



FINANCIAL REPORTING COUNCIL

AMENDMENTS TO GUIDANCE ON AUDIT COMMITTEES

SUMMARY OF CONSULTATION RESPONSES

OCTOBER 2008

SUMMARY OF THE MAIN POINTS RAISED BY RESPONDENTS

Introduction

1. The Market Participants Group's (MPG) report on 'Choice in the UK Audit Market', published in October 2007, contained four recommendations that were to be implemented, in full or in part, through amendments to the FRC Guidance on Audit Committees (formerly known as the Smith Guidance):
 - *Recommendation 8:* The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.
 - *Recommendation 9:* When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.
 - *Recommendation 12:* The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.
 - *Recommendation 15:* Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.
2. Consultation on proposed revisions to the Guidance on Audit Committees was carried out between March and June 2008. The revisions proposed in the consultation document concerned the appointment of the external auditor and related disclosures, and the independence of the external auditor.
3. 26 responses were received, including 12 from the accountancy profession (audit firms and representative bodies), seven representing corporate interests, five from the investment community and two others. A complete list of respondents is at Annex A. Copies of individual responses are available at:

<http://www.frc.org.uk/corporate/responseAuditCommittees.cfm>.
4. This paper summarises the responses to the proposed changes. For each proposal, it contains the full text of the proposed amendment, a summary of comments received, and records what action was taken as a result.

Paragraph 4.19

Proposal

The audit committee should assess annually the qualification, expertise and resources, and independence (see below) of the external auditors and the effectiveness of the audit process. The assessment should cover all aspects of the audit service provided by the audit firm, and include obtaining a report on the audit firm's own internal quality control procedures *and consideration of audit firms' annual transparency reports, where available*

Summary of responses

5. Nine respondents commented on this paragraph, all of whom supported the proposed change. There were however mixed views about how useful the transparency reports would be to audit committees. Some felt they would be, while others were more sceptical:

"These reports should improve transparency of the capabilities of individual audit firms and promote an understanding of audit quality. If audit firms disclose more information on matters such as their governance, client profiles, quality control procedures and policy issues faced, audit committees should be better able to clarify their preferences between audit firms and decide which auditors will best be able to meet their needs." (IMA)

"We have currently some reservations that such material may be used as a marketing tool rather than a governance statement. We look forward with interest to the outcome of the Audit Firm Governance Working Party and its development of a code of best practice." (ICSA)

Outcome

6. The proposed revisions have been incorporated into the revised guidance.

New Paragraph 4.21

Proposal

The audit committee should assess periodically the risks associated with the possible withdrawal of their external auditor from the market and consider whether any mitigating action is appropriate.

Summary of responses

7. 14 respondents commented on this paragraph. The majority supported, or raised no objections to, the addition of the proposed new paragraph. However, eight respondents had doubts as to whether this recommendation would have a significant impact because it would be difficult for companies to identify cost-effective mitigating actions:

"If the mitigating action proposed is to set up a 'stand-by' firm, a joint auditor arrangement or to employ another firm to audit part of the group we consider it unlikely, given the costs, that companies will be willing to take this action unless a specific event occurs" (Hundred Group).

8. Three respondents argued that for this reason the proposed paragraph should not be added to the guidance. In addition one respondent was concerned that:

"the suggestion that companies should develop contingency plans to deal with the possibility of their auditor leaving the market... will in effect require boards to "appoint" another audit firm as their "stand-by". This means that companies may decide to disengage altogether from using non-audit services from these "stand-by" firms". (Ernst & Young)

9. Two respondents said that the proposed wording appeared to allow less flexibility than intended by the MPG's recommendation for companies to decide whether, in their particular circumstances, the risk was significant enough to merit further consideration:

"if the provision is retained, the wording [should be] made more flexible, for example by replacing "The audit committee should assess" with "The audit committee should consider if there is merit in assessing", thereby enabling the audit committee to weigh up the costs and benefits before undertaking such an exercise". (AIC)

Outcome

10. The paragraph has been retained, but the wording changed to match that in MPG Recommendation 15. The revised paragraph now reads:

The audit committee should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

New Paragraph 4.22

Proposal

The audit committee report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment and removal of the external auditors. This explanation should normally include:

- any contractual obligations that acted to restrict the audit committee's choice of external auditors;
- when the audit was last subject to tender; and
- when the current group auditor was appointed.

