

Chris Hodge
Financial Reporting Council
Fifth Floor
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6th June 2008

Dear Mr. Hodge,

Consultation on proposed changes to guidance on Audit Committees (the Smith Guidance) - March 2008

The CFA Institute Centre for Financial Market Integrity (“CFA Institute Centre”) welcomes the opportunity to comment on the Financial Reporting Council’s (FRC) consultation on proposed changes to guidance on Audit Committees (the “Consultation”).

We are supportive of the FRC’s proposals to implement recommendations 8 and 9 of the Market Participants Group (MPG)¹ into the Smith Guidance². These recommendations address disclosing information about the auditor-selection decision (8) and disclosing any contractual obligations pursuant to the appointment of the auditor (9). We believe that both recommendations would lead to increased clarity and transparency in the section of the annual report relating to the work of the audit committee. Such transparency, we believe, is in the best interests of shareowners and investors, as it facilitates more informed decision-making, which ultimately leads to more efficient market outcomes.

We also feel that the noted benefits associated with this disclosure outweigh the costs suggested in section 4 (draft impact assessment) of the Consultation. We believe the additional costs of preparing and publishing this information are not significant relative to the transparency benefits. Additionally, the suggested possible cost of putting the audit out to tender may have related benefits in terms of opening up the market for appointment of the external auditor if implemented alongside certain other changes to enhance the propensity for non-Big Four firms to audit public interest entities³.

We broadly support the FRC’s proposals to implement recommendation 12 of the MPG into the Smith Guidance. This recommendation addresses the issue of consistency between the independence section of the Smith Guidance and the independence requirements stipulated in the relevant Ethical Standards for auditors. Consistency ensures that a common basis exists for both the audit committee and external auditor when assessing

¹ “Choice in the UK Audit Market”, Final Report of the Market Participants Group, October 2007

² The section on guidance for audit committees in the FRC’s Combined Code on Corporate Governance is commonly referred to as the “Smith Guidance”, after the proposals of Sir Robert Smith in January 2003.

³ Public interest entities are those that have significant public relevance due to the nature of their business, their size, or the number of employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings.

independence issues such as the provision of non-audit services. This consistency promotes clarity. However, we feel the proposals should focus on aligning independence requirements with shareowners' interests. Alignment of the independence requirements for audit committees and the external auditor does not itself generate significant benefit unless these requirements are in the first instance consistent with the best interests of shareowners, even though the implicit assumption is that this is the case.

Further, we believe that there is scope for the proposals surrounding MPG recommendation 12 to be extended to cover disclosure of all aspects of the auditor-client relationship. The present proposals refer to the set-up and application of a formal policy for audit committees to adhere to in addressing non-audit services. It also covers how independence and objectivity are safeguarded. We suggest that full disclosure of the auditor-client relationship in the audit committee section, including details on all fees and service contracts, would better serve shareowners' interests.

The FRC's proposal to implement MPG recommendation 15, whilst sound in principal, is of limited benefit, particularly in the absence of clear improvements to the supply side in the market for audit services. Whilst we do not object to the need to consider the risk of a company's auditor withdrawing from the market, such risk planning and evaluation cannot function effectively whilst auditor choice remains a barrier.

Yours faithfully,

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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.”

Our detailed response to question 1 follows the paragraph ordering per the consultation. Paragraph references relate to the Smith Guidance; (FRC’s) proposed revisions are in italics.

Para. 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.”

We are supportive of the proposal for audit committees to consider the transparency reports to be published by audit firms of public interest entities (Directive 2006/43/EC). Consideration of these reports should improve the decision-making process on the part of the audit committee with regards to auditor selection and appointment decisions. This should help ensure that decisions surrounding auditor quality and capability are transparent and therefore that shareowner interests are served.

[New] Para. 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.”

