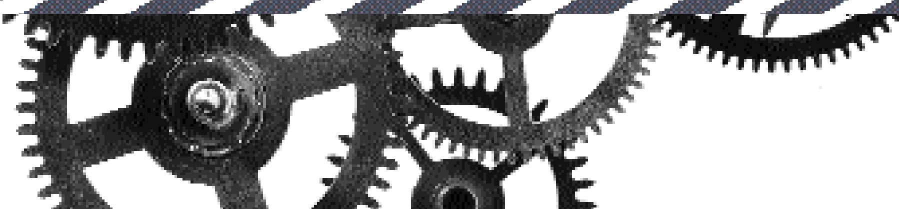
Guidance for audit committees

Working with your auditors

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.

Working with your auditors

One of the Smith Guidance requirements is that 'The audit committee is the body responsible for overseeing the company's relations with the external auditor'.

Two of the aspects of this relationship are:

- At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit.
- The audit committee should review, with the external auditors, the findings of their work.

This publication explains how these aspects of the relationship might work, how they relate to the auditing standards that auditors are required to follow and the practices followed by auditors in implementing those standards and the other pronouncements of the Auditing Practices Board (APB). *Company reporting and audit requirements* sets out an overview of company reporting and auditing, including the role and authority of the APB. *Reviewing auditor independence* and *Evaluating your auditors* deal with other aspects of the audit committee/external auditor relationship.

The APB issued the second edition of its Briefing Paper *Effective communication between audit committees and external auditors* in September 2002. Although it predates the Smith Guidance, it contains much material that is still relevant and helpful to audit committees and external auditors.

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.

Background

The directors are responsible for preparing a company's annual accounts that comply with the provisions of the Companies Act 1985 (the 'Act') and give a 'true and fair view' of the company's profit or loss for the year and the state of affairs at the balance sheet date. They are also responsible for the other parts of the annual report, principally the directors' report, the report on compliance with the Combined Code on Corporate Governance, the directors' remuneration report and the operating and financial review or equivalent material.

The external auditors are responsible under the Act for auditing the annual accounts and for reporting 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). They are also required under the Listing Rules to review whether the company's corporate governance statement reflects its compliance with those provisions of the Combined Code specified for their review and to report if it does not. They also 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.

Under s389A of the Act auditors are entitled to ask for all the information and explanations that they consider necessary for the conduct of their audit. If they are unable to obtain any information and explanations they need, they are required to state this in their audit report. Moreover, directors are guilty of an offence under the same section if they knowingly or recklessly provide information to the auditor that is misleading, false or deceptive. In its White Paper 'Modernising Company Law', the Government proposes extending this provision to require directors to volunteer information to the auditors.

The external auditors are required to comply with auditing standards set by the APB, i.e. the basic principles and essential procedures set out in the Statements of Auditing Standards (SASs) which also include non-prescriptive explanatory material. The APB also issues Practice Notes (PNs) and Bulletins which are persuasive rather than prescriptive and are indicative of good practice. PNs assist in the application of SASs to particular circumstances and industries, such as banks, insurance companies and investment businesses. Bulletins provide timely guidance on new or emerging issues.

The preparation of the annual accounts is not an exact science as it includes making judgements on accounting estimates, i.e. estimates made where there are uncertainties regarding the outcome of events. Examples include allowances to reduce stocks and debtors to the amounts that will be realised, the estimated life of long-term assets such as plant, equipment and buildings for depreciation purposes, estimating the profit or loss on long-term contracts and the outcome of any lawsuits. For the same reasons and because the report of the auditors is based on work which is the selective testing of transactions and other information, the report is an opinion, not a certification of fact. An audit cannot create precision where precision is inherently not possible; nor can it be a certification as this would require exhaustive verification of every detail in the annual accounts.

The external audit process

This publication focuses on the following aspects of the external audit process set out in the Smith Guidance, namely that the audit committee should:

- approve the terms of engagement and the remuneration to be paid in respect of audit services provided;
- at the start of each annual audit cycle, ensure that appropriate plans are in place for the audit;
- review, with the external auditors, the findings of their work;
- at the end of the annual audit cycle, assess the effectiveness of the audit process.

