



THE BUCK STOPS HERE? NEW CHALLENGES FOR AUDIT COMMITTEES

AN ANALYSIS OF AUDIT COMMITTEE REPORTING
NEW CHALLENGES INITIATIVE



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INTRODUCTION

This is a particularly appropriate time to review audit committee reporting. Until now, there have been no explicit requirements for audit committees to include their own material within the overall report and accounts. However, new challenges are emerging for audit committees, which could be significant and burdensome. This joint research undertaken by ICAEW and BDO contributes to the debate in the UK and provides a context for change. It is particularly important at a time when the effectiveness of the UK's comply or explain model is being hotly debated in Europe and beyond.

Audit committees have a vital role to play in corporate governance and although the quality of audit committee reporting is not necessarily a reflection of their effectiveness, such reporting is critical in helping build investor confidence in their role.

The Financial Reporting Council's (FRC) September 2011 publication on Effective Company Stewardship has responded to concerns about the current value of financial statements by concluding that audit committees should provide the narrative information that shareholders and other stakeholders are seeking and currently not finding in the annual report.

In the future, audit committees may have to report on: key sensitivities that are relevant to the integrity of the annual report and how they are addressed; matters of significance that aren't addressed elsewhere in the annual report; how they assessed internal and external audit effectiveness; and how they've judged the independence and reappointment, or otherwise, of their external auditors.

Authorities in the European Union and the United States are more likely to require auditors, rather than audit committees, to report more fully on the areas listed above. The FRC proposal does not appeal where audit committees are less developed or where more regulation of their activities is likely to be resisted as politically unacceptable.

The results of the research in this paper demonstrate the significant gap between what may soon be expected of audit committees in respect of public reporting and where they are now. Bridging this gap will require significant time and effort and may potentially test audit committees' relationships with executive board members. The direction of travel is that governance will become increasingly important and audit committees will be expected to drive this forward.

James Roberts, Partner BDO LLP **Vanessa Jones**, Head of Corporate Governance ICAEW

1. EXECUTIVE SUMMARY

Audit committees have been held up by some as one of the biggest corporate governance success stories in the UK over the last twenty years or so. The financial crisis of 2008 and the resulting economic climate has put the governance role of audit committees firmly in the spotlight. The committee is seen as playing a key role in the restoration of trust in company financial reporting and has wide-ranging, time consuming and intensive work to do. It is likely that even greater focus is to be placed on them in the UK in the future although this trend is not necessarily reflected in the rest of the world.

Appendix 1 provides an overview of current UK regulation relevant to audit committee reporting.

In recent years the responsibilities of audit committees and the time commitment of non-executive directors who serve on them have increased greatly. While traditionally the key role of the audit committee has been to look after the relationship with the external auditors, the annual audit and financial reporting, many audit committees now have a much broader role in areas such as risk management. Some organisations have re-named the committee 'the audit and risk committee' to reflect this wider role.

CURRENT REMIT

The UK Corporate Governance Code (Code) stipulates that a separate section of the annual report should describe its work of the audit committee. This has put a spotlight on the audit committee and gives it an authority that it may have previously lacked.

Clearly the role of the audit committee will vary from company to company and it is for each board to decide its precise role and to delegate authority to it. Currently the Code and guidance see the role of the audit committee covering broadly:

- monitoring the integrity of **financial statements** and reviewing significant financial reporting judgements;
- reviewing **internal financial control** systems and, unless otherwise dealt with by the board itself or a separate risk committee, the **risk management** systems;
- reviewing **whistleblowing** arrangements;
- monitoring the effectiveness of the company's **internal audit function** or where one does not exist, considering whether it is needed;
- making recommendations to the board covering the **terms of engagement, appointment and remuneration of the external auditor**;
- monitoring the **external auditor's independence, objectivity and effectiveness**;
- developing and operating policy for the supply of **non-audit services** by the external audit firm.

However, there is a view in the UK that the audit committee remit could be widened further and it is in the context of that direction of travel that it is relevant to look closely at audit committee narrative reporting.

CHANGES AFOOT

The Financial Reporting Council (FRC) has proposed a more substantial communication role for audit committees so that they will in future provide fuller reports to shareholders, particularly in relation to the risks faced by the business. At the start of 2011 the FRC published a consultation paper *Effective Company Stewardship – Enhancing Corporate Reporting and Audit* which was followed up in September with *Effective Company Stewardship – Next Steps* in which the FRC set out some of the actions it proposes to take.

The key proposals are:

- Extension of the audit committee's remit to include consideration of the whole annual report and to ensure the report, viewed as a whole, is fair and balanced;
- Amendment of auditing standards to ensure that auditors always report the outcome of their review of the whole annual report;
- Requiring companies to put their audits out to tender at least once every ten years, or explain why they have not done so.

In addition to the FRC proposals, the Department for Business Innovation & Skills (BIS) launched a consultation in September 2011 on a new reporting framework which requests views on whether audit committee reports should be required to set out:

- How long the current auditor has been in post and when a tender was last conducted; and
- The length of time since the directors, including the members of the audit committee, have held discussions with principal shareholders about the company's relationship with its auditors, including the quality of service provided.

The current BIS consultation confirms that as part of the new reporting structure, it is intended that the audit committee report should form part of a new Annual Directors' Statement.

Recent consultations from the International Auditing and Assurance Standards Board (IAASB) and the US Public Company Accounting Oversight Board (PCAOB) were both concerned with how the auditor's reporting model could be changed to increase the transparency and relevance of both the audit process and the financial statements. In the EU, following the European Commission Green Paper on the role of external auditors, we are not too far away from possible additional legislation. These initiatives may have big implications for audit committees.

Our findings have shown diversity of reporting practice and have identified areas where the practical application of the Code and guidance does not achieve its full potential. Practice in the companies covered by this research suggests that some audit committees could put more effort into ensuring that their activities are explained in a clear and concise way.