Summary of responses

Contractual obligations

11. Ten respondents commented on the proposed disclosure of contractual obligations, with the majority either supporting or raising no objections to the proposal. One respondent considered this recommendation should be incorporated into the Combined Code so that the "comply or explain" principle applied directly.

12. Two respondents had concerns that this recommendation on its own would not be sufficient. One considered that the guidance should also recommend disclosure of other influence and restrictions, for example:

"the inclusion of a clause in a draft agreement (which may subsequently be removed), or a reference in a letter or a conversation, that influences an entity not to appoint a non Big 4 firm" (BDO)

13. The other respondent considered that the FRC should separately encourage disclosure by banks and other intermediaries:

"Where banks and other intermediaries influence the audit appointment, the choice restriction occurs in practice before any contractual obligation is imposed. We believe that the proposed guidance will not be effective in meeting the MPG's objective in this area. We believe that a more effective measure by the FRC would be to encourage large banks and other intermediaries to publish their policies (if they have one) on audit appointments. It is clearly appropriate that intermediaries should be allowed to have a policy on auditor selection, our strong belief is that such policies should be transparent." (Grant Thornton)

14. Only two respondents opposed the proposal, of which one was under the impression that it would apply to non-audit as well as audit work (which was not intended). The other was:

“unsure what use shareholders will make of this information. Furthermore, by making the audit firms aware that competition for audit services is limited, there may be an opportunity for audit fees to be unnecessarily increased” (AIC)

Tender and appointment date

15. Twenty respondents commented on the proposal that companies should disclose the dates when the current auditor was appointed and the audit was last put out to tender. Views were divided on the merits of this proposal. In general, it was supported by smaller audit firms and investors, some of whom wanted the guidance to go further, but opposed by the Big 4 audit firms and some corporate interests.
16. Ten respondents supported this proposal on the grounds that it would make boards more accountable for their auditor selection decisions and encourage greater engagement with shareholders on the issue, and that it could encourage more frequent tendering which could bring the companies concerned direct benefits from a reduction in costs and/or from the provision of improved service.

“Transparent disclosure of how the audit committee reached its auditor recommendation ensures that the decisions of the board are openly accountable; this is clearly in the best interests of shareowners. Further, the disclosure of such information should facilitate increased engagement between shareowners and the board over auditor selection, which goes toward ensuring an efficient market outcome.” (CFA Institute)

“Currently many companies only change their auditors every twenty to twenty-five years and certain of our members do not consider that this is frequent enough and believe it could impact a firm’s independence and quality. Disclosure of when the audit was last subject to tender and when the current group auditor was appointed could encourage more tendering and we would urge the FRC to keep the operation of these disclosures under review to see if they help address our concerns.” (IMA)

“We are not persuaded by the argument sometimes put forward that more frequent audit tendering would involve companies in unnecessary costs. We firmly believe that more frequent tendering of audits by listed and other public interest entities would bring the companies concerned direct benefits from, in some instances, a reduction in costs and/or from the provision of improved service. Such a change would also lead to benefits for investors arising both from the benefits enjoyed by the companies in which they hold shares and from those related

to enhanced innovation and responsiveness which we consider would more generally result from increased competitiveness in the audit market.” (Mazars)

17. Three respondents suggested additional disclosures that should also be recommended in the guidance. These included, for example:

“when the committee next expects to mount a tender process; whether or not a tender process was considered, and, if not why not; if applicable, whether or not the tender invited responses from any non-big four firms, and, if not why not; and other factors it considered to arrive at its decision”. (Hermes)

18. Ten respondents opposed the proposal. The main objections were that the proposed revisions were overly prescriptive and went beyond the spirit of the MPG’s original recommendation, and that they would create a demand for regular tenders and/or audit firm rotation which would be unnecessary, costly and could undermine audit quality, at least in the short term.

“The second and third bullets represent the FRC staff’s interpretation of “information relevant to the auditor selection decision”. We argue that this goes against principles-based standards-setting and goes beyond the spirit of the MPG recommendation. We also question why the FRC chose to select these two elements as specific requirements relevant to the auditor selection decision. In our view more relevant information would be matters such as quality, independence and objectivity.” (Deloitte)

“In our view the emphasis of this very selective disclosure requirement is likely be interpreted as meaning that a long-standing audit relationship and infrequent tenders are indications of poor governance. It is by no means proven that, in the absence of specific concerns about audit quality, the audit firm’s capability or conflicts of interest, putting an audit out to tender is a demonstration of good governance.” (Independent Audit)

