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cutting through complexity

AUDIT COMMITTEE INSTITUTE

Audit Committee Handbook

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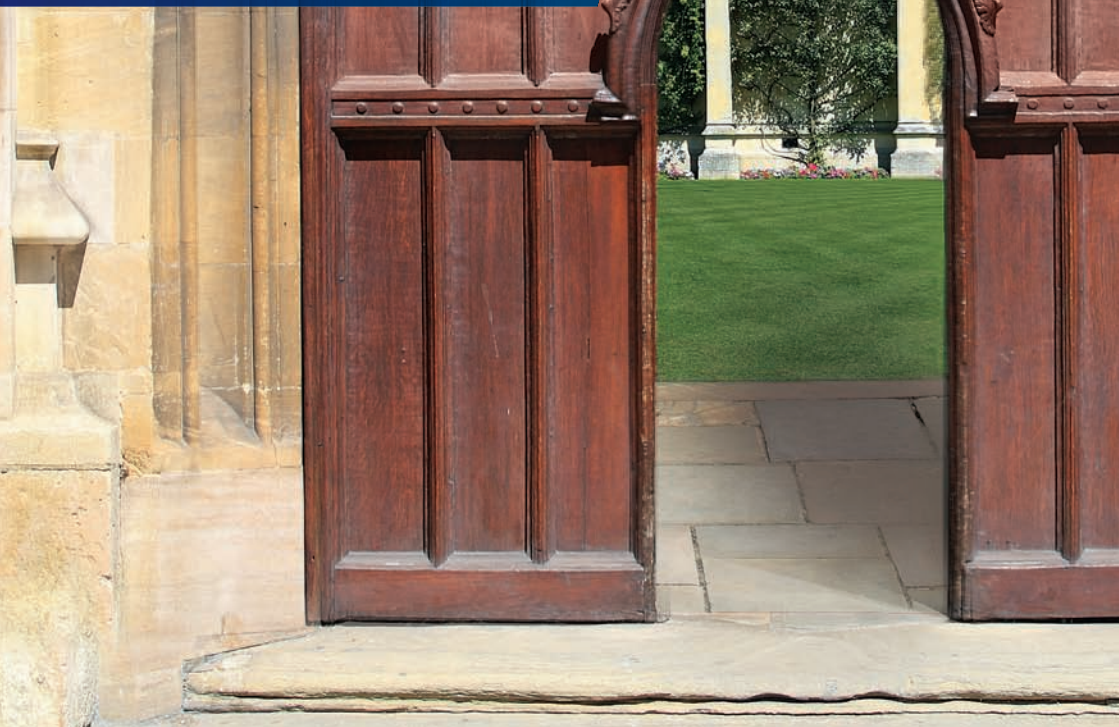

"An audit committee is essentially an oversight committee, for it is management who are responsible for the internal controls and the financial statements.

The committee, however, has to satisfy itself, on behalf of the Board and ultimately the shareholders, that key controls are operating, that ethical practices are being reinforced, that key accounting estimates and judgements are being properly made and that internal and external audits are effective."

Audit Committee Chairman

Audit Committee Handbook

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About the
Audit Committee Institute

Recognising the importance of governance issues, the Audit Committee Institute (ACI) was created to serve both audit committee members and non executive directors to help them to adapt to their changing role.

Sponsored by KPMG, the ACI provides knowledge to audit committee members and non executive directors and is a resource to which they can turn for information or to share experience.

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FOREWORD

David Meagher
Chairman, Audit Committee
Institute Ireland

Corporate governance excellence continues to be an important element of business, both in the Ireland and across the globe. Expectations of stakeholders have never been higher, and the scrutiny by regulators and investors never more stringent. As a consequence, the role of the audit committee has rapidly increased in importance and expanded in scope.

In today's complex and evolving business environment, audit committees can make a strong contribution to a 'no surprises' environment and an effective audit committee can be a key feature of a strong corporate governance culture, bringing significant benefits to an organisation.

Such committees are supported by fundamental building blocks: an appropriate structure and foundation; reasonable and well defined responsibilities; an understanding of current and emerging issues; and a proactive, risk-based approach to its work.

Carefully designed practices can also help an audit committee to maximise its contribution to an organisation. However, it is important that each board and audit committee should assess its own circumstances, governance structure, financial complexity, maturity and issues – when defining its specific audit committee practices. Practices that work best for one organisation may not be ideal for another – especially in a governance environment where culture, risk and governance needs can vary dramatically from organisation to organisation. Nevertheless, certain guiding principles underlie the effectiveness of every audit committee and the right principles can help to ensure that 'company specific' practices are applied effectively – that is, by the right people with the right information, processes and perspectives.

This publication, applicable to organisations in either public or the private sectors, articulates the principles underlying the audit committee's role and provides non-prescriptive guidance to help audit committees gain a better understanding of the processes and practices that help create effective audit committees.

The Irish regulatory landscape is explored in chapter one while the composition of the audit committee and the procedures and practices that provide the support and structure necessary to discharge an audit committee's duties, are discussed in chapter two.

Chapter's 3 to 8 focus on the duties of the audit committee: monitoring the corporate reporting process; monitoring the effectiveness of internal control and risk management systems; monitoring the effectiveness of internal and external audit; and communication with shareholders.

At the back of this book are a number of appendices that are intended to provide practical support to audit committees – most of them can also be found in Word format on the Audit Committee Institute Ireland website.

I hope this publication provides practical guidance to help audit committees to identify and achieve their objectives and add value to the board of directors, the organisation and its stakeholders.

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THE IRISH REGULATORY LANDSCAPE

CHAPTER 1

This chapter intends to give an overview of regulations and guidelines applicable to the audit committees of listed entities in Ireland. Organisations, such as state bodies and regulated financial institutions, need to be mindful of regulation and guidance impacting their specific circumstances, but generally this will not be inconsistent with the principles enshrined in the regulations discussed below.

The Financial Reporting Council's Corporate Governance Code

The Irish Stock Exchange (ISE) has endorsed the Financial Reporting Council's (FRC's) UK Corporate Governance Code ('the Code') as setting the standard for corporate governance internationally and its Listing Rules require issuers to apply the Code supplemented by its Irish Corporate Governance Annex. Hence for Irish companies, the primary guidance currently applicable to audit committees is that set out in the Code as issued by the FRC in September 2012. The Irish Corporate Governance Annex adds two specific disclosure requirements but does not in other ways add to the Code's provisions on audit committees.

The Code is considered best practice for organisational corporate governance and is based on the principles of accountability, transparency, probity and focus on the sustainable success of an entity over the longer term. It consists of 18 main corporate governance principles, supporting principles and 53 detailed provisions. Adherence to the Code is not mandatory; rather it provides an overarching framework for good corporate governance.

The FRC's Corporate Governance Code (September 2012)

Those elements of the Code that specifically address the role of the audit committee are:

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors. (Main Principle C.3)

The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. (Provision C.3.1)

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

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;

- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and
- to report to the board on how it has discharged its responsibilities. (Provision C.3.2)

The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. (Provision C.3.3)

Where requested by the board, the audit committee should 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. (Provision C.3.4)

The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action. (Provision C.3.5)

The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report. (Provision C.3.6)

The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. 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. (Provision C.3.7)

A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
- 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; and
- if the auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded. (Provision C.3.8)

Irish Corporate Governance Annex

Elements of the Annex addressing audit committees are as follows:

5.1 Companies should include a meaningful description of the work carried out by the audit committee during the financial year. Issuers should not simply recycle the committee's terms of reference, which are required to be made available to investors in accordance with provision C.3.3 of the UK Code.

5.2 The description should, in particular, explain the work done by the Committee relating to the oversight of risk management on behalf of the board. If the board has assigned work on risk management to a specific risk committee, a meaningful description of the work carried out by that committee should also be included.

The Listing Rules

The Irish Stock Exchange's Listing Rules require all companies listed on its Main Securities Market with Premium Listed securities to report on how they apply the 18 main corporate governance principles and confirm the extent of their compliance with the 53 detailed provisions and explain the rationale behind any non-compliance– the so-called 'comply or explain' framework. An equivalent provision in the UK Financial Conduct Authority's Listing Rules applies to Irish companies that have a Premium Listing on the London Stock Exchange. In effect, for listed companies the Listing Rules give the Code 'teeth'.

The Statutory Audit Directive

Until recently, specific audit committee practices, and indeed the requirement for companies to have an audit committee, were not mandated. However, this changed when the Statutory Audit Directive (Directive 2006/43/EC), published by the European Commission in 2006, set audit committees on the path to becoming a key feature of the legislative governance framework of all EU Member States.

In an effort to help ensure investors and other interested parties can rely fully on the accuracy of audited accounts the Statutory Audit Directive required each Member State to enact legislation requiring public-interest entities – primarily companies whose securities are admitted to trading on a regulated market but also credit institutions and insurers – to have an audit committee (or similar body) composed of non-executive directors; and that that audit committee carry out certain specified tasks that were broadly consistent with those set out in the UK Corporate Governance Code. In Ireland the Directive's rule relating to audit committees were implemented by statutory instrument, in the European Communities (Statutory Audits) (Directive 2006/43/EC) Regulations 2010 (SI 220/ 2010), whose provisions require that issuers (and, subject to a number of exemptions, other public interest entities) must:

- appoint an audit committee consisting of at least two independent directors, with responsibility for performing the functions set out below and ensure that at least one member of the committee has competence in accounting and/or auditing.
- ensure that the audit committee's functions at least include:
  - the monitoring of the financial reporting process;
  - the monitoring of the effectiveness of the entity's systems of internal control, internal audit and risk management;
  - the monitoring of the statutory audit of the annual and consolidated accounts; and
  - the review and monitoring of the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

In addition, any proposal of the board of directors of a public-interest entity with respect to the appointment of a statutory auditor or audit firm to the entity shall be based on a recommendation made to the board by the audit committee.

Banks, other credit institutions and insurers are also required to apply the relevant Corporate Governance Code issued by the Central Bank of Ireland.

The UK took a different approach and, for listed companies, implemented the Directive via Chapter 7.1 of the Disclosure and Transparency Rules (DTR) issued by the Financial Services Authority (the current Financial Conduct Authority's predecessor body).

At the time of implementing the Statutory Audit Directive, the Financial Services Authority confirmed its view that compliance with the relevant provisions of the UK Corporate Governance Code would result in compliance with the requirements of the DTR – and hence those of the Directive. Though no specific public statement to that effect has been made by a regulatory body in Ireland, the same view can be taken in relation to SI 220's provisions relating to audit committees.

Rules, regulations and guidance

The rules, regulations and guidance for audit committees are set out in four places:

- ISE Listing Rule 6.8.3 (which includes the 'Comply or Explain' requirement) (UK: FCA Listing Rule 9.8.6);
- Provisions 5.1 and 5.2 of the ISE Irish Corporate Governance Annex;
- Regulation 91 of SI 220 the European Communities (Statutory Audits) (Directive 2006/43/EC) Regulations 2010 (UK: FCA Disclosure and Transparency Rules Chapters 7.1 and 7.2 (which include the requirement to have an audit committee and certain mandatory disclosures); and
- The FRC's UK Corporate Governance Code.

Audit committees should also be familiar with four other pieces of FRC guidance that will help them to apply elements of the Code. They are:

- *Guidance on Audit Committees* - This guidance provides direction on how companies might apply and comply with the Code provisions and principles relating to audit committees.
- *Internal Control: Guidance to Directors* - This Guidance sets out best practice in internal control and assists companies in applying section C.2 of the FRC's Corporate Governance Code. This has not been revised since 2005 and in 2011, the FRC were intending to hold a series of meetings to establish its continued suitability.
- *Guidance on Board Effectiveness* - This Guidance is intended to stimulate boards' thinking when considering how they are applying the leadership and effectiveness sections of the FRC's Corporate Governance Code.
- *Going Concern and Liquidity Risk* - This Guidance brings together the requirements of the Listing Rules, UK company law and accounting standards, and provides further assistance on their application. For Irish listed companies, its commentary and guidance is relevant in meeting the ISE Listing Rule requirements on going concern and to support other Irish companies' application of accounting standards and company law provisions on going concern. Chartered Accountants Ireland has also issued, with the FRC's support, an equivalent guidance document 'title tba'.

Corporate governance regulation and guidance continues to evolve with initiatives from Europe and elsewhere impacting business. However, this chapter has detailed the cornerstone of governance regulation that is applicable to audit committees. For up to date developments in this area please refer to www.kpmg.ie/aci or email aci@kpmg.ie to be placed on our mailing list.

CREATING AND SUSTAINING AN AUDIT COMMITTEE

CHAPTER 2

Look at the governing structure of most large organisations and you are likely to find an audit committee. They are generally regarded as an indicator of good governance, however, as many recent, well publicised corporate governance failures have demonstrated, having an audit committee does not, or itself, guarantee good governance.

Audit committees are formed by the board of an organisation (when referring to the board we also include, governing body, council, etc.) and will normally be composed wholly or partly of board members.

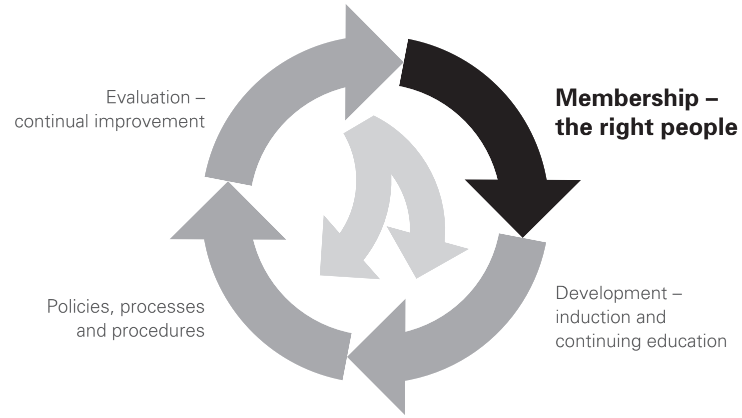
In the main, audit committees are constituted to help to discharge the board's responsibility for adequate and effective risk management, financial reporting, control and governance. How an audit committee fulfils this remit varies according to the abilities and behaviours of its members, the clarity of the committee's mission, and the tone set at the top of the governance structure. However, certain characteristics and practices mark a strong, effective audit committee.

Audit committees should view these characteristics, not as elements carved in stone but, as components in a process that can and should be continually improved to enhance the committee's effectiveness.

> *"The audit committee is not a supervisory board, despite attempts to make it one. The audit committee is a committee of the board and should not usurp or take on the board's role and authority."*
>
> Audit Committee Chairman

MEMBERSHIP

The Audit Committee Cycle



Terms of appointment

The terms of appointment of an audit committee member should be clearly set out at the time of appointment. All members of the audit committee should have a clear understanding of:

- what will be expected of them in role, including time commitment;
- how their individual performance will be appraised (including a clear understanding of what would be regarded as unsatisfactory performance and the criteria that would indicate the termination of membership); and
- the duration of their appointment and how often it may be renewed.

How many members?

The size of the audit committee will vary depending on the needs and culture of the organisation and the extent of responsibilities delegated to the committee by the board. Too many members may stifle discussion and debate. Too few may not allow the audit committee chair to draw on sufficient expertise and perspectives to make informed decisions.

The objective is to allow the committee to function efficiently, encourage all members to participate and to ensure that there is an appropriate level of diversity of skill, knowledge and experience.

Numbers of audit committee members

	Lower quartile	Median	Upper quartile		Lower quartile	Median	Upper quartile
ISE	3	4	4	ESM	2	3	3

*The above analysis is based on the most recently published annual report and accounts of each company as of June 2013

Co-opted members

In the public sector it is common practice for audit committees to co-opt members with particular expertise or experience who are not members of the board or governing body. These non-board members act as 'experts' and bring new and/or different perspectives to the board.

Such arrangements arguably:

- allow the audit committee to draw from a larger pool of industry or accounting expertise;
- give the audit committee greater independence; and
- provide potential future board members with experience and allow the board to assess their suitability for full board membership.

Others argue that such arrangements can more easily allow audit committees to abrogate responsibility for important complex decisions to the 'experts' on the audit committee and that these independent 'advisers' could quickly transform into shadow-directors. There are also questions around the legal liability such positions attract, as generally boards remain legally responsible for the matters addressed by audit committees, and the information made available to 'co-opted' members, may be very different from that provided to those who are full board members. Finally, at least for larger organisations, a need to bring in external committee members might indicate that the board itself does not have the mix of skills and experience that it needs, in which case the problem might be better addressed at board level, not committee level.

Where co-opted members are appointed only to the audit committee and not the board of directors, they will have to make particular efforts to obtain and maintain an appropriate understanding of the organisation.

In this respect, appropriate induction training is critical, as is an ongoing programme of activity to ensure that members maintain sufficient contact with the organisation. Where appropriate, co-opted members should be copied in on the minutes of the board of directors and the papers prepared for board meetings. Co-opted members are not normally appointed as the committee's chair, since the chair would expect to attend, as of right, all board meetings.

Appointments to the audit committee, including co-option arrangements, should be transparent and should be made by the board on the recommendation of the nomination committee, in consultation with the audit committee chair. Terms of three years, with staggered expiration dates to help ensure continuity, are common.

Notwithstanding the arguments for and against co-opted members, it is helpful for audit committees to bring in experts to advise the committee on specific issues when required.

Rotation policy

Rotation of audit committee members can provide a practical way to refresh and introduce new perspectives to audit committee processes. Rotation also creates the opportunity for more members of the board to gain a greater and first-hand understanding of the important issues dealt with by the audit committee, thus contributing to greater understanding on the board. However, given the complex nature of the audit committee's role, rotation needs to be balanced with the desire to have members who possess the necessary skills and experience to discharge their responsibilities effectively.

Independence

Independence is one of the cornerstones of the committee's effectiveness, particularly when overseeing areas where judgements and estimates are significant. Audit committee members must be adept at communicating with management and the auditors and be ready to challenge and ask probing questions about the company's risk management and control systems, accounting and corporate reporting.

It is up to the board to assess the integrity and independence of an audit committee candidate, so every member's appointment is an occasion for careful deliberation. The board should have a strong understanding of the relevant definitions of independence and how a lack of independence occurs and is interpreted in practice. Independence issues are often most prevalent with respect to business relations. The board should also be cognisant and mindful of situations in which the definition of independence is met; yet perceived conflicts of interest may still arise.

When determining the independence of an audit committee member, the board might consider whether any material relationships or circumstances are likely or could appear to affect the person's judgement.

Such relationships and circumstances may occur if the individual has, for example:

- been an employee of the organisation or group within (say) the last five years;
- had within (say) the last three years, a material business relationship with the organisation either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- received or receives additional remuneration from the organisation apart from a director's fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme;
- close family ties with any of the organisation's advisers, directors or senior employees;
- cross directorships or has significant links with other directors through involvement in other organisations;
- a significant shareholding; or
- served on the board for more than (say) nine years from the date of their first election.

Financial expertise

At least one member of the audit committee should have recent and relevant experience in finance, accounting or auditing. What constitutes such experience will, of course, vary from organisation to organisation, and each board should determine its own criteria having regard to appropriate regulation. In many cases 'recent and relevant' must go beyond basic familiarity with financial statements.

Members must be able to understand the rules and, more importantly, the principles underpinning the preparation of the financial statements and the auditor's judgements. They must be prepared to invest the time necessary to understand why critical accounting policies are chosen and how they are applied, and satisfy themselves that the end result fairly reflects their understanding. As such, past employment experience in a significant financial role or one that included oversight responsibilities for financial reporting, or a qualification in finance or accounting might be appropriate.

While financial literacy is a great asset for an audit committee member, not every member need have recent and relevant experience in finance, accounting or auditing. Indeed, there is great value in having committee members from diverse backgrounds who are not afraid to ask simple questions such as 'Why is that the case?', 'What would one expect to see?' and 'Tell me again because I still don't understand.' These are good, simple questions that can easily be overlooked by more financially literate audit committee members. Nevertheless, the committee as a whole must possess sufficient financial acumen to discharge its responsibilities effectively.

Collective experience vs individual experience

While national rules or codes often stipulate that at least one member of the audit committee must possess the requisite financial experience, some organisations choose to rely on the collective experience of the audit committee as a whole. This raises the question of who has what experience? Does each committee member have a particular area of expertise, such that it is only when they come together as a whole they have the necessary recent and relevant financial experience? Or, by stating that they rely on the collective experience of the audit committee, are they ensuring that no one director can be held more liable than another by virtue of experience and knowledge?

Meeting attendance is also relevant to the financial expert debate. If an audit committee relies on its collective experience then what happens if one member does not attend a meeting? Does this mean that they do not have the requisite experience to operate? Equally, those audit committees that have identified one member as having the recommended experience need to be cautious of holding meetings when that individual is not in attendance. It is perhaps not surprising that companies commonly identify the audit committee chairman as the 'financial expert'.

Other skills, experience and personal attributes

In determining the composition of the audit committee, it is important to balance formal qualifications with consideration of personal qualities and relevant experience. What has been highlighted, since the 2007/8 financial crisis, is that there should be an appropriate balance of skills and experience on the board (and by implication its committees) to enable the board to discharge its duties effectively.

Generally, an audit committee member should possess certain attributes such as:

- integrity and high ethical standards;
- strong interpersonal skills;
- sound judgement;
- the ability and willingness to challenge and probe; and
- the time and personal commitment to perform effectively.

> *"Probably the most important point for an audit committee member to remember is never to assume that others understand something you cannot fathom. Always ask for an explanation and persevere until you do understand. You will be surprised how often your colleagues find the answer illuminating and adding to their knowledge."*
>
> Audit Committee Chairman

Members should have experience pertinent to the business. So for example, given the complex nature of the banking industry it would be desirable for audit committee members to have previous experience of that particular sector.

A committee's effectiveness is certainly enhanced by, and is often dependent upon, the member's experience, knowledge and competence in business matters, financial reporting, and internal control and auditing. It is important that the audit committee is not reliant solely on management to provide it with such experience.

> *"Audit committees and indeed auditors should remember the Latin origin of their title, which is 'listener'. 'Listening' is the prerequisite to balanced analysis, judgement and challenge… but is often given too little time in our pressured and regulated schedules."*
> Audit Committee Chairman

Conflicts of interest

Audit committee members, including co-opted members, should declare any matter in which they have an interest. Normally, the process for recording declarations of conflicts of interests in the audit committee should mirror that used by the board. Each member of the committee should take personal responsibility for declaring proactively, at the outset of each meeting, any potential conflict of interest relating to business arising on the committee's agenda or from changes in the member's personal circumstances. The chair of the audit committee should then determine an appropriate course of action with the member. For example, the member might simply be asked to leave while a particular item of business is taken, or in more extreme cases the member could be asked to step down from the committee.

If it is the chair that has a conflict of interest, the board should ask another member of the committee to lead in determining the appropriate course of action. A key factor in determining the course of action is the likely duration of the conflict of interest: a conflict likely to endure for a long time is more likely to indicate that the member should step down from the committee.

The audit committee chair

Effectiveness and true independence often hinge on the chair's effectiveness. The essential characteristics of a strong chair are often personal attributes. The chair should be recognised for his or her leadership and vision, and be perceived by other committee members and management as able to set and manage the audit committee's agenda. The chair should be acknowledged as having the personal courage to raise and deal with tough issues and support other members to do the same.

Formal meetings of the audit committee are at the heart of its work. They are not, however, its only point of contact with the company. The audit committee chair and, to a lesser extent, the other audit committee members, need to keep in touch with key audit committee stakeholders such as the board chairman, chief executive officer, chief financial officer, chief risk officer, the external audit partner and the chief internal auditor. In many companies, the audit committee chair meets regularly with each of these individuals as part of the process of developing the meeting agenda and preparing for each meeting. A successful audit committee chair should not only understand the importance of the audit committee's relationship with these individuals but also have the interpersonal skills to build and maintain effective working relationships.

> *There are two extremes of corporate environment for the audit committee chair role. The mature, well resourced company with good system, which is on top of the ever evolving governance environment and the relatively under resourced company, which tends to be behind the curve in terms of evolving governance. The former requires authoritative leadership to keep everything sharp and value adding whereas the latter can require quite exhaustive mentoring.*
> Audit Committee Chairman

The characteristics of an effective audit committee chair might include being:

- an independent proactive leader with confidence and integrity;
- a highly respected and experienced board member, who possesses strong financial literacy skills and time available to develop and closely monitor the committee agenda;
- a person with an excellent working knowledge of an audit committee's functions and risk management frameworks;
- a good listener and communicator who can facilitate successfully;
- able to champion open and frank discussion with discipline; and
- tenacious and prepared to ask the tough questions.

It is extremely unlikely that an audit committee would hold a meeting without its chair present. This is why it is sometimes suggested that the audit committee member with the highest level of financial acumen should chair the committee. Of course, this need not be the case, although it could be argued that as the chair may have more perceived authority it would make sense. The chair's role is not to do all the work; rather, the chair should engage other members in the work of the committee by asking them to take responsibility for specific aspects and recognise their contribution.

Eight steps to effective audit committee chairmanship	
1. Get the committee membership 'right'	• Ensure the skills, knowledge and experience of committee members is appropriately diverse and up to the task. • Don't dismiss so-called soft skills. • Ensure appropriate succession plans are in place for the chair and committee members.
2. Ensure committee members (and the committee as a whole) are 'up-to-speed'	• Identify learning needs and knowledge gaps. • Ensure each member has a tailored professional development plan. • Ensure the committee has access to outside experts and other specialists.
3. Ensure the committee has constructive relationships with management, auditors and other advisors	• Engage in informal meetings/dialogue with management, auditors and advisors to build empathy. • Make full use of the 'in camera' private sessions at each audit committee meeting by planning ahead. • Attend 'away days' and use social functions constructively to deepen relationships. • Attend meetings in the business to deepen understanding of issues and provide context for committee meetings. • Ensure key management (operational heads, individuals responsible for key risks, etc.) attend and present at meetings. • Ensure the 'marzipan layer' of management is appropriately engaged.
4. Create solid ground rules for meetings	• Address issues, not personalities. Focus on what is right – not who is wrong. • Don't use the audit committee meeting to address matters that should be raised in board or management meetings. • Avoid the use of 'jargon' and keep to the point – don't be ambiguous or go off the topic being discussed. • Do not use audit committee meetings to demonstrate superior intellect, knowledge or excellence. • Be positive and constructive – only disagree by making a constructive suggestion.
5. Ensure the committee has access to the 'right' information	• Work with members to ensure committee papers, access to management and other information flows are appropriate. • Ensure papers: – are timely – prioritise the key issues – are well signposted – include appropriate benchmarking and trend data – are understandable – i.e., not overly long or complex.
6. Ensure the right conversation around the audit committee table (see below)	• Plan the style and content of the audit committee conversations ahead of time. • Ensure every conversation has 'clarity of purpose'. • Make time for both 'hard' and 'soft' subjects, for decision and reflection, for introspection and evaluation. • Ensure the routine business of the audit committee does not crowd out the critical issues. • Ensure the overall agenda is not so tight that it cannot adjust to include 'special business' or matters raised by individual audit committee members.
7. Ensure the committee is exposed to broad external perspectives	• Use external experts to present/discuss specific risk, business or macroeconomic issues. • Ensure investor views on management, the organisation and the sector are understood.
8. Evaluate performance on an ongoing basis as well as formal periodic reviews	• Observe, question and resolve as required. • Engage in one-to-one sessions with members and committee attendees. • Use an independent third party to evaluate committee performance every (say) three years.

"Whatever the environment, the audit committee is the pinnacle of constructive top down pressure that goes to support professionalism in a complex multi faceted business environment. A key aspect of which lies with the authority that the committee chair conveys in the handling of the committee and it agenda and how it communicates to both management and the board what it has reviewed and its conclusions and recommendations relating thereto."

Audit Committee Chairman

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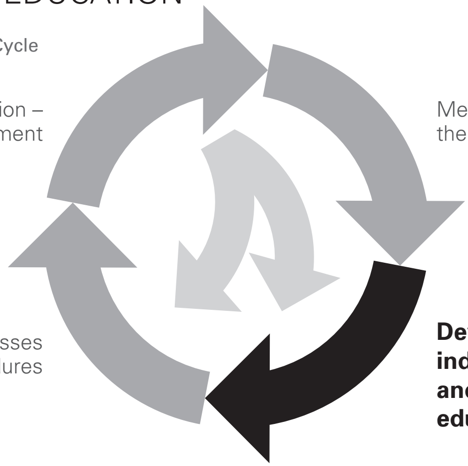
DEVELOPMENT – INDUCTION AND CONTINUING EDUCATION

The Audit Committee Cycle



Since the financial crisis of 2007/8 the skills, experience and continuing education of board directors has come under the spotlight. Does an individual director contribute to the effectiveness of the audit committee? Do they have the skills, experience and personal characteristics to discharge their role competently?

Induction

It is good practice to provide a formal induction programme for new members. The chair and/or secretary to the committee should ensure that the programme is tailored to suit the individual's specific needs. So, whilst all will require induction into the organisation itself, a director that is taking on their first audit committee role may need something different from a seasoned audit committee chair.

> *When I joined the board the Chairman asked me to join the Audit Committee. He said it would be hard work but it would be the best and fastest way to find out how the company worked. He was right on both counts.*
>
> Audit Committee Chairman

Induction programmes help to ensure audit committee members understand their responsibilities, current issues and the circumstances of the particular organisation. The programme may include meetings with senior management and site visits – the objective of which is to give new board members an insight into the operation of the business. Given the complex nature of the audit committee's role, additional time may be spent with

new audit committee members to help ensure that they are aware of their particular responsibilities and the expectations of the board.

An induction programme might include inter alia:

- Providing copies of:
  - the committee's terms of reference and recent committee minutes and presentations to the board;
  - relevant company policies, including the code of conduct and whistle-blowing policy;
  - the most recent annual and interim reports to shareholders;
  - a summary risk register;
  - management's and any auditor's report on the effectiveness of internal control over financial reporting;
  - recent press releases, material change reports and correspondence with any securities regulatory authorities or other regulatory bodies;
  - the internal audit terms of reference, work plan and recent reports to the audit committee; and
  - the external auditor's work plan, the most recent year end report to the audit committee and the more recent management letter.
- Obtaining an explanation from management and the internal auditor of the company's control, risk and compliance frameworks.
- Meeting with management to discuss current audit and financial reporting issues including significant accounting policies and estimates, unusual transactions, outstanding contingencies and litigation.
- Being introduced to the internal and external auditors. Written materials should support oral presentations so that the new audit committee member has appropriate reference materials and tools as a result of the induction programme.

Newly appointed members may feel overwhelmed if they are given all the necessary information on their first day. It is important that the company secretary, or appointed person, plans the director's induction so that the programme can be staggered over a suitable time period. After a few months, individuals should be given the opportunity to review the induction programme and raise questions on any areas.

Ongoing professional development

Even in times of uncertainty, the one thing that organisations can be certain of is that change is constant – not only in the area of financial reporting but also in regulatory compliance, technology and business risk. The chairman, committee chair and individual director are all responsible for monitoring professional development requirements. A robust audit committee evaluation process should also highlight development needs of individual directors or of the audit committee as a whole.

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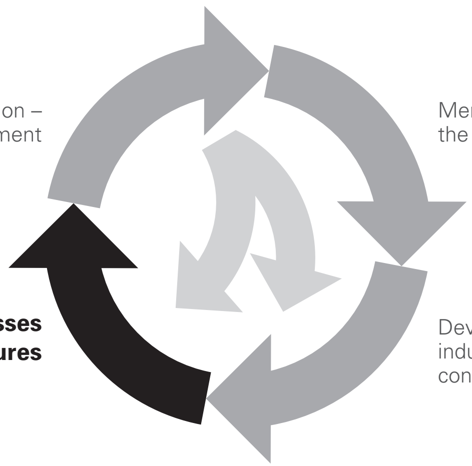
All members should seek periodic continuing professional education both inside and outside of the audit committee. The secretary to the committee might be tasked with ensuring the appropriate development opportunities are made available to audit committee members, whether through in house briefings or externally organised seminars. The most common means of updating the audit committee is through briefings by internal and external audit, the audit committee chair, the company secretary and the chief financial officer (CFO). In addition many members attend external courses and conferences.

> *"Understanding the context of the big decision is essential. Knowing the business and the capabilities of the people who will implement the decision, getting inputs from outside advisors and assessing the alternatives are vital for an effective challenge and an informed judgement."*
> Audit Committee Chairman

Co-opted members have to make particular efforts to obtain and maintain an appropriate understanding of the organisation. Induction and an ongoing programme of activity to ensure that co-opted members maintain sufficient appropriate contact with the organisation are critical. Where appropriate, co-opted members should be copied in on the both the board packs and the minutes of the board meetings.

POLICIES, PROCESSES AND PROCEDURES

The Audit Committee Cycle



Terms of reference

The audit committee terms of reference should set out the main role and responsibilities of the committee. In terms of responsibilities, most audit committees would assume the following:

- To monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- To review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- To monitor and review the effectiveness of the company's internal audit function;
- To make recommendations to the board in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- To review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements;
- To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

The audit committee's terms of reference should be clear on the scope of the committee's responsibilities and how these should be discharged. The role of the audit committee is ultimately for the board to decide subject to any regulatory or legislative requirements. However, it is essential for the audit committee to be independent, have sufficient authority and resources to form an opinion and report on the organisation's risk management, control and governance arrangements.

> *"Focus on the processes supporting the adequacy of the risk management framework, the internal control environment and the integrity of reporting. Resist 'mission creep' into using the outputs of these processes, as that is the full Board's role."*
> Audit Committee Chairman

An audit committee's terms of reference should be tailored to the company's specific needs and should clearly outline the committee's duties and responsibilities; and the structure, process and membership requirements of the committee. Ideally, it should describe the background and experience requirements for committee members and set guidelines for the committee's relationship with management, the internal and external auditors, and others.

In addition, the audit committee's terms of reference should be co-ordinated with the responsibilities of other committees in the organisation – finance committee, remuneration committee, governance committee, risk management committee, and other committees focused on a particular risk (e.g., investment committee or environment, health and safety committee). These committees may be required to consider the same issue from different perspectives. Care should be taken to define clearly the roles and responsibilities of each committee, when collaboration is required, whether cross-membership is allowed, and whether the audit committee chair or members might attend other committee meetings as an observer (and vice versa).

The terms of reference should be detailed enough to clarify roles and responsibilities and include items that can be reasonably accomplished. However, audit committees should be mindful of the potential implications of increased workload and make sure they are not undertaking so many responsibilities that cannot be reasonably achieved, or that may subject committee members to future liability. Audit committees should guard against becoming the 'dumping ground' for new responsibilities. They should be mindful of accepting responsibilities that rightfully reside with the board of directors as a whole. It should be remembered that the audit committee is not a body that makes binding decisions in its own right: the committee exists exclusively to assist the board in discharging its responsibilities.

To help ensure that the audit committee's effectiveness is not impaired by an increased workload, it is crucial that the audit committee – and indeed the board – robustly review the terms of reference on an annual basis. This annual assessment should highlight any changes to the organisation's circumstances and any new regulations or leading practices that may affect the committee's remit. The review may be incorporated into the self-evaluation process that the audit committee undertakes.

> *An audit committee is essentially an oversight committee, for it is management who are responsible for the internal controls and the financial statements. The committee, however, has to satisfy itself, on behalf of the Board and ultimately the shareholders, that key controls are operating, that ethical practices are being reinforced, that key accounting estimates and judgements are being properly made and that internal and external audits are effective.*
>
> Audit Committee Chairman

Appendix 2 includes an example audit committee terms of reference. Our intention is not to advocate an exhaustive terms of reference. Rather, the example is intended to help audit committees and boards of directors in evaluating the completeness of their terms of reference for their specific circumstances. It should serve as a guide in establishing the audit committee work plan and meeting agendas.

Setting the meeting agendas

A detailed agenda is vital for keeping the committee focused. Effective agendas are set with input from the CEO, CFO, CRO and the internal and external auditors. The audit committee chair however, should maintain accountability for the agenda and should not allow management to dictate the content.

Meeting agendas ultimately drive the work the audit committee does. For this reason audit committee agendas should be closely linked to the committee's terms of reference. The audit committee agenda for the year should ideally originate from a detailed work plan. A wide ranging work plan helps members focus on their job. However, the nature of audit committee responsibilities and the ever-changing environment in which companies operate make it difficult to determine a fixed agenda of topics for each meeting. The committee should assess what is currently important and develop its agenda accordingly.

The detailed work plan would originate from the terms of reference. Appendix 3 includes an example of audit committee agenda topics that should be considered when developing detailed audit committee agendas for the year. An example audit committee agenda for the year is presented as Appendix 4.

> *"To make the audit committee meeting as effective as possible you have to do a lot of homework in advance with the finance team at the company, the internal auditors and the external auditors. The committee papers are themselves a result of a negotiation between these parties on how best to describe any matters which have been controversial among them. You need to be able to identify the real issues lying behind the papers and to assess the relative weight to attach to each at the meeting. Sometimes you discover that something which is mentioned quite briefly in the papers is highly significant, has been a point of real difficulty and is worth a large allocation of time and discussion at the meeting. Similarly material covered at great length in the papers can turn out to be uncontroversial and easily despatched."*
>
> Audit Committee Chairman

The secretary to the audit committee should ensure that the committee receives the meeting agenda and supporting materials in a timely manner, to enable committee members to give full and proper consideration to the issues. This would usually be at least one week prior to the meeting.

Frequency and timing of meetings

The audit committee should meet as often as its role and responsibilities require.

Timing meetings to coincide with key dates within the financial reporting and audit cycle enables the audit committee to make timely and influential decisions. Equally, having sufficient time available at each meeting is critical. The committee must be able to cover all agenda items, hold as full a discussion as is required, and enable all parties to ask questions or provide input. There should also be sufficient time for audit committee members to discuss issues, without others being present (private session), at each meeting.

An appropriate interval should be allowed between audit committee meetings and other related meetings (such as main board meetings) to allow any work arising from the audit committee meeting to be carried out and reported on as appropriate.

The most important issue is that audit committee members hold effective meetings. The quality and timeliness of pre-meeting materials, an appropriate balance between discussion/debate and listening to presentations, and better prioritisation of issues all help drive the effectiveness and efficiency of audit committee meetings.

Some audit committee chairs have developed innovative ways of managing their workload in an attempt to maximise the efficiency, and more importantly, the effectiveness of audit committee meetings. One such mechanism is to hold pre-meeting phone calls with committee members to work through the routine matters. This allows the face-to-face meetings to focus on the critical issues. Another mechanism is for the audit committee chair to hold early meetings with key stakeholders - such as the auditors and CRO – to get an understanding of the key issues well in advance of the formal audit committee meeting.

Improving the quality of audit committee ‘conversations’

The whole subject of chairing audit committee meetings deserves careful thought as getting the ‘right conversation’ around the audit committee table is an essential component of audit committee effectiveness. Our research and experience indicate that many audit committees could significantly improve their oversight capabilities and therefore their effectiveness through greater consideration of the style and content of the conversations they have. There are some important overarching considerations when preparing for audit committee meetings:

- Arranging the space available in the audit committee calendar for all the subject matter that should be covered involves mapping out the agenda. It is important to make time available for both ‘hard’ and ‘soft’ subjects, for decision and reflection, for introspection and evaluation. It is important that the routine business of the audit committee does not crowd out the critical issues, and that the overall agenda is not so tight that it cannot adjust to include ‘special business’ or matters raised by individual audit committee members.
- Every conversation needs framing. Whether challenge, debate or ‘for information’, every audit committee ‘conversation’ needs clarity of purpose so that all audit committee members have the appropriate information available before the conversation takes place. Conversations needs clear purpose and outcome (whether a decision or an agreed position or simply being better informed), and follow-up.

Where ‘conversations’ around the audit committee table are not as effective as they might be, consideration of the following might be helpful. The two left-hand columns indicate the concerns and likely symptoms. The right hand columns suggest the role that the audit committee chair and members might play in addressing these concerns.

