AUDIT COMMITTEES

COMBINED CODE GUIDANCE

A report and proposed guidance

by an FRC-appointed group chaired by

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Submitted to the Financial Reporting Council in December 2002 and published in January 2003

Electronic copies of this report are available at:

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'Review of the role and effectiveness of non-executive directors'

are available at:

www.dti.gov.uk/cld/non_exec_review

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Audit committees - Combined Code guidance

1. Introduction

1.1. 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.

1.2. This guidance includes certain essential requirements that every audit committee should meet. These requirements are presented in **bold** in the text. Compliance with these is necessary for compliance with the Code. Listed companies that do not comply with these requirements should include an explanation as to why they have not complied with these requirements in the statement required by the Listing Rules.

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

1.4. Conversely, best practice goes beyond meeting the essential requirements. 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.

1.5. While all directors have a duty to act in the interests of the company the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.

1.6. 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.

1.7. Nevertheless, this guidance requires a separate section within the directors' report describing the role, responsibilities and activities of the audit committee. This requirement deliberately puts the spotlight on the audit committee and gives it an authority that it might otherwise lack. This is not incompatible with the principle of the unitary board.

1.8. The guidance contains recommendations about the conduct of the audit committee's relationship with the board, with the executive management and internal and external auditors. However, the most important features of this relationship cannot be put into a code of practice: a frank, open working relationship and a high level of mutual respect are essential, particularly between the audit committee chairman and the board chairman, the chief executive and the finance director. The audit committee must be prepared to take a robust stand, and all parties must be prepared to make information freely available to the audit committee, to listen to their views and to talk through the issues openly.

1.9. In particular, the management is under an obligation to ensure the audit committee is kept properly informed, and should take the initiative in supplying information rather than waiting to be asked. The board should make it clear to all directors and staff that they must cooperate with the audit committee and provide it with any information it requires. In addition, executive board members will have regard to their common law duty to provide all directors, including those on the audit committee, with all the information they need to discharge their responsibilities as directors of the company.

1.10. Many of the core functions of audit committees set out in this guidance are expressed in terms of 'oversight', 'assessment' and 'review' of a particular function. It is not the duty of audit committees to carry out functions that properly belong to others, such as the company's management in the preparation of the financial statements or the auditors in the planning or conducting of audits. To do so could undermine the responsibility of management and auditors. Audit committees should, for example, satisfy themselves that there is a proper system and allocation of responsibilities for the day-to-day monitoring of financial controls but they should not seek to do the monitoring themselves.

1.11. However, the high-level oversight function may lead to detailed work. The audit committee must intervene if there are signs that something may be seriously amiss. For example, if the audit committee is uneasy about the explanations of management and auditors about a particular financial reporting policy decision, there may be no alternative but to grapple with the detail and perhaps to seek independent advice.

1.12. Under this guidance, audit committees have wide-ranging, time-consuming and sometimes intensive work to do. Companies need to make the necessary resources available. This includes suitable payment for the members of audit committees themselves. They – and particularly the audit committee chairman - bear a significant responsibility and they need to commit a significant extra amount of time to the job. Companies also need to make provision for induction and training for new audit committee members and continuing training as may be required.

1.13. This guidance applies to all companies to which the Code applies – i.e. UK listed companies. For groups, it will usually be necessary for the audit committee of the parent company to review issues that relate to particular subsidiaries or activities carried on by the group. Consequently, the board of a UK-listed parent company should ensure that there is adequate cooperation within the group (and with internal and external auditors of individual companies within the group) to enable the parent company audit committee to discharge its responsibilities effectively.

1.14. Where a company is listed in the UK but is part of a group with an overseas parent, or where the company is dual-listed, there is a theoretical possibility of a clash of jurisdictions. In practice this is not likely to cause significant problems. But if it did, the company concerned would need to decide upon an appropriate solution; if the result is that the UK-listed company does not comply with the provisions of the Code as supplemented by this guidance on audit committees, the non-compliance would need to be explained.

1.15. This guidance shall apply in respect of accounting periods starting on or after 1 July 2003.

2. The audit committee and its purpose

2.1. **The board should establish an audit committee, the main role and responsibilities of which 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 and review the external auditor's independence, objectivity and effectiveness;**

- **to develop and implement policy on the engagement of the external auditor to supply non-audit services.**

Where the audit committee's monitoring and review activities reveal cause for concern or scope for improvement, it should make recommendations to the board on action needed to address the issue or to make improvements.

3. Membership, procedures and resources

Membership and appointment

3.1. **Audit committees should include at least three members, who should all be independent non-executive directors**[1].

3.2. **The chairman of the company should not be an audit committee member**.

[1] For the definition of 'non executive directors' and 'independent directors' for the purposes of the Code, see the Higgs report "Review of the role and effectiveness of non-executive directors" and paragraph A.3.4 in the revised Code proposed by Higgs.

3.3. 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.

3.4. 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.

Meetings of the audit committee

3.5. It is for the audit committee chairman, in consultation with the company secretary, to decide the frequency and timing of its meetings. There should be as many meetings as the audit committee's role and responsibilities require. It is recommended there should be not fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle[2]. However, most audit committee chairmen will wish to call more frequent meetings.

3.6. **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. It is to be expected that the external audit lead partner will be invited regularly to attend meetings as well as the finance director. Others may be invited to attend.

3.7. Sufficient time should be allowed to enable the audit 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.

3.8. The audit committee should, at least annually, meet the external and internal auditors, without management, to discuss issues arising from the audit.

3.9. Formal meetings of the audit committee are the heart of its work. However, they will rarely be sufficient. It is expected that the audit committee chairman, and to a lesser extent the other members, will wish to keep in touch on a continuing basis with the key people involved in the company's governance, including the board chairman, the chief executive, the finance director, the external audit lead partner and the head of internal audit.

[2] For example, when the audit plans (internal and external) are available for review and when interim statements, preliminary announcements and the full annual report are near completion.

3.10. There should be arrangements for the audit committee to meet with external and internal auditors independently during the year without the presence of management.

Resources

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

3.12. The audit committee should have access to the services of the company secretary and staff on all audit committee matters including: assisting the chairman in planning the audit committee's work, drawing up meeting agendas, maintenance of minutes, drafting of material about its activities for the annual report, collection and distribution of information and provision of any necessary practical support.

3.13. The company secretary should ensure that the audit committee receives information and papers in a timely manner to enable full and proper consideration to be given to the issues.

3.14. The board should make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so.

Remuneration

3.15. In addition to the remuneration paid to all non executive directors[3], each company should consider the further remuneration that should be paid to members of the audit committee to recompense them for the additional responsibilities of membership. Consideration should be given to the time members are required to give to audit committee business, the skills they bring to bear and the onerous duties they take on, as well as the value of their work to the company. The level of remuneration paid to the members of the audit committee should take into account the level of fees paid to other members of the board. The chairman's responsibilities and time demands will generally be heavier than the other members of the audit committee and this should be reflected in his or her remuneration.