“Audit tenders are costly for both audit firms and companies in terms of direct external costs as well as management time. An audit tender is a good mechanism for checking that a company is receiving value for money and a quality audit but it is not the only method of ensuring both these key attributes of an audit service. Companies, on a regular basis, already review the cost of their audit and benchmark it against similar organisations. Quality of opinion and service is also reviewed regularly by audit committees and management. Auditors have to be re-appointed by shareholders each year, so the appropriateness of their re-election comes up for consideration every year.” (Hundred Group)

Outcome

19. The proposed disclosures are recommended in the revised guidance, although the wording of this paragraph has been amended to reflect more closely the wording of the MPG's Interim Report published in April 2007. The revised paragraph reads:

The audit committee section of the annual report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors. This explanation should normally include supporting information on tendering frequency, the tenure of the incumbent auditor, and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

Paragraphs 4.24-4.31

The proposed revisions to these paragraphs were all intended to align the guidance with the Auditing Practices Board's Ethical Standards for auditors that have been developed since the guidance was issued in 2003. Sixteen respondents stated that they supported all the proposed changes without commenting in any more detail.

Paragraph 4.24

Proposal

The audit committee should ~~have procedures to ensure~~ assess the independence and objectivity of the external auditor annually, taking into consideration relevant UK professional and regulatory requirements. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services). The audit committee should consider whether, taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor's ~~judgement or~~ **independence and objectivity**.

Summary of responses

20. Only three respondents had substantive comments on this paragraph. All considered that this paragraph should follow the Ethical Standards for auditors by referring to safeguards that might address any apparent lack of independence:

“There is no direct mention of safeguards which might ensure that any apparent lack of independence was not in practice problematic... Without mention of a need to consider safeguards which would mitigate any apparent impairment of independence, we are concerned that this sets a very high standard which may not reflect business realities, as well as not reflecting the framework set by ES1. We are concerned that this may drive an overly adversarial relationship between audit committees and the auditors, rather than driving the collaborative and business-focused approach which will be most productive. Smaller company audit committees are often more in need of support from the auditors, and a regulatory framework which hampers this would be particularly unhelpful to them.” (QCA)

Outcome

21. Additional wording has been added to the guidance to address the issue of safeguards. The revised paragraph reads:

The audit committee should assess the independence and objectivity of the external auditor annually, taking into consideration relevant UK law, regulation and professional requirements. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services) and any safeguards established by the external auditor. The audit committee should consider whether, taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor’s independence and objectivity.

Paragraph 4.25

Proposal

The audit committee should seek reassurance that the auditors and their staff have no ~~family, financial, employment, investment or business~~ **family, financial, employment or family and other personal relationship with the company (other than in the normal course of business) which could adversely affect the auditor’s independence and objectivity, taking account of auditor ethical standards.** The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.

Summary of responses

22. Only one respondent commented on this paragraph. They noted that:

“There is no definition of “close personal relationship” and further that auditor ethical standards permit personal relationships to continue under certain circumstances. We suggest, therefore, that the words “which permit some relationships subject to appropriate safeguards and conditions” be added to paragraph 4.25 after the words “taking account of auditor ethical standards”. (PricewaterhouseCoopers)

Outcome

23. The proposed revisions have been incorporated into the revised guidance.

Paragraph 4.26

Proposal

The audit committee should agree with the board the company’s policy for the employment of former employees of the external auditor, paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. This should be drafted taking into account the relevant ethical guidelines governing the accounting profession. The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the company, and consider whether in the light of this there has been any impairment, or appearance of impairment, **of the auditor’s judgement or independence and objectivity in respect of the audit.**

Summary of responses

24. There were no substantive comments on this paragraph.

Recommendation

25. The proposed revisions have been incorporated into the revised guidance.

Paragraph 4.27

Proposal

The audit committee should monitor the external audit firm's compliance with applicable United Kingdom ethical guidance relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, ~~office and partner~~, or relevant part of it and other related regulatory requirements.

Summary of responses

26. One respondent considered that *"the words 'or relevant part of it' are ambiguous and would benefit from clarification"* (ACCA). There were no other substantive comments on this paragraph.

Outcome

27. The change to this paragraph was made to reflect changes that have been made to Ethical Standard 4, which deals with fees and remuneration, but it is acknowledged that the meaning of the phrase "relevant part of it" will not be clear to those unfamiliar with ES4. A footnote has therefore been added to the guidance which sets out the definition in ES4. It reads:

Where the audit firm's profits are not shared on a firm-wide basis, the relevant part of the firm is that by reference to which the audit engagement partner's profit share is calculated.