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Underlying issue	'Red flags'	Audit committee chair's response	Audit committee member's response	Management's response
There are dominant personalities or groups in the audit committee meetings controlling the debate	• Dissenting voices marginalised • Difficult issues not sufficiently discussed • Debate becomes personalised not issue focused • Special insights not used • Individuals reticent to speak up • Third parties stereotyped as out of touch • Management team is defensive or aggressive	• Build trust and respect with all members. Speak with them ahead of meetings and make sure they are sufficiently briefed to contribute effectively • Give weight to the views raised • Demonstrate by own behaviour that uncertainty and questioning of assumptions is appropriate • Engineer a counter case in the debate • Encourage and give 'air cover' to new committee members • Address directly with the chair of the board if dominance continues	• Speak up but don't hog airtime • Ensure fully briefed • Add value by adding fresh insight • Build relationships with other members and 'rehearse' difficult questions or concerns before the audit committee meeting	• Recognise the different knowledge levels amongst the committee members and address member's areas of discomfort • Consciously ask for input and advice • Seek input from specific directors outside committee meetings
The audit committee is being 'managed' by the executive team in attendance	• Executives don't provide the committee with different viewpoints – all proposals appears to be a *fait accompli* • Insufficient focus on the big picture/too much focus on operational matters • Probing challenge not welcomed by the executive team	• Use the company secretary actively in preparation of papers • Pre-agree with relevant executives how particular issues should come to the committee • Personally demonstrate behaviour required by querying judgements and assumptions	• Respect the executive need for 'instant decisions', but 'push back' in the discussion • Get to know the business and people below the top executive team – the marzipan layer	• Use scenarios to show the range of uncertainty • Use 'reverse stress testing' to demonstrate risk awareness and control

Underlying issue	'Red flags'	Audit committee chair's response	Audit committee member's response	Management's response
	• Insufficient emphasis on risk • Papers not tailored to board needs	• Insist on meeting relevant executives ahead of papers coming to committee	• Be active conduits to the external world	• Show willingness to suspend own assumptions
'Groupthink' – the audit committee lacks diversity of thought	• Constant drive to get through the agenda and 'move on' to next topic • Scenarios rarely used • Lack of any external input or challenge • Assumptions not tabled openly • Different options not presented or evaluated • 'Out of the box' thinking discouraged	• Use a facilitative style to manage the debate • Use third party briefings etc. to increase insight, drive debate and facilitate opposing views • Review the committee membership • Review the style and effectiveness of the boardroom conversation	• Use 'intelligent naivety' to ask the non-obvious questions • Keep asking questions in different ways until satisfied • Suspend prevailing assumptions • Change the angle of debate	• Present options and alternatives rather than a *fait accompli* • Actively request debate and introduce difficult issues as 'finely balanced' • Overtly welcome the committee's views • Ensure the committee has all the relevant information
The audit committee is overly focused on process	• Overemphasis on ticking the boxes at the expense of proper debate • Inappropriate allocation of time to critical issues • Sense of pressure to get through the agenda • Failure to stand back and look at the big picture • Unwillingness to challenge 'the way we do things here'	• Involve multiple inputs when setting the agenda • Differentiate agenda items by importance • Listen hard for signals of discomfort • Don't be afraid to park items for further review where necessary • Be prepared to call additional meetings where necessary	• Raise concern either in meeting or offline with the audit committee chair • Offer to lead the discussion on a specific upcoming issue • Specifically cover during the annual evaluation process	• Ensure committee members are properly briefed on critical issues and audit committee priorities • Provide meaningful and constructive feedback if asked to contribute to the evaluation process • Proactively volunteer constructive thoughts from outside the committee

Underlying issue	'Red flags'	Audit committee chair's response	Audit committee member's response	Management's response
Low commitment, engagement or capability of some audit committee members	• Attendance in person but not in spirit • Lack of preparation • Consistent lack of contribution • Focus narrowly on 'own world view' • Too much 'shooting from the hip'	• Get to know each member by spending time with them outside formal committee meetings • Be clear with members about the contribution required • Demand brains are switched on and mobiles switched off • Change the committee's constitution if appropriate	• Raise any issues promptly with the audit committee chair • Move on if not able to contribute	• Be sensitive to committee members feeling out of depth or marginalised • Discuss offline and encourage greater contribution, even in areas outside their specialisation • Share own thinking journey with committee members
Lack of reflection time about the committee's own performance and style	• Little discussion on how debate could be improved • No opportunities to consider what might be done differently next time • Process suggestions derided • Annual committee evaluation does not get to the real issues	• Encourage occasional wide ranging discussion on meeting craft at (say) post meeting dinners. • Meet with each director to gather their views on the quality of conversation/ debate and get their suggestions for improvement	• Insist on the maintenance of high standards • Use external experience to support behavioural change	• Provide meaningful and constructive feedback if asked to contribute to the evaluation process • Proactively volunteer constructive thoughts from outside the committee

Meeting attendees

No one other than the audit committee members should be entitled to attend any meeting of the audit committee. It is the audit committee itself that should decide who should attend any particular meetings (or part of it).

As noted previously, circulating the meeting agenda to the board chairman may generate interest from other independent directors and the chair. The audit committee may also choose to invite specific directors or members of other board committees because of their knowledge and perspective on the issue being discussed.

Many audit committees regularly invited the CFO, CRO, the external audit partner, chief internal auditor, and perhaps the CEO to attend committee meetings. The CEO often has valuable insights to share, but the chair of the audit committee should make sure that the CEO does not inhibit open discussion at the meeting. In addressing a significant and complex issue, some audit committees choose to invite all directors – essentially operating as a 'committee of the whole' with the meeting chaired by the audit committee chair. This approach enables all directors to understand and apply their knowledge to an important issue.

In camera or private meetings

A number of audit committees hold meetings (or parts thereof) with only the formal committee members present. Holding such meetings *in camera* gives the members a good opportunity to discuss any issues or concerns among themselves, and positions them to better understand and challenge management and the auditor at the audit committee meeting.

It is also good practice to hold separate *in camera* meetings with the internal and external auditors. Frequently, such sessions are held at the end of the scheduled audit committee meeting. The executives are asked to leave, and the committee then invites comments from, and asks questions of, the representatives from internal and external audit.

A private session where management is not present arguably reinforces the independence of the audit committee and allows it to ask questions on matters that might not have been specifically addressed as part of the audit. It allows auditors to provide candid, often confidential, comments to the audit committee on such matters. However, the audit committee chair should manage such private sessions carefully as they introduce a lack of transparency, in that executives do not hear about any problems or issues first hand and may not be given an opportunity to respond. This in turn may cause them to feel excluded and even defensive. Introducing such sessions as part of the regular process might alleviate some of these tensions.

Typically, there should be few such items to discuss *in camera*. Nevertheless, it is useful to have a process in place should issues arise. All key matters related to risk management, financial reporting and internal control should usually be reviewed in a candid, robust manner with executives, audit committees and auditor during the audit committee meeting. The audit committee can use the private session as a follow up if members are not satisfied with the answers given at the committee meeting, or if they thought the discussions were too guarded or uneasy. However, it is preferable to air such matters fully at the audit committee meeting, so they do not need to be readdressed in the private session.

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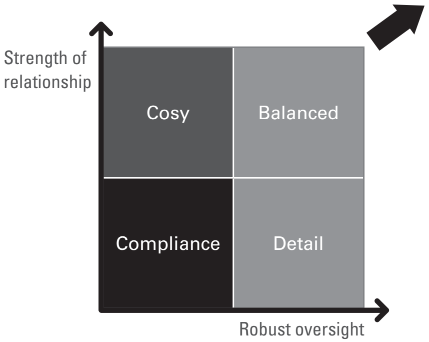
Appendix 5, provides a detailed discussion of the private session with the external auditor together with a framework for conducting such meetings and a list of questions that audit committee members might ask of the auditor.

Relationships

Audit committees work more effectively when all board members have a clear understanding of what responsibilities are devolved to the committee (and conversely what responsibilities are not devolved to the committee). Each need to determine their own ways of working together, but of paramount importance is a strong relationship between board members, audit committee members and those working with them such as auditors, risk functions and executive management.

The 'oversight and relationship' paradox



Based on an idea first presented by Independent Audit Limited

Paradoxically, the balance between strong relationships and robust oversight is at the heart of the audit committee role. A committee that fails to understand the line between oversight and management can easily find itself in a poor relationship with executive management; and effective oversight is difficult to achieve where management sees the audit committee as nothing more than a necessary corporate governance burden. Equally, an overly cosy relationship is unlikely to lead to effective oversight as challenging questions are all too easily avoided in such circumstances. The ideal place to be is where those working with the audit committee (whether it be the CFO, CRO or auditors) look to the committee as a useful partner or sounding board. The exchange of information flourishes in such circumstances and as audit committees are only ever as good as the information they have access to, this naturally leads to better oversight.

> *"Trust is good. Trust with verification is better!"*
> Board Chairman

Identifying issues early

Questions of substance should not be raised for the first time at the year-end audit committee meeting. Serious problems may result if there are unexpected answers. If the year-end audit committee meeting is conducted effectively, the chair should be communicating with financial management as well as the internal and external auditors during the weeks before the meeting. The chair should also bring matters of potential concern to the attention of the audit committee members ahead of time. The relationship with the auditors should be such that any serious concerns are brought to the audit committee's attention promptly, but in a non-adversarial way.

> *"In my view, the Audit Committee should actively develop and maintain a robust and open dialogue with not only the Group FD but also the Partner responsible for the Audit and the Risk Manager/Senior Internal Auditor. This should ensure that emerging issues that require the attention of the Committee are communicated in good time."*
> Audit Committee Chairman

An effective annual plan for meeting agendas can help the audit committee identify issues and discuss them as early as possible during the year. Management should be expected to discuss key accounting estimates and subjective adjustments for each accounting period. The external auditor should periodically discuss the appropriateness of accounting judgements and estimates, including any accounting alternative choices made by management.

Responding to crises

Organisations may, from time to time, get into difficulty due to fraud, industrial action by employees, failure to meet a key piece of legislation or other reasons. On such occasions, the board of directors acting through executive management is responsible for crisis management and any remedial action. Nevertheless, the audit committee is often ideally placed to advise, provide appropriate oversight and, in exceptional circumstances, deal with outside agencies.

The audit committee should consider the key processes and policies required to determine when to undertake an internal investigation, and ensure that any investigation is sufficient in scope and objective and is thorough.

Who would participate in the investigation? What disclosures would be required or advisable? Who would lead the investigation? How would an independent legal counsel or outside expert be selected? To what extent should the investigation be documented? These and other essential aspects of an internal investigation should form part of a robust action plan, which can be invaluable in guiding the investigation to a timely, credible and conclusive result – particularly when faced with time pressures.

Independent investigation may be required in the event of a major fraud or regulatory inquiry; or where, for example, an organisation is required to restate its accounts due to an error.

When the board (on the advice of the audit committee) determines that an independent investigation is required, the following factors can be essential to establishing credibility of the investigation:

- conducting the investigation in an objective and timely manner;
- employing outside experts – such as legal counsel and forensic accounting professionals – who are truly independent and appropriately qualified (such experts can help to define the scope of the investigation and ensure the immediate preservation of electronic and other evidence);
- considering external auditor involvement, including what communications and updates may be appropriate (the external auditor may conduct its own parallel or 'shadow' investigation);
- making timely and accurate disclosures to regulators and others, as appropriate or required;
- documenting key processes, findings and remedial actions taken (as recommended by legal counsel); and
- investigating the matter until the audit committee is fully satisfied that all relevant issues have been addressed.

Audit committees should also be regularly apprised of the legal and regulatory issues that arise during an investigation, including financial reporting deadlines and necessary disclosures.

Approaching accounting investigations in a proactive manner can offer important advantages. An internal corporate investigation can allow the organisation to take control of a potentially negative situation and effectively manage the flow of information and the pace and direction of the investigation. A well managed internal investigation may also result in a shorter and less disruptive external inquiry.

Resources for the audit committee

The audit committee should be provided with sufficient resources to undertake its duties and make effective use of its time.

Internal audit is likely to be the single most significant resource used by the audit committee in helping the governing body to discharge its responsibilities. The relationship between the audit committee and internal audit function is discussed in Chapter Six.

The audit committee should have a secretary – normally the secretary to the board of directors or some other independent person. In determining the secretary to the committee, the board should consider whether the proposed secretary has significant financial or other senior management responsibilities that might impair, or be seen to impair, the independence of the individual.

The secretary should support the committee in all audit committee matters, including supporting the chair in planning the committee's work and drawing up meeting agendas, maintaining minutes, drafting material about the committee's activities for the annual report, co-ordinating the timely collection of supporting papers and distributing them, and other support as needed. As noted earlier, the chair must maintain the committee's independence while securing the necessary input and support from management. The organisation via the board should also make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the committee reasonably believes it necessary to do so.

Communication and reporting

The audit committee chair should report to the board after every audit committee meeting, in sufficient depth to enable the board to fulfil its oversight responsibilities. The minutes of each audit committee meeting should be prepared on a timely basis and drafted in such a manner so as to clearly:

- summarise the work undertaken by the audit committee, explaining if necessary the importance of the work and any conclusions drawn or actions taken; and
- advise the chairman of the board on any relevant matters, including any matter on which the audit committee believes the board should be taking action and the committee's recommendation thereon.

Practical difficulties can arise when the audit committee meeting and board meeting are held such that there is little time to prepare formal minutes. In such circumstances it is normal for the chair of the audit committee to report orally to the board with the formal report sent to board members at a later date.

Audit committee minutes are normally copied to the head of internal audit and the external audit partner. Further communications with internal and external audit are covered in Chapters Six and Seven.

Audit committee remuneration

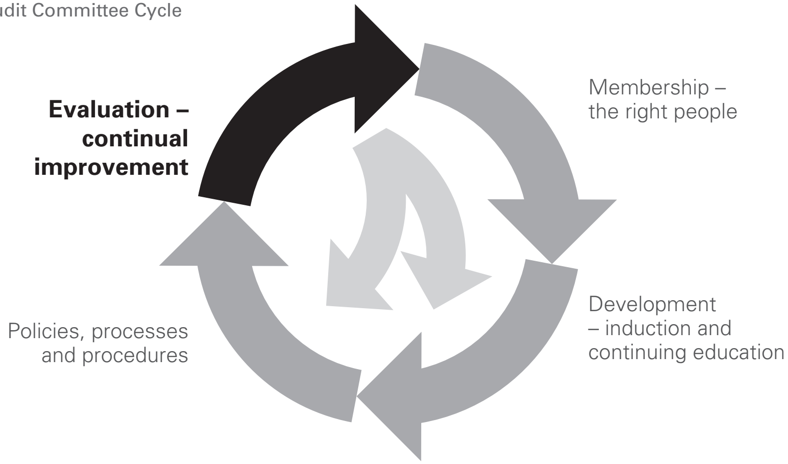
Whether an audit committee member is remunerated for services will depend on the sector the organisation operates within. So, for example, audit committee members in parts of the public and third sectors are sometimes unpaid volunteers, however, in the private sector audit committee members are usually remunerated for their services.

In publicly listed organisations, the quantum of remuneration paid to audit committee members (and the chair of the committee) is usually determined by the board within the limits set in the Articles of Association. It is reasonably well established in practice that the committee chair receives more remuneration than other members, reflecting the time commitment and responsibilities of the role. 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 to the company of their work.

Remuneration for non-executive service can sometimes pose a dilemma for both management and committee members. While compensation should be enough to recognise the time commitment required and the liabilities accepted in order to attract good and responsible directors, the amount should not be excessive such that independence may be perceived to be impaired.

EVALUATION – CONTINUAL IMPROVEMENT

The Audit Committee Cycle



The audit committee should regularly assess its own effectiveness and the adequacy of its terms of reference, work plans, forums of discussion and communication. Regular assessment may identify areas in which the committee and its processes might be more effective, or may highlight skills and/or knowledge gaps in the committee. This may lead to a request for additional development (continuing education) or, in exceptional circumstances, require the chair to begin discussions on the possible recruitment of a new member.

The audit committee needs to ensure that it has the requisite knowledge to discharge its duties at all times. For this to be achieved the audit committee chair, working with the nomination committee, should annually review the status of succession to the audit committee and aim to ensure that there is continuous access to suitable candidates.

What does effectiveness mean?

An effective audit committee is one that successfully supports the organisation in fulfilling its responsibilities relating to corporate reporting, risk management, control and governance. This goes beyond simply carrying out the tasks set out in the audit committee's own terms of reference.

An effective audit committee will:

- Comprise a capable chair and members who are independent, diligent and knowledgeable;
- Have timely access to all the appropriate information;
- Be efficient in the discharge of its business;
- Operate in an environment where committee members and others within the organisation have a common understanding of the committee's role;
- Strike an appropriate balance between robust oversight and strong relationships with the organisation's management and auditors;
- Focus on the key issues and a risk based approach to its work;
- Be alert for and responsive to emerging issues;
- Have a positive impact within the organisation;
- Be credible within the organisation;
- Take action to sustain best practice in risk management, control and governance within the organisation

Above all, an effective audit committee will demonstrably add value to the board and organisation.

Assessing effectiveness

The precise method by which the board and audit committee assess the audit committee's effectiveness should be for the board and the audit committee to decide. It is common for the board and committees to self evaluate. However, it is good practice that organisations have externally facilitated board (and therefore board committee) evaluations once every three years. No single process will be appropriate for all organisations, nevertheless, the following guidelines are recommended:

- *Independence:* To be credible, the assessment process must be independent – and be seen to be independent – of executive influence or authority. The audit committee chair should control the assessment process and criteria, albeit taking into consideration the views of the chair of the board, and other interested parties where appropriate.

- *Clearly established goals:* Clear goals for the assessment should be established. If the assessment of the audit committee is to be more than a box ticking exercise, it must be designed to encourage audit committee members to perform the inherently difficult task of candidly and constructively critiquing each other's performance as individuals as well as their collective performance as a committee.
- *Tailoring evaluations to the organisation:* Each evaluation process should be tailored to meet the needs of the institution. The audit committee chair should establish a process and performance criteria that suit the individuals and the culture of the organisation.
- *Ensuring candour, confidentiality and trust:* The audit committee chair should encourage candour, openness, fairness and discretion in the assessment process while ensuring strict confidentiality with respect to each participant's input and feedback. Implementing a constructive assessment process depends on the committee's ability to develop a culture of frankness and mutual trust.
- *Regular review of the assessment process:* Any assessment process will be shaped by many forces, including the organisation's circumstances and performance, committee tenure and relationships between individual committee members. Consequently, the committee should periodically review its assessment practices and criteria to ensure their continued efficiency and appropriateness.
- *Feedback:* To ensure credibility, it is important that those involved in the evaluation process receive feedback.

The audit committee should regularly assess its own effectiveness and the adequacy of its terms of reference, work plans and forums of discussion and communication. In doing so, it should consider:

- ascertaining whether the board is satisfied with the committee's performance;
- comparing the committee's activities to any relevant guidelines or recommendations;
- comparing the committee's activities to leading practices in different sectors;
- comparing the committee's activities to any previously established criteria;
- comparing the committee's activities to any previously identified shortcomings; and
- comparing the committee's activities to the terms of reference, the committee's aspirations and any objectives set by the board.

The committee should also consider requesting feedback on its performance from management, auditors and other relevant stakeholders.

Questionnaires are one mechanism that audit committees can use in assessing their effectiveness. However, consultation and feedback is improved by face to face discussions where appropriate. Informal meetings with the auditors or *in camera* sessions during regular audit committee meetings can by employed for this purpose.

A suggested framework for an audit committee's review of its effectiveness and the adequacy of its terms of reference and work plans can be found at Appendix 6. The results of the evaluation and any action plans arising should be reported to the board after discussion with the chair. Any necessary changes should be recommended to the board.

The audit committee chair should also assess the performance of individual committee members as well as the performance of the committee as a whole. The performance evaluation of individual members might consider inter alia:

- expertise;
- enquiring attitude and independence;
- ability to take a tough constructive stand at meetings when necessary;
- understanding of the organisation;
- willingness to devote the time needed to prepare for and participate in committee meetings and deliberations;
- approach to conflict and whether the person helps the committee to manage conflict constructively and productively.

The evaluation of the audit committee chair should be done by the chair of the board, based on similar criteria. The results should be reported to the board.

Evaluations which are well performed demonstrate the committee's intention and commitment to achieve its responsibilities in an effective, diligent manner. They should focus on:

- What is the committee for and what does success look like?
- Do others within the institution understand what the audit committee is supposed to do?
- Outcomes rather than activities – not what the committee did, but how it did it.
- Is time spent on the right areas?
- What impact has the committee had? Has it added value to the governance process?

After completing the evaluation, the chair of the board and the audit committee chair should discuss the outcomes so that appropriate action can be taken. The audit committee chair should discuss with individual members the outcomes of the evaluations and any actions required.

THE CORPORATE REPORTING PROCESS

CHAPTER 3

Audit committees are generally responsible for reviewing, on behalf of the board, 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.

Audit committees can also review related information presented with the financial statements, including the operating and financial review, and corporate governance statements relating to the audit and to 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 (without being inconsistent with any requirement for prompt reporting under (say) the Listing Rules) the board should consider asking the audit committee to review such statements first.

Sometimes the board might ask, or regulation might require, that the audit committee fulfil a wider remit and carry out such oversight necessary to advise the board on whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the company's performance, business model and strategy.

Whatever the extent of the committee's remit, where following its review, the audit committee is not satisfied with any aspect of the proposed corporate reporting, it shall report its views to the board.

The financial statements

Organisations are generally required to prepare annual reports, including audited financial statements, and these are the mechanism by which boards report on the stewardship of the organisation and its assets to investors and/or other stakeholders. Annual reports then provide the underpinning to other communications by companies – such as interim management statements, market sensitive information, and investor presentations. Given the important role that they play in the corporate reporting framework, it is essential that annual reports are relevant and present an accurate, coherent and balanced picture of the business and its prospects.

Responsibilities

While boards have overall responsibility for preparing annual reports that present a balanced and understandable assessment of the organisation's position and prospects, in practice this responsibility is delegated to management. Therefore, it is management, not the audit committee, that are accountable for preparing the annual report, including complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations.

The audit committee has an important oversight role in providing the board with assurance as to the propriety of the financial reporting process. It 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 organisation has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements. The audit committee should review the clarity and completeness of disclosures in the financial statements and consider whether the disclosures made are set properly in context.

To perform their role effectively, the audit committee needs to understand the context for financial reporting, and in particular:

- management's responsibilities and their representations to the committee;
- management's remuneration, especially any incentive arrangements;
- the external auditor's responsibilities (under generally accepted auditing standards);
- the nature of critical accounting policies, judgements and estimates;
- any significant or unusual transactions where the accounting is open to different approaches;
- the impact of relevant accounting standards and company law;
- financial reporting developments; and
- the overall requirement that the financial statements present a 'true and fair' view.

Audit committees should be confident that they are being made aware of any relevant accounting policy or disclosure issues or changes, and that this information is communicated to them early enough to enable appropriate action to be taken. A regular two-way dialogue between the audit committee and the CFO should take place though the audit committee should also look to the internal and external auditors for support, using the auditor's insights to help to identify potential issues early and assist the committee to oversee the quality and reliability of financial information.

Accounting policies, judgements and estimates, complex transactions and transparency

In fulfilling their oversight role, the audit committee should understand the process by which management ensure the timely and transparent delivery of meaningful information to investors and other users of financial statements. The audit committee should seek to ensure that such a process is both fit for purpose and working as intended.

The assessment of the appropriateness of the organisation's accounting policies, underlying judgements and estimates, and the transparency of the financial disclosures in reflecting financial performance, should be at the core of the audit committee's discussions with management and the statutory auditor.

Critical accounting policies, judgements and estimates

The preparation of financial statements requires numerous judgements and estimates. Each judgement or estimate can significantly impact a company's financial statements and each estimate has a range of possible and supportable results. Understanding the company's business, as well as the industry in which it operates, will help the audit committee to focus on the appropriateness of the company's approach.

In order to properly understand and assess the appropriateness of critical accounting policies, judgements and estimates the audit committee should:

- understand and evaluate the facts and economics of the transaction or group of transactions;
- consider the appropriateness of management's selection of accounting principles and critical accounting policies. What were the alternatives? Have they changed in the current period? Why have they changed? How might the changes affect current and future financial statements?
- assess management's judgements and critical accounting estimates. What are the key assumptions behind those estimates? How sensitive are current and future financial statements to changes in those assumptions?
- question the degree of aggressiveness or conservatism surrounding management's judgements and estimates. Is there potential for management bias in developing the estimates?
- consider the relevant accounting guidance and any alternative accounting treatments. What are other companies doing in similar circumstances?
- ensure the statutory auditor is satisfied that management's accounting policies, judgements and estimates reflect an appropriate application of generally accepted accounting practice.

In practice, these steps may not be performed sequentially and are often combined due to the iterative nature of the decision process.

When considering the impact on the financial statements of any changes to accounting standards or generally accepted accounting practices, the audit committee should satisfy itself that:

- management has sufficient resources devoting appropriate attention to understanding recent developments in financial reporting; and
- the application of new requirements is appropriate in light of the nature of the organisation's operations and significant transactions.

Audit committees should understand the circumstances in which management may feel pressure to engage in inappropriate earnings management. It could be that: market expectations are unrealistic; targets are not being met; or management remuneration incentives are heavily weighted to earnings measures. The audit committee should recognise when these conditions are present and where necessary receive what they hear with professional scepticism.

Unusual and complex transactions

The audit committee should assess the treatment of any unusual or complex transactions. In addition to the considerations with respect to critical accounting policies, judgements and estimates, the audit committee should understand:

- the business rationale for the transaction;
- how the transaction disclosed is in the financial statements and whether such disclosure is appropriate;
- the impact on the comparability of financial position and performance with respect to past and future periods; and
- any factors surrounding the accounting for any unusual transaction.

Completeness, clarity and transparency

Overall, the audit committee needs to assess the completeness, clarity and transparency of the financial statements and related disclosures, by asking such questions as:

- Do the financial disclosures consistently reflect the institution's financial performance?
- How clear and complete are the financial statement note disclosures?
- What are equivalent organisations doing, based on publicly available information?

Management and the external auditor can greatly assist the audit committee in understanding and assessing these matters by providing the committee with clearly written communications, augmented with face-to-face discussions.

Going concern

Audit committees can be tasked by boards to provide confirmation that a robust going concern risk assessment has been made. In such circumstances, the audit committee should pay particular attention to management's use of the going concern assumption in the preparation of the financial statements and should satisfy itself that:

- regard has been had to the latest authoritative guidance, for example, the FRC guidance Going Concern and Liquidity Risk: Guidance for Directors of UK Companies;
- proper consideration has been given to cash flow forecasts prepared for at least, but not limited to, twelve months from the date of approval of the financial statements including an analysis of headroom against available facilities and that all available information about the future has been taken into account;
- consideration has been given to the need to extend the cash flow forecast exercise to evaluate issues that may arise after the end of the period covered by the initial budgets and forecasts;
- appropriate evidence has been obtained about the group's ability to secure new or to renew existing funding commitments;
- an analysis of the terms of current banking facilities and covenants has been considered by management and that such an analysis would identify those risks that need to be addressed. If so, are plans in place to manage those risks;
- full consideration has been given to guarantees, indemnities or liquidity facilities that have been provided to other entities that the group may be called on to honour. Has management considered whether the group has the resources to meet such obligations should they arise?

Boards should consider disclosing to shareholders in the annual report the role of the audit committee in confirming that a robust going concern risk assessment has been made together with information on the material risks to going concern that have been considered by the board/audit committee and, how they have been addressed.

External audit adjustments

The audit committee should review the external auditor's recommended audit adjustments and disclosure changes, focusing on both the adjustments and changes made by management and those that management has not made.

To establish a framework for these reviews, the audit committee should:

- tell the external auditor and management what audit differences the committee wants to hear about – material audit differences or a broader definition?
- convey its expectations that the external auditor will promptly identify, discuss with management and the audit committee, and recommend audit adjustments and disclosure changes;
- understand the reason behind any misstatements; and
- encourage management to adjust for all audit differences.

The year-end timetable

If the audit committee is to make an effective contribution, it should review the final draft version of the audited annual financial statements prior to their approval by the board of directors. An appropriate interval should be left between the audit committee meeting at which the committee recommends approval of the financial statements and the board meeting at which the financial statements are approved. This allows any work arising from the audit committee meeting to be carried out and reported as appropriate.

An example year-end timetable is given at Appendix 7.

Any delays in preparing and auditing the financial statements should be followed up by the audit committee, as they might indicate underlying problems within the finance function or external audit process.

Narrative reporting and other corporate reports

All information published by organisations is potentially open to close scrutiny by the investment community and other stakeholders, and a company's share price may be significantly affected by investors' reactions to results announcements. Organisations also produce narrative reports, analyst briefings/investor presentations, half-year accounts and interim management statements, sustainability reports, and other financial and non-financial information posted on the corporate website.

It is not always appropriate for the audit committee (or the board) to review all corporate reporting, but management should have a process in place to ensure the relevance and probity of such information; and audit committees have a role to play in ensuring such processes are fit for purpose and working as intended. Audit committees (and boards) also have a role to play in ensuring the tone of reported information is appropriate. Indeed, some corporate governance regimes suggest that audit committees have an explicit role in advising the board of directors on whether the whole annual report 'cover-to-cover' is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy. In such circumstances, the audit committee would potentially review, and report to the board on, the content of the annual report (including any narrative report) and the processes supporting the preparation of that information.

The factors an audit committee would consider when carrying out such an extended oversight role are, in many respects, very similar to those discussed above in the context of the financial statements. However, audit committees might specifically consider whether:

- appropriate consultation has been carried out to understand stakeholders' needs – both valuation and stewardship considerations apply;

- the language used is precise and explains complex issues clearly;
- jargon and boiler-plate are avoided;
- appropriate weight is given to the 'bad news' as well as the 'good news';
- the narrative in the front end is consistent with the financial statements in the back end; significant points in the financial statements are appropriately explained in the narrative report so that there are no hidden surprises;
- the description of the business model and strategy (and risk) is sufficiently specific that the reader can understand why they are important to the organisation;
- the disclosed business model and strategy accords with the committee's understanding;
- the disclosed business model and strategy is appropriately linked to disclosure of risk and performance;
- the disclosed risks are genuinely the principal risks that the board are concerned about. The links to accounting estimates and judgements are clear;
- highlighted or adjusted figures, key performance indicators (KPIs) and non-GAAP measures are clearly reconciled to main heading figures in the accounts and any adjustments are clearly explained, together with the reasons why they are being made;
- important messages, policies and transactions are highlighted and supported with relevant context and are not obscured by immaterial detail. Cross -referencing is used effectively; repetition is avoided;
- issues are reported at an appropriate level of aggregation and tables of reconciliations are supported by, and consistent with, the accompanying narrative; and
- significant changes from the prior period, whether matters of policy or presentation, are properly explained.

Audit committees might also want to consider the assurance asymmetry between the financial statements and the rest of the annual report. Historically, the probity of the financial statements and the systems generating the information reported in the financial statements, receives a lot of attention from management, internal audit and external audit. The same is rarely true for some other elements of the annual report.

The audit committee should therefore consider the materiality of all information reported in the annual report and whether the assurance received over such information is appropriate in the circumstances. It is a reasonable assumption that if information is of value to stakeholders then it should be reported to them and, conversely, if an organisation reports information then it is on the basis that it believes that the information is of value to stakeholders. In either case there should be an expectation that such information is accurately reported and that it is not otherwise misleading. Independent assurance on such information therefore has the potential to provide value to stakeholders by increasing confidence in its accuracy.

Analyst briefings and investor presentation

Practices regarding analyst briefings/investor presentations differ and whilst some audit committees review such presentations in advance of the analyst/investor meetings, many do not. Nevertheless, all audit committees should ensure that there is an appropriate process for the information's preparation and protocols for its review and release.

Subsidiaries

The audit committee is primarily concerned with public reporting, and hence information relating to the consolidated group. The remit of some audit committees may, however, be extended to the financial reports of individual group companies. Alternatively, some companies set up separate audit committees for significant subsidiaries due to the importance of these operations. The audit committee terms of reference should reflect the role and responsibilities of the audit committee in these circumstances.

CHALLENGES ARISING FROM DEPRESSED ECONOMIC CONDITIONS

Times of economic uncertainty are particularly difficult for management and may increase the risk that annual reports and accounts misreport facts and circumstances and contain uncorrected errors and omissions.

The following questions – reproduced from the Financial Reporting Council's publication *'Update for audit committees: Issues arising from current economic conditions (November 2010)'* – seek to identify issues that will be particularly relevant to the work of audit committees when organisations are experiencing the effects of a recession in one form or another.

Assessing and communicating risk and uncertainties

Has the board set out in the annual report a fair review of the company's business including its principal risks and uncertainties? Are the risks clearly and simply stated? Are there many of them and if so, are they really principal risks? Is it clear how the risks might affect the company?

Has full consideration been given to how the business may have been changed to address the effects of the recession and the additional challenges, if any, posed by the forecast significant reduction in government expenditure?

Is it clear how the board is managing the risks? Are the processes used to manage risks supported by systems and internal controls that are effective in achieving their objectives?

Is the committee satisfied that the group has monitored the effects on the business of the continued volatility in the financial markets and reduced supply of credit, including its exposure to liquidity risk and customer and supplier default risk?

Has the committee considered whether the audited financial statements describe fairly all of the key judgements about the application of accounting policies and the estimation uncertainties inherent in the value of assets and liabilities?

Have all relevant issues that have concerned management during the year and that have been drawn to the attention of the board and/or the audit committee been considered for disclosure?

Reliance on estimates assumptions and forecasts

Has the audit committee considered the processes in place to generate forecasts of cash flow and accounting valuation information, including the choice and consistent use of key assumptions?

Are the forecasts and valuation processes supported by appropriate internal controls and reasonableness checks and have those internal controls been tested by internal and/or external audit?

Has consideration been given to the need for changes in the approach to valuations and key assumptions underlying forecasts since last year and are those changes consistent with external events and circumstances? Have last year's key forecasts and valuations been compared to actual outcomes and have any lessons been fed into the current year process?

Do models and key assumptions adequately address low probability but high impact events? Has management considered which combination of scenarios could conspire to be the most challenging for the company?

Is the audit committee satisfied that appropriate sensitivity analysis has been conducted to flex assumptions to identify how robust the model outputs are in practice and that the assumptions are free from bias?

Where assets are not traded, perhaps because markets are no longer active, is the committee satisfied that appropriate additional procedures have been undertaken to estimate fair values through the selection of market-based variables and the use of appropriate assumptions?

Are the assumptions that underlie valuations, including any impairment tests, consistent with internal budgets and forecasts and with how the prospects for the business have been described in the narrative sections of the annual report and accounts?

Have the auditors been asked for a written summary of their views on the assumptions that underlie cash flow forecasts and other estimation techniques used to value assets and liabilities? Is the committee satisfied that any material concerns have been properly addressed by management?

Assessing audit quality and creating the right environment for constructive challenge

Has the audit committee discussed the outcome of the prior year review of the effectiveness of the annual audit with the auditor and does the audit strategy and plan appropriately address the issues raised?

Where an internal audit function exists, has the committee considered whether it wishes internal audit to conduct additional work up to or at the year end? For example, to look at new or amended products and services? Is the committee comfortable with the boundary between internal and external audit?

Has the audit committee discussed business and financial risks with the auditor and is the committee satisfied that the auditor has properly addressed risk in their audit strategy and plan? Is the committee satisfied that the external auditor has allocated sufficient additional and experienced resources to address heightened risks and, if not, are negotiations scheduled to secure additional commitments? Has management exerted undue pressure on the level of audit fees such that it creates a risk to audit work being conducted effectively?

Has consideration been given to any recommendations for improvement in prior year annual reports or audit from the press or regulatory agencies including the Financial Reporting Review Panel or the Audit Inspection Unit?

Have arrangements been agreed with the auditor to ensure they express any concerns they have about estimates, assumptions and forecasts without undue influence by management?

Earnings management

The audit committee must remain alert to inappropriate earnings management. Inappropriate practices might include questionable revenue recognition; inappropriate deferral of expenses; misuse of the materiality concept; and misconstrued recognition, reversal or use of provisions and allowances without events or circumstances to justify such actions.

Accounting standards do not produce financial statements that are 'right' in the sense that there is only one possible answer; application of the standards can sometimes produce a range of possible answers. For example, valuations and estimates – which inevitably require judgement – are needed for many elements of the financial statements, particularly for transactions that span the year-end or several years (such as retirement benefits and major capital projects). International Financial Reporting Standards (IFRSs), and the continuing move towards 'fair value' accounting has also introduced significant subjectivity into financial statements. The audit committee should enquire about the basis used by management when making significant judgements.

Estimates in accounting are required because of the uncertainty inherent in many transactions. No matter how carefully estimates are made, revisions to some of them may prove necessary from time to time. Revisions should be based on new developments, subsequent experience or new information. The audit committee should enquire into changes in estimates to ascertain the degree to which management bias (if any) is evident.

Areas of potential concern

Specific areas of accounting warrant special attention. They are particularly vulnerable to interpretations that may obscure financial volatility and adversely affect the quality of reported earnings:

Revenue recognition – Recognising sales revenue before a sale is complete, or at a time when the customer still has options to terminate, void or delay the sale, has attracted great attention in recent years.

Changing estimates – Changing estimates to make the numbers is another frequently used method for managing earnings. While changes to estimates may be perfectly acceptable when supported by real economic facts, all too often estimates are altered when the underlying economics of the business do not support the change, and without any disclosure to investors.

Abuse of the materiality concept – Errors may be intentionally recorded under the assertion that their impact on the bottom line is not significant. However, given the market's reaction to even small changes in earnings per share, what is and is not significant may not always be clear.

Capitalisation and deferral of expenses – Costs that should be accounted for as a cost of the period may be capitalised or deferred. The capitalising and deferring of such costs can occur through, for example, ambiguously defined capitalisation criteria for property, plant and equipment and intangible assets, unreasonable amortization periods, or the capitalisation of costs for which future economic benefits are not reasonably assured.

Non-GAAP measures – Some companies use non-GAAP measures to disseminate an idealised version of their performance that excludes any number of costs and expenses yet still suggests reliability and comparability. Often, undue emphasis is placed on results before unusual items; start-up operations; earnings before interest, tax and depreciation and amortisation (EBITDA); and even marketing expenses.

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Recognising and avoiding inappropriate interpretations

Understanding the company's business, as well as the industry in which it operates will help the audit committee to focus on the appropriateness of management's approach. However, audit committees must also be aware of the circumstances in which management may feel pressure to engage in inappropriate earnings management. It could be that:

- market expectations are unrealistic;
- targets are not being met; or
- management's remuneration incentives are heavily weighted to earnings measures.

The pressure to achieve earnings targets can place a heavy burden on senior management, in terms of both job security and remuneration. Unfortunately, this pressure can lead to the consideration of biased, aggressive, and sometimes incorrect or inappropriate financial reporting interpretations.

Audit committee members need to know enough about their company to recognise when these conditions are present. In such cases, they need to receive what they hear with some scepticism. If the audit committee is not alert and sceptical, many of the improvements in the quality and reliability of financial reporting in recent years will be undermined just when they are most needed. Audit committee members therefore need to ensure their knowledge of the business remains up to date.

Auditors must also play their part. The traditional audit qualities of rigour and scepticism will be needed, but they may not be enough. The auditor's role is to express an opinion on the fairness of the financial statements, usually tested by reference to accounting standards and materiality. There are circumstances, however, where materiality considerations should not cloud financial reporting integrity and ethics. For example, under some circumstances an immaterial adjustment could make the difference between a company recording a profit or a loss.

The audit committee should not acquiesce to deliberate errors or allow incorrect or inappropriate financial reporting interpretations.

Keeping up to date with corporate reporting developments

The audit committee should consider the impact on the organisation's corporate reports of any changes to accounting standards, generally accepted accounting practices and other corporate reporting developments. Audit committees should satisfy themselves that:

- management has sufficient resources devoting appropriate attention to understanding recent developments in corporate reporting (including financial reporting); and
- the application of new requirements is appropriate in light of the company's operations and significant transactions.

To keep their knowledge up to date, audit committees should consider asking management and/or the external auditor to describe and explain recent developments in financial reporting. What is required is more than a general update. Audit committee members must clearly understand if and how the developments or changes will affect the organisation. Ideally, the audit committee should be briefed before any changes come into effect.

Audit committee members must also stay abreast of changes in such areas as securities and regulatory matters, corporate law, risk management and business trends. These development needs can be met by attending external courses and conferences; through self-study and reading; or by web-based learning. It is the role of the chairman of the board/audit committee to ensure that all directors, including the audit committee members, receive appropriate training and development.

Evaluating the finance function and CFO

The audit committee should annually consider and satisfy itself of the appropriateness of the expertise and adequacy of resources of the finance function; and experience of the senior members of management responsible for the financial function. This would include evaluating the suitability of the expertise and experience of the CFO. The audit committee should report its conclusions and any recommendations to the board.

Evaluating the finance function

When evaluating the expertise and adequacy of resources of the finance function, the audit committee might consider:

- Getting exposure to key finance people beyond the CFO. This might include:
  - requesting formal attendance at audit committee meetings to present, and answer questions, on relevant topics; and/or
  - visiting different parts of the finance function to better understand the challenges faced, the quality of the people and the information they produce.

Site visits are a good mechanism to meet the key finance people at different business units and/geographies:

- Requesting a report from the CFO (verbal or written) on the quality of the finance function and the challenges it faces. This might include an analysis of the people, their backgrounds, strengths and weakness, and how the CFO is responding to them.
- Discussing the effectiveness of the finance function with those individuals who come into regular contact with it. This might include the CFO, treasurer, the head of internal audit and the external auditor.
- Attending the finance function's annual meeting.

Evaluating the CFO

Traditionally audit committees have rarely played more than a marginal role in assessing the CFO's performance, but this is an evolving area – not least because some corporate governance regimes now recommend that audit committees evaluate the suitability of the expertise and experience of the CFO and/or finance director on an annual basis.[1]

The CEO has the prime role to play in evaluating the performance of the CFO, but the board, audit committee, and remuneration committee should all input into the process. Indeed, from a broader governance perspective, it is important that the CEO isn't given sole responsibility for evaluating the CFO.

When evaluating the suitability of the expertise and experience of the CFO, the audit committee might consider whether the CFO:

- oversees the creation of good financial reporting and internal control processes;
- is an independent thinker who speaks up and challenges the CEO;
- has integrity;
- has a cooperative attitude towards the audit committee and shows a willingness to help the audit committee understand complex issues;
- has a commitment to transparency in corporate reporting and other matters; and
- has a good track record in recruiting, managing and retaining good staff.

