



# SHAPING THE IRISH AUDIT COMMITTEE AGENDA

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# Shaping the Irish Audit Committee Agenda

Effective leadership and corporate governance form essential elements in achieving business success. Expectations of stakeholders in the corporate governance process, including financial reporting, have never been higher, and the scrutiny by regulators and investors never more stringent. As a consequence, the role of the audit committee has rapidly increased in importance and expanded in scope. Today, audit committees are being asked to assume responsibilities well beyond their traditional duties - yet must not lose sight of the need to balance these new responsibilities with making effective contribution to a business's strategic thinking.

Recognising that effective corporate governance is the cornerstone of shareholder protection, initiatives by regulators and stakeholders to help shape and guide corporate governance practices have confirmed the audit committee's key role in corporate governance and oversight. The Companies (Auditing and Accounting) Act 2003, contains specific provisions which, when brought into effect, will delineate the duties expected of audit committees in both listed and larger private companies. For companies listed on the Irish and UK Stock Exchanges, the Financial Reporting Council's revised Combined Code on Corporate Governance and the related guidance for audit committees ('the Smith guidance') are already affecting practice, and contain recommendations designed to strengthen the effectiveness of audit committees, clarify and enhance their oversight roles, and enhance their accountability over the financial reporting process. The optimal framework for corporate governance is also under debate in the European Union, both in the revised 8th Directive and through the European

Corporate Governance Forum - though the extent of change that may ultimately result is uncertain. Expectations are also shaped by developments in the United States. Understanding the purpose and implications of current requirements and best practice is critical in evaluating the challenges facing audit committees and the direction in which corporate governance is heading.

With an increased emphasis on the role of the audit committee in corporate governance, audit committees need to maintain an active approach to assessing the value of their current work and what is needed to ensure they are ready for future challenges. We believe that the building blocks of an effective audit committee, from an effective agenda and committee structure to a keen awareness of current and emerging issues, are fundamental in fulfilling the audit committee's responsibilities. This publication identifies current and emerging issues that audit committees must be aware of, and react to, and describes audit committee practices that provide the support and structure necessary in fulfilling their terms of reference. We believe all audit committees can benefit from comparing their practices against the practices described in this publication in their effort to critique, tailor and improve their own practices.

In today's complex and evolving business environment, audit committees can contribute tremendously to confidence in business and the capital market as well as bringing significant benefits to individual companies. We hope this publication will help ensure that audit committees achieve their objectives and add value to the board of directors, the organisation and its stakeholders.

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## Introduction

The role of those responsible for corporate governance and the financial reporting process continues to face intense scrutiny by regulators, legislators, security analysts, institutional investors and the general public. Attention is being placed not only on the board of directors but also on those committees that have been delegated responsibility and accountability by the board. Audit committees are clearly viewed as a critical component of the overall corporate governance process - a position now recognised for the first time in Irish law by the inclusion of specific provisions relating to audit committees in the Companies (Auditing and Accounting) Act 2003 ('the 2003 Act'). Accordingly, many audit committees are examining the nature and extent of their oversight roles, members' qualifications and independence, and their interaction and involvement with the audit process.

Effective audit committees are supported by fundamental "building blocks" - an appropriate structure and foundation, reasonable and well-defined responsibilities, and an understanding of current and emerging issues. Only through carefully designed practices can an audit committee maximise its contribution to an organisation. Audit committees need to understand these building blocks and the specific practices that can be used in implementing governance activities. This publication describes such practices and provides a toolkit to assist committees in maximising current and future effectiveness.

The terms of reference for Irish audit committees will in future be shaped partly by the specific duties introduced by the 2003 Act, when brought into effect. Overall, these duties are broadly consistent with current best practice but as they are brought into effect,

boards and audit committees will need to ensure that the terms of reference adopted include all the matters mandated by statute. The new requirements are highlighted in this document and summarised in Appendix II.

But within this new legal framework, the terms adopted by each audit committee will also need to take into account the needs of the individual company - no one set of practices will fit all entities. Each committee should select a unique set of practices that is considered best in the circumstances. Audit committees should understand their responsibilities, and tailor their practices to fit their individual circumstances. Audit committees, however, should not avoid practices simply because they appear onerous - often those are the practices that may be most effective and should receive additional attention if warranted by the circumstances.

Audit committees have evolved from ad hoc committees with few defined responsibilities to what they are today: critical committees with growing responsibilities that are accountable to the board of directors, and ultimately to shareholders.

The Combined Code on Corporate Governance and the Smith guidance are designed to assist boards of listed companies in making suitable corporate governance arrangements. Smith provides best practice recommendations and guidance to assist directors serving on audit committees. Best practice requires that every board should consider in detail whether its audit committee arrangements are best suited for its particular circumstances. However, audit committee practices need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company.

Specific practices are not mandated by the Code. However, the Listing Rules of both the Irish Stock Exchange and the UK Listing Authority require companies to report on how they apply the 14 corporate governance principles and 21 supporting principles included in the Combined Code; and confirm the extent of their compliance with the 48 detailed Combined Code provisions and explain the rationale behind any non-compliance. The Smith guidance provides direction on how companies might apply and comply with the Combined Code provisions and principles relating to audit committees. The Combined Code recommendations relating to audit committees are set out in Appendix III. The Smith recommendations are referred to throughout this publication and, more specifically, in Appendix IV.

In addition, developments in the US have had an increasing effect in governance arrangements in Europe and elsewhere:

- The report by the U.S. Blue Ribbon Committee on *Improving the Effectiveness of Corporate Audit Committees* (the “Blue Ribbon Committee”), released in 1999, resulted in the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASDAQ) and the American Stock Exchange (AMEX) revising their listing requirements and mandating various audit committee practices. The recommendations also resulted in new regulations by the US Securities and Exchange Commission (SEC) regarding audit committee processes and reporting.
- The Sarbanes-Oxley Act of 2002 mandated sweeping corporate governance changes and new audit committee practices. As a result of the Act, the SEC issued new regulations pertaining to audit committees and the NYSE, NASDAQ and AMEX revised their listing requirements. In some cases, the NYSE requirements go beyond the SEC's requirements. A comparison of the Smith guidance and the relevant recommendations of the SEC and NYSE are set out in Appendix IV.

