

Chris Hodge
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London
WC2B 4HN

6 June 2008

Ref:

Direct line: 0207 951 3254

Email: jbabiak@uk.ey.com

By post and e-mail: smithguidance@frc.org.uk

Dear Mr Hodge

Proposed changes to the Smith Guidance

INTRODUCTION

- 1 Ernst & Young LLP welcomes the opportunity to comment on the *Consultation on Proposed Changes to Guidance on Audit Committees (The Smith Guidance) March 2008* (the "Consultation Document").
- 2 We note that the original intention of the FRC, when it formed the Smith Group, was to produce guidance on audit committee best practice. This was accomplished in 2003 and the guide's content incorporated into the Combined Code. The guidance was subsequently revised together with the Code, and both were reissued and subjected to further reviews.
- 3 Given this level of revision, we question the need for the FRC to propose further substantive changes to the guide. We suggest instead - and in compliance with the *Principles of Good Regulation* - that the FRC limit its proposed changes to minor adjustments (for example, paragraph 4.19 which acknowledges the EU's Statutory Audit Directive). This should also obviate the need to make any significant updates to the Combined Code.
- 4 To maintain our position as a global leader in the capital markets, it is important the UK shows leadership in the influence, adoption and sponsorship of global commercial principles, protocols, rules and standards without gold plating. Gold plating adds considerable complexity and cost for global companies and audit firms, which are ultimately borne by investors. Much of the proposed change in this consultation document, when compared with international standards, could be described as gold plating, without any compensatory benefits.



INVESTOR IN PEOPLE

RESPONSES TO QUESTIONS

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

We agree with some of the proposals, in particular those that are not extensions of existing global standards. This includes suggested changes to reflect the outcome of the 2007 review of the Combined Code: i) the more realistic proposal that audit committees should annually “assess”, rather than have “procedures to ensure”, the independence and objectivity of the external auditor (paragraph 4.24); and ii) audit committees should “reduce” potential threats to the independence of the audit “to an acceptable level”, rather than be required to “ensure that there is no threat to objectivity” when an audit firm provides non-audit services (paragraph 4.28).

These changes, if implemented, could give audit committees greater flexibility, in-keeping with the principles-based ethos of the FRC’s regulatory regime. They might also support companies in their task to recruit non-executive directors, by commercial alignment of responsibilities and the perceived liabilities associated with the role. However, we strongly disagree with three other proposed changes and encourage the FRC to reconsider their inclusion in the Smith Guidance. We believe they carry the risk of reducing audit quality and choice, for little or no benefit to the audit committee or shareholder.

Firstly, the proposal (paragraph 4.22) requiring audit committees to inform shareholders of their recommendations to appoint, re-appoint or remove an auditor (to include details on the incumbent auditor’s length of service and the last time the audit was subject to tender) could be an unwelcome distraction for company boards.

They may be persuaded - by well meaning but vocal and largely uninformed minority interest groups - into putting the audit out to tender at set frequencies, regardless of whether they believe a change in their auditor is in the shareholders’ best interests. We believe this could seriously undermine audit quality by: distracting the incumbent auditor; adding more pressure on a company’s finance function and creating unnecessary audit firm rotation resulting in service discontinuity.

Secondly, the proposal (paragraph 4.25) preventing an audit firm from providing specific non-audit services, if ‘the external auditor develops close personal relationships with the company’s personnel’, might influence boards to use another auditor and retain the incumbent firm solely for non-audit services. This could inhibit wider competition and restrict overall choice in the audit market. While such a concern had greater merit in the last Century, expansive and fundamental changes to UK and global independence rules had been explicitly defined earlier in this decade to address such concerns. These were defined after considerable consultation with many stakeholders, who are finding the current rules an impediment to choice already. Introducing different independence rules in the UK would create added cost and complexity for global compliance.

Thirdly, the suggestion (paragraph 4.21) that companies should develop contingency plans to deal with the possibility of their auditor leaving the market, particularly if this is combined with another proposal (paragraph 4.25), will in effect require boards to “appoint” another audit firm as their “standby”. This means that companies may decide to disengage altogether from using non-audit services from these “standby” firms, creating the same problem as mentioned above.

Given the current number of viable market participants, the loss of another firm would require rapid and substantial interaction between: government; regulators; the employees and partners of the collapsed firm; the remaining firms and the companies they audit. The impact of all this is trivialised by the implied suggestion that an audit committee could be fully prepared to handle such an eventuality.

In reality, companies would be better served by having an alternative firm(s) working with the company, within the existing or even more reasonable globally accepted independence rules. This would enable a change in auditor, whether voluntary or compulsory, to be a more seamless process rather than a “cold start” for the successor.

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

We suggest that the assumed regulatory implications (quality, cost and effectiveness) should be viewed more broadly by the FRC. This is because the key assumptions made in the draft impact assessment require considerably more analysis and evidential support.

Firstly, it is assumed that contingency plans (paragraph 4.12) will not increase costs significantly for companies: we disagree. The existing level of independence rules, as implemented in recent years, spawned a significant and costly infrastructure with the global firm networks and, to a lesser extent, individual companies. The proposed contingency plans would extend this to non-audit relationships, with an associated cost likely to be greater than audit monitoring, which is more easily ring-fenced but still challenging to control in global organisations.

Secondly, we disagree with the assumption made in regard to the disclosure of audit tenders and appointments (paragraph 4.22). The FRC accepts that companies will incur the additional cost of putting audits out to tender (when a change in auditor is deemed necessary). This includes the cost of communicating audit committee recommendations to shareholders. In our opinion this is a very narrow and materially understated view of the extra costs.

For example, we believe that many boards will feel obliged, due to external pressure, to put the audit out to tender regardless of whether they believe a change in auditor is in the shareholders’ interests. Therefore a higher frequency of tenders, over an extended period of time, will certainly increase costs significantly for companies, without any

commensurate benefit in terms of audit quality or choice, and with a greater risk of audit failure, according to several independent studies on auditor rotation.¹


Of course if this results in companies changing their auditors more frequently, new and significant costs will be created, including management and audit committee time. The cost to a firm that bids for a prospective client will often be equivalent to a year's fees from that client. Companies will then have to spend a considerable amount of extra time and effort helping and supporting the incoming auditor. Conversely, the knowledge and experience which is usually lost when the outgoing auditor leaves could, over time, erode the overall quality and effectiveness of the audit.

CONCLUSION

We believe that the net-effect of all these changes, if implemented, is unlikely to provide even a marginal benefit in terms of audit committee effectiveness. However, the likelihood of higher costs and lower quality for company audits could be significant. Therefore we recommend that any changes to the Smith Guidance are kept to an absolute minimum.

We hope our response is helpful and respectfully ask the FRC to publish it alongside other responses shortly after the consultation closes. If the FRC would like further clarification on the points raised by Ernst & Young, please contact me at your convenience.

Yours sincerely



Jan Babiak
Managing Partner
Regulatory & Public Policy
Northern Europe, Middle East, India and Africa

¹ Examples of independent studies and commentary include:
Mandatory audit firm rotation and audit quality: Andrew B. Jackson, School of Accounting, The University of New South Wales, Sydney, Australia, 2008.
Mandatory auditor rotation and retention: impact on market share: Managerial Auditing Journal, Volume 20, Number 3, 2005.
Audit failure and the crisis of auditing: European Business Organization Law Review, 2004.
Unilever chief rounds on auditor rotation: Daily Telegraph, 31 July, 2002.