1 King Report on Governance for South Africa 2009 (King III)

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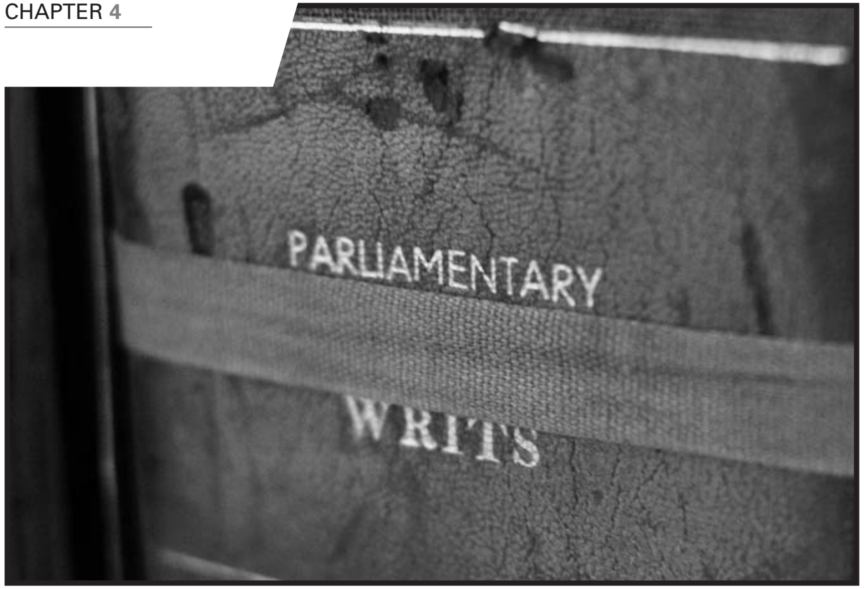
RISK MANAGEMENT AND INTERNAL CONTROL SYSTEMS

CHAPTER 4



Boards are responsible for both determining the nature and extent of the significant risks an organisation is willing to take in achieving its strategic objectives and for ensuring that the significant risks faced by an organisation are properly identified, evaluated and managed in the manner which it has approved.

The management of risk requires the establishment and maintenance of effective systems of internal control. Internal control comprises all the policies, processes, tasks, behaviours and other aspects of an organisation that, taken together ensure, as far as practicable, the orderly and efficient conduct of business. This includes adherence to management policies, compliance with applicable laws and regulations, the safeguarding of assets, the detection of fraud and error, the accuracy and completeness of accounting records and the timely preparation of internal and external reports.

Risks manifest themselves in a range of ways and the effect of risks crystallising may have a positive as well as a negative outcome for the organisation. It is vital that those responsible for the stewardship and management of an organisation be aware of the best methods for identifying and subsequently managing such risks.

Internal controls are one of the principal means by which risk is managed. Other devices used to manage risk include the transfer of risk to third parties, sharing risks, contingency planning and the withdrawal from unacceptable risky activities. Institutions can accept risk, but need to do so objectively and transparently and within the board's policy regarding risk appetite.

The risks facing organisations are continually changing and the system of internal control should be responsive to such changes. Effective risk management and internal control are therefore reliant on a regular evaluation of the nature and extent of the risks.

Successful risk management is the process that achieves the most efficient combination of controls necessary to provide *reasonable assurance* that the organisation's objectives can be achieved reliably.

Responsibilities

Boards are ultimately responsible for maintaining sound risk management and internal control systems, however the task of establishing, operating and monitoring such systems are generally delegated to management.

The board should ensure that management sets appropriate policies for risk management and internal control, and regularly assures itself that appropriate processes are functioning effectively to monitor the risks the organisation is exposed to, and that the internal control system is effective in reducing those risks to an acceptable level. It is essential that the right tone is set at the top of the organisation – the board should send out a clear message that risk and control responsibilities must be taken seriously.

In determining its policies with regard to risk management and internal control, and thereby assessing what constitutes a sound system, the board should consider the:

- nature and extent of the risks facing the organisation;
- extent and categories of risk it regards as acceptable for the organisation to bear (risk appetite);
- impact and likelihood of risks materialising;
- organisation's ability to reduce the incidence and impact of materialised risk; and
- cost of control relative to the benefit obtained in managing the related risks.

While ultimate responsibility for the risk management and internal control system rests with the board, all employees have some accountability towards implementing the board's policies on risk and control. Management is responsible for implementing the policies adopted by the board. In fulfilling these responsibilities, management should identify and evaluate the risks faced by the organisation, and design, operate and monitor an appropriate system of internal control.

Oversight

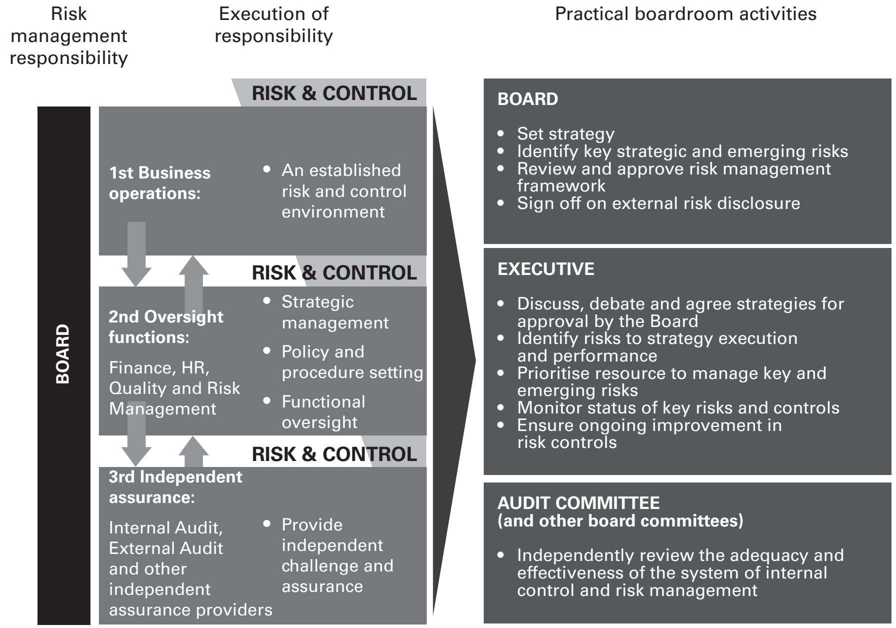
Reviewing the effectiveness of internal control and risk management systems is an essential part of the board's responsibility. However, aspects of the review work are normally delegated to the audit committee.

Traditionally, audit committees have been concerned with the oversight of internal financial controls. However, in recent times the remit of many audit committees has been broadened to include responsibility for monitoring the effectiveness of internal control and risk management systems in their entirety. This goes beyond the financial reporting process and encompasses the system of risk and control associated with other areas such as operational matters and compliance with laws and regulation.

Audit Committee versus Board (Committee): Who oversees what risks?

This diagram illustrates who is responsible for overseeing which risks. The audit committee's traditional responsibility for overseeing financial reporting risks is depicted in the top left triangle. The board must clarify the responsibilities for non-financial risk, depicted in the lighter blue, deciding whether a board committee or the board itself will oversee these risks. Where the audit committee doesn't oversee all aspects of risk, it should have processes in place (as depicted by the black boxes) to ensure it is informed of those other risks that may have financial reporting implications.

The precise role of the audit committee in the review process should be for the board to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the significant risks that the company faces.



> *"The audit committee is sometimes portrayed (wrongly in my view) as part of the third line of defence in risk management. But if you find yourself signing off a prospectus for a major capital raising or acquisition it will feel more like the front line."*
>
> Non-executive Director

In practice many boards create risk committees to provide direction and oversight of risk management systems. Often this is an executive (or management) committee reporting directly to the board or audit committee; but board risk committees (comprised predominantly of non-executive directors) are becoming more common, particularly in financial services organisations. In such circumstances it is usual for the board risk committee to (on behalf of the board) concern itself with issues associated with risk strategy and risk appetite; whereas the audit committee would continue to provide oversight over the processes and procedures designed to providing assurance over the systems of risk management and internal control. Whatever the precise arrangements are, it is important that the audit committee liaises closely with any risk committee or other relevant body such as a compliance committee or credit committee.

Risk committees

Some organisations, particularly those in the financial sector, establish board risk committees (comprised predominantly of non-executive directors) to provide focused support and advice on risk governance. The responsibilities of board risk committees typically include:

- providing advice to the board on risk strategy, including the oversight of current risk exposures, with particular, but not exclusive, emphasis on prudential risks;
- developing proposals for consideration by the board in respect of overall risk appetite and tolerance, as well as the metrics to be used to monitor the organisation's risk management performance;
- oversight and challenge of the design and execution of stress and scenario testing;
- oversight and challenge of management's day-to-day risk management and oversight arrangements;
- oversight and challenge of due diligence on risk issues relating to material transactions and strategic proposals that are subject to approval by the board;
- providing advice to the organisation's remuneration committee on risk weightings to be applied to performance objectives incorporated in the incentive structure for the executive; and
- providing advice, oversight and challenge necessary to embed and maintain a supportive risk culture throughout the organisation.

To the extent that the audit committee does monitor the effectiveness of the company's internal control and risk management systems on behalf of the board, the results of the committee's deliberations should be reported to, and considered by, the board. The board will need to form its own view on effectiveness based on the information and assurances provided to it by the audit committee, exercising the standard of care generally applicable to directors in the exercise of their duties.

The audit committee's role is not an executive function that properly belongs to management; rather the committee is aiming to satisfy itself that management has properly fulfilled its responsibilities. As such, the audit committee needs to establish:

- the degree to which management has assumed ownership for risk and control;
- how key business risks are identified, evaluated and managed;
- whether the controls are fit for purpose and working as intended; and
- the rigour and comprehensiveness of the review process.

By asking probing questions about risk management, the audit committee can help bring clarity to the process used to manage risk and the assignment of accountabilities to monitor and react to changes in the organisation's risk profile.

The system of risk management and internal control

An effective risk management and internal control system encompasses the policies, processes, tasks, behaviours and other aspects of an institution that, taken together, facilitate its effective and efficient operation, help to ensure the quality of internal and external reporting, and help to ensure compliance with applicable laws and regulations. An organisation's system of internal control commonly comprises the following elements:

- *Control environment.* The control environment provides discipline and structure. Factors include the integrity, ethical values and competence of the organisation's people; management's operating style; the way authority and responsibility are assigned; and the attention and direction provided by the board.
- *Identification and evaluation of risks and related controls.* Risk assessment is concerned with identifying and evaluating those risks that threaten the achievement of the organisation's objectives.
- *Control activities.* Control activities are the policies and procedures which help to ensure that necessary actions are taken to address those risks that threaten the achievement of the organisation's objectives.
- *Information and communication processes.* Information must be identified, captured and communicated in a timely manner and in a form that enables people to carry out their responsibilities.
- *Processes for monitoring the effectiveness of the internal control system.* The performance of the system of internal control should be assessed through ongoing monitoring activities, separate evaluations such as internal audit, or a combination of the two.

These elements of internal control are based on those set out in *Internal Control – Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Reviewing the effectiveness of risk management and internal control

An organisation's system of risk management and internal control has as its principal aim the management of risks that threaten the achievement of the organisation's objectives. Therefore, in order to have effective risk management and control processes, an organisation needs to:

- identify its objectives;
- identify and assess the risks that threaten the achievement of those objectives;
- design internal controls and strategies to manage/mitigate those risks;
- operate the internal controls and strategies in accordance with their design specification; and
- monitor the controls and strategies to ensure that they are operating correctly.

Risk identification and assessment

The board should have clarity over the strategic business objectives that are crucial to the organisation's success. By making these explicit, the likelihood of overlooking significant risks which threaten the survival of the organisation or could lead to a significant impact on its performance or reputation will be reduced.

Linking the identification of key business risks to the organisations strategic objectives may already be part of the normal calendar of work supporting the strategic planning and budgeting process. However, it is important to ensure that the risk identification process:

- has a sufficiently broad perspective – external risks such as macro-economic and systemic risks as well as internal risks such as weak controls and compliance related matters;
- is dynamic – the unpredictability of the financial crisis has shown the speed to which 'new' risks can materialise and therefore the importance of giving due consideration to both those risks 'flying under the radar' and early warning indicators; and
- extends sufficiently far into the future – while there is often a temptation to focus on immediate operating and reporting issues, boards should also look forwards to understand what the organisation and its markets will look like in (say) 10 years time.

The audit committee should review the process by which the organisation's significant risks are identified and ensure that the board is fully apprised of the significant risks facing the business.

When assessing risk, the audit committee should ensure that management has given proper consideration to the underlying gross risks, which are the risks faced by the organisation before any form of control or mitigation, not merely the net risk to which the organisation is exposed after controls have been exercised. This enables evaluation of potentially critical controls and any significant under or over control.

For each identified risk, a value judgement must be made as to the impact – both financial and reputational – its crystallisation would have on the organisation and the likelihood of the risk occurring. It is particularly important to consider the reputational impact as well as the direct financial or operational impact, since the consequence of a risk crystallising may go beyond the initial financial/operational impact. The effect on an organisation's reputation may, over the medium term, have a far greater cost than the perceived initial impact.

Management's process for assessing risks should:

- be clear and transparent;
- assess both the probability of the risk occurring and its likely impact;
- apply causation analysis to identify the root cause of risk; and
- acknowledge that risks can have single or multiple causes and single or multiple impacts. These interdependencies can be critical in identifying the real impact of risks, and hence the cost-benefit analysis applied to their mitigation.

Being responsible for both determining the nature and extent of the significant risks an organisation is willing to take in achieving its strategic objectives - the organisation's risk appetite – the board must decide whether to accept each significant risk or mitigate it through control procedures. For those risks that cannot be controlled, the board must decide whether to accept them or whether to withdraw from or reduce the level of activity concerned.

THE AUDIT COMMITTEE MAY WANT TO ASK:

- Does the organisation have clear objectives and have they been communicated so as to provide effective direction to employees on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?
- Do management and others within the organisation have a clear understanding of what risks are or are not acceptable to the board?
- Can management articulate a clear understanding of (say) the 10 major risks within the organisation?
- Is there clarity over the role of the audit committee? Do the committee's terms of reference explicitly set out the remit of the audit committee vis a vis other committees?
- Does management have a clear and structured process for the identification, assessment and reporting of risk? Does this process provide a complete picture of the organisation's risk profile?
- Does the organisation have the right risk professionals and are they sufficiently integrated with both operations and assurance functions?
- How often are the major risks reviewed? Is the process sufficiently dynamic? Can the organisation adapt to new risks?
- Does the risk horizon extend sufficiently far into the future? What time-frames are management considering?
- Does management take a sufficiently broad perspective to risk identification? Are significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis?
- What risks have recently been added or removed from the organisations risk profile and why? What risks are flying just under the radar?
- Could other sources of information e.g., external data be used to identify emerging risks

Appendix 8 provides a number of high level questions that the board or its committees may wish to consider when framing their discussions with management. The list is not exhaustive and will require tailoring based on the particular circumstances of the organisation as well as the terms of reference of the committee.

Identification of appropriate controls

Internal controls should be used to maintain the risks facing the organisation within the defined risk tolerance levels set by the governing body, bearing cost-benefit considerations in mind.

The audit committee may not know the fine detail of how all risks which could lead to a material loss are controlled, but should be satisfied that proper control policies, procedures and activities have been established and are operating as intended. Controls may be both preventative and detective.

THE AUDIT COMMITTEE MAY WANT TO ASK:

- Does management have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks? Has the board been consulted?
- Does the organisation's culture, code of conduct, human resource policies and performance reward systems support its objectives and the risk management and internal control system?
- Does senior management demonstrate, through their actions as well as their policies, the necessary commitment to competence, integrity and fostering a climate of trust within the organisation?
- Is authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the organisation appropriately co-ordinated?
- Does the organisation communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as health, safety and environmental protection; security of tangible and intangible assets; expenditure; accounting; and financial and other reporting.
- Do employees have the knowledge, skills and tools to effectively manage risk?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

Monitoring of controls

Procedures for monitoring the appropriateness and effectiveness of the identified controls should be embedded within the normal operations of the organisation. Although monitoring procedures are part of the overall system of control, such procedures are largely independent of the elements they are checking.

Examples of monitoring procedures include:

- *Management self-assessment reviewed and tested by internal audit or other independent functions such as risk or compliance.* Such self-assessment needs to be carefully managed. Management already has an implicit responsibility for the design and operation of the system of internal controls, and self-certification is a means of formalising this responsibility.

  Self-certification may not be sufficient on its own, as the right amount of independent challenge may not be built into the process. The results should be independently reviewed (for example, by internal audit) on behalf of the board or audit committee. This independent review should challenge the:
  - completeness of the organisational objectives covered;
  - process for identifying and assessing the associated risks;
  - design and operation of the key mitigating controls;
  - process for reporting any excess of residual risk beyond defined risk tolerance levels; and
  - process for reporting any significant over or under control.
- *Internal audit visits on a cyclical basis.* Although internal audit should maintain independence from management, it can perform more than just a monitoring role. In many organisations internal auditors also act as facilitators and internal advisers to management on effective means of controlling operational risk. Internal audit arrangements naturally vary, but have the potential to play a central role within the monitoring process.
- *Special reviews by external auditors or specialists on a cyclical basis.* Responsibility for reviewing and concluding on the effectiveness of internal control rests with the board. However, the external auditors are likely to have useful knowledge and access to specialist consultants with expertise in specific aspects of risk management and control evaluation. Such procedures are outside the scope of the statutory audit, but could be provided as part of a separate engagement. Before any such review takes place, care must be taken to ensure that there are no circumstances which could potentially impair the independence and objectivity of the external audit.

While effective monitoring throughout the organisation is an essential component of a sound system of internal control, the board cannot rely solely on embedded monitoring processes to discharge its responsibilities. The board, with the assistance of the audit committee, should regularly receive and review reports on internal control and be informed about how the reviews giving rise to the reports have been undertaken.

In addition, the board – again supported by the audit committee – should undertake an annual assessment exercise to ensure that it has considered all significant aspects of internal control for the accounting period and the period up to the date of approval of the annual report and accounts.

The audit committee should define the process to be adopted for its review of the effectiveness of internal control, and ensure that it is provided with appropriately documented support for any 'internal control' statements or reports it (or the board) is required to make – whether that be to regulators or explanatory disclosures in the annual report and accounts. Much of this support will come from the audit committee, which in turn will base its opinion on the work of the internal auditor, other assurance providers and, to a lesser extent, the external auditors. (Note: external auditors are not part of an organisations internal control framework and carry out control work with a view to forming an opinion on the truth and fairness of the financial statements.) The board also needs to consider the scope and frequency of the reports it receives during the year, together with the process for its annual assessment.

THE AUDIT COMMITTEE MAY WANT TO ASK:

- Do management and the board receive timely, relevant, reliable reports on progress against the institution's objectives and the related risks that provide them with the information needed for decision-making and review purposes?
- Are information needs and related information systems reassessed as objectives and related risks change, or reporting deficiencies are identified?
- Are periodic reporting procedures effective in communicating a balanced, understandable account of the organisation's position and prospects?
- Are there areas of the organisation's operations that are not fully understood by internal audit or other assurance providers?
- Are there established channels of communication (e.g. whistle-blowing) for individuals to report suspected breaches of laws or regulations or other improprieties?

As part of its assessment, the audit committee should obtain from management an overview of the risks facing the organisation together with the policies, procedures and controls in place to mitigate such risks. The committee should request, however, that the information it receives is manageable; it should not be so voluminous as to deter a proper understanding of the key risks. It is more important that the audit committee gains meaningful insight into the key sources of risk and how such risks are managed, rather than being presented with a long list of every imaginable risk facing the business.

> *"One role for the audit committee is to review the wider risk map and ensure all important components are under the purview of the board and/or a board committee."*
>
> Board Chairman

An example risk summary and register focused on a small number of key risks is included as Appendix 9. Such a summary is designed to give audit committee members a quick insight into the key risks and the effectiveness of the controls in place.

Indications that the system of internal control isn't working as intended

Symptom	Warning signs
Executive and business teams are not engaged in the risk and control processes	• Formal risk and control discussions are regularly postponed • Risk and control processes are disconnected from 'business as usual'
Development of the system of internal control is seen as the ultimate goal	• The process seems overly complex and business teams are slow to adopt, or develop their own models • Little enhanced debate or further quantification
Oversight and challenge is not robust	• Reporting focuses on risk coverage, rather than action • Risk and control assessments, reports/ processes rarely change • Business owners are not challenged, and receive little feedback
The role of the risk function is confused, at best misunderstood – at worst ignored	• Little remit to challenge strategy and key investments • Seen as consolidators of information
Unclear accountability for risk and control	• Risks are not addressed in a timely manner, and struggle to find a home • Internal audit facilitates the process
Assurance is patchy – strong for traditional risks; confused for emerging risks	• No clear assurance map • Internal audit plans rotate around the same topics • Executive teams rely heavily on management self-assurance

The ongoing review process

The reports from management and/or others qualified to prepare them in accordance with agreed procedures should provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in the areas covered. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact they have had, could have had, or may have on the organisation and the actions being taken to rectify them.

It is essential to have a frank, open dialogue between management and the audit committee on matters of risk and control.

When reviewing reports during the year, the audit committee should consider:

- What the significant risks are and assess how they have been identified, evaluated and managed. The significant risks threatening the achievement of business objectives should have been identified, assessed and controlled within the board's defined risk tolerances.

- The effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses that have been reported.
- Whether appropriate action is being taken on a timely basis to remedy any significant failings or weaknesses. It is not sufficient for the audit committee to satisfy itself that weaknesses are being identified; it must also consider the remedial actions taken and whether such steps are appropriate.
- Whether the findings indicate a need for more extensive monitoring of the internal control system. Where a weakness identified in one area of the organisation may be duplicated in other areas, it may be appropriate for the audit committee to seek a more comprehensive review.

Indications that risk information is weak and therefore the system of internal control is compromised

Symptom	Warning signs
Risk information is produced, but not used	• Strategies, plans, budgets and processes do not change as new risks emerge
Inconsistent risk data is delivered from a number of competing risk functions	• There is no single, accepted risk process and management cannot give a united, single view of risk
The risks on the register do not reflect business reality	• Risk assessments rarely change
Risk information is not escalated to the right person at the right time	• Lack of strategic or emerging risks • Risks are materialising, but were not on the risk register
Quantity has the upper hand over quality	• Risk reports run to many pages, and are in fact risk registers • There is little analysis of key themes or interactions between risks

The annual review exercise

The annual assessment should consider the issues dealt with in the reports reviewed during the year, together with additional information necessary to ensure that the board has taken account of all significant aspects of internal control for the organisation's accounting period and the period up to the date of approval of the annual report and accounts.

The annual assessment should consider:

- Changes since the last review in the nature and extent of the significant risks and the organisation's ability to respond effectively to changes in its operations and external environment. The audit committee should review the organisations activities and operational structure to identify changes that might alter the risk profile. The ability to respond effectively to changed circumstances is vital.
- The scope and quality of management's ongoing monitoring of risks, the system of internal control and, where applicable, the work of the internal audit function and other assurance providers. The audit committee should consider whether management's approach to ongoing monitoring of the internal control system covers the key risks to the organisation in what it believes to be an appropriate cycle and with a level of diligence it deems satisfactory. The internal audit function may provide significant additional comfort, as long as it has sufficient resources and authority to be effective.
- The extent and frequency of communications with the audit committee, enabling it to build up a cumulative assessment of the state of control in the organisation and the effectiveness with which risk is identified and managed. The audit committee should consider whether it receives the output from the monitoring process regularly enough to be able to form a timely opinion of the ongoing effectiveness of the process. Strategic decision-making may be impaired if the results of monitoring activities are not received, reviewed and acted upon on a timely basis.
- The incidence of significant control failings or weaknesses identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have a material impact on the organisation's performance or reputation. The audit committee will want to reflect on the incidence of control weaknesses occurring during the period and the effect those weaknesses have had, could have or still may have on the organisation operations and results.
- The effectiveness of the reporting process. The efficiency of the year-end reporting process from all areas of the organisation will provide an indication of the level of management control throughout the organisation.

Should the audit committee become aware at any time of a significant failing or weakness in internal control, it should determine how this failing or weakness arose and reassess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

THE AUDIT COMMITTEE MAY WANT TO ASK:

- Are there ongoing processes embedded within the organisation's operations, and addressed by senior management, that monitor the effective application of the policies, processes and activities related to internal control and risk management? (Such processes may include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews or other management reviews.)
- Do these processes monitor the organisation's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, business and external environment?
- Are there effective follow-up procedures to ensure that appropriate modification or action occurs in response to changes in risk and control assessments?
- Is there appropriate communication to the board (and committees) on the effectiveness of the ongoing monitoring processes for risk and control matters? This should include reporting any significant failings or weaknesses on a timely basis.
- Are there specific arrangements for management to monitor and report to the board on risk and control matters of particular importance? These could include, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the organisation's reputation or financial position.

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Reporting

To the extent that the audit committee does monitor the effectiveness of the company's internal control and risk management systems on behalf of the board, the results of the committee's deliberations should be reported to, and considered by, the board. The board will need to form its own view on effectiveness based on the information and assurances provided to it by the audit committee, exercising the standard of care generally applicable to directors in the exercise of their duties.

External reporting

The audit committee needs to be cognisant of any external reporting requirement relating to risk and control – whether that is private reports to regulators or disclosure in the annual report and accounts. The committee should ensure that it is provided with appropriately documented support for any risk and/or internal control statements/reports it (or the board) is required to make.

Specific requirements will depend on the nature and circumstances of the organisation, but it is not uncommon for organisations to disclose the following within their annual report and accounts:

- a description of the principal risks and uncertainties facing the organisation;
- that the board is responsible for maintaining the organisation's risk management and internal control systems and for reviewing their effectiveness;
- that risk management and internal control systems are designed to manage rather than eliminate the risk of failure and can only provide reasonable assurance against material misstatement or loss;
- a summary of the key features of the risk management and internal control systems;
- that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified during the board's review; and
- any other information considered necessary to assist shareholders' understanding of the main features of the risk management and internal control systems.

Monitoring special circumstances

A company's risk profile can also change as a result of its stage in the growth cycle. To illustrate, we highlight two very common examples – a fast-growing, entrepreneurial company and a company expanding globally through mergers, acquisitions and reorganisations.

Emerging companies

Fast-growing entrepreneurial companies often lack a formalised management structure and may not have well-established corporate governance programmes. Policies, procedures, and processes may be evolving haphazardly to meet demands. In addition the dominant role of an individual executive may overshadow the need to foster a strong control environment and can potentially affect the financial reporting and audit processes.

As companies grow, a more standardised corporate governance process becomes a necessity, regardless of the entity's public aspirations.
For companies considering an initial public offering, the need for a formalised structure becomes obvious. While the risks described in this publication represent important issues in today's marketplace for public companies, they also apply to entrepreneurial and other companies that remain private. Responding to these risks is equally important to companies that wish to deter fraud and improve the quality of their corporate reporting.

Dominant or autocratic management can also be a cause for concern in an established company. Such leadership can put a strain on the enterprise's controls and corporate governance processes and set the wrong tone from the top. Ensuring that management fosters an atmosphere that supports a strong control environment is a core audit committee responsibility.

Complex corporate structures

Mergers, acquisitions and reorganisations often involve melding organisations not only with distinct corporate cultures but also from different industries and different areas of the world. In today's business environment, companies frequently cross borders for every aspect of their business. This environment presents management and the audit committee with unique oversight challenges. While governance practices in such environments are evolving, the influence of different cultures needs careful consideration.

For the audit committee, many questions will need answers.

- How are management's reporting, control, and compliance responsibilities integrated?
- Is there effective oversight of local boards?
- How does the committee evaluate domestic and international audit results, both internal and external?
- How does management determine the company's compliance with various countries' rules and regulations?

Reorganisation often means downsizing and outsourcing. The process of downsizing often means that companies remove or weaken controls. As companies focus on core competencies, they often outsource to third party providers non-core activities and specialised skills. Has the organisation carefully evaluated the ongoing internal control impact of such decisions?

Audit committees' responsibilities do not stop at national or organisational boundaries – they extend to the organisation as a whole. Audit committees of parent companies and subsidiaries should coordinate and communicate with one another. They should have a common appreciation of the control frameworks and cultures of the entities, and undertake substantial sharing of information.

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FRAUD, MISAPPROPRIATION AND WHISTLE-BLOWING

CHAPTER 5

Audit committees can play an important role in ensuring that the systems in place to mitigate the risk of fraud and misappropriation – not only in monetary terms but also intellectual property rights, data loss, accounting manipulation, inappropriate use of an organisation's assets by employees, and other matters – are fit for purpose and working as intended.

While ultimate responsibility rests with the board as a whole, audit committees are typically tasked with the principal oversight of fraud, misappropriation and whistle-blowing systems; including inter alia:

- reviewing and discussing any issues raised during the organisation's assessment of the risk of fraud and irregularity;
- reviewing and discussing with the internal and external auditors any findings on the quality of the organisation's anti-fraud systems and controls;
- reviewing arrangements by which employees (and others) may, in confidence, raise concerns about possible improprieties in accounting, auditing and other matters; and
- ensuring that arrangements are in place for the receipt and proportionate investigation of questions or concerns regarding possible improprieties in accounting, auditing and other matters and for appropriate follow-up action.

Responsibilities

Direct responsibility for anti-fraud efforts would generally reside with a member of the senior management team, such as the chief financial officer or another officer with specific compliance duties. This person would be responsible for co-ordinating the organisation's approach to the prevention of fraud and misconduct, detection and response. When fraud and irregularity issues arise, this individual can draw together the right resources to deal with the problem and make necessary operational changes. The compliance officer may also co-ordinate the organisation's risk assessment efforts in this area by:

- establishing policies and standards of acceptable practice;
- overseeing the design and implementation of anti-fraud programmes and controls; and
- reporting to the board and/or audit committee on the results of the institution's fraud risk management activities.

The internal audit function is a key participant in anti-fraud activities, supporting management's approach to preventing, detecting and responding to fraud and irregularity. Typically, internal audit is tasked with:

- planning and evaluation of the design and operating effectiveness of anti-fraud controls;
- assisting in the fraud risk assessment and helping to draw conclusions as to appropriate mitigation strategies; and
- reporting to the audit committee on internal control assessments, audits, investigations and related activities.

It should be noted that the external auditors have a duty to report to those charged with governance (usually the audit committee) any serious weaknesses, fraud, irregularities or accounting breakdowns they come across in the normal course of their duties.

The role of the audit committee

How can the audit committee ensure that appropriate procedures are in place to minimise the risk of losses arising from fraud, bribery and corruption? Unpalatable though it may be, the audit committee has to address these risks head-on. Identification of the risk of losses arising from fraud and other impropriety, through diagnostic studies of the risks within the organisation, should be considered an important first step. The audit committee should question whether management has considered those risks likely to have greatest financial, reputational or regulatory impact on the organisation. This should include identifying the risk of fraud and impropriety; a rigorous assessment of any relevant internal controls and their ability to prevent and/or detect fraud; and monitoring those controls.

The audit committee should determine whether a consistent approach is taken across the organisation, whether those risks assessed as high are dealt with appropriately, and whether management is engaged in the process.

It is important that staff at all levels receive training relevant to their role: this might include fraud awareness, anti-bribery and corruption and other matters. A common theme arising from the investigation of many improper activities is that countless people in the affected organisation knew or suspected that irregularities were occurring, but were not given the skills to identify the signs of fraud or provided with an opportunity to communicate their concerns. The audit committee should enquire as to whether the organisation has an effective awareness programme which is updated as appropriate and provided in a relevant format to employees at different levels within the organisation.

The audit committee is not involved in day-to-day management, and therefore not closely involved with the detail of matters related to fraud and improper activities. However, it can usefully focus attention on the need for proper policies and procedures to help in preventing fraud. In some organisations the board may delegate this role to an 'ethics committee'.

The audit committee should question whether appropriate policies have been issued and whether they are user-friendly and adopted throughout the organisation. Policies which might be considered include an anti-fraud policy, an anti-bribery and corruption policy, a whistle-blowing policy (see page 78) and response plans. The committee should consider not just

whether these policies are appropriate, but whether they are effective and how management has confirmed this. 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 – i.e., an oversight role.

The committee should ensure that management is providing clear direction to the organisation on fraud and impropriety, and requesting and receiving relevant information on suspected misconduct.

The following are, among other factors, sometimes seen as symptomatic of a potential for fraud and misconduct to occur:

- overly dominant senior executives with unfettered powers;
- frequent changes in finance or other key personnel, auditors or other professional advisers;
- implausible explanations as to surpluses, or projections that are 'too good to be true';
- organisations 'bucking the trend' or significantly out-performing the competition;
- individuals who have expensive lifestyles or habits that are potentially at variance with the remuneration they receive from the organisation;
- aggressive accounting policies;
- highly leveraged reward schemes; and
- overly complex corporate structures involving havens of secrecy.

Measures to guard against fraud, bribery and corruption include:

- Boards taking responsibility for the fight against fraud, bribery and corruption
- Appointing a senior officer accountable for oversight
- A clear statement of an anti-fraud and anti-corruption culture
- Documented policies and a code of ethics, applicable regardless of local laws or culture, which must also apply to business partners
- Consistent disciplinary processes providing for individual accountability
- Assessing risks specific to the organisation
- Financial controls and record-keeping to minimise the risk of fraud, bribery and corruption
- Policies and procedures on gifts, hospitality, and facilitation payments
- A policy and procedure on the use of outside advisers/third parties including vetting, due diligence and appropriate risk assessments
- A policy covering political contributions and lobbying activities
- Training to ensure dissemination of the anti-fraud and anti-corruption culture to all staff
- Establishing whistle-blowing procedures e.g., a helpline
- Regular and risk-based checks and auditing
- Wherever possible, implementation of procurement and contract management procedures to minimise the opportunity for corruption by sub-contractors and suppliers

Whistle-blowing

Whistle-blowing procedures are a major line of defence against fraud and audit committees have a role in ensuring such procedures are effective.

Barriers to an effective whistle-blowing procedure include:

- *Operational* – is the whistle-blowing process fully embedded within the organisation? Do all staff know what to do, what to look for? Do the hotlines and reporting lines actually work?
- *Emotional and cultural* – Whistle-blowers are commonly viewed as snitches, sneaks, grasses, super grasses and gossips. This perception can make it difficult to blow the whistle even though individuals recognise that it is good for the company, employees, shareholders and other stakeholders.
- *Fear* – Potential whistle-blowers often fear reporting incidents to management. Areas such as legal protection, fear of trouble and potential dismissal all play a part when an individual is considering whistle-blowing.

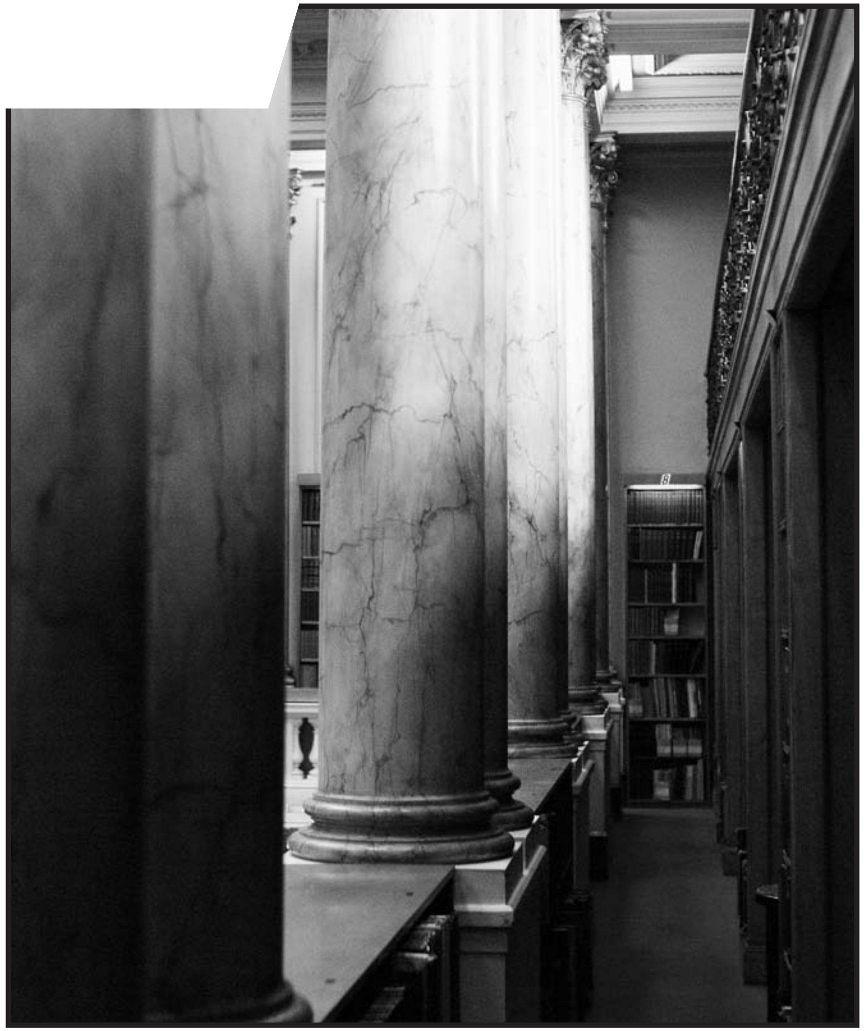
When reviewing whistle-blowing procedures, the audit committee should consider the following:

- Are whistle-blowing procedures documented and communicated throughout the organisation?
- Does the policy make clear that it is both safe and acceptable for employees to raise concerns about wrongdoing?
- Were the whistle-blowing procedures arrived at through a consultative process? Do management and employees 'buy into' the process?
- Are concerns raised by employees (and others) responded to with a reasonable time frame?
- Are procedures in place to ensure that all reasonable steps are taken to prevent the victimisation of whistle-blowers?
- Are there procedures to ensure that all reasonable steps are taken to keep the identity of whistle-blowers confidential?
- Has a senior person been identified to whom confidential concerns can be disclosed? Does this person have the authority and determination to act if concerns are not raised with, or properly dealt with, by line management and other responsible individuals?
- Are success stories publicised?
- Does management understand how to act if a concern is raised? Do they understand that employees (and others) have the right to blow the whistle?
- Has consideration been given to the use of an independent advice centre as part of the whistle-blowing procedure?

An example of a whistle-blowing policy is set out at Appendix 10.

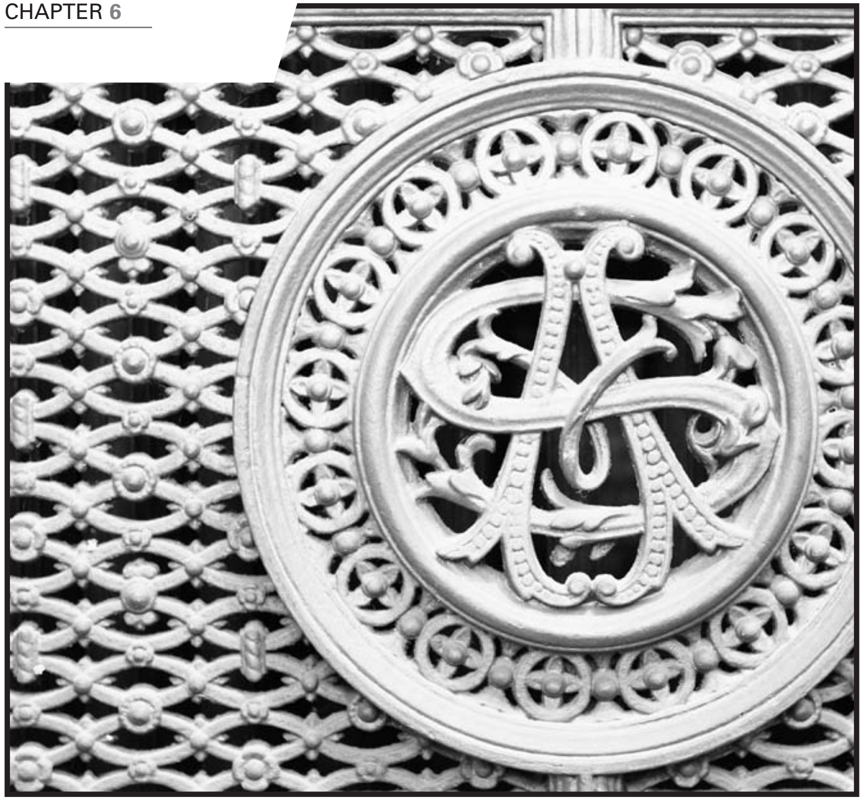
Audit committees can add value by asking how much detected fraud is captured by the whistle-blowing system. If it's less than (say) 50%, they might want to consider whether:

- there are areas of the business (either geographical or functional) where there are few, if any, whistle-blowing reports – suggesting effectiveness is patchy;
- management are motivated to follow up whistle-blowing activity; and
- a significant number of detected frauds were not detected by the whistle-blowing process – suggesting procedures are less than effective.



INTERNAL AUDIT

CHAPTER 6



Internal audit can have a positive impact on the control environment of an organisation and the effective design and operation of internal control. Internal audit can also play a significant role in supporting the audit committee through the provision of assurance as to whether the controls implemented by management are fit for purpose and working as intended. Part of the audit committee's role is to annually review the need for an internal audit function and, where such a function exists, its effectiveness.

The need for an internal audit function will vary depending on organisation specific factors including the scale, diversity and complexity of the organisation's activities and the number of employees, as well as cost/benefit considerations. When undertaking its assessment of the need for an internal

audit function, the audit committee should also consider whether there are any trends or current factors relevant to the organisation's activities, markets or other aspects of its external environment which have increased, or are expected to increase, the risks faced by the organisation. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.