When discharging these responsibilities, it is important to bear in mind the following points:

- Good open communication between the audit committee and the external auditors is a two-way process. Auditors should provide the committee with relevant information that will help its members to gain a good understanding of any concerns and their causes in time to do something about them. The committee should provide auditors with information and their views on corporate governance arrangements and the environment in which the internal controls operate, as well as the key accounting and auditing issues. Both parties should provide each other with information about how such issues are resolved.

- Although the external audit process is broken down into separate sections, they are not isolated units; they are linked. For example, discussion of the audit plan and findings from work done feeds into the assessment of audit effectiveness, which in turn is one of the factors in the recommendation to the board on auditor appointment.

- The committee's oversight should not just be seen in terms of the pronouncements in the Combined Code and APB's standards and guidance. Much of the relationship between a company and its auditors depends on personal factors and relationships, such as oral and written communication skills, the openness of discussions and the abilities and personalities of individuals.

- The requirements in the Smith Guidance that relate to the annual audit cycle do not introduce any changes in the auditing standards followed by firms. The Smith Guidance might be seen as requiring a greater or more formalised involvement by audit committees in the company/external auditor relationship. However, communication between external auditors and the audit committee is already covered by SAS 610 *Communication of audit matters to those charged with governance* which covers communications throughout the audit.(1) These communications should be on a sufficiently prompt basis to enable the company to take appropriate action.

SAS 610 includes communications on planning information and findings from audit work which are covered below. Communications relating to auditor independence are covered in *Reviewing auditor independence*.

Terms of engagement

The Smith Guidance states 'The audit committee should approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided' (para 4.18).

Although the audit appointment is a statutory requirement, SAS 140 *Engagement letters* requires that an engagement letter is agreed in writing between the company and the auditors on first appointment. Subsequently it should be regularly reviewed and any updates agreed in writing. Legal and regulatory requirements, as well as the company's circumstances, frequently change and updating letters are required to deal with these.

(1) Although SAS 610 does not specifically refer to audit committees for all communications, this is the effect of the Smith Guidance.

A long series of updating letters with the risk of anomalies developing is not desirable. It is usually clearer and safer for both parties for new engagement letters to be issued periodically, possibly even annually.

The engagement letter, which formally documents and confirms the appointment, includes a summary of the responsibilities of the directors and of the auditors, the scope of the engagement and the form of any reports. The letter would also normally cover work that is inextricably linked with the statutory audit such as the review of the corporate governance statement and reporting to a regulator such as the Financial Services Authority or an industry body. In this way, the committee and the auditors should have a clear understanding of their own and the other's responsibilities. It should minimise the risk of subsequent misunderstandings that can lead to problems with the annual accounts, the effectiveness of the audit and the company/auditor relationship.

The Smith Guidance states 'The audit committee should satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee'. Fee negotiations are, like any other negotiation, a commercial issue to be agreed between the parties. There are no 'scale rates' or lists of 'approved fees' by size of company. The committee's assessment should include, but not necessarily be limited to, the following factors:

Key issues and audit approach

The committee will need to understand the scope of the engagement, the complexity of the audit, the complexity of key accounting and audit judgements, the auditor's reliance on internal controls and internal audit, etc. This understanding is also an integral part of the committee's consideration of the audit plan (see below).

As part of this understanding, the audit committee might wish to consider:

- *Does the audit team have relevant industry expertise and experience?*
- *Does the audit team's approach take due account of the company's internal controls?*
- *Does the audit team's approach place appropriate reliance on the role of internal audit and its findings?*

The amount of time required at the main partner/ staff levels

For example:

- *Will the lead engagement partner be spending enough time on the company's audit bearing in mind the known and anticipated major issues? If applicable, will the other key audit partners be spending enough time on the company's audit?*
- *Will the senior audit managers and specialists involved in the audit, such as tax specialists and IT specialists, be spending enough time on the company's audit?*
- *Does the time to be spent by other audit staff seem reasonable?*
- *In arriving at the proposed timing, are significant areas or divisions being rotated out of audit? Is this acceptable?*

The mix of partners and staff

For example:

- *Should there be a greater partner involvement and a lower non-partner involvement bearing in mind actual or possible major issues, or vice versa?*
- *Should there be more/less specialist partner or staff involvement than planned?*

Audit plans

The Smith Guidance states 'At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit' (para 4.30).

