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Dear Sir

Consultation on Proposed Changes to Guidance on Audit Committees (the Smith Guidance)

We welcome the opportunity to comment on the above consultation issued in March 2008. We understand the reasons for the consultation, as set out in the introductory section of the consultation paper and we are supportive of any initiative to enhance the efficiency of the market and mitigate risks associated with an audit firm leaving the market. The Market Participants Group (MPG) has made some sensible and proportionate recommendations to this end and we can appreciate the usefulness of some refinements to the Smith Guidance in order to provide further assistance and high level guidance to audit committees in discharging their responsibilities.

However, we have significant concerns in relation to the potential impact of the proposed changes on audit quality and the scope for judgement to be exercised by audit committees. In addition, there are substantial cost and board-level disruption implications if, as we believe, the proposals could lead to unnecessary audit tenders.

Audit quality and the role of the audit committee

We continue to support the FRC's stated aim to promote confidence in corporate reporting and governance. In achieving this, we consider that audit quality is paramount and note that it is a key objective of both audit firms and audit committees. The role of an audit committee is to seek to ensure that a robust, high quality audit is performed, for the benefit of the shareholders. The FRC, in its proposals, appears to have lost sight of this fundamental aspect of governance and is instead appearing to introduce a new responsibility for audit committees, that of promoting choice in the audit market.

Status of the existing Smith Guidance

The status of the Smith Guidance is correctly identified in the consultation paper as being guidance to assist boards in implementing the relevant provisions of the Combined Code, rather than a volume of mandatory requirements. In retaining this status, it is important that the FRC does not introduce wording that alters the character more towards that of prescriptive rules, rather than a useful and practical reference guide for directors who serve on audit committees. These prescriptive rules are highly likely to lead to a checklist approach to auditor selection, resulting in the gradual erosion of audit committee judgement, which clearly has the potential to damage audit quality.

In 2002 the FRC group charged with producing guidance for audit committees was asked by the Government to develop the existing Combined Code guidance on audit committees. The role of audit committees in recommending the appointment of the auditors and maintaining an appropriate relationship with the company's auditors, including keeping under review the independence and objectivity of the auditors, was a concept that had been embedded in the corporate governance framework since the very early days, appearing in the Cadbury Report of 1992. That report established that "shareholders look to the audit committee to ensure that the relationship between the auditors and management remains objective". Therefore, it is clear that audit committees have long been familiar with the need to monitor auditor independence and make appropriate enquiries of the auditor in relation to the scope of the audit and any additional services provided.

The reason we set out this background is to place our concerns about the proposed introduction of overly prescriptive wording in context. The Smith Guidance is intended to provide supplementary guidance to experienced directors, in relation to well-understood basic duties that have existed for some considerable time. These duties are clearly set out in the Combined Code and in bold type in the Smith Guidance itself.

Undermining the role of audit committees and audit quality

Amendments proposed by the FRC should neither undermine audit quality nor change the underlying nature of the guidance to audit committees. Unfortunately, we believe that the two final metrics in proposed new paragraph 4.22, which are additional to those proposed by the Market Participants Group, will do just that. Disclosure of when the audit was last put out to tender and the tenure of the existing auditor is, in practice, likely to result in fixed-tenure audits, as audit committees come under pressure to introduce unnecessary and costly audit tenders (and exclude the incumbent audit firm) in order to avoid negative reaction from the corporate governance arms of the investor organisations, rather than using their judgement to act in the best interests of the company and the shareholders whom they represent.

Academic research issued in 2002, from the Milan based SDA Bocconi School of Management in Italy, where mandatory audit firm rotation has been in place for some years, concluded that audit quality deteriorated in the first two years following the appointment of a new auditor and in the last year of a fixed-tenure audit. It also concluded that mandatory audit firm rotation had in fact increased concentration in the market for audit services. The UK Government and most other developed economies have, in the recent past, rejected audit firm rotation, opting instead for a robust system of audit partner rotation.

Our view is that an inevitable result of the proposed amendments will be the imposition of disproportionate cost and burdens on business as audits are put out to tender more frequently than is currently the case.

Our answers to the consultation questions are set out below. References to paragraph numbers relate to the paragraphs in the proposed revised Smith Guidance.

Consultation question 1: Do you agree with the proposed changes based on Market Participants Group (“MPG”) recommendations? If not, please explain and, if possible, suggest how the proposed changes could be improved.

PARAGRAPH 4.19

We note that an audit firm’s annual transparency report may be among the suite of information that an audit committee wishes to review, in order to satisfy its duties in accordance with the existing recommendation in paragraph 4.19 of the Smith Guidance. We consider, however, that the information of most use and relevance to audit committees is the report on the audit firm’s own internal quality control procedures, which the Guidance already refers to. Consequently, whilst we are content to support the proposed addition of the phrase “*and consideration of audit firms’ annual transparency reports, where available*”, we would add to this, “*and where considered appropriate.*” This will allow the audit committee to exercise judgement rather than follow a prescribed approach.