In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself, the audit committee and the board that the system of internal control is functioning as intended. In these circumstances, the audit committee will need to assess whether such processes provide sufficient and objective assurance.

Establishing and maintaining an effective internal audit function

Internal audit can be sourced either through an in-house function or an external service provider. The decision as to which is appropriate will usually be driven by the availability of appropriate skills and the breadth and depth of experience to cover the organisation's operations adequately. The cost implications of each approach may differ significantly.

Outsourcing continues to be a common option, not least because it arguably enhances the internal audit function's independence from operational management and provides access to a wider range of skills and experience than can typically be maintained by a small in-house team.

The relative strengths and weaknesses of different internal audit sourcing options are discussed in more detail in Appendix 11.

Where an internal audit function exists, the audit committee should participate in the appointment, promotion or dismissal of the head of internal audit, and help determine the required qualifications, reporting obligations and compensation. The audit committee should also help to ensure internal audit has access to all appropriate persons both at board level and within the company.

The audit committee should be involved in developing and approving internal audit's remit, goals and mission, to be certain of its proper role in the oversight function. Collaboration with both management and internal audit in developing internal audit's remit should help ensure a proper balance between the assessment of internal control and any responsibilities for operational efficiency, risk management and other special projects.

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Establishing the 'right' role for the internal audit function is not a 'one size fits all' exercise, and the focus areas and strategic ambitions of any internal audit function rarely stay the same from one financial year to the next. Indeed, if there are signs that an internal audit plan simply rolls-over, this in itself offers a warning sign that there could be an absence of the kind of robust challenge that is needed; an organisation's key risks are rarely static – especially in the current economic environment.

Audit committees looking to optimise internal audit's resources and activities need to ensure that the function's audit plans are clearly defined in the context of the organisation's overall assurance landscape. A clearly defined and communicated remit helps to remove unnecessary duplication of effort and ensure the audit teams and expertise are focused and the investment in the internal audit function is maximised.

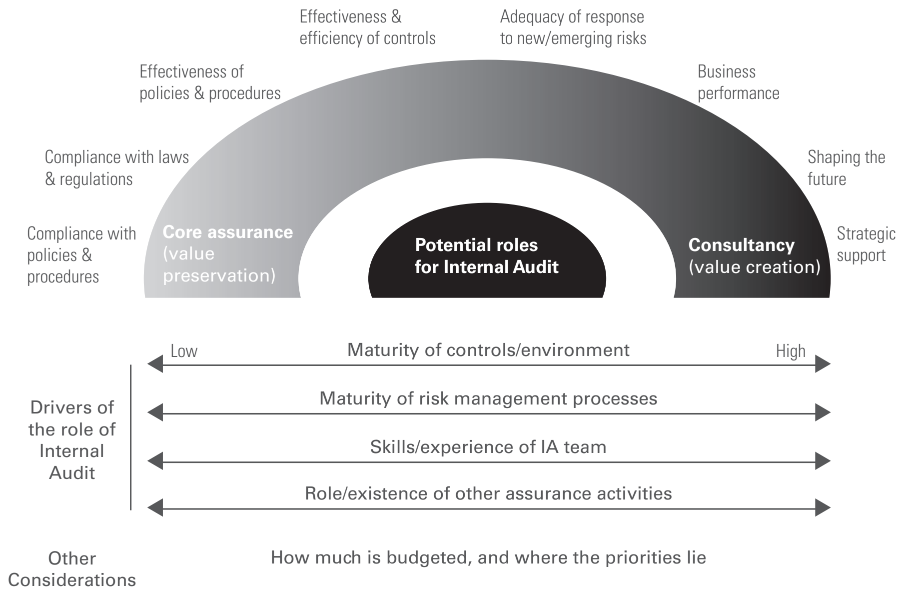
Getting the right balance between core assurance and value creation audit

In a business that has an unstable control environment, or is experiencing significant change or growth, value is often demonstrated by giving high quality assurance over the effectiveness of core controls. This helps to mitigate the risk of control failures and associated financial surprises. Newly established internal audit functions are also more likely to be focused on assessing the effectiveness of the 'basic' processes and controls.

Where there is a strong and stable control environment and where the risk management processes are mature and have an experienced team in place, internal audit can focus more on risk-based auditing. Particularly where there are other sources of assurance over core controls, such as self assessment or review by risk and / or compliance functions.

Adjusting the balance can see internal audit working alongside management in a business partnering role. The richness of assurance and opinion can help to support major change programmes or challenge controls design as processes are streamlined. This is at the high end of value creation and is an achievable ambition provided that a number of factors are in place [see diagram]. This type of role requires careful management to ensure the responsibilities of the business and the independence of internal audit do not become blurred.

An overview of the potential roles and range of input internal audit can provide



The audit committee should also ensure that the internal audit function has adequate 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. The audit committee should pay particular attention to the experience and resources within the internal audit function in times of crisis and ensure the internal audit budget and activities are not inappropriately curtailed as a result of cost cutting exercises.

Staff costs and size (Internal Audit functions with 1 to 10 full time equivalents)

Revenue	Staff Count	Staff costs	IA cost as a % of revenue
Under $500m	4.46	$613,723	0.3062%
$500m - $1billion	4.97	$737,837	0.1044%
$1billion - $5billion	6.56	$1,103,575	0.0592%
$5billion - $15billion	7.73	$1,432,760	0.0209%

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Staff costs and size (all Internal Audit functions)

Revenue	Staff Count	Staff costs	IA cost as a % of revenue
Under $500m	7.20	$819,188	0.3674%
$500m - $1billion	7.39	$908,637	0.1272%
$1billion - $5billion	13.12	$1,966,616	0.0883%
$5billion - $15billion	36.69	$4,959,768	0.0569%
$15billion - $25billion	40.64	$6,499,301	0.0361%
Over $25billion	106.29	$19,490,205	0.0349%

The data set out above is extracted from pages 16 and 17 of the *'Global Auditing Information Network (GAIN): HOIA International Network'* report, May 2010, The Institute of Internal Auditors.

When considering the skills and experience of the internal audit function, the audit committee should not overlook the personal attributes of those within the internal audit function and the need to balance quality internal audit/operational management relationships with the need to remain impartial and maintain professional scepticism. The audit committee will require internal audit to be objective and 'to the point' – and this may involve implicit or explicit criticism of management. Consequently, internal audit will need the right mix of technical skills, industry/business knowledge and 'soft skills' if they are to be fully effective.

THE AUDIT COMMITTEE MAY WANT TO ASK:

- Does internal audit have appropriate authority and standing within the organisation to carry out its duties effectively?
- Does internal audit have clearly defined terms of reference that articulate the scope of its work? Is the charter regularly reviewed to ensure it remains appropriate?
- Are internal audit's reporting lines unambiguous and is it clear that internal audit has direct access to the audit committee?
- Do internal audit's terms of reference provide for regular meetings between the head of internal audit and the audit committee – including *in camera* meetings without management being present?
- Is an appropriate relationship maintained between the internal audit function and the external auditors (and other assurance providers)?

Oversight of the internal audit function

In providing oversight over 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;
- review and assess the skills and competence mix of the internal audit team; and
- monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

Ensuring internal audit has direct access to the audit committee

A significant challenge for internal audit lies in understanding its responsibility to both the audit committee and management. The internal auditor is 'employed' by management and yet reviews management's conduct. In addition, the internal auditor reports to the audit committee and yet is not line-managed on a day-to-day basis by the audit committee (although the committee has a significant role in appointing the internal auditor).

Falling into a detailed, and not terribly helpful, analysis of 'straight line' versus 'dotted line' reporting is all too easy. The fundamental point is that internal audit has, for all practical purposes, a dual reporting relationship where the head of internal audit reports to executive management (ideally the CEO) for assistance in establishing direction, support, and administrative matters; and to the audit committee for strategic direction, reinforcement, and accountability.

Normally, the audit committee would approve the internal audit terms of reference; approve the audit function's risk assessment, audit plan, and budget; receive reports from the head of internal audit on the results of internal audit activities or other matters that the head of internal audit determines necessary; approve the appointment, removal, evaluation, and compensation of the head of internal audit; and determine whether there are scope or budgetary limitations that impede the internal audit function in carrying out its work. By contrast, the administrative reporting line to the CEO would typically include budgeting and management accounting; human resource administration; internal communications; and internal administrative matters such as expense approvals, leave approvals and logistics.

The precise reporting arrangements may differ from organisation to organisation; however, it is important that internal audit always retain a degree of independence from management so that it can carry out its duties objectively. For this reason a clear line of responsibility to the audit committee is essential. The committee should have processes in place to facilitate confidential exchanges with the internal auditor, with regular meetings scheduled between the audit committee and the head of internal audit. Many audit committee chairs go further and maintain informal contact with the internal auditor between meetings.

The audit committee should also do its utmost to ensure that internal audit has:

- sufficient status, respect and support within the institution;
- unrestricted access to all records, assets, personnel and premises;
- authorisation to obtain whatever information and explanations are considered necessary by the head of internal audit; and
- adequate human and other resources to perform its work effectively.

Assessing the annual internal audit work plan

The internal auditor should prepare an audit plan based on the organisation's assurance needs. This plan should address how all the organisation's key systems and processes will be audited during the audit cycle, together with the resources to be applied – normally expressed in 'man days'. Areas of greater risk might be addressed at the beginning of the audit cycle and then revisited later in the cycle.

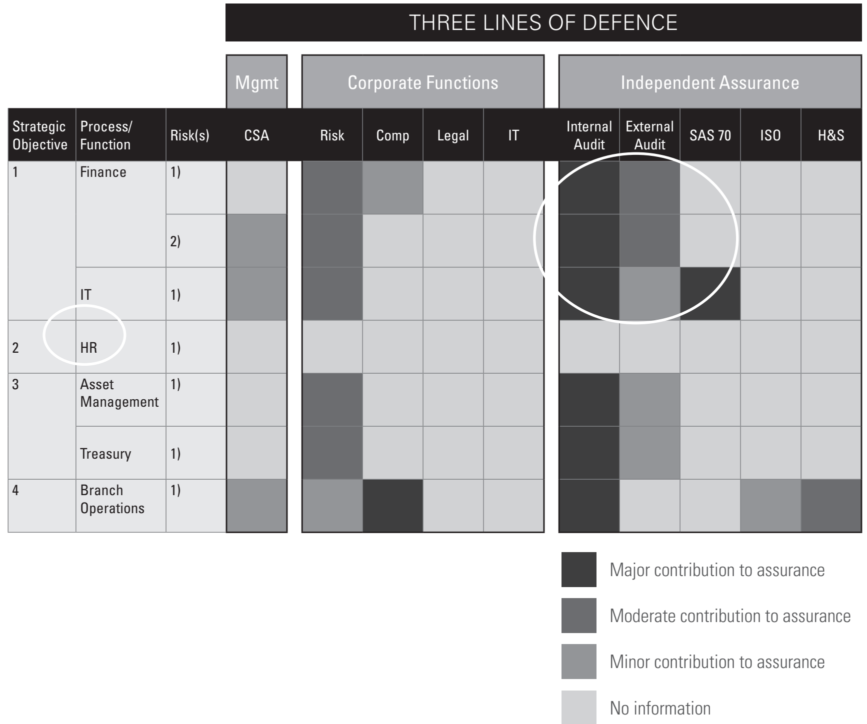
As an audit plan is unlikely to cover all areas of risk within a single year, the plan for any given year should place its work in the context of work done in the preceding year and projected for the succeeding year. The audit committee and management may take a different view of timing and priorities, which should be resolved through discussion.

A specimen internal audit plan is included at Appendix 12 and the key steps in a typical internal audit annual cycle are discussed at Appendix 13.

> *"Recent events have highlighted the need for audit committees to focus on the controls judged by management to bring the most significant risks facing the organisation before mitigation down to acceptable risks after mitigation. The audit plan should be designed primarily to provide the board with the assurance that these controls are truly effective."*
>
> Chair of Audit & Risk Committee

Assurance mapping

The audit committee should review the risk map and audit plan to satisfy itself that appropriate audit coverage will be devoted to all the organisation's assurance needs. If internal audit is not covering a particular risk area - or not covering it in sufficient depth - then other means of assurance should be in place, whether that be assurance from the business operations, head office functions or other independent assurance providers such as risk or compliance functions.



When the audit committee is satisfied with the audit plan, it should recommend the plan to the board for approval, if its terms of reference so require. Once the plan has been approved, the audit committee should monitor the auditor's progress against it during the year.

Internal auditors may carry out additional work at the request of management (including investigations), provided such work does not compromise the objectivity of the audit service or achievement of the audit plan. The audit committee should satisfy itself that the objectivity of internal audit has not been affected by the extent and nature of other work carried out.

Internal audit reports and monitoring management's response

While internal audit reports to management (preferably the CEO) on a day-to-day basis, audit committees have a responsibility for oversight and therefore need to determine appropriate communication channels and reporting arrangements with internal audit. Some audit committees want to see every audit report, some a summary of every report, and others a periodic summary. Progress reports, comparing audit activity against the audit plan, are also useful.

An illustrative internal audit report is set out at Appendix14.

It is important that the audit committee considers significant individual audit findings or recommendations, though it need not be concerned with more detailed findings unless the committee considers it valuable to do so. It is good practice for internal auditors to prioritise their findings against agreed standards. This indicates the importance of each audit recommendation and the urgency of any required action.

The audit committee should concentrate on gaining assurance that the organisation's risk management, control and governance arrangements are adequate and effective. For this purpose, the committee should ensure that there is an adequate system to monitor the implementation of agreed audit recommendations. An implementation plan detailing the recommendation, the required action, priority, person responsible and timescale is a good method of fulfilling this objective.

Internal audit should have a systematic process of follow-up to obtain appropriate assurance that management has taken timely and effective action. It should promptly advise the audit committee of its findings and further action required.

The board, advised by the audit committee, should ultimately be responsible for either ensuring that management takes prompt and effective action on those audit reports which call for it; or recognising and accepting the risks of management not taking action.

What is internal audit telling the audit committee?

An audit committee might reasonably question what assurance it's receiving when confronted with audit reports drafted along the following lines:

"Significant improvements have been made in this area in the last 12 months. However, the management agenda reflects a number of issues whose resolution would enable further, necessary improvements to be made."

This is compromise wording. Such reports are not uncommon. However, if an audit committee ever receives a summary like this, it may legitimately ask itself what on earth it means. For example: having done extensive testing and comparison to best practice, the internal auditor wants to say, "the management of controls in this area is poor". However, management believe (say) that the area in question was poorly managed some time ago, but a lot of work has been done during the year and therefore there is no value in internal audit raising issues that they are already both aware of, and dealing with (albeit slowly). They will express incredulity that internal audit should want to make a fuss about a well-known issue. Hence the compromise wording: carefully crafted to maintain pride on both sides.

The audit committee might reasonably conclude that the head of internal audit is too weak, or too junior, or too bullied and does not feel able to say what he or she really thinks.

"Whilst a number of improvements have been made in this area, further change is required if its management is to become world-class."

This is told you so wording. It means that if controls fail, some financial catastrophe looms and the audit committee turns to the head of internal audit and asks, "Why wasn't I warned?" she or he can reply, "I told you so. We reported it to you. Wasn't it clear? You could have asked for more details if you had any questions or even requested the full report."

The underlying cause of such wording might be that people are afraid of bringing bad news either to the audit committee or, more likely, they're afraid of trying to get it past the executive team.

"Wider variations in base rate and potential dynamic margin shifts to reflect market positioning would mean that the business would be more exposed to rate increases than decreases".

This is preventative wording. Many audit committee members might legitimately have a problem understanding what this means; yet all it is saying is that the business in question is vulnerable to a rise in interest rates. Preventative wording is designed to prevent the reader understanding the issue. Can it really have any other purpose?

Internal audit does not want the audit committee to understand because they might ask difficult, inconvenient questions that will be embarrassing or maybe just tedious to answer. Or maybe, no one can do anything about the issue anyway so why make trouble? Whatever the motivation, whether it is conscious or sub-conscious, internal audit are reporting to the audit committee in a way designed to elicit a reduced reaction. Preventative wording is extremely dangerous and audit committees should be alert to it.

"In the last six months, we have issued 74 reports of which 27 were rated as significant. These are split by division in the table below. A further chart showing traffic light ratings etc., etc".

This is death by statistics. An audit committee can look at all of this information yet be unable to draw a single, meaningful insight from any of it. Of course, this form of reporting can be valuable where internal audit is doing standard processes at multiple locations, such as retail store audits. But, where one piece of work is not directly comparable with another, it is just filler. The underlying cause is that the internal audit function wants to demonstrate progress but has no idea how to demonstrate value.

'In camera' meetings with the head of internal audit

Many audit committees want to meet the head of internal audit in a private session where management is not present. This approach allows the audit committee to ask questions on matters that might not have been specifically addressed by the internal audit function's formal work programme – nevertheless, the head of internal audit might, as a result of his work, have valuable views and opinions. A private session allows the head of internal audit to provide candid, often confidential, comments to the audit committee on such matters.

Typically there should be few items to discuss. Ideally all key matters relating to internal audit should have been addressed in a candid and robust manner by management, the audit committee and the head of internal audit during the formal audit committee meeting.

The audit committee can use the private session as a follow-up if members were not satisfied with the answers given at the audit committee meeting or if they thought discussions had been too guarded or uneasy. However, such matters should have been fully aired at the audit committee meeting and generally should not need to be readdressed in the private session.

Rather then the private session should focus on areas where the head of internal audit can provide additional, candid, and often confidential, comments to the audit committee on other matters. The private session gives the audit committee an opportunity to explore such matters in a frank and open forum. In addition, the audit committee may have more knowledge than the head of internal audit on other matters, and this session allows the audit committee an opportunity to air such issues.

Overall, private sessions can play an important role in the development of a trusting and respectful relationship between the audit committee and the head of internal audit.

The audit committee may want to ask questions around relationships, attitudes and resources, such as:

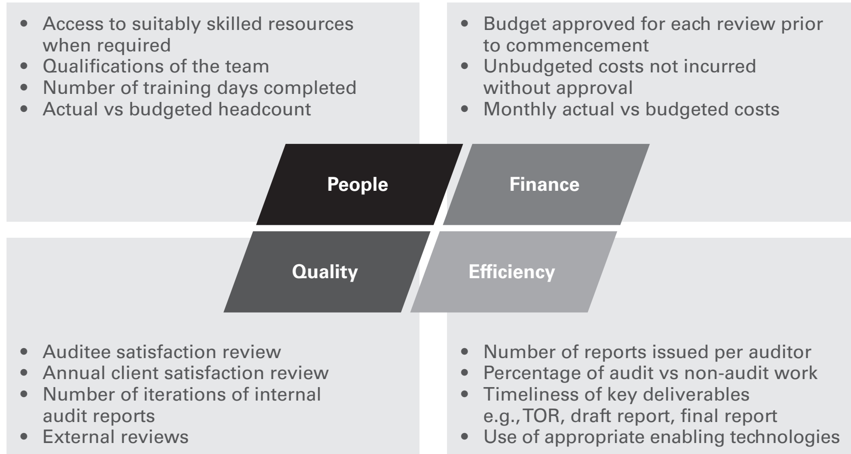
- How strong is the relationship between the internal audit function and management/operations?
- Does internal audit receive appropriate cooperation from operational and head office management?
- Have any requests for information been denied or otherwise obstructed?
- Is the internal audit function subject to undue pressure from any source?
- How constructive is the relationship between the internal audit function and external audit?
- What is management's attitude towards risk management and internal controls?
- Are adequate people and other resources devoted to key areas of the business and control functions?

Assessing the internal audit function's performance

The audit committee should monitor the performance and effectiveness of internal audit on an annual basis. This should include any matters affecting the audit function's independence and objectivity.

Self-assessment by the head of internal audit is a useful assessment tool, but it should not be the sole means of assessing the effectiveness of internal audit. The audit committee should draw its own conclusions based on its experience and contact with internal audit as well as the views of others such as the CFO, divisional heads and external audit. In evaluating the work of internal audit, the audit committee should review the annual internal audit work plan, receive periodic reports on the results of the internal auditor's work and monitor management's responsiveness to the internal auditor's findings and recommendations.

When agreeing appropriate performance measures for internal audit, the audit committee should recognise that such measures need to be adapted to each organisation's circumstances. The following diagram illustrates some of the more common measures used to monitor the performance of internal audit.



Appendix 15 provides a framework to assist audit committees when reviewing the effectiveness of the internal audit function.

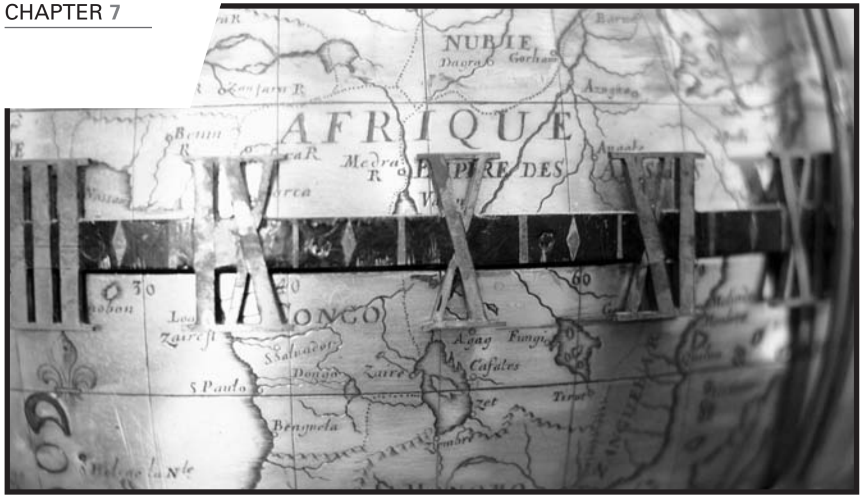
Best practice internal audit professional standards suggest that an external assessment of the effectiveness of the internal audit function should be performed at least once every five years.

Relationship with the statutory auditor

The audit committee should ensure that there is a constructive relationship between the internal audit function and statutory audit. While each audit function provides independent assurance, the audit committee should, where appropriate, seek to ensure that the internal audit function and statutory auditor co-ordinate their audit effort and avoid duplication.

EXTERNAL AUDIT

CHAPTER 7



Audit committees have a role in helping boards discharge their duties by providing independent oversight over external audit. Audit committees are usually tasked with:

- reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements;
- making 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; and
- developing and implementing a policy on the engagement of the external auditor to supply non-audit services, taking into account any relevant ethical guidance regarding the provision of non-audit services by external auditors.

Maintaining an effective relationship

The external auditor and audit committee should have a strong and candid relationship – anything less may limit the committee's effectiveness in achieving its oversight responsibilities. The audit committee should establish that the auditor is directly accountable to the committee and, through it, to the board of directors and ultimately the organisation's shareholders.

The audit committee should make sure its actions and communications with the auditor are consistent with this accountability. The audit committee should also be sure to communicate its expectations to the auditor, and ensure that both parties understand and have agreed to those expectations.

The chair of the audit committee should communicate with the audit partner prior to each audit committee meeting. This step allows the chair and the audit partner to review agenda items and should reduce any surprises arising at the audit committee meeting. If particularly controversial or difficult items are identified, the chair should also discuss those issues with management and consider the need to give advance warning to the other members of the audit committee.

It is good practice for audit committees to, at least annually, meet with the external (and internal) auditor, without management, to discuss matters relating to its remit and any issues arising from the audit. Appendix 5 addresses these 'private meetings' between the auditor and audit committee in more detail.

Selecting, appointing and removing the auditor

Making recommendations to the board on the appointment, reappointment and removal of the auditor is an important audit committee responsibility. The audit committee's recommendation to the board should be based on its assessment of the qualifications, expertise and resources, and independence of the auditor and the effectiveness of the audit process. As described later in this chapter, 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 and, where relevant, consideration of the audit firm's annual transparency report.

If the audit committee considers a formal audit tender is appropriate, it should oversee the selection process and in doing so ensure the process is conducted in a fair and unbiased manner. It is good practice to advise shareholders when the company intends to put the audit contract out to tender. Further guidance on how to conduct an audit tender is set out in Appendix 16.

The audit committee should approve the terms of engagement and recommend the compensation to be paid to the auditor in respect of audit services provided. In doing so, it should satisfy itself that the level of fees in respect of the audit is appropriate and that an effective audit can be conducted for such a fee.

When considering the appointment (or reappointment) of the statutory auditor, consideration is normally given to a range of factors including:

- understanding of the organisation's risks and needs (including strategic management issues);
- geographical coverage;
- perceived value added;
- experience of sector and existing client list;
- staff experience and number of planned partner/senior staff hours; and
- proposed fee and value for money considerations.

It is important that in making its recommendation the audit committee also has regard to the effectiveness of the audit process (see below).

In the unlikely event that the board does not accept the audit committee's recommendation regarding the appointment/reappointment of the auditor, it is good practice to include in the annual report, and in any papers recommending the appointment or reappointment of the auditor, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different position.

Local codes and regulations may contain recommendations or have requirements (such as auditor rotation rules) that impact the audit committee's selection of statutory auditor. Contractual obligations may also act to restrict the audit committee's choice of statutory auditor.

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

Assessment of audit effectiveness

In the current environment, many audit committees are considering how they should discharge their responsibilities in relation to the effectiveness and efficiency of the external audit arrangements. Tendering the audit is being encouraged by regulators, but is by no means the only available option under this responsibility - audit committees are capable of evaluating the performance of their independent auditors and holding them accountable for the performance of their professional duties. Indeed, it is best practice for audit committees to evaluate the effectiveness of their audit arrangements *every* year.

A review of the audit process, the effectiveness and performance of the audit team, and the output, quality and cost effectiveness of the audit is, a valid alternative to the tender approach, subject to regulation. Not only does such a review help optimise the performance of auditors; it also encourages good communication between the auditor and the audit committee.

> *"A good auditor is constructive, but critical. Reasoned, but concise explanation of judgements adds real value."*
> Audit Committee Chair

Such a review should evaluate the relationship between the auditor and executive management and ensure that an appropriate balance exists. The relationship should not be so close as to put at risk the auditors' independence and objectivity yet, at the same time, should be such that management and auditors can work together in an environment of constructive challenge.

In determining the appropriateness of the external auditor, the audit committee should have full regard to the auditor's competence, the quality and efficiency of the audit, and whether the audit fee is appropriate in relation to size, complexity, and risk and control profile of the company.

The committee might consider:

- ensuring the statutory auditor has met the agreed audit plan.Understanding the reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditor to address those risks;
- the robustness and perceptiveness of the auditor in handling the key accounting and audit judgements identified, responding to questions from the audit committee, and commenting where appropriate on the systems of internal control;
- obtaining feedback about the conduct of the audit from key stakeholders such as the CFO and chief internal auditor;
- the views of shareholders;
- the timeliness and quality of communication between the statutory auditor and the audit committee – including, where appropriate, audit highlights memorandum, reports on control weaknesses, conduct during audit committee meetings and ad hoc communications between meetings. Good statutory auditors will identify issues early and brief the audit committee on the available options in a timely manner;
- the 'value-added' by the audit process; and
- the degree to which the statutory auditor has been able to engage with the committee on broad business and strategic issues.

Audit Quality Framework

The FRC's Audit Quality Framework (February 2008) promotes the key drivers of audit quality and is a useful tool in assisting audit committees in both evaluating audit proposals and undertaking annual assessments of the effectiveness of external audits.

Driver	Indicator
The culture within an audit firm	The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm: • Creates an environment where achieving high quality is valued, invested in and rewarded. • Emphasises the importance of 'doing the right thing' in the public interest and the effect of doing so on the reputation of both the firm and individual auditors. • Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise. • Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality. • Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgement. • Ensures robust systems for client acceptance and continuation. • Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing. • Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.
The skills and personal qualities of audit partners and staff	The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where: • Partners and staff understand their clients' business and adhere to the principles underlying auditing and ethical standards. • Partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit. • Staff performing detailed 'on-site' audit work have sufficient experience and are appropriately supervised by partners and managers. • Partners and managers provide junior staff with appropriate 'mentoring' and 'on the job' training. • Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.
The effectiveness of the audit process	An audit process is likely to provide a positive contribution to audit quality where: • The audit methodology and tools applied to the audit are well structured and: – Encourage partners and managers to be actively involved in audit planning. – Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently. – Require appropriate audit documentation. – Provide for compliance with auditing standards without inhibiting the exercise of judgement. – Ensure there is effective review of audit work. – Audit quality control procedures are effective, understood and applied. • High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with. • The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor. • The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.
The reliability and usefulness of audit reporting	Audit reporting is likely to provide a positive contribution to audit quality where: • Audit reports are written in a manner that conveys clearly and unambiguously the auditor's opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations. • Auditors properly conclude as to the truth and fairness of the financial statements. • Communications with the audit committee include discussions about: – The scope of the audit. – The threats to auditor objectivity. – The key risks identified and judgements made in reaching the audit opinion. • The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.
Factors outside the control of auditors	Factors outside the control of auditors which are likely to make a positive contribution to audit quality include: • An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process. • Audit committees that are active, professional and robust in dealing with issues identified during the audit. • Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements. • Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period. • Appropriate, agreed arrangements for any limitation of liability. • An audit regulatory environment that focuses on the drivers of audit quality.

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Appendix 17, Evaluation of the external auditor, provides a framework for an audit committee to carry out a formal review of the effectiveness and efficiency of the external auditor. Such a review provides the audit committee with a disciplined approach to monitoring the auditor's performance.

Removal or resignation of auditors
Boards can generally pass a resolution to remove auditors before the end of their term of office if serious shortcomings are identified.

External auditors who have resigned or been removed from office for whatever reason are generally entitled to attend, and make representations to, the general meeting at which their term of office would have expired, or at which it is proposed to fill the vacancy caused by their resignation or removal. They are generally entitled to receive notices of, or other communications relating to, that meeting and to be heard on any part of the business which concerns them as former auditors of the organisation.

Where auditors cease to hold office for any reason, they would generally provide the organisation with a statement of the circumstances connected with their ceasing to hold office. In the case of a UK quoted company a statement of circumstances must be deposited at the companies registered office. The audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

Safeguarding auditor independence

The external auditor should remain independent and objective at all times. The audit committee should, at least annually, consider the external auditor's independence and carry out procedures to help ensure the auditor's independence and objectivity, taking into consideration relevant professional and regulatory requirements. For its part, the audit firm should have internal policies and procedures in place, which are properly monitored, to establish that the audit firm and its individual members are independent from the organisation.

In considering matters that may bear on the auditor's independence, both the auditor and the audit committee should consider whether conflicts exist, such as:

- the auditor holding a financial interest, either directly or indirectly, in the organisation;
- personal and business relationships of the auditor's immediate family, close relatives and partners with the organisation;
- the nature of the relationship between the audit partner and the CEO and/or the CFO;

- economic dependence by the auditor through its relationship with the organisation; and
- the nature and extent of services provided by the auditor in addition to the audit engagement.

Each year the audit committee should obtain from the audit firm information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners. The audit committee should understand the audit firm's plans for audit partner rotation on its engagement.

Employment of former employees of the external auditor

The audit committee should agree on a policy for the employment of former employees of the statutory auditor, taking into account the relevant ethical guidelines governing the accounting profession and any local regulation or recommendations.

The audit committee should monitor application of the policy, including the number of former employees of the statutory auditor currently employed in senior positions in the organisation, and consider whether, in the light of their employment, there has been any impairment, or appearance of impairment, of the auditor's judgement or independence.

Particular attention should be given to members of the audit team moving directly to the organisation and former employees moving into financial oversight positions within the organisation. In both cases, the audit committee might consider 'cooling off' periods to be necessary.

An example policy on employing former employees of the external auditor can be found at Appendix 18.

Pre-approving non-audit services

To help ensure that non-audit services provided by the statutory auditor do not impair, or appear to impair, the auditor's independence or objectivity, the audit committee should develop, and recommend to the board, a policy on the provision and pre-approval of all non-audit services; and keep that policy under review.

In determining the policy, the audit committee should consider:

- whether the skills and experience of the statutory audit firm make it a suitable supplier of the non-audit service;
- whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to audit objectivity and independence (see overleaf);

- the nature of the non-audit services;
- the fees incurred, or to be incurred, for non-audit services both for individual services and in aggregate, relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

Threats to audit objectivity and independence may arise from:

- the auditor having a financial or other interest that might cause them to be reluctant to take actions that would be adverse to the interests of the audit firm or any individual in a position to influence the conduct and outcome of the audit (self-interest threat);
- the auditor (or others in the firm) performing non-audit services the results of which are reflected in the amounts included or disclosed in the financial statements of the audited entity (self-review threat);
- partners and employees of the audit firm making judgements or taking decisions on behalf of the management of the audited entity (management threat);
- the audit firm undertaking work that involves acting as advocate for the audited entity and supporting a position taken by management in an adversarial context (advocacy threat);
- the auditor being predisposed to accept or is insufficiently questioning of the audited entity's point of view (familiarity threat); and
- the auditor's conduct being influenced by fear or threats (intimidation threat).

The threats identified above mirror those set out in the Auditing Practices Board's (APB) Ethical Standard 5 (Revised) *Non-audit services provided to audit clients*. The Standard provides requirements and guidance on specific circumstances arising from the provision of non-audit services by audit firms to their audit clients, which may create threats to the auditors' objectivity or perceived loss of independence. In particular it states that the audit engagement partner should ensure that those charged with governance of the audited entity (usually the audit committee) are appropriately informed on a timely basis of:

- all significant facts and matters that bear upon the auditor's objectivity and independence, related to the provision of non-audit services, including the safeguards in place; and
- for listed companies, any inconsistencies between APB Ethical Standards and the company's policy for the supply of non-audit services by the audit firms and any apparent breach of that policy.

It is good practice that the non-audit services policy devised by the audit committee should formally specify the types of non-audit work (if any):

- for which the use of the external auditor is pre-approved (i.e. approval has been given in advance as a matter of policy, rather than the specific approval of an engagement being sought before it is contracted);

- for which specific approval from the audit committee is required before they are contracted; and
- from which the external auditor is excluded.

Pre-approval of the use of the statutory auditor may be appropriate where the threats to auditor independence are considered low, for example if the engagement is routine in nature and the fee is not significant in the context of the audit fee, or for an audit related service.

Audit related services

Audit related services include inter alia:

- Reporting required by law or regulation to be provided by the auditor;
- Reviews of interim financial information;
- Reporting on regulatory returns;
- Reporting to a regulator on client assets;
- Reporting on Government grants;
- Reporting on internal financial controls when required by law or regulation; and
- Extended work that is authorised by those charged with governance on financial information and/or financial controls performed where this work is integrated with the audit work and is performed on the same principal terms and conditions.

Those non-audit services for which specific approval from the audit committee is required before they are contracted are likely to include those which are thought to give rise to threats to the auditor's independence because of their size or nature or because of special terms and conditions (for example, contingent fee arrangements). Where contracting such services from the audit firm, audit committees should give careful consideration as to whether any safeguards to be put in place by the audit firm are likely to be effective.

It is good practice to disclose a summary of the non-audit services policy in the annual report.

An example policy on the appointment and remuneration of external auditors for audit and non-audit work can be found at Appendix 19.

Understanding the audit cycle

Once the external auditor has been appointed, the audit committee should review and agree to the audit engagement letter, ensuring that it reflects the organisation's current circumstances.

Timing considerations

Sufficient time should be allowed to enable the audit committee to complete its review and engage in an appropriate dialogue with the auditor. An appropriate timetable should therefore be agreed upon up-front by the board, management and the auditor.

Major issues should not be raised for the first time at the meeting at which the audit committee intends to recommend the approval of the financial statements. While this concept may appear to be common sense, in practice, it is not always followed and can create significant pressure on the committee. If the final audit committee meeting is to be conducted effectively, audit findings should be reviewed on an ongoing and timely basis, for example, after the interim audit work. Issues can then be identified at an early stage and last minute surprises reduced. The audit committee chair should talk with the auditor in advance of each meeting so that they can direct the attention of the audit committee members to matters of substance on the agenda. One would expect the relationship with the auditor to be such that, if there are serious concerns, the auditor will bring them to the audit committee's attention promptly.

Reviewing the audit plan

The audit committee needs to understand the scope of the audit and how it is to be approached. An effective way to achieve this is to hold a meeting with the auditor prior to the auditor finalising the audit plan. The discussions may uncover areas where the committee assumes that work is done but is not, and other areas where audit effort is directed but of which the committee may be unaware. Discussion should also focus on what the auditor considers to be the significant balances and the transactions posing the most risk.

The audit committee should determine that an appropriate audit plan is in place. It should carefully consider the appropriateness of the business risks identified by the statutory auditor and whether, because of the audit committee's own knowledge of the organisation's risk environment, other risks should also be taken into account.

This focus applies both at a strategic level – those risks that are fundamental to the achievement of the entity's strategy – and at the more detailed operational level: those risks that affect day-to-day operations, the recognition of revenue and costs, the custody and value of assets, and the completeness of recognition of liabilities.

In general terms, the audit committee should understand:

- the areas where the statutory auditor intends to perform detailed substantive testing and those areas where the auditor intends to rely on internal controls;
- whether divisions or subsidiaries receive adequate coverage, particularly those that are remote either geographically or culturally; and
- whether other audit firms are involved in auditing specific geographic locations or group entities that might impact on the organisations overall risk profile.

The audit committee should also seek to understand whether, and to what extent, the statutory auditor is content to rely on the work of the internal auditors in support of their audit work, and whether they will be reviewing the work of the internal auditor.

At the pre-audit planning meeting, the audit committee may determine that the external auditor should perform additional work to satisfy the needs of the institution, such as increased internal control testing or aspects of the internal audit work. In such circumstances, the audit committee should consider the effect this may have on the effectiveness of the company's overall arrangements for internal control.

Reviewing representations by management or the board

The audit committee should review any written representations by management or the board.

Representation letters may cover matters such as:

- confirmation that all accounting records have been made available, all transactions properly recorded in the accounting records, and all other records and related information made available;
- management's plans or intentions that may affect the carrying value of assets and liabilities;
- knowledge of events occurring subsequent to the balance sheet date that would require adjustment to the financial statements;
- presentation and disclosure of the fair value measurement of material assets, liabilities and components of equity;
- knowledge of fraud, or suspected fraud, affecting the organisation;
- confirmation that the effects of uncorrected financial statement misstatements are immaterial; and
- confirmation that all information provided regarding related parties is complete.

The audit committee should give particular consideration to matters relating to non-routine or unusual issues. It should consider whether the information provided is complete and appropriate based on its own knowledge.

Statement on information given to auditors

Where the organisation is incorporated under the UK Companies Acts, the directors are required by s418 of the Companies Act 2006 to include in the Directors' Report a statement that, in the case of each person who was a director at the time when the Directors' Report is approved:

- so far as the director is aware, there is no relevant audit information of which the auditors are unaware; and

- the director has taken all the steps that they ought to have taken as a director to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

An example statement:

The directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that they ought to have taken as a director to make them aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Although the responsibility of each board member, many boards look to the audit committee to seek assurance on behalf of each board member in advance of them making their declaration. In such circumstances, the audit committee might consider:

- Discussions with the auditor during the audit planning meeting around gaining access to particular information.
- Identifying those areas most at risk of not being communicated to the auditor including, for example, bad news stories.
- The 'flow of information' with the auditor. Enquire as to whether the auditor has:
  - met all the directors and senior management;
  - had any issues concerning access to information;
  - had access to board papers, minutes and management information; and
  - met with senior management to gain a solid understanding of risk management processes; and that they are familiar with how information is captured and how it is reported, as well as the risks to the process.
- Identifying those key areas where the board needs additional assurance and reviewing whether any such assurance processes are fit for purpose and working as intended. For example, does each business unit head confirm to the finance director (or relevant person), on a regular basis, that there are adequate procedures and controls relating to the disclosure of information and/or that they are satisfied that the auditors have had access to all relevant information.
- Identifying who the committee should rely on for any additional assurance. Ask the internal audit function to consider any assurance gaps between the s418 statement the board members are required to give and the reports they receive from internal audit and other assurance providers.

Reviewing audit findings

The audit committee should review the external auditor's findings, including any changes in audit approach or any modification to the statutory audit report. In particular, the audit committee should review key accounting

and audit judgements and discuss with the statutory auditor both major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved – obtaining explanations about why certain errors might remain uncorrected. Consideration of those issues that have subsequently been resolved and uncorrected misstatements that are not material in the context of the financial statements, can provide insight into the appropriateness of the system of internal control, or be indicative of management's approach to the preparation and presentation of financial information.

The audit committee should also have a frank and open dialogue around the quality and acceptability of corporate reporting, including, for example:

- the appropriateness of the accounting policies to the particular circumstances of the company;
- the timing of transactions and the period in which they are recorded;
- the appropriateness of accounting estimates and judgements;
- the potential impact of any uncertainties, including significant risks and exposures, such as pending litigation;
- material uncertainties that may cast doubt on the company's ability to continue as a going concern;
- the extent to which the financial statements are affected by unusual transactions;
- inconsistencies between the financial statements and any other information in the document containing the financial statements for example, narrative reporting;
- the overall balance and clarity of the financial statements; and
- the design and operation of the company's internal control and risk management systems (see below).

Communication

The external auditor and audit committee should have a strong, candid relationship – anything less may limit the committee's effectiveness in achieving its oversight responsibilities. The committee should establish that the auditor is directly accountable to the audit committee and, through it, to the board and ultimately to shareholders. The committee should make sure that its actions and communications with the auditor are consistent with this accountability. The audit committee should also be sure to communicate its expectations to the auditor, and ensure that both parties understand and agree to those expectations.