Within Europe, revision to the 8th Directive and other initiatives now under debate may also affect future governance structures.

From these developments, audit committees have evolved and improved, and leading practices have emerged and will continue to develop. Many audit committees are currently performing a number of these leading practices. We recognise that not all practices outlined in this publication will apply equally to all different entities - but all audit committees can benefit from comparing their practices against those described in this publication in an effort to maintain and develop the quality of their contribution to effective governance and public confidence in business.

Finally, it is vital to recognise that whilst this publication focuses on practices audit committee members can undertake to improve their effectiveness, audit committees also need the support of the board and management (and auditors). The board and management must be fully committed to build and maintain effective audit committees and to work with the committee to ensure it meets its objectives in a dynamic environment.

# AUDIT COMMITTEE RESPONSIBILITIES



## Audit Committee Responsibilities

The revised Combined Code<sup>1</sup> and the Smith guidance<sup>2</sup> require audit committees of listed companies to examine what they are doing and how they are doing it with a view to becoming more effective in discharging their very significant responsibilities. For Irish companies, the 2003 Act provides that public limited companies incorporated under the Companies Acts 1963 to 2003 must establish audit committees with terms of reference that include a substantial list of duties, noted throughout this publication and summarised in Appendix II. Private companies with turnover of over €50 million and assets of over €25 million must consider whether to establish equivalent committees. If they do not, or they vary the terms of reference, reason must be given in the directors' report. Consequently there is an additional need for existing audit committees to consider the adequacy of their terms of reference and procedures, whilst boards of companies that have not yet appointed audit committees need to assess the way in which their governance structures may need to change in the light of the 2003 Act's provisions. To aid in such an assessment, we highlight practices that, based on our experience, form the foundation for effective audit committees - from broad oversight responsibilities to committee composition. We emphasise that there are many ways of achieving good governance, and the following practices are some that audit committees may consider.

*Requirements of the Companies (Auditing and Accounting) Act 2003, are noted in the margins of this publication, identified by the shaded box.*

*The Smith report recommendations that parallel these leading practices have been abridged and included in the margins throughout the remaining sections of this publication in a clear box with shaded text.*

The most effective audit committees not only are critically aware of their responsibilities but also completely understand and embrace them, and recognise what is necessary to effectively fulfil them. The work of audit committees has been evolving in response to changes in the business environment and leading practices.

Every audit committee should assume three fundamental responsibilities:

- overseeing financial reporting;
- overseeing the process related to the company's financial risks and internal control; and
- overseeing internal and external audit processes.

<sup>1</sup> *The Combined Code on Corporate Governance (The Combined Code), Financial Reporting Council, July 2003*

<sup>2</sup> *Guidance on Audit Committees (The Smith report), Financial Reporting Council, July 2003*

## Overseeing Financial Reporting

The audit committee should monitor the financial integrity of the financial statements and any formal announcements relating to the company's financial performance.

*The audit committee should review the annual financial statements prior to their consideration by the board.*

As part of this review, the audit committee should ensure they are made aware of accounting policy or disclosure issues and that this information is communicated to them early enough to enable appropriate action to be taken as needed. The audit committee should enquire of management and/or the auditors regarding recommended audit adjustments and disclosure changes, those made by management and those not made by management; the accounting principles and critical accounting policies adopted by management; unusual transactions; and accounting provisions and estimates included in the financial statements. A thorough understanding of all of these factors is integral to the committee's ability to meet its oversight responsibilities.

*The audit committee should review the significant financial reporting issues and judgments made in connection with the preparation of the financial statements, interim reports, preliminary announcements and related formal statements.*

Recent instances of high-profile irregularities has intensified both regulators' and the investing public's interest in the propriety of a company's financial reporting. In an environment where missing analysts' expectations by a small amount can lead to significant decreases in share price, market capitalisation and overall investor confidence, this focus is hardly surprising. As a result, audit committees would be prudent to sharpen their focus on current and emerging issues and respond accordingly. Understanding the company's financial statements is therefore crucial for audit committee members. In general, audit committees should assume the following responsibilities:

- understand management's responsibilities and representations;
- understand and assess the appropriateness of management's selection of accounting principles and the most critical accounting policies;
- understand management's judgments and accounting estimates applied in financial reporting;
- understand the communications received from the external auditors concerning their responsibilities under generally accepted auditing standards;
- confer with both management and the external auditors about the statements;
- assess whether financial statements are complete and fairly presented and that disclosures are clear and transparent; and
- review earnings releases, financial statements, and other information presented with the financial statements, prior to release.

*The audit committee should assess whether the financial statements comply with relevant accounting standards and give a true and fair view, and should recommend whether the board should approve the statements.*

*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 judgments.*

*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, whenever practicable, the audit committee should review such statements first.*

Smith's report recommends that the audit committee's oversight role be extended beyond the financial statements and related information (e.g., the operating and financial review, and corporate governance statements relating to the audit and to risk management), to include, where practicable, the review of other statements containing financial information and requiring board approval (e.g., significant financial returns to regulators, release of price sensitive information and summary financial statements). Often it will not be practicable for an audit committee to review such statements before board approval. Where this is the case, the audit committee should satisfy itself that adequate control processes are in place.

