THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Guidance for audit committees

Monitoring the integrity of financial statements

March 2004

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 & 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.

Monitoring the integrity of financial statements

Under the revised Combined Code, one of the main roles and responsibilities of a company's audit committee is to monitor the integrity of the financial statements and any other formal announcements relating to financial performance of the company. This publication gives a high level overview of the Code Provisions and the types of issues to be considered, covering:

- the elements of financial statements; and

- areas of judgement and factors affecting their significance.

Each company is unique and audit committees will need to apply the Combined Code Provisions and related 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 Code and related guidance and other relevant sources such as legislation and regulatory requirements. In some situations it will be necessary for the committee to take its own professional advice.

Background

Internationally, the credibility of financial statements has been seriously damaged in recent years. A number of initiatives have been proposed to restore public confidence in financial reporting. In the UK, a key initiative has been the revision of the Combined Code.

The Combined Code principle that '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' has been retained but has been strengthened in a number of areas, including in the audit committee's role and responsibilities:

- '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'; and, as with other aspects of the committee's role,
- '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'.

In accordance with the 'comply or explain' concept, a company will be required either to confirm that it complies with the provision or, where it does not, to provide an explanation.

'Integrity' is primarily a personal quality. Integrity in relation to financial statements is the result of both the integrity of those involved in preparing the financial statements and the robustness of processes by which financial statements are prepared. This publication focuses on the integrity of processes, although many of the considerations will provide valuable insight into the integrity of individuals.

Information to be reviewed

Code Provision C.3.2 refers to the financial statements (i.e. the annual statutory accounts of the company) and 'formal announcements relating to the company's financial performance'. Formal announcements would be those for which board approval is required, which can be either:

- regular – the interim report (usually six monthly but may be quarterly) and preliminary announcement required for all listed companies, but for some companies may include reports to regulators and summary financial statements; or

- ad hoc – in response to specific events such as releasing price sensitive information or documents issued in connection with acquisitions or disposals of companies or lines of business.

The audit committee's monitoring should also include a review of the related information presented with the financial statements. The Smith Guidance states that this includes 'the operating and financial review and the corporate governance statements relating to the audit and risk management' (para. 4.4). However, in practice, the review should also include other sections of the annual report such as the directors' report (a statutory requirement) and other pages where financial information is included or referred to. Further, the committee's review should focus not only on financial information itself but on the form and context in which it appears. For example, an audit committee should be concerned if any narrative is inconsistent with the financial information or is otherwise misleading. This makes a review of the entire annual report necessary to ensure the view presented is consistent with the audit committee's understanding of the business's performance and financial position.

As the financial statements are normally subject to a timetable to meet company reporting deadlines, it is important that the audit committee's monitoring and review is factored into the company timetable, allowing sufficient time for both review and subsequent clarification and discussion. The timetable should also take into account that 'significant financial reporting judgements' will probably be a key element of the committee's review with the external auditors of the findings of their audit work. Similarly, the monitoring and review of other announcements should be factored into the company's timetables and, where relevant, include the internal and external auditors. Even if the external auditors have no formal or contractual role in relation to these announcements, the audit committee should consider obtaining their views as they may be relevant at a later date e.g. during preparation of the annual financial statements.

As part of its review, the audit committee should also consider the process by which the financial statements and other financial information are produced, including management's determination and regular review of accounting policies, the identification and decision-making process for significant judgements and the procedures for reviewing financial and non-financial disclosures.

Where the audit committee has any concerns over the process, it should discuss them with senior management and, if necessary, the internal and external auditors. If satisfactory resolution cannot be

achieved, the audit committee should prepare a report to the board describing the issue and making recommendations as to the steps to be taken to resolve it. The Smith Guidance also provides (para. 3.5) that, where there are extreme disagreements with the rest of the board that cannot be resolved, the audit committee should be permitted to report directly to shareholders.

The audit committee might wish to consider:

- *is there a company plan, including a timetable, setting out which documents will need to be monitored and reviewed by the audit committee and when?*
- *is sufficient time allowed in the timetable for the review and subsequent follow-up with management, the board and the external auditors?*
- *could any improvements be made to the plan for subsequent years?*

Financial statements

Financial statements[1] are required by law to give a true and fair view of the profit or loss of a company for its financial year and its state of affairs at the year end, and to comply with the requirements of the Companies Act 1985. The 'true and fair' concept lies at the heart of UK financial reporting and is the ultimate test for financial statements. It is not defined in legislation or accounting standards, and it evolves in response to accounting and business practice. Significant accounting judgements and disclosures should be considered in terms of their impact on the entire financial statements, not a particular line item or account balance.

