



PRUDENTIAL

[Sent by email to smithguidance@frc.org.uk]

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Your ref
Our ref GS/RW/tel: 020 7548 3848

Dear Mr Hodge,

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

Prudential welcomes the opportunity to comment on the above consultation paper published in March 2008. Prudential plc is a publicly traded company listed in London and New York and is a leading international financial services group offering insurance and pensions products and retail and institutional fund management services, with operations in the UK, Europe, the US and Asia. We set out below our comments in relation to the following proposed changes set out in the consultation document.

Q1 *Do you agree with the proposed changes (marked up in italics/blue below) based on MPG recommendations? If not, please explain and, if possible, suggest how the proposed changes could be improved.*

Comment **We set out below our comments on each proposed change.**

SG 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.*

Explanation: To promote greater transparency of the capabilities of individual firms (MPG recommendation 5) 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.

Comment **We agree. This is a logical amendment following the introduction of the new requirement (in accordance with the Statutory Audit Directive) for audit firms to publish transparency reports.**

[New] SG 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.

Explanation: To implement MPG recommendation 15.

Comment We support this recommendation, which is sensible.

[New] SG 4.22 The audit committee report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment and removal of the external auditors. This explanation should normally include:

- *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.*

Explanation: To implement MPG recommendations 8 and 9.

Comment We agree this proposal, subject to the following comments.

We request greater clarity as to what is meant by disclosure of “contractual obligations” that act to restrict the audit committee’s choice of external auditors. We understand the rationale for and would support disclosure of any such contractual restrictive covenants with the company’s auditor. However, we would want to safeguard against disclosure of any contractual arrangements that the company has with other audit firms, which as a consequence may mean that such firms cannot be appointed as the company’s auditor for independence reasons. Such contractual arrangements with other audit firms could be confidential for commercial reasons.

SG 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.

Explanation: Both changes to this paragraph are points of consistency with relevant ethical standards for auditors to implement MPG recommendation 12. The existing guidance to ‘ensure’ independence and objectivity could be interpreted as setting a very high barrier for relationships between the company and the audit firm. This proposed revision would bring the Smith Guidance in line with the ES 1 which is based around the identification and assessment of threats to auditor independence and objectivity and then the identification and assessment of safeguards.

ES 5 suggests that relationships between the company and the audit firm could adversely affect the auditor’s objectivity and independence. This, in turn, might impact the auditor’s judgement. The same logic is applied here.

Comment We agree all the above proposed changes and support the explanation given in the consultation paper.

SG 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 other personal~~ relationship with the company

(other than in the normal course of 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 with relevant requirements, including current requirements regarding the rotation of audit partners and staff.

Explanation: The change to the types of relationships achieves consistency with ES 1 and has the advantage of removing the possible overlap between 'financial' and 'investment' and adding 'other personal'. Additionally, some relationships, even in the normal course of business, could result in a threat to independence and objectivity, for example a direct financial interest in an audit client. ES 2 prohibits some financial relationships and permits others on normal business terms, depending on their likely impact on auditor independence and objectivity.

Comment **We agree the proposed amendments. We support the explanations given in the consultation paper. We are content with the deletion of "other than in normal course of business" – we agree this makes sense as it implied that a normal course of business relationship that actually affected independence was permitted. We are also content with adding "other personal" relationships. We note that both of these changes are subject to the overriding requirement that any such relationships are only relevant if they impact adversely auditor independence and objectivity.**

SG 4.26 The audit committee should agree with the board the company's policy for the employment of former employees of the external auditor, paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. This should be drafted taking into account the relevant ethical guidelines governing the accounting profession. The audit committee should monitor application of the policy, including the number of former employees of the external 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, of the auditor's *judgement or independence and objectivity* in respect of the audit.

Explanation: See 4.24 above

Comment **We agree these proposed changes.**

4.27 The audit committee should monitor the external audit firm's compliance with applicable United Kingdom ethical guidance relating to the rotation of audit partners, the level of fees that the 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.

