hpc health professions council

Audit Committee 26 June 2008

Proposed changes to guidance for audit committees

Executive summary and recommendations

Introduction

The Guidance on Audit Committees (the Smith Guidance) was first published in 2003. It is intended to assist company boards when implementing the sections of the Combined Code on Corporate Governance dealing with audit committees and to assist directors serving on audit committees in carrying out their role. The Financial Reporting Council is responsible for keeping the Combined Code on Corporate Governance under review, together with associated guidance including the Smith Guidance.

Although the guidance is aimed at companies, the principles could be applied to an organisation such as the HPC.

The Market Participants Group (MPG) of the Financial Reporting Council was established in October 2006 to provide advice on mitigating the risks that could arise in the event of one of more of the major audit firms leaving the market. The Group's final report, containing 15 recommendations to improve the efficiency of the UK audit market, was published in October 2007.

A number of the MPG's recommendations were targeted at companies. Four of these have particular relevance to audit committees and the Smith Guidance. The recommendations called for:

- Company boards to provide information to shareholders relevant to their auditor selection decision.
- Company boards to disclose any contractual obligations (such as loan agreements) to appoint certain types of audit firms.
- Large companies to consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.
- Sections of the Smith Guidance dealing with auditor independence to be reviewed for consistency with the relevant ethical standards for auditors.

The Financial Reporting Council recently carried out a consultation on proposed changes to the Smith Guidance. The consultation period closed on 6 June 2008 and the amended version of the Smith Guidance is due to be published by the Financial Reporting Council later in 2008.

Decision

This paper is for information. No decision is required.

Background information

Background material to the consultation is available on the Financial Reporting Council's website at:

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

At its meeting on 12 June 2006, the Committee agreed to use the National Audit Office's self-assessment checklist to assess its effectiveness on an annual basis.

Resource implications

None

Financial implications

None

Appendices

Copy of consultation document published by Financial Reporting Council, March 2008. Please note that the proposed amendments to the Smith Guidance are only the consultation draft and this is not the final guidance.

Date of paper

9 June 2008.

FRC

FINANCIAL REPORTING COUNCIL

CONSULTATION ON PROPOSED CHANGES TO GUIDANCE ON AUDIT COMMITTEES (THE SMITH GUIDANCE)

MARCH 2008

Contents

One - Background

The Smith Guidance

Following the major corporate failures in the US in 2002, the FRC was asked to set up an independent group to clarify the role and responsibilities of audit committees. The role of audit committees in reinforcing the independence of the auditor was a particular concern. Sir Robert Smith, Chairman of The Weir Group PLC and a member of the FRC's then Council, was invited to chair the group.

The Smith Group published its report in 2003 and proposed best practice guidance relating to audit committees. Its main recommendations were incorporated into the revised Combined Code on Corporate Governance issued in July 2003. In addition a separate publication, The Guidance on Audit Committees (The Smith Guidance), was published to assist company boards in making suitable arrangements for their audit committees, and to assist directors serving on audit committees in carrying out their role. While company boards are not required to follow the Smith Guidance when applying the Combined Code, the more detailed Smith Guidance is intended to assist boards when implementing the relevant provisions of the Code.

Following a recommendation of the committee set up to review the Turnbull Guidance on Internal Control, the Smith Guidance was reissued in October 2005 incorporating three paragraphs on the audit committee's role and responsibilities in respect of the internal audit process that had previously formed part of the Turnbull Guidance. No other changes were made to the Smith Guidance at that time.

The FRC is responsible for keeping the Combined Code on Corporate Governance under review together with associated guidance including the Smith Guidance.

Need for this consultation

The Market Participants Group (MPG) was established in October 2006 to provide advice to the Financial Reporting Council on possible actions that market participants could take to mitigate the risks arising from the characteristics of the market for audit services to public interest entities[1] in the United Kingdom. These risks include the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. In establishing the terms of reference of the Group, the FRC noted the importance of audit quality and the need to avoid actions that would damage audit quality.

The MPG found that due to the level of auditor concentration there was concern amongst market participants over the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. This risk could be mitigated through increased choice of auditors.

[1] Public interest entities means entities that are of significant public relevance because of the nature of their business, their size or the number of their employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings.

However a number of current market characteristics, when taken together, reduced the propensity of existing or new non-Big Four firms to make 'step change' investments in their capability to audit public interest entities and the propensity for public interest entities to select non-Big Four firms as auditors.

The MPG's October 2007 report set out recommendations for a package of actions designed to enhance the efficiency of the market and in so doing mitigate the risks associated with a firm leaving the market. Copies of the report are available from the FRC's website at http://www.frc.org.uk/about/auditchoice.cfm.

The main objectives of the MPG's 15 recommendations are to:

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

A number of the recommendations are targeted at companies and four of these have particular relevance to audit committees. The amendments to the Smith Guidance proposed in this paper are intended to assist company boards and their audit committees by incorporating the changes recommended by the MPG. The relevant recommendations are:

- *MPG 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.

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

- *MPG 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.

In addition to the proposed changes based on the MPG recommendations, the draft revised guidance also contains further changes that might be needed following the 2007 Review of the Combined Code, on which the FRC has consulted separately. These possible consequential changes are described in Section Three. The FRC is not aware of a significant case for any other changes at present and therefore is not carrying out a general review of the Smith Guidance.

This paper includes two consultation questions which are shown on page 13. The FRC will review responses to these questions before finalising the changes to the Smith Guidance, which will include the consequential change arising from the 2007 Review of the Combined Code if appropriate. A revised version of the Smith Guidance will then be published later in 2008.

