



THE AUDIT COMMITTEE

INTRODUCTION

The work of audit committee is a fundamental component of the corporate governance arrangements of every quoted company and in the, nearly, 10 years following the financial crisis of 2008-9, all aspects of the audit committee's role have come under scrutiny. The Financial Reporting Council (**FRC**) and other regulatory bodies have been prolific in issuing guidance on how audit committees should fulfil their duties.

This Prism Briefing looks at the role, composition and work of the audit committee and how it assesses the effectiveness and integrity of an organisation's internal control and external reporting, its relationship with auditors and finally, how it assesses its own work.

Composition

The number of directors who sit on the audit committee will depend, to a large extent, on the size and complexity of the company. The UK Corporate Governance Code 2016 (the "**Code**") which applies to companies with a premium listing, requires that the audit committee comprise at least three, or in the case of smaller companies (below FTSE350), two independent non-executive directors whilst the Quoted Company Alliance in its Audit Committee Guide (the "**QCA Guide**") published in 2014 cautions against having a committee which is too large. The committee should be small enough to work effectively as a sub-committee, which alleviates the workload of the board, but also contains sufficient expertise and independent members to give the board the comfort it needs to trust the committee's recommendations. It is usual for audit committees to be wholly comprised of independent non-executive directors and whilst this is not an explicit requirement of the Code it is certainly in its spirit and is supported by many institutional investors and proxy agency guidelines.

The chairman of the board should not, generally, sit on the audit committee of larger companies but the Code does allow that the chairman can be a member of, but not chair, the committee in smaller companies.

The Code requires that at least one member of the committee should have recent and relevant financial experience. The Disclosure Guidance and Transparency Rules (**DTR**) go further and require at least one member of the audit committee to have competence in accounting and/or auditing. In addition both the Code and the DTR require that the committee, as a whole, should have competence relevant to the sector in which the company operates. Whilst this is an additional requirement, it is still a fairly broad description and would not preclude any competent and experienced non-executive director from serving on an audit committee. The QCA Guide provides a useful list of attributes of an effective audit committee which should have, not only "recent and relevant financial experience" but also, overall:

- Extensive business experience;
- Knowledge of financial markets;
- Knowledge of the company's industry; and
- Knowledge of any relevant specialist regulatory or legal requirements.

The FCA "Guidance on Audit Committees" published in April 2016 (the "**FCA Guide**") also refers to the importance of an "independent mind-set" and a capability to take a robust stand.



When succession planning, the nomination committee and audit committee chair should consider carefully proposals to appoint former audit firm partners or ex-employees to the audit committee. Regulations prevent an audit firm from being selected as the next auditor if an ex-partner or employee from the audit firm had a close relationship with the audit team in the last two years and is then appointed as a director or member of a board committee.

In summary the audit committee should comprise individuals with financial and market experience who are able to command the respect of the board, the management and the external auditors.

Terms of Reference

The Code sets out the requisite components of the audit committee's terms of reference and, on 1 March 2017, the Institute of Chartered Secretaries and Administrators updated its model terms of reference, which serve as an excellent guide. However, as stated by the FCA Guide, a committee's terms of reference should be tailored to the "particular circumstances of the Company". The terms should also be reviewed at least annually to ensure that they remain appropriate.

Frequency of Meetings

The FCA Guide recommends that there are no fewer than three meetings during the year, held to coincide with the key dates within the financial reporting and audit cycle. These are around the interim and final results (or quarterly results if appropriate). It is also useful for the audit committee to take some time with the external auditors to go through the audit plan and review the initial engagement letter and scope of the audit prior to the audit commencing.

The Work of the Committee

Monitoring the Integrity of the Accounts

Whilst ultimate responsibility lies with the Board, the company's management will be responsible for preparing and completing accurate financial statements and disclosures in accordance with prevailing accounting standards, the board will look to the audit committee for assurance on the appropriateness of any judgements made. In doing this, it is not sufficient for the committee simply to review the financial reporting at the end of the process, shortly before the statements are considered by the board. Instead it should take a forensic approach towards its work and meet with management and the auditors early on. The board will look to the committee to have satisfied itself, by a process review and robust questioning of management and the auditors, on the suitability of key accounting policies and the treatment of any significant accounting issues. The committee should confirm that the entity is a going concern and, where a company is listed on the main market, should take a view on the long term viability statement, as required by the Code.