It is good practice for the external auditor to attend all audit committee meetings and any finance committee meetings at which the audited financial statements are discussed, and to attend board and other meetings when appropriate.

The chair of the audit committee should communicate with the audit partner prior to each audit committee meeting. This allows the chair and the audit partner to review agenda items, and should reduce any surprises arising at the committee meeting. Of course, if particularly controversial or difficult items are identified, the chair should also discuss these with management and consider the need to give advance warning to the other members of the audit committee (see also *'in camera meetings'* in Chapter 2).

Sufficient time should be allowed to enable the audit committee to complete its review and engage in an appropriate dialogue with the external auditor, including one or more discussions in camera. The governing body, management and the auditor should agree on an appropriate timetable.

Major issues should not be raised for the first time at the meeting at which the audit committee intends to recommend approval of the financial statements. While this notion may appear common sense, it is not always followed in practice and can create significant pressure on the committee. If the final audit committee meeting is to be conducted effectively, audit findings should be reviewed on an ongoing and timely basis, for example after any interim audit work. Issues can then be identified at an early stage and surprises reduced. The audit committee chair should talk with the external auditor in advance of each meeting so that the chair can direct the attention of the committee members to matters of substance on the agenda. The relationship with the external auditor should be such that if there are serious concerns the auditor will bring them to the audit committee's attention promptly.

The external auditor is required to bring to the attention of those charged with governance – usually the audit committee – any unadjusted misstatements in the financial statements, other than those that are 'clearly trifling'. Auditors are also required to discuss, in an open and frank manner, the quality and acceptability of the institution's reporting, including for example:

- the appropriateness of the accounting policies to the particular circumstances of the institution;
- the timing of transactions and the period in which they are recorded;
- the appropriateness of accounting estimates and judgements made;
- the potential impact of any uncertainties, including significant risks and exposures, such as pending litigation;
- material uncertainties that may cast doubt on the institution's ability to continue as a going concern;
- the extent to which the financial statements are affected by unusual transactions, including non-recurring surpluses;
- inconsistencies between the financial statements and any other information in the document containing the financial statements; and
- the overall balance and clarity of the financial statements.

Communications from external auditors

International Statement on Auditing 260 *Communication with those charged with governance* (ISA 260) formalises auditors' communications with those charged with governance in respect of the financial reporting process - for listed companies, this will usually be the audit committee. Matters to communicate include inter alia:

The Auditor's Responsibilities in Relation to the Financial Statement Audit – The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

Planned Scope and Timing of the Audit – The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit.

Significant Findings from the Audit – The auditor shall communicate with those charged with governance:

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:
 (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and
 (ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Auditor Independence – In the case of listed entities, the auditor shall communicate with those charged with governance:

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and

(b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgement, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and

 (ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

Management letter

International Standards on Auditing require auditors to communicate appropriately to those charged with governance (the audit committee) and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attention.

International Standards on Auditing acknowledge that external auditors only consider internal control and risk management systems to the extent necessary for them to form their opinion of the financial statements. However, where the auditor identifies deficiencies in internal control during their audit and judge such deficiencies to be significant, the Standards require the auditor to report their findings in writing to the audit committee on a timely basis.

In this context, a significant deficiency in internal control is a deficiency or combination of deficiencies in internal control that, in the auditor's judgment, is of sufficient importance to merit the attention of the audit committee.

A deficiency in internal control exists when:

- a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Where significant deficiencies in internal control are identified by the external auditor, the audit committee should expect to receive a description of the deficiencies and an explanation of their potential impact – including sufficient information to enable the audit committee (and management) to understand the context of the report, such as:

- the purpose of the audit was for the external auditor to express an opinion on the financial statements;
- the audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
- the matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to the audit committee.

The audit committee should also expect the statutory auditor to report the following to management at an appropriate level of responsibility on a timely basis:

- significant deficiencies in internal control that the auditor has reported (or intends to report) to the audit committee (unless it would be inappropriate to communicate directly to management in the circumstances); and
- any other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgement, are of sufficient importance to merit management's attention.

Management should provide written responses to any recommendations made or issues raised by the external auditor and, as part of the ongoing monitoring process, the audit committee should review and monitor management's response to the auditors' findings and recommendations, to ensure that appropriate action is taken in a timely manner.

The management letter should also indicate:

- that the external auditor has reviewed the work of the internal auditors; and
- whether, or to what extent, the external auditor is content to rely on the work of the internal auditors in support of external audit work.

The letter, with management responses, should be made available to the audit committee (in draft if necessary) in time to inform the committee's annual report. If submitted in draft, a final version should be submitted to the audit committee as soon as possible thereafter, and not later than two months after issuing an opinion on the financial statements.

A specimen management letter is included in Appendix 20.

Relationship with the internal auditor

The audit committee should ensure that internal and external audit complement one another and that, where appropriate, they co-ordinate their audit effort and avoid duplication.

External auditors should be given access to the internal audit function's working papers and plans so that their work programmes can be adjusted accordingly and the extent of their reliance on the work of the internal audit function determined.

Copies of the internal audit services reports should be available to the external auditors. The internal audit services should also receive copies of the external auditors' plans and management letters, and any other relevant reports.

COMMUNICATION WITH SHAREHOLDERS

CHAPTER 8

There are two main channels of communication between the audit committee and shareholders: the written report which forms part of the published financial statements, and the annual general meeting, at which the audit committee chair is generally available to answer questions.

Annual general meeting

It is quite unusual, and some would argue inappropriate, for the audit committee chair to have face-to-face contact with investors. This is generally felt to be the responsibility of the board chairman on governance matters and CEO on issues relating to the performance of the company. However, most observers would agree that the audit committee chair should be willing to meet with investors if requested to do so; and that any dialogue should generally be limited to questions about governance and the manner in which the financial statements are put together, rather than commercial questions which are better left to the executive directors.

Anecdotal evidence suggests that at annual general meetings the board chairman may pass questions to the chief financial officer or chief executive officer or, in the case of remuneration, to the chair of the remuneration committee. Currently there are very few instances when questions are passed to the audit committee chair.

Annual reports

National governance codes and regulations have for some time contained disclosure recommendations/requirements relating to how an audit committee discharges its duty. However, in the light of the 2007/8 financial crisis there has been considerable international debate around the need for greater transparency about the auditor/audit committee relationship and in particular about the judgements made in the course of preparing and auditing financial statements.

Despite widespread agreement on the information users need, the route through which it is provided has become polarised with the European Commission and the PCAOB essentially suggesting such information should be provided directly by the auditors (whether through an expanded audit report or through a separate statement), whereas others have advocated the provision of such information through a report by the board (or audit committee) on how the audit committee has discharged its duties. Whatever approach is adopted, it is important that so-called 'boiler plate' is avoided.

Where the board (or audit committee) reports on how the audit committee has discharged its duties, consideration should be given to disclosure of *inter alia:*

- the names and qualifications audit committee members (i.e., why these individuals are the right people for the audit committee);
- the number of audit committee meetings;
- a summary of the audit committee's remit and how it addresses that remit during the year;
- the reasons for the absence of an internal audit function if no such function exists;
- the significant issues the audit committee considered in relation to the financial statements and how these issues were addressed, having regard to matters communicated to it by both management and the auditors;
- confirmation that a robust going concern risk assessment has been made together with information on the material risks to going concern which have been considered by the board/audit committee and, where applicable, how they have been addressed;
- the approach taken to the appointment or reappointment of the external auditor, including:
  - an assessment of the effectiveness of the external audit process (and internal audit process where relevant);
  - the steps taken in deciding whether or not to recommend that the audit be put out to tender, when a tender was last carried out and the tenure of the current audit firm;
  - whether and when the organisation intends to put the audit out to tender in the foreseeable future;

- where the board does not accept the audit committee's recommendation on the appointment or reappointment of the auditor, an explanation of the committee's recommendation and the reasons why the board has taken a different position; and
- if the external auditor provides non-audit services, how auditor objectivity and independence is safeguarded.

Example disclosures are shown in Appendix 21.

In October 2011, the Enhanced Disclosure Working Group of the Global Auditor Investor Dialogue[2] published comprehensive revised guidelines to both assist boards and audit committees when preparing their reports; and also help investors and shareholders who are being increasingly challenged to engage on audit and corporate reporting issues. The *'Audit Committee Reports: Global Disclosure Guidelines'* are reproduced below. The *Audit Committee Report Disclosure Checklist* appended to the Guidelines is reproduced in Appendix 22.

Global guidelines for enhanced disclosure

Guideline 1 – Substance not form
The audit committee should provide a non-boilerplate report that provides a useful and engaging account of its activities, giving informative emphasis to key audit issues and how they are managed. For example providing specific information about:

- key areas of judgements and estimates used for the preparation of the financial statements;
- the use of experts to cover specific issues;
- any incidents of disagreements with management and/or the auditors; and
- any fraud that was brought to the committee's attention will help to achieve this.

All members of the committee, and particularly the chairman, are encouraged to take an active role in writing the audit committee report.

Guideline 2 – Audit committee charter
The board and audit committee should undertake annually a considered and in depth review of the audit committee charter, which should be disclosed on the company's website and, where appropriate, be included in the proxy statement, and satisfy themselves that it provides the terms of reference to enable the audit committee to fulfil its responsibilities.

The board and the audit committee should disclose that the charter has been reviewed and summarise any changes that have been made to enable the audit committee to fulfil its responsibilities. The audit committee should confirm that it has fulfilled its responsibilities under its charter.

The audit committee should confirm that its charter permits it to obtain independent external advice at the company's expense. It should disclose whether or not it has obtained such advice.

2 The Global Auditor Investor Dialogue is an informal forum whose members comprise the major global auditing networks and leading global investors and share owners. The Global Disclosure Guidelines may or may not represent the views of the individual Dialogue members.

Guideline 3 – Audit committee membership
The board should disclose that it has reviewed the audit committee's composition during the year, and that it is satisfied that the audit committee has the expertise and resource to fulfil effectively its responsibilities, including those relating to risk and controls.

Furthermore, the board should provide a convincing and informative explanation to support its opinion that the audit committee has not only recent and relevant financial and audit experience but also the commercial, financial and audit expertise to help it assess effectively the complex accounting, audit and risk issues it has to address. Any changes to the composition of the audit committee should be disclosed and explained.

Guideline 4 – Information flows to the audit committee
The audit committee should identify the information it needs to enable it to fulfil its responsibilities, which should be reviewed and analysed with an independent mindset, so that the committee is confident as to the completeness and integrity of the information it receives. The information should be provided to it in a timely manner and in a format which is complete, understandable and reliable.

The audit committee should confirm to shareowners and investors that it has received sufficient, reliable, and timely information from management and the external auditors to enable it to fulfil its responsibilities

Guideline 5 – Risk and internal controls
The board, audit committee, or other relevant board committee should disclose what steps it has taken to satisfy itself that the risk and control framework and processes are operating, and have operated, properly. It should disclose a summary of the process it has applied (directly or through relevant committees) in reviewing the operation of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. The scope should encompass business model, financial, operational and behavioural risks and incentives which impact on the achievement and evaluation of appropriate key performance indicators (KPIs).

Guideline 6 – Valuation of assets and liabilities
The audit committee should confirm that the significant assumptions used for determining fair values have been disclosed, scrutinised and, where appropriate, challenged by the audit committee, and that they have satisfied themselves that the auditors have brought to bear an appropriate degree of professional scepticism in fulfilling their responsibilities. In addition, the audit committee should confirm that they have satisfied themselves that the markets and/or models to which the valuations are marked have liquidity and transaction profiles that are adequate and sufficiently robust for enabling reliable and relevant valuations to be determined. Also, that they are satisfied that there is meaningful disclosure of critical judgements and key estimates.

Periodically, valuations can and should undergo a careful ex-post examination. The audit committee should ensure that shareowners and investors are provided with an unbiased explanation of the factors which account for any significant deviation from previously reported values.

Guideline 7 – Write-downs and impairment provisions
The audit committee should provide a brief, informative discussion of the factors which they have taken into account and the considerations they have made when fulfilling their responsibilities in respect of endorsing material write-downs and impairment provisions. Also, the audit committee should confirm that they have satisfied themselves that the auditors have fulfilled their verification responsibilities with diligence and professional scepticism.

The audit committee, and ultimately the board, should carefully weigh other factors that might have influenced management's proposed write-downs and provisions with a view to satisfying itself that management's proposals are consistent with a true and fair presentation, free from bias, take into consideration prevailing economic conditions, and are appropriately prudent.

Guideline 8 – Securitisation, off-balance sheet and contingent liabilities
The audit committee should satisfy itself that all material securitisation arrangements, off-balance sheet liabilities and contingent liabilities have been identified for financial reporting purposes and that they are disclosed in sufficient detail in the financial statements.

The audit committee should critically assess and, when appropriate, challenge the valuations ascribed to these liabilities, and the methodologies used to determine them, to satisfy itself that the valuations used are fair and reasonable. The audit committee report should contain a meaningful description of the work it has undertaken in this regard.

Guideline 9 – Internal and external auditors
The audit committee should disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and the key conclusions arising there from. The external auditors should be subject to an annual evaluation and the audit committee should provide a convincing, informative and non-boilerplate explanation which supports its choice of auditor.

In addition, the audit committee should provide an informative account regarding the controls over non-audit services and a commentary on the level and nature of non-audit services provided.

The audit committee should state how long the audit firm has been retained as auditor to the company, and it should set out its policy in respect of putting the audit out to tender, confirming that it has complied or otherwise with that policy.

If the external auditor should change, the board or the audit committee, as appropriate, should promptly disclose the change to the market and provide an informative and convincing explanation of the reasons for it.

Guideline 10 – Audit planning and main audit issues
The audit committee should provide an engaging and informative account of how it has fulfilled its responsibilities in respect of audit planning by both the internal and external auditors. The audit committee should disclose whether or not it has met with the auditors of the key subsidiaries and/or joint ventures.

The audit committee should report, subject to issues of commercial confidentiality, on the nature of the main audit issues arising and how they have been resolved.

The audit committee should confirm that it has considered internal control and risk issues that have been brought to its attention by the internal and external auditors. It would be helpful to shareowners and investors to have some indication as to the nature of the issues arising. The audit committee should state that it is satisfied that management has addressed the issues or has plans so to do.

Guideline 11 – Executive compensation and risk
When addressing the financial crisis, many regulators, commentators and others have called into question executive compensation policies and practices which may incentivise executive behaviour that has been counter-productive to maintaining a well controlled, sustainable enterprise. Determining compensation and remuneration policies and practices is the responsibility of compensation and remuneration committees, and the audit committee should assist these committees in ensuring that compensation policies and practices are consistent with an effective control environment. In particular, the board and/or the audit committee should satisfy itself that key finance, control and risk management personnel have appropriate performance incentives, In fulfilling this responsibility, regard should be had to KPIs, as referred to in Guideline 5 (Risk and internal controls).

The audit committee should provide (a) a brief but informative description of its interaction with the compensation or remuneration committee in respect of executive compensation policies and practices and (b) comfort that the compensation policies and practices for top executives, key business unit leaders and senior finance, control and risk management personnel are, in its opinion, appropriate for maintaining a robust control environment, consistent with good stewardship, and the long-term objectives and risk appetite of the company.

If this disclosure is provided by the compensation or remuneration committee, this should be referred to in the audit committee report.

FIVE GUIDING PRINCIPLES FOR AUDIT COMMITTEES

APPENDIX 1

Those seeking to strengthen corporate governance and enhance audit committee oversight often look for (and recommend) 'leading' or 'best' practices – and with good reason: they suggest processes, policies, or approaches that 'work.' Yet, practices that work best for one organisation may not be ideal for another – especially in a corporate governance environment where corporate culture, financial reporting risks and governance needs can vary dramatically from entity to entity.

The ACI believes, however, that certain guiding principles underlie the effectiveness of every audit committee. Even as specific oversight practices evolve to address changing risks, regulatory requirements and corporate governance needs, the right principles can help ensure that practices are applied effectively – that is, by the right people with the right information, processes and perspectives. To this end, we offer five guiding principles for audit committees and boards of directors to consider when developing, evaluating, and refining the audit committee's oversight processes and practices:

1. Recognise that one size does not fit all.
2. Have the 'right' people on the committee.
3. Monitor and insist on the right 'tone from the top.'
4. Ensure the oversight process facilitates the committee's understanding and monitoring of key roles, responsibilities and risks within the financial reporting environment.
5. Continually reinforce the audit committee's direct responsibility for the external auditor.

These five principles have long been important to audit committee effectiveness and are vital to the independence, objectivity, and integrity of the financial reporting process.

Refocusing on the basics

With compliance processes related to existing regulatory requirements widely in place, many audit committees are refocusing their agendas on matters they

believe are most critical to the integrity of the financial reporting process – from critical accounting judgements and estimates, to internal audit resources, to the oversight of risks affecting financial reporting.

Given the demands of the new corporate governance environment, this 'back to basics' focus presents its own challenges. The complexity of accounting issues, increased oversight responsibilities, and unprecedented expectations of shareholders and regulators require audit committees to be more focused than ever on enhancing their efficiency and effectiveness, including improving the committee's interaction with management, internal audit and the external auditor. In tackling these and other challenges, we encourage directors and others to consider the five guiding principles presented here. We believe they can provide a strong foundation and framework for audit committees to develop their own 'leading practices' – and, ultimately, to be effective in their oversight of the financial reporting process.

Five guiding principles for audit committees

1. One size does not fit all: When delegating oversight responsibilities to the audit committee, recognise that the needs and dynamics of each company, board and audit committee are unique.

In general, audit committees are responsible for oversight of the company's financial reporting process, including related risks and controls as well as the company's internal and external auditors. In delegating these and other oversight responsibilities to the audit committee, however, each board should factor in the unique needs, dynamics and culture of the company and the board.

The responsibilities of the audit committee should be clearly communicated and precisely defined, and its workload and agenda should be appropriately limited and focused on essential issues, activities and responsibilities.

Once delegated, the activities of the audit committee – including appropriate management interaction – should have the ongoing support of the full board.

2. The board must ensure the audit committee comprises the 'right' individuals to provide independent, objective and effective oversight.

Members of the audit committee should be independent and financially literate, and have the personal and professional characteristics necessary to be effective committee members. As a body, the audit committee should be informed, vigilant and effective overseers of the financial reporting process.

If audit committees are to provide meaningful protection for investors, they must be in a position to challenge management and draw sufficient attention to dubious practices – even in apparently successful companies. To do this, audit committee members must be prepared to invest the time necessary to understand why critical accounting policies were chosen, how they were applied, and why the end result fairly presents the company's actual status.

In essence, this means that they need to understand their businesses and the substance of complex transactions, and determine that the financial statements reflect fairly their understanding. Even where audit committees comprise vigorously independent directors, they will prove ineffective unless they have both access to, and understanding of, all the relevant information.

It is imperative that all audit committee members are able, both in theory and in practice, to express views to the board that are different to those of the CEO and be confident that, provided this is done in a considered way, they will not suffer. Perhaps the most important characteristic of an effective audit committee member is a willingness to challenge management; this is the essence of independence.

3. The board and audit committee must continually assess whether – and insist that – the 'tone from the top' sets an expectation of integrity and accuracy in financial reporting.

In establishing the 'right tone,' the company's leaders – from the CEO, CFO and other senior management to line management across the enterprise – should be unequivocal in their insistence on accuracy and transparency in financial reporting. They must set the expectation that all financial numbers and statements represent the actual financial performance of the company.

The audit committee, as part of a system of checks and balances on management and the guardian of shareholder interests, should continually assess whether management has set the 'right' tone and whether that tone is reaching the rest of the organisation.

To help maintain the right tone from the top – and throughout the company – the audit committee should insist that management talk about the company's standards and expectations at every opportunity and demonstrate its commitment by putting its ethics policies into everyday practice.

4. The audit committee's oversight process should facilitate its understanding and monitoring of key roles, responsibilities and risks within the financial reporting environment.

An effective oversight process encompassing people, policies and practices provides the framework for the audit committee to carry out its oversight responsibilities by helping the committee understand and monitor:

- the company's critical financial reporting (and related) risks
- the effectiveness of financial reporting controls
- the role and effectiveness of the audit committee (vis-à-vis the roles of the full board, management, and external auditors)
- the independence, accountability, and effectiveness of the external auditor
- the transparency of financial reporting and disclosures.

Developing an effective oversight process requires the active participation of the audit committee, management (including internal audit), and the external auditor – collectively, the 'three-legged stool' of financial reporting. To this end, the audit committee should understand the specific and unique role that each 'leg' plays in the financial reporting process and must hold each participant accountable to the board and the audit committee.

An effective oversight process also is predicated on the audit committee's having an understanding of the company's financial reporting risks (and the controls related to those risks) as well as appropriately communicating and coordinating its responsibilities and activities with other committees of the board in areas of oversight that may overlap (e.g., risk management and compensation). Ultimately, an effective oversight process is one that is well defined, clearly articulated, and driven by informed and persistent listening, questioning, assessing and challenge on the part of the audit committee.

5. The audit committee must continually reinforce its direct responsibility for the external auditor.

One of the most significant changes to come out of recent regulatory requirements is the audit committee's 'direct responsibility' for the external auditor – specifically, overseeing the auditor's work and independence, and recommending to the board its appointment and remuneration. To ensure the auditor's true independence from management, however, the audit committee's direct oversight responsibility for the auditor must be more than just words in the audit committee's terms of reference or items on its agenda. All parties – the audit committee, external auditor and senior management – must acknowledge and continually reinforce this direct reporting relationship in their everyday interactions, activities, communications and expectations.

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ICSA'S – AUDIT COMMITTEE TERMS OF REFERENCE

APPENDIX 2

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ICSA Guidance on Terms of Reference Audit Committee

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A Introduction

This guidance note proposes model terms of reference for the audit committee of a company seeking to comply fully with the requirements of the UK Corporate Governance Code, published June 2010 (the Code). It draws on the experience of company secretaries and is based on best practice as carried out in some of the UK's top listed companies. Companies with additional primary listing(s) may need to amend the terms of reference in light of additional requirements in the relevant country, in particular the US Sarbanes-Oxley Act.

B The UK Corporate Governance Code

The Code states that:

> 'The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.'[1]

It goes on to clarify that, in practical terms, this means that: 'The board should establish an audit committee...'.[2]

The Code recommends that the main role and responsibilities of the audit committee should be 'set out in written terms of reference'[3] and be made 'available' (e.g. by including them on a website maintained by or on behalf of the company).[4]

In addition, it recommends that the work of the committee should be described in a separate section of the annual report[5] and that the committee chairman should attend the AGM to answer any questions on the committee's area of responsibility.[6] So, as with most aspects of corporate governance, companies are required not only to go through a formal process of considering their internal audit and control procedures and evaluating their relationship with their external auditor, but to be seen to be doing so in a fair and thorough manner. As part of this process, it is essential that the audit committee is properly constituted with a clear remit and identified authority.

C Notes on the terms of reference

The FRC Guidance on Audit Committees[7] recognises that 'audit committee arrangements need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company'.[8]

As regards the composition of the committee, we have followed the Code and recommend a minimum of three independent non-executive directors (although two is permissible for smaller companies).[9] The board should satisfy itself that at least one member of the committee has recent and relevant financial experience.[10] We have made specific recommendations that others may be required to assist the committee from time to

1 The Code C.3
2 The Code C.3.1
3 The Code C.3.2 and FSA Rule DTR 7.1.3 R
4 The Code C.3.3 (see footnote 7 to the Code).
5 The Code C.3.3
6 The Code E.2.3
7 FRC Guidance on Audit Committees, October 2008 available separately from the FRC website www.frc.org.uk.
8 FRC Guidance on Audit Committees, October 2008, para. 1.3.
9 A smaller company is defined in footnote 6 to the Code as one which is below the FTSE 350 throughout the year immediately prior to the reporting year.
10 The Code C.3.1 and also FSA Rule DTR 7.1.1R

time, according to the particular items being considered and discussed.

Although not a provision in the Code, it is good practice for the company secretary, or his or her nominee, to act as secretary to the committee. The FRC Guidance for Audit Committees states that the audit committee should have access to the services of the company secretariat 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. It also states that 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.[11] In this regard, it is the company secretary's responsibility to ensure that the board and its committees are properly constituted and advised, and that there is clear co-ordination between the board and the various committees.

The frequency with which the committee needs to meet will vary from company to company and may change from time to time. The FRC Guidance for Audit Committees states that it is for the audit committee chairman, in consultation with the company secretary, to decide the frequency of meetings. There should be as many meetings as the audit committee's role and responsibilities require and it recommends there should be no fewer than three meetings each year.[12]

The list of duties we have proposed are those which we believe all audit committees should consider. Some companies may wish to add to this list[13] and some smaller companies may need to modify it in other ways.

The Code provides for a report on the audit committee to be included in the company's annual report.[14] Such report should include the following:

- a summary of the role and main responsibilities of the audit committee
- composition of committee, including relevant qualifications and experience

- a description of the main activities of the year to:
  - monitor the integrity of the financial statements
  - review the integrity of the internal financial control and risk management systems
  - review the independence of the external auditors, and the formal policy on the provision of non-audit services
  - describe the oversight of the external audit process, and how its effectiveness was assessed
  - explain the recommendation to the board on the appointment of auditors

D Model terms of reference

Note: square brackets contain recommendations which are in line with best practice but which may need to be changed to suit the circumstances of the particular organisation, or excluded where not relevant to the company or if the company has a separate risk committee.

1. Membership

1.1 The committee shall comprise at least [three] members. [Membership shall include at least one member

11 FRC Guidance on Audit Committees, October 2008, paras. 2.12 and 2.13.
12 FRC Guidance on Audit Committees, October 2008, para. 2.6.
13 For example, some companies also require the committee to monitor/make recommendations on the potential implications of legal actions being taken against the company, the adequacy of arrangements for managing conflicts of interest, the expenses incurred by the chairman and treasury management policies.
14 The Code, C.3.3 and FRC Guidance on Audit Committees, October 2008, para. 5.2.

of the risk committee.][15] Members of the committee shall be appointed by the board, on the recommendation of the nomination committee in consultation with the chairman of the audit committee.

1.2 All members of the committee shall be independent non-executive directors[16] at least one of whom shall have recent and relevant financial experience. The chairman of the board shall not be a member of the committee.[17]

1.3 Only members of the committee have the right to attend committee meetings. However, other individuals such as the chairman of the board, chief executive, finance director, other directors, the heads of risk, compliance and internal audit and representatives from the finance function may be invited to attend all or part of any meeting as and when appropriate and necessary.

1.4 The external auditor will be invited to attend meetings of the committee on a regular basis.

1.5 Appointments to the committee shall be for a period of up to three years, which may be extended for further periods of up to three years, provided the director still meets the criteria for membership of the committee.

1.6 The board shall appoint the committee chairman who shall be an independent non-executive director. In the absence of the committee chairman and/or an appointed deputy, the remaining members present shall elect one of themselves to chair the meeting.

2. Secretary

The company secretary or his or her nominee shall act as the secretary of the committee.

3. Quorum

The quorum necessary for the transaction of business shall be [two] members.[18] A duly convened meeting of the committee at which a quorum is present shall be competent to exercise all or any of the authorities, powers and discretions vested in or exercisable by the committee.

4. Frequency of meetings

The committee shall meet at least [four] times a year at appropriate times in the reporting and audit cycle and otherwise as required.[19]

5. Notice of meetings

5.1 Meetings of the committee shall be called by the secretary of the committee at the request of any of its members or at the request of external or internal auditor if they consider it necessary.

5.2 Unless otherwise agreed, notice of each meeting confirming the venue, time and date together with an agenda of items to be discussed, shall be forwarded to each member of the committee, any other person required to attend and all other non-executive directors, no later than [five] working days before the date of the meeting. Supporting papers shall be sent to committee members and to other attendees as appropriate, at the same time.

15 if the board has a separate risk committee
16 Guidance on circumstances likely to affect independence is given in Code provision B.1.1
17 Except on appointment, the Chairman of the company is not considered independent. Code provisions A.3.1, B.1.1 and note 5
18 As it is a Code provision that at least one member of the Committee has recent and relevant financial experience, it would be preferable for any quorum to include a member with recent and relevant financial experience, whenever possible.
19 The frequency and timing of meetings will differ according to the needs of the company. Meetings should be organised so that attendance is maximised (for example by timetabling them to coincide with board meetings and/or risk committee meetings if the company has a separate risk committee).

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6. Minutes of meetings

6.1 The secretary shall minute the proceedings and decisions of all meetings of the committee, including recording the names of those present and in attendance.
6.2 Draft minutes of committee meetings shall be circulated promptly to all members of the committee. Once approved, minutes should be circulated to all other members of the board unless it would be inappropriate to do so.

7. Annual General Meeting

The committee chairman should attend the annual general meeting to answer shareholder questions on the committee's activities.

8. Duties

The committee should carry out the duties below for the parent company, major subsidiary undertakings and the group as a whole, as appropriate.

8.1 Financial reporting

8.1.1 The committee shall monitor the integrity of the financial statements of the company, including its annual and half-yearly reports, interim management statements, and any other formal announcement relating to its financial performance, reviewing significant financial reporting issues and judgements which they contain.
8.1.2 In particular, the committee shall review and challenge where necessary -

8.1.2.1 the consistency of, and any changes to, accounting policies both on a year on year basis and across the company/group
8.1.2.2 the methods used to account for significant or unusual transactions where different approaches are possible
8.1.2.3 whether the company has followed appropriate accounting standards and made appropriate estimates and judgements, taking into account the views of the external auditor
8.1.2.4 the clarity of disclosure in the company's financial reports and the context in which statements are made; and
8.1.2.5 all material information presented with the financial statements, such as the business review/operating and financial review and the corporate governance statement (insofar as it relates to the audit and risk management).

8.2 Internal controls and risk management systems[20]

The committee shall

8.2.1 keep under review the adequacy and effectiveness of the company's internal financial controls and internal control and risk management systems;[21] and
8.2.2 review and approve the statements to be included in the annual report concerning internal controls and risk management.[22]

[20] If the company has a separate risk committee review of internal controls and risk management systems could be included in the duties of that committee.
[21] Code provisions C.3.2
[22] Unless this is done by the board as a whole.

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8.3 Compliance, whistleblowing and fraud[23]

The committee shall

8.3.1 review the adequacy and security of the company's arrangements for its employees and contractors to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters. The committee shall ensure that these arrangements allow proportionate and independent investigation of such matters and appropriate follow up action
8.3.2 review the company's procedures for detecting fraud
8.3.3 review the company's systems and controls for the prevention of bribery and receive reports on non-compliance[24]
8.3.4 [review regular reports from the Money Laundering Reporting Officer and the adequacy and effectiveness of the company's anti-money laundering systems and controls]
8.3.5 [review regular reports from the Compliance Officer and keep under review the adequacy and effectiveness of the company's compliance function]

8.4 Internal audit

The committee shall

8.4.1 monitor and review the effectiveness of the company's internal audit function[25] in the context of the company's overall risk management system[26]
8.4.2 approve the appointment and removal of the head of the internal audit function
8.4.3 consider and approve the remit of the internal audit function and ensure it has adequate resources and appropriate access to information to enable it to perform its function effectively and in accordance with the relevant professional standards. The committee shall also ensure the function has adequate standing and is free from management or other restrictions
8.4.4 review and assess the annual internal audit plan
8.4.5 review reports addressed to the committee from the internal auditor
8.4.6 review and monitor management's responsiveness to the findings and recommendations of the internal auditor
8.4.7 meet the head of internal audit at least once a year, without management being present, to discuss their remit and any issues arising from the internal audits carried out. In addition, the head of internal audit shall be given the right of direct access to the chairman of the board and to the committee

8.5 External Audit

The committee shall

8.5.1 consider and make recommendations to the board, to be put to shareholders for approval at the AGM, in relation to the appointment, re-appointment and removal of the company's external auditor. The committee shall oversee the selection process for a new auditor and if an auditor resigns the committee shall investigate the issues leading to this and decide whether any action is required
8.5.2 oversee the relationship with the external auditor including (but not limited to)

8.5.2.1 recommendations on their remuneration, whether fees for audit or non-audit services and that the level of fees is appropriate to enable an adequate audit to be conducted
8.5.2.2 approval of their terms of engagement, including any engagement letter issued at the start of each audit and the scope of the audit

[23] If the board has a separate risk committee whistleblowing and fraud (including the prevention of bribery) could be included in the duties of that committee.
[24] If the company has a separate risk committee prevention of bribery could be included in the duties of that committee.
[25] If the company does not have an internal audit function, the committee should consider annually whether there should be one and make a recommendation to the board accordingly. The absence of such a function should be explained in the annual report.
[26] If the board has a separate risk committee the duties of that committee could include review of the company's internal control and risk management systems.

8.5.2.3 assessing annually their independence and objectivity taking into account relevant [UK] professional and regulatory requirements and the relationship with the auditor as a whole, including the provision of any non-audit services
8.5.2.4 satisfying itself that there are no relationships (such as family, employment, investment, financial or business) between the auditor and the company (other than in the ordinary course of business)
8.5.2.5 agreeing with the board a policy on the employment of former employees of the company's auditor, then monitoring the implementation of this policy
8.5.2.6 monitoring the auditor's compliance with relevant ethical and professional guidance on the rotation of audit partner, the level of fees paid by the company compared to the overall fee income of the firm, office and partner and other related requirements
8.5.2.7 assessing annually the qualifications, expertise and resources of the auditor and the effectiveness of the audit process, which shall include a report from the external auditor on their own internal quality procedures
8.5.2.8 seeking to ensure co-ordination with the activities of the internal audit function

8.5.3 meet regularly with the external auditor, including once at the planning stage before the audit and once after the audit at the reporting stage. The committee shall meet the external auditor at least once a year, without management being present, to discuss the auditor's remit and any issues arising from the audit
8.5.4 review and approve the annual audit plan and ensure that it is consistent with the scope of the audit engagement
8.5.5 review the findings of the audit with the external auditor. This shall include but not be limited to, the following

8.5.5.1 a discussion of any major issues which arose during the audit
8.5.5.2 any accounting and audit judgements
8.5.5.3 levels of errors identified during the audit
8.5.5.4 the effectiveness of the audit

The committee shall also

8.5.6 review any representation letter(s) requested by the external auditor before they are signed by management
8.5.7 review the management letter and management's response to the auditor's findings and recommendations
8.5.8 develop and implement a policy on the supply of non-audit services by the external auditor, taking into account any relevant ethical guidance on the matter.

9. Reporting responsibilities

9.1 The committee chairman shall report formally to the board on its proceedings after each meeting on all matters within its duties and responsibilities.
9.2 The committee shall make whatever recommendations to the board it deems appropriate on any area within its remit where action or improvement is needed.
9.3 The committee shall produce a report on its activities to be included in the company's annual report.

10. Other matters

The committee shall

10.1 have access to sufficient resources in order to carry out its duties, including access to the company secretariat for assistance as required
10.2 be provided with appropriate and timely training, both in the form of an induction programme for

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new members and on an ongoing basis for all members
10.3 give due consideration to laws and regulations, the provisions of the Code and the requirements of the UK Listing Authority's Listing, Prospectus and Disclosure and Transparency Rules and any other applicable Rules, as appropriate
10.4 be responsible for co-ordination of the internal and external auditors
10.5 oversee any investigation of activities which are within its terms of reference
10.6 arrange for periodic reviews of its own performance and, at least annually, review its constitution and terms of reference to ensure it is operating at maximum effectiveness and recommend any changes it considers necessary to the board for approval.

11. Authority

The committee is authorised

11.1 to seek any information it requires from any employee of the company in order to perform its duties
11.2 to obtain, at the company's expense, outside legal or other professional advice on any matter within its terms of reference
11.3 to call any employee to be questioned at a meeting of the committee as and when required
11.4 to have the right to publish in the Company's annual report details of any issues that cannot be resolved between the committee and the board.[27]

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[27] FRC Guidance on Audit Committees, October 2008, para. 3.5.

POTENTIAL AUDIT COMMITTEE TOPICS

APPENDIX 3

Our experience suggests that the following topics deserve consideration when establishing the detailed agendas for the audit committee meetings during the year.

Risk management
√ Risk management process and control (particularly financial reporting risks)
√ Operating reviews
√ Budget reviews
√ Industry and market updates
√ Review financial community expectations
√ Information technology changes
√ Legal briefings
√ Understand senior management compensation programmes
√ Executive sessions with appropriate senior management
√ Current and emerging risk issues

Assess processes relating to the company's control environment
√ Compliance with code of ethical conduct
√ Control policies and procedures (including earnings management, error and fraud)
√ Management's assessment of key third-party providers
√ Internal and external auditor internal control observations and recommendations
√ Compliance with specific industry regulations

Oversee corporate reporting
√ Financial statements and earnings releases
√ Recommend approval of financial statements to board of directors
√ Periodic reports and filings
√ Management overview of financial results for quarter/year
√ Critical accounting policies
√ Significant and unusual transactions and accounting estimates
√ Current developments in auditing, accounting, reporting, and tax matters
√ Executive session with senior management
√ 'Front half' of the annual report
√ Analyst briefings and investor presentations

Evaluate the internal and external audit processes
√ Coordination of the internal and external audit effort and definition of responsibilities

√ External auditors
– Engagement letter
– Audit engagement team
– Independence letter
– Consider all significant non-audit services to be performed by the external auditor
– Scope, procedures, and timing
– Audit results
– Audit reports
– Meeting with external auditors
– Management's responsiveness to audit results
– Assess effectiveness
– Consider the appropriateness of tendering the audit
– Audit partner succession

√ Internal audit department
– Assess need for internal audit
– Mandate and objectives
– Appointment and compensation of chief auditor
– Budget, staffing, and resources
– Scope, procedures, and timing of the audits
– Audit results
– Audit reports
– Meeting with internal auditors
– Management's responsiveness to audit results
– Assess effectiveness

Audit Committee Structure
√ Terms of reference
√ Assess audit committee performance

AUDIT COMMITTEE MEETING AGENDA

APPENDIX 4

This audit committee meeting planner pro-forma can be used to plan what gets addressed at each audit committee meeting. It should be tailored to suit the needs of each organisation.

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Constitution							
Review audit committee's terms of reference	✓						
Review code of conduct	✓						
Assess independence, financial literacy skills and experience of members	✓						
Establish number of meetings for the forthcoming year	✓						
Audit committee chair to establish meeting agenda and attendees required			✓				
Enhance skills and experience – professional development			✓				
Corporate reporting (discuss with management and external auditors where applicable)							
Hold *in camera* session with management		✓					

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Review both corrected and uncorrected audit differences	✓						
Review new accounting and reporting developments			✓				
Review critical accounting policies and alternative accounting treatments	✓						
Review significant accounting judgements and estimates			✓				
Review large, unusual and complex transactions			✓				
Review and recommend approval of annual financial statements	✓						
Review the narrative sections of the annual report	✓						
Review and recommend approval of half year financial statements	✓						
Review and recommend approval of quarterly financial information		✓					
Review and recommend approval of any earnings releases			✓				

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Review and recommend approval of any analyst briefings or investor presentations			✓				
Risk management and controls (discuss with management and external auditors where applicable)							
Evaluate the corporate culture and the 'tone from the top'		✓					
Review the process by which risk strategy and appetite is determined	✓						
Review and assess the risk management and internal control systems	✓						
Review weaknesses in internal control and management's remediation plan	✓						
Review anti-fraud and bribery programmes and the risk of management override	✓						
Review whistle-blowing arrangements	✓						
Assess crisis management and business continuity plans	✓						
Understand management remuneration structures and the drivers of bias			✓				

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Meet with the 'marzipan layer' (i.e., those below the executive tier)			✓				
Review reports from regulators and management's response			✓				
External auditors							
Recommend appointment and review performance	✓						
Approve audit fees and terms of engagement	✓						
Consider policy in relation to non-audit services	✓						
Consider hiring policy for former employees of the auditor	✓						
Consider objectivity/ independence and obtain confirmation from auditor	✓						
Review audit plan and scope of audit work	✓						
Review external audit findings	✓						
Discuss appropriateness of accounting policies, estimates and judgements		✓					
Discuss external auditors views on control environment		✓					

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	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Discuss issues with auditor in absence of executives and management		✓					
Ongoing communication (written/oral) of external auditor with audit committee		✓					
Consider audit partner succession	✓						
Consider need for audit tender	✓						
Internal auditors							
Where no internal audit function, consider the need for an internal audit function	✓						
Recommend appointment and review performance	✓						
Review internal audit plan	✓						
Review significant internal audit reports and findings		✓					
Review progress on actions taken in response to the committee's representations		✓					
Discuss issues with auditor in absence of executives and management		✓					

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Other responsibilities							
Review progress on actions taken in response to the representations of the auditors		✓					
Review legal and compliance developments			✓				
Review report to shareholders on role and responsibilities of the committee	✓						
Perform self-assessment of audit committee performance	✓						
Assess the CFO and finance function	✓						
Review CFO and financial personnel succession planning	✓						
Work with the nomination committee to develop an audit committee succession plan	✓						
Review director and officer expenses and related party transactions	✓						
Conduct special investigations and perform other activities as appropriate			✓				
Provide appropriate induction for new members			✓				
Maintain minutes and report to board			✓				

PRIVATE SESSION WITH THE AUDITOR

APPENDIX 5

Most audit committees want to meet the external auditor in a private session where management is not present. This approach allows the audit committee to ask questions on matters that might not have been specifically addressed as part of the audit. The private session allows the auditor to provide candid, often confidential, comments to the audit committee on such matters. Often this meeting would be held toward the end of the audit committee meeting.

