Audit Committee Institute

Guidance for audit committees (the Smith report)

As part of the UK response to the issues raised by recent major corporate failures in the US, the Financial Reporting Council (FRC) was asked to set up a small group to develop the existing guidance for audit committees contained in the Combined Code. That group, chaired by Sir Robert Smith, has produced guidance to assist boards in making suitable arrangements for their audit committees, and to assist directors serving on audit committees in carrying out their role.

The proposed guidance applies to all companies to which the Combined Code applies and compliance with the bold paragraphs set out in the guidance will be necessary for compliance with the Code.

It is recognised that some of the recommendations may be inappropriate for some listed companies. In particular, many smaller companies may have fewer than three independent non-executive directors. All listed companies are encouraged to meet the recommendations but if they cannot, or if they believe that a recommendation is inappropriate in the circumstances of the company, the right course is to explain the position.

Conversely, best practice goes beyond meeting the recommendations. Every board needs to consider in detail what arrangements for its audit committee are best suited for its particular circumstances. Audit committee arrangements need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company.

Recognising that the report already reflects a wide consultation process, it is intended that fatal flaws comments will be invited until April (though the substance of the recommendations will not be re-opened). Thereafter, a definitive version of a revised Combined Code will be issued and will come into effect in respect of accounting periods starting on or after 1 July 2003.

Key elements of the guidance are set out on the forthcoming pages. Copies of the guidance can be obtained from: www.frc.org.uk/publications.html

Key elements

Purpose

The main role and responsibilities of audit committees should be:

- to monitor the integrity of the financial statements of the company;
- to review the company's internal financial control system and, unless addressed by a separate risk committee or by the board itself, risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor following appointment by the shareholders in General Meeting;
- to monitor the effectiveness of the external auditor's performance and their independence and objectivity; and
- to develop and implement policy on the engagement of the external auditor to supply non-audit services.

Relationship with the board

- Nothing in the guidance should be interpreted as a departure from the principle of the unitary board.
- All directors remain equally responsible for the company's affairs as a matter of law.
- The audit committee, like other committees to which particular responsibilities are delegated (such as the remuneration committee), remains a committee of the board. Any disagreement within the board, including disagreement between the audit committee's members and the rest of the board, should be resolved at board level.
- The board should provide written terms of reference for the audit committee. The terms of reference should be tailored to the particular circumstances of the company.
- The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board.
- The board should review the audit committee's effectiveness annually.
- Where disagreements between the audit committee and the board cannot be resolved, the audit committee should have the right to report the issue to the shareholders as part of the report on its activities in the company's annual report.

Membership

- Audit committees should be comprised solely of independent non-executive directors.
- "Independent" is defined by Higgs as a director who is independent in character and judgement and has no relationships or circumstances which affect his judgement. Such relationships and circumstances would include where the director was an employee within the last five years, where the director holds cross directorships or has significant links with other directors through involvement in other company boards or bodies, and where the director has served on the board for more than ten years.
- The chairman of the company should not be an audit committee member.
- At least one member of the audit committee should have significant, recent and relevant financial experience eg, as an auditor or finance director of a different company.
- The need for a degree of financial literacy among the other members will vary according to the nature of the company, but experience of corporate financial matters will normally be required.

Meetings

- Only audit committee members should be entitled to be present at audit committee meetings. Others may be invited to attend.
- The audit committee should, at least annually, meet the external and internal auditors, without management, to discuss issues arising from the audit.
- A sufficient interval should be allowed between audit committee meetings and main board meetings to allow any work arising from the audit committee meeting to be carried out and reported to the board as appropriate.

Resources

- The audit committee should be provided with sufficient resources to undertake its duties.

Training

- An induction programme should be provided for new audit committee members. This should cover: the role of the audit committee, including its terms of reference and expected time commitment by members; and an overview of the company's business, identifying the main business and financial dynamics and risks. Meeting some of the company staff is also recommended.
- Training should also be provided to members of the audit committee on an ongoing and timely basis and should, at least, include an understanding of the principles of, and developments in, financial reporting and related company law.
- In appropriate cases, it may also include, for example, understanding financial statements, applicable accounting standards and recommended practice; the regulatory framework for the company's business; and the role of internal and external auditing and risk management.
- The induction programme and ongoing training may take various forms, including attendance at formal courses and conferences, internal company talks and seminars, and briefings by external advisers.

