

The ICSA **Audit Committee Guide**

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Audit Committee Guide

Timothy Copnell

Director, Audit Committee Institute

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Foreword

Corporate governance excellence continues to be an important element of UK business. Expectations of stakeholders in the corporate governance process, including financial reporting, 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. Today, audit committees are being asked to assume responsibilities well beyond their traditional duties.

Recognising that effective corporate governance is the cornerstone of shareholder protection, initiatives by regulators and stakeholders to help shape and guide corporate governance practices have confirmed the audit committee's key role in corporate governance and oversight. The Financial Reporting Council's revised Combined Code and the related guidance for audit committees (the Smith Guidance) contain recommendations designed to strengthen the effectiveness of audit committees, clarify and enhance their oversight roles, and enhance their accountability over the financial reporting process. Understanding the purpose and implications of these recommendations is critical in evaluating the challenges facing audit committees and the direction in which corporate governance is heading.

With an increased emphasis on the role of the audit committee in corporate governance, audit committees must assess what they are doing now and how they are doing it to ensure they are ready for the challenges ahead. The Audit Committee Institute (ACI) believes that the building blocks of an effective audit committee, from an effective agenda and committee structure to a keen awareness of current and emerging issues, are fundamental in fulfilling the audit committee's responsibilities. This publication identifies current and emerging issues that audit committees should be aware of, and react to, and describes audit committee practices that provide the support and structure necessary in fulfilling their terms of reference. We believe all audit committees can benefit from comparing their practices against the practices described in this publication in their effort to critique, tailor and improve their own practices.

In today's complex and evolving business environment, audit committees can contribute tremendously to a 'no surprises' environment. An audit committee that operates effectively is a key feature in a strong corporate governance culture and can bring significant benefits to a company. We hope this publication will help ensure that audit committees achieve their objectives and add value to the board of directors, the organisation and its stakeholders.

We owe our thanks to those who have supported the Audit Committee Institute since its formation in 2002. We believe this book will help audit committee mem-

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bers meet the challenges demanded of them by providing genuinely practical guidance. Our thanks in particular to Sarah Ray and John Glover, without whose efforts this book could not have been produced.

Michael Hughes

Chairman of Audit, KPMG Audit Plc

Timothy Copnell

Director, Audit Committee Institute, sponsored by KPMG LLP (UK)

About the Audit Committee Institute

Recognising the importance of audit committees, the Audit Committee Institute (ACI) has been created to serve audit committee members and help them to adapt to their changing role. Historically, audit committees have largely been left on their own to keep pace with rapidly changing information related to governance, audit issues, accounting, and financial reporting. Sponsored by KPMG LLP (UK), the ACI provides knowledge to audit committee members and a resource to which they can turn for information or to share knowledge.

The ACI's primary objective is to communicate with audit committee members and enhance their awareness and ability to implement effective audit committee processes.

The ACI aims to serve as a highly useful, informative resource for audit committee members in such key areas as:

- audit committee governance, technical and regulatory issues;
- sounding board for enhancing audit committees' process and policies; and
- surveys of trends and concerns.

For more information on the work of the ACI, please visit our website: www.kpmg.co.uk/kpmglaci/index.cfm.

Introduction

Shaping the audit committee agenda

The role of those responsible for corporate governance and the financial reporting process continues to face intense scrutiny by regulators, legislators, security analysts, institutional investors and the general public. Attention is being placed not only on the board of directors but also on those committees that have been delegated responsibility and accountability by the board. Audit committees are clearly viewed as a critical component of the overall corporate governance process. Accordingly, many audit committees are examining the nature and extent of their oversight roles, members' qualifications and independence, and their interaction and involvement with the audit process.

Effective audit committees are supported by fundamental 'building blocks' – an appropriate structure and foundation, reasonable and well-defined responsibilities, and an understanding of current and emerging issues. Only through carefully designed practices can an audit committee maximise its contribution to an organisation. Audit committees need to understand these building blocks and the specific practices that can be used in implementing governance activities. By comparing practices currently being performed to leading practices, audit committees can identify and select a 'set' of practices as the most effective and efficient in its particular circumstances. This publication describes such practices.

Audit committees have evolved from ad hoc committees with few defined responsibilities to what they are today: critical committees with growing responsibilities that are accountable to the board of directors, and ultimately to shareholders.

Brought to prominence in 1992 through Sir Adrian Cadbury's *Report on the Financial Aspects of Corporate Governance*, the duties of audit committees have grown with successive corporate governance reports. These culminated in the Financial Reporting Council's revised *Combined Code on Corporate Governance* and the related guidance for audit committees (the Smith Guidance) issued in 2003.

The Combined Code and the Smith Guidance are designed to assist boards in making suitable corporate governance arrangements. Smith provides best practice recommendations and guidance to assist directors serving on audit committees. Best practice requires that every board should consider in detail whether its audit committee arrangements are best suited for its particular circumstances. However, audit committee practices need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company.

Specific practices are not mandated. However, the Financial Services Authority's Listing Rules do require companies incorporated within the UK to report on how they

apply the 14 corporate governance principles and 21 supporting principles included in the Combined Code; and confirm the extent of their compliance with the 48 detailed Combined Code provisions and explain the rationale behind any non-compliance. The Smith Guidance provides direction on how companies might apply and comply with the Combined Code provisions and principles relating to audit committees.

In recent years, events in the US have influenced corporate governance practices in the UK:

- The report by the US Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the 'Blue Ribbon Committee'), released in 1999, resulted in the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASDAQ) and the American Stock Exchange (AMEX) revising their listing requirements and mandating various audit committee practices. The recommendations also resulted in new regulations by the US Securities and Exchange Commission (SEC) regarding audit committee processes and reporting.
- The Sarbanes-Oxley Act of 2002 mandated sweeping corporate governance changes and new audit committee practices. As a result of the Act, the SEC issued new regulations pertaining to audit committees and the NYSE, NASDAQ and AMEX revised their listing requirements. In some cases, the NYSE requirements go beyond the SEC's requirements. A comparison of the Smith Guidance and the relevant recommendations of the SEC and NYSE is set out in Appendix 15.

From these developments, audit committees have evolved and improved and leading practices have emerged. Many audit committees in the UK are currently performing a number of these leading practices; however, others are not. All audit committees can benefit from comparing their practices against the practices described in this publication in an effort to improve their own practices. The Audit Committee Institute recognises that not all practices outlined in this publication will apply equally to all different entities.

Using this book

This book starts by looking at the role of the audit committee as set out by the revised Combined Code. The chapters that follow look at how to create an effective audit committee, and then how to run that committee. The last three chapters are devoted to the three fundamental responsibilities of audit committees: overseeing financial reporting; overseeing the process related to the company's financial risks and internal control; and overseeing internal and external audit processes.

For the convenience of readers, many of the documents contained in the appendices are reproduced on the accompanying CD so that they may easily be adapted to suit individual requirements. References to the relevant sections of the Smith Report are highlighted in individual boxed sections.