.

We are unable to see the need for provision D.1.2 within the audit firm governance code as it appears to be an unnecessary level of detail which is addressed within provision D1.1.

D.2 – Risk management principle/D.3 – People management principle

With respect to provision D.2.3 and principle D.3, we suggest that the ISQC1 framework is an appropriate model that should be referenced in the code. This approach will ensure compliance with relevant standards without adding disproportionate costs on audit firms.