Agenda Item 4-B

Firm Culture and Governance – Project Proposal

A. Subject

1. This project proposal addresses the development of a new Standard and revisions to the *International Code of Ethics for Professional Accountants (including International Independence Standards (IIS))* (the Code) [1] to establish a Firm Culture and Governance framework (FCG Framework) that promotes, supports, and reinforces ethical behavior within firms.

B. Introduction

Background

2. The accountancy profession has been facing high-profile incidents linked to unethical behavior in accounting firms (firms) relating to both their audit and consulting services. Some recent cases involving professional accountants in public practice (PAPPs) have led to significant practice sanctions, multi-million-dollar penalties[2] and other adverse consequences for individual PAPPs and their firms in multiple jurisdictions. This is a critical challenge for the accountancy profession and for its value proposition.

3. In response to these issues, the IESBA released a public statement in July 2023 emphasizing the vital importance of ethical behavior for all professional accountants (PAs) and reminding them of their ethical obligations under the Code. These obligations include upholding the fundamental principles of the IESBA Code[3] (the Code) and complying with its specific requirements, which enable PAs to meet their responsibility to act in the public interest.[4]

4. The IESBA is of the view that recurring unethical behaviors in firms call into question their culture and governance and how such culture and governance might impact the ethical behavior of individual PAs and their compliance with the Code. As emphasized in the IESBA's 2024-2027 Strategy and Work Plan (SWP), firm culture affects the reputation of individual firms, the quality of their services and public trust in the accountancy profession.

5. Recognizing the significant public interest implications of unethical behavior in the profession and the IESBA's responsibilities as a global ethics standard-setter, the IESBA has determined to address the topic of Firm Culture and Governance (FCG) as a strategic priority in its SWP, with a new work stream that commenced in Q1 2024.

6. At its March 2024 meeting, the IESBA formally approved the Terms of Reference (TOR) for a new working group (WG), the FCGWG, to gain an understanding of culture and governance and their

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1 For purposes of this document, the reference to the extant Code is the 2024 edition of the IESBA Handbook which includes the most recent IESBA-approved revisions.

2 For example, in the United States, the US SEC and PCAOB have placed sanctions on firms in relation to the examination cheating scandals that occurred between 2019 and 2024. The fines imposed ranged from $2 million to $100 million.

3 International Code of Ethics for Professional Accountants (including International Independence Standards) (the Code)

4 The Global Accounting Alliance (GAA), representing an alliance of professional accounting organizations (PAOs), also highlighted the profession's responsibility to act in the public interest despite increasing pressures on PAs to act unethically, thereby reinforcing the Code's importance (August 2023).

impact on ethical behavior within firms as well as the relevance of the extant Code in addressing these issues.

5. The FCGWG undertook an outreach program to engage with a broad range of stakeholders, including regulators, national standard setters (NSS), investors, those charged with governance (TCWG), academics, accounting firms, and professional accountancy organizations (PAOs), to gather feedback on the issues surrounding firm culture and governance.[5] These outreach efforts have been instrumental in identifying key common themes, particularly around the need for strong ethical leadership and a culture and governance framework that prioritizes ethical values and incentivizes ethical behavior. The FCGWG also undertook a literature review as well as commissioned an academic study to explore the link between firm culture and governance and ethical behavior.

6. At its December 2024 meeting, the IESBA considered and accepted the FCGWG's Final Report (the Report) and its recommendations.

Firm Culture and Governance Working Group Final Report

7. The Report examines the interplay between firm culture and governance and ethical behavior within accounting firms, incorporating stakeholder insights on the crucial role of leadership and governance in establishing a firm-wide ethical culture.

8. The Report has found that to have an environment that fosters ethical behavior within a firm, there must be leaders who prioritize ethical values and who, by their conduct and leadership approach, exemplify that behavior. There must also be a culture and governance framework that embeds ethical values in the firm's oversight, governance, rewards and incentives system and other elements within that framework, such as the importance of transparency, the use of independent input, education, and training, and a culture of speaking up, open discussion and challenge. In addition, the Report highlights the role of key stakeholders within the ecosystem in promoting a high level of ethical behavior, some of them being the ultimate beneficiaries of such an improvement, like companies and investors.