[MPG recommendation 15]

Evaluation and planning for the possibility of the firm’s external auditor leaving the market is a logical component of a firm’s overall risk management procedures. However

⁴ The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards (“GIPS®”), and the Asset Manager Code of Professional Conduct (“AMC”). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

⁵ CFA Institute is best known for developing and administering the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

the effectiveness of this evaluation and planning is limited to the extent that auditor choice is limited. In the absence of measures to increase the supply of audit services to major public interest entities, contingency planning for the event of withdrawal from the market of the incumbent auditor cannot function effectively. In the event that certain other measures to increase auditor choice are introduced (for example, those set out in the MPG's October 2007 report), the resulting supply-side improvements would likely render such risk evaluation and planning at least partially redundant - an efficiently functioning market should be flexible enough to swiftly adjust for the loss of the incumbent. Accordingly we do not consider there to be any significant marginal benefit to arise from mandating this recommendation as part of the Smith Guidance.

[New] Para. 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.”*

[MPG recommendations 8 and 9]

We support the FRC’s proposals to incorporate this new paragraph into the Smith Guidance. Transparent disclosure of how the audit committee reached its auditor recommendation ensures that the decisions of the board are openly accountable; this is clearly in the best interests of shareowners. Further, the disclosure of such information should facilitate increased engagement between shareowners and the board over auditor selection, which goes toward ensuring an efficient market outcome.

We welcome the explicit reference to the provision of details regarding contractual obligations, when the audit was last subject to tender, and the length of tenure of the incumbent auditor. Such disclosures ensure informational asymmetries between board and shareowners regarding auditor selection are minimised. These disclosures also reveal important information to shareowners about the degree of flexibility that audit committees have in making their recommendations to the board over auditor selection, particularly with regards to contractual obligations. Contractual obligations present an impediment to the decision-making process regarding auditor selection. It is appropriate, therefore, that shareowners are fully aware of such frictions in the market for audit services.

The remaining comments in response to question 1 are related to the proposals stemming from MPG recommendation 12.

Para. 4.24 - 4.26

We support the proposals set out in the Consultation to amend the wording in the Smith Guidance, regarding independence, to be consistent with the independence requirements applicable to the external auditor (as per the APB Ethical Standards). We agree, for example, that amendment of the wording to cover “independence *and objectivity*” is more inclusive, as objectivity precedes judgment. Consistency between the two sets of standards also alleviates any ambiguity surrounding interpretation.

The proposals could be improved, however, if the recommendations were extended beyond the alignment of the guidance for audit committees and auditors regarding independence, to encompass alignment with shareowners' interests. Our corporate governance manual states that:

“The audit committee’s primary objective is to ensure that the financial information reported by the Company to Shareowners is complete, accurate, reliable, relevant, verifiable and timely”.

Our manual goes on to state:

“To this end, the audit committee is responsible for.... ensuring that the external auditors’ priorities are aligned with the best interests of Shareowners”

Accordingly, we would prefer the wording to encapsulate this relationship. For example (para 4.24):

“The audit committee should assess the independence and objectivity of the external auditor annually... This assessment should involve a consideration of all relationships between the company and the audit firm. The audit committee should consider whether... those relationships appear to impair the auditor’s independence and objectivity, and hence whether the auditor’s priorities are aligned with the best interest of Shareowners.”

Para. 4.27, 4.28, 4.31, 5.2

We are broadly supportive of the proposals to improve the Guidance surrounding independence requirements in relation to non-audit services. However we feel that the present proposals could be extended to cover disclosure of all aspects of the auditor-client relationship. Full disclosure of this relationship would better enable investors to determine how the company manages potential conflicts of interest and how such potential conflicts are resolved. Our corporate governance manual proposes that investors should determine whether:

“The audit committee has the authority to approve or reject other proposed non-audit engagements with the external audit firm... Investors also should determine whether the audit committee has policies relating to any fees paid by the Company to the external auditor for non-audit consulting services and for resolving these types of potential conflicts of interest.”