NEW PARAGRAPH 4.21

We believe that the audit committee of a public interest entity should, in accordance with the Turnbull Guidance, evaluate the material risks to which the business is exposed and plan accordingly. It is likely that the risks associated with the possible withdrawal of the external auditor of a public interest entity from the market place is currently a risk that is considered by its directors in determining the nature and extent of risks facing the company. If this is already the case, then this proposed new paragraph is superfluous. However, if the FRC believes it is necessary to encourage boards not to overlook the possibility of loss of their audit firm, then the wording should be closer to that of the actual MPG recommendation, which is to consider the *need* to include this particular risk in their annual planning and evaluation process.

NEW PARAGRAPH 4.22

As noted above, we have fundamental concerns surrounding the impact of the proposed amendment.

Inclusion of the final two bullet points goes beyond implementation of MPG recommendations 8 and 9. We note that the MPG final report of October 2007 included details of concerns expressed by investors about the potential impact of increasing recommended disclosure in the area of auditor selection. Such concerns included an increase in the likelihood of boilerplate reporting in annual reports and accounts and, more worryingly, increased costs for companies who may feel compelled to put the audit out to tender unnecessarily. It is for the audit committee to decide what should “normally” be included in any enhanced disclosure in this area, not the FRC.

In relation to the inclusion of the first bullet point of the proposed new paragraph 4.22 concerning contractual obligations, we have no objection to its inclusion, although we are not aware of any significant audit engagement being governed by such a contractual obligation.

In conclusion, therefore, we suggest that the FRC restricts the wording of new paragraph 4.22 to implementation of MPG recommendation 9 only.

PARAGRAPHS 4.25 AND 4.31

We disagree with the proposed insertion in paragraph 4.31 of the phrase “*the external auditor develops close personal relationships with the company’s personnel*”: the threat is already dealt with in paragraph 4.25. Similar to the intimidation threat, the assessment by the audit committee of whether or not the familiarity threat exists is highly subjective, and is something that is therefore primarily a matter for the audit firm itself to judge, at least in the first instance. We note that there is no definition of “close personal relationship” and further that auditor ethical standards permit personal relationships to continue under certain circumstances. We suggest, therefore, that the words “*which permit some relationships subject to appropriate safeguards and conditions*” be added to paragraph 4.25 after the words “*taking account of auditor ethical standards*”.

PARAGRAPH 5.2

We support the proposed change to paragraph 5.2, but wish to draw your attention to a further change that might be made. We note that the FRC has made clear that this is not a general review of the Smith Guidance. However, there is scope to eliminate some duplication. Paragraph 5.1 sets out the key objective of the separate section in the annual report: namely, to describe the work of the audit committee in discharging its responsibilities. The fourth bullet point in paragraph 5.2 which states “*a report on the way the audit committee has discharged its responsibilities*” appears to duplicate this unnecessarily. We therefore suggest deletion of the fourth bullet point in paragraph 5.2.

POSSIBLE CHANGES BASED ON 2007 REVIEW OF THE COMBINED CODE

We recognise that the proposed changes in paragraphs 2.3 and 2.4 will be dependent upon whether the FRC makes changes to the Combined Code following the 2007 Review, and in relation to paragraph 2.3, our understanding is that it would be necessary for the new wording to align with Combined Code provision C.3.1. Our response to the FRC’s consultation regarding the 2007 Review is set out in our letter dated 14 March 2008 and a copy is attached for ease of reference. In light of our response, we suggest that the following wording is added to the end of the second sentence in paragraph 2.3:

“and provided that no relationships or circumstances have arisen since his or her appointment as chairman that would appear to compromise his or her independence”

We have expressed reservations relating to the chairman being the only member of the audit committee having recent and relevant financial experience. Thus, we suggest that the phrase “*other than the chairman of the company*” is inserted in paragraph 2.4, between the phrases “*The board should satisfy itself that at least one member of the audit committee*” and “*has recent and relevant financial experience*”.

We note that there appears to be a typographical error in the changes marked in italics in paragraph 2.4; the deleted sentence “*In FTSE 350 companies all members of the committee should be independent non-executive directors*” does not appear in paragraph 2.4 of the existing Smith Guidance.

Consultation question 2: Do you have comments that will assist the FRC in finalising the impact assessment?

NEW PARAGRAPH 4.22

We believe that the introduction of this new paragraph has the potential to increase significantly the costs for companies, not only in terms of preparing the information required, discussions at audit committee meetings, publishing the information and the substantial additional costs entailed in connection with unnecessary tenders, but also the extensive dialogue with shareholders that the change is likely to entail.

PARAGRAPH 5.2

Many larger companies have started to include the information detailed in the last two bullet points of paragraph 5.2 voluntarily, because institutional investors have requested it. However, for smaller companies there may be an imbalance between the costs associated with compiling the information and the benefit to shareholders.

Conclusion

As set out in our opening paragraphs, we have significant concerns about a number of the proposed amendments. These arise principally because of the potential for serious damage to audit quality, caused by the weakening of audit committees through changing the nature of what should be practical guidance into prescribed requirements and introducing new requirements that will effectively engender a lack of focus on ensuring that a good audit has been carried out. Add to this, likely increased costs to business as a result of audit committees coming under pressure to put the audit out to tender. We believe that these proposals will result in unintended and unwelcome consequences for the market.

Please contact Peter Wyman if you wish to discuss any particular issues in relation to our response.

Yours faithfully

PricewaterhouseCoopers LLP