We believe that this research and our findings will be helpful in contributing to the current debate in relation to the wider reporting responsibilities shouldered by audit committees.

HIGHLIGHTS

- The best audit committee reports are those where the audit committee chairman reports directly to shareholders. An audit committee report which is written this way appears clearer, more authoritative and convincing. A report which is separate and personal is very effective in communicating the work of the audit committee and underlines the committee's independence.
- The role and the authority delegated to the audit committee by the board, as described in its terms of reference, are frequently repeated within the report, but how the audit committee actually discharges those responsibilities is rarely covered. A description of how the audit committee deals with issues would provide greater insight into the effectiveness of the audit committee and greater comfort over the company's governance.

- Not many audit committee reports deal sufficiently well with how the committee undertakes the annual assessment of the external auditor effectiveness. Reporting of how the annual assessment is carried out and what information the audit committee reviews are extremely relevant but yet so few audit committee reports cover these matters in full. Many audit committee reports do not include confirmation that they have obtained a report on the external audit firm's own quality control procedures or consideration of the audit firm's annual transparency reports.
- Compliance with the Code is high but buy-in to the various pieces of guidance is less which is evident in the majority of audit committee reports in the sample reviewed. For example, very few companies included Market Participants Group (MPG) recommended disclosures in respect of audit tenure and contractual obligations in relation to the appointment of external auditors.
- There is incomplete identification of the nature and extent of threats to independence and objectivity when it comes to the external auditor. Very few audit committee reports manage to make effective disclosure in this area.
- When internal audit is outsourced there is frequently very little by way of narrative reporting on how quality is assured, nor is much more said when there is no outsourcing.
- Non-audit services and the non-audit services policy are often poorly described in the main and this is one of the key areas where boiler-plate is evident.
- Very few companies in the sample follow the FRC's Guidance on Audit Committees on review of audit communications in their disclosures on the relationship with the external auditor.
- There is no discernable similarity of audit committee reporting amongst companies audited by the same external auditor. This perhaps indicates that audit committee reporting is not influenced by the external auditor.

These findings highlight positive opportunities for audit committee reporting and indicate clear areas for improvement and greater focus.

The good narrative disclosure practices shown by the top reporters need to be sustained and best practice encouraged throughout the FTSE making sure that the need to produce a clear narrative audit committee report is not swamped by a rigid box-ticking mentality.

2. RESEARCH OBJECTIVES AND METHODOLOGY

RESEARCH OBJECTIVES

The main objectives of the research were to ascertain:

- What reporting listed companies have included in their annual reports in respect of the work of the audit committee.
- Whether conclusions could be drawn on the quality of reporting in this area.
- If there were practical observations that could be made to help audit committees achieve better reporting outcomes.

METHOD

The annual reports of 237 listed companies with year-ends spanning March 2010 to June 2011 were reviewed to determine the current state of play. The companies were split by size giving the following categories:

Category	No. of Accounts reviewed
FTSE 100	51
FTSE 250*	48
FTSE All-Share**	46
AIM 100	46
AIM All-Share***	46

* FTSE 250 describes the companies ranked from 101–350 in terms of market capitalisation.

** FTSE All-Share is the aggregation of the FTSE 100, FTSE 250 and FTSE Small Cap indices.

*** AIM All-Share is an index consisting of all companies quoted on the Alternative Investment Market which meet the requirements for liquidity and free float.

The FTSE 100 and FTSE 250 listings were taken as at 14 April 2011. All reports and data used for the research were in the public domain.

There are certain disclosures for which a numerical analysis is appropriate – either the disclosure was there or it wasn't. However, the power of disclosure is in the value it can add by virtue of the quality of the information provided and the emphasis of the research was on how detailed and informative the disclosures were. A scoring system was used to grade the quality of disclosures giving each a score out of five with five being the most comprehensive and insightful and zero being the least comprehensive and insightful.

Two researchers conducted the research by reviewing the audit committee disclosures against a comprehensive range of statements and questions. Consistency of scoring was checked by comparison of the researchers' scores for a sample of disclosures.

The Corporate Governance Guidelines for Smaller Quoted Companies published by the Quoted Companies Alliance in September 2010 is intended to represent a minimum standard for AIM companies as they are not subject for the full Code. The vast majority of AIM companies sampled followed these guidelines and only included the minimum disclosure. However, four companies did produce comprehensive narrative disclosure that gave much more insight in to the companies' governance.

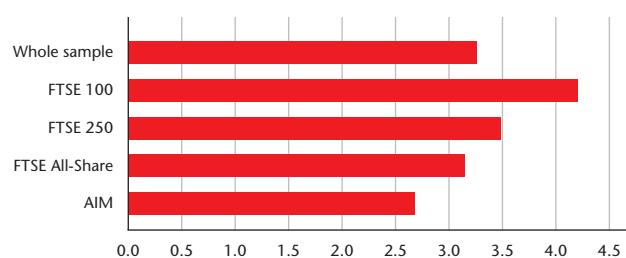
3. WHAT THE RESEARCH TELLS US

3.1 HOW AUDIT COMMITTEES OPERATE: COMPOSITION AND MEETINGS

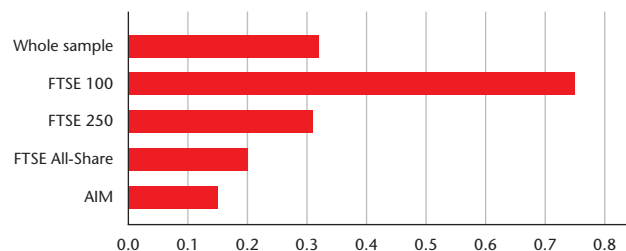
The Code provides that each board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.