9. The Report recommended that the IESBA initiate a standard-setting project to more extensively address the importance of ethical leadership and a culture and governance framework that prioritizes ethical values and incentivizes ethical behavior and decisions. It also recommended to the IESBA the development of a series of Non-Authoritative Materials (NAMs) on the topic to complement the standard-setting project.

C.   Public Interest Issues

10. Accounting firms have developed a brand that commands public trust, underpinned by a longstanding reputation for professionalism and integrity. Central to this trust is the crucial role firms play in the audit function, where they provide independent assurance on the reliability of financial statements—thereby fulfilling a vital public function in capital markets and for investors and economies more widely. In jurisdictions that require statutory audits, auditors operate under a legal and regulatory framework that defines their gatekeeper or watchdog role in the public interest, which is foundational to their legitimacy and license to operate.

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[5]   See Appendix 7 of the FCGWG Final Report on Firm Culture and Governance.

11.   As firms diversify their service offerings, expanding into non-assurance areas, it is recognized that their ability to leverage (and maintain) the public trust associated with their audit service offerings is intrinsically linked to the profession's responsibility to act in the public interest.

12.   Although PAs generally strive to act ethically, unethical behavior with damaging consequences has become a persistent occurrence in recent times (as evidenced, for example, by recent high-profile events in Australia, the UK, the US, South Africa, and the Netherlands, among other jurisdictions). Unethical behavior can significantly tarnish the reputation of the firm involved, result in the delivery of poor-quality services, and have major impacts on the firm and its employees, the profession, and the public. In this regard, consulting services, including tax advisory services and services provided to government bodies or agencies, can often carry with them high levels of public interest, such as those provided on public policy-related matters or major infrastructure projects. Further, ethical failures in a firm's consulting services may impact not only public trust in that service line but also all other service offerings of the firm, including its audit services.

13.   Further, where firms provide services that have banking or other industry or economy-wide effects or impact public services, they may be considered by some stakeholders to be "systemically important entities."[6] The stakes are even higher for these firms, as their actions can have broader impacts on industries and economies, with significant public interest implications.

14.   Therefore, ensuring that ethics is a high priority across all service lines is essential for a firm to maintain public trust and confidence in its work in the long term. Firms should recognize that adherence to the highest ethical standards across all service lines is a strategic value proposition and not an "optional extra," and that this may be the best safeguard against reputational risks from unethical behavior and related consequences and policy options. Recognition as an ethical firm will help a firm to grow its business in a much more sustainable way.

15.   To facilitate firms operating as ethical firms and thereby mitigate the risk of ethical failure more holistically, it is essential to address not only ethical behavior at the individual level but also the broader organizational issues of ethical culture and governance frameworks, including leadership. These broader issues should be considered firm-wide, covering all service lines.

D.   Project Objective

Objective

16.   The objective of the project is to develop a culture and governance framework that promotes, supports and reinforces a high standard of ethical behavior across all of a firm's services, thereby helping the firm develop a reputation as a highly ethical firm, mitigate the risks of unethical behavior and strengthen public trust and confidence in all of its services.

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[6]   According to Jeremy Hirschhorn (Second Commissioner, Client Engagement Group at Australian Tax Office), "Once a firm gets to a particular size, it fundamentally changes how it should think about itself and how society will think about it. Our concept of 'systemically important' is a firm with industry or economy-wide effects in a local jurisdiction. Naturally, we say that public interest is much more important once you get to that because you can change how things work in your society. Being systemically important brings a greater demand for transparency and public accountability and when I look at the big firms in Australia, we see them as systemically important across four distinct markets: financial statements audits, large market tax advice, private sector consulting and government consulting. This of course may not be the case in all jurisdictions" (April 17, 2024)(https://www.linkedin.com/pulse/firm-culture-governance-jeremy-hirschhorn-hs9lc).

