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# Audit Committe



## The audit committee

The UK Corporate Governance Code (**UKCG Code**) of the Financial Reporting Council (**FRC**) applies to UK and overseas companies with a premium listing of equity shares in the UK (**listed companies**). However, some companies (in particular, AIM-listed companies or companies with a standard rather than premium listing) choose to comply with the UKCG Code in the interests of best practice and good governance even though they are not required to do so.

References: UK Corporate Governance Code 2010

UK Corporate Governance Code 2012

The Listing Rules, LR 9.1.1 R, LR 9.6.8(5) R, LR 9.6.8(6) R and LR 9.8.7 R

The current version of the UKCG Code was issued in September 2012 and applies to companies with accounting periods beginning on or after 1 October 2012.

The previous version of the UKCG Code was issued in June 2010 and will continue to apply for a transitional period to companies that are still within accounting periods beginning prior to 1 October 2012. This practice note provides links to each of the 2010 and the 2012 versions of the UKCG Code, and specifies where there are any differences between the two versions.

The Combined Code was the predecessor to the UKCG Code. It is no longer applicable (it applied to companies with financial years beginning before 29 June 2010).

The UKCG Code contains provisions that relate to establishing committees of the board, including an audit committee. The FRC has also issued guidance on audit committees, which is referred to throughout this note. The FRC notes that boards are not required to follow the guidance, but that it is intended to assist them with implementing the relevant provisions of the UKCG Code.

References: FRC guidance on audit committees, issued September 2012

The Disclosure Rules and Transparency Rules (**DTR**) of the Financial Conduct Authority (**FCA**) also contain provisions relating to audit committees of issuers (as defined), details of which are set out in this note.

References: The Disclosure Rules and Transparency Rules (DTR)

Financial Conduct Authority Handbook, Glossary, definition of issuer for the DTR chapter 7

### Requirement to establish an audit committee

One of the UKCG Code's main principles is that boards of listed companies should establish formal and transparent arrangements for considering how they should apply the corpo-

rate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.

References: UKCG Code 2010, main principle C.3

UKCG Code 2012, main principle C.3

The UKCG Code provisions clarify that a company should establish an audit committee.

References: UKCG Code 2010, provision C.3.1

UKCG Code 2012, provision C.3.1

## **Membership of the audit committee**

### **Members**

The UKCG Code states that boards should establish an audit committee of at least three or, in the case of smaller companies outside the FTSE 350, two independent non-executive directors.

References: UKCG Code 2010, provision C.3.1

UKCG Code 2012, provision C.3.1

The board is required to identify in its annual report which of its non-executive directors that are considered to be 'independent'.

UKCG Code 2012, B.1.1

### **Experience and training**

The board must satisfy itself that at least one member of the audit committee has recent and relevant financial experience. The FRC's guidance gives further detail on this requirement by stating that it is desirable that the committee member whom the board considers to have recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies.

References: FRC guidance on audit committees, issued September 2012, para 2.16

The guidance also states that 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. The availability of appropriate financial expertise will be particularly important where the company's activities involve specialised financial activities.

The company should provide an induction programme for new audit committee members to ensure that they have a clear idea of the role of the audit committee, its terms of reference, expected time commitment and a clear overview of the company's business.

References: FRC guidance on audit committees, issued September 2012, para 2.17

Training should also be provided to members of the audit committee on an ongoing and timely basis.

References: FRC guidance on audit committees, issued September 2012, para 2.18

### **Appointment and duration**

Appointments to the audit committee should be made by the board on the recommendation of the nomination committee (where there is one), in consultation with the audit committee chairman.

References: FRC guidance on audit committees, issued September 2012, para 2.4

Appointments should be for a period of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.

References: FRC guidance on audit committees, issued September 2012, para 2.5

### **Role of the audit committee**

The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

References: UKCG Code 2010, provision C.3.2

UKCG Code 2012, provision C.3.2

- o 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 judgments contained in them
- o 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
- o to monitor and review the effectiveness of the company's internal audit function
- o to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor
- o 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
- o 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, and
- o to report to the board on how it has discharged its responsibilities

The terms of reference should be 'made available'. Including the terms on the company's website would fulfil this requirement.

References: UKCG Code 2010, provision C.3.3

UKCG Code 2012, provision C.3.3

The terms of reference should be tailored to the particular circumstances of the company. The terms, and the audit committee's own effectiveness, should be reviewed annually and recommend any necessary changes to the board.

References: FRC guidance on audit committees, issued September 2012, paras 3.2-3.4

The Institute of Chartered Secretaries and Administrators (**ICSA**) publishes specimen terms of reference for audit committees.

References: ICSA Model Terms of Reference--Audit Committee

The UKCG Code 2012 sets out an additional task for the audit committee which is to, when requested by the board, provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy. This requirement will not apply to companies that are not yet subject to the 2012 version of the UKCG Code.

References: UKCG Code 2012, provision C.3.4

The UKCG Code requires the audit committee to review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters (otherwise known as 'whistleblowing'). Its 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.