Explanation: See MPG recommendation 12. For any individual partner it is almost inevitable that the fees will be a high proportion of his or her overall fee income. The threat to independence is tied to the extent to which the firm and its partners are reliant on the fee income. This reliance will depend on the arrangements for profit sharing within the firm which are often not based on offices. This change is in line with ES 2.

Comment **We welcome this proposed change, which is sensible.**

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:

- whether the skills and experience of the audit firm make it a suitable supplier of the non audit service;
- whether there are safeguards in place to ~~ensure that there is no~~ reduce any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor *to an acceptable level*;
- the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

Explanation: See MPG recommendation 12. The existing guidance to 'ensure' independence and objectivity could be interpreted as setting a very high barrier for relationships between the company and the audit firm. This would bring the Guidance in line with the ES 1 which is based around the identification and assessment of threats to auditor independence and objectivity and then the identification and assessment of safeguards.

Comment **We agree the proposed amendments and support the explanation given in the consultation paper.**

SG 4.31 In determining the [see SG4.29:] 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:

- the external auditor audits its own firm's work;
- the external auditor makes management decisions for the company;
- a mutuality of interest is created; ~~or~~
- *the external auditor develops close personal relationships with the company's personnel; or*
- the external auditor is put in the role of advocate for the company.

Explanation: See MPG recommendation 12. ES 1, paragraph 28, includes six principle types of threats to auditors' objectivity and independence. Although one of these, intimidation, is a matter for the audit firm to judge rather than the audit committee, a familiarity (or trust) threat could be created or worsened through the delivery of non-audit services such as recruitment services.

Comment **The proposed change states that, inter alia, the audit committee should not agree to an auditor providing a non-audit service if it results in a close personal relationship. We do not support this change in SG 4.31 for the following reasons.**

First, we query whether this proposed change will be workable in practice. For example, what is the definition of "close personal relationships"? Is it a personal relationship in a work context or in a social context? The test for the audit committee to consider is subjective, it will require the audit committee to look into the future and take a view as to whether such a relationship will develop. When does the point at which such a relationship may "develop" be regarded as too far into the future?

Secondly, the need to avoid close personal relationships should relate to both audit and non-audit services, and would be better dealt with elsewhere in the Smith Guidance. We note that the proposed amendments to SG 4.25 will already deal with prohibiting the audit firm and its staff from having personal relationships with the company, and in practice this prohibition will apply to where the audit firm is providing non-audit services.

SG 5.2 The audit committee section [of the annual report (SG 5.1)] should include, inter alia:

- a summary of the role of the audit committee;
- the names and qualifications of all members of the audit committee during the period;
- the number of audit committee meetings;
- a report on the way the audit committee has discharged its responsibilities; ~~and~~
- ~~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 the external auditors provided for in paragraph [new] 4.22 above.

Explanation: These changes are made for consistency with those earlier in the Guidance. The paragraph numbers shown in square brackets will change due to the insertion of new paragraphs earlier.

Comment We are content with these amended disclosure requirements, subject to the following comments in relation to the explanation to be given in the annual report required by the final bullet point above.

Please see our comment to the proposed new SG 4.22 above. As stated, we believe that it needs to be made clear that there is no need to disclose any confidential contractual arrangements that a company has with audit firms, other than its auditor, which has the effect of restricting the choice of external auditors (for independence reasons).

We would point out that there seems to be an overlap between the explanation required by the above final bullet point together with SG 4.22 and the disclosure required by SG 4.17/Combined Code A.3.6. The former requires an explanation how the audit committee reached its recommendation to the board regarding the appointment, reappointment and removal of external auditors. The latter only requires a statement in the annual report if the board does not accept the audit committee's recommendation, explaining this recommendation and the reasons why the board has taken a different position.

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

Comment We are content with the draft impact assessment.

Yours sincerely,

B. Walker

Bob Walker
Deputy Group Secretary (Technical Advisor)