Typically there should be few items to discuss. All key matters related to financial reporting should have been reviewed in a candid and robust manner with management, the audit committee and the auditor during the audit committee meeting. The audit committee can use the private session as a follow-up if members were not satisfied with the answers given at the audit committee meeting or if they thought discussions had been too guarded or uneasy. However, such matters should have been fully aired at the audit committee meeting and generally should not need to be readdressed in the private session.

Rather, the private session should focus on areas where the auditor can provide additional, candid, and often confidential, comments to the audit committee on other matters. The private session gives the audit committee an opportunity to explore such matters in a frank and open forum. In addition, the audit committee may have more knowledge than the auditor on other matters, and this session allows the audit committee an opportunity to talk to the auditor about them.

Overall, private sessions can play an important role in the development of a trusting and respectful relationship between the audit committee and the auditor. Questions often focus on one or more of the following areas:

Attitudes – management's attitude toward financial reporting, internal controls and the external auditor.

Resources – the adequacy of people and other resources in the financial management area and the internal audit function.

Relationships – the nature of the relationship between the auditor, management and the internal auditor.

Other issues – other issues of concern to the audit committee or the auditor.

The following is a list of illustrative questions. It is not an exhaustive list but is intended to stimulate thought as to the type of issues that could be raised with the auditor. Typically, each private session should address a few matters which may vary from meeting to meeting, in addition to any matters of current concern.

Attitudes

- What is your assessment of the tone from the top?
- What is your assessment of the ethics, values and integrity of management?
- What do you believe are the reasons management did not adjust for the uncorrected audit differences?
- Does management have plans to correct these audit differences in the future?
- Was management fully supportive of the corrected audit differences?
- What is your assessment of the quality of the company's financial reporting, narrative reporting, and press releases?
- How does this company's attitude toward financial reporting compare to other companies?
- Is there excessive pressure on management or operating personnel to meet financial targets including sales or profitability incentive goals?
- Is there excessive pressure to meet unrealistic or aggressive profitability expectations by investment analysts or others?
- What is your assessment of management's attitude toward:
  - disclosure controls and procedures; and
  - internal control systems and procedures?

Resources

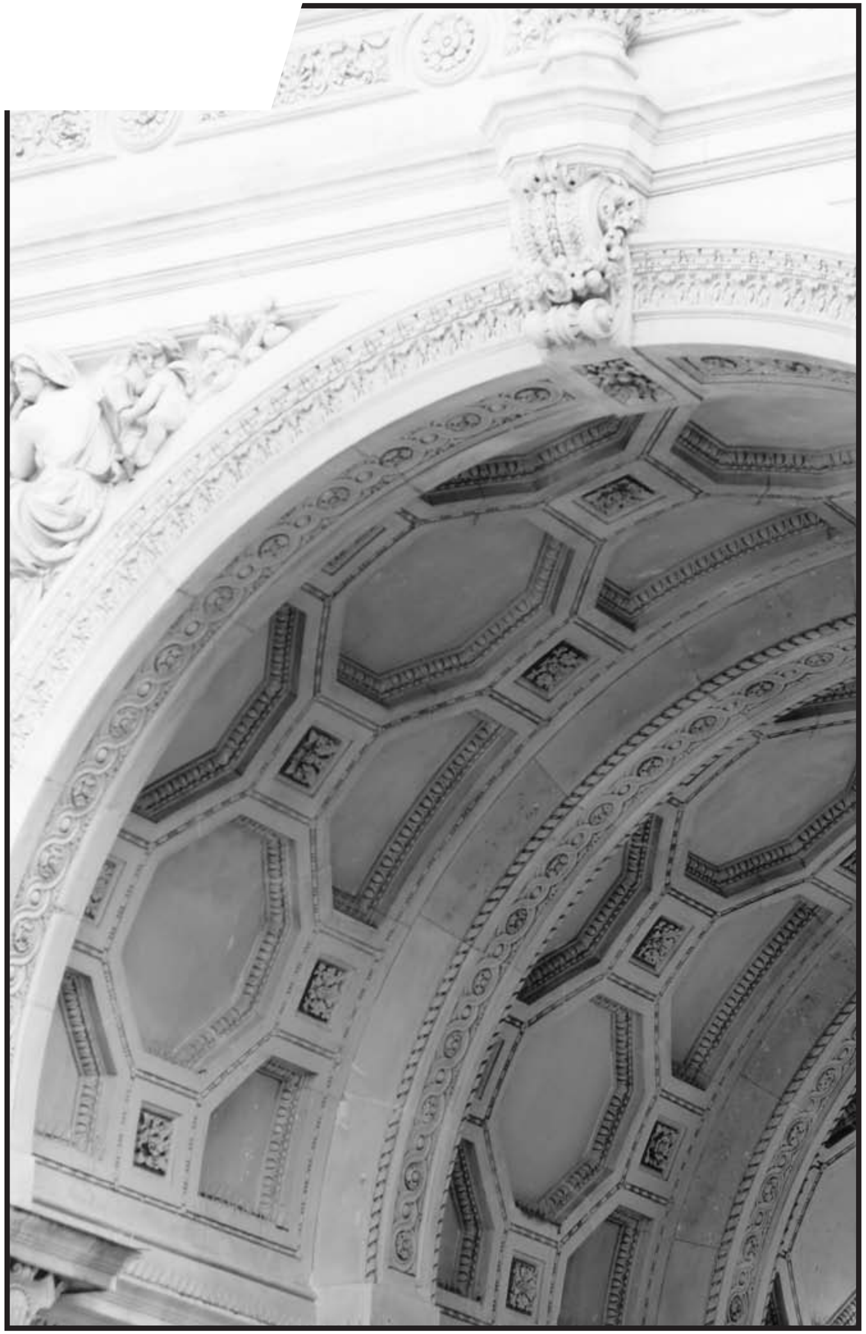
- Do the finance and internal audit functions have the appropriate number of people?
- Do they have a sufficiently broad range of knowledge and experience to be able to deal with the types of transactions faced by the company?
- Are these people competent for their position? Do you have any concerns?
- Has management adequately responded to your management recommendations?
- Are there other areas where internal audit should focus its activities?
- If the company does not have an internal audit function, what is your assessment of the need to have one?

Relationships

- Did you receive full cooperation during the audit and did you get full, honest answers to all questions that were asked?
- Was any information withheld from you?
- Was management forthcoming, open and candid in discussions with you?
- How are your relationships with financial management personnel? Internal audit? CEO? CFO?
- What was the nature of any consultations that were held with other accountants or auditors?

Other issues

- Did you receive everything you requested on a timely basis?
- Did you have adequate time to carry out all your audit procedures?
- Is the audit fee at an appropriate level?
- On what issues was the most amount of audit time spent?
- What is the most complex issue that was encountered during the audit that has not been discussed at the audit committee meeting?
- What were the two or three issues that you spent the most amount of time discussing with management?



AUDIT COMMITTEE SELF-ASSESSMENT

APPENDIX 6

This self-assessment process focuses on your personal perception of the audit committee as a whole - it does not seek to evaluate individuals and their personalities.

The questionnaire takes about 30 minutes to complete and should be completed in the following manner:

- Using a scale of **1** (low) to **10** (high), complete each question by placing your score in the two boxes beside the question. **'Actual'** is your view of the current position of the audit committee on that issue. **'Ideal'** is the score that you would like to see. The difference will allow us to see the size of the issue and, therefore, its relative priority.
  You may wonder why we give you a choice of score on the **Ideal** position as you may think it should always be a ten. There are, however, occasions where, for example, you feel that the audit committee spends too much time and effort on an activity which should be done by someone else and in that case you would score the **Ideal** lower than ten. We would stress that the main reason for asking for the two scores is to see where the biggest gaps are between **Actual** and **Ideal** as this identifies where the committee's development priorities lie.
- There is a **Comments** space besides each question. This is for you to make any notes which you might wish to comment on during the later interview stage of the assessment exercise. You are, however, not obliged to make comments. We do appreciate that you may not always know the answer but the interview gives you an opportunity to seek clarification and to elaborate on the reasons for your scores.
- N/A can be used where you don't have a view on the matter in question, for example, an executive attending audit committee meetings will not necessarily have a view on all the questions e.g., the usefulness of private sessions with the auditors .
- All responses will be treated as anonymous.

Typical answers might look like this:

	Actual	Ideal	N/A	Comments
1. Audit committee members, both individually and collectively, understand what is expected of them and the committee?	*8*	*10*		*Several membership changes have altered the emphasis on what is important.*

A. Creating an effective audit committee

	Actual	Ideal	N/A	Comments
1. Appropriate steps have been taken by the audit committee/board to review/approve the committee's terms of reference on a timely basis?				
2. Audit committee members, both individually and collectively, understand what is expected of them and the committee (e.g., how the committee supports the board in discharging its responsibilities with regard to financial reporting, risk management and control)?				
3. Audit committee members are independent of the organisation's management and exercise their own judgement; voice their own opinions; and act freely from any conflicts of interest?				
4. The process by which audit committee members are appointed is appropriate?				
5. Appropriate succession planning is in place?				
6. Audit committee members, as a whole, have sufficient skills, experience, time and resources to undertake their duties?				
7. The audit committee includes at least one member with sufficient recent and relevant financial experience?				
8. The audit committee is not over reliant on any individual member (e.g., the committee member with recent and relevant financial experience)?				
9. Audit committee members have a sufficient understanding of the organisation and the sector in which it operates?				
10. Audit committee members demonstrate the highest level of integrity (including maintaining utmost confidentiality and identifying, disclosing and managing conflicts of interest)				
11. The level of 'secretarial support' placed at the audit committee's disposal is appropriate?				
12. The process by which funds are made available to the audit committee to take independent legal, accounting or other advice (when it reasonably believes it necessary to do so) is appropriate?				

B. Running an effective audit committee

	Actual	Ideal	N/A	Comments
1. The audit committee chairman's leadership style is appropriate (e.g., are they decisive, open minded and courteous; do they set a good example, allow members to contribute and hold members to high standards; do they relate well to other members/attendees, deal effectively with dissent and work constructively towards consensus)?				
2. The audit committee's workload is dealt with effectively?				
3. Audit committee members work together and constructively as a team?				
4. The audit committee maintains constructive working relationships with those individuals who attend audit committee meetings?				
5. The relationship between a) the audit committee and b) the CEO, CFO and members of the senior management team, strikes the right balance between challenge and mutuality?				
6. The audit committee's discussions enhance the quality of management's decision making (e.g., the committee engages those reporting to the committee in dialogue that stimulates and enhances their thinking and performance)?				
7. The audit committee provides effective support to the board in fulfilling its responsibilities and adds value to the organisation?				
8. The audit committee's work plan covers the committee's main responsibilities and maps across to any regulatory requirements?				
9. The committee's meeting arrangements (e.g., frequency, timing, duration, venue and format) enhance its effectiveness?				
10. Audit committee meetings allow sufficient time for the discussion of substantive matters?				
11. Audit committee meeting agendas and related background information are circulated in a timely manner to enable full and proper consideration to be given to the important issues?				

	Actual	Ideal	N/A	Comments
12. Audit committee papers are of an appropriate quality (e.g., not overly lengthy and clearly explain the key issues and priorities)				
13. Sufficient time is allowed between audit committee meetings and meetings of the full board to allow any work arising to be carried out and reported to the board as appropriate?				
14. Committee meetings are free from inappropriate management influence?				
15. All meeting attendees (e.g., audit committee members, executive directors, management and auditors) are appropriately involved in audit committee meetings?				
16. Appropriate arrangements are in place for the audit committee to meet with external/internal audit without management being present?				
17. Are private meetings with the internal and external auditors useful?				
18. The audit committee's meeting minutes are clear, accurate, consistent, complete and timely? They include key elements of debates and appropriate details of recommendations and any follow up action?				
20. Outstanding actions arising from audit committee meetings are properly followed up?				
21. The audit committee takes appropriate steps to ensure internal and external audit cooperate appropriately to ensure the completeness of assurance coverage?				
22. There is an appropriate dialogue between internal/external audit and management? Is 'bad news' communicated to the audit committee in a timely manner?				
23. Appropriate processes are in place for ensuring the audit committee is kept fully informed on all material matters between meetings (including appropriate external information e.g. emerging risks and material regulatory changes)?				
24. The audit committee reports to the board on a timely and accurate basis and such communications are comprehensive, meaningful and focused?				

C. Professional development

	Actual	Ideal	N/A	Comments
1. New audit committee members are given an appropriate induction covering issues like: the role of the audit committee; its terms of reference; members' expected time commitment; an overview of the organisation; and the main operational and financial dynamics and risks?				
2. The ongoing professional development received by the audit committee (e.g., regulatory matters, accounting and financial reporting, audit and risk) is both appropriate and timely?				
3. Audit committee members are given appropriate opportunities to attend formal courses and conferences, internal talks and seminars, and briefings by external advisers such as the auditors and legal advisers?				
4. The induction and professional development programmes adequately equip audit committee members to understand the business environment in which the organisation operates?				

D. Overseeing financial reporting

	Actual	Ideal	N/A	Comments
1. Appropriate processes are in place to enable members to understand:				
• the appropriateness of the organisation's critical accounting policies, estimates and judgements?				
• the clarity and completeness of disclosures in the financial statements?				
• the impact on the financial statements of any developments in accounting standards or generally accepted accounting practice?				
2. The audit committee robustly challenges the proposed financial reporting and seek appropriate changes where necessary?				
3. The audit committee understands and approves the degree of management bias inherent within the financial statements and other documents within its remit?				

E. Overseeing risk management and internal control

	Actual	Ideal	N/A	Comments
1. The audit committee fully understands its role in providing oversight over internal financial controls; the wider aspects of internal control; and risk management systems?				
2. Does the audit committee understand the organisation's risk appetite for each material category of risk falling within the committee's remit?				
3. Does the audit committee have an appropriate understanding of the processes in place to identify, evaluate and monitor the key risks facing the organisation?				
4. Appropriate processes are in place to enable the audit committee to understand how each material risk will impact the organisation's operations and financial condition?				
5. Appropriate processes are in place to monitor changes in the organisation's risk profile?				
6. Appropriate processes are in place to provide the audit committee with suitable reports on the effectiveness of the systems of internal control?				
7. Appropriate processes are in place to ensure the risk management and internal control systems are fit for purpose and working as intended?				
8. The reports presented to the audit committee are sufficient and timely? The focus on risk trends and management action is appropriate?				
9. The audit committee splits its time appropriately between focusing on risk identification and assessment, and time spent focused on the effectiveness of the risk management framework itself? (e.g., time spent on reports and risk content vs time on whether executives are taking the right approach.)				

F. Overseeing external audit

	Actual	Ideal	N/A	Comments
1. The audit committee plays an appropriate role in recommending the appointment of the external auditor?				
2. External audit staff are appropriately qualified and experienced (taking into account the skills and the breadth and depth of experience necessary to cover the organisation's operations?				
3. The audit committee takes appropriate steps to ensure the external auditor has direct access to the audit committee and makes appropriate use of that access through informal as well as formal meetings?				
4. The audit committee has taken the appropriate steps to ensure the independence and objectivity of the external auditor is not compromised – including where the external audit provides non-audit services?				
5. The process by which the audit committee reviews and assesses the external audit work plan is appropriate?				
6. The external audit work plan focuses on the organisation's key audit risks?				
7. The quality of the external audit reports (and other documents) presented to the audit committee is appropriate?				
8. The audit committee has an appropriate dialogue with the external auditor regarding the major issues that arose during the course of the audit; the key accounting and audit judgements; and the levels of errors identified during the audit?				
9. The audit committee takes appropriate steps to ensure management respond to the external auditor's enquiries and recommendations in a timely and fitting manner?				
10. The process by which the audit committee reviews the effectiveness of the external audit is both timely and rigorous?				

G. Overseeing internal audit

	Actual	Ideal	N/A	Comments
1. The audit committee plays an appropriate role in approving the appointment of the internal audit provider?				
2. The internal audit function is appropriately resourced taking into account the skills and the breadth and depth of experience necessary to cover the organisation's operations?				
3. The audit committee takes appropriate steps to ensure the head of internal audit has direct access to the audit committee and makes appropriate use of that access through informal as well as formal meetings?				
4. The process by which the audit committee reviews and approves internal audit's remit is appropriate?				
5. The independence and objectivity of internal audit is not compromised in any way?				
6. The process by which the audit committee reviews and assesses the internal audit work plan is appropriate?				
7. The internal audit work plan focuses on the key risks and controls?				
8. The quality of internal audit reports (and other documents) presented to the audit committee is appropriate?				
9. The audit committee takes appropriate steps to ensure management respond to internal audit recommendations in a timely and fitting manner?				
10. The process by which the audit committee reviews the effectiveness of the internal audit is both timely and rigorous?				

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H. Comparison of XYZ Plc's audit committee with other audit committees you may have experience of

Issue	Comments

SPECIMEN YEAR-END TIMETABLE

APPENDIX 7

Year end reporting timetables will vary for a variety of reasons. The timetable illustrated below is typical for a FTSE 250 company with a December year end.

Year end	31 December
Management prepares draft financial statements	By mid January
Financial statements audited by external auditor (fieldwork)	Mid January to mid February
Meeting with CFO to discuss audit findings and draft audit committee memorandum	End of 2nd week in February
Audit committee papers circulated (including the draft financial statements and management and auditors comments thereon including any significant management letter points)	Beginning of 3rd week in February
Meeting between audit committee chairman and audit partner to discuss any contentious issues	End of 3rd week in February
Audit committee meeting to: • Review and recommend approval of the annual report (including the financial statements) and preliminary announcement (and analyst presentation) • Review representation letters from CEO, CFO, etc.	Beginning of 4th week in February
Board meeting to approve the annual report (including the financial statements), preliminary announcement and analyst presentation	Beginning of 4th week in February*
Preliminary results announcement to market and commence investor road shows	Middle of 4th week in February
External auditor prepares and issues the management letter	March
Management letter points considered by management	March
Mail out of annual report commences AGM papers to shareholders Publish annual report on internet and intranet	March
AGM	April

* Ideally at least one day later than the audit committee meeting

EXAMPLE QUESTIONS AROUND IDENTIFYING AND ASSESSING RISK

APPENDIX 8

In view of the different approaches boards may take in referring oversight powers to the audit committee in respect of risk management and the control framework, it is vital that there is an unambiguous understanding of what the board of directors, other board committees and the audit committee are responsible for in this important area of corporate governance. The audit committee's responsibilities should be reflected in its terms of reference.

To meet its responsibilities under its terms of reference, the audit committee needs to assess whether it is getting appropriate risk management information regularly enough and in a format that meets the needs of members. It needs to evaluate at least annually the adequacy and timeliness of management reporting to the committee on financial, non-financial, current and emerging risk trends. The audit committee needs also to discuss risk management with senior executives, internal and external audit. The scope of those discussions and considerations will be determined by reference to the audit committee terms of reference.

The following are high-level questions the audit committee may like to consider in framing discussions with management. The list is not exhaustive and will require tailoring based on the audit committee's terms of reference as well as the particular circumstances of the organisation.

Risk management framework	Evaluation of risk management framework
Risk strategy: the approach for associating and managing risks based on the organisation's strategies and objectives.	• What are the risks inherent in our business strategies and objectives? • How is our risk strategy linked to our business strategy? • Is our risk management policy clearly articulated and communicated to the organisation? If not, why not? If yes, how has this been achieved? • Is our risk appetite (the amount of risk the organisation is willing to take) clear? How is it linked to our objectives? • How has the board's perspective on risk permeated the organisation and culture?
Risk structure: the approach for supporting and embedding the risk strategy and accountability.	• Is there a common risk management language/terminology across the organisation? If not, why not? • Is accountability for risk management transparent at the management level? If not, why not? If yes, describe how this has been achieved. • Are risk management activities/responsibilities included in job descriptions? • How do our performance management and incentive systems link to our risk management practices?
Measuring and monitoring: the establishment of Key Performance Indicators (KPIs) and continuous measuring and improving of performance.	• Are risk owners clearly identified? If not, why not. • If yes, how? • Are there systems in place for measuring and monitoring risk? • How are risks, including suspected improprieties, escalated to the appropriate levels within the organisation? • How is the risk management framework linked to the organisation's overall assurance framework?
Portfolio: the process for identifying, assessing and categorising risks across the organisation.	• Does a comprehensive risk profile exist for the organisation? If not, why not? • Does the risk profile evidence identification and evaluation of non-traditional risk exposures? • Are the interrelationships of risks clearly identified and understood? **Operational risk** • What are the risks inherent in the processes chosen to implement the strategies? • How does the organisation identify, quantify and manage these risks given its appetite for risk? • How does the organisation adapt its activities as strategies and processes change? **Reputation risk** • What are the risks to brand and reputation inherent in the way the organisation executes its strategies? **Regulatory or contractual risk** • Which financial and non-financial risks are related to compliance with regulations or contractual arrangements? **Financial risk** • Have operating processes put financial resources at undue risk? • Has the organisation incurred unreasonable liabilities to support operating processes? • Has the organisation succeeded in meeting measurable business objectives? **Information technology risk** • Is our data/information/knowledge reliable, relevant and timely? • Are our information systems reliable? • Do our security systems reflect our reliance on technology, including our e-business strategy? **New risks** • In a business environment that is constantly changing, are there processes in place to identify emerging risks? If not, why not? If yes, describe. • What risks have yet to develop? These might include risks from new competitors or emerging business models, recession risks, relationship risks, outsourcing risks, political or criminal risks, financial risk disasters such as rogue traders, and other crisis and disaster risks.
Optimisation: balancing potential risks and opportunities based on the appetite to accept risk.	• Does the risk approach include a regular search for new markets, partnering opportunities and other risk optimisation strategies? If not, why not? If yes, how is this achieved? • Is risk a priority consideration whenever business processes are improved? If not, why not? If yes, describe how this is achieved.

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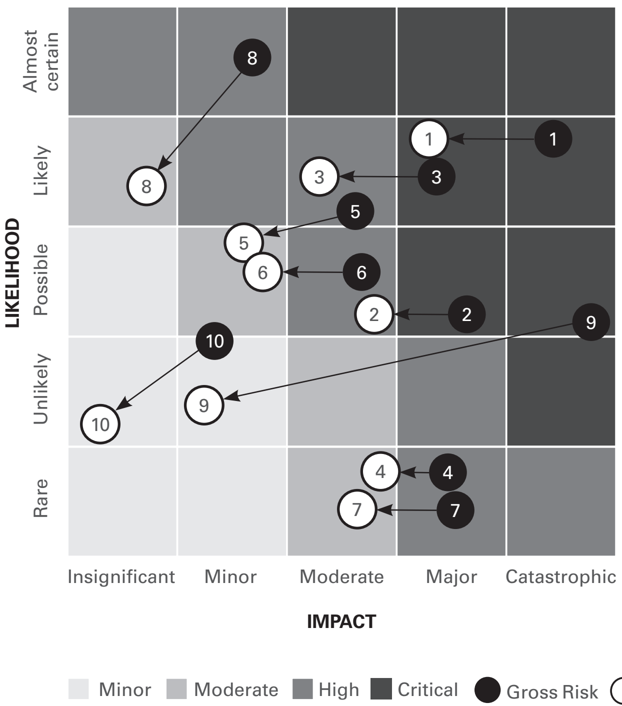
EXAMPLE RISK SUMMARY AND REGISTER

APPENDIX 9

The following chart illustrates management's view of the top 10 risks facing the business. Each of these risks has been assessed in terms of potential impact and likelihood of occurrence, using descriptive scales. The quantification criteria for likelihood and impact are set out below the risk summary.

The grid below has been used to provide a graphical illustration of the likelihood and impact for each of the group's top ten risks, the arrows representing the influence existing internal controls are thought to have on that risk.



Top ten key risks:

1. Inappropriate acquisition strategy and process
2. Fall in investor confidence due to media criticism
3. Failure to comply with appropriate regulatory and legal requirements (i.e., cartels)
4. Post implementation IT systems failures*
5. Failure to allow current business strategy enough time to develop
6. Failure to manage and respond adequately to economic uncertainty
7. Inadequate business continuity and disaster recovery plans to manage a major IT network failure
8. Inability to protect brand name
9. Parcel and Express services division fail to deliver their expected growth strategy
10. Loss of key staff and inadequate succession planning

Note: Arrows represent effectiveness of controls currently in place

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QUANTIFICATION CRITERIA FOR LIKELIHOOD AND IMPACT

Minor Moderate High Critical

LIKELIHOOD

				1	2	3	4	5
Event is expected to occur in most circumstances	>90%	Almost	5					
Event will probably occur in most circumstances	50 - 90%	Likely	4					
Event should occur at some time	30 - 5-%	Possible	3					
Event could occur at some time	10 - 30%	Unlikely	2					
Event may occur only in exceptional circumstances	<10%	Rare	1					

	1 Insignificant	2 Minor	3 Moderate	4 Major	5 Catastrophic
Time	Resolution would be achieved during normal day to day activity	Resolution would require input from regional management team	Resolution would require input from executive team	Resolutions would require the mobilisation of a dedicated project team	Resolution would require input from the board
Profit	Less than 1% or no impact	1% to 3% impact	3% to 10% impact	10% to 25% impact	Greater than 25%
Turnover	Little or no impact	1% to 3% impact	3% to 10% impact	10% to 25% impact	Greater than 25%
Environment	On-site environmental exposure immediately contained	On-site environmental exposure contained after prolonged effort	On-site environmental exposure contained with outside assistance	On-site environmental exposure contained with outside assistance	Environmental exposure off-site with detrimental effects
Reputation	Letters to local/ industry press	Series of articles in local/industry press	Extended negative local/ industry media coverage	Short term national negative media coverage	Extensive negative national media coverage
Regulatory	Minor breaches by individual staff members	No fine - no disruption to scheduled services	Fine but no disruption to scheduled services	Fine and disruption to scheduled services	Significant disruption to scheduled services over an extended period of time
Management effort	An event, the impact of which can be absorbed through normal activity	An event, the consequences of which can be absorbed but management effort is required to minimise the impact	A significant event which can be managed under normal circumstances	A critical event which with proper management can be endured	A disaster with potential to lead to collapse of the business

IMPACT

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SUMMARY RISK REGISTER

	Risk description			Inherent risk assessment				Residual risk assessment					Improvement actions		
	Risk description	Cause(s)	Consequence(s)	Inherent Likelihood	Inherent Impact	Risk Score	Ownership	Existing Controls	Sources of assurance	Residual Likelihood	Residual Impact	Risk Score	Actions for further control	Action owner	Due date
	What might occur?	What might cause the risk to occur?	What are the possible consequences if the risk occurs?	1= Rare 2=Unlikely 3=Possible 4=Likely 5=Almost certain	1=Insignificant 2=Minor 3=Moderate 4=Major 5=Catastrophe	Likelihood multiplied by impact	Who has overall accountability for this risk? (senior management level)?	What existing processes/ controls are in place to manage the risk?	What assurance do you get over these controls?	1=Rare 2=Unlikely 3=Possible 4=Likely 5=Almost certain	1=Insignificant 2=Minor 3=Moderate 4=Major 5=Catastrophe		What further action (if deemed necessary) is planned to treat the risk?	Who is responsible for developing the action plan (senior management level)?	When are the agreed actions to be delivered by?
WEAK	Reputation	Bad publicity	Share price drop	5	5	25	All management	All corporate policies and processes	Annual review of policies	5	5	25	None, ongoing	All management	Not applicable
STRONG	Loss of a key customer impacting profit and growth objectives	1. Spread of customers not sufficient 2. Poor customer service e.g., deliveries	1. Customer represents 15% of revenue or profit 2. Impacts reputation for good service 3. Impacts ability to win new business	4	4	16	Commercial Director	1. Weekly verbal updates with key customer and account manager 2. Formal monthly reviews of performance with key customer and Commercial Director 3. Compulsory training for all customer facing staff	Internal Audit on complaints procedure tracking and marketing from annual independent client reviews	2	4	8	1. Align account team personal performance metrics with key customer satisfaction metrics 2. Informal account team customer feedback sessions on monthly basis per key customer update meetings 3. Improve IT data capture of informal complaints with weekly updates required from account teams	1. Account team manager 2. Commercial Director 3. IT Director with input from Commercial Director	1. Include in 1st Quarter goal setting 2. Immediate 3. By 1st Quarter 200X

- Risks linked to business objectives and their KPIs and/or categories of risk.
- Specific and concise, supported by key causes and consequences.

- Causes consider external and internal factors.
- Consequences directly linked to business objectives and their KPIs and consider direct and indirect impacts.

- Inherent and residual risk scores clearly explained.
- Likelihood linked to business planning cycle (e.g., 3-5 years).
- Impact includes both financial and non- financial impact and linked to financial performance targets.

- Controls are split between different types (formal/ informal).
- Controls include sources of assurance.
- Control owners are evident.

- Improvement actions are SMART, have clear owners, a due date and linked to formal management reporting.
- Action owners are accountable.

WHISTLE-BLOWING POLICY

APPENDIX 10

All employees are encouraged to raise genuine concerns about possible improprieties in matters of financial reporting and other malpractices at the earliest opportunity, and in an appropriate way.

This policy is designed to:
- support our values;
- ensure employees can raise concerns without fear of suffering retribution; and
- provide a transparent and confidential process for dealing with concerns.

This policy not only covers possible improprieties in matters of financial reporting, but also:
- fraud;
- corruption, bribery or blackmail;
- criminal offences;
- failure to comply with a legal or regulatory obligation;
- miscarriage of justice;
- endangering the health and safety of an individual; and
- concealment of any of the above.

Principles
- All concerns raised will be treated fairly and properly.
- We will not tolerate the harassment or victimisation of anyone raising a genuine concern.
- Any individual making a disclosure will retain their anonymity unless they agree otherwise.
- We will ensure that any individual raising a concern is aware of who is handling the matter.
- We will ensure no one will be at risk of suffering some form of retribution as a result of raising a concern even if they are mistaken. We do not however extend this assurance to someone who maliciously raises a matter they know to be untrue.

Grievance procedure
If any employee believes reasonably and in good faith that malpractice exists in the work place, then he or she should report this immediately to their own line manager. However, if for any reason they are reluctant to do so, then they should report their concerns to either the:

- group company secretary; or
- director of human resources.

Employees concerned about speaking to another member of staff can speak, in confidence, to an independent third party by calling the **whistle-blowing hotline** on [ ]. This is provided through the independent party who provide the employee care counselling and legal advice service. Your concerns will be reported to the company without revealing your identity.

If these channels have been followed and employees still have concerns, or if employees feel the matter is so serious that it cannot be discussed with any of the above, they should contact the senior independent director on [ ].

Employees who have raised concerns internally, will be informed of who is handling the matter, how they can make contact with them and if there is any further assistance required. We will give as much feedback as we can without any infringement on a duty of confidence owed by us to someone else.

Employees' identities will not be disclosed without prior consent. Where concerns are unable to be resolved without revealing the identity of the employee raising the concern, (e.g., if their evidence is required in court), we will enter in to a dialogue with the employee concerned as to whether and how we can proceed.

If you are unsure whether to use the procedure or you want independent advice at any stage, you may contact the independent charity [ ].
Their lawyers can give you free confidential advice at any stage about how to raise a concern about serious malpractice at work.

Legal protection for disclosures
Employees in Ireland [and the UK] are protected by law when making defined disclosures.

Criminal Justice Act 2011

In Ireland, the Criminal Justice Act 2011 affords protection for employees making disclosures of relevant offences defined by the Act. Relevant offences are defined in Schedule 1 to the Act. 'Relevant offences' consist of a number of specific offences under nearly 30 separate enactments or statutory instruments. These are listed in Schedule 1 to the Act and in general terms cover:

- provision of false information, either knowingly or recklessly, to
  - regulatory authorities (eg Central Bank)
  - investors (eg false information in a prospectus)
  - a liquidator
  - the public (eg false information in documents filed at the Companies Registration Office)
- insider dealing and market manipulation
- concealing or destroying documents required for regulatory purposes
- offences connected with company liquidation, including:
  - concealing or diverting assets owned by a company being placed in liquidation
  - fraudulent trading
  - obtaining credit for a company unable to meet its obligations
- other company law offences
  - financial assistance for purchase of own shares
  - failing to keep proper books of account
  - making false statements to auditors
- theft and fraud offences under the Criminal Justice (Theft and Fraud Offences) Act 2001
  - money laundering and terrorist financing
  - Actual or attempted money laundering, or assisting another
  - Failure to carry out adequate client due diligence, including both identity checks and steps to identify 'politically exposed persons'
  - 'Tipping off'
- corruption offences
- breaches of financial sector law, including
  - acting without proper authorization
  - misappropriate of client funds
- withholding information from NAMA.

If group includes UK entities

Public Interest Disclosure Act

All UK employees will be protected under the Public Interest Disclosure Act 1998, where they make a protected disclosure. These are disclosures of information, which in the reasonable belief of the employee making the disclosure, cover the following employer activities:

- a criminal offence has been, is being, or is likely to be, committed;
- that a person has failed, is failing or is likely to have failed to comply with any legal obligation to which they are subject;
- a miscarriage of justice has occurred, is occurring or is likely to occur;
- that health and safety of an individual has been, is being or is likely to be endangered;
- that the environment has been, is being or is likely to be damaged; and
- that information relating to the above is being deliberately concealed.

Employees in other territories will be treated by the company as if such legislation applied to them.

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INTERNAL AUDIT SOURCING OPTIONS

APPENDIX 11

The relative strengths and weaknesses of different sourcing models are set out below.

Sourcing model	Pros	Cons
In-house function	✓ Continuity of staff ✓ Certain and controllable cost ✓ Full control of the function ✓ A resource pool for the business ✓ Training ground for employees ✓ Greater cultural alignment ✓ Insiders	✗ May not be fully employed effectively and efficiently ✗ Difficult to acquire necessary/ maintain all skills and experience to meet the risk profile of the business ✗ Need to continually invest in training and development ✗ Recruitment hassles ✗ Ineffective/inefficient start up ✗ Retention and development strategies required ✗ Reduces opportunity to provide fresh perspective/risk of complacency or familiarity
Co-source	✓ Long term permanent on-site presence through HIA (Head of Internal Audit) ✓ Access to broad range of skills through the partner ✓ Draw on specialist skills as and when, and only when, needed ✓ Continuity through HIA ✓ Pull in up to date skills and experience as needed ✓ Quick to implement ✓ Skills transfer to in house team ✓ Flexible approach, clearly defined service level and KPI measures ✓ Credibility to third parties ✓ No or reduced training cost	✗ Time taken to recruit HIA ✗ Possible cost impact ✗ Management resource needed in recruitment and relationship development ✗ Dependency on 3rd party ✗ Possible lack of staff continuity ✗ Other challenges for in house resource as above

Sourcing model	Pros	Cons
Full outsource	✓ Established methodologies & benefit of refreshment based on experiences across different organisations ✓ Up to date, skilled staff ✓ Ability to draw on a wide range of skills as and when required ✓ No time taken up by managing service and resources ✓ Clearly defined service level and performance measures ✓ Easily established and quickly effective ✓ Credibility to third parties ✓ Ability to manage costs by avoiding non-productive periods	✗ No permanent on-site resource to help other areas of the business ✗ Potential cost impact ✗ Possible lack of staff continuity ✗ Remote from business developments, the culture and politics ✗ Management time to establish and maintain relationships

SPECIMEN INTERNAL AUDIT PLAN

APPENDIX 12

Internal audit provides independent, objective assurance over an organisation's risk management, internal control, governance and the processes in place for ensuring effectiveness, efficiency and economy.

Each audit plan will be different and tailored to the organisation's needs. However, there are common elements that the audit committee should expect to see when reviewing the audit plan, albeit in practice these elements might be presented in many different ways. These elements are discussed below.

Overview of the audit approach

The audit committee should expect the audit planning document to set out that the audit plan has been developed by:

- taking account of the risks identified by the organisation in its risk register and other documents;
- using the internal auditor's experience of the organisation and the sector more generally to identify other areas of risk which may warrant attention; and
- discussing all identified risks and other relevant issues with the organisation's management to identify the potential scope of internal audit.

Risk-focused internal audit coverage

Where the organisation's risk management policy allocates each risk a likelihood and impact rating between 'high' and 'low', the audit plan might for example focus on 'high' and 'medium' priority risks over (say) a three-year period. However the internal audit is focused, the audit committee should be fully informed of:

- which areas are being addressed;
- how many audit days have been allocated to each area;
- when the fieldwork is being undertaken; and
- when the internal auditors will report their findings.

Exhibit 1 (below) illustrates which risks identified by the organisation in the risk register are addressed by the internal audit plan. Exhibit 2 puts these risks in the context of a three-year audit plan. It is also useful to keep the audit committee apprised of the risks that are not addressed by the internal audit plan – see Exhibit 3.

Other reviews

The internal audit strategy may address some *ad hoc* areas that do not feature as a high or medium risk. These are nevertheless areas where the organisation would benefit from an internal audit review, or they are being reviewed to provide assurance to the audit committee and external auditors regarding operation of the key financial and management information systems. The audit days, fieldwork and reporting expectations for these areas should also be identified in the audit plan.

Contingencies

It is important to adopt a flexible approach in allocating internal audit resources, in order to accommodate any unforeseen audit needs. The audit plan should give an indication as to how many 'man days' have been allowed for contingencies.

Follow-up

For internal audit to be as effective as possible, its recommendations need to be implemented. Specific resources should be included within the plan to provide assurance to the organisation and the audit committee that agreed audit recommendations have been actioned effectively and on a timely basis.

Planning, reporting and liaison

The audit committee should expect the internal audit plan to identify a number of audit days relating to the following:

- quality control review by manager;
- production of reports, including the strategic plan and annual internal audit report;
- attendance at audit committee meetings;
- regular contact with the organisation's management;
- liaison with external audit; and
- internal quality assurance reviews.

The internal audit team

Where the internal audit is outsourced, the audit committee (and management) should expect a brief introduction to the key individuals working on the audit. This might include partners, managers and any specialist advisers.

Timing

The audit plan should set out the timing of the fieldwork and confirm the form and timeliness of reports to management and the audit committee. For example:

- a report for each area of work undertaken within X days of finishing the fieldwork;

- a progress report for each audit committee meeting; and
- an annual report on internal audit coverage to the audit committee (reporting to fit in with the committee meeting dates).

Exhibit 4 outlines how the timing might be presented for an internal audit carried out in three phases to coincide with the audit committee timetable.

Internal audit performance indicators

The internal auditor might propose a series of performance indicators against which management and the audit committee can measure the function's performance. An example of proposed indicators is included as Exhibit 5.

Exhibit 1: Internal audit plan – focus on the organisation's key risks

Risk identified in the risk register	Ranking	Internal audit reviews over a three-year period
1. Failure of the new finance system	High	Finance system implementation
2. Reliance on small number of specialised staff	High	IT
3. Security issues	High	IT
4. Ineffective project assessment procedures	Medium	Contract management
5. Non-performance of contracts	Medium	Contract management/departmental reviews
6. Poor procurement of projects	Medium	Estates
7. Failure to protect intellectual property	Medium	Intellectual property management
8. Statutory non-compliance (H&S)	Medium	Health and safety
9. Non-prevention of foreseeable accidents	Medium	Health and safety
10. Failure to adequately manage occupational stress	Medium	Human resources
11. Failure to attract and retain high-quality staff	Medium	Human resources
12. Non-financial control failure	Medium	Key financial systems/department reviews
13. Fraud, theft and misuse of assets	Medium	Key financial systems/department reviews
14. Breach of financial memorandum	Medium	Key financial systems – treasury management
15. Reputation unclear or fragmented	Medium	Strategic planning
16. Ineffective faculty business planning	Medium	Strategic planning/department reviews
17. Failure to consider future strategies	Medium	Strategic planning

28. Claw back of project funding	Low*	Contract management/departmental reviews
29. Unsatisfactory procurement procedures	Low*	Key financial systems – purchasing

* Although categorised as a 'low' risk, this will be covered within a review of higher risks.