Qualitative Standard-Setting Characteristics

17.   In light of the objective set out above, the key qualitative standard-setting characteristics that will guide the development of the FCG Framework so that it is responsive to the public interest are:

(a)   *Consistency,* by developing the framework to ensure consistency with the Code's fundamental principles and ethics provisions, enabling uniform application across firms and jurisdictions, and supporting adherence to a global baseline of ethical and governance practices.

(b)   *Coherence,* by developing a framework that is logically structured and internally consistent, aligning ethical principles with governance requirements for a unified and readily implementable framework.

(c)   *Scalability*, by ensuring that the framework is designed in a way that will be proportionate to different sizes of firms.

(d)   *Relevance,* by developing principles-based requirements and application material that respond to key issues identified and take into account modern business practices and the different contexts in which firms operate.

(e)   *Completeness*, by conducting consultations and outreaches with a broad range of stakeholders and balancing their views and priorities.

(f)   *Implementability* and *ability to be consistently applied and globally operable,* by ensuring the framework is principles-based, can be applied across all jurisdictions, and adaptable to any ownership and organizational structures.

(g)   *Enforceability,* by developing the framework with clear, actionable requirements that can be consistently enforced by regulatory bodies and PAOs, and monitored within firms.

E.   How the Project Serves the Public Interest and Meets Stakeholder Needs

18.   The project serves the public interest by enhancing trust and confidence in the accountancy profession and the services it provides. It will also meet the needs of stakeholders with legitimate interests in the proposed FCG Framework as follows:

Stakeholder	How the Stakeholder Need is Served
Investors and users of financial and non-financial information	Through the FCG Framework, enhancing firms' ethical culture and ethical performance, thereby better ensuring that firms do not compromise their responsibility to serve the interests of investors and users, and ultimately, the public interest.
Regulators, Oversight Bodies	The FCG Framework will help establish a globally consistent baseline of FCG principles, thereby helping to raise the bar on ethical behavior and practice across firms, and facilitating the regulatory community's fulfillment of its responsibility to protect the public interest.
All firms	Implementing the FCG Framework will help embed ethics in a firm's strategy, governance and operations, thereby supporting the

Stakeholder	How the Stakeholder Need is Served
	firm in being a highly ethical firm, better mitigating risks of unethical behavior across all partners, staff and service lines, enhancing the firm's reputation, building and reinforcing public trust in the firm, and ultimately helping the firm grow its business sustainably.
PAs in public practice and non-PAs in firms	Through the implementation of the FCG Framework within their firms, creating an environment that will foster ethical behavior among PAs and non-PAs in the firms, and helping them develop a reputation as trusted professionals.

F.   Project Scope

19.   The scope of the project encompasses:

(a)   All the service lines of an accounting firm; and

(b)   All sizes of firms, regardless of the jurisdictions in which they operate.

Consideration will be given to the operation of the framework in firms that are part of global networks.

G.   Overview of Key Elements of the FCG Framework

20.   The project will develop a framework of principles to guide the promotion, support and reinforcement of ethical behavior within a firm by addressing the key elements of ethical culture and governance as follows.

(a)   Ethical Leadership and Oversight

Leaders have a responsibility to demonstrate in action an unwavering commitment to ethical values, and to act in the public interest through their decisions and actions. Their behavior, including decision-making, should consistently reflect the firm's values, serving as a model for all partners and staff to follow.

In developing the proposed framework, the project will consider and address, as appropriate, senior leadership's role in, and commitment to, prioritizing ethical values, including developing strategies that embed ethical values, setting the tone at the top, leading by example, and being accountable for their ethical behavior and decisions. Among other matters, the project will also consider:

- Senior leadership's overall responsibility for, and accountability to, the ethical culture and ethical performance of their firm.