Paragraph 4.28

Proposal

The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In this context, the audit committee should consider:

- whether the skills and experience of the audit firm make it a suitable supplier of the non audit service;

- whether there are safeguards in place to ~~ensure that there is no~~ reduce any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor to an acceptable level;
- the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

Summary of responses

28 Two respondents considered that the proposed new wording was too weak, and that the audit committee should at least seek to minimise any threats to objectivity and independence.

“We agree with the MPG that to require, as now, the audit committee to ensure independence and objectivity could be interpreted as setting a very high standard. The absolute certainty might not be capable of being delivered at an acceptable cost. However, we do not believe the rewording on this point implements the MPG’s intentions in the optimum manner. In particular, we consider that the suggested alternative goal of reducing any threat to an acceptable level is too weak a formulation... We believe that the guidance should require, at least, that audit committees consider what safeguards are in place to “minimise” any threat.” (ABI)

29 In addition, one respondent suggested that:

“an additional bullet point should be added after the last bullet point in paragraph 4.28 to read: “whether, having taken into account all relevant factors, the firm is the most appropriate”. We believe that the judgment required is not merely whether that audit firm is appropriate but that it is the most appropriate firm to carry out any non-audit services”. (Hermes)

Recommendation

30 The phrase “reduce to an acceptable level” is taken from Ethical Standard 1. The full wording used in ES1 is to “eliminate or reduce to an acceptable level”. The underlined words have been added to the guidance to reflect ES1 more accurately and to address the concern raised by respondents. The revised paragraph reads:

The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In this context, the audit committee should consider:

- whether the skills and experience of the audit firm make it a suitable supplier of the non audit service;
- whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
- the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

Paragraph 4.31

Proposal

In determining the policy, the audit committee should take into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and in principle should not agree to the auditor providing a service if, having regard to the ethical guidance, the result is that:

- the external auditor audits its own firm's work;
- the external auditor makes management decisions for the company;
- a mutuality of interest is created;
- *the external auditor develops close personal relationships with the company's personnel; or*
- the external auditor is put in the role of advocate for the company.

Summary of responses

31 Five respondents questioned the value of the proposed additional bullet point, which is one of the six threats to independence identified in the Ethical Standards for auditors. The main reason for these reservations was the practical difficulty for the audit committee of monitoring the development of relationships between the auditor and company personnel and judging whether they were a cause for concern. In addition, two of these respondents noted that, under the Ethical Standards, this assessment was primarily the responsibility of the auditor in the first instance.

“First, we query whether this proposed change will be workable in practice. For example, what is the definition of "close personal relationships"? ... The test for the audit committee to consider is subjective” (Prudential)

“Audit committee members may find it difficult to judge whether the closeness of relationships is a cause for concern. Were this addition to be included in final paragraph 4.31, in practice it is likely that the audit committee would have to undertake some form of due diligence by asking the auditor and the management to provide confirmations to the audit committee. We are not convinced that this would add a great deal”. (ICAEW)

Outcome

32 The proposed revisions have been incorporated into the revised guidance.

Paragraph 5.2

Proposal

The audit committee section should include, inter alia:

- a summary of the role of the audit committee;
- the names and qualifications of all members of the audit committee during the period;
- the number of audit committee meetings;
- a report on the way the audit committee has discharged its responsibilities; ~~###~~

- ~~the explanation provided for in paragraph 4.29 above. a summary of the audit committee's policy on non-audit work provided for in paragraph [4.32] above; and~~
- *an explanation of the audit committee's recommendation on the appointment, reappointment and removal of the external auditors provided for in paragraph [new] 4.22 above.*

Note: the revised fifth bullet point is not a new disclosure requirement but corrects an error in the current guidance (the explanation referred to was originally in paragraph 4.29 but moved to paragraph 4.32 when additional paragraphs on the committee's role in relation to internal audit were added following the 2005 revisions to the Turnbull guidance; due to an error the cross-reference in this paragraph was not corrected at the time).

