



FINANCIAL REPORTING COUNCIL

CONSULTATION DOCUMENT:

**REVISIONS TO FRC GUIDANCE ON AUDIT COMMITTEES:
NON-AUDIT SERVICES**

JULY 2010

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REVISIONS TO FRC GUIDANCE ON AUDIT COMMITTEES: NON-AUDIT SERVICES

Introduction

1. The current version of the FRC Guidance on Audit Committees was issued in October 2008. A number of changes are proposed which arise as a result of work undertaken by the FRC's Auditing Practices Board (APB) on the provision of non-audit services and audit partner rotation. These were highlighted as potential actions in the consultation on the revised UK Corporate Governance Code in December 2009.
2. The changes proposed to the Guidance on Audit Committees are shown in the Appendix of this document and summarised in paragraph 10 below.
3. Comments are requested by 23 October 2010. Subject to the outcome of this consultation, the intention is to publish the updated guidance in December 2010.
4. The FRC will be looking at other aspects of corporate governance, narrative reporting and auditing over the next twelve months, some of which may also have implications for audit committees. It is conceivable that further changes to the Guidance might be necessary as a consequence. If that is the case they will be subject to separate consultation.

Background

5. In October 2009 the APB issued a Consultation Paper to respond to the Treasury Select Committee's call for a consultation on their proposal that there should be a prohibition on auditors providing non-audit services to the entities that they audit. That Consultation Paper provided an analysis of the approach that has been taken to auditor independence since 2004 when the APB was given responsibility for setting ethical standards for auditors. This approach includes an enhanced role for audit committees in approving the purchase of non-audit services from the company's auditor and justifying this to shareholders. This continues to be an important element of the framework surrounding the provision of non-audit services by auditors and the Guidance on Audit Committees is intended to support this role.

6. Responses were received on the APB's October 2009 consultation from 150 commentators representing a wide variety of stakeholder groups. A full list of respondents is given in the Feedback Paper being published concurrently with this consultation. The message from the review undertaken by the APB is that commentators (irrespective of the constituency involved) were overwhelmingly of the view that there should be no outright prohibition of, and no major change to the framework surrounding, the provision of non-audit services by auditors to the entities that they audit.
7. However, there is broad acknowledgement that there is a perception amongst investors that confidence in the audit can be reduced where non-audit services are provided by the auditor. Commentators, including investors, emphasise the need to address this perception issue through improved transparency and governance. This focus on governance reflects a theme of many responses that decisions as to whether a company's auditors should be engaged to provide non-audit services is first and foremost a matter of corporate governance.
8. It is thought that one reason for the perception issue is that companies give insufficient disclosure of non-audit services provided by the auditor in their annual reports to enable investors to decide for themselves whether the auditor's objectivity and independence may have been adversely affected by being retained to undertake non-audit services. A number of investor respondents argued that there should be greater disclosure about the nature and level of non-audit services provided by the auditor. Corporate respondents also recognised that there was scope for better disclosure of the type of work being undertaken by the auditor and, where this requires the application of safeguards, how companies ensure that auditor independence is maintained.

'It is fair to say that reporting by the audit committee is too often boilerplate and uninformative in its approach.' - Investor respondent

'...greater clarity and explanation of why audit firms are used and disclosure of non-audit fees would benefit understanding.' -Corporate respondent

9. As a result of the focus on transparency and governance as potential solutions to the perception issue, the APB has developed a proposal on these improvements which entails changes to both its own Ethical Standards for Auditors and the Guidance on Audit Committees. Additionally it has discussed the disclosure of fees for non-audit services in financial statements the format of which is determined by legislation. There are three aspects of disclosure where respondents felt an improvement could be made:

- The statutory disclosure of auditor remuneration¹ is not always provided on a consistent basis, suggesting that the regulations may not be easy to interpret and/or that the associated guidance² has not been followed consistently. In addition the detailed nature of the services provided by the auditors is not always readily apparent, especially as there is a degree of summarisation of the data on non-audit service fees that is carried out;
- Within disclosures in annual reports about compliance with the UK Corporate Governance Code there is often disclosure of the fact that a company has a policy on non-audit services without specifying what this policy is; and
- There is often no explanation of why individual non-audit service engagements have been provided by a company's auditor rather than by another party and how the auditor's independence has been safeguarded.