True and fair applies to the financial statements as a whole, not to individual components. Whilst in this booklet, reference is made to judgements in relation to individual transactions, it is intended that an overall assessment would be performed as to whether the accounts, in their entirety, give a true and fair view.

The Accounting Standards Board (ASB) has issued its *'Statement of principles for financial reporting'* which is a set of high-level principles designed to help it set coherent and consistent Financial Reporting Standards (FRS). Compliance with legal requirements, FRS and, in the absence of standards, other generally accepted accounting practice normally determines the content of financial statements and the giving of a true and fair view.

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[1] For further details see *Company reporting and audit requirements* in this series.

In certain circumstances, following the legal form of transactions has resulted in situations where arguably the information provided has not been sufficiently reliable and relevant to shareholders and other users of financial statements. This has led to a number of standards which follow the economic substance of transactions rather than their legal form (this principle is known as 'substance over form'). In the UK, FRS 5 *Reporting the substance of transactions* sets out a general requirement for accounting treatments to follow substance over form. The most complex areas may be in relation to off-balance sheet financing and derivative financial instruments and the audit committee should make enquiries to understand the treatments adopted in these areas. For further information on FRS 5, see Appendix 1.

The principle of substance over form can also be found in company law. For example, the Companies Act 1985 states, for the purposes of a company's consolidated accounts, that a 'subsidiary undertaking' includes one where a 'parent undertaking' can exercise dominant influence, even though the parent may not hold the majority of, or indeed any, shares in the subsidiary undertaking.

Following an EU Regulation passed in June 2002, all EU listed companies will be required to report their group financial statements under International Accounting Standards (IAS) instead of local accounting standards from 2005. Accordingly, UK listed companies will need to report under IAS from 2005.

Although IAS does not have a specific standard requiring substance over form, its *Framework for the Preparation and Presentation of Financial Statements* contains the concept. The IAS Framework is consistent with the ASB *'Statement of principles for financial reporting'*. The Framework sets out the basic principles by which financial statements should be prepared and also defines the fundamental concepts which guide the preparation of new standards. Like UK standards, there are several individual standards based upon the principle of substance over form.

Although the Companies Act and accounting standards should generally be followed, in very rare circumstances, where compliance would be inconsistent with giving a true and fair view, the Act requires the directors to provide those additional disclosures necessary to give a true and fair view. Where this is not possible, the directors must depart from the relevant provision or requirement to the extent necessary to give a true and fair view and explain the adopted treatment fully.

In summary, whilst legislation and accounting standards are sufficient to result in a true and fair view for the majority of companies' transactions and events, there may occasionally be circumstances in which they do not result in reflecting commercial reality and the true and fair view. In such cases, departure from legislation and accounting standards is not only justified but expected.

The audit committee might wish to consider:

- *what have been the significant events and transactions in the period?*
- *does the accounting for these events and transactions reflect their underlying economic substance?*
- *is a true and fair view given in the financial statements as a result of the accounting treatment adopted?*
- *has this treatment been fully discussed with the external auditors?*
- *what issues have been raised by the external auditors in their communications with the audit committee and what items are referred to specifically in the management representation letter?*

Significant financial reporting judgements

The following sections describe some of the more common situations where senior management and the board may need to exercise judgement. At first sight, the audit committee's task might appear highly burdensome but it should be put in context:

- The majority of transactions are routine and straightforward and reflecting them in financial statements requires little, if any, judgement. The remaining non-routine, non-standard transactions will require most attention from the audit committee.
- Although the Board has ultimate responsibility for risk, the company's management has day-to-day responsibility for the management of risk and this should feed through into the internal control system. Management's risk assessment should include significant financial reporting judgements.
- The audit committee has responsibility for internal financial controls and may also have responsibility for all internal controls and risk management systems (C.3.2). This should provide information and possibly assurance about significant financial reporting judgements.
- The external auditors' audit plans and findings will provide useful information, as the auditors will pay particular attention to judgements.