- The role, responsibilities, and accountability of global leadership of global network firms, including their interaction with local network leadership and regulators.

(b)   The Provision of independent Input

The provision of independent input to a firm from advisors, a committee of advisors or Independent Non-Executives (INEs) through the lens of ethics and public interest contributes to the effectiveness of a firm's culture and governance framework in promoting ethical values and culture.

In developing the proposed framework, the project will consider and address, as appropriate, the role of independent persons as non-executives (INEs) within a firm's governance structure to provide input to the firm's leadership on strategic matters and key decisions, giving particular consideration to the firm's role in acting in the public interest, its commitment to upholding high ethical standards, and how a decision would impact the ethical culture of the firm. Among other matters, the project will also consider:

- The firm's responsibility to ensure the INEs are fit and proper for the role – i.e., that they have the necessary skills, knowledge, availability and experience, are independent from the firm and/or the firm's clients, do not have a track record of unethical behavior, and have proper access to information and senior leadership team.

- Scalability, such as whether only larger firms and networks or those that audit PIEs should appoint individuals as INEs.

(c)   Firm-wide level Accountability

All individuals, from senior partners to entry-level staff, have a responsibility to maintain ethical standards and uphold the firm's ethical values. If such responsibility is properly fulfilled, accountability becomes a proactive mindset, ensuring that issues are identified and resolved before they become more significant problems. This helps build a stronger, more resilient ethical culture that supports the firm's long-term success and underpins public trust in it.

In developing the proposed framework, the project will consider and address, as appropriate, the accountability of all partners and staff with respect to their upholding the ethical values of the firm and complying with ethical standards, as well as senior leadership's accountability to the firm's overall ethical performance. Among other matters, the project will also consider:

- A whole-of-firm accountability framework that includes ethical behavior and requires leadership to take prompt and transparent actions.

- The linkages between accountability, transparency, and rewards and recognition, including promotions.

(d)   Performance Management, including Incentives and Rewards that Promote Ethical Behavior

As incentives, rewards and recognition play a significant role in driving behavior within firms, it is important to align them with ethical performance. When partners and staff see that ethical behavior is recognized and rewarded, they are more likely to prioritize ethical considerations in their work. By aligning incentives with ethical behavior, firms can create an environment where the firm's personnel are driven to act ethically.

In developing the proposed framework, the project will consider and address, as appropriate, performance management (including incentives, rewards, recognition, promotions and disincentives) that recognizes the importance of upholding the firm's ethical values and complying with its ethical standards. Among other matters, the project will consider the need to establish clear rewards and consequences that tie to ethical behavior, promoting accountability among leaders, other partners and staff.

(e)   A Speak-Up Culture that Embraces Open Discussion and Challenge

An ethical culture requires fostering an environment where the firm's personnel can speak up and raise concerns in a safe environment. All partners and staff should feel safe discussing

and questioning practices and decisions openly. This approach promotes transparency and accountability, allowing issues to be addressed before they become bigger problems. A speak-up culture or a culture of open discussion and challenge also extends to creating a workplace environment where asking questions is valued, encouraged and expected. There should be an environment where partners and staff can speak their minds, be curious and constructively challenge the views of their superiors or their colleagues, which will foster mutual learning within a team and improve the quality of their work.

In developing the proposed framework, the project will consider and address, as appropriate, establishing mechanisms that facilitate the reporting of ethical concerns in a safe environment as well as maintaining an open environment where people are encouraged and valued to discuss and challenge ideas and knowledge.

(f) Education and Training on Ethics

Continuous training and education play a vital role in ensuring that all members of a firm, PAs and non-PAs alike, irrespective of business service lines, understand and uphold the firm's ethical values and comply with ethical standards effectively in their professional activities. A firm's goal for its professional staff in relation to training and education should also go beyond the acquisition of knowledge of ethical standards or how to address particular scenarios in order to ensure that the consideration of ethical matters is integrated into the staff's judgments and decision-making.