Two - Proposed changes based on MPG recommendations

Those sections of the Smith Guidance which are affected by the proposed changes are reproduced below showing the proposed changes. The paragraphs in bold in the Smith Guidance are taken from the Combined Code. Explanations for proposed changes include references to the Auditing Practices Board's Ethical Standards (ES).

4 Role and responsibilities

The external audit process

Proposed revised Smith Guidance with changes in italics	**Explanation for proposed changes**
4.16 The audit committee is the body responsible for overseeing the company's relations with the external auditor.	
Appointment 4.17 **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.**	
4.18 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.	
4.19 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 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.
4.20 If the external auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.	

Proposed revised Smith Guidance with changes in italics	**Explanation for proposed changes**
[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.
[New] 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.*	To implement MPG recommendations 8 and 9.

Independence, including the provision of non-audit services

Proposed revised Smith Guidance with changes marked in italics	**Explanation for proposed changes**
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*.	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.

Proposed revised Smith Guidance with changes marked in italics	**Explanation for proposed changes**
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.	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.
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.	See 4.24.

Proposed revised Smith Guidance with changes marked in italics	**Explanation for 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.	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.
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.	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.
4.29 The audit committee should set and apply a formal policy specifying the types of non-audit work: • from which the external auditors are excluded; • for which the external auditors can be engaged without referral to the audit committee; and • for which a case-by-case decision is necessary. In addition, the policy may set fee limits generally or for particular classes of work.	

Proposed revised Smith Guidance with changes marked in italics	**Explanation for proposed changes**
4.30 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.	
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: • 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.	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.
4.32 **The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.**	

5 Communication with shareholders

Proposed revised Smith Guidance with changes marked in italics	**Explanation for proposed changes**
5.1 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section in the annual report should describe the work of the committee in discharging those responsibilities.	
5.2 The audit committee section 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.*	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.

Consultation question 1

Do you agree with the proposed changes based on MPG recommendations? If not, please explain and, if possible, suggest how the proposed changes could be improved.

Three - Possible changes based on 2007 Review of the Combined Code

In December 2007 the FRC invited comments on two proposed changes to the Combined Code. One of these is relevant to audit committees, being that for listed companies outside the FTSE 350, provision C.3.1 of the Code would be amended to allow the company chairman to be a member of, but not chair, the audit committee provided he or she was considered independent on appointment.

No decisions have yet been taken by the FRC's Board on the proposed changes to the Combined Code. If the FRC was to decide to make the proposed change shown above, this would need to be reflected in the Smith Guidance in section 2 (Establishment and role of the audit committee; membership, procedures and resources) as shown below. If the FRC decides not to make the change to the Combined Code then no change would be made to this section of the Smith Guidance. Please note that the FRC has consulted separately over the proposed changes shown below (see http://www.frc.org.uk/corporate/2007review.cfm).

Membership and appointment

Possible revised Smith Guidance with changes marked in italics	**Explanation for possible change**
2.3 ***In FTSE 350 companies*** ~~*A*~~*a***ll 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.***	As shown above, to reflect a possible change to the Combined Code.
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.***	As shown above, to reflect a possible change to the Combined Code.
2.5 Appointments to the audit committee should be made by the board on the recommendation of the nomination committee (where there is one), in consultation with the audit committee chairman.	
2.6 Appointments should be for a period of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.	

Four - Draft impact assessment

The FRC aims to make effective use of Regulatory Impact Assessments (RIAs) and for proposals to provide or update guidance on existing requirements we aim to produce an RIA based on an appropriate simplified approach.

In the case of the proposed changes to the Guidance to Audit Committees contained in this consultation the FRC considers that the majority of the changes, being those made in response to MPG recommendation 12, are clarifications or simplifications or existing guidance. Therefore this simplified regulatory impact assessment focuses on changes in response to other MPG recommendations, to assess whether any of these will have cost implications for some companies.

The following changes are expected to lead to an insignificant increase in costs for companies with audit committees, should they choose to follow the guidance:

- Considering audit firms' annual transparency reports (paragraph 4.19)
- Assessing periodically the risks associated with the possible withdrawal of the external auditor from the market and considering whether any mitigating action is appropriate ([new] paragraph 4.21).

The change that could involve extra costs for companies with audit committees is the guidance to explain to shareholders how the audit committee reached its recommendation to the board on the appointment, reappointment and removal of the external auditors in [new] paragraph 4.22. There are three main elements to this cost:

- The cost of preparing the information, particularly the time required to discuss at an audit committee meeting which might be of the order of one or two hours.
- The cost of publishing the information, particularly in respect of adding to the length of the annual report by a few paragraphs.
- The possible cost of putting the audit out to tender in order to assuage possible concerns of some shareholders, although the MPG considered that companies would only need to incur the cost of putting their audit out to tender when they judge that a change of auditor could be beneficial.

The impact of the possible change based on the 2007 Review of the Combined Code has been consulted on separately (see http://www.frc.org.uk/corporate/2007review.cfm).

Consultation question 2

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

Five - Consultation

Comments are invited on the consultation questions raised in this document:

1. Do you agree with the proposed changes based on MPG recommendations? If not, please explain and, if possible, suggest how the proposed changes could be improved. *(page 10)*
2. Do you have comments that will assist the FRC in finalising the impact assessment? *(page 12)*

The deadline for comments is Friday 6 June 2008.

Comments should be sent by e-mail to smithguidance@frc.org.uk or by post to:
Chris Hodge
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Unless otherwise stated, responses will be regarded as being on the public record. Please indicate whether your response should be treated as confidential (standard disclaimers in responses received by e-mail will be disregarded for this purpose).

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