We analysed the total numbers of non-executives serving on audit committees: this ranges from seven to two with averages in each sector as follows:

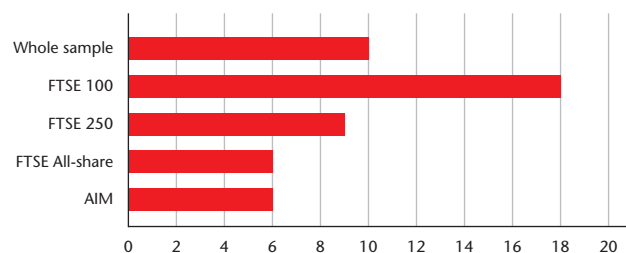
What is the average number of audit committee members?



What is the average number of female audit committee members?

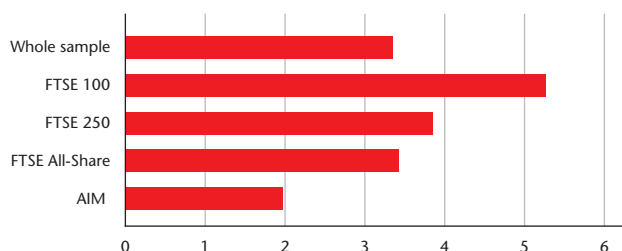


What is the average number of female members as a percentage of audit committee members?



The average number of meetings per year in each sector is as follows, with the highest number of meetings being 15 and the lowest number being one:

What is the average number of audit committee meetings?



Key observations from the survey sample:

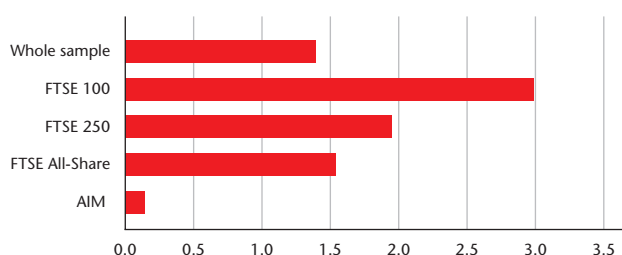
- The average number of meetings in the sample was greater than three which is the minimum mentioned in guidance. However, little or no disclosure is given by the majority on the duration of meetings and so it is difficult to draw conclusions on whether sufficient time had been allowed to enable a full discussion on key topics.
- The 'housekeeping' aspects of audit committee meetings were almost universally well described (attendance, meeting frequency, etc.) but there was little detail on specific matters discussed within the sample reports so it was hard to get a feel for the actual activities.
- The members of the audit committee and their attendance at committee meetings were well disclosed but what was less well handled were the explanations of why individual members had the necessary relevant qualifications and experience for serving on the audit committee. Convincing and informative explanations to support statements that the audit committee has recent and relevant financial experience were few and far between. Few companies explained well why individuals had the necessary commercial and financial experience to enable effective assessment of the matters that audit committees need to address. Many reports simply cross-refer to brief biographies in a different part of the annual report and very few audit committee reports give detailed explanations as to why audit committee members are suited to their role.
- In the case of new members to the audit committee it was seldom explained fully why that person had been appointed.
- Very few audit committee reports disclosed what activities took place outside formal meetings. Clearly much work is done outside meetings yet few companies report on how the audit committee keeps in touch with the key people involved in the company's governance throughout the year.
- Not many audit committee reports took the opportunity to detail how committees assess their own effectiveness and to conclude on whether they were effective or not.
- As is the case for boards overall, female representation on audit committees is low.

3.2 QUALITY OF AUDIT COMMITTEE REPORTING

The Disclosure and Transparency Rules (DTR) stipulate that each issuer must make a statement available to the public disclosing which body carries out the functions required by DTR 7.1.3R and how it is composed. The Code also provides that a separate section of the annual report should describe the work of the audit committee in discharging the role delegated to it by the board.

The average quality score (out of 5) was as follows:

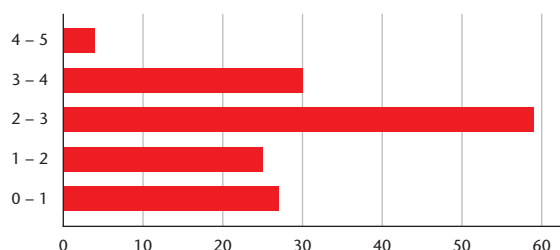
What is the average quality score? (number)



There was a marked difference between the FTSE 100 companies in the sample and the rest. Clearly resources are a consideration here and there was, as expected, much divergence in disclosures in the sample surveyed. Only four companies were above a 4 score. The quality score for the AIM companies sampled was 0.14: as they do not have to comply with much of the Code. This is not surprising although there were some good examples within this sector.

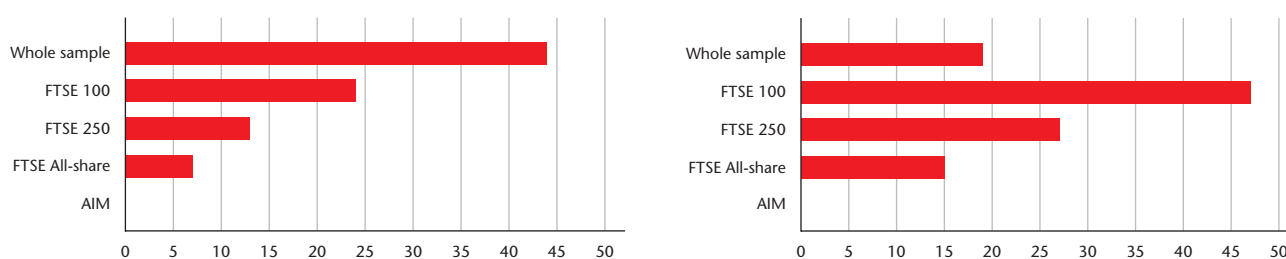
For the fully listed companies in our sample we analysed how many companies had scores of 5, 4 and above, 3 and above, 2 and above, 1 and above and between 0 and 1. The results are analysed below and show that the majority of companies had a score of between 2 and 3. This is further indication that companies could disclose much more in respect of the activities of their audit committees.