The implication is that the provision of non-audit services may exert influence on auditors such that they are inclined to resolve conflicts regarding financial reporting issues in favour of management as opposed to shareowners. Full and frank disclosure to encompass all aspects of the auditor-client relationship may act as a deterrent to this outcome, and thus ensure that the actions of the auditor are aligned with the best interests of shareowners.

We note that the proposals (e.g. para. 5.2) do provide for disclosure of the audit committee's policy on non-audit work, and how independence and objectivity is safeguarded in these circumstances. However the proposals stop short of outlining exact details regarding the auditor-client relationship. The disclosure we propose would better enable investors and shareowners to assess whether independence and objectivity, and thus shareowners' interests, have been safeguarded.

The Centre's position on non-audit services is set out in our written testimony given before the U.S. Securities and Exchange Commission in 2000⁶. The testimony recommends that disclosures include the percentage of total non-audit fees to total fees paid to the auditor; and the percentage of non-audit fees to total fees for each non-audit service provided by the external auditor. We note that paragraph 4.28 is consistent with these recommendations. However, the disclosures could be expanded further, as outlined in the testimony:

“We recommend that the scope of the disclosure be expanded to include, in addition to fees paid during the reported period, the total value of outstanding service contracts or arrangements by type of service, the fees billed, paid and unpaid for these contracts, as well as any current proposals or bids for future services as of the reported period. In addition, if such arrangements are not prohibited, we suggest that any compensation that has been or may be earned by the audit firm from any contingent or success-fee arrangement, especially related to financial and/or advisory work, should be disclosed.”

We support the clarification to paragraphs 4.28 and 4.31 to align the Smith Guidance with Ethical Standard 1 (identification of threats to auditor independence and objectivity and assessment of safeguards thereon). This is consistent with our comments over paragraphs 4.24 to 4.26. We recommend that para. 5.2 be expanded to make explicit reference to the disclosures suggested above regarding non-audit services such that the text goes beyond reference to the *policy* on non-audit work, to refer to paragraphs that detail the disclosures set out herein.

Consultation Question 2

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

Broadly, we consider the “extra costs” noted in the Regulatory Impact Assessment (RIA) to not be significant relative to the perceived benefits to shareowners and investors of more clear and transparent disclosures. As noted in our covering letter, the suggested possible cost of putting the audit out to tender may in fact have related benefits in terms of opening up the market for appointment of the external auditor if implemented with certain other changes to enhance the propensity for non-Big Four firms to audit public interest entities.

One potential hidden cost not addressed in the RIA relates to the propensity for external audit firms to charge higher fees as a result of the proposals set out herein. This is based on the rationale that the (perhaps) more onerous disclosure requirements may force audit

⁶ See <http://www.cfainstitute.org/centre/topics/comment/2000/00kohn.html>

firms to demand higher fees, both to account for the additional work involved in reviewing these disclosures, and to account for the increased risk faced by the audit firm from having such information (e.g details of contractual obligations) available in the public domain.

We believe, however, that this potential cost can be mitigated by improvements in auditor liability arrangements (a topic addressed in recommendation 3 by the MPG), alongside other improvements in the supply for audit services⁷ as addressed in our response to [new] para. 4.21. Improvements in the supply of audit firms may limit the propensity to raise fees, which will lead to more efficient outcomes for companies and shareowners.

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⁷ Measures that would improve the supply of audit services are identified in the MPG report. These include: changes to audit firm ownership and control rules (to better enable non-Big 4 firms to raise sufficient capital to undertake the audits of public interest entities (PIEs)), disclosure of financial results of statutory audits on a comparable basis (so that non-Big 4 firms can make a clearer assessment of the returns from investment in undertaking the audit of PIEs), improvements in auditor liability arrangements, and greater participation of non-Big 4 firms on standard setting bodies and committees (to improve credibility and therefore increase the propensity for PIEs to select non-Big 4 auditors).