Institutional Position Paper:

A Benchmark for Audit Committees

(November 2002)

Introduction

There is a clear view amongst the investment community that companies, which are well governed and operate in a responsible and sustainable way, should have the culture and transparent mechanisms in place to support their long-term health and shareholder value. Good corporate governance practices establish the frameworks that facilitate both this and the agency relationship that exists between shareholders and a company's management.

Within the above context, this paper has been developed by investors to set out a clear and practical Benchmark for Audit Committees of companies quoted in the UK.

Objectives

This Position Paper and Benchmark have been prepared for use in -

1. Assisting a quoted company (and its Audit Committee) in:

    - developing and structuring the arrangements for and the role and responsibilities of the Audit Committee in a way that will enable it to offer a meaningful and effective contribution to the governance of the quoted company and investor protection; and
    - make the types of disclosure necessary to offer comfort to investors on the policies and practices that are in place.

2. Providing an institutional investor with a Benchmark:

    - against which it can asses the quality and nature of company disclosures; and
    - to help inform and support dialogue with companies on the general nature and scope of arrangements in place or when an issue of concern arises.

The Unitary Board

The assumption underlying this Benchmark is that the unitary board can and should remain a company's core governance body. Final oversight and ultimate responsibility for many of the areas that this Benchmark touches upon, resides with the Board of Directors. Whilst the Benchmark also places particular emphasis on the importance of independence, it does not undermine that model:

- Differentiation between the roles and responsibilities of individuals is already well recognised (e.g. chairman of the board, chief executive, finance director).

- In much the same way that an executive committee operates in support of a board of directors without undermining its unitary nature, so too can an effective Audit Committee.

Non-executive Directors

It is implicit in this Benchmark that non-executive directors should be expected to commit the time necessary to carry out their roles in a meaningful way. This is particularly true in respect of the responsibilities encapsulated herein.

Real change is required in this area and it is recognised that the arrangements and terms associated with such an enhanced role (e.g. the enhanced commitment and responsibilities envisaged in this Benchmark) will need to change. However, those changes must be based on that enhancement of the role.

Practical variations and flexibility

Purely as a practical matter, this is an area that must allow for some flexibility, on a considered basis. This is consistent with the wider and well established UK approach to corporate governance.

Application of this Benchmark will involve some variation in practice, depending on:

- the context in which it must apply[1];
- the size and structure of a business[2]; or
- the nature of its business[3].

However, with flexibility must come transparency. The issues and principles underlying this Benchmark are relevant and applicable to all companies, regardless of size, structure or nature.

Limitation

This Benchmark is not intended to be all encompassing and, in making use of it, Audit Committee members and other readers should seek to embrace its objectives and work in its spirit. It should be taken to complement rather than replace other valuable guidance[4], offering a particular focus on the role and arrangements of the Audit Committee itself.

Next Steps

This paper and the Benchmark it contains are now being submitted to the industry's representative bodies, with the request that they look to take it forward within the wider framework of the industry's 'best practice' guidelines.

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[1] : Practical considerations may lead a small company to consider the use of an independent (ex-officio) technical expert to supplement and support its non-executive directors on the Audit Committee.
[2] : The requirements for a large multinational conglomerate will differ from those for a smaller local business, which will differ from those for an investment trust company.
[3] : Some difference would naturally be expected between the arrangements required for a regulated financial organisation compared, say, to a manufacturing company.
[4] : e.g. *'Internal Control – Guidance for Directors on the Combined Code'* (1999), published by the Turnbull working party under the auspices of the Institute of Chartered Accountants in England and Wales (ICAEW)

The Audit Committee Benchmark

For the purposes of this Benchmark:

- *Any reference to a 'company' should be taken to include any other member of its Group / subsidiary undertakings.*
- *Reference to 'Audit Committees' should be taken to mean the quoted company's own Audit Committee. Arrangements for subsidiary company Audit Committees should structured to complement and support a group's overall approach, as part of a sound system of internal control.*
- *Any reference to an 'external auditor' or audit firm should be taken to include any affiliated or associated undertaking, including any member of a formal network or alliance.*
- *References to 'Non-audit work' should be taken to mean work other than the statutory audit, which the audit firm (or in a general sense, the large accountancy firms) are either to be considered for or undertake. (Outside of this reference should be made to Section I.)*

A. Oversight by the Board

The Board of Directors should ensure that:

A.1 The Audit Committee has written terms of reference which are agreed with the Board and published.

A.2 The Audit Committee reviews and recommends any necessary changes to the terms of reference, to the Board.

A.3 Clear arrangements are in place for the Audit Committee to receive information and papers in a timely manner (e.g. one week before meetings), to enable full and proper consideration to be given to the issues at hand.