Planning is a key element of any audit with SAS 200 *Planning* establishing standards and providing guidance. Specifically SAS 200.1 states that 'auditors should plan the audit work so as to perform the audit in an effective manner'.

There are other SASs that are relevant to planning (and other stages of the audit), namely SAS 210 *Knowledge of the business*, SAS 220 *Materiality and the audit*, SAS 110 *Fraud and error* and SAS 120 *Consideration of law and regulations*. There are also APB Practice Notes for audits of companies in the banking, insurance and investment businesses sectors (PNs 19, 20 and 21 respectively).

The audit committee's focus should therefore be on the content of the overall audit plan rather than its existence. The committee will not only consider whether the plan deals with all the major issues (including key accounting and audit judgements) but, as stated in the Smith Guidance, 'whether the overall work plan, including planned levels of materiality, and proposed resources to execute the audit plan appears consistent with the scope of the audit engagement, having regard also to the seniority, expertise and experience of the audit team'.

There is a substantial overlap between ensuring that appropriate plans are in place for the audit and the approval of the terms of the auditor's engagement and remuneration discussed earlier. It will avoid unnecessary duplication if these two elements and their timing are co-ordinated.

There are two practical aspects that committees will need to bear in mind:

- The audit plan formulates the general audit strategy and therefore sets the direction for the audit and provides guidance for the development of the audit programme. The objectives of the plan are to ensure that appropriate attention is given to different areas of the audit, potential problems are identified and to facilitate review of work by more senior partners and staff. The committee would need to consider this overall plan in order to discharge its responsibilities. The committee would also need to consider whether it wants to consider any of the detailed procedures required to implement the audit plan. This will depend on the company's circumstances and may be necessary in order to understand key issues.

- The audit plan is not set in stone. Company circumstances change and the plan may need to be revised. Also the findings from audit work are evaluated as the audit progresses. This can lead to amendments to the audit plan and how it is implemented.

Possible questions for the audit committee to ask might include:

- *Does the audit plan identify all key accounting matters and home in on the issues that really matter? If not, why not?*

- *Does the audit plan deal with these appropriately?*

- *Are there any other matters that have been mentioned that need to be considered by the auditors for inclusion in their audit strategy, e.g. points raised at company meetings, press comment or at meetings with institutional shareholders?*

- *Does the plan demonstrate that the auditors understand the industry, the company's business and the way it is run? If not, what is the reason?*

- *Is there sufficient audit coverage across the group?*

Audit findings

The Smith Guidance states 'The audit committee should review, with the external auditors, the findings of their work' (para 4.32).

In the course of its review, the audit committee should:

- discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved, and those issues that have been left unresolved;

- review key accounting and audit judgements; and

- review levels of errors identified during the audit, obtaining explanations from management and, where necessary the external auditors, as to why certain errors might remain unadjusted.

The major issues to be discussed and areas to be reviewed will depend on individual company and audit circumstances. They should be raised and discussed by both the committee and the auditors. Although the auditors raise major issues that affect the quality and effectiveness of their work, it is possible that they may be unaware of an issue that gives, or has the potential to give, concern to the committee. It is better for committees to check than to assume that an issue has been resolved.

It may seem unnecessary for the committee to be aware of major issues that have been resolved and unadjusted errors which are not material. However, they might be indicative of weaknesses in the internal controls systems or the ways in which they are operated or over-ridden and are therefore relevant to the committee's responsibilities in this area.

These matters do not stand alone. They are key to other aspects of the committee's role, principally:

- monitoring the integrity of the financial statements;

- reviewing the company's internal financial control and risk management systems;

- monitoring and reviewing the effectiveness of the internal audit function; and

- assessing the effectiveness of the audit process.