Proposed changes to the Guidance

10. The changes proposed to the Guidance on Audit Committees are shown as a mark up to the current version in the Appendix of this document. The changes can be summarised as follows:

- More prominence is given to the importance of non-audit services in the assessment of the objectivity and independence of the company's auditor by moving the guidance currently in paragraphs 4.28 and 4.29 to later in the document (revised paragraphs 4.34 and 4.35);
- A number of corporate respondents to the October 2009 consultation suggested that the practice of seeking specific approval from audit committees for particular categories (and values) of non-audit services to be supplied by the auditor is widely followed. This type of policy and procedure is set out in paragraph 4.30.
- Additional guidance is given in paragraph 4.31 to help the audit committee distinguish between those non-audit services which are closely related to an audit and which give rise to a very low threat to auditor objectivity and those where the threats need more careful consideration. This is consistent with the identification of 'audit related services' as a separate category of non-audit services proposed in the APB's Ethical Standards for Auditors. A number of corporate respondents thought that disclosing the nature of the services provided (particularly where they are similar to an audit) would allay fears that

¹ The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008, which can be accessed at http://www.opsi.gov.uk/SI/si2008/uksi_20080489_en_1

² ICAEW published TECH 06/06 'Disclosure of Auditor Remuneration' when the regulations were first implemented and this guidance was updated in July 2007.

the auditor is conflicted by the purchase of such non-audit services and therefore help maintain confidence in the quality of the audit.

- It is thought that by identifying audit related services, there will be a greater focus on other non-audit services by both audit committees and investors. There is no presumption that services in this third category are services that the entity's auditor should not provide. A judgment needs to be made by audit committees as to the cost and efficiency benefits and the real or perceived threats to auditor independence which are associated with the auditor providing them. Guidance on such judgments is given in paragraph 4.32.
- Improved disclosures of the audit committee policy, as set out in paragraph 4.38, will give more detail on the nature of services provided by the auditor and will outline the reasons why the audit committee decided to purchase non-audit services, other than audit related services, from the auditor rather than from another party. This increased transparency will enable investors to monitor the judgments made by audit committees and to make it known where they disagree.
- Although not directly linked to greater transparency, there are two other amendments proposed to the Guidance on Audit Committees which are connected with the APB Ethical Standards for Auditors:
 - Additional guidance on factors to take into account when the external auditor is being considered to provide internal audit services is added in paragraph 4.8.
 - Additional guidance on flexibility that is available in respect of the rotation of the audit engagement partner is provided in paragraph 4.36.

Further changes to the Guidance

11. As noted in paragraph 4, the FRC will be looking at other aspects of corporate governance, narrative reporting and auditing over the next twelve months, some of which may also have implications for audit committees. For example, the FRC will be carrying out a review of the Turnbull Guidance on internal control, beginning in the second half of 2010. There is some overlap between the Turnbull Guidance and this Guidance, which addresses the audit committee's role in relation to risk management and internal controls (paragraphs 4.5 to 4.7). If any further changes to the Guidance are proposed as a result of that or other reviews they will be subject to separate consultation.

How to Comment

12. Views are invited from all interested parties on the proposed revisions to the FRC Guidance on Audit Committees. In particular, views are sought on whether the proposed changes to the Guidance reinforce audit committees' responsibility for:

- determining whether a company's auditor should be permitted to provide particular non-audit services, and
- providing information about the non-audit services provided by a company's auditor, and

therefore reduce the perceived threats to auditor objectivity and independence arising from the provision of non-audit services? If not, what further guidance should be given?