Significance

The determination as to whether a judgement is significant will vary between companies and there is no single criterion or set of criteria that can be applied universally. In the case of the annual financial statements, the types of factors that may need to be considered include:

- the effect on the trend of the company's results – a judgement may be regarded as significant when there is a risk that it may be used to flex the year's results to show a trend, such as to ensure the maintenance or reversal of the trend in company profits;
- market expectations – a judgement may be regarded as significant if it makes the difference between meeting and failing to meet market expectations;
- the effect on key figures – showing a profit greater than last year or avoiding slipping into a loss may be significant, especially if market expectations are not met;
- the effect on 'trigger points' – if certain borrowing covenants such as interest cover are breached, this can have a significant effect e.g. through higher interest rates or triggering loan repayments;
- note disclosure – the significant judgements are not limited to the key statements of the profit and loss account and balance sheet. Key information may be disclosed in the notes to the accounts such as contingent liabilities (e.g. law suits and tax claims) and information about debt repayment terms. The significance will depend on the level of sensitivity of the disclosure; and
- timing and nature – entries that are non-routine in nature, or are made as part of the post year-end close and consolidation process, may require additional consideration.

Although a financial reporting judgement may appear to have adverse consequences that are out of proportion to the amounts involved, directors, including non-executive directors, must ensure that the financial statements show a 'true and fair view'. The audit committee should also bear in mind that taking, say, an optimistic view about a financial reporting judgement has risks, for example:

- the judgements may have to be reversed in the following year and may merely defer 'bad news';
- once locked into one or more judgements, it can be difficult to correct the situation (especially if a deteriorating situation is made even worse), and the reputation of the company and individual directors can be seriously damaged.

Accounting policies

The Smith Guidance states that audit committees should consider significant accounting policies and any changes to them. Under FRS 18 *Accounting Policies*, the company must adopt the accounting policies most appropriate to its particular circumstances, for the purposes of giving a true and fair view. Also, these accounting policies must comply with accounting standards and company law.

There are two concepts that play a pervasive role in drawing up financial statements and hence in selecting appropriate accounting policies:

- the going concern assumption – when preparing the financial statements, the directors are required to assess whether there are any significant doubts about a company's ability to continue as a going concern; and
- the accruals concept – the effects of transactions and other events are recorded in the year in which they occur and not, for example, in the period in which cash is received or paid.

FRS 18 sets out the objectives that should be used to judge the appropriateness of accounting policies. One of these objectives deals with 'reliability' – information in the financial statements is reliable if:

- 'it can be depended upon by users to represent faithfully what it purports to represent or could reasonably be expected to represent, and therefore reflects the substance of the transactions and other events that have taken place';
- 'it is free from deliberate or systematic bias and material error and is complete' – also known as 'neutrality'; and
- 'in its preparation under conditions of uncertainty, a degree of caution has been applied in exercising the necessary judgements' – also known as 'prudence'.

Companies are generally expected to apply the same accounting principles each year, thus ensuring comparability between one year and the next. However, policies should be reviewed regularly to ensure that they remain the most appropriate for giving a true and fair view. If a new policy is considered more appropriate, the directors should determine whether a change is required, taking into account the impact on comparability.

Under IAS, the fundamental concepts are contained in its Framework, not as a separate standard. The concepts and objectives are consistent with those within FRS 18.

The audit committee might wish to consider:

- *what are the significant accounting policies adopted by peer companies?*
- *are there any major international developments that could define 'best practice'?*
- *what is the reason for, and the impact of, a proposed change in accounting policy?*

Judgements

The Smith Guidance states that the audit committee should consider any significant estimates and judgements. In drawing up the financial statements of a company, the directors make a number of judgements and estimates. Year end balances, such as debtors, may be subject to uncertainties which are not resolved by the time that the financial statements are finalised. The final profit or loss on transactions, such as long-term contracts, cannot be finally determined until the contract is complete and the warranty period has expired.

In all these cases, the directors will need to make judgements about future events and outcomes and, based on this, accounting estimates will be included in the financial statements. In practical terms, the judgements and estimates will often be made by management, but the directors are still responsible for them and for deciding whether the policy and practice followed are appropriate and lead to the right answer.

Examples of judgements and estimates are provided in Appendix 2.

The audit committee might wish to consider:

- *what is the process by which major judgements are made?*
- *have major judgements been reached in an objective, neutral way?*
- *what are the incentives that could influence judgement and are there adequate controls in place to identify and validate these judgements?*
- *what would be the impact on the company's results if different judgements or assumptions had been made?*
- *does the additional published information in, for example, the operating and financial review provide sufficient explanation of these judgements?*

International Accounting Standards

From 2005, all listed companies in the European Union will be required to report their group financial statements under IAS. The first time adoption of IAS will require significant judgements to be made, both in respect of specific accounting policies to be followed and in relation to how the transition will be communicated to the financial markets.