[3] See Higgs report, proposed Code paragraphs B.1 to B.3.

Skills, experience and training

3.16. **At least one member of the audit committee should have significant, recent and relevant financial experience, for example as an auditor or a finance director of a listed company.** It is highly desirable for this member to have a professional qualification from one of the professional accountancy bodies. 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.

3.17. The company should provide an induction programme 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. It could also include meeting some of the company staff.

3.18. Training should also be provided to members of the audit committee on an ongoing and timely basis and should 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; the role of internal and external auditing and risk management.

3.19. 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.

4. Relationship with the board

4.1. **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.

4.2. The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board.

4.3. The board should review the audit committee's effectiveness annually.

4.4. Where there is disagreement between the audit committee and the board, adequate time should be made available for discussion of the issue with a view to resolving the disagreement. Where any such disagreements 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 directors' report.

5. Role and responsibilities

Financial reporting

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

5.2. It is management's, not the audit committee's, responsibility to prepare complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations. However the audit committee should consider significant accounting policies, any changes to them and any significant estimates and judgements. The management should inform the audit committee of the methods used to account for significant or unusual transactions where the accounting treatment is open to different approaches. Taking into account the external auditor's view, the audit committee should consider whether the company has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements. The audit committee should review the financial reporting and consider whether the disclosures made are set properly in context.

5.3. **Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting by the company, it shall report its views to the board.**

5.4. The audit committee should review related information presented with the financial statements, including the operating and financial review, and corporate governance statements relating to audit and risk management. Similarly, where board approval is required for other statements containing financial information (for example, summary financial statements, significant financial returns to regulators and release of price sensitive information), whenever practicable the audit committee should review such statements first.

Internal financial controls and risk management systems

5.5. **The audit committee should monitor the integrity of the company's internal financial controls.**

5.6. **The audit committee, in the absence of other arrangements, eg a risk committee[4], should assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non financial risks**.

5.7. 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.

5.8. 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.

Whistleblowing

5.9. 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, financial control or any 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, and that any matters relevant to its own responsibilities are brought to its attention.

The internal audit process

5.10. **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**

[4] The board may set up other sub- committees to deal the requirements of the Turnbull report on internal controls.

the reasons for the absence of such a function should be explained in the relevant section of the annual report.

5.11. The audit committee should review and approve the internal audit function's remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors[5].

5.12. The audit committee should approve the appointment or termination of appointment of the head of internal audit.

5.13. In its review of the work of the internal audit function, the audit committee should, inter alia:

- 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 auditor's 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.

The external audit process

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

Appointment

5.15. **The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. This recommendation should be made to the board, and thence to shareholders for their approval in general meeting. If the board does not accept the audit committee's**

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5 Further guidance can be found in the Institute of Internal Auditors' Code of Ethics and the International Standards for the Professional Practice of Internal Auditing Standards.

recommendation, it shall include in the directors' report a statement from the audit committee explaining its recommendation and shall set out reasons why the board has taken a different position.

5.16. The audit committee's recommendation to the board should be based on the assessments referred to below. If the audit committee recommends considering the selection of possible new appointees as external auditors, it should oversee the selection process.

5.17. **The audit committee should assess the qualification, expertise and resources, effectiveness and independence (see below) of the external auditors annually.** The assessment should cover all aspects of the audit service provided by the audit firm, and include obtaining a report on the audit firm's own internal quality control procedures.

5.18. If the external auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

Terms and Remuneration

5.19. **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.**

5.20. The audit committee should review and agree the engagement letter issued by the external auditor at the start of each audit, ensuring that it has been updated to reflect changes in circumstances arising since the previous year. The scope of the external audit should be reviewed by the audit committee with the auditor. If the audit committee is not satisfied as to its adequacy it should request additional work should be undertaken.

5.21. The audit committee 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.

Independence, including the provision of non-audit services

5.22. **The audit committee should have procedures to ensure the independence and objectivity of the external auditor annually, taking into consideration relevant UK professional and regulatory requirements**. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services). The audit committee should consider whether, taken as a whole and having regard to the views of the external auditor, management and internal audit, those relationships appear to impair the auditor's judgement or independence.

5.23. The audit committee should seek reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the company (other than in the normal course of business). The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.

5.24. The audit committee should agree with the board the company's policy for the employment of former employees of the external auditor, paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. This should be drafted taking into account the ethical guidelines set out by the accountancy bodies. The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the company, and consider whether in the light of this there has been any impairment, or appearance of impairment, of the auditor's judgement or independence in respect of the audit.

5.25. The audit committee should monitor the external audit firm's compliance with applicable United Kingdom ethical guidance relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, office and partner and other related regulatory requirements.

5.26. **The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity**. In this context, the audit committee should consider:

- whether the skills and experience of the audit firm make it a suitable supplier of the non audit service;
- whether there are safeguards in place to ensure that there is no threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
- the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and

- the criteria which govern the compensation of the individuals performing the audit.

5.27. The audit committee should set and apply a formal policy specifying the types of non-audit work:

- from which the external auditors are excluded;
- for which the external auditors can be engaged without referral to the audit committee; and
- for which a case-by-case decision is necessary.

In addition, the policy may set fee limits generally or for particular classes of work.

5.28. In the third category, if it is not practicable to give approval to individual items in advance, it may be appropriate to give a general preapproval for certain classes for work, subject to a fee limit determined by the audit committee and ratified by the board. The subsequent provision of any service by the auditor should be ratified at the next meeting of the audit committee.

5.29. **In determining the policy, the audit committee should take into account relevant ethical guidance[6] regarding the provision of non-audit services by the external audit firm, and in principle should not agree to the auditor providing a service if, having regard to the ethical guidance, the result is that:**

- **the external auditor audits its own firm's work;**
- **the external auditor makes management decisions for the company;**
- **a mutuality of interest is created; or**
- **the external auditor is put in the role of advocate for the company.**

The audit committee should satisfy itself that any safeguards required by ethical guidance are implemented.

5.30. **The annual report should explain to shareholders how the policy provides adequate protection of auditor independence.**

Annual audit cycle

5.31. **At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit.**

[6] Issued by the professional bodies in The Consultative Committee of Accountancy Bodies.

5.32. The audit committee should consider whether the auditor's overall work plan, including planned levels of materiality, and proposed resources to execute the audit plan appears consistent with the scope of the audit engagement, having regard also to the seniority, expertise and experience of the audit team.