A.4 It reviews the Audit Committee's policy, practice and performance on an annual basis, using independent advisers where appropriate[5], following on from the production of the Audit Committee's annual report.

A.5 Its policy on conflicts of interest addresses matters relevant to the Audit Committee and its members.

A.6 Arrangements are in place to ensure that funds are readily available to the Audit Committee to enable them to appoint advisers freely.

B. Audit Committee Structure

Audit Committees should:

B.1 Be made up of solely of non-executive directors, who should be independent[6] of management[7].

B.2 Have their members appointed by the board as a whole on the recommendation, where appropriate, of the Audit Committee chairman.

B.3 Not have an automatic or standing right of attendance for executives or other staff, who should only attend meetings on the specific invitation of the Audit Committee.

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[5] : Ensuring Audit Committee members receive and undertake appropriate training should form part of the Committee's review and of the performance review of each individual as a director.

[6] : Relevant investor guideline is contained in "Responsible Voting, A Joint ABI - NAPF Statement" (1999)

[7] : An important consideration should be the ability to add value, e.g. this should not be taken to automatically exclude a non-executive Chairman from membership (although ideally not as chairman of the committee).

C. Training and expertise

Audit Committee members should:

C.1 Include at least one person with appropriate financial qualifications (e.g. a qualified member of one of professional accountancy bodies of the CCAB[8]).

C.2 All undergo appropriate training that provides and maintains a reasonable degree of up-to-date financial literacy that enables them to carry out their duties, including but not limited to introductions to and/or updates on:

(i) Reading financial statements.
(ii) Matters that influence or distort the presentation of accounts and key figures.
(iii) Applicable accounting standards and recommended practice (e.g. FRS, SORPS or IAS).
(iv) Company financing.
(v) Relevant legislation, regulation and best practice, as well as their implications and changes to them (e.g. Tax, Listing Rules or OECD guidelines for multinational enterprises).
(vi) The role, nature and scope of the internal and external audits and of the relevant auditor's role and duties.
(vii) Key aspects of the company's approach and comparatives (e.g. accounting policies & practices, systems of internal control - incl. on non-financial risks - sector trends, treasury policy and other relevant policies[9]).

D. Operational arrangements

Audit Committees should have:

D.1 Sufficient meetings planned to enable them to carry out their role and responsibilities in a planned and substantive way, broadly covering:

(i) Results (interims, prelims and full annual results).
(ii) Internal controls.
(iii) Private meetings with the external auditors.
(iv) Other reviews outlined in this Benchmark.

D.2 Formal arrangements in place to hold regular meetings with the external auditors and others[10], without (other) executive or staff presence, to review key issues within their sphere of interest and responsibility[11].

D.3 An explicit right of unrestricted access to company documents and information[12], as well as employees of the company and any external auditor.

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8 : The CCAB includes: ACCA, CIMA, CIPFA, ICAEW, ICAI, ICAS.
9 : Incl. relevant SEE policies or the policies of the Audit Committee itself.
10 : e.g. other external advisers or internal staff incl. the internal auditors.
11 : In addition to the matters outlined in the Benchmark, Audit Committee members may wish to have regard to the questions suggested in Appendix G of the CIMA's Review of Auditor Independence (July 2002) – www.cimaglobal.com
12 : This should be subject to any steps/limitations required in relation to an individual member pursuant to the Board's procedures on the handling and management of conflicts of interest.

D.4 Published arrangements to receive and manage, in-confidence, complaints on accounting, risks issues, internal controls, auditing issues and related matters[13].

E. Audit Committee Advisers

Audit Committees should have:

E.1 An explicit authority to engage independent advisers where appropriate and as they determine necessary, to help them address any particular issues that arise in carrying out their role.
E.2 Explicit authority to commission special investigations, reviews or reports, as appropriate, on any matter within the scope of their responsibility.
E.3 The use of the Company Secretary on all Committee matters including, reporting to the Committee's chairman, provision of the necessary support and co-ordination for training.

F. Internal Auditors

Audit Committees should:

F.1 Have the internal audit function accountable jointly to it and the Chairman of the Board, with the head of internal audit having a direct reporting line and unfettered access to the Audit Committee Chairman.
F.2 Review at least annually the need to establish an internal audit function where one does not exist and make appropriate recommendations to the Board of Directors.
F.3 Be consulted on the appointment of the head of internal audit.
F.4 Agree the internal auditors' work-plans with the head of internal audit, in consultation with the Chairman of the Board and having consulted other relevant directors.
F.5 Ensure the operational framework in which the internal audit function operates and the resources available to it, are appropriate given its role, workplan and objectives.
F.6 Monitor and review the scope and results of internal audit work.

