



FINANCIAL REPORTING COUNCIL

GUIDANCE ON AUDIT COMMITTEES (THE SMITH GUIDANCE)

OCTOBER 2005

GUIDANCE ON AUDIT COMMITTEES (The Smith Guidance)

CONTENTS

Introduction	<i>Paragraph</i> 1.1-1.12
Establishment and role of the audit committee; membership, procedures and resources	2.1-2.20
- Establishment and role	2.1-2.2
- Membership and appointment	2.3-2.6
- Meetings of the audit committee	2.7-2.11
- Resources	2.12-2.15
- Remuneration	2.16
- Skills, experience and training	2.17-2.20
Relationship with the board	3.1-3.5
Role and responsibilities	4.1-4.38
- Financial reporting	4.1-4.4
- Internal financial controls and risk management systems	4.5-4.7
- Whistleblowing	4.8
- The internal audit process	4.9-4.15
- The external audit process	4.16-4.38
Communication with shareholders	5.1-5.3

AUDIT COMMITTEES - COMBINED CODE GUIDANCE

1. Introduction

- 1.1. This guidance is designed to assist company boards in making suitable arrangements for their audit committees, and to assist directors serving on audit committees in carrying out their role.
- 1.2. The paragraphs in bold are taken from the Combined Code (Section C3). Listed companies that do not comply with those provisions should include an explanation as to why they have not complied in the statement required by the Listing Rules.
- 1.3. Best practice requires that every board should consider in detail what arrangements for its audit committee are best suited for its particular circumstances. Audit committee arrangements need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company.
- 1.4. While all directors have a duty to act in the interests of the company the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.
- 1.5. Nothing in the guidance should be interpreted as a departure from the principle of the unitary board. All directors remain equally responsible for the company's affairs as a matter of law. The audit committee, like other committees to which particular responsibilities are delegated (such as the remuneration committee), remains a committee of the board. Any disagreement within the board, including disagreement between the audit committee's members and the rest of the board, should be resolved at board level.
- 1.6. The Code provides that a separate section of the annual report should describe the work of the committee. This deliberately puts the spotlight on the audit committee and gives it an authority that it might otherwise lack. This is not incompatible with the principle of the unitary board.
- 1.7. The guidance contains recommendations about the conduct of the audit committee's relationship with the board, with the executive management and with internal and external auditors. However, the most important features of this relationship cannot be drafted as guidance or put into a code of practice: a frank, open working relationship and a high level of mutual respect are essential, particularly between the audit committee chairman and the board chairman, the chief executive and the finance director. The audit committee must be prepared to take a robust stand, and all parties must be prepared to make information freely available to

the audit committee, to listen to their views and to talk through the issues openly.

- 1.8. In particular, the management is under an obligation to ensure the audit committee is kept properly informed, and should take the initiative in supplying information rather than waiting to be asked. The board should make it clear to all directors and staff that they must cooperate with the audit committee and provide it with any information it requires. In addition, executive board members will have regard to their common law duty to provide all directors, including those on the audit committee, with all the information they need to discharge their responsibilities as directors of the company.
- 1.9. Many of the core functions of audit committees set out in this guidance are expressed in terms of 'oversight', 'assessment' and 'review' of a particular function. It is not the duty of audit committees to carry out functions that properly belong to others, such as the company's management in the preparation of the financial statements or the auditors in the planning or conducting of audits. To do so could undermine the responsibility of management and auditors. Audit committees should, for example, satisfy themselves that there is a proper system and allocation of responsibilities for the day-to-day monitoring of financial controls but they should not seek to do the monitoring themselves.
- 1.10. However, the high-level oversight function may lead to detailed work. The audit committee must intervene if there are signs that something may be seriously amiss. For example, if the audit committee is uneasy about the explanations of management and auditors about a particular financial reporting policy decision, there may be no alternative but to grapple with the detail and perhaps to seek independent advice.
- 1.11. Under this guidance, audit committees have wide-ranging, time-consuming and sometimes intensive work to do. Companies need to make the necessary resources available. This includes suitable payment for the members of audit committees themselves. They – and particularly the audit committee chairman - bear a significant responsibility and they need to commit a significant extra amount of time to the job. Companies also need to make provision for induction and training for new audit committee members and continuing training as may be required.
- 1.12. This guidance applies to all companies to which the Code applies – i.e. UK listed companies. For groups, it will usually be necessary for the audit committee of the parent company to review issues that relate to particular subsidiaries or activities carried on by the group. Consequently, the board of a UK-listed parent company should ensure that there is adequate cooperation within the group (and with internal and external auditors of individual companies within the group) to enable the parent company audit committee to discharge its responsibilities effectively.