How did FTSE companies score on quality? (number)



Of the 237 sets of annual reports reviewed 44 had a separate audit committee report which was written from the audit committee chairman to the shareholders. The vast majority of audit committee reporting was included and embedded within the corporate governance report. We analysed how many companies provided a separate audit committee report:

How many companies provided a separate audit committee report? (number and percentage)

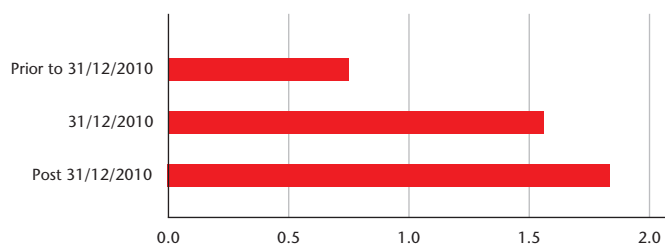


Key observations from the survey sample:

- The best audit committee reports are those where the audit committee chairman reports directly to shareholders. An audit committee report which is written from the chairman directly to the shareholder is generally clearer, more probative and more authoritative.
- Whilst the vast majority of audit committee reports surveyed did a good job in summarising the role of the audit committee many were let down by the description of how the audit committee had actually discharged those responsibilities. The role of the audit committee can be clearly established from the terms of reference, which should be publicly available in any event: it should be the function of the annual audit committee disclosure to deal with how the responsibilities are discharged. However, for our sample we did identify some companies where terms of reference were not available on the corporate website.
- Not all audit committee reports made a specific statement that they considered that they had discharged fully their responsibilities under their terms of reference.
- Very few audit committee reports provide much information about the audit planning process with regards to both the internal and external audits. As planning and oversight are a large part of the audit committee remit it is surprising that little attention is given to this in the majority of reports.

This is however an improving picture. The research showed that the quality score improved over the sample period from an average score of:

Has the average quality score improved over time?

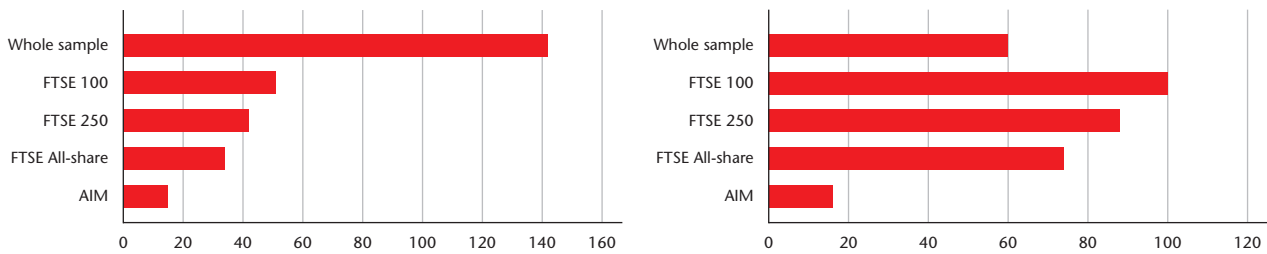


3.3 INTERNAL AUDIT

Code provision C.3.5 stipulates that the audit committee should monitor and review the effectiveness of the internal audit activities. 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. The reasons for the absence of an internal audit function should be explained in the relevant section of the annual report.

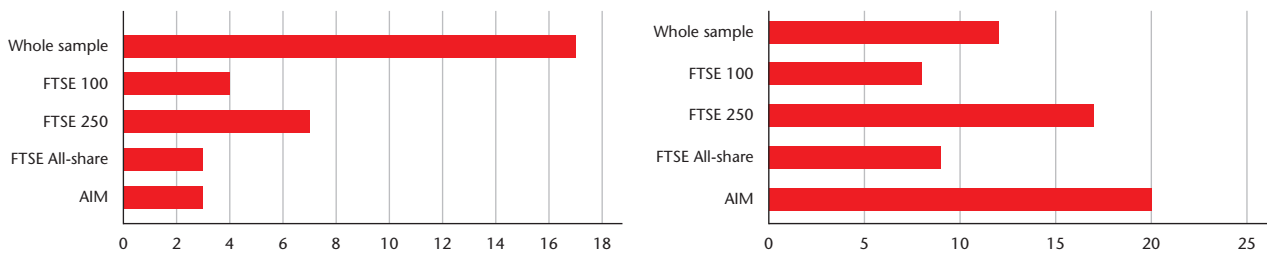
We analysed how many companies had an internal audit function and asked of those in the same that had an internal audit function 'how many were outsourced?'

How many companies had an internal audit function? (number and percentage)



Of those in the sample that had an internal audit function the following had an outsourced function:

Of those who had an internal audit function how many were outsourced? (number and percentage)



The need for an internal audit function will vary depending on company-specific factors as well as cost/benefit considerations and there was wide variation in disclosures in the sample.

Key observations from the survey sample:

- When the internal audit function had been outsourced there was less disclosure than when it was handled internally. When the internal audit function was handled in-house generally the disclosures were fuller, deeper and more meaningful. This may reflect the fact that the internal auditor plays a part in the audit committee report preparation.
- In the few instances when there was no specific and distinct internal audit function the disclosures were generally very good and convincing explanations were provided. Typically these disclosures covered such matters as other relevant teams within the company that provide assurance and advice.
- Not very many audit committee reports from our sample included information on how they reviewed and approved the internal audit remit or how they ensured that the internal audit team had the necessary resources and access to information to fulfil their role. This was particularly the case when the function was outsourced.
- Few sampled reports contained much detail about how the audit committee actually monitor and review management's responsiveness to the internal auditor's findings and recommendations.
- Direct access for the internal auditor (or the outsourced equivalent) to the audit committee and in particular the audit committee chairman is not always clearly articulated and lines of accountability are not always clearly stated or covered in the terms of reference.

