THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Guidance for audit committees

Company reporting and audit requirements

November 2003

The Combined Code on Corporate Governance – July 2003

C.3 Audit Committee and Auditors

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

Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 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, 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 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.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

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.

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.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. 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.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

Introduction

This publication is part of a series which has been prepared by the Institute of Chartered Accountants in England and Wales to assist non-executive directors on audit committees to gain an understanding of the provisions of the Combined Code on Corporate Governance – July 2003 (The Combined Code) relating to Audit Committees and Auditors and the guidance set out in Guidance on Audit Committees (The Smith Guidance). The Guidance is based on the proposals set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

Corporate reporting and audits

Company reporting and audits are governed and influenced by a range of requirements and recommendations emanating from a number of sources. To those unacquainted with the various pronouncements covering company reporting and auditing, it can be difficult to understand what is required or recommended and by whom. This publication has been prepared to provide a high level overview of reporting by listed companies and audit requirements covering:

- the legal requirements and accounting and auditing standards;
- recommendations of codes and guidance; and
- the sources and authorities of those requirements and recommendations.

Each company is unique and audit committees will need to apply the Smith Guidance in a manner that is appropriate to them. This publication does not provide guidance on how to deal with individual situations and reference may need to be made to the various pronouncements mentioned in the text for detailed information.

Legal requirements and recommendations

Companies

Listed companies prepare each year:

- annual accounts[1] that give a 'true and fair' view of the profit or loss for the 'financial year' and state of affairs at the year end of the company or group and comply with the requirements of the Companies Act 1985. The form and content of annual accounts is largely prescribed in legislation (s226/s227 and Schedules 4 and 4A). Accounting standards also require that the annual accounts include a cash flow statement;

- a report by the directors containing a 'fair review of the development of the business of the company and its subsidiary undertakings during the financial year and of their position at the end of it' together with other information specified in the Companies Act including Schedule 7 – which covers directors' interests, political and charitable gifts, important events affecting the company, likely future developments, research and development, acquisition of own shares, employment of disabled persons and employee involvement;

- a report on compliance with the Combined Code on Corporate Governance as required by Listing Rule 12.43A setting out:
  - how the company has applied the principles set out in the Code; and
  - a statement of whether or not it has complied with the Code and, if not, why not (the 'comply or explain' principle); and

- a directors' remuneration report, separate from the annual accounts and directors' report, setting out details of policy and individual directors' packages (The Directors' Remuneration Report Regulations – Statutory Instrument 2002 No.1986).

In addition, the Combined Code requires that the directors' report contain a separate section that describes the role and responsibilities of the company's audit committee and the actions taken to discharge those responsibilities. This is effective for accounting periods beginning on or after 1 November 2003. As with other aspects of the Combined Code, it is not mandatory but failure to comply will have to be disclosed and explained.

[1] 'Annual accounts' is the term used in the Companies Act, but the term 'financial statements' is used in other pronouncements.

The Government has proposed in its White Paper 'Modernising Company Law' that an operating and financial review (OFR) should become a statutory requirement for listed (and other major) companies above a certain size. The OFR is largely, in one form or another, already provided by listed companies in their annual reports to present the Combined Code's 'balanced and understandable assessment of the company's position and prospects' (Combined Code Principle C1). The Accounting Standards Board (ASB) has issued a revised Statement on the content of the OFR (January 2003) as a formulation of best practice; the Statement has persuasive rather than mandatory force.

The directors of the company are responsible for the annual accounts and all the information outlined above.

Auditors

There are three aspects of auditor's reports to shareholders:

- Auditors are required under the Companies Act to audit the annual accounts and to report to the members of the company whether, in their opinion, the annual accounts give a 'true and fair view' and have been prepared in accordance with the Companies Act 1985 (including the 'auditable part' of the directors' remuneration report). Auditors are also required to report under the Companies Act s237 if there are certain failings, such as whether proper accounting records have been kept and if they have not been able to obtain all the information and explanation that they considered necessary for their audit. The auditors are also required, so far as they are reasonably able to do so, to disclose certain information about directors' remuneration if it has not been disclosed in the company's annual report;
- The Listing Rules require the auditors to review whether the corporate governance statement reflects the company's compliance with the provisions of the Combined Code which are specified for their review and to report if it does not; and
- Lastly, the auditors read the directors' report and other information in the annual report and need to consider the implications for their report if they become aware of any apparent misstatements or material inconsistencies with the annual accounts.