2 Establishment and role of the audit committee; membership, procedures and resources

Establishment and role

2.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members.

2.2 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, 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 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.

Membership and appointment

- 2.3 All members of the committee should 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.**
- 2.4 The chairman of the company should not be an audit committee member.
- 2.5 Appointments to the audit committee should be made by the board on the recommendation of the nomination committee (where there is one), in consultation with the audit committee chairman.
- 2.6 Appointments should be for a period of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.

Meetings of the audit committee

- 2.7 It is for the audit committee chairman, in consultation with the company secretary, to decide the frequency and timing of its meetings. There should be as many meetings as the audit committee's role and responsibilities require. It is recommended there should be not fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle¹. However, most audit committee chairmen will wish to call more frequent meetings.
- 2.8 No one other than the audit committee's chairman and members is entitled to be present at a meeting of the audit committee. It is for the audit committee to decide if non-members should attend for a particular meeting or a particular agenda item. It is to be expected that the external audit lead partner will be invited regularly to attend meetings as well as the finance director. Others may be invited to attend.
- 2.9 Sufficient time should be allowed to enable the audit committee to undertake as full a discussion as may be required. A sufficient interval should be allowed between audit committee meetings and main board meetings to allow any work arising from the audit committee meeting to be carried out and reported to the board as appropriate.
- 2.10 The audit committee should, at least annually, meet the external and internal auditors, without management, to discuss matters relating to its remit and any issues arising from the audit.

¹ For example, when the audit plans (internal and external) are available for review and when interim statements, preliminary announcements and the full annual report are near completion.

2.11 Formal meetings of the audit committee are the heart of its work. However, they will rarely be sufficient. It is expected that the audit committee chairman, and to a lesser extent the other members, will wish to keep in touch on a continuing basis with the key people involved in the company's governance, including the board chairman, the chief executive, the finance director, the external audit lead partner and the head of internal audit.

Resources

2.12 The audit committee should be provided with sufficient resources to undertake its duties.

2.13 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.

2.14 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.

2.15 The board should make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so.

Remuneration

2.16 In addition to the remuneration paid to all non-executive directors, each company should consider the further remuneration that should be paid to members of the audit committee to recompense them for the additional responsibilities of membership. 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 of their work to the company. The level of remuneration paid to the members of the audit committee should take into account the level of fees paid to other members of the board. The chairman's responsibilities and time demands will generally be heavier than the other members of the audit committee and this should be reflected in his or her remuneration.

Skills, experience and training

- 2.17 It is desirable that the committee member whom the board considers to have recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies. The need for a degree of financial literacy among the other members will vary according to the nature of the company, but experience of corporate financial matters will normally be required. The availability of appropriate financial expertise will be particularly important where the company's activities involve specialised financial activities.
- 2.18 The company should provide an induction programme for new audit committee members. This should cover the role of the audit committee, including its terms of reference and expected time commitment by members; and an overview of the company's business, identifying the main business and financial dynamics and risks. It could also include meeting some of the company staff.
- 2.19 Training should also be provided to members of the audit committee on an ongoing and timely basis and should include an understanding of the principles of and developments in financial reporting and related company law. In appropriate cases, it may also include, for example, understanding financial statements, applicable accounting standards and recommended practice; the regulatory framework for the company's business; the role of internal and external auditing and risk management.
- 2.20 The induction programme and ongoing training may take various forms, including attendance at formal courses and conferences, internal company talks and seminars, and briefings by external advisers.