5.33. **The audit committee should review, with the external auditors, the findings of their work.** In the course of its review, the audit committee should:

- discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved;
- review key accounting and audit judgements; and
- review levels of errors identified during the audit, obtaining explanations from management and, where necessary the external auditors, as to why certain errors might remain unadjusted.

5.34. The audit committee should also review the audit representation letters before signature by management and give particular consideration to matters where representation has been requested that relate to non-standard issues.[7] The audit committee should consider whether the information provided is complete and appropriate based on its own knowledge.

5.35. As part of the ongoing monitoring process, the audit committee should review the management letter (or equivalent). The audit committee should review and monitor management's responsiveness to the external auditor's findings and recommendations.

5.36. **At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process.** In the course of doing so, the audit committee should:

- 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;
- consider the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, and in their commentary where appropriate on the systems of internal control;

[7] Further guidance can by found in the Auditing Practices Board's Statement of Auditing Standard 440 "Management Representations".

- obtain feedback about the conduct of the audit from key people involved, e.g. the finance director and the head of internal audit; and
- review and monitor the content of the external auditor's management letter, 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.

6. Communication with shareholders

6.1. **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.**

6.2. The audit committee section should include, inter alia:

- a summary of the role of the audit committee;
- the names and qualifications of all members of the audit committee during the period;
- the number of audit committee meetings and attendance by each member; and
- a report on the way the audit committee has discharged its responsibilities.

6.3. **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

1. We consider that the Code itself needs to be expanded and strengthened in this area. We propose the following:

"**D.3** **Audit Committee and Auditors**

Principle The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions

D.3.1 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.

D.3.2 The main role and responsibilities should be set out in written terms of reference and should include:

(a) to monitor the integrity of the financial statements of the company, reviewing significant financial reporting issues and judgements contained in them;

(b) 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;

(c) to monitor and review the effectiveness of the company's internal audit function;

(d) 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;

(e) to monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements;

(f) 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.

D.3.3 The audit committee should be provided with sufficient resources to undertake its duties.

D.3.4 The directors' 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.

D.3.5 The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board.

Code provisions D.3.1. to D.3.5 are amplified in 'Audit committees - Combined Code guidance' [ie the guidance proposed in this report]. As the introduction to the guidance explains, compliance with the parts of the guidance printed in bold type should be regarded as essential for compliance with the Code."

2. We also propose a small change to Code provision D.2.2, in order to bring it into line with paragraph 5.10 of the guidance:

"**D.2.2** Companies which do not have an internal audit function should consider the need for one annually."

Audit committees – Combined Code guidance

Background report

The immediate background to our review

1. In late July 2002, the Government asked the Financial Reporting Council (FRC) to put in hand the development of the existing Combined Code guidance on audit committees. On 12 September the FRC issued a Press Notice announcing the establishment of this Group, its membership and its terms of reference - attached as Appendix IV.

2. We met first in September and were required to report by the end of the year. The FRC's announcement invited comments on the issues raised in our terms of reference. In addition, we wrote to representative organisations and to leading audit firms inviting their comments and assistance. A list of those who offered comments is given in Appendix V. We have looked at experience in other countries and noted current developments in the United States, the European Union and elsewhere – see Appendix III.

3. Our terms of reference instructed us to liaise closely with Derek Higgs, who has been conducting a review of the role and functions of non-executive directors. We have done so and have found the liaison very constructive. We believe that the wider perspective tackled by Mr Higgs is appropriate to address the central issue of director independence as well as issues such as recruitment, pay, and training. On these issues we have kept closely in step with Mr Higgs, but have also considered these issues from the particular perspective of audit committees.

The wider background

4. The Government's request to the FRC to develop guidance on audit committees has of course its root in the dramatic corporate failures in the United States in early 2002. These occurred despite the perception of close US regulation of accounting and auditing and despite the existence of corporate governance institutions including audit committees. The consequence has been falling confidence and rising confusion in capital markets not just in the US but around the world.

5. The question was rightly asked: Could it happen here? And the answer has generally been, again rightly in our view: Yes; perhaps less likely than in the US, but it can be by no means ruled out. The Government therefore established its Co-ordinating Group on Auditing and Accounting Issues, on which the Financial Reporting Council is represented, to co-ordinate the many strands of the UK response to the need to strengthen defences against corporate malfeasance of the kind seen in the US.

6. Audit Committees are no more than a part of those defences. But we believe that they are a most important part and that there could be considerable benefits if their role were clarified and enhanced. This would be beneficial not only in increasing the level of assurance against catastrophic failure and gross malfeasance; it would also offer improvements on a wider front, raising the overall standard of corporate governance for all companies that implement our guidance.

What are audit committees for?

7. The primary role of audit committees is to ensure the integrity of financial reporting and the audit process by ensuring that the external auditor is independent and objective and does a thorough job, and by fostering a culture and an expectation of effective oversight.

8. We also see a wider role for audit committees, in typical circumstances, in ensuring that the company has sound internal financial control systems and systems for the control of non-financial risks, of the kind dealt with in the Turnbull report 'Internal Control – Guidance for Directors on the Combined Code'. Some boards may decide to take on this role themselves or to delegate it to a separate 'risk committee', and we would not wish our guidance to remove those options.

9. Audit committees have a particular role in underpinning the assurance that boards give to shareholders of the integrity of the company's audit and internal control processes.

10. If things go wrong, the audit committee also has a role in ensuring that they are put right – for example if an audit failure seems to be leading to poor, or even deliberately misleading, financial reporting decisions. This can put the committee into an adversarial relationship with both the external auditors and the executive, and audit committees must be ready to accept that role if necessary. The US corporate failures of 2002 point vividly to the importance of this. We believe that failures on that scale will continue to be rare, but audit committees must be capable of tackling the worst.

11. In outline, we see the key functions of audit committees as the following:

    to monitor the processes which ensure the integrity of the financial statements of the company;

    to review the company's financial control and 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 and review the external auditor's performance, independence and objectivity; and

to develop and implement policy on the engagement of the external auditor to supply non-audit services.

Where the committee's monitoring and review activities reveal cause for concern or scope for improvement, it should make recommendations to the board on action needed to address the issue or to make improvements.

12. We have drawn up specimen terms of reference for an audit committee, attached as Appendix 1. This is intended as a starting-point only, not a prescription, and therefore does not form part of the Code guidance. The board should think carefully about the particular circumstances of the company and the role that the audit committee should play. Against the background of the US corporate failures, the salient requirement on audit committees is that they ensure that the auditor is independently minded and rigorous and that poor financial disciplines and bad financial reporting decisions are properly challenged and rectified. The work of the committee should however go beyond catching inappropriate reporting or inadequate auditing. Rather its work should be more pervasive and seek to build into the organisation a culture of compliance and fair reporting, an environment in which issues are openly discussed and resolved before they become matters of real concern.

