

Consultation on proposed changes to Guidance on Audit Committees (The Smith Guidance)

Submission from the Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the Financial Reporting Council's consultation on proposed changes to the "Guidance on Audit Committees (The Smith Guidance)".

The AIC represents some 340 investment companies with approximately £74billion of assets under management. The AIC takes a keen interest in the corporate governance debate and understands the key role that audit committees play in overseeing the financial reporting and internal control processes for the main board. The role of the audit committee is particularly important for investment companies, the vast majority of which outsource their day-to-day management and administrative functions to third parties. The audit committee of an investment company focuses on the internal control and risk management systems in place within third party service providers. For this reason most investment companies do not have their own internal auditor.

The AIC believes that the Smith Guidance continues to provide a useful source of information for investment company boards and their audit committees. The AIC supports the flexibility provided by the Smith Guidance in terms of its relationship with the Combined Code and its status as guidance rather than a compulsory rulebook.

As investment companies are listed vehicles, the AIC's members fall within the scope of the review carried out by the Market Participants Group on possible actions that companies can take to mitigate the risks arising from the characteristics of the audit market to 'public interest entities' in the UK. Approximately 70% of investment companies are audited by one of the Big Four audit firms, and approximately another 23% are audited by three mid-tier firms. There are a further 14 or so firms which audit three or less investment companies. Therefore, although the sector is dominated by the Big Four, there are a number of alternative firms providing services to this specialist market.

Generally speaking there appears to be very little that an investment company board can do to mitigate the risks associated with its audit firm leaving the market. If this were to happen, it seems unlikely that an investment company would encounter significant disruption or excessive costs, and therefore the benefits associated with any detailed contingency planning appear minimal. In practice the only action available to an investment company board whose audit firm withdraws its services is to appoint another firm. In the short term this may take the board's attention away from its usual activities, but the process is not unduly complicated. An investment company board may benefit by maintaining an ongoing relationship with two or more audit firms to facilitate the planning for a beauty parade. The investment company sector also has the benefit that a number of mid-tier and smaller audit firms operate

in this sector, providing a credible alternative to the Big Four if one of the larger firms left the market.

The AIC's responses to the questions raised in the consultation paper are set out below. The AIC notes the FRC's statement that it is not carrying out a general review of the Smith Guidance at this stage and has therefore largely restricted its comments to the specific issues raised.

Response to consultation questions

Q1. Do you agree with the proposed changes based on MPG recommendations? If not, please explain and, if possible, suggest how the proposed changes could be improved.

Our comments only cover sections below where we do not agree with the suggested amendments or where we recommend that further changes are made.

- **Section 4.21:** This is a proposed new section which recommends that the audit committee periodically assesses the risks associated with the possible withdrawal of their external auditor from the market and considers whether any mitigating action is appropriate.

The AIC has concerns that this recommendation places additional responsibility on the audit committee with very little benefit. For example, the AIC is unclear about what 'mitigating action' an investment company board could undertake if it believes that its auditors may withdraw from the market. Considering the suitability of the auditors' re-appointment or removal is already a responsibility of the audit committee under section 4.1 of the Smith Guidance. This provision should not be included unless it adds something to this process, which we doubt.

We note that the final MPG report stated that *"for some companies their options for mitigating the risk may be limited"*. The AIC therefore **recommends** that, if the provision is retained, the wording is 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. The AIC also **recommends** that additional wording is included to provide some examples of what type of mitigating action a company could take.

The AIC also **recommends** that the wording is amended to clarify that the risks which the audit committee might consider are only in relation to the company itself, and not to the market generally. It is outside the remit and capability of an audit committee to influence or change the characteristics of the market for the provision of audit services.

- **Section 4.22 and 5.2:** These sections recommend that the audit committee report includes an explanation to shareholders on how it

reached its recommendations to the board on the appointment, re-appointment and removal of the external auditors. The recommendation includes three items which it expects would normally be covered in this explanation.

The AIC has reservations about the company disclosing any contractual obligations that restrict the audit committee's choice of external audit. The AIC is 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. The AIC therefore **recommends** that this recommendation is not inserted into the Smith Guidance.

- **Section 4.27:** The first part of this section recommends that the audit committee should monitor the external audit firm's compliance with applicable UK ethical guidance relating to the rotation of audit partners.

The AIC believes that the responsibility of the audit committee in this regard should be limited to monitoring compliance only in terms of the rotation of the audit partner allocated to their company. It should not be responsible, as the wording currently suggests, for the overall partner rotation of the audit firm as a whole. Indeed, an investment company board has no control over, nor necessarily any information on, whether audit partner rotation guidelines are being met in relation to the audit firm's other clients. Although this part of section 4.2.7 does not fall within the scope of the current consultation, the AIC **recommends** that the wording is amended to limit the scope of the audit committee's responsibilities.

The second part of section 4.27 recommends that the audit committee monitors the external audit firm's compliance with relevant UK guidance on fee levels in proportion to the overall fee income of the firm (or relevant part). The responsibility of the audit committee should be limited to ensuring they are aware of the company's audit fee in proportion to the overall fee income of the audit firm. The guidance might recommend that where the audit committee believes the fee represents a (substantial?) majority of the auditors' income it should be disclosed in the audit committee report. This would provide shareholders with useful information to judge whether the external audit firm is placing undue reliance on the company's fee income, and hence whether there may be an issue relating to the audit firm's independence.

The third part of this section recommends that the audit committee monitors the external audit firm's compliance with applicable UK ethical guidance relating to "*other related regulatory requirements*". The AIC believes that this wording is too vague and imposes an unnecessarily wide scope of responsibility on the audit committee. The AIC therefore **recommends** that this part of section 4.27 is removed.

Q2. Do you have any comments that will assist the FRC in finalising the impact assessment?

The AIC agrees with the points raised in the draft impact assessment set out in section four of the consultation paper. The AIC would make two additional comments.

Firstly, the proposed change in section 4.22 recommending that the audit committee report discloses any contractual obligations that restrict the audit committee's choice of external auditors could, by making public the fact that the choice of alternative auditors is limited, lead to an unjustified increase in audit fees as discussed above. This would be an unacceptable outcome of amending the guidelines.

Secondly, by removing the overly onerous recommendations in section 4.27 for the audit committee to monitor the audit firm's general compliance with UK ethical guidance relating to audit partner rotation across the firm and with "*other related regulatory requirements*", the audit committee could make savings in terms of time and resources which could be redirected to more relevant and more directly beneficial matters. Again, such an outcome would be welcome.

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To discuss the issues raised by this response please contact:

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