In developing the proposed framework, the project will consider and address, as appropriate, mandatory ethics training programs at all levels of the firm, ensuring that all partners and professional staff across all service lines understand and uphold the firm's ethical values and comply with ethical standards in their professional activities.

(g) Transparency

Being open about the occurrence of unethical behavior and the steps taken to address it shows a commitment to accountability and continuous improvement. It will also help build a culture where ethical behavior is expected.

In developing the proposed framework, the project will consider and address, as appropriate, relevant disclosures by firms that will allow stakeholders to assess their ethical performance as well as open and transparent discussions with regulators and other supervisory bodies to address ethical concerns. Among other matters, the project will also consider:

• Public disclosures by firms on ethics-related matters, including ethical failures.

• Encouragement of regular dialogue with regulators and other relevant stakeholders.

(h) Other Areas

In the course of the project, the Project Team may identify new areas that the FCG Framework should also address as part of this project.

21. The FCG Framework will:

(a) Be principles-based, recognizing that there is no one-size-fits-all model;

(b) Apply to the firm's leadership, other partners, and staff as well as across all service lines of the firm; and

(c)   Be scalable to fit the different sizes of firms, from small practices to large firms with global networks. For instance, consideration may be given to whether there should be any size threshold for the use of INEs.

22.   The Project Team will consider the options for the location of the FCG Framework, including:

(a)   Part 3 of the Code.

(b)   A new Part within the Code.

H.   Approach to Developing the FCG Framework

23.   The information gathered will be used to develop the FCG Framework as well as a series of NAM.

Global Roundtables

24.   The Project Team will convene a series of global roundtables in Q1-Q2 2025 to engage with a broad group of stakeholders on matters for consideration in the project and any other issues relevant to this project.

Non-authoritative Material

25.   As the standard-setting project progresses, a second Project Team will develop a series of NAMs, such as position papers, white papers and thought pieces. The IESBA may also consider collaborating with partners such as NSS to develop these materials.

26.   The Report has identified the following as potential NAM topics:

(a)   Importance of Ethical Culture in Driving Behavior

NAM on this topic will highlight the importance of ethical culture in driving ethical behavior within firms. It will touch on the key factors identified in the Report that contribute to a strong ethical culture across the whole firm, such as leadership commitment, transparency, and accountability, and expand on how these factors can be embedded in a firm's structure and operations.

It is anticipated that this NAM will be developed as a short statement to be released in Q2 2025.

(b)   Common Characteristics of an Ethical Firm

NAM's work on this topic will build on the FCGWG's view on the common characteristics of an ethical firm highlighted in the Report and further develop those characteristics that are common to all firms, irrespective of the types of services provided or jurisdictions in which they operate.

It is anticipated that this NAM will be developed as a white paper to be released in Q4 2025.

(c)   The Contributions of Stakeholders within the Ecosystem in Promoting Ethical Behavior

The topic will discuss the role of various key stakeholders within the ecosystem — such as regulators, investors, those charged with governance, and PAOs — in promoting ethical behavior within firms. This NAM will emphasize the importance of proper interactions among these stakeholders and with firms to ensure a comprehensive approach to ethics. Individually and collectively, these stakeholders play a crucial role in setting expectations, offering guidance, and providing oversight and enforcement where appropriate.

27.   In the course of this new work stream and the standard-setting project, the IESBA may also identify other topics that could be addressed through NAMs. For instance, the IESBA may consider developing more detailed guidance material on some of the key factors identified in the Report that contribute to a strong ethical culture, illustrating through practical examples how firms can integrate ethics into their strategy and operations.

Coordination with the Emerging Issues & Outreach Committee (EIOC)

28.   Private equity investments in firms have been an important recent development in the accountancy profession. The typical private equity business model involves restructuring, expanding, or enhancing an entity's value before eventually exiting through a sale or public offering. Private equity investments have the potential to significantly impact the ethical culture and governance of the firms involved.