G. Appointment of External Auditors/Accounting firms

Audit Committees should:

G.1 Have responsibility for selecting and recommending to the Board, the external auditors to be put forward for appointment by the shareholders in general meeting.
G.2 Set and apply a formal policy specifying (and articulating the rationale for) types of non-audit work (i) from which the external auditors are excluded[14] and (ii) where the use of external auditors is deemed appropriate and particularly advantageous, in the context of the need

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13 : This might include arrangements to hold or enable the internal auditors to hold 'exit interviews' with departing/recently departed employees.
14 : For example, Auditors should not be engaged on activities where they might be expected to review/audit those activities or matters they had contributed to (a self-review conflict).

to maintain independence, given the expertise offered and on the basis of real cost effectiveness[15]:

(G.2) Non-audit work

Types of non-audit work that the policy should cover include, but are not limited to (in no particular order):

(i) Internal accounting or other internal financial services.
(ii) Defined audit-related work and related regulatory reporting.
(iii) Reporting Accountant services.
(iv) Design, development or implementation of financial information or internal control systems.
(v) Internal audit services or their outsourcing.
(vi) Compliance services (incl. on fraud and money laundering)
(vii) Forensic Accountant services
(viii) Transaction work (mergers/acquisitions/disposals/schemes of arrangement etc).
(ix) Valuation services.
(x) Fairness opinions and contribution-in-kind reports.
(xi) Actuarial services.
(xii) Personal tax services.
(xiii) Corporate tax services
(xiv) Executive or 'management' roles and functions.
(xv) Management consultancy.
(xvi) HR or recruitment services.
(xvii) Remuneration consultancy.
(xviii) IT consultancy.
(xix) Other financial services (e.g. broker, financial adviser or investment banking services).
(xx) Legal services and other professional services unrelated to the audit.

G.3 In the context of auditor independence, develop, agree with the full board of directors and apply a formal policy on the rigorous use of competitive tendering for other non-audit services.
G.4 Have specific responsibility for agreeing the fees for the work of external audit firms employed by the company[16].
G.5 Ensure appropriate rotation of the lead audit / co-ordinating / review partners, at least every 5 years.
G.6 Have a formal policy on reviewing the existing audit contract and the criteria and arrangements for re-tendering that contract.
G.7 Ensure both that fee levels are not a result of 'loss-leading' and that they will not lead to inadequate levels of service or assurance.

[15] : Audit Committees may wish to recommend to the Board 'exceptional arrangements' when a de-minimis issue or an extremely urgent need exists, an appointment may be approved jointly by the Group Finance Director and Chief Executive, in consultation with the Audit Committee Chairman. This should reported at the earliest opportunity to the Audit Committee with appropriate explanations.
[16] : See footnote 15.

H. Oversight of External Auditors/Accounting Firms

Audit Committees should:

H.1 Have the external auditors accountable jointly to it and the Chairman of the Board, with the audit partner having unfettered access to both the Chairman of the Board and the chairman of the Audit Committee.
H.2 Keep under review the arrangements for day to day management of the audit relationship and any issue that might effect or be perceived to affect an external auditor's independence,[17] seeking appropriate assurance that an external auditor's independence is being clearly maintained.
H.3 Review as appropriate the arrangements that are in place both internally and in any external audit firm to identify, report and manage any conflicts of interest in relation to the external audit.
H.4 Agree the external auditors' work-plans.
H.5 Monitor and review the scope and results of external audits and, where relevant, other work by an external audit/accounting firm employed by the company.
H.6 Receive all formal or key communications[18] between those firms and the company (e.g. Management letters and adjustments proposed by the external auditors).
H.7 Review annually with the external auditors each of the latter's areas of responsibility, associated duties and performance.
H.8 Where appropriate, review the context of or arrangements for turnover of other key external audit staff[19].
H.9 Be consulted before the appointment of anyone who has been employed by an external auditor of the company in the last 3 years, to a senior management or board position, reviewing the rationale, justification and implications and advise the Board/Nominations Committee as appropriate.
H.10 Carry out a review with any external auditor that resigns, which includes discussion of the reasons for that resignation and any associated issues and implications.

I. Other external company advisers

Where other advisers are appointed in areas that fall within or overlap with the scope of its responsibilities, an Audit Committee should, within reason[20]:

I.1 Be consulted on the appointment of those external advisers.[21]
I.2 Review the arrangements[22] and (where relevant) the work, proposals and outputs, as well as their implications.