Preliminary announcements

The directors are responsible for issuing a 'preliminary statement of annual results and dividends' within 120 days of the company's year end (Listing Rule 12.40). The statement has to be agreed with the auditors and, if the auditor's report is likely to be qualified, give details of the nature of the qualification.

Half yearly or interim reports

A listed company has to issue a report on its activities and profit or loss for the first six months of each year within 90 days (Listing Rules 12.46 and 47). There is no requirement for the statement to be audited or reviewed. If the interim report is reviewed by the auditors, Bulletin 1999/4 of the Auditing Practices Board (APB) gives guidance and the review report needs to be included in full (Listing Rule 12.54). Some companies also issue quarterly reports either voluntarily or because they are required for innovative high growth companies (Listing Rules Chap 25).

The form and content of preliminary and interim reports are much shorter than for annual accounts and are set out in the Listing Rules (12.40 for the preliminary statement and 12.46 to 12.59 for the half yearly report).

Other reports

There are other situations where companies are required to issue statements or reports, such as profits warnings, prospectuses and major acquisitions or disposals. These and the related Listing Rules requirements are not covered by this publication.

Sources and authorities

The form and content of the annual accounts and audit requirements are set out in legislation, principally the Companies Act 1985, various Regulations issued under that Act and accounting standards (see below). The Listing Rules (Chapter 12 – Financial Information) are those of the UK Listing Authority, i.e. the Financial Services Authority (FSA), which also determines the content of the statements or reports outlined above.

The Financial Reporting Council (FRC) is the guardian of the Combined Code and is responsible for updating its requirements. The Smith Guidance is effective for accounting periods starting on or after 1 November 2003. The requirements of the Code do not have the force of law but, under Listing Rule 12.43A, companies are required to comply or explain why they have not complied.

It is not UK practice to include detailed accounting and auditing requirements in legislation. Legislation provides the framework and a statutory underpinning for the detailed pronouncements of the bodies charged, through legislation or otherwise, with issuing standards on accounting and auditing matters. Thus, accounting standards are the statements issued by the standard setting body prescribed by law, namely the ASB. Standards issued since 1990 are known as Financial Reporting Standards (FRSs) and, prior to then, as Statements of Standard Accounting Practice (SSAPs) issued by the ASB's predecessor body. The SSAPs were adopted by ASB in 1990 and therefore have the status of accounting standards under legislation although many have been superseded by FRSs.

Accounting standards

There are four bodies dealing with accounting standards:

- the Financial Reporting Council, i.e. the over-arching body that guides the standard setting body (ASB) on work programmes and issues of public concern, sees that work on accounting standards is properly financed and acts as a powerful proactive public influence for securing good accounting practice. The FRC has members nominated by a wide constituency of interests and, currently, is jointly financed by the Government, the business community and the accountancy profession in equal proportions.

Under the FRC currently are:

- the Accounting Standards Board that develops, issues and withdraws accounting standards[2] assisted by:
- the Urgent Issues Task Force (UITF) that issues pronouncements (called Abstracts) where unsatisfactory or conflicting interpretations have developed or seem likely to develop. Each Abstract sets out UITF's consensus, i.e. the considered view of a large majority of its membership. They are not accounting standards, but are likely to be treated by the Courts as having 'considerable standing'.

- the Financial Reporting Review Panel enquires into the accounts of listed companies where it appears that the requirements of the Companies Act, including the 'true and fair view' requirement, and accounting standards might have been breached. Currently this is a reactive role based on investigating complaints, adverse press comment and qualified audit reports but, following the report of the joint DTI/Treasury Co-ordinating Group on Audit and Accounting Issues (CGAA) published in January 2003, this body will become proactive and work with the FSA; how this will be done needs to be developed.

[2] ASB also recognises certain industry bodies for the purpose of issuing Statements of Recommended Practice on accounting practices for their specialised industry or sector, as set out in ASB's 'SORPs: Policy and Code of Practice'.

With the globalisation of capital markets, international accounting standards[3] set by the International Accounting Standards Board are becoming increasingly relevant. The European Commission has determined that they should be applicable to listed companies for accounting periods starting on or after 1 January 2005.

Audit requirements

As a result of the CGAA report and the DTI Review of the Regulatory Regime of the Accountancy Profession, a number of significant structural changes will take place. The following notes set out the current position and indicate how it will change.

Audit regulation

Auditors of listed companies have to be 'Registered Auditors' which means that they are to comply with the Audit Regulations, i.e. the set of regulations agreed between the accountancy bodies and the DTI under the Companies Act 1989.

