FRC

Financial Reporting Council

Amendments to Guidance on Audit Committees

Regulatory Impact Assessment

October 2008

REGULATORY IMPACT ASSESSMENT

AMENDMENTS TO FRC GUIDANCE ON AUDIT COMMITTEES

Purpose and intended effect

1 The FRC Audit Committee Guidance (formerly known as the Smith Guidance) is non-binding guidance addressed to the audit committees of UK incorporated companies listed on the Main Market of the London Stock Exchange. It is designed to assist directors serving on audit committees in carrying out their role and in complying with the provisions of Section C3 of the Combined Code on Corporate Governance. The Code sets out standards of good governance practice; all companies incorporated in the UK and listed on the London Stock Exchange are required under the FSA Listing Rules to report on how they have applied the Combined Code in their annual report.

2 The revisions being made to the guidance are intended to implement a number of recommendations made in the Market Participants Group's (MPG) report on 'Choice in the UK Audit Market', published in October 2007. These were:

- *Recommendation 8:* The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.

- *Recommendation 9:* When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.

- *Recommendation 12:* The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.

- *Recommendation 15:* Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

3 The main changes to the guidance are:

- audit committees are encouraged to consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning;

- companies are encouraged to include in the audit committee's report information on the appointment, reappointment or removal of the auditor, including supporting information on tendering frequency, the tenure of the incumbent auditor and any contractual obligations that acted to restrict the committee's choice of auditor;

- a small number of detailed changes have been made to the section with the independence of the auditor to bring the guidance in line with the Auditing Practices Board's Ethical Standards for auditors, which have been issued since the guidance was published in 2003; and

- an appendix has been added containing guidance on the factors to be considered if the company was contemplating employing firms from more than one network to undertake the audit.

Business sectors affected

4 Changes to the Combined Code and associated guidance directly affect those companies incorporated in the UK and fully listed on the Main Market of the London Stock Exchange, as they are required by the Listing Rules to report on how they have applied the Code. As of 31 August 2008 there were 1,200 such companies, operating across all business sectors. In addition, some companies and organisations in other sectors of the economy may have voluntarily chosen to follow the guidance.

Issues

5 As noted in paragraph 1, the Guidance on Audit Committees is non-binding and compliance with its recommendations is entirely voluntary. If a company considers that the cost of following one or more of it recommendations would exceed the benefits, it is free to choose not to comply with them.

6 The changes to the sections of the guidance dealing with the independence of the auditor have been made to ensure the terminology is consistent with that of the Ethical Standards for auditors, but do not substantively change the actions that audit committees are recommended to take. These changes are therefore expected to be cost-neutral.

7 There may be a small cost associated with the recommendations that the audit committee should consider the need to include the risk of the withdrawal of their auditor from the market, and whether there might be a benefit in using firms from more than one audit network. These costs would arise from the time taken to prepare papers for the audit committee, and the time taken by the committee in considering whether

further action was appropriate. None of the respondents to the public consultations were able to quantify these costs.

8 If the audit committee concluded that further action was appropriate – either taking mitigating action to guard against the possibility of the external auditor leaving the market, or taking steps to engage more than one audit network – there would be further costs involved. However, it is envisaged that companies would only take further actions if they concluded that the benefits of doing so outweighed the associated costs.

9 The change that could involve extra costs for companies with audit committees is the recommendation that companies should explain to shareholders how the audit committee reached its recommendation to the board on the appointment, reappointment and removal of the external auditors. The guidance recommends that this should include tendering frequency, tenure of the incumbent auditor, and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

10 The direct costs associated with this recommendation would include the cost of preparing the information, including the time required to discuss at the audit committee, the cost of publishing the information in the annual report, and the cost – for both the company and its shareholders – of any engagement between the two parties prompted by the disclosures. None of the respondents to the public consultation were able to quantify these costs.

11 The consultation exercise revealed differing views on the possible indirect costs and benefits associated with this recommendation, depending on whether respondents believed that greater disclosure about the company's tendering history would lead to more frequent tendering.

12 When a company puts the audit out to tender costs will be incurred by the company and by the audit firms that choose to tender (one audit firm that responded to the consultation estimated that the cost of tendering could be as much as the equivalent of one year's audit fee).

13 In principle there should also be benefits for the company – for example, from an improved service and/or reduced audit fee – as well as for the market as a whole if competition and choice is increased as a result. In its report the MPG emphasised that companies should only go out to tender if they considered that a change of auditor would be beneficial, and nothing in the guidance requires companies to go out to tender.

14 However, some respondents considered that simply making information on companies' tendering history available would create an expectation on the part of investors that there should be regular tendering whether or not the company had concerns about the quality of service provided by its current auditor. These respondents considered that, if this situation were to arise, the costs would outweigh the benefits. As well as the direct costs associated with tendering, some respondents argued that – if the tender led to a change of auditor - companies would incur further costs arising from the time needed to support the incoming auditor, and that the knowledge and experience lost when the outgoing auditor left could, at least in the short time, erode the overall quality and effectiveness of the audit.

Enforcement and sanctions

15 As noted in paragraph 1, the Guidance on Audit Committees is not binding. While the FRC will review a selection of audit committee statements in annual reports to monitor the extent to which companies are choosing to make the additional disclosures recommended in the revised guidance, compliance with the guidance is voluntary any no enforcement action will be taken if a company chooses not to follow the guidance.

Consultation

16 Consultation on proposed revisions to the Guidance on Audit Committees was carried out between March and June 2008. A summary of the main points raised by respondents, and copies of individual responses, can be found at: http://www.frc.org.uk/corporate/auditcommittees.cfm

17 A separate consultation on guidance regarding the use of audit firms from more than one network was carried out between May and August 2008. Copies of individual responses can be found at:

http://www.frc.org.uk/about/auditchoice.cfm

Monitoring and review

18 The FRC will continue to monitor implementation of the Combined Code and its related guidance, including the Guidance on Audit Committees.

Summary and recommendations

19 The direct costs associated with the proposed changes to the guidance are limited and the non-binding nature of the guidance means that if a company considers that the cost of following one or more of it recommendations would exceed the benefits, it is free to choose not to comply with them.

20 There are potentially significant indirect costs and benefits associated with the recommendation that companies should disclose more information relating to auditor selection, if this increases tendering for audits. The MPG's view was that companies should only go out to tender if they considered that a change of auditor would be beneficial. If this view is adhered to the benefits for companies and the market as a whole should outweigh the costs, but the impact of this change will need to be kept under review.

Contact point

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

E-mail: c.hodge@frc.org.uk

Financial Reporting Council
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Financial Reporting Council
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN
Tel: +44 (0)20 7492 2300
fax: +44 (0)20 7492 2301
Website: www.frc.org.uk