



Financial Reporting Council

# **Operational Separation: objectives, outcomes, and principles**

October 2024

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## **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 increase 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 the FRC, including financial statements, audit quality indicators and other information which indicates whether these outcomes are being delivered.
- The FRC will publish annually an assessment of whether firms are delivering these objectives and outcomes.
- The FRC will seek backstop powers to require firms to deliver these outcomes as part of the forthcoming audit reform legislation.

# Principles<sup>1</sup>

## 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), independent of the firm and its audited entities.

### 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.

<sup>1</sup> These revised Principles are effective from financial years starting in 2024.

## 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 recommend 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 and admission, 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 sub-committee of ANEs.

## Other governance matters

- P9 Appointments of individuals to the Audit Board should be subject to a formal, rigorous, and transparent procedure.
- P10 The Audit Board should have the authority to commission reviews from Internal Audit to support their oversight role.

## Scope of the separate practice

### Services within the "ring-fence"

- P11 Statutory audit should be provided by the audit practice. The audit practice may also provide:
- 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.

### 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 annually produce a separate profit and loss account for the audit practice to a level of detail which is consistent with the firm's own published statutory financial statements. 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. The individual(s) should annually

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provide the FRC with an attestation regarding the firm's compliance with the principles, using the wording supplied by the FRC.





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