



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

3 June 2008

Dear Mr Hodge

Comment on Consultation Document "Proposed Changes to Guidance on Audit Committees" dated March 2008

Independent Audit Limited is a specialist governance consultancy which amongst other things advises audit committees on their effectiveness and compliance.

We agree with the proposed changes to the Combined Code/Smith Guidance, except for the two related points set out below.

We have a general concern that, even though the quality of an audit committee's work is of increasing interest to shareholders, audit committee reporting to shareholders is often insufficient to show how, and how well, an audit committee is fulfilling its responsibilities. Although there has been improvement in the last few years, boilerplate remains common and too many audit committees do little more than restate their terms of reference.

We therefore suggest that the revised Code/Guidance should place greater emphasis on the need for meaningful and informative reporting about what an audit committee has done and how it has done it.

One area of often weak reporting, regarding the audit committee's evaluation of external audit effectiveness, is related to a specific concern we have relating to [new] paragraph 4.22. This requires the audit committee to explain its position regarding the appointment, reappointment and renewal of the external auditors. It specifies three items that the audit committee report should normally explain, two of which are when the current group auditor was first appointed and when the audit was last subject to tender.

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. The idea that companies should have periodic tenders "on grounds of good governance" already has considerable currency, and if the Code were to be changed as proposed, audit committees would be encouraged to feel it is preferable to have an audit tender rather than to publish information that might attract adverse comment.

The proposed change to the Code is therefore likely to have the consequence of encouraging audit committees to put audits out for tender, even if the company did not "judge that a change of auditor would be beneficial" (quoting from page 12 of the consultation document). We do not believe that this is in the interests of companies or their shareholders, for the reasons summarised below. Instead, we suggest that the Code should require an audit committee to explain the company's policy regarding auditor terms of office and routine tendering, rather than merely stating its past practice, and at the same time to provide a clear description of how it assessed the effectiveness of the audit as a basis for making its retention decision.

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. A tender process neither assesses past audit quality nor assures it in future, and there is some evidence that a change of auditor for reasons other than concerns over past audit quality can actually lead to a deterioration in future quality, at least in the short term, because of the new auditor's lack of knowledge of the client. In our experience an otherwise unnecessary audit tender is just as capable of being a demonstration of weak governance as it is of strong governance, and in any event is a significant cost to both the client company and the tendering firms.

Nor is it at all clear that encouraging more tenders would make a significant contribution to the public policy goal of creating opportunities for new entrants to the large company audit market. We observe that audit tenders, particularly those where there is no dissatisfaction with the service provided by the incumbent, seem most likely to result in no change of auditor. In the absence of specific dissatisfaction, this is usually the preferred outcome of management, which would quite reasonably prefer to avoid the disruption and inconvenience caused by an unnecessary change of auditor. The main effect, if any, of such audit tenders can be on the audit fee, which we consider to be a matter for the company's management, audit committee and shareholders, rather than something for the Combined Code.

A rigorous approach to assessing the effectiveness of external audit (along with that of internal audit and other significant high-level control systems) is a more important element of good governance than routine tendering. When done well, it should provide a more objective basis for the decision either to retain or to change auditors, which would help to avoid tenders as a matter of routine. It also clarifies any areas of dissatisfaction with the audit service and provides a basis for client and auditor constructively to discuss how each might make improvements.

In short, audit tenders, in the absence of specific concerns about audit quality, the audit firm's capability or conflicts of interest, are of dubious value but incur a significant cost.

We therefore think that the Code's form of words should not risk encouraging the expectation that audit tenders should be held as a matter of routine, but should instead place greater emphasis on the company's policy on auditor selection and the audit committee's assessment of the quality of the audit service as a substantive basis for making the retention decision.

The first sentence of [new] paragraph 4.22 partly addresses this, with the requirement to explain to shareholders how the audit committee reached its position on the appointment, reappointment and removal of the external auditors. Because of the importance of external audit to shareholders, it will be important that audit committees meet the requirement with substantive explanations rather than with standard formulae. We therefore suggest that the final part of [new] paragraph 4.22 should provide greater encouragement to clear reporting, along the lines proposed below:

Where no change of auditor is proposed, this explanation should normally include:

- *the audit committee's view of external audit effectiveness and how that opinion was formed*
- *other important criteria used for assessing the external auditors' suitability for remaining in office (including details of any tender that resulted in the incumbent's reappointment)*
- *when the senior members of the audit team first took on their present roles, together with details of their prior roles in the audit engagement*
- *the audit committee's policy regarding whether/when an audit tender should be considered*
- *any present or expected future contractual obligations or conflicts of interest that acted to restrict the audit committee's choice of external auditors*

Where a change of auditor has occurred, this explanation should normally include:

- *the reasons for considering that a change of auditor was in the interests of shareholders*
- *how many audit firms were invited to tender, analysed between Big Four and other firms*
- *a description of the selection process and the principal criteria used*
- *any present or expected future contractual obligations or conflicts of interest that acted to restrict the audit committee's choice of external auditors*

Where a change of auditor is proposed but has not yet occurred, the explanation should normally include as much of the above information as is practicable and relevant in the circumstances.

Yours sincerely



Jonathan Hayward
Direct Line: 020 7220 6582
E-mail: jonathan.hayward@independentaudit.com