



5 June 2008

Our ref: ICAEW Rep 71/08

Chris Hodge  
Financial Reporting Council  
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By e-mail

Dear Chris

### **CONSULTATION ON PROPOSED CHANGES TO GUIDANCE ON AUDIT COMMITTEES (THE SMITH GUIDANCE) MARCH 2008**

The Institute of Chartered Accountants in England and Wales (the "Institute") welcomes the opportunity to comment on the consultation paper *Consultation on Proposed Changes to Guidance on Audit Committees (The Smith Guidance)* published by the Financial Reporting Council in March 2008.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council (FRC). As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

#### **Overall comments**

Whilst we agree with many of the proposed changes to the Smith Guidance that are the result of recommendations from the Market Participants Group (MPG) we have reservations about three of the proposed changes as set out below.

#### **Periodic assessment of the risk of the loss of an audit firm (paragraph 4.21)**

The loss of a company's audit firm (for whatever reason) is a risk that companies, especially audit committees, need to be aware of and be vigilant to. Periodic consideration of contingency plans for such an event is a prudent exercise for an audit committee, even though the probability of such an event has historically been perceived as low.

Given the current market concentration on a few firms at the larger company end of the listed market, the impact on larger listed companies or companies in specialised industries of the loss of their audit firm is often cited. However, we strongly suggest that the knock-on effect on the smaller listed clients of that audit firm should not be forgotten.

The effect of making the proposed disclosures in paragraph 4.21, which serves to highlight the issue, will ensure that, periodically, audit committees have the matter on their agenda. However, for a number of companies it is perhaps difficult to consider what might be the practical mitigating actions the board and audit committee can take given the concentrated audit market with the potential of conflicting interests for other audit firms who provide non-audit services to the company. We are concerned that it may be impracticable for some companies to maintain adequate back-up arrangements.

### **Transparency of auditor selection (paragraph 4.22)**

The primary responsibility for the selection of a company's auditor and the frequency of audit tenders must ultimately remain with the company's board of directors and particularly with the members of the audit committee. They will need to weigh up their perception of the quality of the audit and the auditor's independence, as well as comments from relevant shareholders, and the cost and consequences of audit tenders.

Transparency in the policy and process of auditor selection should provide additional information to shareholders so that they may then engage in discussions with the board and/or audit committee. Whilst transparency in the process may encourage audit committees to consider for tender a wider selection of auditors, there are some potential adverse unintended consequences.

We are aware that some commentators remain concerned that proposed paragraph 4.22 (which in part appears to go beyond the recommendations in the MPG's final report) will lead to additional costs for potentially unnecessary tenders.

Two aspects of the proposed disclosure, relating to length of tenure and when the audit was last subject to tender, have resulted in considerable differences of opinion amongst interested parties.

We note from page ten of its final report that the MPG was aware that some recommendations "could result in an increased rate of audit tendering, particularly for companies that have not actively considered alternatives for their incumbent for many years." We also note that the MPG's report goes on to say that "The Group considers that companies would only need to incur the cost of putting their audit out to tender when they judge that a change of auditor could be beneficial." This final sentence is repeated in the Impact Assessment to this consultation on the Smith Guidance.

We trust that the FRC will give due consideration to whether the potential outcomes of proposed paragraph 4.22 will align with the MPG's hoped for outcomes with a careful review of all the responses it receives particularly those from boards and audit committees who will have to act on proposed paragraph 4.22.

### **Non-audit services policy (paragraph 4.31)**

Paragraph 4.31 appears to be a tidying up measure that aligns guidance to audit committees with aspects of the Ethical Standards that apply to auditors.

In relation to the new bullet "*the external auditor develops close personal relationships with the company's personnel*" we have reservations about whether a standard for auditors, being a requirement for the auditors' own judgement, can be realistically applied by the members of an audit committee.

Whilst audit committee members will observe the auditor's relationship with management at meetings, they will most likely not have the same information as the auditor and/or management on personal relationships between the two parties. Audit committee members may thus 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.

We again suggest that the FRC carefully considers responses from companies on this matter and decides whether this should simply remain a matter for the auditor when following Ethical Standards.

Please contact Jonathan Hunt, Vanessa Jones or myself should you wish to discuss any of the points raised in this response.

Yours sincerely

A handwritten signature in cursive script that reads "Robert".

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