Summary of responses

- 33 Seventeen respondents commented on this paragraph, with the majority supporting the proposed revisions.
- 34 Four respondents opposed adding the last bullet point, but this was because they opposed some of the recommended disclosures in that paragraph (the dates of auditor appointment and last tender) rather than for any separate reasons. A further five respondents were content with the proposed revisions in paragraph 5.2 subject to their concerns over paragraph 4.22 being met.
- 35 Four respondents suggested further disclosures to be added to this paragraph. These included, for example:

"A statement [from the audit committee] confirming that it has considered threats to auditor independence, and is satisfied that the safeguards in place are adequate to protect auditor independence." (AIA)

"Full disclosure of the auditor-client relationship... including details on all fees and service contracts would better serve shareowners' interests" (CFA Institute)

Outcome

- 36 The changes proposed in the consultation document have been made, although the cross-references to disclosures recommended elsewhere in the guidance have been shortened. The revised paragraph reads:

The audit committee section should include, inter alia:

- a summary of the role of the audit committee;

- the names and qualifications of all members of the audit committee during the period;
- the number of audit committee meetings;
- a report on the way the audit committee has discharged its responsibilities; and
- the explanations provided for in paragraphs 4.22 and 4.34 above. [*The numbering of the paragraphs cross-referenced here has changed as a result of the insertion of new paragraphs 4.21 and 4.22*]

Other comments on the consultation document

37 Two respondents commented on the draft revised wording relating to the composition of the audit committee (paragraphs 2.3 and 2.4), noting that this was not the same as the wording used in the revised Combined Code published in June 2008. The reason for this was that the consultation document was issued before the changes to the Code had been finalised. The revised guidance replicates the wording in the Code, which reads:

The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

38 Two respondents raised a general concern that the proposed revisions amounted to ‘gold-plating’ and that the cumulative effect was to make the guidance overly prescriptive.

39 One respondent commented on the Auditing Practices Board’s consultation on the Ethical Standards and audit partner rotation:

“We believe that there might be scope for introducing an element of flexibility in exceptional circumstances but believe this would need to be balanced by an additional measure of consultation and dialogue between audit committees and shareholders. This would be very much in accordance with the Code’s ‘comply-or-explain’ framework and shareholder consultation expectations over what would be a departure from normal benchmark practice. This would require either the Code, or more likely the Smith guidance, to be modified to accommodate this change. We suggest account is taken of any developments on this front as the current consultation on changes to the Smith guidance is taken forward”. (ABI)

- 40 One respondent commented on the provision of non-audit services to audit clients:

"We consider it can lead to cross-subsidisation and underbidding for "foot in the door" opportunities. Thus it can create a barrier for smaller firms that do not have the capacity to provide such a wide range of services. IMA would not support such services being prohibited but considers there is a case for restricting them". (IMA)

Guidance on the use of firms from more than one audit network

- 41 This guidance, which has been incorporated as an Appendix to the Guidance on Audit Committees, was the subject of a separate consultation exercise carried out between May and August 2008. Copies of responses to that consultation are available at:

<http://www.frc.org.uk/about/auditchoice.cfm>

- 42 An additional sentence has been added to the main body of the guidance to reflect the addition of the Appendix. Revised paragraph 4.19 now reads:

The audit committee should assess annually the qualification, expertise and resources, and independence (see below) of the external auditors and the effectiveness of the audit process. The assessment should cover all aspects of the audit service provided by the audit firm, and include obtaining a report on the audit firm's own internal quality control procedures and consideration of audit firms' annual transparency reports, where available. It might also be appropriate for the audit committee to consider whether there might be any benefit in using firms from more than one audit network.

Financial Reporting Council
October 2008

RESPONDENTS TO THE CONSULTATION

1. Association of British Insurers
2. Association of Chartered Certified Accountants
3. Association of International Accountants
4. Association of Investment Companies
5. Barclays PLC
6. BDO Stoy Hayward LLP
7. CBI
8. CFA Institute Centre for Financial Market Integrity
9. Chartered Institute of Public Finance and Accountancy
10. Deloitte & Touche LLP
11. Ernst & Young LLP
12. Grant Thornton UK LLP
13. Hermes Equity Ownership Services
14. Hundred Group of Finance Directors
15. Independent Audit Ltd
16. Institute of Chartered Accountants in England & Wales
17. Institute of Chartered Accountants of Scotland
18. Institute of Chartered Secretaries and Administrators
19. Institute of Internal Auditors
20. Investment Management Association
21. KPMG LLP
22. Mazars LLP
23. PricewaterhouseCoopers LLP
24. Prudential plc
25. Quoted Companies Alliance
26. Standard Life plc



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