13. The audit committee can face serious difficulties if, for example, management propose to capitalise a set of costs in a way which transforms the company's results, the auditors support the proposal and yet the audit committee thinks it questionable. The audit committee has to pit its judgement against that of the 'experts', perhaps on a technically complex issue. If the committee remains unconvinced, what are they to do?

14. To add to the difficulties in this example, the audit committee meets only three times a year, perhaps for not much more than an hour on each occasion. In the time available, the audit committee fails to resolve its difference of view with the management and the auditors. The members of the audit committee are outnumbered on the board by executive directors. The only available options are to give in or to resign. But resignation has the drawbacks of a nuclear threat: it will highlight in public that there is a problem, and will probably pull down the share price significantly and disproportionately to the particular issue. This has the perverse effect, at least in the short term, of penalising the shareholders in

whose interests the audit committee does its work. The pressure on the audit committee in such a case to concede the point can be enormous.

15. Most of the time most companies and most audit committees will come nowhere near such a crisis. A strong committee should be able to pick up signs of trouble at an early stage and confront them immediately, preventing a drift towards crisis. But the example highlights the pressures audit committee members should be ready to deal with.

16. The main conclusion to be drawn is that a great deal depends on the personal qualities of the audit committee members. They need to be tough, knowledgeable and independent-minded. But we also need to be realistic in our expectations. The job is difficult and it is inevitable that some committees will struggle to meet the highest standards. That is one reason why in our guidance we have provided for assessment and self-assessment of the performance of the audit committee itself.

17. An adversarial relationship between the audit committee and the management is of course not typical and where it exists it suggests a failure of corporate governance. Where things are working well, the relationship between the members of the audit committee and the executive will be based on frankness and mutual respect. The audit committee will not hesitate to express misgivings if necessary and the executive will listen and respond in a constructive, non-defensive, way.

18. No guidance can in itself ensure that this is always achieved. A great deal depends on the culture of the company, the personalities concerned and the relationships between the key people (particularly the audit committee chairman, the board chairman, the chief executive, the finance director and both external and internal auditors).

The place of the audit committee within a unitary board structure

19. We support the unitary board model. Non-executive board members can make a positive contribution to board discussion, in a way which is helpful to the executives; and their presence at board discussions deepens non-executives' insight into the company's business. This applies as much to the members of audit committees as to other non-executive directors. We believe that an audit committee separate from the board would be less effective than the conventional audit committee established as a sub-committee of the board.

20. Under a unitary board structure, each director, executive or non-executive, has to decide whether to go along with the collective decision or to leave. Members of the audit committee, like others, are bound by board membership into supporting the board's decisions. And the audit committee itself is, and should be seen as, a committee of the board. Audit committee members are not, and are

not intended to be, independent of the board. But they must be independent of the executive management.

21. As members of the board, audit committee members share legal liability with all their director colleagues. Derek Higgs' report deals with the question of liability insurance.

22. We attach the utmost importance to the idea of audit committee independence within the unitary board structure. The most important aspect of independence is the independence of mind of the individuals on the committee, rather than any rule-book or formula. What matters above all is the quality of the people concerned, their relationship with each other and more generally the 'culture' of the company, whereby the audit committee is seen as a source of strength for the company and its shareholders.

23. It is not the role of the audit committee to prepare the company's financial statements and disclosures in compliance with financial reporting standards and applicable rules and regulations or to plan and conduct audits. Audit committees should take care not to duplicate the role of the executive or of the auditors. In all ordinary circumstances, an audit committee should seek to satisfy itself that the executive and the auditors (internal and external) are carrying out their roles properly and effectively, not to step in to do it themselves. Time pressure will in any case normally make that impossible. If an audit committee is drawn in too closely to the detail and slips into making decisions for the company, it risks blurring the distinction between the executive and non-executive roles and undermining the responsibilities of both management and auditors. It should seek to ensure that the process as a whole works well and that the actors in it play their full roles. In doing this, it will however need to have a clear understanding of the key accounting and audit judgements made.

24. But if things are going seriously wrong the committee may have no alternative but to explore the issues exhaustively. If the audit committee is drawn into a line of questioning about the executive's handling of a controversial issue, it cannot let it go until it is satisfied with the answers. So there is a delicate balance to be struck between a detached oversight role as the normal mode of operation and a willingness to become more closely involved when things may be going wrong.

25. It is difficult to reflect these themes fully in guidance for audit committees. However, we have kept them in mind throughout as principles as we have developed our guidance.

26. The guidance we have drawn up is self-sufficient and self-explanatory. However, there are three broad areas on which we believe a brief commentary will help explain our proposals.

Resources

27. We believe that the audit committees of most listed companies have a major task to perform. This applies particularly to the largest and most complex companies. Yet few audit committees have more than three members, and many have fewer, if only because they have fewer than three independent non-executive directors.

28. The first requirement is therefore to increase the quality, quantity and variety of the pool of potential non-executive directors who can bring the appropriate skill, experience and energy to the task and commit the appropriate time. This is a topic which Derek Higgs addresses.

29. But membership, and particularly chairmanship, of audit committees imposes additional burdens of time and commitment. It is not a light optional extra. Chairmen and members of audit committees should expect to be paid appropriately for that extra time and commitment.

30. To do the job well, all members of audit committees will need to develop and maintain their knowledge and skills. This should include training, in the broadest sense of the term. This too involves a time commitment, which needs to be planned for and paid for.

31. We, and those who contributed their views to us, have debated extensively the qualifications that should be sought in audit committee members. In most cases, a mix of skills and qualifications will be desirable, including:

    professional accounting expertise combined with recent relevant experience in at least one member;

    a degree of financial literacy in other members; and

    generalist business experience, preferably at board level and if possible in businesses broadly comparable in scale and complexity to the company's.

32. The debate has mainly been about the need for a member with an accountancy qualification. It is generally agreed that an accountancy qualification on its own is not sufficient, particularly if it was gained a long time ago. But is a qualification necessary? Or should we consider the path taken by the US Sarbanes-Oxley Act, which avoids a requirement for a qualification but demands a formidable list of accounting knowledge and skills? Both these options seem to us to be unduly prescriptive. In our view, to have one member with an accountancy qualification is usually highly desirable, and virtually essential for some complex businesses. But we believe that it would be wrong for the guidance to require it.

33. There may also be advantage in including a member without much financial experience or literacy but with a strong intellect, who can perhaps more easily

than others cut through the technicalities and raise the right straightforward questions. This is perhaps most realistic for the smaller comparatively straightforward companies.