29.   In September 2024, the IESBA agreed to monitor this development, including any regulatory responses or actions, and tasked its Emerging Issues & Outreach Committee (EIOC) to commence research to understand the broader implications of private equity investments in firms.

30.   As ownership structures, including external investment, can impact a firm's culture, the Project Team will coordinate with the EIOC to identify any FCG-related issues that should be considered as part of the project.

Coordination with the IAASB

31.   The International Auditing and Assurance Standards Board's (IAASB) ISQM 1[7] deals with a firm's responsibilities to design, implement, and operate a system of quality management (SOQM) for audits or reviews of financial statements, or other assurance or related services engagements. The objective of the SOQM is to provide the firm with reasonable assurance that the firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements. It also provides the firm with reasonable assurance that engagement reports issued by the firm or engagement partners are appropriate in the circumstances. SOQMs in compliance with ISQM 1 were required to be designed and implemented by December 15, 2022.

32.   Given that ISQM 1 addresses a number of matters relevant to an FCG Framework, such as governance and leadership, the Project Team will closely collaborate with the IAASB to ensure that the FCG Framework aligns with and is interoperable with the principles of ISQM 1.

I.   Development Process, Project Output, and Project Timetable

Development Process

33.   The project will follow the IESBA's due process, including seeking input and advice from the Stakeholder Advisory Council (SAC) and exposing the proposed provisions for public consultation for a 90-day period.

Project Output

34.   It is anticipated that the output of the project will include:

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[7]   International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

<u>Standard-Setting Work Stream</u>

(a)   New provisions in the Code setting out an FCG Framework that promotes, supports, and reinforces ethical behavior within firms.

(b)   Revisions to the extant provisions in the Code relating to organizational culture and leadership as appropriate.

<u>NAM Work Stream</u>

(c)   A series of NAMs that will complement the standard-setting output.

Project Timetable

35.   Subject to the IESBA's approval of the project proposal, this project will commence in Q1 2025. The specific project milestones and outputs will depend on the matters that the project team ultimately determines are appropriate to address as part of the project and the priorities assigned to those matters.

36.   The table below provides indicative timing for the standard-setting project. This timeline is subject to revision based on the learnings and insights from stakeholder consultation, including feedback from the SAC and global roundtables. It does <u>not</u> include the timeline for the release of the NAM series.

Month	Actions
2024	
December 2024	• Approval of project proposal
2025	
Jan 2025	• Release of Working Group Final Report and summary statement
March – April 2025	• Global consultation – roundtables
June 2025	• Feedback and discussion of global roundtables
Sept 2025	• Discussion and preliminary draft of proposed provisions
October 2025	• SAC meeting
November 2025	• Second read of Exposure Draft (Virtual meeting)
Dec 2025	• Approval of Exposure Draft
2026	
June 2026	• High-level review of respondents' feedback
Sept 2026	• Full analysis and first read post-Exposure Draft

October 2026	• SAC meeting
November 2026	• Second read post-Exposure Draft (Virtual meeting)
December 2026	• Approval of Standard

37. The IESBA will consider whether to undertake a post-implementation review (PIR) in due course to assess whether the implementation of the provisions is meeting the project objective. The IESBA will consider such a PIR during the development of its next strategy and work plan.

J. Resources Required

38. The project will have two work streams (Standard-setting and NAM). Operating under the staff-driven model, each workstream will be supported by a project team comprising 2-3 IESBA staff members, including a senior technical staff member. The two project teams will initially be advised by two IESBA members acting as Board Advisors. Notwithstanding the Board Advisors, each project team will have full authority and flexibility to engage as needed with Board members, individually or in small groups, at any time throughout the project or NAM initiative, as applicable.

39. Depending on the scope and intensity of the particular initiative undertaken within the NAM work stream and the extent to which it would proceed concurrently with the standard-setting project, consideration might be given to identifying up to two additional Board Advisors to be dedicated to advising the NAM project team, so that the two existing Board Advisors may focus on the standard-setting work stream. Full coordination will be maintained between the two work streams.