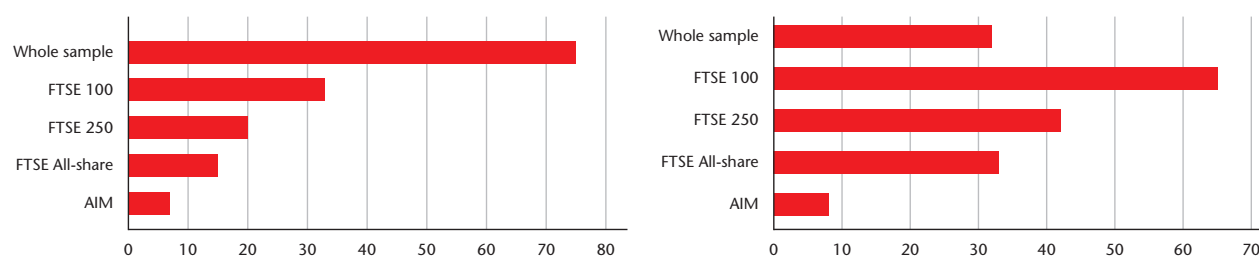
3.4 EXTERNAL AUDIT AND NON-AUDIT SERVICES

Code provision C.3.6 states that the audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditor. In addition Code provision C.3.7 states that the annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence are safeguarded.

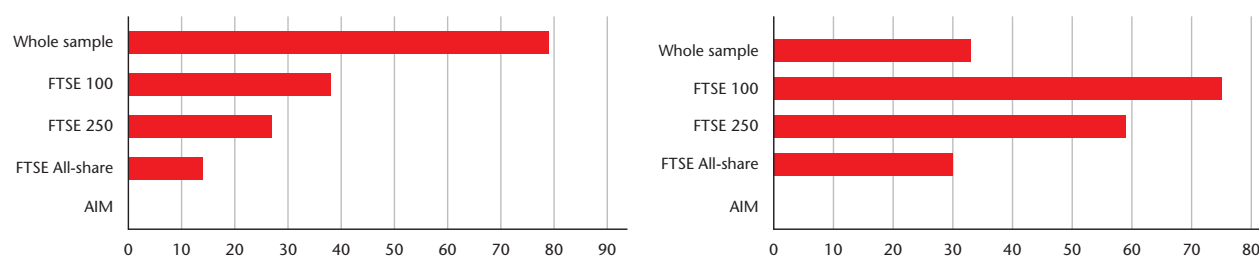
The audit committee is the body responsible for overseeing the company's relationship with the external auditor.

We analysed how many companies either stated the extent of non-audit services provided by the auditor in the audit committee report or cross-referred to the relevant disclosure in the accounts. We also analysed how many companies referred to a review of the effectiveness of the external auditor in the audit committee report.

How many companies cross referred to non-audit services in the audit committee report?
(number and percentage)



How many companies referred to a review of the effectiveness of the external auditors? (number and percentage)



Key observations from the survey sample:

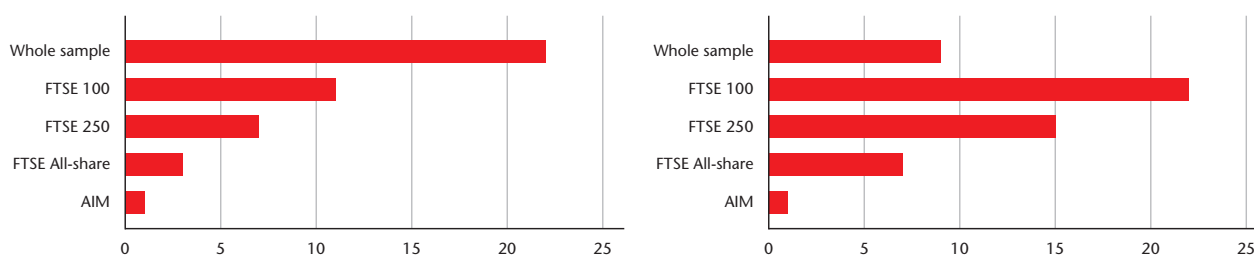
- Very few companies in the sample followed the FRC's Guidance on Audit Committees in respect of their disclosures on the relationship with the external auditor.
- Not many audit committee reports dealt well with how they undertake the annual assessment of external auditor effectiveness. Greater information on how the assessment is carried out and what information the audit committee reviews is extremely relevant but few audit committee reports cover all aspects. Many do not include confirmation that they have obtained a report on the external audit firm's own quality control procedures or consideration of the audit firm's annual transparency report.
- The explanations to shareholders about how the audit committee had reached its recommendation to the board on the appointment, reappointment or removal of the external auditors were very variable. Very few companies provided any 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 auditor. It is a pity that many audit committee reports do not give greater attention to explaining their position on these issues.
- Boiler-plating is evident in explanations to shareholders about how the independence and objectivity of the auditor is achieved.
- Very few audit committees make reference to any consideration of the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.
- Not many audit committee reports surveyed adequately deal with the external auditors' terms of engagement and remuneration and the engagement letter approval process is very little discussed. As this activity is a key part of the audit committee remit it is perhaps surprising that such little disclosure attention is given to it, especially as the audit committee must satisfy itself that the level of fees payable in respect of the audit service is appropriate for an effective audit to be carried out.
- Very few audit committee reports include any information on reviewing audit representation letters or management letters and on management's responsiveness to the external auditor's findings and recommendations.
- Formal non-audit services policies are well disclosed and in the vast majority of cases what constitutes non-audit services is well explained. Some companies include their non-audit services policy with their terms of reference. What is less well handled is how audit committees monitor the external auditor's compliance with APB Ethical Standards for Auditors relating to the rotation of audit partners.
- Disclosure of the level of non-audit services fees that a company pays in proportion to the overall audit fee is sometimes hard to establish simply from reading the audit committee report alone. This is an area where lack of consistency of location of disclosure is evident. Many audit committee reports do not cross refer to the notes to the accounts where such information is set out. The very best examples in our sample clearly set out the disclosure within the audit committee report.