Financial reporting

- The audit committee should review the significant financial reporting issues, judgements, and clarity and completeness of disclosures made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements such as the OFR.

Internal financial control and risk management systems

- The audit committee should monitor the integrity of the company's internal financial controls.
- The audit committee, in the absence of other arrangements (eg a risk committee), should assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non financial risks.
- Management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the board that it has done so. Except where the board or a risk committee is expressly responsible for reviewing the effectiveness of the internal control and risk management systems, the audit committee should receive reports from management on the effectiveness of the systems they have established and the results of any testing carried out by internal and external auditors.
- Except to the extent that this is expressly dealt with by the board or risk committee, the audit committee should review and approve the statements included in the annual report in relation to internal financial control and the management of risk.

Internal audit

- The audit committee should monitor and review 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.
- The audit committee should review and approve the internal audit function's remit, having regard to the need for the internal and external audit functions to complement one another.
- The audit committee should approve the appointment or termination of appointment of the head of internal audit.
- As part of its review work, the audit committee should:
  - ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee;
  - review and assess the annual internal audit work plan;
  - receive a report on the results of the internal auditors' work on a periodic basis;
  - review and monitor management's responsiveness to the internal auditors' findings and recommendations;
  - meet with the head of internal audit at least once a year without the presence of management; and
  - monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

External audit – appointment

- The audit committee is responsible for overseeing the company's relations with the external auditor.
- The audit committee should have primary responsibility for making a recommendation to the board 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 directors' report a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different stance.
- The audit committee should assess the qualification, expertise and resources, effectiveness and independence of the external auditors annually.

External audit - terms and remuneration

- The audit committee should approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided. It should satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee.

External audit - independence

- The audit committee should assess the procedures in place to ensure the independence and objectivity of the external auditor annually.
- The audit committee should develop and recommend to the board a policy in relation to the provision of non-audit services by the auditor.
- The annual report should explain to shareholders how the policy provides adequate protection of auditor independence.

External audit - annual audit cycle

- At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit.
- The audit committee should review, with the external auditors, the findings of their work.
- At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process.

Communication with shareholders

- The directors' report should contain a separate section that describes the role and responsibilities of the audit committee and the actions taken by the audit committee to discharge those responsibilities. This should include:
  - a summary of the audit committee's role;
  - the names and qualifications of all members of the audit committee during the period;
  - the number of audit committee meetings and who attended them;
  - a report on how the committee has discharged its duties.
- Where disagreements between the audit committee and the board cannot be resolved, the audit committee should have the right to report the issue to the shareholders as part of the report on its activities in the company's annual report.
- If the board does not accept the audit committee's recommendation regarding the appointment, reappointment and removal of the external auditors, a statement from the audit committee explaining its recommendation and reasons why the board has taken a different stance should be included in the annual report.
- The annual report should explain to shareholders how the policy in relation to the provision of non-audit services by the auditor provides adequate protection of auditor independence.
- The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board, on the report on the audit committee's activities and matters within the scope of audit committee's responsibilities.

Combined Code: proposed section on audit committees

- The board should establish an audit committee of at least three members, who should all be independent non-executive directors. At least one member of the audit committee should have significant, recent and relevant financial experience.
- The main role and responsibilities should be set out in written terms of reference and should include:
  - to monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements contained in them;
  - to review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;
  - to monitor and review the effectiveness of the company's internal audit function;
  - to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
  - to monitor and review the external auditor's independence, and objectivity and effectiveness, 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.
- The audit committee should be provided with sufficient resources to undertake its duties.
- The annual report should contain a separate section that describes the role and responsibilities of the committee and the actions taken by the committee to discharge those responsibilities.
- The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board.

If you would like further information on any of the matters discussed in this publication, please talk to your usual contact at KPMG UK or contact:

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Further material is available on the Audit Committee Institute website at
www.kpmg.com/aci/uk/home.html

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