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A Consultation Document on Proposed Changes to Guidance on Audit Committees (The Smith Guidance)

Preamble

As many of our members work for listed PLCs they follow the Smith Guidance and any amendments to the guidance are therefore of particular interest. The general consensus of members is that there should be greater choice than just the “Big Four” audit firms to audit larger international organisations. The difficulties of audit firms outside this group to enter the market are recognised and some have suggested that sufficient incentives should exist for smaller audit firms to be able to offer audit services to larger companies so as to provide a greater field of choice. However, this does not mean that there should be any reduction in the quality, rigour and standards of firms which wish to operate in that arena.

It has been opined also that auditors are reducing their exposure but not their fees and that this can impact on the quality of the financial statements. Some commentators also feel that a company’s ability to review and assess the ethical standards of auditors is possibly illusory.

The following observations and comments have been made in light of experience with assisting a number of emerging market companies in establishing their company secretarial activity in the period immediately before and after an IPO. This includes establishing board and committees policies and procedures befitting a FTSE100 company:

- Many FTSE100 and 250 companies’ reports have become increasingly expansive in their description of the activities of their audit committee in the past few years. Much of this disclosure has focused on the substance of the work of the audit committee and this is to be welcomed. However, there is a concern that, in attempting to prove objective independence, the value of relationships with auditors is somehow discounted. It is felt that there is efficiency in having an auditor who understands the market context of a client, their business and the people working for them. This is an important dynamic which cannot be described easily in a report; neither can the value judgments which have to be made when assessing an auditor. Consequently, it has been suggested that whilst the process used to select a new auditor should be described, the creation of a tick box mentality in assessing the

outcome from the process should be avoided. It has been opined that the prescriptive nature of the current Code can be illustrated by the fact that many issuers in their first year as a listed company have been criticized for the high level of their non-audit fees compared to audit fees. The reason for this is invariably that the external auditors act as the reporting accountants on an IPO. There is a view that logically the existing auditors are the obvious people to perform this role because they can combine both an existing knowledge of the company concerned with an appropriate level of independence which gives assurance to the market that their work is sound. This would appear to be a sensible scenario, yet it gives rise to an unintended consequence of institutions rejecting auditor committee chairman re-appointments because the level of non-audit fees was too high.

- Much work is undertaken to ensure a meaningful approach to the evaluation of external auditors which, if done properly, provides a valuable mechanism for checking and improving efficiency and effectiveness. It is also a powerful way of demonstrating that the relationship between company and auditor is independent. Consequently, it has been suggested that enhancing the disclosure concerning the auditor evaluation process and changes resulting from that (in much the same way as changes resulting from some board evaluation are being reported on) would be a more useful mechanism.
- In emerging markets, there is little choice in terms of auditors and often it is not possible to choose among the Big Four, let alone any others. There is an assumption that the market for auditors is a perfect one in which it is possible to select from the Big Four and others in all countries and sectors all the time. As the London market becomes increasingly global this will not always be a valid assumption. This makes the risks associated with the auditor withdrawing from a particular market potentially quite high and it would be helpful to shareholders to be able understand that risk. For example, if the energy resources sector in Timbuktu is only big enough to warrant one Big Four accountancy firm being present there, this will be an important risk factor for anyone investing in that particular Timbuktu plc.
- The Big Four appear to operate within the ethical standards set by the ASB and others. Some find it difficult to see why there is so much emphasis on this point in reporting as it is highly unlikely that any Big Four firm (or other large audit practice) will operate outside those standards. Furthermore, it is felt that some of the emphases within that guidance are red herrings. For example, some find it difficult to understand the need for a policy on the employment of former employees of the external auditor. If a former employee of the external auditor joins a client company, it is queried why the market should not appreciate the level of accounting expertise working within the company rather than alarmed because of a perceived threat to auditor independence, which in reality is probably non-existent. Therefore some feel that employing former employees assists knowledge and expertise transfer. Instead it is felt that the guidance on the provision of non-audit services is much more significant and provided a company describes its policy for complying with that guidance well, it is difficult to see why there is so much concern in areas such as the employment of former employees.
- For AIM and small main market companies, there are difficulties in recruiting competent NED's who can meaningfully contribute to audit committee activity. Enabling the company chairman to sit on the audit committee (provided that they are independent on appointment) is sound reasoning. It is these companies that should be encouraged to look outside the Big Four for their auditors. It is only when the smaller main market companies start using the second tier of large audit firms that the FTSE250 companies will consider looking outside the Big Four. It is observed that FTSE100 companies will not start to look outside the Big Four until the second tier audit firms have a greater presence in the FTSE250.

Detailed Observations

Please find below our responses to the questions raised in your consultation document:

Q1	Do you agree with the proposed changes based on MPG recommendations ¹ ? If not, please explain and, if possible, suggest how the proposed changes could be improved?
A1	In general ICSA members support the proposed changes however, note the comments made in the preamble and in each section below.