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[17] : On the question of auditor independence, Audit Committee members might, amongst other things, refer to:
- the EU Commission Recommendation 'Statutory Auditor's Independence in the EU: A Set of Fundamental Principles' (May 2002) (2002/590/EC) *Official Journal L 191 , 19/07/2002 P. 0022 - 0057*
- the ICAEW's Statement 1.201 'Integrity, Objectivity and Independence' (www.icaew.co.uk)
- the ICAEW's Supplementary statement 'Additional Guidance on Independence for Auditors' (Oct 2002)
- CIMA's Review of Auditor Independence (July 2002) (www.cimaglobal.com)

[18] : This is intended to refer to matters of substance (i.e. opinions, advice, instructions etc) rather than general information flows.

[19] : e.g. it may be appropriate for a company seeing an unusual turnover of external audit staff or significant change in the level of experience in the audit team to consider the impact that may have on the level of service it is receiving.

[20] : Where for valid, practical reasons de-minimis arrangements are agreed by the Audit Committee, the arrangements need to include the subsequent reporting of appropriate details to the Committee.

[21] : Including, but not limited to: actuaries, credit rating agencies, brokers and investment bankers.

[22] : Including: terms, fees, conflicts of interest and issues of independence.

J. Internal controls

Audit Committees should:

J.1 Review and monitor the steps taken by the executive to implement the approach agreed by the Board to maintain a sound system of internal control across the group[23].

J.2 Ensure proper arrangements[24] are in place for and monitor the review of that system's effectiveness across the group[25].

J.3 Review with the internal and external auditors their work and reviews in the context of internal controls, business risks,[26] regulatory risks and general risk management.

J.4 Review the steps taken to ensure new products, operations and activities are integrated into the framework and philosophy on internal control.

K. Accounting policies, practices and trends

Audit Committees should:

K.1 Review the key accounting policies and practices used by the company[27], with the executive and with the external auditors (without executives present), in particular key areas of judgement or other matters which might distort or undermine the quality or clarity of disclosure – some examples might include:

(i) Treatment of goodwill and other intangibles.
(ii) Off-balance sheet transactions.
(iii) Non-cash consideration or swaps.
(iv) Other arrangements or practices that might be considered to be or have the effect of earnings management (e.g. treatment and timing of revenue and expense recording, disputed or unrealised transactions, one-off gains and losses, liability estimates, valuations).
(v) Complex financial instruments and derivatives.

K.2 Review with the external auditors the alternative treatments of financial information within the GAAP used / IAS that have been discussed with management.

K.3 Satisfy itself that the company's policies, practices and controls do not risk distorting or misrepresenting the company's financial position (i.e. focussing on their quality and implications, not merely their technical acceptability).

K.4 Review with the Finance Director and external auditors the rationale for and implications of differences between the approach adopted by the company and the norms used in the company's industry / sector.

K.5 Review the reasons for and effects of any proposed changes in accounting policies and practices with the external auditors, without executives present.

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23 : See the Combined Code and related Turnbull Guidance: 'Internal Control – Guidance for Directors on the Combined Code' (1999) (www.icaew.co.uk)
24 : Based on a proper 'needs assessment' and which reflect the company's risk profile.
25 : See footnote 23.
26 : Relevant non-financial risks extend to those associated with SEE and reputational risk.
27 : This should include consideration of their implications and effects.

K.6 Make a formal recommendation to the Board on any proposed change in accounting policy and practice.

K.7 Ensure that the information the company presents and its policies support a balanced, clear and understandable assessment of its position and prospects[28].

L. Audit Committee Reporting

Audit Committees should:

L.1 Raise issues of concern that arise out of their role and responsibilities with the Chairman of the Board and/or the full board of directors and both investigate them further with the executive and monitor them until they are satisfactorily resolved.

L.2 In addition to its regular ongoing reports and contributions to the board, prepare an annual report for the board - with a view to it being included in the Annual Report and Accounts - which should:

(i) set out the framework (incl. roles and responsibilities) or terms of reference within which the Audit Committee operates
(ii) outline the policies and practices that it applies and operates
(iii) outline any relevant matters or conclusions that raise significant issues or reflect steps that the Audit Committee has taken.

L.3 Have its chairman present at the AGM to answer questions on the report and matters within the scope of Audit Committee's responsibilities.

L.4 Ensure that either their report or the wider Report & Accounts provide reasonable / satisfactory information on audit and non-audit work (see attached illustrative example in the Appendix A):

(i) the levels of audit -vs- audit related -vs- non-audit fees.
(ii) their breakdown by type of work.
(iii) information on policy and practice.
(iv) information on the appointment and oversight of external audit and accounting firms.