It is management's, not the audit committee's nor the auditors', 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 needs to assure itself that the external auditors are satisfied that the accounting estimates and judgments made by management, and management's selection of accounting principles, reflect an appropriate application of Generally Accepted Accounting Practice (GAAP). As companies convert to international accounting standards, this will require developing an understanding of the requirements of International Financial Reporting Standards and their application in the EU<sup>3</sup>. The appropriateness, including the degree to which management bias, if any, is evident, of the company's accounting principles and underlying estimates and the transparency of the financial disclosures in reflecting financial performance would be at the core of discussions between the audit committee and external auditor. The committee should be interested in discussing and understanding the auditors' views on accounting issues, and should actively seek to develop a relationship with the external auditor that allows a full, frank and timely discussion of all material issues.

### Oversight of financial reporting - relevant communications from external auditors

International Statement on Auditing (UK and Ireland) 260 *Communication of audit matters to those charged with governance* (ISA (UK and Ireland) 260) formalises auditors' communication with those charged with governance in respect of the financial reporting process - for listed companies, this will usually be the audit committee. *Inter alia* ISA (UK and Ireland) 260 requires auditors to communicate:

- expected modifications to the auditors' report;
- uncorrected misstatements (the ISA also requires the auditor to seek written representation concerning reasons for not correcting misstatements);
- material weaknesses in internal control identified during the audit;
- their views about qualitative aspects of the entity's accounting practices and financial reporting;
- matters specifically required by other Auditing Standards to be communicated; and
- any other audit matters of governance interest.

During the year, the external auditor's review of interim financial information can be a valuable resource to the audit committee as the committee fulfils its oversight responsibility for financial reporting. Further recommendations on the relationship between the audit committee and the external auditor are set out later in this chapter.

<sup>3</sup> EC Regulation 1606/2002 requires listed companies to prepare financial statements in accordance with international financial reporting standards as adopted for use in the EU.

## Overseeing the Process Related to the Company's Financial Risks and Internal Control

The audit committee is the overall guardian of financial integrity for the shareholders. Audit committee members must be critically aware of their oversight responsibilities, and must completely understand them. How the responsibilities are carried out may vary, but a failure to address them may have consequences for the audit committee, the board and the shareholders.

### Overseeing the process related to the company's financial risks

Risk management involves identifying risks that may prevent a company from achieving its objectives, analysing those risks, avoiding certain risks, and managing the risks that remain. The board of directors is ultimately responsible for the risk management system and for reviewing its effectiveness. 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.

The process related to identifying and managing the company's risks, as a part of the company's overall control environment, influences the identification and management of financial risks that can affect the company's financial reporting - a matter of critical importance to the audit committee.

*The audit committee should review the company's internal financial controls (that is, the systems established to identify, assess, manage and monitor financial risks).*

The audit committee, as a committee appointed by the board of directors, is responsible for assisting the board in fulfilling its oversight responsibilities. In particular, the audit committee's primary duties and responsibilities are to monitor the management of the principal risks that could impact the financial reporting process of the company, monitor the integrity of the system of internal controls regarding financial reporting and accounting compliance, and oversee the internal and external audit process.

In addition to their direct oversight responsibilities for risks affecting financial reporting, audit committees are sometimes asked by the board to examine objectively the degree to which management has assumed "ownership" for overall risk management, the appropriateness of the risk management strategy and process adopted in addressing this responsibility, and the adequacy and effectiveness of systems to support the process.

By asking probing questions about risk management, the audit committee can help bring clarity to the process used to manage risk and the assignment of accountabilities to monitor and react to changes in the organisation's risk profile.

Appendix I: Exhibit 8 contains a number of high-level questions the audit committee may like to consider in framing discussions with management.

*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. financial risks).*

*The audit committee should assess, at least annually, whether proper books of account have been kept in accordance with section 202 of the Companies Act 1990.*

## Overseeing internal control

An effective control environment needs more than good controls; it needs competent oversight. Management, internal auditors, external auditors and the audit committee each have roles in ensuring an effective control environment exists.

The audit committee is responsible for overseeing the financial reporting process, including the risks and controls in that process. Internal control, however, encompasses not only financial reporting but also compliance with laws and regulations and operational control. The board is responsible for the overall risks and controls of the company and, therefore, has the discretion to give the audit committee responsibility for oversight of compliance with laws and regulations and operational controls. Indeed, the Smith report suggests that the audit committee should review the wider aspects of internal control and risk management systems unless expressly addressed by the board or a separate risk committee comprised of independent directors<sup>4</sup>. Furthermore, except to the extent that this is expressly dealt with by the board or risk committee, the audit committee should review and approve any statements included in the annual report in relation to internal control and the management of risk.

Whilst the duties set out in the 2003 Act do not refer to risk management and internal controls, the Act adds a specific requirement for audit committees to assess 'at least annually' the adequacy of the company's arrangements for maintaining accounting records in the light of statutory provisions relating to books of account, set out in section 202 of the Companies Act, 1990. Committees may therefore wish to widen reports obtained from management and internal audit to include formal consideration of each of the section's specific requirements.

There is a tension in this area between the role of the audit committee as articulated in the Smith report and the guidance *Internal Control: Guidance for directors on the Combined Code* ('the Turnbull guidance') which expressly states that "reviewing the effectiveness of internal control is an essential part of the board's responsibilities" and that "the board takes responsibility for the disclosures on internal control in the annual report and accounts." Turnbull does not preclude the audit committee from carrying aspects of the board's review work: however, the results of the committee's work should be reported to, and considered by, the board prior to the board reaching its own conclusions.

The Turnbull guidance goes on to clarify the role of board committees in the review process. It states that the role of such committees, including the audit committee, "is for the board to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the significant risks that the company faces." It is imperative that audit committees ensure they understand any responsibilities they have for internal controls beyond those related to financial reporting.