4 Role and responsibilities	
Changes in <i>italics</i>	Explanation for / Comment on proposed change
4.19 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.	To promote greater transparency of the capabilities of individual firms (MPG R5). This change is intended to help ensure that audit committees consider the transparency reports that auditors of public-interest entities will be required to publish from 2009. <i>Comment: Although this will require additional audit committee resources to review those reports, it appears a reasonable amendment especially if auditors of public-interest entities will be required to publish them from 2009 anyway.</i>
[New] 4.21 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.	To implement MPG recommendation 15. <i>Comment: This would appear to be a reasonable assessment for any audit committee to consider periodically and how such an event would impact upon their company.</i>
[New] 4.22 The audit committee report should explain to shareholders how it reached its recommendations to the board on the appointment, reappointment and removal of the external auditors. This explanation should normally include: <ul style="list-style-type: none"> 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. 	To implement MPG recommendations 8 and 9. <i>Comment: It is generally agreed that disclosure as to how long an accounting firm has acted as auditor and when the audit contract was last reviewed and put out to tender are acceptable disclosures to make to shareholders. It is acknowledged that the requirement is not to change auditors annually but to report on the Audit Committee's annual review process which is not unduly onerous and provides a good safety check. One commentator raised the question of how to report the appointment date of auditors when there have been so many mergers of audit firms in the past few years – a company could therefore appear to have changed auditors several times in 20 years, but in reality these are only names changes following mergers of audit firms, perhaps guidance could be given on this.</i> <i>The main concern expressed by some commentators is the undue pressure placed on companies to review and put out to tender the provision of audit services, too frequently. There is a presumption that the requirement to tender audit services is a good thing, however this is not necessarily the case. Long term relationships help to build up background knowledge of the company which provide more accurate audits. This in turn reduces costs and provides shareholders with value for money. Safeguards are provided by monitoring the balance between audit and non audit work and</i>

- ¹ Market Participation Group - MPG recommendation 8: Amendment to the Smith guidance dealing with communications with shareholder to include a requirement for the provision of information relevant to the auditor selection decision.
- MPG recommendation 9: When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.
- MPG recommendation 12: The independence section of the Smith Guidance should be reviewed to ensure it is consistent with the relevant ethical standards for auditors.
- MPG recommendation 15: Major public interest entities¹ should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

	<p><i>the rotation of audit partners, not by putting audit services out to tender too often. It has been recommended by some that audit contracts should be put out to tender every ten years (twice the audit partner rotation period).</i></p> <p><i>Although it is agreed that audit committees should review the aspects contained within 4.22, there are reservations as to whether these should be reported to shareholders. This is especially in light of the fact that shareholders of plcs have to consider the appropriateness of auditors each year by voting on their reappointment each year at AGM. ICSA acknowledge that the reference to contractual obligations reflects the practice referred to in the MPG report² of some banks insisting on a company appointing a big four auditor, as part of their loan conditions. We question whether the requirement might be thought by competition authorities as anti-competitive. In fact, many commentators were unaware of this practice actually being enforced and so questioned the necessity of the first bullet point.</i></p>
<p>4.24 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.</p>	<p>Both amendments are consistency changes to reflect ethical standards for auditors as per MPG recommendation 12.</p> <p>It was felt that the term “ensure” could set a high barrier for relationships between companies and their auditors and that the proposed amendment was in line with the Accounting Practices Board’s ethical standards (ES) no.1 based on identification and assessment of threats to auditor independence and objectivity and safeguards to avoid.</p> <p>ES 5 suggests that relationships between the company and the audit firm could adversely affect the latter’s objectivity and independence and therefore their judgement and so the amended wording reflects this.</p> <p><i>Comment: Both are reasonable amendments bringing all guidance and standards into line to avoid confusion over interpretation.</i></p>
<p>4.25 The audit committee should seek reassurance that the auditors and their staff have no family, financial, employment, investment or business financial, business, employment or family and the other personal relationship with the company (other than in the normal course for 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 and relevant requirements, including current requirements regarding the rotation of audit partners and staff.</p>	<p>Changes achieve consistency with ES 1, removes overlaps between ‘financial’ and ‘investment’ and adds ‘other personal’ as a catch all.</p> <p>Some relationships in the normal course of business could still threaten independence and objectivity hence the change. ES 2 prohibits some financial relationships and permits others in normal business terms, depending on the likely impact on auditor independence and objectivity.</p> <p><i>Comment: Both are reasonable amendments bringing all guidance and standards into line to avoid confusion over interpretation.</i></p>
<p>4.26The audit committee should monitor application of the [company’s] policy [for employment of former employees of the external auditor], including the number of former employees of the 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, if the auditor's judgement or independence and objectivity in respect of the audit.</p>	<p>See. 4.24</p>
<p>4.27 The audit committee should monitor the external audit firm’s compliance with applicable UK ethical guidance relating to the rotation of audit partners, the level of fees that the</p>	<p>In line with MPG recommendation 12 and ES 2. It is inevitable that fees will be a high proportion of a partners income and the threat to independence is tied to the extent to</p>