In thinking about the timing of the committee's review of the findings of the audit work the following practical aspects need to be considered:

- The audit is not complete until the auditors sign their report, which will be when the board of directors has approved the accounts, which in turn cannot take place until the audit committee has satisfied itself about the integrity of the financial statements. The timing of the company's preliminary statement should be taken into account to ensure that the figures in that statement are reliable and that all major audit issues have been resolved. Companies are required under the Listing Rules to indicate if the audit report is likely to be qualified. The committee will therefore need to agree a timetable with the board and finance director that allows the committee to do its work properly and efficiently. This timetable needs to be part of the company's overall timetable for preparing the company's annual report and accounts.

- Most audits involve work before the year end. It is advisable for findings to be reviewed on an ongoing and timely basis. The committee should review the findings of the external auditors after the interim work, if not during the work. It enables issues to be identified and dealt with at an early stage, thus avoiding surprises and unnecessarily burdensome year end work for management, the audit committee and auditors.

- One of the final stages of the audit involves the representation letter issued by a company to its auditors. SAS 440 *Management representations* states that 'auditors should obtain written confirmation of representations from management on matters material to the financial statements when those representations are critical to obtaining sufficient appropriate audit evidence'. The audit committee should review this letter before signature by management and give particular consideration to matters where representation has been requested that relate to non-standard issues. The audit committee should consider whether the information provided is complete and appropriate based on its own knowledge.

Representation letters cover matters such as:

- Confirmation that all accounting records have been made available, all transactions have been properly reflected and recorded in the accounting records, and all other records and related information have been made available. While this should not be an area for concern in most companies and may seem unnecessary, it has been known for information to be withheld, deliberately or otherwise, and therefore the letter provides an opportunity for companies to consider carefully whether all relevant information has been properly disclosed.

- Confirmation about the directors' anticipation of the outcome of future events affecting key accounting judgements, e.g. recovery of doubtful debts and recognition of profit or loss on long-term contracts.
- Confirmation about the future intentions and expectations of the company.

SAS 610 requires the communication of findings from the audit. This includes expected modifications to the auditor's report and unadjusted misstatements which will be discussed with the audit committee before the accounts and audit report are finalised. It will also cover, possibly in more detail shortly afterwards, material weaknesses in the accounting and internal control systems identified during the audit and the auditor's views about the qualitative aspects of the company's accounting practices and financial reporting. This information is communicated in a management letter which the audit committee should review. The audit committee should also review and monitor management's responsiveness to the external auditor's findings and recommendations.

Possible questions for the audit committee to ask might include:

- *Have all significant matters raised in the overall audit plan and related discussions with the external auditors been satisfactorily resolved?*
- *Do the explanations provided by management and the auditors make sense in the light of the committee's knowledge of the company and its executive management? If not, why not and what are the implications?*
- *Have any matters come to the committee's attention during the year or since the year end suggesting that further explanations or work are required from management and/or the auditors?*
- *What pressures are there on executive management that might have led to a lack of objectivity or candour in how they have dealt with key accounting and audit issues?*
- *Is management putting undue pressure on the external auditors to limit their work or accept management's explanations?*
- *Why aren't unadjusted errors being corrected?*

Effectiveness of the audit process

The Smith Guidance states 'At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process' (para 4.35).

The assessment of the effectiveness stage is inevitably linked with the recommendation to the board on the appointment of the external auditors for the following year. It will be one of the major factors in the committee's assessment of the qualification, the expertise and resources, the effectiveness and the independence of the external auditors. It is relevant regardless of whether a change is proposed or not. If there is to be no change, it will help to improve the company/auditor relationship. If a change is contemplated, it will identify those attributes that the committee wishes to retain (or avoid) in the next firm.

During the finalisation of the accounts and the audit, the audit committee will be able to start the assessment process by:

- reviewing whether the auditor has met the agreed audit plan and understanding the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
- considering the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, including where appropriate questions on the systems of internal control;
- obtaining feedback about the conduct of the audit from the finance director, the head of internal audit and others in the organisation; and
- reviewing and monitoring the content of the external auditor's management letter in order to assess whether it is based on a good understanding of the company's business and establishing whether recommendations have been acted upon and, if not, the reasons why not.

The publication *Evaluating your auditors* gives further guidance on this assessment process.

Additional copies may be obtained by calling: +44 (0)20 7920 8634 or downloaded by visiting www.icaew.co.uk/policy.

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Guidance for audit committees

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

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