34. The audit committee must also have access to other resources: to administrative and other support from the company secretary and his staff; to information from other directors, from the company's staff and from the auditors; and to independent advice paid for from company resources. In some cases it may be appropriate for the committee to buy in continuing consultancy help. It is ultimately for the board as a whole to decide resource issues of this kind but the underlying rule should be that the committee should have whatever resources it reasonably requests in pursuit of its tasks. And the board should place an obligation on staff, directors and both internal and external auditors to volunteer relevant information to the audit committee, not to wait to be asked.

The independence of the external auditor

35. It is one of the prime tasks of the audit committee to monitor the performance and, in particular, the continued independence of the auditor. There has been much controversy over the question whether, and how far, the auditor should be allowed to supply non-audit services. We cannot rehearse all the arguments here. However, we do not believe it would be right to seek to impose specific restrictions on the auditor's supply of non-audit services through the vehicle of Code guidance. We are sceptical of a prescriptive approach, since we believe that there are no clear-cut, universal answers. Whether there is a threat to auditor independence will depend on the circumstances of the case. And there may be genuine benefits to efficiency and effectiveness from auditors doing non-audit work.

36. We therefore put forward some key principles (see guidance, para 5.29) for audit committees to consider – principles which reflect the accountancy profession's existing codes of ethics. The audit committee should then develop its own policy in this area, for board approval. This may or may not include outright bans on certain services. It may include preapproval up to certain limits for others. The important point is that the policy is designed by the committee for the company's particular circumstances, with the maintenance of the auditor's independence as the overriding consideration. The policy must include proper oversight by the audit committee of non audit services provided by auditor and the committee must be satisfied that the auditors' objectivity has not been jeopardised.

37. We believe that the audit committee should carry out an annual assessment of the auditor's performance and independence before the decision on re-appointment is made. This assessment need not be laborious. Clearly, if there are *prima facie* doubts about the incumbent auditor, the assessment will need to go deeper than if everything is working well. In either case, the assessment must be serious enough to throw light on the key question: should the incumbent auditor be reappointed or should competing bids be invited? The assessment

should be formally reported to the board and taken into account in recommending the appointment of auditors to shareholders.

38. We considered whether a fuller, periodic review, such as triennially, of the audit service should be recommended, or whether there should be a "backstop" of ten years when the audit should be put out to tender. But these options have drawbacks: they can potentially reduce the effectiveness and credibility of an annual assessment; and the second risks setting a 'norm'. We therefore stand by our proposal for formal annual assessment. It may be that audit committees will want to adopt a detailed review or retender periodically, but that is for the audit committees to determine in relation to their respective circumstances.

Reporting to shareholders

39. On reporting to shareholders, it has been suggested that the directors' report in the company's annual report should include a separately identifiable section on the audit committee's activities. We support this. The report should explain how the committee fulfilled its role and its responsibilities, including any differences the committee has had with the board – for example if it has had its recommendation on the appointment of the auditor overturned. We expect this to happen rarely but we believe the possibility may have a significant and positive impact on the dynamics of the relationship between the board and the committee. Similarly, we propose that the audit committee chairman should be present at the AGM to take questions, through the board chairman, on the audit committee's activities. We have provided a specimen outline of the audit committee section of the annual report, at Appendix II. Like the specimen terms of reference, this should not be seen as a prescription and does not form part of the Code guidance.

40. Finally, the audit committee should have a special role in relation to whistle-blowing. This should be an oversight role: the committee should not deal with individual cases but should ensure that there is a satisfactory system to ensure that whistles are heard and that blowers' rights are properly safeguarded.

Specimen terms of reference for an audit committee

Constitution

1. The board hereby resolves to establish a committee of the board to be known as the Audit [*and Risk*] Committee.

Membership

2. The committee shall be appointed by the board. All members of the committee shall be independent non-executive directors of the company. The committee shall consist of not less than three members. A quorum shall be two members.

3. The chairman of the committee shall be appointed by the board from amongst the independent non-executive directors.

Attendance at meetings

4. The finance director, head of internal audit and a representative of the external auditors shall attend meetings at the invitation of the committee.

5. The chairman of the board, the CEO and other board members shall attend if invited by the committee.

6. There should be at least one meeting a year, or part thereof, where the external auditors attend without management present.

7. The company secretary shall be secretary of the committee.

Frequency of meetings

8. Meetings shall be held not less than [three] times a year, and where appropriate should coincide with key dates in the company's financial reporting cycle.

9. External auditors or internal auditors may request a meeting if they consider that one is necessary.

Authority

10. The committee is authorised by the board to:

    a. investigate any activity within its terms of reference;

    b. seek any information that it requires from any employee of the company and all employees are directed to cooperate with any request made by the committee; and

    c. obtain outside legal or independent professional advice and such advisors may attend meetings as necessary.

Responsibilities

11. The responsibilities of the committee shall be:

    a. to consider the appointment of the external auditor and assess independence of the external auditor, ensuring that key partners are rotated at appropriate intervals;

    b. to recommend the audit fee to the board and preapprove any fees in respect of non audit services provided by the external auditor and to ensure that the provision of non audit services does not impair the external auditors' independence or objectivity;

    c. to discuss with the external auditor, before the audit commences, the nature and scope of the audit and to review the auditors' quality control procedures and steps taken by the auditor to respond to changes in regulatory and other requirements;

    d. to oversee the process for selecting the external auditor and make appropriate recommendations through the board to the shareholders to consider at the AGM ;

    e. to review the external auditor's management letter and management's response;

    f. to review the internal audit programme and ensure that the internal audit function is adequately resourced and has appropriate standing within the company;

g. to consider management's response to any major external or internal audit recommendations;

h. to approve the appointment or dismissal of the head of internal audit;

i. to review the company's procedures for handling allegations from whistleblowers;

j. to review management's and the internal auditor's reports on the effectiveness of systems for internal financial control, financial reporting and risk management;

k. to review, and challenge where necessary, the actions and judgements of management, in relation to the interim and annual financial statements before submission to the board, paying particular attention to:
   i. critical accounting policies and practices, and any changes in them
   ii. decisions requiring a major element of judgement
   iii. the extent to which the financial statements are affected by any unusual transactions in the year and how they are disclosed
   iv. the clarity of disclosures
   v. significant adjustments resulting from the audit
   vi. the going concern assumption
   vii. compliance with accounting standards
   viii. compliance with stock exchange and other legal requirements
   ix. reviewing the company's statement on internal control systems prior to endorsement by the board and to review the policies and process for identifying and assessing business risks and the management of those risks by the company; and

l. to consider other topics , as defined by the board.

Reporting procedures

12. The secretary shall circulate the minutes of meetings of the committee to all members of the board, and the chairman of the committee or, as a minimum, another member of the committee, shall attend the board meeting at which the accounts are approved.