Responses are requested by 23 October 2010 and should be sent by e-mail to:

corporategovernance@frc.org.uk

or in writing to:

**Chris Hodge
Corporate Governance Unit
Financial Reporting Council
Fifth Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN**

It is the FRC's policy to publish on its website all responses to formal consultations issued by the FRC and/or any of its Operating Bodies unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for nondisclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

ANNEX

DRAFT REVISED GUIDANCE ON AUDIT COMMITTEES

***Note:** The text of Section 4 of the draft revised Guidance on Audit Committees is provided with a mark up showing all of the changes (except where an existing paragraph is simply moved, in which case the current reference is shown at the end of the paragraph without mark-up). No further changes in other sections are proposed and these have therefore not been provided.*

4 Role and responsibilities

Financial reporting

- 4.1 The audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements.
- 4.2 It is management's, not the audit committee's, responsibility to prepare complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations. However the audit committee should consider significant accounting policies, any changes to them and any significant estimates and judgements. The management should inform the audit committee of the methods used to account for significant or unusual transactions where the accounting treatment is open to different approaches. Taking into account the external auditor's view, the audit committee should consider whether the company has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements. The audit committee should review the clarity and completeness of disclosures in the financial statements and consider whether the disclosures made are set properly in context.
- 4.3 Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting by the company, it shall report its views to the board.
- 4.4 The audit committee should review related information presented with the financial statements, including the operating and financial review, and corporate governance statements relating to the audit and to risk management. Similarly, where board approval is required for other statements containing financial information (for example, summary financial statements, significant financial returns to regulators and release of price sensitive information), whenever practicable (without

being inconsistent with any requirement for prompt reporting under the Listing Rules) the audit committee should review such statements first.

Internal controls and risk management systems

- 4.5 The audit committee should review the company's internal financial controls (that is, the systems established to identify, assess, manage and monitor financial risks); and unless expressly addressed by a separate board risk committee comprised of independent directors or by the board itself, the company's internal control and risk management systems.
- 4.6 The company's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the board that it has done so. Except where the board or a risk committee is expressly responsible for reviewing the effectiveness of the internal control and risk management systems, the audit committee should receive reports from management on the effectiveness of the systems they have established and the conclusions of any testing carried out by internal and external auditors.
- 4.7 Except to the extent that this is expressly dealt with by the board or risk committee, the audit committee should review and approve the statements included in the annual report in relation to internal control and the management of risk.
- 4.8 If the external auditor is being considered to undertake aspects of the internal audit function, the audit committee should consider the effect this may have on the effectiveness of the company's overall arrangements for internal control and investor perceptions in this regard. Investor perceptions are likely to be influenced by:
- the rationale set out in the annual report for the work being performed by the external auditor,
 - the nature and extent of the work performed by the external auditor, and
 - whether, in the absence of internal audit work, the audit committee is wholly reliant on the views of the external auditor about the effectiveness of its system of controls relating to core activities and significant locations.

Whistleblowing

- 4.9 **The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.**

The internal audit process

- 4.10 **The audit committee should monitor and review the effectiveness of the company's internal audit function. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.**
- 4.11 The need for an internal audit function will vary depending on company specific factors including the scale, diversity and complexity of the company's activities and the number of employees, as well as cost/benefit considerations. Senior management and the board may desire objective assurance and advice on risk and control. An adequately resourced internal audit function (or its equivalent where, for example, a third party is contracted to perform some or all of the work concerned) may provide such assurance and advice. There may be other functions within the company that also provide assurance and advice covering specialist areas such as health and safety, regulatory and legal compliance and environmental issues.
- 4.12 When undertaking its assessment of the need for an internal audit function, the audit committee should also consider whether there are any trends or current factors relevant to the company's activities, markets or other aspects of its external environment, that have increased, or are expected to increase, the risks faced by the company. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.
- 4.13 In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself, the audit committee and the board that the system of internal control is functioning as intended. In these circumstances, the audit committee will need to assess whether such processes provide sufficient and objective assurance.
- 4.14 The audit committee should review and approve the internal audit function's remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors³.