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<sup>4</sup>*It should be noted that the Smith report refers to risk committees comprised solely of independent directors not, as is more common among listed companies in Ireland and the UK, executive risk committees. While management clearly have the major role in the risk management framework, it is not an oversight role. This should properly be carried out by the board as a whole (or a committee comprised of independent directors if the board delegates its obligations under the Smith report).*

Management is responsible for designing and implementing an effective system of internal control. The audit committee must determine that management has implemented policies that ensure the company's risks around financial reporting (and, where applicable, the wider sphere of business risk) are identified and that controls are adequate, in place, and functioning properly. As part of its assessment, the audit committee should consider requesting from management an overview of the risks, policies, procedures, and controls surrounding the integrity of financial reporting. However, the committee should strive to ensure that the information it receives is manageable - it should not be so voluminous as to deter a proper understanding of the key risks. It is more important that the audit committee gains meaningful insight into the key sources of risk and how such risks are managed, and responds with pertinent challenge than be presented with a substantial, albeit complete, register of all the risks facing the business.

A key question the audit committee can ask is *"what changes have there been and why?"* Within a competitive market place, a business has to accept more risk, or at least adjust the range and degree of risk within the business (i.e., the risk portfolio) to merely stand still!

An example risk summary and register focused on a small number of key risks is included in Appendix I: Exhibit 14. Such a summary is designed to give audit committee members a quick insight into the key risks and the effectiveness of the controls in place.

The audit committee should supplement representations received from management with further information and assurance from the internal and external auditors.

The integrity and attitude of senior management and the board of directors, including its committees (referred to as the "tone at the top") is the most important factor contributing to the integrity of internal controls, including those surrounding the financial reporting process. The "tone at the top" becomes the cultural core of the company and a model of appropriate conduct for every level. The committee should annually evaluate whether management is setting, documenting and communicating the appropriate tone. To facilitate the review, the committee should consider requesting updates and briefings from management and others on how compliance with ethical policies and other relevant company procedures is being achieved.

*Audit committees should review the company's annual compliance statement and assess whether it based on due and careful enquiry and is fair and reasonable.*

*The committee should also recommend to the board whether to approve the statement.*

## Compliance with relevant obligations

In addition to factors affecting control over the financial reporting process, the 2003 Act introduces a requirement for audit committees to review the directors' annual statement concerning compliance with relevant obligations<sup>5</sup>.

As the duty is set out in the 2003 Act, a rigorous assessment is implied of the way that the board proposes to support the required conclusion as to whether the directors consider that they have made all reasonable endeavours to secure compliance. Inevitably, this is likely to involve the committee considering whether sufficient steps have been taken to identify relevant obligations and then monitor procedures in place, or introduce additional procedures, to meet them.

In the financial sector, the Financial Regulator also has power under the Central Bank and Financial Services Authority of Ireland Act 2004 to require additional compliance statements on specified matters. The Financial Regulator is expected to publish proposals for implementation of this provision during 2005.

## Whistle blowing

Audit committee members are not involved in the day-to-day management of the company and therefore will not be close enough on an on-going basis to the detail on matters related to fraud and unethical activities. The audit committee can, however, usefully focus attention on the need for proper policies and procedures to help prevent fraud and unethical activities.

The audit committee's objective should be to ensure that appropriate arrangements are in place for the proportionate and independent investigation of concerns about possible improprieties and that appropriate follow-up action is taken - an oversight role.

The audit committee's role in relation to fraud and whistle blowing is discussed further on page 39.

*The audit committee should review arrangements by which staff may raise concerns about possible improprieties in matters of financial reporting or other matters.*

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<sup>5</sup>Introduced by section 45 of the 2003 Act. Two statements are required: a statement of policies relating to compliance with relevant obligations and an annual statement focussing on the adequacy of the company's procedures to secure compliance during the relevant year. "Relevant obligations" consist of company law, tax law, and other enactments that may have a material effect on the company's financial statements. At the time of going to print, the nature of the new obligations introduced by section 45 had been referred to the Company Law Review Group for review.

## Overseeing the Internal and External Audit Processes

Under both the 2003 Act and the Combined Code, audit committees need to address issues relating to the quality of internal and external audit.

### Internal auditors' oversight

*Audit committees should assess the suitability of arrangements for internal audit and of the resources available to it.*

*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 such a function.*

*When reviewing the internal audit function's remit, the audit committee should have regard to the complementary roles of the internal and external audit functions.*

Companies often need to weigh the benefits and costs of internal control considerations. One such decision often relates to the need or desirability of having an internal audit function. Internal audit functions, designed and deployed effectively, can have a very positive impact on the control environment of a company and the effective design and operation of internal controls.

As an important aspect of its mandate, internal audit can provide the audit committee with a means of monitoring whether the controls management has put in place are reliable, functioning properly and sufficient to address the risks in the financial reporting process. Accordingly, the audit committee should review the need for an internal audit function, and where such a function exists, its effectiveness.

If a company has an internal audit function, both the internal audit department and the external audit firm execute a company's audit coverage. While each has its own unique responsibilities, the audit committee should ensure that they complement each other, that their audit effort is coordinated and that there is effective communication between them. The external auditor is responsible for auditing and attesting to the company's financial statements; the internal auditor, inter alia, for monitoring the performance of a company's internal controls. The external auditor should identify the internal audit activities that are relevant to planning the external audit.

Where an internal audit function exists, the audit committee should participate in the appointment, promotion, or dismissal of the head of internal audit, and help determine his or her qualifications, reporting hierarchy - to ensure access to all necessary contacts both at the board level and within the organisation - and compensation.

*The audit committee should approve the appointment or termination of appointment of the head of internal audit.*

The audit committee should be involved in developing and approving the internal audit department's mandate, goals and mission to be certain of its proper role in the oversight function. A collaborative effort with both management and internal audit in the development of the internal audit mandate often helps ensure a proper balance between the assessment of internal controls related to financial reporting and other special projects, operational efficiency and risk management responsibilities. A specimen internal audit plan is included in Appendix I: Exhibit 13.

The audit committee should also be satisfied that the internal audit function has adequate resources. The committee should stay up to date on the scope and results of the department's operations and management's responses to the department's recommendations on internal controls and compliance. The department's objectivity and independence of judgment should be periodically evaluated. The committee should monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system and, in particular, ensure that the internal audit department's involvement in the financial reporting process is appropriate.