3.5 RISK AND INTERNAL CONTROL

Code provision C.2.1 states that the board should, at least annually, conduct a review of the effectiveness of the company’s risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.

We analysed how many companies had a separate risk committee. As expected there is a varied practice here.

How many companies had a separate risk committee? (number and percentage)



Key observations from the survey sample:

- The majority of audit committee reports surveyed did make a statement that the audit committee had reviewed the company’s internal financial controls. However, the majority did not include any details about how this had been done and what activities had been completed in order to help establish, assess, manage and monitor financial risks.
- Very few audit committee reports explained what steps the audit committee had taken to satisfy itself that the control framework was operating currently and had operated effectively throughout the year.
- Where there was no separate board risk committee most audit committee reports did cover risk management systems but were light on detail.
- Where there was a separate risk committee most reports surveyed did an effective job of explaining the activities of the separate risk committee but in a few limited instances the lines of reporting and division of responsibility were not clear.

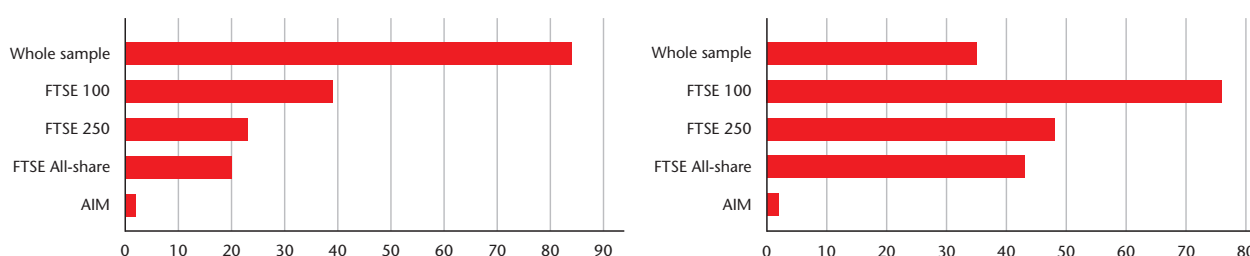
3.6 WHISTLEBLOWING

Code provision C.3.4 provides that each 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 objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for the appropriate follow-up action.

It is perhaps surprising, given the audit committee's wider remit to monitor the effectiveness of internal control and risk management systems, that very few audit committee reports include any detail of whistleblowing procedures and a large number do not refer to it at all.

Although there is no accompanying guidance on how the relevant Code provision is to be interpreted, some companies deal with this area in a very open and clear way and some even include their whistleblowing policies on their corporate sites to further evidence their activities.

How many companies referred to or noted their whistleblowing policy? (number and percentage)



Key observations from the survey sample:

- Companies that disclose their whistleblowing policies do so comprehensively and provide sufficient information to allow a reader to gain a real feel for how they operate their policy within the organisation.
- Very many companies in the sample simply said that they had a whistleblowing policy but gave no supporting information. This may be because they do not feel stakeholders would value this information, but it is a good way of giving the stakeholder comfort over the integrity of the company and an insight into its culture.

4. SIMPLE STEPS TO IMPROVE THE QUALITY OF AUDIT COMMITTEE REPORTING

Through our research we wanted to find out how listed companies are reporting on the work of the audit committee in their annual reports and to conclude on the quality of disclosures in this area.

Having undertaken the research we propose some practical steps to help audit committees achieve better reporting. Some of these are quite simple to achieve. Key areas where audit committee reporting could be enhanced are as follows:

- An audit committee report which is written by the audit committee chairman and provides readers with a 'direct voice' from the audit committee is more compelling and readable and allows the audit committee to speak clearly and independently.
- As the audit committee considers significant accounting policies, significant estimates and judgements and any changes to them it would be beneficial to see greater explanation of how the audit committee assures itself that the disclosures made in financial statements are set properly in context.
- Audit committees work hard throughout the year and have wide-ranging and time-consuming responsibilities. Yet the majority of audit committee reports do not take the opportunity to 'tell the story' of the work that they do throughout the year and in between meetings.
- Many could include more detail on effectiveness reviews of the audit committee, the external auditor and the internal audit function where one exists.
- It is important to conclude formally on whether the functions are effective or not. Many audit committee reports provide little or no information about the discussions that they have with the external auditor. Audit committee reports might be improved considerably if there were more focus on what discussions had taken place with the auditor and how conclusions were reached.
- The audit committee has a particular role, acting independently from executive directors, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control. Therefore, greater focus on what shareholders are interested in would enhance the audit committee report.
- More emphasis on relationships with the external and internal audit function as well as the board and management would be helpful to add 'colour' to the audit committee report. Understanding a company's governance framework and how the audit committee sits within this is useful to readers of annual reports. Why audit committees do what they do and how they do it, are of interest to readers of accounts.
- The skills, experience and on-going training of audit committee members is of fundamental interest to investors, yet many reports make minimal disclosure in this respect. Greater emphasis on the description of audit committee members would be helpful especially given the scale and pace of developments in financial reporting standards and practice. How audit committee members keep up to date is generally not well explained and this is an area where greater disclosure would be useful.
- Where internal audit and control functions are out-sourced to a third party supplier, more description could be given of the activities carried out. Details of the effectiveness of the systems and the conclusions of any testing carried out by internal and external auditors would also be useful disclosures.

5. WHAT THE FUTURE HOLDS

We have suggested ways in which audit committees could improve their governance reporting to shareholders. Of course not all of our suggestions will be applicable to every audit committee and what works best for one company may not be appropriate for another.

