



October 9, 2009

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ICAEW  
Chartered Accountants' Hall  
P.O. Box 433  
Moorgate Place  
London EC2P 2BJ  
United Kingdom

**Re: Request for Public Comment: *Audit Firm Governance – Second Consultation Paper***

Dear Robert:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants. The CAQ appreciates the outreach efforts that you made to us in August of this year to discuss the Audit Firm Governance – Second Consultation Paper (the "Code") proposed by the Working Group of the Institute of Chartered Accountants in England and Wales (ICAEW) and welcomes the opportunity to comment on the Code.

The CAQ recognizes the important role that auditors of public companies serve to capital market participants. As such, we are supportive of efforts that would offer enhancements to firms' existing governance structures. However, we believe there are certain aspects of the Code related to the responsibilities of independent non-executives (INEs) that could present significant challenges to the accomplishment of its intended objectives. As we stated in our comment letter in response to the U.S. Department of Treasury's

Advisory Committee on the Auditing Profession (Treasury Committee), we think there may be benefits to including independent members on firm boards. The CAQ recognizes that a governance regime featuring independent, outside perspectives could improve public confidence in the profession, add to the diversity of perspectives within the audit firms, and contribute to the firms' best practices and supply specific expertise.<sup>1</sup> Our objective in providing comment is to facilitate a further understanding among the members of the Working Group on those aspects of the Code that are related to the responsibilities of INEs. We believe these aspects may impact its application for UK firms that perform audits of companies listed in the United States as well as firms that operate as part of international networks which include the United States. We encourage the ICAEW to consider these areas as it develops any final audit firm governance code.

In addition, we note that in the introduction to the Code, the Working Group suggests that firms that operate within international structures consider whether the provisions of the Code should be applied outside of the UK firm. While we do not provide comment on the application of the Code to firms in the United States, you will note that the involvement of INEs and other aspects of the Code were subject to deliberations by the Treasury Committee, and we encourage you to consider views provided as part of those proceedings as you develop any final code. This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

### **Independence of Non-Executives**

One of the most significant provisions of the Code relates to the involvement of INEs in a firm's governance structure. Under the Code, INEs would serve roles intended to increase the public's confidence that firms are governed in a manner considerate of their significant role in the capital markets. As such, an INE's duties would include having a meaningful role in a firm's decision making process, in the management of reputational risks associated with businesses that are not otherwise addressed by regulation and facilitating dialogue with stakeholders. In order to successfully accomplish these duties, the consultation paper recognizes the importance of INEs being independent from the firm, its partners and its audit clients – both in fact and in appearance – and recognizes the challenges that firms may face in appointing members who meet these requirements.

For UK firms that perform audits on UK companies listed in the United States, U.S. independence rules would appear to exacerbate these challenges. Auditors of companies listed in the United States must comply with the independence standards as set forth by the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB). These rules govern relationships between the accounting firm and the audit client, and include matters such as financial, employment and business relationships. The independence provisions extend to certain persons within

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<sup>1</sup> See Center for Audit Quality, Comment Letter to the Advisory Committee on the Auditing Profession (June 26, 2008), p. 16; available at <http://comments.treas.gov/files/CAQCommentletter62708FINAL.pdf>

the firm (defined as “covered persons”),<sup>2</sup> which include members of the audit engagement team as well as personnel in the “chain of command.” A firm’s “chain of command” includes all persons who: 1) supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm’s chief executive; 2) evaluate the performance or recommend the compensation of the audit engagement partner; and 3) provide quality control or other oversight of the audit.<sup>3</sup>

In their proposed role, INEs should represent a majority of the governance structure that oversees public interest matters of an audit firm and/or be members of other governance structures within the firm. The manner in which a firm elected to incorporate INEs into its governance structure would determine whether, based on a fact-based analysis, the INE would be in the firm’s “chain of command.” Current SEC rules do not provide exceptions for non-executive members of the firm who would meet such definition. Were this the case, INEs of UK firms would need to be independent of UK companies that are listed in the United States in order for UK firms to continue their involvement with such companies, and the INEs would be subject to other personal independence requirements. In addition, with regard to the appearance of independence, and in consideration of conflicts of interest, an INE would not be able to serve as a director, officer or substantial stockholder on an attest client of the firm. This will likely complicate the ability of UK firms that perform audits of companies listed in the United States to identify candidates qualified to serve such roles.

### **Duty of Care**

Section C.2 of the Code states that “independent non-executives should have a duty of care to the firm.” The Code also provides that INEs have a right of access to relevant information and people, and a right to report a fundamental disagreement regarding the firm to its owners and, in circumstances where the disagreement cannot be resolved, to report publicly. We note that the Code does not define a “fundamental disagreement,” nor does it provide a framework for the situations where an unresolved disagreement should be reported publicly. Rather, the Code allows firms to develop and disclose their processes for dealing with disagreements and presumably, the criteria used in the determination for public reporting.

The CAQ believes that these provisions could result in situations where the governance structures contemplated by the Code may be unable to conduct their duties in accordance with the Code for UK firms that operate in international networks. For example, INEs’ right to report publicly under the Code would seem to be intended to mean that INEs have a duty of care to other stakeholders. This existence of a duty of care to stakeholders besides the owners of the firm may impede the open sharing of relevant information between U.S.-based member firms and UK firms (and perhaps other countries as well)

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<sup>2</sup> Rule 2-01(f)(11) of Regulation S-X

<sup>3</sup> See Regulation S-X; Rule 2-01(f)(8)

due to a concern that information provided to INEs in the conduct of their duties may adversely impact the firm. This, in turn, would be in conflict with an INE's duty of care to the firm. In addition, we note that UK firms who utilize non-affiliated firms in the conduct of audits may face similar challenges with respect to sharing of information. We suggest the Working Group consider whether aligning the rights and responsibilities of INEs with that of directors of listed companies under the Combined Code would assist in addressing these concerns.

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We appreciate the opportunity to comment on the proposed Code and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations.

Sincerely,

A handwritten signature in black ink that reads "Cynthia M. Fornelli". The signature is written in a cursive style with a large initial 'C'.

Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality

cc:  
Paul Boyle, Chief Executive, Financial Reporting Council