Self-assessment by the head of internal audit is an effective assessment tool, but it should not be the sole means by which the effectiveness of the internal audit function is reviewed. The committee should draw its own conclusions based on its experience of and contact with the internal audit function. Appendix I: Exhibit 6 provides a framework which audit committees can adopt when reviewing the effectiveness of the internal audit function.

*The audit committee should ensure that the internal audit 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.*

In monitoring the work of the internal audit function, the audit committee should review and assess the annual internal audit work plan; receive a report on the results of the internal auditors' work on a periodic basis; and review and monitor management's responsiveness to the internal auditors' findings and recommendations.

Recognising the important role of internal audit and its changing activities in today's business environment, the audit committee should also consider the following as it oversees the internal audit function:

- *How does the internal audit department best add value to the business model?*
- *How effectively does the company use the internal audit department to evaluate management's response to its strategic, financial, technological, security, and operational risks?*
- *Should the internal audit department be driving process improvements and best practices sharing? Is it?*
- *Is internal audit a training ground for future leaders?*
- *Does the internal audit department have the resources and appropriate expertise to satisfy its responsibilities?*
- *Would the company's objectives for the internal audit function be better served or supplemented through the use of a third-party service provider?*

*The audit committee should ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee.*

The internal auditor is in the unique position of being employed by management yet expected to review its conduct. The audit committee should have mechanisms in place to facilitate confidential exchanges with the internal auditor, with regular meetings scheduled between the audit committee and the internal auditor.

Today's internal audit functions generally apply a risk-based methodology, and have access to the specialised skills necessary to deal with complex treasury, technology and operational strategies being employed by the company.

## External auditors' oversight

First and foremost, the external auditor and audit committee should have a strong and candid relationship - anything less may limit the committee's effectiveness in achieving its oversight responsibilities. The audit committee should ensure that the external auditors are accountable to the audit committee - and through them, to the board of directors and ultimately the company's members. The audit committee should ensure its actions and communications with the external auditor are consistent with this accountability. The audit committee should also ensure that they communicate their expectations to the external auditor, and that both parties understand and have agreed to those expectations.

*Audit committees should advise the board on the recommendation to be made to shareholders concerning appointment of an auditor.*

### ***Appointment, reappointment and removal***

Making recommendations to the board on the appointment, reappointment and removal of the external auditors is an important audit committee responsibility. The audit committee's recommendation to the board should be based on its assessment of the qualification, expertise and resources, and independence 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. If the audit committee recommends considering the selection of possible new appointees as external auditors, it should oversee the selection process.

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

The audit committee should approve the terms of engagement and recommend the remuneration to be paid to the external auditor in respect of audit services provided. In doing so, it should satisfy itself that the level of fee payable in respect of the external audit is appropriate and that an effective audit can be conducted for such a fee.

In the unlikely event that the board does not accept the audit committee's recommendation regarding the appointment/reappointment of the auditor, compliance with the Combined Code requires it to include in the annual report, and in any papers recommending the appointment or reappointment of the auditor, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different position.

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

*The audit committee should monitor the auditor's independence from the company, obtaining up-to-date information for this purpose and making recommendations as to whether contracts for non-audit work should be granted to the auditor or an affiliate of the auditor.*

*The audit committee should have procedures to ensure the independence and objectivity of the external auditor and should seek reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the company.*

### **Independence**

The audit committee should consider the auditor's independence and annually carry out procedures to ensure the independence and objectivity of the external auditor, taking into consideration relevant professional and regulatory requirements. For their part, all auditing firms should have internal policies and procedures in place and properly monitored to ensure that the audit firm and its individual members are independent from the company.

In considering matters that may bear on the auditor's independence, both the auditor and the audit committee should consider whether conflicts exist, such as the auditor holding a financial interest, either directly or indirectly, in the company; personal and business relationships of the auditors' immediate family, close relatives and partners with the company; economic dependence by the auditor through its relationship with the company; and the nature and extent of services provided by the auditor in addition to the audit engagement. Each year the audit committee should seek from the audit firm, 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.

### **Independence - relevant communications from external auditors**

International Standard on Auditing (UK and Ireland) 260 *Communication of audit matters to those charged with governance* (ISA (UK and Ireland) 260) and APB Ethical Standard 1 *Integrity, Objectivity and Independence* require that the audit engagement partner ensures those charged with governance are appropriately informed on a timely basis of all significant matters that bear upon the auditor's objectivity and independence. Such communications will generally include the key elements of the partner's assessment of independence, including:

- the principal threats, if any, to objectivity and independence, together with the safeguards adopted and the overall assessment of threats and safeguards;
- any independent partner review;
- information about the firm's general policies and processes for maintaining objectivity and independence.

In the case of listed companies, the auditor at a minimum:

- a) discloses in writing to the audit committee, and discusses as appropriate:
  - all relationships between the audit firm and its related entities and the client entity and its related entities that may reasonably be thought to bear on the firm's independence and the objectivity of the audit engagement partner and the audit staff, and related safeguards that are in place;
  - fees paid to the auditor, analysed into appropriate categories;
- b) confirms in writing to the audit committee that the auditor complies with APB Ethical Standards and that, in the auditor's professional judgment, the auditor is independent and the auditor's objectivity is not compromised; and
- c) seeks to discuss these matters with the audit committee.

The audit committee should agree with the board a policy for the employment of former employees of the external auditor, taking into account the relevant ethical guidelines governing the accounting profession. Particular attention should be paid to those individuals who were part of the audit team and moved directly to the company. 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 judgment or independence. Appendix I: Exhibit 11 contains an example policy on the employment of former employees of the external auditor.

The audit committee should also monitor the external auditor's compliance with the APB Ethical Standards and ethical guidance issued by the Institute of Chartered Accountants in Ireland 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; the provision of non-audit services; and other related regulatory requirements.