13. The committee members shall conduct an annual review of their work and these terms of reference and make recommendations to the board.

14. The committee's duties and activities during the year shall be disclosed in the annual financial statements.

15. The chairman shall attend the AGM and shall answer questions, through the chairman of the board, on the audit committee's activities and their responsibilities.

Outline report on the activities of the audit committee

1. **Role of the audit committee**

   - Main responsibilities of the audit committee

2. **Composition of the audit committee**

   - Members and secretary – names and appointment/resignation dates
   - Appointment process
   - The relevant qualifications, expertise and experience of each member

3. **Resources**

   - Any dedicated resources available to the committee, internal or bought-in

4. **Meetings**

   - Number of meetings, and attendance

5. **Remuneration of the members of the audit committee**

   - Describe the specific policies in relation to the members of the audit committee (or cross refer to the Directors' Remuneration Report)

Main activities of the committee in the year to xxxx

6. **Financial statements**

   - Describe the activities carried out in order to monitor the integrity of the financial statements

7. **Internal financial control and risk management systems**

   - Describe the activities carried out in order to review the integrity of the company's internal financial control and risk management systems

8. **External auditors**

   - Describe the procedures adopted to review the independence of the external auditors, including disclosure of the policy on the provision of non audit services and an explanation of how the policy protects auditor independence

- Describe the oversight of the external audit process and confirm that an assessment of the effectiveness of the external audit was made

- Explain the recommendation to the board on the appointment of the auditors and, if applicable, the process adopted to select the new auditor

9. Internal audit function

- Confirm that a review of the plans and work of the department was carried out. If there is no function explain the committee's consideration of whether there is a need for an internal audit function in accordance with the recommendations of the Turnbull Report.

International comparisons

We reviewed a number of codes of practice and relevant legislation in Europe and around the world. To gain a general understanding of the position in other European countries we reviewed a study commissioned by the European Commission 'Comparative study of Corporate Governance Codes Relevant to the European Union and its Member States' (January 2002), which covers a wide range of codes. Subsequent to the issue of that paper, the EU High Level Group of Company Law Experts presented their report. We also looked at developments in statutory or non statutory requirements in a number of individual EU and non-EU countries: the United States, Canada, Australia, France and Ireland.

The table attached as Appendix IIIA gives a schematic view of the position in the countries we looked at.

European Union

The **High Level Group of Company Law Experts** presented their final report in November 2002 on a Modern Regulatory framework for Company Law in Europe. This report provided guidance on the role and composition of audit committees. It recommends that a company should comply with a national code on corporate governance or company law on a "comply or explain" basis.

The report emphasises the role of a majority of independent non executive directors in the supervision of the audit of the company's accounts. It recommends the audit committee should comprise non executive or supervisory directors who are in the majority independent, and should be responsible for:

- Selecting the external auditor for appointment by shareholders and the terms and conditions of their appointment.
- Monitoring the relationship with the external auditor and the company and its executive management, in particular safeguard auditor independence.
- Monitoring the provision of non audit services: the Group sees a case for prohibiting them altogether; however, as long as they are not prohibited they should be closely monitored by the audit committee.
- Meeting at least once a quarter with the external auditor and at least once a year in the absence of executive managers.
- Ensuring that the external auditor has access to all information required to perform his role.
- Receiving auditors' management letter with comments on the financial statements and consider whether these comments should be disclosed in the financial statements.

- Reviewing accounting policies and changes thereto.
- Monitoring internal audit procedures and the company's risk management system.
- Meeting regularly with those who are responsible for the internal audit procedures and risk management systems.
- Considering what extent the findings of the risk management system should be reported in the company's financial statements.

The audit committee should have access to all internal information relevant to performing its role.

USA

Sarbanes Oxley Act 2002 legislated on the role and composition of the audit committee:

- The audit committee of an issuer of securities registered with the SEC has responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.
- It shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.
- Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.
- Each issuer shall provide appropriate funding to the audit committee.
- The audit committee must pre approve non-audit services, subject to de minimis limits.
- Auditor Reports to Audit Committees **-** The accounting firm must report to the audit committee all "critical accounting policies and practices to be used…all alternative treatments of financial information within [GAAP] that have been discussed with management …ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.
- Audit committee members must be a member of the board of directors of the issuer, and to be otherwise independent.
- The SEC shall issue rules to require issuers to disclose whether at least one member of its audit committee is a "financial expert".

The **SEC rules** are in the process of being amended to take into account the requirements of Sarbanes Oxley. Currently they require:

- *A Declaration of Independence* - issuers must specify in their proxy statements whether the audit committee members are "independent" under the new standards established by the NYSE, NASD and AMEX, as applicable. The proxy statement also must disclose, for any non-independent director, the nature of the relationship that makes the director not independent and the reasons for the board's decision to appoint such director to the audit committee.

- *An Audit Committee Charter* - the annual proxy statement must specify whether the board of directors has adopted a written charter for the audit committee and, if so, include a copy of the charter as an appendix to the proxy statement at least once every three years.
- *An Audit Committee Report* - issuers must include an audit committee report in each year's annual proxy statement. This report must state:
  - whether the audit committee has reviewed and discussed the issuer's audited financial statements with management;
  - whether the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61;
  - whether the audit committee has received the written disclosures and letter from the issuer's independent auditors relating to their independence as required by Independent Standards Board ("ISB") Standard No. 1, and has discussed with the auditors the auditors' independence; and
  - whether the audit committee has recommended to the board of directors, based on the reviews and discussions referred to in the three items above, that the audited financial statements be included in the company's annual report on Form 10-K.

The **New York Stock Exchange** issued new **r**ules in August 2002. An audit committee must:

- Have at least three independent directors, each of whom is financially literate and at least one of whom has accounting or financial management expertise.
- Have a formal written charter and code of business conduct that has been adopted and approved by the board of directors (minimum requirements).
- Assist board oversight of the integrity of the company's financial statements, the company's compliance with legal and regulatory requirements, the independent auditor's qualifications and independence and the performance of the company's internal audit function and independent auditors.
- Retain and terminate the company's independent auditors (subject to shareholder approval if applicable). The audit committee has the sole authority to hire and fire independent auditors and to approve any significant non-audit relationship with the independent auditors.
- A least annually, obtain and review a report by the independent auditors describing the firm's internal quality control procedures, any material issues raised by the most recent internal quality control

review, or any external review, and all relationships between the independent auditor and the company.