³ Further guidance can be found in the Institute of Internal Auditors' Code of Ethics and the International Standards for the Professional Practice of Internal Auditing.

- 4.15 The audit committee should approve the appointment or termination of appointment of the head of internal audit.
- 4.16 In its review of the work of the internal audit function, the audit committee should, inter alia:
- ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee;
 - review and assess the annual internal audit work plan;
 - receive a report on the results of the internal auditors' work on a periodic basis;
 - review and monitor management's responsiveness to the internal auditor's findings and recommendations;
 - meet with the head of internal audit at least once a year without the presence of management; and
 - monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

The external audit process

- 4.17 The audit committee is the body responsible for overseeing the company's relations with the external auditor.

Appointment

- 4.18 **The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or reappointment, a statement from the audit committee explaining its recommendation and should set out reasons why the board has taken a different position.**
- 4.19 The audit committee's recommendation to the board should be based on the assessments referred to below. If the audit committee recommends considering the selection of possible new appointees as external auditors, it should oversee the selection process.
- 4.20 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. It might also be appropriate for the audit

committee to consider whether there might be any benefit in using firms from more than one audit network⁴.

- 4.21 If the external auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.
- 4.22 The audit committee should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.
- 4.23 The audit committee section of the annual report should explain to shareholders how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors. This explanation should normally include supporting information on tendering frequency, the tenure of the incumbent auditor, and any contractual obligations that acted to restrict the audit committee's choice of external auditors.

Terms and Remuneration

- 4.24 The audit committee should approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided.
- 4.25 The audit committee should review and agree the engagement letter issued by the external auditor at the start of each audit, ensuring that it has been updated to reflect changes in circumstances arising since the previous year. The scope of the external audit should be reviewed by the audit committee with the auditor. If the audit committee is not satisfied as to its adequacy it should arrange for additional work to be undertaken.
- 4.26 The audit committee should satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee.

Independence, including the provision of non-audit services

- 4.27 The audit committee should assess the independence and objectivity of the external auditor annually, taking into consideration relevant UK law, regulation and professional requirements. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services) and any safeguards established by the external auditor. The audit committee should consider whether, taken as a whole and having regard to the

⁴ Guidance on the considerations relevant to the use of firms from more than one audit network can be found in the Appendix.

views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor's independence and objectivity.

4.28 The audit committee should seek reassurance that the auditors and their staff have no financial, business, employment or family and other personal relationship with the company which could adversely affect the auditor's independence and objectivity, taking account of relevant 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.

4.29 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 eliminate or reduce to an acceptable level any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
- the nature of the non-audit services;
- the fees incurred, or to be incurred, for non-audit services both for individual services 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.

4.30 The audit committee should set and apply a formal policy specifying the types of non-audit ~~service work~~ (if any):

- ~~• from which the external auditors are excluded;~~
 - for which the use of the external auditors is pre-approved (i.e. approval has been given in advance as a matter of policy, rather than the specific approval of an engagement being sought before it is contracted) can be engaged without referral to the audit committee; and
 - for which specific approval from the audit committee is required before they are contracted; and
 - from which the external auditor is excluded.
- ~~• for which a case-by-case decision is necessary.~~

In addition, the policy may set fee limits generally or for particular classes of work

4.31 Pre-approval of the use of the external auditor may be appropriate where the threats to auditor independence are considered low, for example if the engagement is:-

- routine in nature and the fee is very small not significant in the context of the audit fee, or
- for an audit related service⁵

4.32 In the third category, if it is not practicable to give approval to individual items in advance, it may be appropriate to give a general pre-approval for certain classes for work, subject to a fee limit determined by the audit committee and ratified by the board. The subsequent provision of any service by the auditor should be ratified at the next meeting of the audit committee. The non-audit services that fall within the second category in paragraph 4.30~~31~~ above are likely to be those which, because of their size or nature or because of special terms and conditions (for example, contingent fee arrangements), are thought to give rise to threats to the auditor's independence. As a consequence, careful consideration will be needed when determining whether it is in the interests of the company that they should be purchased from the audit firm (rather than another supplier) and, if so, whether any safeguards to be put in place by the audit firm are likely to be effective, and how this will be disclosed in the annual report.