Exhibit 2: Three-year rolling plan

Internal audit reviews	Current year	Year 2	Year 3	Total days
Risk based reviews				
a. Contract management	-	-	15	15
b. Departmental reviews	-	25	20	45
c. Estates	-	-	15	15
d. Finance system implementation	50			50
e. Key financial systems	-	25	25	50
f. Health and safety	15	-	-	15
g. Human resources	15	-	-	15
h. Intellectual property management	15	-	-	15
i. IT systems	20	15	15	50
j. Strategic planning	20	-	-	20
Total risk-based days	135	65	90	290
Other reviews				
k. Risk management	10	8	8	26
l. Corporate governance	-	7	-	7
m. Corporate structures	-	-	22	22
n. Costing processes	-	15	-	15
o. Sickness management	-	15	-	15
Total other review days	10	45	30	85
Other				
p. Contingency	8	8	8	24
q. Follow-up	8	8	8	24
r. Planning, reporting and liaison	34	9	9	52
Total other days	50	25	25	100
Total days	**195**	**135**	**145**	**475**

Exhibit 3: Risks not subject to internal audit review

Risk	Ranking
18. Defamation/professional negligence	Medium
19. Necessity for redundancies	Medium
20. Fire/explosion	Medium
21. Influential connections lost	Medium
22. Failure to prevent a major incident	Medium
23. Failure to adopt equal pay provisions	Medium
24. Failure to prevent dismissals	Medium
25. Missed commercial opportunities	Low
26. Failure to adequately manage disability issue	Low
27. Failure to prevent major health incident	Low
30. Statutory non-compliance – services	Low
31. Failure to prevent outbreak of food poisoning	Low
32. Building collapse	Low
33. Exposure to higher interest rates	Low

Exhibit 4: Annual plan 2012-13

Internal audit reviews	Current year	Phase	Fieldwork	Report to audit committee
Risk-based reviews				
d. Finance system implementation	50	All phases	All audit visits	Feb/May/ Oct meeting
e. Health and safety	15	Phase 2	w/c 26.02.2013	31.05.2013
f. Human resources	15	Phase 1	w/c 20.11.2012	08.02.2013
g. Intellectual property management	15	Phase 2	w/c 26.02.2013	31.05.2013
h. IT systems	20	Phase 1	w/c 20.11.2012	08.02.2013
i. Strategic planning	20	Phase 1	w/c 20.11.2012	08.02.2013
Total risk-based days	**135**			
Other reviews				
j. Risk management	10	Phase 2	w/c 26.02.2013	31.05.2013
Total other review days	10			
Other				
q. Contingency	8			
r. Follow-up	8	Phase 3	w/c 14.05.2013	09.10.2013
s. Planning, reporting and liaison	34			
Total other days	50			
Total days	**195**			

Exhibit 5: Performance indicators

Performance indicator	Target
Percentage of audit work delivered by qualified staff	60%
Operational plan to be submitted by September each year	September of each year
Follow-ups to be performed within 1 year of the audit taking place	Within 1 year of assignments
Issue of draft reports within 30 days of work being completed	30 working days
Issue of final report within 10 working days of receipt of management responses	10 working days
Recommendations made compared with recommendations accepted	80%
Internal audit attendance at audit committee meetings	100%
Issue of internal audit annual report	September of each year

INTERNAL AUDIT ACTIVITIES – KEY STEPS IN THE ANNUAL AUDIT CYCLE

APPENDIX 13

The key steps in an annual cycle	
Produce the annual work programme	• Create an annual internal audit plan for approval by the audit committee, typically as part of an indicative 3 or 5 year plan linked to a wider risk/audit universe • Identify resource requirements, including relevant subject matter and industry experience to add value to the process, and associated budgets • Agree the timeline for performing individual assignments in the agreed plan • Additional reviews may be required: the approach needs to be nimble to respond to the needs of the audit committee and the executive team • Consideration should also be given at this stage to the interaction with risk management activities and the specific linkage of risk and assurance
Plan individual assignments	• For each allocated audit assignment, terms of reference should be agreed in advance • Staff requirements should be confirmed and communicated to the team reasonably far in advance of the work to help continuity • Planning meetings with the nominated business sponsor and business process owners, information gathering and briefing of team members prior to each assignment
Perform fieldwork	• Fieldwork should commence with an opening meeting involving all relevant team members so that: – expectations are understood; and – the objectives, scope, techniques and emphasis of the review are clear. • A 'no surprises' approach is fundamental. The nominated business sponsor should be informed of issues as they arise

The key steps in an annual cycle	
	• Ways of working should be defined and consistently applied and measured (including the business responsibilities) • Variations to timelines or budgets should be monitored and flagged as soon as they are identified to key sponsors
Exit meeting	• Prior to formal reporting, an exit meeting should be held with the relevant business sponsor and other employees as agreed • The purpose of the meeting is to: – confirm that expectations have been met; – highlight and re-confirm the findings of the review; – validate the findings; and – where appropriate, obtain management's acceptance and support for the recommendations made, including their commitment to actions with clear dates for implementation
Reporting	• Prepare a draft report to be issued to management within an agreed number of working days of completion of each audit and finalise the report, again within an agreed time frame of receipt of management responses • Report in accordance with standard template • Determine who should attend and present at stakeholder and audit committee meetings
Issue resolution tracking	• Following the issue of final reports, monitor agreed upon management action plans and subsequent reporting to senior management and the audit committee • Clear protocols for follow up work as and when needed
Overall considerations	• Defined audit charter • A defined strategy • An ongoing awareness of key business risks and how this drives audit • Clear role defined on related activities e.g., investigations/*ad hoc* assignments • Agreed communication protocols • Clear business case/cost analysis and monitoring • Ways of working protocols • KPIs to track progress and delivery • Stakeholder satisfaction surveys

ILLUSTRATIVE INTERNAL AUDIT REPORT

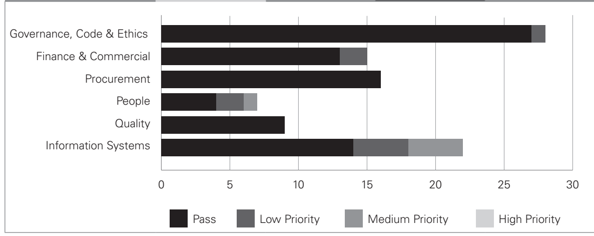
APPENDIX 14

Overall rating and summary of findings

Rating	Overview
Satisfactory Represents an assessment of a control environment that is satisfactory and supports meeting management's objectives.	The vast majority of internal audits carried out during the period received a 'pass' grade and there were no 'high priority' observations. However, there were a small number of 'medium priority' and 'low priority' observations which are discussed in more detail below. Overall, the control environment is in good order and management are working to resolve the issues identified during the audits.
Adequate with opportunity for further development – Medium priority for management to address Represents an assessment of an adequate control environment that broadly supports management's objectives but has further opportunities for development.	
Unsatisfactory – High priority for management to address A high number of control deficiencies or business issues where the potential financial, operational or reputation risk exposure to XYZ Plc is significant and management should address these issues immediately.	

Performance improvement opportunities ('PIOs')

Status	High Priority	Medium Priority	Low Priority	Total
New PIOs	0			
Accepted PIOs	0			



High Priority Observations

No high priority observations were noted.

Overview

A summary of the control environment and process improvement opportunities identified as part of this internal audit is provided below:

Area	Compliance/Good Practice	Process improvement/ efficiency opportunity
Governance, Conduct and Ethics		
Finance and Commercial		
Etc.		

Detailed findings

This section summarises in the form of performance improvement observations (PIOs) the issues arising from this review that we believe require action. PIOs are rated using the scale in the legend below:

Priority rating for performance improvement observations raised		
HIGH: Issues referring to important matters that are fundamental to XYZ's system of internal control. We believe that the matters observed might cause a business objective not to be met or leave a risk unmitigated and need to be addressed as a matter of urgency.	**MEDIUM:** Issues referring mainly to matters that have an important effect on XYZ's controls, but do not require immediate action. A business objective may still be met in full or in part or a risk adequately mitigated, but the weakness represents a significant deficiency in the system.	**LOW:** Issues arising that would, if corrected, improve XYZ's internal control in general, but are not vital to the overall system of internal control.

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No	Priority	Issue	Risk	Performance Improvement Observation	Management Response	Responsibility/ Date
Governance, Conduct and Ethics						
1	**LOW**					
Finance and Commercial						
2	**HIGH**					
	MEDIUM					
Etc.						
3						

Appendix: Scope of work and audit approach

Objective	Issues/controls being reviewed	Internal audit approach

EVALUATION OF THE INTERNAL AUDIT FUNCTION

APPENDIX 15

This assessment process focuses on your personal perception of the internal audit function as a whole – it does not seek to evaluate individuals and their personalities. The audit committee chairman should determine who is asked to complete the questionnaire. It is not unusual for it to be completed by audit committee members, (prior to feedback from other areas of the organisation); the heads of major business units/subsidiaries and the CFO; and the head of the internal audit function (i.e., self assessment). The external auditor may also be asked to comment.

The questionnaire takes about 10 minutes to complete and should be completed in the following manner:

- Using a scale of **1** (low) to **10** (high), complete each question by placing your score in the two boxes beside the question. '**Actual'** is your view of the current position of the internal audit function on that issue. **'Ideal'** is the score that you would like to see. The difference can be used to determine the relative priority of each issue.

  You may wonder why there is a choice of score on the **Ideal** position as you may think it should always be a ten (the maximum). This may often be the case; however, there may be occasions where you feel an area is of less importance and therefore may merit an **Ideal** score lower than ten. We would stress that the main reason for asking for the two scores is to see where the biggest gaps are between **Actual** and **Ideal** as this identifies where any development priorities lie.

- There is a space for comments beside each question. You are not obliged to make comments; however, comments do improve the quality of the review and therefore are to be encouraged.

- 'N/A' can be used where you don't have a view on the matter in question.

- All responses will be treated as anonymous unless the individual completing the questionnaire wishes otherwise.

Typical answers might look like this:

	Actual	Ideal	N/A	Comments
1. Internal audit have a comprehensive strategic plan, developed in collaboration with the audit committee, executive management and principal stakeholders; and aligned to the organisation's own strategy and medium term risk profile?	6	10		*The audit committee has little input into the audit plan. It is received late in the day and is essentially a fait accompli.*
2. Internal audit harness technology throughout its audit and administrative processes to maximise efficiencies and improve audit effectiveness?	7	7		*The technology used is appropriate for a small organisation (and IA function), but it is recognised that more might be achieved if resources permitted.*

A. Positioning

	Actual	Ideal	N/A	Comments
Mandate and strategy				
1. Internal audit have a comprehensive strategic plan, developed in collaboration with the audit committee, executive management and principal stakeholders; and aligned to the organisation's own strategy and medium term risk profile?				
2. Internal audit is recognised by business leaders as a function providing quality challenge (for example by telling them things they did not already know, identifying root causes of control breakdowns and opportunities for improving control design, and trends in risks and controls)?				

	Actual	Ideal	N/A	Comments
3. Internal audit have a sound understanding of business strategy and the associated risks, and be able and willing to challenge the control environment and infrastructure supporting the strategy and be able to read across from one part of the organisation to another?				
4. Internal audit have an integral role in the governance structure (as the "third line of defence") which is clearly aligned with its stakeholders, clearly articulated in its mandate and widely understood throughout the organisation?				
Organisation and structure				
5. Internal audit are independent from the business and have clear and unfettered reporting into the audit committee and direct access to the chairman of the board?				
6. Internal audit are structured so as to enable both the maintenance of independence and objectivity on the one hand, and proximity to the business (so as to establish and maintain relationships with and comprehensive understanding of the business) on the other?				
7. Internal audit consult and collaborate with risk control functions to ensure an appropriate allocation of responsibility within the organisation?				

	Actual	Ideal	N/A	Comments
8. Internal audit have a presence in major governance and control forums throughout the organisation, for example, any risk committee?				
Stakeholders				
9. Internal audit is characterised by strong relationships at the highest levels (for example, does the head of internal audit and senior colleagues have direct and strong relationships with board members, business heads and senior management)?				
10. Internal audit regularly attend executive meetings to present audit findings, trends and current views (of the control environment)?				
11. Internal audit regularly attend audit committee meetings to present audit findings, trends and current views (of the control environment)?				
12. Through its activities, internal audit is able to articulate to senior management the risks of their actions in a structured and balanced manner, and provide credible recommendations to mitigate the risks?				
13. Internal audit have strong relationships with key external stakeholders (in particular, external auditors and any relevant regulators)?				
14. Internal audit proactively manages relationships with its key stakeholder population?				

	Actual	Ideal	N/A	Comments
Funding				
15. Internal audit have no unreasonable budgetary constraints which limit its ability to deliver on its mandate, given the risk appetite of the organisation?				
16. Internal audit manages its resources effectively to maximise the value of its service to the business?				

B. People

	Actual	Ideal	N/A	Comments
Leadership				
1. Internal audit have the standing, credibility and impact to present its views in audit (and risk) committees, and influence the organisation?				
2. Internal audit includes sufficient individuals who are senior and experienced enough, with sufficient business understanding, to apply judgement and challenge the business on a broad array of topics?				
Competencies				
3. Internal audit comprises a diverse talent pool with a broad mix of skills and experience gained within internal audit and in business?				
4. Internal audit includes individuals recognised (by the business) as experts in governance, control and risk mitigation?				

	Actual	Ideal	N/A	Comments
5. There is an appropriate mechanism for identifying the skills and competencies required to deliver its annual plan, identifying and relieving gaps and being responsive to the changing risk profile of the organisation?				
Staffing strategy				
6. Internal audit is forward thinking in its medium to longer term staffing strategy (for example, by taking into account growth areas in the business, new and emerging risk areas, and both internal and external factors affecting the function's ability to attract talent)?				
7. Internal audit is able to attract the 'right' people by providing a value adding career development opportunity to the organisation's top talent?				
8. Internal audit is able to develop its personnel through comprehensive training and development?				
Culture				
9. Internal audit is characterised by a culture of challenge, probing, and continuous improvement?				
10. Internal audit is characterised by a culture of continuous improvement in the internal audit process?				
11. Internal audit acts as a role model and adheres to high ethical standards and values?				

	Actual	Ideal	N/A	Comments
Reward and appraisal				
12. Internal audit have competitive remuneration polices based on the achievement of defined performance metrics (for example, based on quality of work and impact upon the business, and not simply delivery against plan and business performance).				

C. Processes

	Actual	Ideal	N/A	Comments
Risk assessment and planning				
1. Internal audit have a risk based audit plan based on a risk assessment accepted and approved by the board?				
2. Internal audit is forward looking when determining the audit plan and is nimble enough to adapt its planned activities, sometimes rapidly, in the case of new and emerging risks?				
3. Internal audit submits its plan to the audit committee for approval on a timely basis (at least annually) and as appropriate when updates are required?				
Execution				
4. Internal audit reflects on and adapts its methodology to ensure that it remains fresh and relevant, through integrated (not post hoc) quality assurance and learning programmes?				

	Actual	Ideal	N/A	Comments
5. Internal audit conducts end-to-end/corporate wide audit activities which enable it to obtain a holistic view (for example, within and across business units, functions, processes, and jurisdictions) as to whether the primary risks facing the organisation are appropriately mitigated?				
6. Internal audit harness technology throughout its audit and administrative processes to maximise efficiencies and improve audit effectiveness?				
7. Internal audit maintain and promote comprehensive knowledge management systems, widely used by its staff?				
Reporting				
8. Internal audit produce reports for individual audits with a clear rating scale which identify both root causes and consequences of issues and which are delivered on a timely basis with clarity and impact, and include credible recommendations to management?				
9. Internal audit produce reports for the audit committee which present information in a clear, concise and impactful manner, including the identification of themes and trends, and their consequences for the organisation as a whole?				
10. Internal audit have rapid and effective mechanisms in place for the escalation of issues requiring senior management attention?				

	Actual	Ideal	N/A	Comments
Overall				
11. Internal audit has added value to the organisation? How?				

D. Comparison of XYZ Plc's internal audit function with other internal audit functions you may have experience of:

Risk	Comments

HOW TO CONDUCT AN AUDIT TENDER

APPENDIX 16

The competitive tender, or proposal, has become a common method of selecting auditors and professional advisers.

This document is based on our experience of helping organisations through the tender process.

Identifying the objectives

The objectives behind an audit tender might include:

- improved service;
- new ideas;
- new approach;
- fee reduction;
- testing the market;
- rationalising the advisers in a group;
- keeping incumbents on their toes;
- access to a wider range of experience;
- better continuity; and/or
- responding to corporate governance best practices.

Consider carefully of the scope of services involved including:

- which companies within the group should be included? Are there subsidiaries or overseas locations currently serviced by another provider? Would it make sense to include them in this tender?
- which services should be included? Are there potential benefits from tendering taxation or other services at the same time as the external audit? Including additional services will increase the effort involved in managing the tender, but this could be marginal compared with conducting separate tenders.
- what is the period of the appointment? Is there a policy for tendering the audit at regular intervals?

Is tendering the right approach?
Tendering can be an extremely effective method of selecting advisers; however it is not the most appropriate approach for all circumstances.

Tendering can be a very time-consuming and expensive process, for both the purchaser and the service provider, and there is often a more efficient way to realise the desired outcome. It is important to consider what you are trying to achieve.

If your sole objective is to achieve a keen price, and you know which firm you would prefer to appoint, you can meet that goal without going to the trouble of a tender. Simply negotiate directly with the firm involved. This will save significant effort for both parties.

The real value of tendering lies in its ability to present you with comparisons in style and approach between different teams and the firms they represent, and to help identify which firm you think would fit best with your organisation. The process can also help to generate new ideas and enable management to test its assumptions about the business: as outside observers, the participants should be able to comment objectively on your company's strengths and weaknesses, and perhaps bring a fresh perspective or new experience to some of the issues.

Planning the process

Planning is important; not only to help achieve a successful outcome, but also to ensure the process is as efficient as possible. Careful planning can enable you to control the amount of time devoted to the exercise, while at the same time allowing the firms the access they need to develop an effective proposal.

A poorly managed tender can create additional work through, for example, participants needing to clarify matters or seek additional information, duplicated effort by internal personnel or an inefficient decision making process. There is also a risk that significant management resources will be diverted from the 'real' job, of managing the business.

When to hold an audit tender

The timing of an audit tender can be important. This should be considered in light of your objectives and the process you define.

Timetable for the process

The length of time you need for your tender will depend on a number of factors:

- the process you decide to follow;
- the number of firms you invite (the more firms you invite, the longer the process is likely to take);
- availability and other commitments of your personnel involved in the tender; and
- timing of existing board and audit committee meetings.

Illustrative timetable for an audit tender process	
Pre-process	Internally, there may be a few weeks planning the process and setting criteria.
Day 1	Invitation to tender dispatched.
Week 1	Initial meeting between the audit committee chair (and CFO) and the firms involved in the tender process.
Week 2	Meetings with other personnel and visits to locations.
Week 3	Tender document submitted.
Week 3–4	Selection panel reviews documents and obtains feedback from locations and shortlists firms for the oral presentations.
Week 4–5	Oral presentations. Selection panel decides its preferred firm and makes a recommendation to the audit committee. Board approval is sought.
Week 6	Firms are informed of the board's decision.
Week 7–8	Debrief with firms on their performance during the process.

Appointing a project manager

Appointing a project manager could allow you to focus your efforts on assessing the firms and reaching the right decision for you based on your evaluation criteria.

The role of the project manager is to manage the process and be the direct contact with the participants.

Timing the audit tender	
After AGM, before interim announcement	This is probably the best time for the proposal process, but quoted companies must ensure that there is sufficient time between appointing new auditors and making their interim announcement. Appointing new auditors immediately after an announcement to reappoint auditors at the AGM might look odd if the proposed tender was not flagged in advance with shareholders. In any event this will involve additional printing and postage costs associated with the circulation of the s519 statement.
After the half year; appointment for the current period	The disadvantage with this timing is that incumbent auditors may have commenced work on their audit planning and are likely to have advised the company on issues relating to the current year.
During the audit	This is inconvenient as the finance function will be extremely busy and it may distract the incumbents from their current audit.
Post-audit, pre-AGM	The proposal process would need to be very short to meet the AGM deadline.

Setting the parameters
The project manager will need direction; you should aim to ensure that the parameters of the process are clearly defined.

The following activities could help smooth the process and increase efficiency:

- document the objectives of the tender;
- define clearly the scope of the work you are offering;
- define the information to be made available to the participants and make it easily available to them;
- establish a timetable for the process, which has due regard for the commitments of both your senior executives and the financial management team. Consider access to the chairman, chair of the audit committee and other non-executives, CEO and other directors as appropriate;
- agree the composition of the selection panel and the decision making process and criteria that you will follow; and
- decide on the scope of the written proposals you require and the format of the oral presentations.

In order for the firms to be able to develop the right approach, they require a good understanding of your business, your needs and your key personnel. This requires you to provide them with sufficient information and access to management. However, this must be carefully balanced in order not to become 'costly'.

Designing the proposal process
A suggested process for selecting professional advisers is included in the next section.

You may shortlist participants following assessment of the site visits and full written submissions. Shortlisting at this stage allows you to form a more informed view of what is on offer, without spending the time attending a large number of presentations. It is important that you have time to build rapport with the proposed teams in order to make a fair decision regarding the personal and cultural fit. If you already have strong relationships with the firms, this may be a good approach.

Selecting the participants
It is sensible to invite only those firms that you know have the resources, infrastructure and geographical coverage to be able to do the job.

If you are not sure which firms to invite, consider those that you, or other people within your organisation, already have a relationship with. You could ask for recommendations from:

- other board members;
- significant shareholders;
- your own contacts;
- other business networks;
- other audit committee chairs (or CFOs)
- multipliers (bankers/lawyers).

If you have a concern about a particular firm which could disqualify it from being appointed, for example over a conflict of interest, it is better to resolve the issue before the tender gets under way. Inviting two firms may be sufficient but organisations regularly invite three firms to provide a fuller picture of what the marketplace has to offer.

Make the right decisions
When planning the proposal process, you should agree who in the organisation should be involved in making the decision and how the decision will be reached.

Your decision is likely to be based on two elements:

- **rational –** a number of factual criteria against which you will compare the firms (the evaluation criteria); and
- **emotional –** how you 'feel' about the firms and the teams they have put forward and how well their cultures fit with your own organisation's style.

The decision makers
The decision makers should include representatives of all the parties who will have a relationship with the advisers. This would typically be:

- those who have responsibility for audit related matters, i.e. the audit committee, the finance director; and
- those who will have a relationship with the advisers; for example the CEO, head of internal audit, head of tax, general managers, members of the finance functions.

It is important to get the right balance between having enough input to the decision and involving too many people and wasting time. Personnel can be asked for their views without being involved in the whole decision making process, e.g., general managers or subsidiary managers can feed back their views following the firms' site visits.

It is essential to try to ensure that all the decision makers are available for key meetings (e.g., site visits and the firms' presentations) and that they have been briefed on the proposal process and its objectives, and agree with the evaluation criteria and decision making process.

Identify the evaluation criteria
You should consider carefully what you are looking for from your audit firm. This will relate to your current needs and to the strategic plans for the future. The factors that are important to you should form the evaluation criteria that you will apply. The decision makers should agree these criteria up-front.

Audit quality is the upmost concern but other factors may include:

- Understanding your business – how well do the prospective teams understand your business, the issues you face and the emerging industry trends?

  The audit firms' experience in providing audit and other services to other companies in the same sector should therefore be assessed. The perceived disadvantage of such sector experience may be that the audit firm provides services to direct competitors. Auditors are under a professional and legal obligation of client confidentiality and normally go to great lengths to construct 'Chinese walls' to prevent any abuse of an apparent conflict. This threat may therefore be more perceived than real, but may be a matter of genuine concern, especially in some sectors.

- People – are the team members authorities in their field? Do they have the experience that you are looking for? Do you trust them?

  It is important that the audit experience on which the company is basing its decision is not concentrated in only a few key individuals, but that it extends by way of training and 'on the job' experience throughout the audit team. Similarly, it is important that the audit team is able to address complex technical issues and that appropriate back up resources are available if required.

- Relationships – is there a personal fit with members of your team? Do the key partners and managers have the qualities to establish the type of relationship the audit committee and executive management prefer?

  One of the many important aspects of the auditors' position is the working relationship with the company's executive management. Accordingly, the finance director and the finance team must believe that they will have a relationship with the new auditors which will work and which can be based on trust and respect for each other. Equally, the audit committee needs to be satisfied that the audit team will have the appropriate level of staff, with the necessary experience and knowledge and that the personal relationship at the key company/audit contact points will be workable.

  In particular, it is important that the audit partner has an appropriate working relationship with the chairman of the audit committee and CFO, and that the audit manager has an appropriate working relationship with the CFO and key finance staff. This should be considered not only at the parent company level, but also in relation to the audit engagement teams for all group companies and operating divisions.

- Organisational fit – does the firm have the global coverage that you need? Does its culture fit well with that of your organisation?

  The firm needs to be capable of serving the needs of the company and its subsidiaries. Groups are moving increasingly towards all the group entities being audited by a single firm. Where the company wishes some or all of its subsidiaries to be audited by the parent company audit firm, it needs to assess whether that firm has the capability to do this, at an acceptable cost, through the use of local offices and/or by transferring auditors from elsewhere. This assessment is particularly important for groups with a significant network of overseas subsidiaries.

- Commitment – how committed is the firm to providing you with the service you want? How far are they prepared to go?

  The level of input at partner level can be an indicator of the level of commitment that the firm has to developing a working relationship with your company.

- Approach – how well does the proposed approach to the work address your needs and provide the added value that you are looking for?

- Proactivity, ideas and strategies – to what extent have the teams demonstrated that they will be proactive, bring new ideas and continually enhance their service to you?

  Throughout the process the level of ideas brought to you will provide you with an indication of the type of performance you can expect in your relationship with the firm. Ideas brought to you upfront in the process also enable you to assess the teams' commercial understanding of your business.

- Dedicated service professional input – to what extent do the firms have the dedicated service professional experience that you would like access to?

  This can be a section required in the documentation by which you can assess approaches and use of industry authorities on the team.

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- Fees – will you get good value for money on an ongoing basis?

  Cost is sometimes reported as a key issue in the selection of new auditors. However, this should not be the key criterion. The executive management may be keen to demonstrate their tight control over the company's costs, through a reduction in the audit fee, but this may not necessarily be in the interests of the board or the shareholders, or even of the executive management themselves. A more appropriate measure may be value for money rather than absolute cost.

  Downward pressure on the audit fee poses a particular challenge to the audit process. The audit committee should be mindful of the appropriateness of the proposed audit fee, so as to strike a balance such that the fee is low enough to present a challenge to the auditor to improve the efficiency and effectiveness of the audit, but high enough to enable the auditors to undertake a thorough audit in accordance with auditing standards. Audit quality is paramount.

  The audit committee must satisfy itself that the audit fee quoted is a realistic fee for undertaking a full and proper audit and that the auditors are not relying on obtaining additional non-audit work to subsidise an unrealistically low audit fee.

  To some extent, audit efficiency can be facilitated by the company providing the correct information in an appropriate format at the right time, and in this way the company may have some influence over the overall audit cost. Such arrangements, and any other ways by which the company might be able to facilitate the efficiency of the audit, should be discussed with the potential audit firms as part of the selection process.

Other assessment and selection criteria
- The general reputation of the firm provides a good indication of its strength and professionalism.
- Any previous experience of obtaining professional services from the firm.
- The quality of the outputs and of the staff involved in previous engagements for the company and for other entities in which the directors are involved should provide a strong indicator of the firm's culture and capabilities.

Recommendations from others
First hand recommendations can often provide a great deal of comfort. These should be provided independently of the bidding firm.

Independence and objectivity
The audit committee needs to consider any threats to objectivity faced by each audit firm and the safeguards which each proposes to overcome those threats. The audit committee should thus assess the extent to which each audit firm would be, and be seen to be, independent and objective in the position of auditor.

Decision making process
There are a number of different ways in which you can use the criteria. For example:
- as an informal checklist or reminder of what you are looking for;
- to score each firm against the criteria and select based on the highest number score; and
- weight the criteria according to importance and number score.

A more complicated approach involves asking all relevant internal parties to identify and weight the criteria that are important to them. This approach, whilst taking account of the different needs within your organisation, may not reflect the relative roles of group functions compared with business units or subsidiaries.

Firms like to know what your criteria are, to help them tailor their approach to your needs. This allows them to demonstrate the aspects that are most important to you so that you can make an informed decision.

Make sure that whatever process you devise takes into account both the 'fact' and the 'emotion'. If you rely solely on the highest score, you may appoint a firm that is the best technically, but find that key people in your organisation do not wish to work with them.

Begin the audit tender
Audit tenders generally follow a standard structure:
- Invitation to tender – the organisation writes to the firms asking if they are interested in pitching for the work.
- Site visits – the firms meet with key personnel to understand the business and its needs.
- Document – firms submit a document setting out their 'proposal'. The company reviews the documents and can then draw up a shortlist.
- Presentations – selected firms present to a panel and answer questions.
- Appointment – the decision makers agree which firm they wish to appoint, notify the firm and complete negotiations and contractual aspects.

Discussion and negotiation may continue throughout the process.

Issuing the invitation to tender
The first stage is to prepare and dispatch an information pack to the firms. The pack should include a formal invitation to tender and additional background information.

Your invitation to tender letter should set out clearly:
- the scope of the services being tendered;
- the period of the appointment;
- the process and timetable;
- the evaluation criteria;
- areas to include in the proposal document;
- document delivery information: number of copies required, format and delivery details;
- likely format, content and timing for any presentation phase;
- any ground rules for the proposal (for example, all communication must be copied to the project manager);
- information regarding access to your personnel; and
- contact information for the key contact.

Provide as much relevant background information on the company as you can. You should consider asking the firms to sign a confidentiality agreement before releasing documents that are not in the public domain.

Information firms find useful in developing their response to an audit tender

Organisational
- Mission statement and corporate strategy.
- Organisation chart, showing the key individuals, responsibilities and reporting lines.
- Organisation structure, e.g., business processes, business units, functional, including key locations.
- List of subsidiaries and associates.
- Names of all audit committee members and senior management.
- Locations and operations, domestic and overseas.
- Cultural information.

Financial
- Most recent financial statements for all key group companies (last two years).
- Group structure chart.
- Latest actual and budgeted figures.
- Year-end/reporting/consolidation process and timetable.

Other (as appropriate)
- Internal audit scope and plan.
- Internal audit department structure, responsibilities and reporting lines.
- IT systems in operation.
- Current tax arrangements/suppliers
- Latest tax computations.
- Current tax status.

Site visits
Get feedback from your staff on their impressions of the firms during their visits to your sites. To ensure some consistency in their feedback, you might find it helpful to provide a site visit scorecard for them to complete.

Example site visit scorecard

Please answer the following questions by circling the relevant score based on your perception of the firm during the site visit. **1** = totally dissatisfied – do not believe they will deliver **4** = completely satisfied – wholeheartedly believe they will deliver the service discussed.

Understanding the business	
1. Did the firm demonstrate clear understanding of:	
• the business	1 2 3 4
• the industry	1 2 3 4
• the market place?	1 2 3 4
2. Did the team clearly understand the business issues and take account of these in their approach to you and the work to be undertaken?	1 2 3 4
People	
1. Did the team appear professional?	1 2 3 4
2. Did the culture of the team fit with your site's culture?	1 2 3 4
3. Do you feel you could work well with the team?	1 2 3 4
4. Do you have any concerns about a member of the proposed team? If so who and what?	1 2 3 4
Approach – for audit tenders	
1. Has the team explained and agreed the audit approach with you?	1 2 3 4
2. Will key audit areas and issues be discussed prior to the interim and final audits?	1 2 3 4
3. Will issues be properly discussed and, where possible, resolved prior to Group Reporting?	1 2 3 4
4. Will audit evidence be cost-effectively obtained?	1 2 3 4
5. Does the proposed standard of reporting meet your expectations?	1 2 3 4
Proactivity, ideas and strategies	
1. Has the team delivered on previous occasions?	1 2 3 4
2. Has the team met expectations?	1 2 3 4
3. Has the quality of reporting and feedback obtained from the team been consistently of a high quality?	1 2 3 4
4. Have you found their approach to be robust in dealing with you and your team?	1 2 3 4
5. Have the team been proactive and provided strategies to issues before they have become problems?	1 2 3 4
6. Would you be happy to continue working with this team?	1 2 3 4

Managing site visits

The firms' ability to develop propositions that are tailored to your objectives and requirements depends on them being given reasonable access to management during the process. If you wish to reduce the amount of time this will absorb, you could:

- cut down on the number of firms involved in the tender, rather than reduce the number of managers you allow them to see;
- arrange a group briefing for all firms covering basic matters. Firms will still need individual time with management in order to discuss and refine their thoughts and ideas with you.

Arranging the site visits can be time consuming. Either allow the firms to make their own arrangements, or let the project manager control this stage of the process. It may be easier for your staff to liaise with one internal project manager rather than representatives of a number of firms.

Ensure that the individuals are briefed thoroughly on the process, reasons for the tender and their role in the selection process.

You will need to devise a mechanism by which the individuals are able to feed back their assessments of the bidding firms to the decision makers. This might be done informally, for example through a telephone call, or more formally through a scoring system which could be linked to the evaluation criteria.

Access to company personnel

There are a large number of people that the firms find it useful to meet – primarily the decision makers and those people who can help them understand the business. It will not always be practical or appropriate for them to meet all of these people; however, the more people they have access to the better they will understand your business and your needs.

Relevant people may include:

- the audit committee chairman and committee members;
- the CEO;
- the CFO;
- the chairman;
- other board members and non-executives;
- company secretary;
- general managers of key business units;
- the head of internal audit/head of risk;
- the head of IT;
- the head of tax;
- managing directors and financial directors at subsidiaries and key locations; and
- head of investor relations.

Proposal documents
You should be as specific as you can be in your invitation to tender, regarding the content, number of pages and format that you would like the firms to follow in their documents.

Example content for written audit submissions
The proposal document should include the following information.

Details of your firm
- A statement summarising the potential benefits to [client] of selecting your firm.
- The organisation and structure as it is relevant to this engagement.
- Industry experience and client base.

Resourcing
- Names of your core service team, location and relevant experience.
- Personal fit with the management team and culture.
- The time the key team members will commit to this appointment.
- Succession planning and steps to ensure staff continuity.
- References (at least two) for the firm or each core team member.

Approach
- Understanding of your broader business needs and risks.
- Processes for delivering audit services which are customised, responsive and aligned with [client's] specific needs.
- Processes that your firm will employ to address matters related to client satisfaction, performance measurement and continuous improvement.
- How you will liaise and work with our internal audit function.
- How you will use technology to deliver your service.
- How will you report your audit findings to us?

Evaluating documents
It may be a good idea to assign someone within the organisation to carry out a technical evaluation of the documents and to summarise the findings in a short report. For example, the review could encompass a comparison of fees, comment on the quality and completeness of responses to questions asked in the invitation to tender, facts on the teams and their firm's resources.

As with site visits, you need to decide who should be involved within the organisation at this stage and how they will feed back their comments.

You might also want to contact the firms to discuss the issues they have raised and any points that need clarification. This will help them to focus their presentations on the areas of greatest interest to you.

Presentations
There will be a number of practical matters to attend to in preparing for the presentations. For example, you will need to decide who from your side should attend and who will chair the meeting.

It will be helpful to communicate in advance how long each presentation slot will last, and how this time should be allocated between formal presentation and Q&A. You may also wish to set a limit on the number of people each firm should bring to the presentation and/or give guidance on the inclusion of dedicated service professionals or of overseas team members.

Consider preparing a list of questions to be answered by all firms, to supplement those that arise spontaneously in the individual presentations.

Making the decision
Having discussed the contenders in the light of their performance during the proposal process and at the presentation, a consensus will often emerge on which firm should be appointed. Follow your agreed decision making process and use the evaluation criteria as planned.

Appointing a firm
Once you have reached a decision, first notify all the decision makers and the board (as necessary) and then inform the bidding firms. If you are intending to change your auditors, there will be some procedural company secretarial formalities to comply with.

After the process
It is likely that both the winner and losers will ask you to debrief them on their performance during the process. This is always a helpful learning exercise from the firms' point of view and allows you to communicate how you would like to continue your relationship with them in the future. The firms should appreciate your open and honest feedback and you making time available for them.

Example invitation to audit tender letter

Dear [ ]

Audit Tender

The Board of [ ] has decided to review its audit arrangements for the year ending [ ]. The purpose of this letter is to invite your firm to propose, and to advise you of the process which the audit committee will adopt to select the firm to be recommended for the appointment and the proposed timetable. The selection process will be confined to [ ] and it is anticipated that each firm will bear the costs associated with the tender submission.

Each firm will be required to submit a written proposal setting out your capabilities, the key elements of your service and team, as well as your proposed fee by [ ].

The proposal should cover the following areas:

- Details of your firm
- Resourcing
- Approach
- Transition
- Quality assurance
- Independence and governance
- Fees
- Additional services

From the proposals, we will identify a shortlist who will be asked to make a presentation to [selection panel] including a question and answer session. Appendix X details the key dates in the selection process and Appendix Y set out some background information on the group.

[ ] of our company will be responsible for co-ordinating the tender process and all questions and requests for further information should be co-ordinated through them. They can be contacted as follows [ ].

I should be grateful if you will confirm your willingness to participate in the selection process and your ability to comply with the indicated timetable by [ ].

Yours sincerely

EVALUATION OF THE EXTERNAL AUDITORS

APPENDIX 17

This assessment process focuses on your personal perception of the external audit – it does not seek to evaluate individuals and their personalities.

The audit committee chairman should determine who is asked to complete the questionnaire. It is not unusual for it to be completed by audit committee members, the CFO; the heads of major business units/subsidiaries and others who have regular contact with the external auditor. The internal auditor may also be asked to comment.

The questionnaire takes about 10 minutes to complete and should be completed in the following manner:

- Using a scale of 1 (low) to 10 (high), complete each question by placing your score in the two boxes beside the question. **'Actual'** is your view of the current position of the internal audit function on that issue. **'Ideal'** is the score that you would like to see. The difference can be used to determine the relative priority of each issue.

  You may wonder why there is a choice of score on the **Ideal** position as you may think it should always be a ten (the maximum). This may often be the case; however, there may be occasions where you feel an area is of less importance and therefore may merit an **Ideal** score lower than ten. We would stress that the main reason for asking for the two scores is to see where the biggest gaps are between **Actual** and **Ideal** as this identifies where any development priorities lie.

- There is a space for comments space beside each question. You are not obliged to make comments; however, comments do improve the quality of the review and therefore are to be encouraged.

- 'N/A' can be used where you don't have a view on the matter in question.

- All responses will be treated as anonymous unless the individual completing the questionnaire wishes otherwise.

Typical answers might look like this:

	Actual	Ideal	N/A	Comments
1. The audit partner maintains contact with the audit committee on an informal basis 'between meetings'?	8	10		*I do not see the audit partner as regularly as I would like*
2. The audit firm provide appropriate technical support through seminars and publications?	5	5		*I do not look to the auditor (other than the audit team) for my 'professional development'*

A. Calibre of external audit firm

	Actual	Ideal	N/A	Comments
1. The external audit firm has a strong reputation?				
2. Recent or current litigation against the firm will not have a significant adverse impact on the audit firm's reputation?				
3. The audit firm has a strong presence in this industry?				
4. The external audit firm has the size, resources and geographical coverage required to audit this company?				

B. Quality processes

	Actual	Ideal	N/A	Comments
1. The audit firm has strong internal quality control processes in place? (Factors to be considered include the level and nature of review procedures, the approach to audit judgements and issues, independent quality control reviews and the external audit firms approach to risk.)				
2. The remuneration and evaluation arrangements of audit partners and other key audit individuals do not impair the external auditor's objectivity and independence?				
3. Relevant and qualified specialists are involved in the audit process?				

C. Audit team

	Actual	Ideal	N/A	Comments
1 Audit team members have appropriate qualifications for their roles?				
2 Audit team members have sufficient industry experience for their roles?				
3 Audit team members understand our business and its issues?				
4 Audit team members are proactive in their approach?				
5 Audit team members are responsive to our requests?				

	Actual	Ideal	N/A	Comments
6 Audit team members are consistent in their approach to matters?				
7 There is sufficient continuity of staff to ensure a smooth audit?				
8 The engagement partner's and other senior personnel's involvement in the audit is appropriate?				
9 There is a strong audit team that works together effectively?				

D. Audit Scope

	Actual	Ideal	N/A	Comments
1. The audit plan appropriately addresses the areas of higher risk?				
2. The audit team communicated their audit plan in advance of the audit?				
3. The audit team comprised an appropriate number and level of staff?				
4. Partners and managers were involved sufficiently throughout the audit?				
5. Appropriate specialists are involved in the audit process (IT, tax, Treasury etc.)?				
6. Are all significant operations covered by the external audit?				

	Actual	Ideal	N/A	Comments
7. The audit approach is consistent across the team and audit locations?				
8. The audit team work to appropriate materiality levels?				
9. The audit team complete their work in line with the agreed timetable?				
10 The external audit team's approach to seeking and assessing management representations is appropriate?				
11. The audit team has an effective working relationship with internal audit?				

E. Communications

	Actual	Ideal	N/A	Comments
1. All communications from the audit team are clear and relevant?				
2. Issues are discussed on a timely basis?				
3. The audit committee/ auditor relationship operates on a 'no surprises' basis?				
4. The external audit firm have open lines of communication with the audit committee?				

	Actual	Ideal	N/A	Comments
5. The audit partner maintains contact with the audit committee on an informal basis 'between meetings'?				
6. Communications accurately detail the issues encountered during the audit and their resolution; including:				
a. the business risks relevant to financial reporting objectives, the application of materiality and the implications of their judgements in relation to these for the overall audit strategy, the audit plan and the evaluation of misstatements identified? and audit locations?				
b. the propriety of significant accounting policies (both individually and in aggregate)?				
c. the propriety of management's valuations of the material assets and liabilities and the related disclosures provided by management?				
d. the effectiveness of the system of internal control relevant to risks that may affect financial reporting (including any significant weaknesses)?				
e. other risks arising from the business model and the effectiveness of related internal controls (to the extent, if any, the auditor has obtained an understanding of such matters)?				
f. other matters relevant to the board's determination of whether the annual report is fair, balanced and understandable?				

	Actual	Ideal	N/A	Comments
7. Audit differences are discussed and resolved efficiently?				
8. There is good communication and coordination between local audit teams and the 'head office' audit team?				
9. The external auditor advises the audit committee about new developments regarding risk management, corporate governance, financial accounting and related risks and controls on a timely basis?				
10. The audit team seek feedback on the quality and effectiveness of the audit?				