- Discuss the annual financial statements and quarterly financial statement with management and the independent auditor, including disclosure in the MD&A.
- Discuss earnings press releases as well as financial information and earnings guidance provided to analysts and rating agencies.
- Obtain advice and assistance from outside legal accounting or other advisors.
- Discuss policies with respect to risk assessment and risk management
- Meet separately, periodically, with management, with internal auditors and with independent auditors.
- Review with the independent auditor and audit problems or difficulties and management's response.
- Set clear hiring policies for employees or former employees of the independent auditors.
- Report regularly to the board of directors.
- Carry out an annual performance evaluation their work.

Ireland

The recommendations of the **Review Group on Auditing** have been incorporated into the **Companies (Audit and Accountancy)(Amendment) Bill 2001**. The bill covers public limited companies, or groups headed by plcs, unlisted or listed or large private companies, and requires the audit committee to:

- Have a majority of non executive directors and cannot be employees of the company or the Chairman of the Board.
- Have written terms of reference, covering auditor appointment, monitoring the performance and quality of the work of the auditors, the provision of non audit services by the audit firm and ensuring there is a suitably resourced internal system.
- Hold separate and joint meetings with the company's management, the company's auditors and the company's internal auditor.
- Be responsible to all the directors for all matters in relation to the discharge of its functions as set out in its terms of reference.
- Report as part of the directors' report on its activities – including its review of the performance of the company's auditors.

Other recommendations of the Review Group will be provided for either by way of secondary legislation or in a code of conduct, for example the detailed recommendations regarding the contents of the committee's charter, the relationship with internal audit and the dealing with issues reported in management letters.

France

The **Bouton Report** "Promoting better corporate governance in listed companies" was issued in September 2002. Its key recommendations regarding audit committees were:

- Rules of operation specifying responsibilities and operating procedures should be drawn up by the audit committee and approved by the board.
- The audit committee should report to the board to ensure that the board remains fully informed of the work of the committee.
- The annual report should include a description of the work of the audit committee for the given reporting period.
- Two-thirds of the members should be independent directors and no corporate officer be part of its membership.
- If the nominating committee recommends that the chairman of the audit committee be reinstated for another term, this should be subject to specific review by the board.
- Members should upon appointment be informed of the company's specific accounting, financial and operating features (in addition to their existing financial management and/or accounting expertise).
- They should interview the auditors, and CFO, heads of the accounting and treasury departments. It should be able to hold such meeting without the company's exec management being present.
- The audit committee should review the scope of consolidation and if applicable the reasons why some companies have not been included.
- The audit committee should be able to call upon outside experts if and when necessary.
- Internal audit and risk control – audit committees should examine material risks and off balance sheet commitments, interview the head of internal audit, express their view of the organisation of this department and be informed of its work programme. They should be on copy of internal audit reports or of periodic summaries of these reports.
- Regularly interview statutory auditors, including without exec being present. Audit committees should drive the process of selecting the statutory auditors, express an opinion on the amount of fees requested for statutory audit work and submit the results of the selection process to the board of directors.
- The audit committee should be informed of the amount of fees paid by the company and its group to the audit firm and its network, and ensure that the amount and the proportion that the fees represent in the billings of the audit firm and its network do not jeopardize the independence of the auditors.

- Monitor compliance with the rules designed to ensure auditor independence and that are recommended in this report.
- It must have enough time to conduct its review of the financial statements – at least two days prior to the review by the board.
- The audit committee should be provided with a report from the statutory auditors setting out the key points, not only of results but also of the accounting options that were selected with a report from the CFO describing the company's risk exposures and material off balance sheet commitments.

Canada

Canada has a mandatory requirement for companies to establish audit committees under the **Canada Business Corporations Act** where securities have been issued to the public.

The **TSX** amended its rules in April 2002 to recommend that an audit committee should be composed of unrelated directors, and all members of the audit committee will be required to be "financially literate" with at least one member of the audit committee being required to have accounting or related financial expertise. The board should adopt a charter for the audit committee which sets out the roles and responsibilities, eg:

- Relationship with and expectation of the external auditors including the establishment of the independence of the external auditor.
- Relationship with and expectation of the internal auditor function.
- Oversight of internal control.
- Disclosure of financial and related information.
- Any other matter the audit committee feels are important to its mandate or the board chooses to delegate to it.
- External auditor if ultimately accountable to the board and audit committee as representative of the shareholders.
- Board is to review and assess the adequacy of the audit committee charter on an annual basis.
- Audit committee is to discuss with auditors the quality and not just the acceptability of the company's accounting policies. The audit committee should implement structures and procedures to ensure that it meets the auditors on a regular basis in the absence of management.

Australia

The **Corporations Act** does not require Australian companies to establish audit committees. However, CLERP9 (issued Sept 2002) recommends that it will be mandatory for the top 500 listed companies to have audit committees and that the best practice standards to be developed by the ASX Corporate Governance Council should include the following key issues:

- Audit committees should have a formal written charter adopted and approved by the board of directors. The charter should stipulate matters including:
  - the structure of the audit committee;
  - the requirements for membership of the audit committee;
  - the nature and scope of the audit committee's duties; and
  - the processes to be used by the audit committee in discharging its duties.
- The composition of audit committees should be addressed to ensure that the members are independent.
- Members of audit committees should be financially literate and at least one member should have accounting or related financial expertise.
- Audit committees should have a regular schedule of meetings with a system of reporting to the Board of Directors.
- The broad duties and responsibilities of an audit committee should include the following:
  - the audit committee should review and assess the external reporting of the company;
  - the audit committee should review and monitor related party transactions and assess their propriety; and
  - the audit committee should review and assess internal processes for determining, monitoring and assessing key risk areas.
- The audit committee should review and assess key areas relating to the external audit of the company. In particular the audit committee should:
  - make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the external auditor; and
  - review and assess non-audit service provision by the external auditor, with particular consideration given to the potential for the provision of these services to impair or appear to impair the external auditor's judgment or independence in respect of the company.
- The audit committee should review and assess key areas relating to the internal audit of the company.

Where the appointment of an audit committee cannot be justified for a smaller company, as a matter of good governance, the directors of those companies should undertake the key functions of an audit committee.

The **ASX listing rules** lack a mandatory requirement for companies listed on the Exchange to establish an audit committee. However rule 4.10.2 of the ASX's listing rules requires a company to include in its annual report information whether the entity had an audit committee at the date of the directors' report and, if it did not, it must explain why and rule 4.10.3

provides that the annual report is to contain a statement of the main corporate governance practices that the entity had in place during the reporting period. Among the matters that must be addressed is one requiring an outline of the procedures the entity had in place for the nomination of external auditors, and for reviewing the adequacy of existing external audit arrangements. Where these procedures involve an audit committee, directors are required to set out or summarise the committee's main responsibilities and rights and the names of committee members.