However, here are some of the most important things for an audit committee to be alert to for the next reporting cycle:

- Effectiveness reviews are a vital feed-back mechanism and so should be a top priority for not only the audit committee itself but also for the internal and external auditor. Audit committees should set the process to be adopted for not only its own review but also for that of the internal and external auditor.
- Non-audit services provided by external auditors are of interest to shareholders and wider stakeholders and so greater disclosure of controls over non-audit services and a commentary on the level and nature of non-audit services provided should be an on-going focus.
- Greater disclosure of how the external auditor has been engaged and retained should be a priority and the company policy on this should be apparent.

However, if current FRC thinking is implemented and the remit of audit committees is extended to include consideration of the whole annual report and to ensure that the report, viewed as a whole, is fair and balanced, boards and audit committees will need to review terms of reference and governance frameworks to ensure that the audit committee can discharge its extended remit. This may mean additional resources and it may mean re-framing existing approaches to corporate governance and assurance.

APPENDIX 1: REGULATORY OVERVIEW

Regulation relevant to audit committee reporting is made up of four main differing strands:

- Mandatory requirements in Listing and Disclosure and Transparency Rules (DTR).
- The UK Corporate Governance Code.
- Standards relating to non-audit services: APB Ethical Standard 5 (revised) and ICAEW TECH 06/06 *Disclosure of Auditor Remuneration*.
- FRC Guidance on Audit Committees and the final report of the Market Participants Group.

DISCLOSURE AND TRANSPARENCY RULES DTR 7.1 AUDIT COMMITTEES

Implementation of the audit committee requirements of the Statutory Audit Directive (2006/43/EC) has been effected by introduction of DTR 7, effective for financial reporting periods beginning on or after 29 June 2008. These rules implement the requirements of the Audit Directive on audit committees and, subject to certain exceptions, generally apply to issuers whose transferable securities are admitted to trading and which are required to appoint a statutory auditor. The provisions of DTR 7.1 effectively replicate the provisions on audit committees in the UK Corporate Governance Code. They require issuers to have a body which is responsible for performing the functions that an audit committee would typically carry out. Key points:

- At least one member of that body must be independent and at least one member must have competence in accounting and/or auditing (DTR 7.1.1R). The same member may satisfy both of these requirements (DTR 7.1.2R).
- The relevant body must as a minimum:
 - monitor the financial reporting process;
 - monitor the effectiveness of the issuer's internal control, internal audit and risk management systems;
 - monitor the statutory audit of the annual and consolidated accounts; and
 - review and monitor the independence of the statutory auditor and, in particular, the provision of additional services to the issuer. (DTR 7.1.4R)

In the FSA's view, compliance with provisions A.1.2, C.3.1, C.3.2 and C.3.3 of the UK Corporate Governance Code will result in compliance with DTR 7.1.1R to DTR 7.1.5R.

FSA Rule DTR 7.2.5R requires companies to describe the main features of the internal control and risk management systems in relation to the financial reporting process.

THE UK CORPORATE GOVERNANCE CODE

The UK Corporate Governance Code applies to accounting periods beginning on or after 29 June 2010. The Code is not a rigid set of rules. It consists of principles (main and supporting) and provisions. The Listing Rules require companies to apply the Main Principles and report to shareholders on how they have done so. (Listing Rule 9.8.6R)

The Code contains three Main Principles of good governance in relation to accountability and audit:

- C.1 Financial and Business Reporting
- C.2 Risk Management and Internal Control
- C.3 Audit Committee and Auditors

C.1 FINANCIAL AND BUSINESS REPORTING

The board should present a balanced and understandable assessment of the company's position and prospects. (Main Principle C.1)

The three Code provisions for Main Principle C.1 provide:

- The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and there should be a statement by the auditor about their reporting responsibilities. (Code Provision C.1.1)

- The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company. (Code Provision C.1.2)
- The directors should report in annual and half-yearly financial statements that the business is a going concern, with supporting assumptions or qualifications as necessary. (Code Provision C.1.3)

C.2 RISK MANAGEMENT AND INTERNAL CONTROL

The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

There is only one Code provision for Main Principle C.2:

- The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.

C.3 AUDIT COMMITTEE AND AUDITORS

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.

The seven Code provisions for Main Principle C.3 provide:

- A separate section of the annual report should describe the work of the committee in discharging those responsibilities. (Code Provision C.3.3)
- The board should establish an audit committee of at least three, or in the case of smaller companies, two, independent non-executive directors. A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. (Code Provision C.3.1). (This provision overlaps with FSA Rule DTR 7.1.1.R)
- The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:
 - to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
 - to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
 - to monitor and review the effectiveness of the company's internal audit function;
 - to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
 - to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
 - to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers

that action or improvement is needed and making recommendations as to the steps to be taken. (Code Provision C.3.2)

- The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available (this requirement would be met by having the document available on the company website).
- 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. (Code Provision C.3.4)
- The audit committee should monitor and review the effectiveness of the internal audit activities. 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. (Code Provision C.3.5)
- The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditor. 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 re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position. (Code Provision C.3.6)
- The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded. (Code Provision C.3.7)

STANDARDS RELATING TO NON-AUDIT SERVICES: APB ETHICAL STANDARD 5 (REVISED) AND ICAEW TECH 06/06 DISCLOSURE OF AUDITOR REMUNERATION

APB Ethical Standard 5 provides requirements and guidance on specific circumstances arising from the provision of non-audit services by audit firms to entities audited by them which may create threats to the auditor's objectivity or perceived loss of independence. It gives examples of safeguards that can, in some circumstances, eliminate the threat or reduce it to an acceptable level.

ICAEW TECH 06/06 *Disclosure of Auditor Remuneration* provides guidance on the application of the legal requirement for companies to disclose in their individual and group accounts the remuneration received by the company's auditor and the auditor's associates for the audit of accounts and other non-audit services. It aims to ensure that directors and auditors understand the nature and purpose of the requirement and, in particular, the basis for deciding into which categories and sub-categories a service by the auditor falls.