The Regulations cover, inter alia, requirements that Registered Auditors:

- be independent;
- carry out their work with integrity;
- be 'fit and proper';
- keep to technical standards, e.g. compliance with the Companies Act and auditing standards; and
- be, and continue to be, competent to carry out audit work.

In addition, the Regulations require that auditors monitor at least annually how effectively they comply with the Regulations, carrying out what are often known as quality assurance reviews. Firms' compliance with the Regulations is also monitored by the Joint Monitoring Unit (JMU) which visits the largest audit firms annually and other firms with listed audit clients triennially or more often. The JMU was established by the Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants of Scotland and Institute of Chartered Accountants in Ireland and currently monitors all statutory audit work. However, as a result of the report on the 'Review of the regulatory regime of the accountancy profession' issued in January 2003 (the Swift Report), the monitoring of audits of listed companies and 'major' charities and pension schemes will be

(3) Currently known as 'International Accounting Standards' and in future as 'International Financial Reporting Standards'.

transferred to an independent monitoring unit under a new Professional Oversight Board.

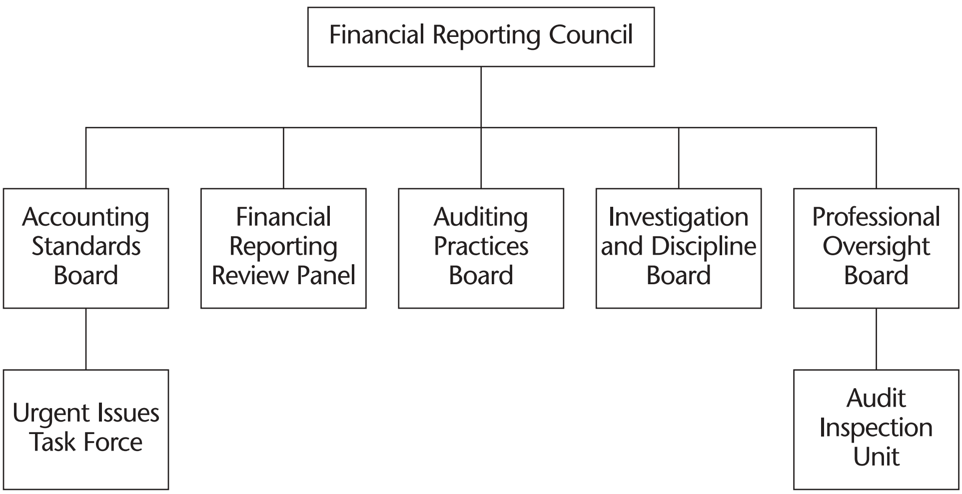
Auditing Standards

Auditing Standards are set out in Statements of Auditing Standards (SASs) which are issued by the Auditing Practices Board. The APB is responsible for issuing (a) Statements of Auditing Standards with which auditors are expected to comply and (b) Practice Notes and Bulletins which are persuasive (rather than prescriptive) and indicative of good practice.

Currently the APB is a subsidiary of the Accountancy Foundation established by the professional accountancy bodies but, following the Swift Report, it will become a subsidiary of the independent FRC and therefore a sister body to the ASB. It is not anticipated that there will be any significant change in the role and responsibilities of the APB, other than for the APB to become responsible for setting standards for independence, objectivity and integrity for auditors.

The new regulatory structure

The Swift Report brings together under a single body (the FRC) the regulation of both accounting and auditing. The proposed structure is set out below:



Within the proposed structure:

- The Investigation and Discipline Board will investigate cases of public interest and, where necessary, take disciplinary action including sanctions such as removing eligibility to audit.
- The Professional Oversight Board will have as its primary focus the oversight of audit.

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The Institute of Chartered Accountants in England & Wales has issued a series of publications to assist non-executive directors on audit committees gain an understanding of the guidance included in the revised Combined Code on Corporate Governance as 'Audit Committees: Combined Code Guidance'. This is closely based on the proposals originally set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

Originally published in May and reissued in November 2003, the first four titles which are not affected materially by the revised Combined Code of July 2003 are:

- Working with your auditors
- Company reporting and audit requirements
- Reviewing auditor independence
- Evaluating your auditors

A further three titles will be published in 2004:

- Monitoring the integrity of financial statements
- The internal audit function
- Whistleblowing arrangements

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Chartered Accountants' Hall PO Box 433 Moorgate Place London EC2P 2BJ
Tel 020 7920 8100 **Fax** 020 7638 6009 **www.icaew.co.uk**