4.33 In determining the policy, the audit committee should take into account the possible threats to auditor objectivity and independence⁶ and relevant APB Ethical Standards for Auditors 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;
- the external auditor develops close personal relationships with the company's personnel; or

⁵ Audit related services are those non-audit services specified as such in APB Ethical Standards for Auditors.

⁶ APB Ethical Standards for Auditors explain that threats to auditor objectivity and independence may arise from:

- Self-interest,
- Self-review,
- Management,
- Advocacy,
- Familiarity, and
- Intimidation.

~~the external auditor is put in the role of advocate for the company.~~
~~The audit committee should satisfy itself that any safeguards required by Ethical Standards are implemented.~~

4.34 The audit committee should agree with the board the company's policy for the employment of former employees of the external auditor, taking into account the APB Ethical Standards for Auditors 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. 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 independence and objectivity in respect of the audit. (*Current paragraph 4.28*)

4.35 The audit committee should monitor the external audit firm's compliance with APB Ethical Standards for Auditors 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, or relevant part of it⁷, and other related regulatory requirements. (*Current paragraph 4.29*)

4.36 A degree of flexibility over the timing of rotation of the audit engagement partner is possible where the audit committee decides that it is necessary to safeguard the quality of the audit. In such circumstances, the audit engagement partner may continue in this position for an additional period of up to two years, so that no longer than seven years in total is spent in this position. The audit committee should disclose this fact and the reasons for it to the shareholders as early as practicable.

4.37 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

4.38 The explanation should:

- describe the work of the committee in discharging its responsibilities;
- set out the audit committee's policy on the engagement of the external auditor to supply non-audit services in sufficient detail to describe each of the elements in paragraph 4.30;
- set out, or cross refer to, the fees paid to the auditor for audit services, audit related services and other non-audit services⁸; and

⁷ Where the audit firm's profits are not shared on a firm-wide basis, the relevant part of the firm is that by reference to which the audit engagement partner's profit share is calculated.

⁸ A template for the provision of this information by the auditors to the audit committee is set out in Appendix [A] to Ethical Standard 1 issued by the Auditing Practices Board.

- if the auditor provides non-audit services, other than audit related services, explain for each significant engagement, or category of engagements, what the services are, why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor (rather than another supplier) and how auditor objectivity and independence has been safeguarded.

Annual audit cycle

- 4.39 At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit.
- 4.40 The audit committee should consider whether the auditor's overall work plan, including planned levels of materiality, and proposed resources to execute the audit plan appears consistent with the scope of the audit engagement, having regard also to the seniority, expertise and experience of the audit team.
- 4.41 The audit committee should review, with the external auditors, the findings of their work. In the course of its review, the audit committee should:
- discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved;
 - review key accounting and audit judgements; and
 - review levels of errors identified during the audit, obtaining explanations from management and, where necessary, the external auditors as to why certain errors might remain unadjusted.
- 4.42 The audit committee should also review the audit representation letters before signature by management and give particular consideration to matters where representation has been requested that relate to non-standard issues⁹. The audit committee should consider whether the information provided is complete and appropriate based on its own knowledge.

⁹ Further guidance can be found in the Auditing Practices Board's International Standard on Auditing (UK and Ireland) 580: "Management Representations".

4.43 As part of the ongoing monitoring process, the audit committee should review the management letter (or equivalent). The audit committee should review and monitor management's responsiveness to the external auditor's findings and recommendations.

4.44 At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process. In the course of doing so, the audit committee should:

- review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
- consider the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, and in their commentary where appropriate on the systems of internal control;
- obtain feedback about the conduct of the audit from key people involved, e.g. the finance director and the head of internal audit; and
- review and monitor the content of the external auditor's management letter, in order to assess whether it is based on a good understanding of the company's business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.



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