3. Relationship with the board

- 3.1 The role of the audit committee is for the board to decide and to the extent that the audit committee undertakes tasks on behalf of the board, the results should be reported to, and considered by, the board. In doing so it should identify any matters in respect of which it considers that action or improvement is needed, and make recommendations as to the steps to be taken.
- 3.2 The terms of reference should be tailored to the particular circumstances of the company.
- 3.3 The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board.
- 3.4 The board should review the audit committee's effectiveness annually.

- 3.5 Where there is disagreement between the audit committee and the board, adequate time should be made available for discussion of the issue with a view to resolving the disagreement. Where any such disagreements cannot be resolved, the audit committee should have the right to report the issue to the shareholders as part of the report on its activities in the annual report.

4 Role and responsibilities

Financial reporting

- 4.1 The audit committee should review 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.
- 4.2 It is management's, not the audit committee's, responsibility to prepare complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations. However the audit committee 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 company 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.
- 4.3 Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting by the company, it shall report its views to the board.
- 4.4 The audit committee should 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 the Listing Rules) the audit committee should review such statements first.

Internal controls and risk management systems

- 4.5 The audit committee should review the company's internal financial controls (that is, the systems established to identify, assess, manage and monitor financial risks); and unless expressly addressed by a separate board risk committee comprised of independent directors or by the board itself, the company's internal control and risk management systems.
- 4.6 The company's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the board that it has done so. Except where the board or a risk committee is expressly responsible for reviewing the effectiveness of the internal control and risk management systems, the audit committee should receive reports from management on the effectiveness of the systems they have established and the conclusions of any testing carried out by internal and external auditors.
- 4.7 Except to the extent that this is expressly dealt with by the board or risk committee, the audit committee should review and approve the statements included in the annual report in relation to internal control and the management of risk.

Whistleblowing

- 4.8 **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.**

The internal audit process

- 4.9 **The audit committee should monitor and review the effectiveness of the company's internal audit function. 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.**
- 4.10 The need for an internal audit function will vary depending on company specific factors including the scale, diversity and complexity of the company's activities and the number of employees, as well as cost/benefit considerations. Senior management and the board may desire objective

assurance and advice on risk and control. An adequately resourced internal audit function (or its equivalent where, for example, a third party is contracted to perform some or all of the work concerned) may provide such assurance and advice. There may be other functions within the company that also provide assurance and advice covering specialist areas such as health and safety, regulatory and legal compliance and environmental issues.

- 4.11 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 company's activities, markets or other aspects of its external environment, that have increased, or are expected to increase, the risks faced by the company. 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.
- 4.12 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.
- 4.13 The audit committee should review and approve the internal audit function's remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary 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 auditors².
- 4.14 The audit committee should approve the appointment or termination of appointment of the head of internal audit.
- 4.15 In its review of the work of 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;

² Further guidance can be found in the Institute of Internal Auditors' Code of Ethics and the International Standards for the Professional Practice of Internal Auditing Standards.

- + 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; and
- + monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

The external audit process

4.16 The audit committee is the body responsible for overseeing the company's relations with the external auditor.

Appointment

4.17 **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 reappointment, a statement from the audit committee explaining its recommendation and should set out reasons why the board has taken a different position.**

4.18 The audit committee's recommendation to the board should be based on the assessments referred to below. If the audit committee recommends considering the selection of possible new appointees as external auditors, it should oversee the selection process.

4.19 The audit committee should assess annually the qualification, expertise and resources, and independence (see below) of the external auditors and the effectiveness of the audit process. 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.

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

Terms and Remuneration

- 4.21 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.
- 4.22 The audit committee should review and agree the engagement letter issued by the external auditor at the start of each audit, ensuring that it has been updated to reflect changes in circumstances arising since the previous year. The scope of the external audit should be reviewed by the audit committee with the auditor. If the audit committee is not satisfied as to its adequacy it should arrange for additional work to be undertaken.
- 4.23 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.