*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.*

To ensure that non-audit services provided by the auditor do not impair, or appear to impair, the auditor's independence or objectivity, the audit committee should develop, and recommend to the board, a policy in relation to the provision of non-audit services. In determining the policy, the audit committee should consider the skills and experience of the audit firm; the potential threats to the auditor's independence and objectivity; and any controls put in place by the auditor to mitigate such threats.

In principle, the audit committee should not agree to the auditor providing a service if the result is that:

- the auditor has a financial or other interest which might cause them to be reluctant to take actions that would be adverse to the interests of the audit firm (**self interest**);
- the results of the non-audit service performed by the auditor may be included in the accounts, and thus not subject to proper review (**self review**);
- the auditor undertakes work that involves making judgments and taking decisions which are the responsibility of management (**management**);
- the auditor undertakes work that involves acting as advocate for the company (**advocacy**);
- the auditor is predisposed to accept or not sufficiently question the company's point of view (**familiarity**);
- the auditors' conduct may be influenced by fear or threats (**intimidation**).

*Audit committees should consider:*

- *whether the skills and experience of the audit firm make it a suitable supplier;*
- *whether there are safeguards in place to ensure that there is no threat to objectivity and independence;*
- *the nature of the non-audit services and the related fee levels; and*
- *the criteria which govern the compensation of the individuals performing the audit.*

The policy devised by the audit committee should formally specify the types of non-audit work from which the external auditors should be excluded; the type of work for which the external auditors can be engaged without referral to the audit committee; and the type of work for which a case-by-case decision is necessary. Where non-audit services require approval on a case by case basis, it may be appropriate for the policy to allow 'pre-approval' for certain types for work, subject to a fee limit determined by the audit committee. The subsequent provision of any service by the auditor should be ratified at the next meeting of the audit committee. More generally, a de minimis fee limit might apply. Appendix I: Exhibit 7 contains an example policy in respect of the appointment and remuneration of external auditors for audit and non-audit work.

### *Understanding the audit cycle*

Once the appointment of an external auditor has been confirmed, the audit committee should review and agree the audit engagement letter ensuring that it has been updated to reflect changes in circumstances arising since the previous year (or previous auditor). Where there has been a change in auditor, all material issues should, in practice, have been addressed during the appointment process.

The committee needs to understand the scope of the audit and how it is to be approached. An effective way to achieve this is to hold a pre-audit meeting with the auditors. Audit committees can sometimes have a limited appreciation of what it is the auditors actually do. Additionally, requirements of audit standards are changing - at the end of 2004, the Auditing Practices Board issued a suite of new standards that incorporate enhanced International Standards on Auditing<sup>6</sup> and introduce significant changes in regulatory requirements concerning the steps involved in:

- understanding and responding to fraud risks;
- understanding and assessing other financial statement risks;
- documenting the audit response to risks;
- obtaining evidence required and documenting that evidence.

Audit committees will need to understand the extent of the external audit work to be undertaken, including changes resulting from the new APB standards. An open discussion around this topic can also throw up quite a number of areas where the audit committee assumes work is done where it isn't and where audit effort is directed and the audit committee has absolutely no appreciation of it. Audit committees should have an interest in the areas of detailed substantive testing which the auditors intend to carry out and on the other hand those where they intend to rely on internal controls and the means by which they justify that reliance. The committee should also be concerned that there is adequate coverage of (say) divisions or subsidiaries, particularly those that are remote either geographically or culturally.

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<sup>6</sup> *Thirty International Standards on Auditing (UK and Ireland) and the International Standard on Quality Control (ISQC) (UK and Ireland) were issued in December 2004. ISAs (UK and Ireland) apply to all audits of financial statements for periods commencing on or after 15 December 2004. Systems of quality control in compliance with the ISQC (UK and Ireland) are required to be established by firms in Ireland and the UK by 15 June 2005.*

*The audit committee should review the scope of the external audit with the auditor. If the committee is not satisfied as to its adequacy it should arrange for additional work to be undertaken.*

*The committee should consider whether planned levels of materiality and proposed audit resources are consistent with the scope of the audit, having regard also to the seniority, expertise and experience of the audit team.*

After the pre-audit meeting, the committee may determine that the external auditors should be performing additional work to satisfy the needs of the company, such as increased internal control testing. The process may also help the audit committee understand and coordinate activities with the internal auditors.

The committee should also ensure that an appropriate audit plan is in place. A proper dialogue needs to take place as to whether the business risks identified by the auditor are the only business risks or whether there are other risks that should be taken account of in view of the audit committee's own knowledge of the company's risk environment. This applies both at a strategic level, those risks which are fundamental to the achievement of the company's strategy and at the more detailed operational level, those risks which impact the day-to-day operations, the recognition of revenue and cost, the custody and value of assets and completeness of recognition of liabilities.

Moving to the end of the audit cycle, the audit committee should oversee the audit findings, including any changes in audit approach or any modification to the standard auditors' report. The issues to be discussed will depend on individual company and audit circumstances. Nevertheless, 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 judgments; 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.

Sufficient time should be allowed to enable the audit committee to complete its review and engage in an appropriate dialogue with the external auditor. An appropriate timetable should be agreed with the board, finance director and the auditor.

This is all very much common sense but, in practice, major issues should not be raised for the first time at the meeting at which the committee intends to recommend the approval of the financial statements. If the final audit committee meeting is to be conducted effectively, it is advisable that audit findings are reviewed on an ongoing and timely basis (for example, after the interim audit work). Issues can then be identified at an early stage and surprises avoided. Audit committee chairmen should consider entering into a regular dialogue with the auditor in advance of the final meeting so that the attention of the audit committee members can be directed to matters of concern rather than cantering through the agenda. One would expect the relationship with the auditor to be such that if there are serious concerns these are brought to the audit committee's attention promptly.