At the end of the audit the audit committee should consider the key audit findings of the external auditor and the management letter to ensure that the key issues arising from the audit are understood and will be addressed.



Review of Internal Controls

One role of the board of directors, as defined by the Code, is “to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed”. Indeed, Listing Principle 1 requires that a listed company must take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations. The board will, therefore, look to the committee to review this framework of controls (generally referred to as the “internal controls”) and assess its effectiveness.

The internal controls of an organisation do not only encompass the systems put in place to ensure the accuracy of financial reporting but encompass a much wider set of components which are fundamental to good governance. The FRC’s “Guidance on Risk Management, Internal Control and Related Financial and Business Reporting” states that “the risk management and internal control system encompass the policies, culture, organisation, behaviours, processes systems and other aspects of a company that, taken together:

- facilitate its effective and efficient operation by enabling it to assess current and emerging risks, respond appropriately to risks and significant control failures and to safeguard its assets;
- help to reduce the likelihood and impact of poor judgement in decision-making; risk-taking that exceeds the levels agreed by the board; human error; or control processes being deliberately circumvented;
- help ensure the quality of internal and external reporting; and
- help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.”

This wide definition, which includes nebulous characteristics such as “culture” and “behaviour”, will require the committee to talk to a wider range of individuals than just the finance director and external auditor and to have a real feel for the business and the people who work in it. The further requirement of the Code, that companies report to shareholders on the review of internal controls and report on actions taken where any significant weaknesses have been identified, mean that, the audit committee should be reviewing the key components of the internal control system on a regular basis, not just at the end of the year.

Oversight of the Management of Risk

A major component of the internal control system is the measures an organisation puts in place to manage risk. Risk management is such a fundamental element of a company’s defence against failure that many committees include “risk” in their title and a significant number of companies form a separate risk committee.

The board remains ultimately responsible for risk, no matter how it has delegated the oversight of risk management. Every company is exposed to risk and, indeed, has to take risks to exploit opportunities, and it is the board which determines an organisation’s tolerance for risk, or “risk appetite”. Management, in its turn, controls risk on a day-to-day basis and takes steps to mitigate risk where this is possible. The role of the audit, or risk, committee is to assess the measures management has put in place and determine whether these fit within the parameters set by the board.

The committee will expect to have oversight of the tools management has used to assess and manage risk and will review outputs such as a risk register, risk heat maps and other methods of setting out the likelihood, impact and potential mitigation of risk.



Risk, and its management, permeate every element of the committee’s responsibilities and a committee cannot give assurance on a company’s going concern or comment on the robustness of a company’s long-term viability statement without first having considered the company’s ability to manage and mitigate risk.

Assessing the Internal Audit Function

The Code requires committees to “monitor and review the effectiveness of the internal audit activities” and, where there is no internal audit function, to consider annually whether there is a need for an internal audit function and make a recommendation to the board. The committee is also required to explain why there is no need for an internal audit function in the relevant section of the annual report.

The FRC Guide sets out the duties and responsibilities of the audit committee regarding the internal audit process which is integral to its review of internal controls. Where an internal audit function has been established the FRC Guide highlights that the committee should ensure the function has an unrestricted scope, necessary resources and access to information.

Anti-Bribery and Whistleblowing

The risk of bribery exists for all organisations, although the significance of that risk will depend on the nature of the business. The audit committee should satisfy itself that the company is handling and mitigating the risk of bribery satisfactorily as part of its overall responsibility to assess internal controls.

The provision of a mechanism where employees can raise concerns about potential and perceived improprieties is often part of a company’s anti-bribery arrangements (although the types of improprieties reported via whistleblowing mechanisms can be much more wide ranging). It is a specific Code requirement that audit committees review whistleblowing arrangements and ensure that procedures are in place for the proportionate and independent investigation and appropriate follow-up actions.

Relationship with the External Auditors

The audit committee oversees all aspects of the company’s relationship with its external auditor from the initial tendering and appointment process, to approving the terms of the engagement (and the appropriateness of the fees levied) and finally to the assessment of the adequacy of the audit itself.