FRC GUIDANCE ON AUDIT COMMITTEES AND THE FINAL REPORT OF THE MARKET PARTICIPANTS GROUP

This guidance is designed 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. Boards are not required to follow this guidance, but it is intended to assist them when implementing the relevant provisions of the UK Corporate Governance Code. The guidance contains recommendations about the conduct of the audit committee's relationship with the board, with the executive management and with the internal and external auditors.

APPENDIX 2: REFERENCE MATERIALS

Guidance on Audit Committees suggests a means of applying the Audit Committee and Auditors sections of the Code. Copies are available at:

www.frc.org.uk/corporate/auditcommittees.cfm

Guidance on Board Effectiveness includes at sections 6.1 to 6.2 guidance on how board committees should report to the board and on the use of board committees generally. Copies are available at:

www.frc.org.uk/images/uploaded/documents/Guidance%20on%20board%20effectiveness%20FINAL6.pdf

Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009 suggests a means of applying Code Provision C.1.3 of the UK Corporate Governance Code. Copies are available at:

www.frc.org.uk/corporate/goingconcern.cfm

Audit Inspection Unit Annual Report 2010/11 includes a key recommendation that audit committee reporting should include a clear and unequivocal statement of the auditor's views on key areas of audit judgement. This report also recommends that greater attention should be given to the audit of the disclosures in financial statements, especially those in respect of key areas of judgement, to ensure that sufficient appropriate disclosures to meet the needs of users have been made. The report states that the AIU will consider how it can further improve its reporting for the benefit of audit committees.

www.frc.org.uk/images/uploaded/documents/AIU%20Annual%20Report%202010-11.pdf

Internal Control: Guidance to Directors (the Turnbull guidance) suggests means of applying the Risk Management and Internal Control sections of the Code. Copies are available at:

www.frc.org.uk/corporate/internalcontrol.cfm

The FRC announced in December 2010 ('FRC to explore best practice by UK company boards in determining and managing their level of risk') that it was deferring its planned review of the Turnbull guidance because it wanted first to explore how companies were responding to the new principle in the UK Corporate Governance Code that boards were responsible for determining the nature and extent of the significant risks they were willing to take in achieving their strategic objectives.

Boards and Risk an FRC publication which includes a summary of discussions with companies, investors and advisers which captures the contributions from these constituencies so that their views can be shared more widely to reflect and contribute to best practice.

www.frc.org.uk/images/uploaded/documents/Boards%20and%20Risk%20final.pdf

Auditor Scepticism: Raising the Bar, copies of the discussion paper, responses to the discussion paper and the feedback paper are available here:

www.frc.org.uk/apb/publications/pub2343.html

Effective Company Stewardship: Enhancing Corporate Reporting and Audit an FRC consultation which contains seven key recommendations. The report proposes that the whole of the annual report and accounts should be balanced and fair, including the Chairman and Chief Executive reports, rather than just specific parts of it as at present.

www.frc.org.uk/images/uploaded/documents/Effective%20Company%20Stewardship%20Final2.pdf

Effective Company Stewardship: Next Steps an FRC publication which outlines the responses the FRC has received to the recommendations in *Effective Company Stewardship* and it summarises the actions that the FRC intends to take.

www.frc.org.uk/images/uploaded/documents/ECS%20Feedback%20Paper%20Final1.pdf

Choice in the UK Audit Market: Final Report of the Market Participants Group an FRC publication 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 in the UK. The 15 recommendations set out actions that could be taken by market participants working collectively and enabling actions by regulators to allow the market to work more efficiently.
www.frc.org.uk/about/auditchoice.cfm

Choice in the UK Audit Market: Fifth progress report an FRC publication on the implementation of the recommendations of the Market Participants Group (MPG) and on the other UK and international developments relevant to choice in the UK audit market. Published in June 2010.
www.frc.org.uk/publications/pub2289.html

Audit Committee Guidance for European Companies an ecoDa publication to help audit committees to identify and achieve their objectives and add value to the board of directors, the organisation and its stakeholders.
www.ecoda.org/docs/Publications/ecoDa%20guidance%20FINAL.pdf

APB Ethical Standard 5 (Revised) Non-Audit Services Provided to Audited Clients contains basic principles and essential procedures together with related guidance in the form of explanatory and other material.
www.frc.org.uk/apb/publications/ethical.cfm

ICAEW Technical Release TECH 06/06 Disclosure of Auditor Remuneration provides guidance on the disclosure of auditor remuneration for the audit of accounts and other (non-audit) services. Copies are available at:
www.icaew.com/en/about-icaew/what-we-do/technical-releases

Appraising Your Auditors: A Guide to the Assessment and Appointment of Auditors an ICAS practical guide which was originally published in 2003 and revised in 2007 to include latest developments in corporate governance and ethics. This guidance covers three specific areas: trigger points for the audit committee's on-going review of the auditor; points to consider in a full annual assessment of the auditors and procedural matters to address during an audit tender process.
www.icas.org.uk/site/cms/contentviewarticle.asp?article=5240

The Future of Narrative Reporting a BIS consultation on a new reporting framework published in September 2011 which asks whether audit committee reports should be required to set out details on the current auditor and when the audit was last put out to tender and the length of time since the directors have had discussions with shareholders about the relationship with the auditor:
www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation

Enhancing the value of auditor reporting: exploring options for change an IAASB consultation. The consultation paper seeks to determine whether there are common views among users of audited financial statements and other stakeholders about the usefulness of auditor reporting. It describes issues with current financial reporting, including a perceived "information gap," identified by some stakeholders. It then sets out possible options for change and seeks input as to whether such options might be effective in enhancing auditor reporting and the communicative value of the auditor's report.
www.ifac.org/IAASB/ExposureDrafts.php



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