## Understanding the audit cycle - relevant communications from external auditors

International Standard on Auditing (UK and Ireland) 260 *Communication of audit matters to those charged with governance* (ISA (UK and Ireland) 260) requires communication of key matters relating to the planning and outcome of the external audit, including:

**Engagement terms** - auditors are required to ensure that those charged with governance receive a copy of the engagement letter on a timely basis;

**Planning** - auditors are required to communicate to those charged with governance an outline of the nature and scope of work to be undertaken and the form of reports expected to be given;

**Adjustment of errors** - ISA (UK and Ireland) 260 requires auditors to bring to the attention of those charged with governance any uncorrected misstatements in the accounts, other than those that are 'clearly trivial'. A representation is also to be sought from directors about their reasons for not correcting the relevant matters;

**Qualitative aspects of financial reporting** - auditors are required to discuss, in an open and frank manner, the quality and acceptability of the entity's reporting, including for example:

- the appropriateness of the accounting policies to the particular circumstances of the company;
- the timing of transactions and the period in which they are recorded;
- the appropriateness of accounting estimates and judgments made;
- the potential impact of any uncertainties including significant risks and exposures, such as pending litigation;
- material uncertainties that may cast doubt on the company's ability to continue as a going concern;
- the extent to which the accounts are affected by unusual transactions including non-recurring profits;
- inconsistencies between the accounts and other information in the document containing the accounts; and
- the overall balance and clarity of the annual report.

While it may seem strange to review issues that have subsequently been resolved and unadjusted errors that are not material, such issues could suggest weaknesses in the design or operation of internal controls, or be indicative of management's approach to the preparation and presentation of financial information (e.g., earnings management).

During an audit many representations are made to the auditors, either unsolicited or in response to specific enquiries. The audit committee should review such representations before signature by management. Representation letters cover matters such as confirmation:

- that all accounting records have been made available, all transactions properly recorded in the accounting records, and all other records and related information made available;
- of the directors' expectations regarding future events that affect critical accounting judgments, for example, the recoverability of debtors; and
- of the company's expectations and future intentions.

Particular consideration should be given to matters that relate to non-standard issues. The audit committee should consider whether the information provided is complete and appropriate based on its own knowledge.

Where the auditors identify material weaknesses in either accounting or internal control systems during their audit report, they report these to the company in a 'management letter'. As part of the ongoing monitoring process, the audit committee should review the management letter and also review and monitor management's responsiveness to the external auditor's findings and recommendations.

#### *Assessment of the external auditor*

The audit committee has primary responsibility for selecting, evaluating, and, if need be, replacing the auditor. The committee's evaluation should consider the auditor's competence, the quality and efficiency of the audit, and whether the audit fee is appropriate in relation to the size, complexity, risk and control profile of the company, to ensure that the company's audit is not compromised.

*The audit committee should monitor the performance and quality of the auditor's work.*

*The audit committee should assess annually the qualification, expertise and resources, and independence 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.*

The Combined Code recommends that the audit committee should review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements. Smith's report builds on this recommendation by further recommending that the audit committee assesses the effectiveness of the audit process, and in doing so:

- reviews whether the auditor has met the agreed audit plan and understands the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
- considers the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgments identified, in responding to questions from the audit committee, and in their commentary, where appropriate, on the systems of internal control;
- obtains feedback about the conduct of the audit from key people involved, e.g., the finance director and the head of internal audit; and
- reviews and monitors 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 establishes whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon.

Appendix I: Exhibit 5 suggests a checklist framework for an audit committee to carry out a formal review of the effectiveness and efficiency of their external auditors. Such a review provides the audit committee with a disciplined approach to keeping the auditors' performance under review.

# CREATING AN EFFECTIVE AUDIT COMMITTEE



## Creating an Effective Audit Committee

Audit committees are established by boards of directors to help discharge their fiduciary responsibility. In the case of Irish listed companies, the 2003 Act will require that the committee's functions include at least the specific matters set out in Appendix II, and large private companies will need to consider whether to appoint a committee whose remit includes some or all of those matters. How the committee fulfils that mandate, varies according to the clarity of the committee's mission, the abilities of the committee's members, and the tone set at the top of the governance structure. We present some of the characteristics and practices that based on our experience, mark a strong and effective audit committee, from the terms of reference through to the many facets of the committee's composition, structure and operation. We encourage each audit committee to review these characteristics not as elements carved in stone but as components in a process that can be - and should be - continually improved to enhance the committee's effectiveness.

### Audit Committee Terms of Reference

In essence, the focus of the audit committee terms of reference defines the scope of the committee's oversight responsibilities and how these are to be discharged. The role of the audit committee is for the board to decide - within the scope introduced by the 2003 Act - and it should tailor its terms of reference to the company's specific needs and clearly outline the committee's duties and responsibilities, including structure, process and membership requirements. The terms of reference should ideally describe the background and experience requirements for committee members and set guidelines for the committee's relationship with management, the internal and external auditors, and others.

*The main role and responsibilities of the audit committee should be set out in written terms of reference and approved the board. The terms of reference should be made available to the public, and should set out explicitly the role and responsibilities of the audit committee with respect to its relationship and expectations of internal and external auditors, its oversight of internal control, and disclosure of financial and related information.*

An audit committee's terms of reference and responsibilities should be coordinated with other committee responsibilities - some companies have a risk committee, others have committees focused on a particular business risk (e.g., investment committee, environmental committee, etc.). Care should be taken to define clearly the roles and responsibilities of each. Terms of reference should be detailed enough to clarify roles and responsibilities, but not so detailed that they include items that cannot be reasonably accomplished. The terms of reference should serve as a guide in establishing the audit committee work plan and meeting agendas. The work plan would specifically set out how the audit committee intends to fulfil each of its responsibilities as disclosed in the terms of reference. Terms of reference prepared by the audit committee should be approved by the board. Appendix I: Exhibit 1 includes an example audit committee terms of reference to assist committees in creating or updating their complete terms of references consistent with the Smith report recommendations, the provisions of Irish Company Law and leading practices.