In recent years a spotlight has been thrown on the importance of independence of the external auditor and a number of measures have been put in place to ensure that this independence is not compromised. All these measures are overseen by the committee.

Audit tendering

The EU audit reforms, which came into effect in June 2016 and have been reflected in changes to the Companies Act 2006, require that all Public Interest Entities conduct an audit tender at least every 10 years and rotate auditors after at least 20 years. The FRC Guide recommends that the audit committee should be responsible for the selection procedure and ensure that all tendering firms have access to information and individuals during the selection process. The Code goes on to recommend that the committee should have primary responsibility



for making a recommendation to the board on the appointment, reappointment or removal of an auditor. The committee should ensure it is aware of the specific provisions of EU audit regulation in relation to the audit tender and selection process such as making a recommendation to the board of at least two choices of audit firms and expressing a justified preference.

Overseeing the audit tender process is obviously a huge amount of work for the committee and for this reason the FRC in its “Audit Tenders Notes on Best Practice” paper published in February 2017 emphasises the importance that the committee “forward plan” its work some years in advance and take into account internal operational and strategic plans when determining the timing of the tender process.

Assessment of the Effectiveness of the Audit Process

It is a Code requirement that the audit committee 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.

The FRC Guide recommends that in the course of its assessment of effectiveness, that committee should:

- ask the auditor to explain the risks to audit quality that they identified and how these have been addressed;
- discuss with the auditor the key audit firm and network level controls the auditor relied on to address the identified risks to audit quality and enquire about the findings from internal and external inspections of their audit and their audit firm;
- review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
- obtain feedback about the conduct of the audit from key people involved, for example the finance director and the head of internal audit, including consideration of the external auditor’s reliance on internal audit; and
- review and monitor the content of the external auditor’s management letter, and other communications with the audit committee, in order to assess whether it is based on a good understanding of the company’s business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.

Non-Audit Services

As part of the effort to enhance the independence of the auditor, EU audit reforms also introduced a list of non-audit services that the appointed external auditors are not able to provide (the ‘black list’). The list includes certain tax services, consultancy and advisory services, certain legal services and services linked to financing, capital structure and investment strategy of the company. In addition a 70% cap applies for certain non-audit services.

Non-audit services outside of the black list may be provided as long as the audit firm has properly assessed any threats to independence and the services are subject to the cap on non-audit service fees. Audit committees, in their turn, should maintain a policy on the provision of non-audit services and look closely at the comparison of audit to non-audit fees, ensuring that this does not become out of kilter and begin to compromise the independence of the external auditor.



Assessing Its Own Performance

The Code requires that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees. As part of this the board will expect the committee to run a self-evaluation and this can be conducted internally by, for instance, questionnaire, or can be facilitated by an external consultant. When considering its own performance the committee needs to consider the responsibilities contained in its terms of reference and assess whether it has achieved those aims. It should consider the performance of the individual committee members and how well the committee functions as a team. It should assess the quality of the information that is provided to it by management, internal and external auditing bodies and the quality of its own reports to the full board.

PRISM PERSPECTIVE

It is clear that company secretaries, with their responsibility for the governance role of audit committees also need to be mindful of the expectations now placed upon their audit committees. The timing of audit committee meetings and the structure of the audit committee agenda needs to be considered in line with the audit timetable at both the half- and full-year. Close co-operation between the chairman and secretary of the audit committee, as well as the chief financial officer and the external auditor, will be important to this process.

The audit committee process is clearly a full-year activity which cannot be wrapped up into a couple of meetings at the half year and preliminary announcement stages. Rising expectations about the reporting on the activities of the audit committee will expose any weaknesses in the governance process. Company secretaries need to take the lead in ensuring that this does not occur.

Useful Sources

The UK Corporate Governance Code, Financial Reporting Council, April 2016

The Financial Reporting Council, Final Draft Guidance on Audit Committees, April 2016

Quoted Companies Alliance, Inspiring Trust, Audit Committee Guide for Small and Mid-Size Quoted Companies, 2014

The Financial Reporting Council, Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, September 2014

The Financial Reporting Council, Audit Tenders Notes on Best Practice, February 2017

The Institute of Chartered Secretaries and Administrators, Guidance Note Terms of Reference for the Audit Committee, March 2017

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