M. The Board of Directors

Given the above, an Audit Committee member's role will entail a particular interest in the Board's:

M.1 Review of the reasons for and implications of problems, including but not limited to:

(i) Delays in financial reporting.
(ii) Profit warnings.
(iii) Trading statements
(iv) Qualifications in relation to the audit opinion.

M.2 Review of the assessment, assumptions and related implications that underpin a company's going concern statement.

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[28] : This should extend to non-financial disclosures, in particular the OFR.

M.3 Review of the position/levels/implications of the company's debt, including but not limited to:

(i) Borrowing authorities
(ii) Gearing.
(iii) Related risk.
(iv) Interest cover.
(v) Credit ratings.
(vi) Capital Adequacy.
(vii) Default provisions, covenants and guarantees.

M.4 Review of the reasons behind any significant change in a company's management / financial ratios and forecasts.

APPENDIX A

Illustrative Disclosure

1. Pending any move to establish a formal Audit Committee report equivalent to that on remuneration, the current narrative statement on application of the Combined Code principles relating to accountability and audit is seen as being of particular importance in this area. Companies need to approach it with that in mind.

2. In that context, companies need to ensure that sufficient disclosure includes a synopsis of policy and practice that applies in this area, covering key points from this Benchmark.

3. Balanced with and as part of that, the Notes to the Accounts need to include a breakdown of audit, audit related and non-audit fees by category of work[29], and other supporting information such as the proportion awarded through competitive tendering.

4. Clearly the balance struck between what appears in the Audit Committee report/narrative statement and what appears in the notes to the account may reasonably vary from case to case.

5. An outline 'note to the accounts' attached over the page is provided by way of illustration of some of the information that companies might include, pending the institution of a proper Audit Committee report.

[29] : Broad categories of non-audit work would include those listed in Section G.2 of the Benchmark.

Illustrative Note to the financial statements -- Auditors' remuneration

Years ended 31 March ($ million)

	2001 UK	2001 Total	2000 UK	2000 Total	1999 UK	1999 Total
Audit fees – [Name of auditor]:						
Group audit	x	x	x	x	x	x
Subsidiary audit	x	x	x	x	x	x
	-------	-------	-------	-------	-------	-------
	x	x	x	x	x	x
	====	====	====	====	====	====
Audit related fees– [Name of auditor]:						
Mandatory Regulatory Work	x	x	x	x	x	x
Half yearly report review	x	x	x	x	x	x
	-------	-------	-------	-------	-------	-------
	x	x	x	x	x	x
	====	====	====	====	====	====
Fees for other services – [name of auditor]:						
Acquisition work	x	x	x	x	x	x
Tax work	x	x	x	x	x	x
	-------	-------	-------	-------	-------	-------
	x	x	x	x	x	x
	====	====	====	====	====	====

An overview of the auditors appointment process – e.g.

- The audit fees payable to [Auditor] are reviewed by the Audit Committee in the context of other [global] companies for cost effectiveness. The committee sets the policy for awarding non-audit work to the auditors and reviews the nature, extent of such work and related fees, to ensure that independence is maintained. The fees disclosed above consolidate all payments made to [Auditors] by the company and its subsidiaries.
- A full competitive tender process is used for all awards of work exceeding £x (details provided below) and awards of non-audit work to [Auditor] are reviewed and approved by the audit committee.
- Where de-minimis issues or an extremely urgent need exists (details provided below), such an appointment may be approved jointly by the Group Finance Director and Chief Executive in consultation with the Audit Committee Chairman. Such instances are reported at the earliest opportunity to the Audit Committee.

Explanations of auditors use on types of non-statutory work – e.g.

- [Auditor] has selected to provide audit related work [outline its nature] in addition to its statutory audit duties where [note basis of appointment] or it is required by the relevant regulatory body.
- X% of work other than statutory audit work was awarded to [Auditor] on the basis of a competitive tender, in line with Audit Committee policy. This included [Xyz services]. These services are for a fixed term.
- Following review and approval of the Audit Committee [xyz services] were awarded other than by competitive tender, given the assessment of the expertise of [Auditor] relative to that of other potential service providers, the value for money offered and assurance that individually or cumulatively with any other factors the [auditor]'s independence did not risk being compromised.
- Exceptional cases arose in relation to [xyz services] and the appointment of [Auditor] was approved by Group Finance Director and Chief Executive in consultation with the Audit Committee chairman. The total value of work awarded in this way was £x.
- In aggregate non-statutory audit work totalling £x was awarded other than by competitive tender.

An explanation of fees in context – e.g.

- Fees to major firms of accountants other than [Auditor] for non-audit services amounted to £x (2000 £y and 1999 £z).