The audit committee might wish to consider:

- *has there been an evaluation of the areas of maximum risk, difficulty and uncertainty?*
- *is there a plan showing the resource and training requirements?*
- *can management explain the areas which are considered minor, for which lower resources will be allocated?*
- *how is management tracking adjustments that will be required to contracts with, for example, finance providers and employees?*
- *are disclosures and related communications sufficient to explain the changes and adjustments to shareholders and other stakeholders?*

For further information, visit **www.iasknowledge.com**.

Appendix 1: FRS 5 Reporting the substance of transactions

FRS 5 provides guidance relevant to the ownership of assets and the timing of sales. It states:

'The objective… is to ensure that the substance of an entity's transactions is reported in its financial statements. The commercial effect of the entity's transactions, and any resulting assets, liabilities, gains or losses, should be faithfully represented in its financial statements.'

In other words, it is concerned with ensuring that a company does not inappropriately reduce the gearing of its balance sheet by offsetting assets and liabilities, or record profits before they have been earned.

The vast majority of company transactions are not affected by FRS 5 in the sense that the legal form and the substance are the same. Also FRS 5 does not apply in those cases where a more specific standard exists. FRS 5 mainly affects more complex transactions where the economic substance may not be readily apparent. The true commercial effect may not be adequately expressed by the legal form of those transactions and, where this is the case, it is not sufficient to account for them by merely following their legal form.

This does not mean that the substance of all complex transactions differs from their legal form, but the possibility needs to be considered. Transactions requiring particularly careful analysis often include features such as:

- the party that gains the principal benefits generated by an item is not the legal owner of the item e.g. finance leases;
- a transaction is linked with others in such a way that the commercial effect can be understood only by considering the series as a whole e.g. sale of goods with a commitment to repurchase; or
- an option is included only on terms that make its exercise highly likely e.g. sales with an option to repurchase where an economic penalty (such as the foregoing of a profit) would be suffered if the option is not exercised.

FRS 5 has *Application notes* attached to it dealing with:

- consignment stock;
- sale and repurchase agreements;
- factoring of debts;
- securitised assets;
- loan transfers;
- private finance initiative and similar contracts; and
- revenue recognition.

Appendix 2: Examples of judgements and estimates

Examples of judgements and estimates include:

- the economic lives of fixed tangible assets and the corresponding annual depreciation charge. Economic lives should be reconsidered annually and if, for example, it is determined that a particular economic life has become shorter, the annual depreciation charge will need to be increased. It may also be necessary to write down a fixed asset if it is worth less than its book value or is no longer economically viable. Although depreciation is often considered in terms of years, there are situations where depreciation should be provided according to productive capacity e.g. writing off oil field plant and equipment by reference to production and total estimated reserves.
- the economic lives of intangible fixed assets and the annual amortisation charge – again these lives should be reconsidered annually. It is important to understand what gave rise to each asset and its nature, as the underlying value of these assets can fall sharply.
- the recoverability of the cost of stock and work in progress and amounts needed to reduce such items to their net realisable value.
- the outcome of long-term contracts – future revenues and costs will need to be estimated for each contract and either a suitable amount of profit recorded for the year or the estimated full loss provided.
- the recoverability of debts due to the company and amounts provided for bad or doubtful debts.
- provisions for warranty costs – the level of future warranty claims will need to be estimated, taking into account the company's terms and conditions of sale and accepted industry practice, and appropriate provision made.
- providing for pensions – the most significant judgements in this context arise from defined benefit pension plans. Following appropriate input from the company's actuaries, estimates must be made of the expected long-term return on scheme assets, future inflation, rate of increase of pensionable salaries, rate of increase of pensions in payment and an appropriate discount rate.
- taxation provisions – an estimate must be made of the most likely tax treatment for items in the accounts. The company's tax filing may not take place until after the financial accounts have been filed and the final tax treatment may not be determined for several years. Also the decision whether to recognise a deferred tax asset will depend on estimates of future taxable income.
- financial instruments – where FRS 13 applies, detailed disclosures of financial instruments are required, including estimates of their fair values.
- contingencies – the likelihood of a contingency must be estimated. Unless the likelihood is considered remote, the most likely financial outcome must also be estimated and, where the contingency is considered probable, accrued.
- insurance loss reserves – what assumptions have been made with respect to the timing, likelihood and cost of future incidents and how does this relate to historical experience.

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The following titles are available:

- Company reporting and audit requirements
- Monitoring the integrity of financial statements
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