Independence, including the provision of non-audit services

- 4.24 The audit committee should have procedures to ensure the independence and objectivity of the external auditor annually, taking into consideration relevant UK professional and regulatory requirements. This assessment should involve a consideration of all relationships between the company and the audit firm (including the provision of non-audit services). The audit committee should consider whether, taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor's judgement or independence.
- 4.25 The audit committee should seek reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the company (other than in the normal course of business). The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.
- 4.26 The audit committee should agree with the board the company's policy for the employment of former employees of the external auditor, paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. This should be drafted taking into account the relevant ethical guidelines governing the accounting profession. The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the company, and consider whether in the light of this there has been any impairment,

or appearance of impairment, of the auditor's judgement or independence in respect of the audit.

- 4.27 The audit committee should monitor the external audit firm's compliance with applicable United Kingdom ethical guidance relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, office and partner, and other related regulatory requirements.
- 4.28 The audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In this context, the audit committee should consider:
- + whether the skills and experience of the audit firm make it a suitable supplier of the non audit service;
 - + whether there are safeguards in place to ensure that there is no threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor;
 - + the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee; and
 - + the criteria which govern the compensation of the individuals performing the audit.
- 4.29 The audit committee should set and apply a formal policy specifying the types of non-audit work:

- + from which the external auditors are excluded;
- + for which the external auditors can be engaged without referral to the audit committee; and
- + for which a case-by-case decision is necessary.

In addition, the policy may set fee limits generally or for particular classes of work.

- 4.30 In the third category, if it is not practicable to give approval to individual items in advance, it may be appropriate to give a general pre-approval for certain classes for work, subject to a fee limit determined by the audit committee and ratified by the board. The subsequent provision of any service by the auditor should be ratified at the next meeting of the audit committee.
- 4.31 In determining the policy, the audit committee should take into account relevant ethical guidance regarding the provision of non-audit services by

the external audit firm, and in principle should not agree to the auditor providing a service if, having regard to the ethical guidance, the result is that:

- + the external auditor audits its own firm's work;
- + the external auditor makes management decisions for the company;
- + a mutuality of interest is created; or
- + the external auditor is put in the role of advocate for the company.

The audit committee should satisfy itself that any safeguards required by ethical guidance are implemented.

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

Annual audit cycle

- 4.33 At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit.
- 4.34 The audit committee should consider whether the auditor's 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.
- 4.35 The audit committee should review, with the external auditors, the findings of their work. 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.
- 4.36 The audit committee should also review the audit representation letters before signature by management and give particular consideration to matters where representation has been requested that relate to non-standard issues³. The audit committee should consider whether the

³ Further guidance can be found in the Auditing Practices Board's Statement of Auditing Standard 440 "Management Representations".

information provided is complete and appropriate based on its own knowledge.

4.37 As part of the ongoing monitoring process, the audit committee should review the management letter (or equivalent). The audit committee should review and monitor management's responsiveness to the external auditor's findings and recommendations.

4.38 At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process. In the course of doing so, the audit committee should:

- + review whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
- + consider 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, and in their commentary where appropriate on the systems of internal control;
- + obtain feedback about the conduct of the audit from key people involved, e.g. the finance director and the head of internal audit; and
- + review and monitor 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 establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.

5 Communication with shareholders

5.1 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 in the annual report should describe the work of the committee in discharging those responsibilities.

5.2 The audit committee section should include, inter alia:

- + a summary of the role of the audit committee;
- + the names and qualifications of all members of the audit committee during the period;
- + the number of audit committee meetings;
- + a report on the way the audit committee has discharged its responsibilities; and
- + the explanation provided for in paragraph 4.29 above.



FINANCIAL REPORTING COUNCIL

5TH FLOOR

ALDWYCH HOUSE

71-91 ALDWYCH

LONDON WC2B 4HN

TEL: +44 (0)20 7492 2300

FAX: +44 (0)20 7492 2301

WEBSITE: www.frc.org.uk