² Choice in the UK Audit Market, the final report of the Market Participants Group October 2007, pg 36,37

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.	which the firm and any profit share scheme relies on such fee income.
4.28 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: [only amended bullet points listed] <ul style="list-style-type: none"> Whether there are safeguards in place to <i>ensure that there is no reduce any</i> threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor <i>to an acceptable level;</i> 	Brings the guidance in line with MPG recommendation 12 and ES 1. It was felt that term 'ensure' was too onerous and set a high barrier for relationships and also that the threats to and safeguards against auditor independence and objectivity need to be identified, and assessed.
4.31 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: [only amended bullet points listed] <ul style="list-style-type: none"> <i>The external auditor develops close personal relationships with the company's personnel; or</i> 	See MPG recommendation 12 and ES 1, para 28. The latter includes six principal types of threat to an auditor's independence. Although one: intimidation, is a matter for the audit firm to judge not the audit committee, a familiarity (or trust) threat could be created or worsened through the delivery of non-audit services such as recruitment. <i>Comment:</i> This would appear to be a reasonable additional bullet point.
5.2 The audit committee section should include, inter alia: [only amended bullet points listed] <ul style="list-style-type: none"> the explanation provided for in paragraph 4.29 above a summary of the audit committee's policy on non-audit work provided for in paragraphs [4.29] and [4.32] above; and an explanation of the audit committee's recommendation on the appointment, reappointment and removal of external auditors, provided for in para 4.22 above. 	Changes reflect consistency with changes listed earlier in the Guidance. Para nos. will change in due course.
Proposed changes in line with Combined Code review Changes in italics	Explanation for / Comment on proposed change
2.3 In FTSE 350 companies All members of the committee should be independent non-executive directors. The Board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. In smaller companies the company chairman may be a member of, but not chair, the committee provided he or she was considered independent on appointment as chairman. All other members of the committee should be independent non-executive directors.	<i>Comment: As stated above changes reflect those proposed in the Combined Code and will be welcomed by many smaller pls.</i>
2.4 The chairman of the company should not be an audit committee member. In FTSE 350 companies all members of the committee should be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.	<i>Comment: As above.</i>

Q2	Do you have any comments that will assist the FRC in finalising the impact of the assessment?
A2	Companies are always seeking to reduce costs, not incur additional costs. However, the importance of the 15 MPG recommendations and their objectives are recognised and in order to achieve these, a balance needs to be made. If the benefit outweighs any additional resources involved, the latter could be justified. The key point is that the old clichés of tick boxing procedures and boiler plate explanations are avoided. If the resulting explanations are not

	meaningful and transparent, it is a waste of resources.

Conclusion

Although there is general support for the above recommended changes, there are also some reservations as to the prescriptive nature of some. Sight must not be lost of the main premises behind these changes: the MPG was established in October 2006 to report to the FRC on how market participants could mitigate risks connected with the audit services market. One risk is the uncertainty and costs involved if one of the Big Four audit firms leaves the market. One way of mitigating that risk is to increase the choice of auditors. However, a number of market characteristics exist which reduce the ability of those outside of the Big Four to enter the higher audit arena. The MPG issued a report in October 2007 containing 15 recommendations to enhance the efficiency of the market and mitigate associated risks. The main objectives of the 15 recommendations were to:

- Increase the feasibility of investment in the supply of audit serviced to public interest entities by existing non-Big Four firms or new firms;
- Reduce the perceived risks to directors if selecting a non-Big Four firm;
- Improve accountability of boards for their auditors selection decisions;
- Improve choice from within the Big Four;
- Reduce the risk of firms leaving the market without good reason; and
- Reduce uncertainty and disruption costs in the event of a firm leaving the market.

As illustrated in the preamble, the experience of some commentators in assisting clients to establish sound board and committee procedures and policies, are that the true objectives are occasionally lost when they are translated into actual guidance. This results in some questionable regulations, leading to tick box exercises rather than effective monitoring and reviewing decision making processes which can be easily identified and explained.

With so much guidance and regulation for companies to follow, it has also been requested that that the next issue of the Combined Code include, as a single volume, all of:

- The Combined Code;
- The revised Smith Guidance;
- The current Turnbull Guidance; and
- Suggestions for Good Practice from the Higgs Report (i.e. pp. 59 to 82 of the 2003 edition of the Combined Code);

thus providing all of the above important material in a single volume. It is also suggested that The Institute of Chartered Accountants of Scotland booklet on Appraising Auditors, published in 2003, should be updated in line with current changes and cross referenced and perhaps should be published with the above.

I hope that you find these comments useful, but please do not hesitate to contact me if you wish to discuss further.

Yours sincerely



Catherine Wright