Appendix IIIA

	EU	USA	Ireland	France	Canada	Australia
Membership						
Independent board members/non executive		•	•	• 2/3	•	•
At least one financial expert/ financial literate person		•			•	•
Duties						
Selecting/terminating contract of the auditor	•	•	•	•		•
Monitoring independence of the auditor	•	•	•	•	•	•
Monitoring auditor effectiveness						•
Monitoring/approval of non audit services	•	•				•
Being given sufficient time to carry out duties				•		
Reviewing accounting policies	•	•				
Monitoring internal audit	•	•	•	•	•	•
Reviewing risk management and internal control	•	•		•	•	•
Having authority to engage independent advisors		•		•		
Accessing information	•					
Being provided with appropriate funding by company		•				
Receiving report from/discuss with auditors on critical accounting policies…alternative treatments , key matters, management letters	•	•	•	•	•	
Establishing procedures for the receipt, retention and treatment of complaints received by the company re accounting, internal controls and auditing		•				
Receiving a report from CFO re risks and off balance sheet commitments				•		
Having a charter/terms of reference		•	•	•	•	•
Reporting to the shareholders		•	•	•		
Reporting to the board			•	•		•
Having oversight of integrity of financial statements		•	•	•	•	•
Holding regular joint and separate meetings	•	•	•	•	•	
Receiving induction training on appointment to committee				•		
Reviewing consolidation				•		

FINANCIAL REPORTING COUNCIL
Holborn Hall, 100 Gray's Inn Road, London WC1X 8AL Telephone 020·7611·9700 Fax 020·7404·4497
Website http://www.frc.org.uk

Chairman: Sir Bryan Nicholson
Deputy Chairmen: Sir John Egan Peter Wyman
Secretary: Ann Wilks

FRC PN 67 **FOR IMMEDIATE RELEASE ON 12 SEPTEMBER 2002**

PRESS NOTICE

FRC GROUP ON AUDIT COMMITTEES STARTS WORK

The Co-ordinating Group on Audit and Accounting Issues, set up by the Government to oversee and co-ordinate the response in the UK to the issues raised by recent major corporate failures in the US, reported in July. As part of the follow-up to that report, the FRC was asked to set up a small group to develop the existing guidance for Audit Committees contained in the Combined Code (which the FRC is presently responsible for keeping under review).

The Chairman of the FRC, Sir Bryan Nicholson, has now appointed the group. It will be chaired by Sir Robert Smith, Chairman of The Weir Group. The members are:

Mark Armour	Chief Financial Officer, Reed Elsevier PLC
Ted Awty	UK Head of Assurance, KPMG
Glyn Barker	Head of Audit and Business Advisory Services, PwC
Richard Delbridge	Formerly Group Chief Financial Officer, NatWest Group
Richard Fleck	Partner, Herbert Smith and Vice-chairman, Auditing Practices Board
David Rough	Formerly Group Director (Investments), Legal & General

The group will work closely with Derek Higgs' review of the role and effectiveness of non-executive directors, and with the Auditing Practices Board, and will take account of the recommendations made by the Co-ordinating Group on Audit and Accounting Issues.

The group plans to start its work immediately and to complete it by the end of the year. The group would be glad to receive views as soon as possible on the issues set out in its terms of reference, attached.

Notes to Editors

1 The Financial Reporting Council's role is to promote good financial reporting and to act as the overarching and facilitating body for its two operational bodies, the Accounting Standards Board (ASB) and the Financial Reporting Review Panel.

2 The Co-odinating Group on Audit and Accounting Issues issued its interim report in July. It is available on the DTI website, ref URN 02/1092. The FRC's reaction was given in FRC Press Notice 66 of 24 July 2002.

3 Comments should be sent to: Charles Bridge, Assistant Secretary, Financial Reporting Council, Holborn Hall, 100 Gray's Inn Road, London WC1X 8AL, email c.bridge@asb.org.uk, telephone 020 7611 9706.

END

Press Enquiries: Charles Bridge, FRC Assistant Secretary, on 020 7611 9706

FRC GROUP TO DEVELOP COMBINED CODE GUIDANCE FOR AUDIT COMMITTEES: TERMS OF REFERENCE

To develop the guidance on Audit Committees in the Combined Code, alongside Derek Higgs' review of the role and effectiveness of non-executive directors, taking into account recommendations made by the co-ordinating group on audit and accounting issues in its interim report to government.

In addition to the principle and provisions in the Code the FRC Group will seek to clarify the role and responsibilities of Audit Committees by developing guidance on

- Terms of reference for Audit Committees including guidance on Committee activities and proceedings

- The composition of the Audit Committee, paying due regard to the characteristics which members would need to have to ensure independence from the executive, to avoid conflicts of interest and to achieve a suitable balance of skills and experience;

- The competences required for the proper exercise by individual Audit Committee members of their responsibilities; including any training needs, and the time required to discharge those responsibilities;

- The relationship between the Audit Committee and the full Board;

- Safeguarding the interest of shareholders, including for example any report from the Audit Committee directly to shareholders;

- Monitoring the company's financial controls and financial policies;

- Establishing an effective working relationship with the auditors;

- Criteria for reviewing the effectiveness of the audit and its value to shareholders and other stakeholders;

- Recommending to shareholders the auditors' appointment and reappointment, approving the auditors' remuneration;-the use of the auditors for non-audit work, including the purchasing policy for any such use, the policy for tendering for audit services and the means of reporting on these activities;

- The relationship with the company's head of internal audit and the internal audit team. The prior approval of the appointment and dismissal of the head of internal audit.

Any other relevant matters drawn to the FRC Group's attention in the course of the review.

In reviewing these aspects, the Group should liaise closely with Derek Higgs, and with the Auditing Practices Board. The Group should report by the end of 2002.

Financial Reporting Council
September 2002

Consultation respondents

The Association of British Insurers
The Association of Chartered Certified Accountants
Barclays Global Investors
The Confederation of British Industry
Central Finance Board
Cooperative Insurance Society
Coal Pension Trustees
Deloitte & Touche
Deutsche Asset Management
Ernst & Young
Foreign and Commonwealth
Gartmore Investment
Grant Thornton
Henderson Global Investors
Hermes Investment Management
The 100 Group of Finance Directors
The Institute of Chartered Accountants in England and Wales
The Institute of Chartered Accountants in Ireland
The Institute of Chartered Accountants of Scotland
The Institute of Chartered Secretaries and Administrators
The Institute of Internal Auditors
KPMG
London Stock Exchange
Morley Fund Management
National Association of Pension Funds
Newton
PricewaterhouseCoopers
The Quoted Company Alliance
Schroder Investment Management
Trades Union Congress
Universities Superannuation Scheme

Duncan Alexander
Eric Anstee
P L Bunting
Professor Stewart Hamilton
Kevin Lomax
David Mallett
Dame Pauline Neville-Jones
Lord Sharman