F. Technical expertise

	Actual	Ideal	N/A	Comments
1. Audit team members have sufficient technical experience for their roles?				
2. The audit team responds to technical questions with a definitive answer within an agreed time frame?				
3. The audit team's advice reflects our commercial considerations in an appropriate manner?				
4. The audit firm provide appropriate technical support through seminars and publications?				

G. Audit governance and independence

	Actual	Ideal	N/A	Comments
1. External audit partners and staff demonstrate a high degree of integrity in their dealings with the audit committee?				
2. The external audit firm discuss their internal process for ensuring independence with the audit committee?				
3. Management respect the external auditors as providers of an objective and challenging audit process?				
4. The level and nature of entertainment between the external audit firm and management is appropriate?				
5. The nature of non-audit services is appropriate and adequate safeguards exist to preserve audit objectivity and independence?				
6. The external auditor's relationship with both the audit committee and management is appropriate?				

H. Audit Fee

	Actual	Ideal	N/A	Comments
1. The external audit fee is appropriate given the scope of the external audit? (Consider how the audit fee compares with other similarly sized companies in this industry – a fee that is either too high or too low can be of concern.)				
2. Differences between actual and estimated fees are handled appropriately?				
3. The relationship between audit and non-audit fees is appropriate?				

I. Comparison of XYZ Plc's external audit experience with other external audits you may have experience of:

Issue	Comments

EXAMPLE POLICY ON EMPLOYMENT OF FORMER EMPLOYEES OF THE EXTERNAL AUDITOR

APPENDIX 18

As part of its remit, the audit committee keeps under review the objectivity, independence and effectiveness of the external auditor. The committee approved on [ ] a policy on employment of former employees of external auditors. Under this policy:

- On an ongoing basis, the audit committee agrees with the external auditors which members of the audit team are categorised as the 'key audit partners' and 'other key team members.'
- Key audit partners will not be offered employment by the company or any of its subsidiary undertakings within two years of undertaking any role on the audit.
- Other key team members will not be offered employment by any group company within six months of undertaking any role on the audit.
- Other audit team members who accept employment by any group company must cease activity on the audit immediately they tender their resignation to the audit firm.

Any offer of employment to a former employee of the audit firm, within two years of the employee leaving the audit firm, must be pre-approved by the audit committee where the offer is made in respect of a senior executive position. Between meetings, the audit committee chairman has delegated authority to deal with such appointments at his discretion. Any such interim approval must be ratified at the next meeting of the committee.

EXAMPLE POLICY ON THE PROVISION OF NON-AUDIT SERVICES BY THE EXTERNAL AUDITOR

APPENDIX 19

XYZ Plc's approach to engaging the external auditor for the performance of audit and other services ensures that those services:

- Are approved by appropriate levels of XYZ Plc management.
- Do not impair the independence of the external auditor.
- Are regularly reported to the XYZ Plc audit committee.

Any engagement of the external auditor must satisfy applicable rules and legislation. The external auditor does not have a preferred supplier status for the provision of other services and is to be appointed only when they are best suited to undertake the work and do not have a conflict of interest due to a relationship with another entity.

Independence considerations

The directors of XYZ Plc must satisfy themselves that the services provided by the external auditor do not compromise external auditor independence. Factors that the directors should consider include:

- The level of fees paid for the provision of other services as a proportion of total fees paid to the external auditor.
- Whether the compensation of individuals employed by the external auditor who are performing the audit of XYZ Plc is tied to the provision of other services and, if so, whether this impairs or appears to impair the external auditor's judgement or independence.
- Whether the individuals performing the audit would also be involved in providing other services.

- Whether the audit fees are sufficient to adequately compensate the external auditors or whether the audit fees are at a level that could increase the need for the external auditor to perform other services to make the external audit commercially viable.
- The external auditor's independence declaration which is required to identify whether there have been any contraventions of external auditor independence requirements.

Reporting

- All other services provided by the external auditor must be reported every quarter to the audit committee by the external auditor.
- Details of fees paid to the external auditor must be disclosed in the annual report as specified by applicable financial reporting standards and corporate governance codes.
- The annual report should address the approval framework and explain how auditor objectivity and independence is safeguarded.

Approval process

XYZ Plc protects the independence and objectivity of the external auditor by mandating an approval process for engaging the external auditor. The audit committee has defined the services that may not be provided by the external auditor; refer to the section Prohibited external auditor services. No approval can be given under any authority for the provision of prohibited services. The audit committee has identified specific types of services that are considered to be pre-approved (see Pre-approved audit and other services). Whether or not pre-approved by the audit committee, all engagements of the external auditor for the provision of other services are subject to the following approval requirements.

Approval requirements

- Approval must be obtained before the engagement of the external auditor for other services.
- The external auditor must provide a written statement of independence for all engagements, approved by the appropriate authority within the audit firm (typically the principal engagement partner).
- All engagements requiring approval by the CEO, executive committee member or the audit committee must be described in a written recommendation setting out the:
  – Nature and scope of the proposed services.
  – Supplier selection process and criteria.
  – Chosen supplier and rationale as to selection of that supplier.
  – Relationship of individuals within the firm to perform the proposed other services with those within the firm undertaking audit work
  – Fee estimate, identifying the total cost and the cost expected for the current financial year.
  – Category of pre-approved service where relevant.

- Where audit committee approval is required, it must be communicated to the Head of Group Reporting and be noted in the minutes of the next audit committee meeting.

Approvals

XYZ Plc has established monetary approval thresholds as follows:

	Approval required
Hiring staff from the external auditor	Audit Committee
External audit fee	Audit Committee
Services not previously pre-approved regardless of fee	Audit Committee
Any engagement > £100,000	Audit Committee
Pre-approved services between £20,000 and £100,000	CEO or executive committee member
Pre-approved services < £20,000	Direct report to the executive committee

Where the nature or scope of an engagement changes such that the prior approval obtained is insufficient, subsequent approval of the revised engagement must be obtained. For example, if a pre-approved service with a fee estimate of £20,000 increases in scope to £100,000, the approval of the audit committee must be obtained.

Prohibited external audit services

The external auditor must not provide services that impair, or appear to impair, their independence as external auditor. Generally, services that are prohibited include those where the external auditor:

- Participates in activities that are normally undertaken by management.
- Is remunerated by way of success fees, contingent fees or commissions.
- Acts in an advocacy role for XYZ Plc.
- May be required to audit their own work.

The following services must not be provided by the external auditor:

- Book-keeping, preparation of, and other services in relation to, accounting records and financial statements.
- The design and implementation of financial information systems, or financial controls.
- Valuation services, appraisals or fairness opinions;
- Outsourced internal audit services.
- Secondments to XYZ Plc where the audit firm secondee acts as an employee, or performs any decision-making, supervisory or ongoing monitoring functions.
- Human resources and recruitment services.
- Actuarial services.
- Management functions.
- Legal services.
- Broker-dealer, investment advisor or investment banking services;
- Expert services unrelated to the audit (advocacy in litigation proceedings, other than tax matters).
- The marketing, planning or positively opining on the tax treatment of confidential transactions or aggressive tax position transactions.
- Tax services to a person in a financial reporting oversight role.

Pre-approved audit and other services

Only the audit committee is permitted to grant pre-approval for specific types of services. All specific pre-approved services are prescribed below. Any proposed engagement that is not specifically identified below or which calls on judgement to be exercised as to whether it is included below, must be treated as not pre-approved. All such engagements require specific approval by the audit committee.

Pre-approved audit services
Pre-approved audit services is work that constitutes the agreed scope of the statutory audit (including interim reviews) of the group consolidated financial report and the financial reports of all subsidiaries and affiliates of the group. (The audit committee monitors the audit services engagements, and approves, if necessary, any changes in terms and conditions resulting from changes in audit scope, group structure or other relevant events.)

- Statutory audit engagements for the company, the group and each subsidiary and affiliate as required by applicable legislation.
- Financial statement audit engagements for any group entity, incremental to the audit work required for the purpose of the consolidated financial statements, where required by applicable laws or regulations, or as requested to meet internal management requirements for audited financial statements.

- Audits of selected financial information as required by applicable laws or regulations for the purpose of the group satisfying self-insurance and workers compensation arrangements.
- Reviews of interim financial reports of the group as required by applicable companies and securities legislation.
- Audits of management certifications as to the adequacy of internal controls where such audits are mandated by applicable companies and securities legislation.

Pre-approved audit related and other assurance services
Pre-approved audit related and other assurance services comprise work that is outside the required scope of a statutory audit, but is consistent with the role of the statutory external auditor. This category includes work that is reasonably related to the performance of an audit or review and is a logical extension of the audit or review scope, is of an assurance or compliance nature and is work that the external auditors must or are best placed to undertake.

- Audits of financial statements of group entities for the purpose of inclusion in prospectuses and other forms of offering documents relating to the issuance or registration of debt or equity securities of Group entities.
- Conduct of agreed procedures to permit the issuance of comfort letters in connection with prospectuses and other forms of offering documents referred to above.
- Financial statement audits of employee benefit plans as required by applicable legislation.
- Conduct of review procedures to permit the issuance of working capital reports as specified by UK listing rules.
- Conduct of review or audit procedures to permit the issuance of an Independent Accountants Report that XYZ Plc may call for in connection with regulated market transactions, but only where that report addresses historical financial information.
- Agreed-upon procedures, extended audit procedures and regulated attest engagements applied to selected accounting financial and non-financial information or financial statements required to respond to or comply with financial, accounting, or regulatory reporting matters, including audits of royalty, emissions and similar returns.
- Audits of reports containing financial or non-financial information prepared to meet group governance objectives, such as the annual sustainability report.
- The audit of selected financial information of group entities in support of disposal and borrowing transactions.
- Consultations on the accounting treatment or disclosure requirements of transactions or events including discussions, research consultations and auditing procedures relating to unusual or non-recurring transactions, including assistance in responding to regulatory comment letters on the group's financial reports.

- Consultations on the accounting treatment or disclosure requirements emanating from new or proposed rules, standards or interpretations by regulatory or standard setting bodies.
- Assistance with financial due diligence investigations pertaining to potential business acquisitions/dispositions and other major transactions and events (excluding valuation services, appraisals or fairness opinions) including the review of financial statements and other financial data and records and discussions with counterparty finance and accounting personnel.
- Translation of audited financial reports into another language for filing with a national regulator, or to satisfy other financial reporting requirements of a group entity or affiliate.

Pre-approved tax services
Pre-approved tax services comprise work of a tax nature that does not compromise the independence of the external auditor. Items of such work are typically confined to compliance-related services and must not extend to services involving tax-related investments or transactions. None of these services are pre-approved where they would contain elements of assistance or advice on matters of a strategic tax planning or structuring nature.

- Acting as agent of group companies in the lodgement of income tax returns pursuant to federal, state and local tax legislation.
- Assistance in the preparation of tax returns referred to in the two items immediately above but with no authority for making elections or determining amounts declared therein.
- The provision of advice concerning the filing of tax returns and the handling of specific items in those returns and in connection with responding to queries in relation to those returns from the tax authorities.
- Advice and assistance with respect to transfer pricing matters, including preparation of reports used by the group to comply with taxing authority documentation requirements regarding royalties and inter-company pricing and assistance with tax exemptions.
- Compliance reviews and advice on compliance in the areas of tariffs and classification, origin, pricing, and documentation, including assistance with customs audits.
- The provision of independent opinions containing interpretations of taxation legislation as it applies to specific transactions executed or proposed by a group entities, where those opinions are complementary to the external auditor's examination of the relevant financial statements.
- The provision of independent opinions containing interpretations of taxation legislation in connection with tax audits, negotiations with or appeals before federal, state, local and foreign tax agencies.
- Valuation services pertaining exclusively to tax compliance matters.
- The provision of general news and information regarding statutory, regulatory or administrative taxation developments.

Pre-approved other services
Pre-approved other services is work of an advisory nature that does not compromise the independence of the external auditor. Items of such work are typically confined to risk management, funding or investigative advisory services.

- Review of operational effectiveness of treasury operations relating to cheque clearing and float-management practices and recommendations regarding potential areas of improvement.
- Conducting internal investigations and fact finding in connection with alleged improprieties, other than where they relate to potential accounting irregularities.
- Review of actuarial reports and calculations to assist the group in understanding the various processes surrounding actuarial valuations and the potential impact of plan changes or changes in accounting standards.
- Review of compliance by group companies with local statutory regulations concerning incorporation of entities, constituent documentation (such as constitutions and articles of association) and lodgement of statutory filings with regulatory bodies.
- Assistance in the registration of pension plans as and when required by country specific regulations.
- Risk management advisory services in the assessment and testing of security infrastructure controls.

SPECIMEN MANAGEMENT LETTER

APPENDIX 20

Dear Sirs

Audit of XYZ Plc for the year ended 31 December 2013

The purpose of this report is to set out certain matters that came to our attention during the course of the interim audit of the financial statements of XYZ Plc for the year ended 31 December 2013.

Our objective is to use our knowledge of the business gained during our routine audit work to make useful comments and suggestions for you to consider. However, you will appreciate that our routine audit work is designed to enable us to form an opinion on the financial statements of the business and it should not be relied upon to disclose all irregularities that may exist nor to disclose errors that are not material in relation to the financial statements.

Our report is designed to include useful recommendations that may help improve performance and avoid weaknesses that could lead to material loss or misstatement. It is your obligation to take the actions needed to remedy those weaknesses and should you fail to do so we shall not be held responsible if loss or misstatement occurs as a result.

The report is provided on the basis that it is for the information of directors and management of the business; that it will not be quoted or referred to, in whole or in part, without our prior written consent; and that we will accept no responsibility to any third party in relation to it.

This report is set out in three sections. The first section addresses our observations from this year's audit and our recommendations in each area. These matters have been discussed with management and their response is included as appropriate. The second section is a summary of the matters previously raised in management reports that have not yet been implemented/resolved and their current status. The third section is a summary of matters previously raised in management reports that have been addressed during the current financial year.

We have graded our management report observations:

- Grade 1 observations are those where there is a risk of a significant financial impact on the business that must be addressed immediately.
- Grade 2 observations are those where there is a risk of moderate financial impact on the business, for example a control failure or the absence of a control in an area of moderate risk.
- Grade 3 observations are those that relate to minor control deficiencies or enhancements in control efficiency.

Please do not hesitate to contact me if you have any questions about this report.

Yours faithfully,

Robert Millar
Partner

Grade 1 points

Title of point

Observation
This section should give a brief description of the point, with any necessary background information, and should highlight the specific risks associated with the observation. It is important that such risks are given, and that they are relevant and realistic.

Recommendation
This section should give a brief description of our recommendations, which should be clearly stated and which must be viable in a business context. It should also state the benefits of implementing the recommendations.

Management response
This must be agreed with management.

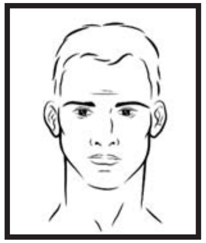
Action
This section should give an action plan for the implementation of the agreed recommendations, naming the member of operating unit staff responsible for implementing the recommendation and the date by which he/she intends to do so.

Grade 2 points
[Included in the same format as for grade 1 points]

Grade 3 points
[Included in the same format as for grade 1 points]

SPECIMEN AUDIT COMMITTEE STATEMENT

APPENDIX 21



As audit committee chairman, I consider the key role of the committee to be in providing oversight and reassurance to the board, specifically with regard to the integrity of the company's financial reporting, audit arrangements, risk management and internal control processes and governance framework.

Fundamental to this role is the committee's access to both information and local management. I believe the presentations and reports received during the year from management and the auditor have been sufficient, reliable and timely; and have enabled the committee to fulfil effectively its responsibilities. Committee meetings are always attended by the chief financial officer, chief risk officer, head of group internal audit, and often by the chief executive and chairman. Individual managers join meetings for specific topics, e.g., treasury or business continuity planning. In total, 13 different managers attended one or more meetings during the year. During the board's visit to our US operations, members of the committee met with local senior financial management to discuss risk management, financial control and the implementation of our code of conduct. In December, the committee met with the company's chief information officer and director of digital strategy to discuss our approach to technology risk management, including cyber security. The committee will continue to operate in this manner during 2013, and is planning to meet local management in at least two regular committee meetings and whenever the board is scheduled to meet in overseas locations.

Also fundamental to the role of the committee is its relationship with both the internal and external auditors. The committee has a healthy interaction with internal and external auditors and both have direct access to the committee to raise any matter of concern and to report on the results of work directed by the committee. Both the external auditor and the head of internal audit attend all our regular committee meetings and meet privately with the audit committee, in the absence of management, after each meeting. The audit committee also meets with the auditors of our key subsidiaries.

Ed Clancy
Audit Committee Chairman

The members

The board has reviewed the audit committee's composition during the year and is satisfied that the committee's members have the broad commercial knowledge and extensive business leadership experience, having held between them various roles in major business, Government, financial management, treasury and financial function supervision and that this constitutes a broad and suitable mix of business and financial experience necessary to fulfil effectively the committee's responsibilities. The board has determined that Geraint Thomas and the audit committee chairman, Ed Clancy, are the designated 'financial experts' and have recent and relevant financial expertise. Both are fellows of the Institute of Chartered Accountants in England and Wales (ICAEW). Geraint Thomas also serves as audit committee chairman for XYZ plc and ABC Plc. The qualifications and relevant experience of the other committee members are detailed on page XX. All committee members are expected to be financially literate and to have an understanding of the following areas:

- the principles of, and developments in, financial reporting including the applicable accounting standards;
- key aspects of the company's operations including corporate policies and the group's internal control environment;
- matters which may influence the presentation of accounts and key figures;
- the principles of, and developments in, company law, sector-specific laws and other relevant corporate legislation;
- the role of internal and external auditing and risk management; and
- the regulatory framework for the group's businesses.

Audit committee appointments are for a period of three years after which they are subject to annual review, extendable by additional three-year periods so long as members continue to be independent.

Committee members	Meetings	
	Eligible to attend	Attended
Ed Clancy	4	4
Geraint Thomas*	3	3
Steven Burke	4	4
Peter Kennaugh	4	4

*Geraint Thomas joined the committee on 1 March 2012

Our role

The committee has written terms of reference which clearly set out its authority and duties. These are reviewed annually and are available on our website.

Corporate reporting: We review the published financial results; the Annual Report and other published information for statutory and regulatory compliance and report our views to the board to assist in its approval of the results announcements and the annual report.

External audit: We recommend the appointment and re-appointment of the external auditors and consider their resignation or dismissal, recommending to the board appropriate action to appoint new auditors. As part of this process, we assess the performance of the external auditors annually by seeking views on their performance from key stakeholders across the group. We also discuss with the auditors the scope of their audits before they commence, review the results and consider the formal reports of the auditors and report the results of those reviews to the board.

As a result of regulatory requirements, or to ensure efficiency and quality of delivery, it may be necessary to employ the external auditors for certain non-audit services. In order to safeguard the independence and objectivity of the external auditors, the audit committee has determined policies as to what non-audit services can be provided by the external auditors and the approval process related to them.

Internal audit: We review internal audit and its relationship with the external auditors, including plans and performance. Additionally we monitor, review and report on risk management processes and the standards of risk management and internal control, including the processes and procedures for ensuring that material business risks, including risks relating to IT security, fraud and related matters, are properly identified and managed. On behalf of the board, we review the group's risk profile, endorse a programme of testing of the risk mitigations and controls that underpin the group's assessment of residual risk and review the group's current risk exposure and capability to identify new risks.

Internal controls and risks: We review the process relating to the identification and evaluation of significant risks; and the design and operation of internal controls. We also receive reports on the processes for dealing with complaints received by the company regarding accounting, internal accounting controls or auditing matters. This includes the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters, ensuring arrangements are in place for the proportionate, independent investigation and appropriate follow up of such matters.

Audit Committee Charter: Our terms of reference are reviewed annually and drive the work carried out by the committee. After the last review, the terms of reference were amended to formally acknowledge the committee's role in advising the board on whether appropriate processes are in place to ensure the annual report and accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the company's performance, business model and strategy.

The committee has unrestricted access to company documents and information – as well as to employees of the company and the external auditors – and may take independent professional advice on any matters covered by its terms of reference at the company's expense. During the year, the only independent professional advice sought by the committee was the regular presentations from external sector specialists including an independent economist. The committee engage such specialists to guard against asymmetric information risk.

The committee's effectiveness is reviewed on an annual basis as part of the board's performance evaluation process (see page XX) and the committee confirm that it has fulfilled its responsibilities under its terms of reference.

Summary of responsibilities

In accordance with its terms of reference, the committee is authorised by the board to:

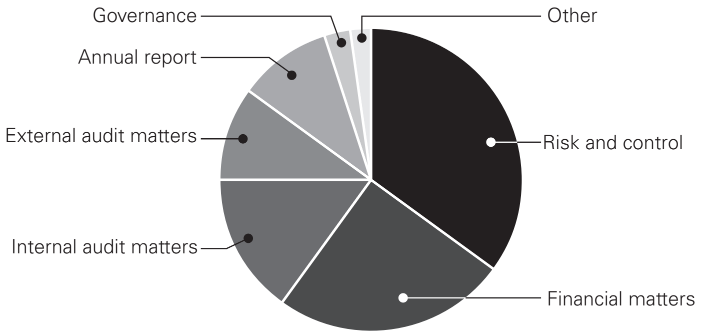
- Monitor the integrity of the group's report and accounts and any formal announcements relating to the group's performance;
- Oversee the relationship with the group's external auditors including reviewing their objectivity and independence;
- Monitor and review the role and effectiveness of the group's internal audit function;
- Oversee the effectiveness of the risk management and internal control systems; and
- Oversee the group's whistle-blowing arrangements.

The full terms of reference of the audit committee are available on the Company's website.

What we have done

The audit committee met four times during the year and has an agenda linked to events in the group's financial calendar. The chart below shows how the committee allocated its time.

Where we spent our time



At every meeting, the committee considered reports on the activities of the group internal audit function, including the results of internal audits, risk reviews, project assurance reviews and fraud and whistle-blowing reports. The committee also monitored the company's financial reporting, internal controls and risk management procedures and considered any significant legal claims and regulatory issues in the context of their impact on financial reporting. Specifically, the committee considered the following matters during the course of the year:

- The 2012 preliminary announcement and the annual report and accounts (including the associated analyst briefings and investor presentations);
- The accounting principles, policies and practices adopted in the group's financial statements and proposed changes to them; including a review of important accounting issues, areas of complexity and significant financial reporting judgements;
- The fairness, balance and understandability of the annual report; and whether it provided the information necessary for shareholders to understand our business model, strategy and performance;
- Compliance with the UK Corporate Governance Code;
- Assessment of the effectiveness of the group's internal control environment;
- Reappointment, remuneration and engagement letter of the external auditors;
- Cybersecurity and IT risk management;
- The risks inherent in senior management reward and incentive arrangements;
- Review of the interim financial statements and announcement;
- Annual re-approval of the internal audit mandate and annual internal audit plans;
- Reviews of the effectiveness of the audit committee, the external auditors and the internal audit function;
- UK Bribery Act adequate procedures guidance and our anti-corruption programme;

- Review of the committee's terms of reference;
- Review of company risk returns (including Social, Ethical and Environmental (SEE) risks); and
- Annual review of treasury policy.

Financial reporting
After discussion with both management and the external auditor, the audit committee determined that the key risks of misstatement of the group's financial statements related to provisions for doubtful debts and the assessment of goodwill and intangible assets for impairment, in the context of current market conditions.

These issues were discussed with management during the year and with the auditor at the time the committee reviewed and agreed the auditors' group audit plan, when the auditor reviewed the half year interim financial statements in July 2012 and also at the conclusion of the audit of the financial statements.

Provisions for doubtful debts – As further explained in note XX to the financial statements, our approach to estimating bad debt provisions on trade receivables was amended in the second half of last year resulting in an additional provision of £25 million, giving total provisions at 31 December 2011 of £75 million. Management confirmed to the committee that the new approach had been applied consistently during the current year and none of the committee's other enquiries, nor the auditor's work, identified any errors or inconsistencies that were material in the context of the financial statements as a whole.

Management informed the committee that it had monitored the recovery of those debts against which provision had been made at 31 December 2011 and concluded that just £1.5 million (2%) of the amounts provided has been recovered in the period. No significant amounts had subsequently become irrecoverable against which no amounts were provided.

The auditor explained to the committee the work they had conducted during the year, including how their audit procedures were focused on those businesses - such as our Greek, Spanish and Portuguese businesses - where debt recovery risk was greatest due to depressed economic conditions or other reasons. On the basis of their audit work, the auditor reported no inconsistencies or misstatements that were material in the context of the financial statements as a whole; and in our view this supports the appropriateness of our methodology.

Further information about our exposure to credit risk and the quality of our receivables is set out in note XX.

Impairment of goodwill and intangible assets
As more fully explained in note XX, the total carrying amount of goodwill and intangibles at 31 December 2012 is £1.2 billion. During the year management assessed the carrying value of goodwill and intangible assets (including detailed calculations of Value in Use for those Cash Generating Units whose recoverable amount is not significantly greater than its carrying amount) to ensure the carrying values are supported by future discounted cash flows. This resulted in an impairment of £70 million with respect to our Greek business.

The auditor explained the results of their review of the estimate of Value in Use, including their challenge of management's underlying cash flow projections, the key growth assumptions and discount rates. On the basis of their audit work, no additional impairments that were material in the context of the financial statements as a whole were identified by the auditor.

In respect of the £180 million of goodwill related to our Greek business, management's estimated Value in Use of £110 million is based on growth assumptions and a discount rate of 15%. As explained in note XX, this resulted in an impairment of £70 million which has been recognised in the current year.

Management concluded that the growth rate and appropriate discount rate were significant judgements and have explained those judgements in the notes to the financial statements. Based on the growth rate used, the auditor considered that a discount rate between 14% and 23% would be appropriate for similar Greek businesses. Based on their work, the auditor did not identify any further impairment and agreed that it was appropriate for the financial statements to disclose the growth and discount rates as key assumptions and to provide appropriate sensitivity analysis in respect of them. This is set out on page XX.

With regard to the £150 million of goodwill related to our Spanish business, management's estimated Value in Use was £153 million. This was also based on growth assumptions and a discount rate of 15%. The calculation was reviewed by the auditor and, though the headroom is small, in the light of our informed discussions no provision has been recognised in the current year. The key assumptions and sensitivity analysis is set out on page XX.

Misstatements – Management confirmed to the committee that they were not aware of any material misstatements or immaterial misstatements made intentionally to achieve a particular presentation. The auditors reported to the committee the misstatements that they had found in the course of their work and no material amounts remain unadjusted. The committee confirms that it is satisfied that the auditors have fulfilled their responsibilities with diligence and professional scepticism.

After reviewing the presentations and reports from management and consulting where necessary with the auditors, the audit committee is satisfied that the financial statements appropriately address the critical judgements and key estimates (both in respect to the amounts reported and the disclosures). The committee is also satisfied that the significant assumptions used for determining the value of assets and liabilities have been appropriately scrutinised, challenged and are sufficiently robust.

External audit
The audit committee is responsible for the development, implementation and monitoring of policies and procedures on the use of the external auditors for non-audit services, in accordance with professional and regulatory requirements. These policies are kept under review to meet the objective of ensuring that the group benefits in a cost-effective manner from the cumulative knowledge and experience of its auditors whilst also ensuring that the auditors maintain the necessary degree of independence and objectivity.

Consequently, any non-audit work to be undertaken by the auditors in excess of £200,000 is required to be authorised by the chairman of the audit committee and the group finance director prior to its commencement. Individual assignments of less than £200,000 are approved by the group finance director. The aggregate expenditure with the group auditors is reviewed by the audit committee.

Typically, the committee will approve the use of the external auditors to provide: accounting advice and training; employee benefit plan audits; corporate responsibility, IT and other assurance services; due diligence in respect of acquisitions and disposals; certain specified tax services including tax compliance, tax planning and related implementation advice; and certain other services when it is in the best interests of the company to do so and they can be undertaken without jeopardising auditor independence. No individually significant non-audit assignments that would require disclosure were undertaken in the financial year.

The company has a policy that any recruits hired directly from the external auditors must be pre-approved by the group HR director, and the group finance director or group financial controller. Recruits into senior positions must be approved by the audit committee.

The audit committee has formally reviewed the independence of its auditor and the auditor had provided a letter confirming that they believe they remain independent within the meaning of the regulations on this matter and their professional standards.

To fulfil its responsibility regarding the independence of the external auditors, the audit committee reviewed:

- changes in the audit plan for the current year;
- a report from the external auditors describing their arrangements to identify, report and manage any conflicts of interest; and
- the extent of non-audit services provided by the external auditors.

To assess the effectiveness of the external auditors, the committee reviewed:

- the external auditors' fulfilment of the agreed audit plan and variations from it;
- reports highlighting the major issues that arose during the course of the audit;
- feedback from the businesses evaluating the performance of each assigned audit team; and
- the report from the FRC's Audit Inspection Unit.

The audit committee holds private meetings with the external auditors after each committee meeting to review key issues within their sphere of interest and responsibility.

To fulfil its responsibility for oversight of the external audit process, the audit committee reviewed:

- the terms, areas of responsibility, associated duties and scope of the audit as set out in the external auditors' engagement letter for the forthcoming year;
- the external auditors' overall work plan for the forthcoming year;
- the external auditors' fee proposal;
- the major issues that arose during the course of the audit and their resolution;
- key accounting and audit judgements and estimates;
- the levels of errors identified during the audit; and
- recommendations made by the external auditors in their management letters and the adequacy of management's response.

Although the auditor has been in place for fifteen years, the auditor periodically changes its audit partners at a group, divisional and country level in accordance with professional and regulatory standards in order to protect independence and objectivity and provide fresh challenge to the business. Such changes are carefully planned to ensure that the group benefits from staff continuity without incurring undue risk or inefficiency.

Mr Wiggins completed his five-year term as lead audit partner, as specified by auditing standards, at the conclusion of the audit last year. His successor, Ms Froome, will continue as lead audit partner until the conclusion of the 2016 audit. Ms Froome undertook a detailed review of the external audit arrangements across the group, including a review of senior audit staff, and presented her findings and recommendations to the audit committee.

As part of the normal audit partner rotation arrangements, four divisional audit partners changed during the year.

The audit committee is satisfied with the auditors' effectiveness and independence; and the degree of diligence and professional scepticism brought to bear. As such, the committee has not considered it necessary this year to conduct a tender process for the appointment of its auditors. Having carried out the review described above and having satisfied itself that the external auditors remain independent and effective, the audit committee has recommended to the board that the auditor be reappointed for 2013/14.

The committee has noted the revisions to the UK Corporate Governance Code introduced by the FRC in September 2012 and, in particular, the recommendation to put the external audit out to tender at least every ten years. The FRC have proposed non-binding suggested transitional arrangements with respect to audit tendering, including a suggestion that tendering should normally fit the five yearly cycle of partner rotation. The committee will consider its tendering arrangements towards the conclusion of Ms Froome's period in office – or earlier if it has cause to do so. There are no contractual obligations restricting the committee's choice of external auditors.

The total fees paid to the auditor for the year ended 31 December 2012 were £7.0m of which £3.3m related to non-audit work. Further details of audit and non-audit fees are set out on page XX.

Internal audit

The audit committee assists the board in fulfilling its responsibilities relating to the adequacy of the resourcing and plans of internal audit. To fulfil these duties, the committee reviewed:

- internal audit's reporting lines and access to the committee and all members of the board;
- internal audit's plans and its achievement of the planned activity;
- the results of key audits and other significant findings, the adequacy of management's response and the timeliness of resolution;
- statistics on staff numbers, qualifications and experience and timeliness of reporting;
- the level and nature of non-audit activity performed by internal audit; and
- changes since the last annual assessment in the nature and extent of significant financial risks and the group's ability to respond to changes in its business and the external environment.

The key areas of internal audit focus during the year were our strategy setting process and governance procedures, whistle-blowing arrangements, accounts payable and receivable, project velodrome, regulatory compliance, data security and fraud risk.

The key control issues identified by internal audit during the year concerned our procedures to embed our anti bribery and corruption policies in the Far East and our IT data protection controls in our US operation. The committee is satisfied that no loss has occurred as a result of these control weaknesses and that management has taken appropriate action to address these issues in a timely fashion (see page XX).

Internal controls and risks
In fulfilling its responsibilities relating to the adequacy and effectiveness of the internal control and risk management systems, the committee reviewed:

- the external auditors' management letters and audit highlights memoranda;
- internal audit reports on key audit areas and significant deficiencies in the financial control environment;
- in conjunction with the remuneration committee, the remuneration structures and incentives for senior executives.
- reports on the systems of internal financial controls and risk management; and
- reports on fraud perpetrated against the group.

The interaction between executive remuneration and risk management has been a particular area of focus during the year and the audit committee chairman, Mr Clancy, has regularly attended meetings of the remuneration committee to familiarise himself with the executive remuneration arrangements and how various financial and other metrics are used in the company's incentive arrangements. The committee has also, in conjunction with the remuneration committee, considered the appropriateness of the incentive structure and whether it contributes to increased fraud risk; and whether adequate and appropriate focus is being paid to the remuneration of officers and directors, including the appropriate use of corporate assets. The committee has concluded that the remuneration policies and practices for top executives, key business unit leaders and senior finance, control and risk management personnel are appropriate for maintaining a robust control environment consistent with good stewardship.

The group's whistle-blowing policy contains arrangements for the company secretary to receive, in confidence, complaints on accounting, risk issues, internal controls, auditing issues and related matters for reporting to the audit committee as appropriate.

The group's anti-fraud policy has been communicated to all employees and states that all employees have a responsibility for fraud prevention and detection. Any suspicion of fraud should be reported immediately and will be investigated vigorously.

A description of the group's principal risks and uncertainties, the main features of the system of internal control and the process by which the board have

reviewed the effectiveness of the group's risk management and internal control system is given on page XX. The committee confirm that appropriate actions have been or are being taken to remedy any significant failings or weaknesses identified from the reviewing the system of internal control.

How we keep up to date
The committee receives regular technical updates from management, the auditors and KPMG's Audit Committee Institute, as well as specific or personal training as required. To guard against information bias and to broaden the scope of the audit committee's thinking, the committee also receives regular presentations from external sector specialists including an independent economist.

Committee members also meet with local management on an ongoing basis in order to gain a better understanding of how group policies are embedded in operations. For example, during its visit to our US operations, the committee met with local senior finance managers.

The committee's effectiveness is reviewed on an annual basis as part of the board's performance evaluation process (see page XX). The process involved a review of information provided to the audit committee followed by confidential interviews with the audit committee members, the chairman of the board, CEO, CFO, company secretary, head of risk management and both internal and external auditors. The outcome of the evaluation has confirmed that the audit committee has a good balance of skills, is working well and continues to be refreshed, with the appointment of Mr Thomas during the year. The committee feel well-informed and key issues are well-managed, with sufficient opportunity for challenge and debate. However, recognising that there is always room for improvement, the process also identified a number of areas for focus in the coming year, including improving:

- the committee's access to local management by increasing the number of presentations that will be made to the committee by operational managers;
- the focus on risk management by restructuring meetings to distinguish between the 'business as usual' agenda and the risk management agenda. Reporting to the committee on significant risk matters will be enhanced.

Furthermore, a revision to the timings of audit committee meetings to improve the timing of information flows has been implemented; however, the number of audit committee meetings is a subject which the committee intend to keep under review.

Further questions
Ed Clancy, the audit committee chairman, will be present at the annual general meeting to answer questions on this report, matters within the scope of the committee's responsibilities and any significant matters brought to the committee's attention by the external auditors.

AUDIT COMMITTEE REPORT DISCLOSURE CHECKLIST

APPENDIX 22

The following checklist has been extracted from '*Audit Committee Reports: Global Disclosure Guidelines*' published in October 2011 by the Enhanced Disclosure Working Group of the Global Auditor Investor Dialogue[1].

Guideline 1 - Substance not Form	
1. Does the report use non-boilerplate language?	☐
2. Does the report provide a useful and engaging account of the audit committee's activities, providing specific information about the work the audit committee has done?	☐
3. Does the audit committee report give informative emphasis to key audit issues and how they are managed?	☐
Guideline 2 - Audit Committee Charter	
4. Has reference been made to the annual review of the audit committee charter?	☐
5. Have any changes to the audit committee charter been disclosed and explained?	☐
6. Does the audit committee confirm that it has fulfilled its responsibilities under the charter?	☐
7. Does the audit committee confirm that its charter permits it to obtain independent external advice at the company's expense?	☐
8. Has the audit committee disclosed whether or not it obtained independent external advice?	☐

1 The Global Auditor Investor Dialogue is an informal forum whose members comprise the major global auditing networks and leading global investors and share owners. The Global Disclosure Guidelines may or may not represent the views of the individual Dialogue members.

Guideline 3 - Audit Committee Membership	
9. Has the board confirmed that it has reviewed the audit committee's composition during the year and that it is satisfied that the audit committee has the expertise and resource to fulfil effectively its responsibilities, including those relating to risk and controls?	☐
10. Has the board provided a convincing and informative explanation to support its opinion that the audit committee has not only recent and relevant financial and audit experience but also commercial, financial and audit expertise to help it assess effectively the issues it has to address?	☐
11. Have any changes to the composition of the audit committee been disclosed and explained?	☐
Guideline 4 - Information flows to the Audit Committee	
12. Has the audit committee confirmed that it has received sufficient, reliable and timely information from management and the external auditors to enable it to fulfil its responsibilities?	☐
Guideline 5 - Risk and Internal Controls	
13. Has the board, audit committee or other relevant board committee disclosed what steps it has taken to satisfy itself that the risk and control framework and processes are operating properly?	☐
14. Is a summary of the process that has been applied in reviewing the operations of the system of internal controls been disclosed?	☐
15. Has confirmation been provided that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from reviewing the system of internal control?	☐
Guideline 6 - Valuation of Assets and Liabilities	
16. Does the audit committee provide an assurance that the significant assumptions used for determining values have been scrutinised and challenged by it?	☐
17. Has the audit committee confirmed that it has satisfied itself that the markets and/or models to which the valuations are marked have liquidity and transaction profiles that are adequate and sufficiently robust?	☐
18. Does the audit committee disclose that it is satisfied that there is meaningful disclosure of critical judgements and key estimates?	☐
19. Has the audit committee provided an unbiased explanation of the factors which account for any significant deviation from previously reported values?	☐
20. Does the audit committee disclose that it is satisfied that the auditors have brought an appropriate degree of professional scepticism to bear?	☐

Guideline 7 - Write-downs and Impairment Provisions	
21. Has the audit committee provided an informative discussion of the factors which it has taken into account and the considerations it has made when fulfilling its responsibilities in respect of endorsing material write-downs and impairment provisions?	☐
22. Has the audit committee confirmed that it is satisfied that the auditors have fulfilled their verification responsibilities with diligence and professional scepticism?	☐
Guideline 8 - Securitisation, off-balance Sheet and Contingent Liabilities	
23. Has the audit committee provided a meaningful description of the work it has undertaken to:	
• Satisfy itself that all material securitisation arrangements, off-balance sheet liabilities and contingent liabilities have been identified and disclosed in sufficient detail in the financial statements?	☐
• Critically assess and, when appropriate, challenge the valuations ascribed to these liabilities, and the methodologies used to determine them?	☐
Guideline 9 - Internal and External Auditors	
24. Has the audit committee disclosed when and how periodic formal evaluations of the internal and external auditors were undertaken and the key conclusions arising there from?	☐
25. Has the audit committee provided a convincing, informative and non-boilerplate explanation which supports its choice of auditor?	☐
26. Has the audit committee provided an informative account regarding the controls relating to the provision of non-audit services?	☐
27. Has the audit committee provided a commentary on the level and nature of non-audit services provided?	☐
28. Has the audit committee stated how long the audit firm has been retained as auditor to the company?	☐
29. Has the audit committee set out its policy of putting the audit out to tender and confirmed that it has complied or otherwise with that policy?	☐
30. If there has been a change, or a change is proposed, to the external auditor, has the board or the audit committee disclosed the change promptly to the market and provided in the audit committee report an informative and convincing explanation of the reasons for the change?	☐
Guideline 10 - Audit Planning and Main Audit Issues	
31. Has the audit committee provided an engaging and informative account of how it has fulfilled its responsibilities in respect of audit planning by:	
• the internal auditors; and	☐
• the external auditors	☐
32. Has the audit committee disclosed whether or not it has met with the auditors of the key subsidiaries and/or joint ventures?	☐
33. Has the audit committee reported, subject to issues of commercial confidentiality, on the nature and resolution of the main audit issues arising?	☐

34. Has the audit committee confirmed that it has considered the internal control and risk issues that have been brought to its attention by the internal and external auditors?	☐
35. Has the audit committee provided an indication as to the nature of the control and risk issues that have been brought to its attention by the auditors?	☐
36. Has the audit committee disclosed that it is satisfied that management has addressed the internal control and risk issues that have been brought to its attention, or has plans to do so?	☐
Guideline 11 - Executive Compensation & Risk	
37. Has the audit committee provided:	
• a brief but informative description of its interaction with the compensation or remuneration committee?	☐
• comfort that the compensation policies and practices for top executives, key business unit leaders and senior finance, control and risk management personnel are appropriate for maintaining a robust control environment consistent with good stewardship?	☐
38. If the above disclosure (#35) has been provided by the compensation or remuneration committee, has the audit committee referred to this in its report?	☐

Audit Committee Handbook

> "The audit committee is not a supervisor board, despite attempts to make it one.
>
> The audit committee is a committee of the board and should not usurp or take on the board's role and authority."

Audit Committee Chairman

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