References: UKCG Code 2010, provision C.3.4

UKCG Code 2012, provision C.3.5

FRC guidance on audit committees, issued September 2012, paras 4.9-4.16

The audit committee should also have primary responsibility for making recommendations on the appointment, reappointment and removal of the external auditors. However, 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.

References: UKCG Code 2010, provision C.3.6

UKCG Code 2012, provision C.3.7

### **Operation of the audit committee**

It is for the audit committee chairman, in consultation with the company secretary, to decide on the frequency and timing of its meetings. There should be as many meetings as the audit committee's role and responsibilities require but it is recommended that there should be no fewer than three meetings during the year. The FRC guidance states that most audit committee chairmen will wish to call more frequent meetings.

References: FRC guidance on audit committees, issued September 2012, para 2.6

No one other than the audit committee's chairman and members is entitled to be present at a meeting of the audit committee. It is for the audit committee to decide if non-members

should attend for a particular meeting or a particular agenda item. The external audit lead partner will be invited regularly to attend meetings as well as the finance director.

References: FRC guidance on audit committees, issued September 2012, para 2.7

The audit committee should, at least annually, meet the external and internal auditors, without management, to discuss matters relating to its remit and any issues arising from the audit.

References: FRC guidance on audit committees, issued September 2012, para 2.9

Sufficient time should be allowed to enable the committee to undertake as full a discussion as may be required. 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.

References: FRC guidance on audit committees, issued September 2012, para 2.8

The FRC gives guidance on the reporting of any disagreement between the audit committee and the board.

References: FRC guidance on audit committees, issued September 2012, para 3.5

### **Statements in the annual report**

The 2010 version of the UKCG Code states that a separate section of the annual report should describe the work of the audit committee in discharging its responsibilities. The 2012 version of the UKCG Code expands upon this requirement with a new provision that sets out that the report should include:

References: UKCG Code 2010, provisions C.3.3

UKCG Code 2012, provision C.3.8

- o the significant issues that the committee considered in relation to the financial statements and how these issues were addressed, and
- o an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted

Both the 2010 and 2012 versions of the UKCG Code require the annual report should also explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded. The explanation given pursuant to this UKCG Code requirement should:

References: UKCG Code 2010, provision C.3.7

UKCG Code 2012, provision C.3.8

FRC guidance on audit committees, issued September 2012, para 4.46

- o describe the work of the committee in discharging its responsibilities

- o set out the audit committee's policy on the engagement of the external auditor to supply non-audit services, or cross-refer to where this information can be found on the company's website
- o set out, or cross refer to, the fees paid to the auditor for audit services, audit related services and other non-audit services, and
- o if the auditor provides non-audit services, other than audit related services, explain for each significant engagement, or category of engagements, what the services are, why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor (rather than another supplier) and how auditor objectivity and independence has been safeguarded

Where there is no internal audit function, the reasons for the absence of such a function should be explained in the relevant section of the annual report.

References: UKCG Code 2010, provision C.3.5

UKCG Code 2012, C.3.6

If the board does not accept the audit committee's recommendation regarding the appointment, reappointment or removal of the external auditors, it should include in the annual report, and in any papers recommending appointment or reappointment, a statement from the audit committee explaining the recommendation and should set out the reasons why the board has taken a different position.

References: UKCG Code 2010, provision C.3.6

UKCG Code 2012, provision C.3.7

Where there are any disagreements between the board and the audit committee that 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 annual report.

References: FRC guidance on audit committees, issued September 2012, para 3.5

A company subject to the DTRs must also include within its corporate governance statement a description of the composition and operation of all of its administrative, management and supervisory bodies and their committees.

References: DTR 7.2.7 R

### **The DTR requirements**

The DTR effectively replicate the provisions on audit committees in the UKCG Code in that they require issuers to have a body responsible for performing the functions that an audit committee would typically carry out.

References: DTR 7.1

In the FCA's view, compliance with UKCG Code, provisions A.1.2, C.3.1-C.3.3 will result in compliance with the requirements of DTR 7.1.1 R-DTR 7.1.5 R.

References: DTR 7.1.7 G

The DTRs require that at least one member of the audit committee must be independent and at least one member must have competence in accounting and/or auditing, although the same member may satisfy both of these requirements. This is a slightly less onerous

requirement than that set out in the UKCG Code (which requires that the audit committee should consist of three, or in the case of smaller companies, two independent non-executive directors).

References: DTR 7.1.1 R

#### DTR 7.1.2 G

The DTRs require that the audit committee must, as a minimum:

References: DTR 7.1.3 R

- o monitor the financial reporting process
- o monitor the effectiveness of the issuer's internal control, internal audit, where applicable, and risk management systems
- o monitor the statutory audit of the annual and consolidated accounts, and
- o review and monitor the independence of the statutory auditor and, in particular, the provision of additional services to the issuer

These requirements overlap with UKCG Code provision C.3.2.

An issuer must base any proposal to appoint a statutory auditor on a recommendation made by the audit committee. This rule overlaps with UKCG Code provision C.3.6.

References: DTR 7.1.4 R

The DTRs require that an issuer makes a public statement disclosing details of the audit committee and how it is composed. This rule overlaps with UKCG Code provision C.3.3.

References: DTR 7.1.5 R