It is very important that the audit committee takes into consideration the responsibilities laid out in the terms of reference and related work plan as each meeting's agenda is set, and that all responsibilities are reviewed on at least an annual basis. This review could be incorporated into any self-evaluation process that the audit committee undertakes.

*The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board. The board should review the audit committee's effectiveness annually.*

Once established, the audit committee terms of reference should be updated annually. The annual assessment of the committee's terms of reference should be a robust process reflecting changes to the company's circumstances and any new regulations that may impact the audit committee's responsibilities.

The revised Combined Code recommends that the audit committee terms of reference be disclosed to shareholders through inclusion on the company's websites - most listed companies now do this. However, audit committees should be mindful of the implications of increased disclosure and ensure they are not undertaking so many responsibilities that they cannot be reasonably accomplished, or that may subject the committee to future liability.

## Audit Committee Composition

*The audit committee should consist of not fewer than two directors whom the board thinks fit and who have not been employees of the company (or subsidiary of the company) during the last three years.*

The size of the audit committee will vary depending upon the needs and culture of the company and the extent of delegated responsibilities to the committee. The Combined Code recommends that audit committees should comprise at least three independent non-executive directors. In determining the audit committee's composition, the principal objective is to allow the committee to function efficiently, all members to participate, and an appropriate level of diversity of experience and knowledge. Committees of three to six individuals are generally most appropriate to achieve those objectives. The provisions of the 2003 Act also need to be taken into account. Curiously, these do not include any specific requirements relating to independence and competence of committee members, requiring simply the appointment of individuals who have not recently been employed in the company or group and whom the board thinks fit. In determining that judgment, however, it would be expected that boards take into account the Combined Code's guidance on the identification of appropriately qualified committee members.

*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.*

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. Terms of three years, with staggered expiration dates to ensure continuity, are common in business today. Most companies have no set policies for rotating committee members but depend on weighing a member's experience against the risks of complacency. Without a rotation policy, it is important for the board of directors to evaluate an audit committee member's performance to see that it meets both the board's and committee's expectations.

## Independence

Audit committee independence is the cornerstone of the committee's effectiveness, particularly when overseeing a company's financial reporting integrity and evaluation of areas where judgments and decisions are significant. Audit committee members must be adept at communicating with management and the auditors and ready to ask key, probing questions about the company's financial risks and accounting and financial reporting.

It is up to the board to assess the integrity and independence of an audit committee candidate, so every member's appointment is an occasion for careful deliberation. The board should have a strong understanding of the relevant definitions of independence and how a lack of independence occurs and is interpreted in practice. Independence issues are most prevalent with respect to business relations. The board should also be cognisant and mindful of situations in which the definition of independence is met; yet perceived conflicts of interest may still arise.

## Independence

The Combined Code states that the board should determine whether a director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, their judgment. Such relationships and circumstances include if the director:

- has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

*All members of the committee should be independent non-executive directors. The chairman of the company should not be an audit committee member.*

Compliance with the revised Combined Code requires that audit committees should comprise at least three independent non-executive directors - two for companies outside the FTSE 350. For the avoidance of doubt, the Combined Code does not consider a board chairman to be independent in this context.

## Financial expertise and other skills

Like any non-executive director, audit committee members should (at least as a group) possess a wide range of knowledge, skills and personal attributes: sound judgment; integrity and high ethical standards; strong interpersonal skills; and the ability and willingness to challenge and probe. Specifically, audit committee members must have expertise, or access to expertise, that goes beyond mere familiarity with financial statements. They must be able to understand the rules and, more importantly, the principles that underpin the preparation of financial statements. They must be prepared to invest the time necessary to understand why critical accounting policies are chosen, how they are applied, and satisfy themselves that the end result fairly reflects their understanding.

The Combined Code states that the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. It is sensible that the other members are, at least, financially literate.

Recent and relevant financial experience is deliberately undefined - each board should determine its own criteria. However, it is clear that it must go beyond a basic familiarity with financial statements and perhaps comprise past employment experience, or a qualification, in finance or accounting or related service that may include experience as a CEO, with financial reporting oversight responsibilities, or finance director.

*All audit committee members would normally be expected to have experience of financial matters, and at least one member should have recent and relevant financial experience. It is desirable that the member with recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies.*

It has been suggested that the audit committee member with the highest level of financial expertise should also chair the committee, but this need not necessarily be the case. The member who is designated as having “financial experience” should be aware of his role, but it is not necessary for them to be identified in the annual report and accounts. For companies who have or will raise capital in foreign jurisdictions involving additional financial reporting obligations, audit committees should consider having at least one member of the audit committee with accounting or financial management expertise in that foreign country.

Members should have experience in areas pertinent to the business. A committee's effectiveness in performing its mission is certainly enhanced by, and is often dependent upon, the members' experience, knowledge and competence in business matters, financial reporting, internal controls and auditing.

#### ***The US definition of financial expert***

In determining whether the audit committee has a member with recent and relevant financial experience, the board could consider the Securities Exchange Commission's (SEC) rules relating to the definition of an audit committee financial expert - a requirement for audit committees in US listed companies. The SEC defines a financial expert as a person who has all of the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

The SEC rules go on to set out that an individual may not be considered an audit committee financial expert solely by virtue of their prior service as an audit committee member - they must have acquired the attributes of an audit committee financial expert through: education or experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in one or more positions that involve the performance of similar functions; experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions; experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; and other relevant experience.

*Training should be provided on an ongoing and timely basis and should include an understanding of the principles of, and developments in, financial reporting and related company law.*

*The company should provide an induction programme covering 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, financial dynamics and risks.*

*It is for the audit committee chairman, in consultation with the company secretary, to decide the frequency and timing of its meetings.*

## Professional development

All members should seek periodic continuing professional education both inside and outside the boardroom. Management, internal and external auditors, and the company secretary are sources of background information and training for audit committee members. Periodic briefings, reports and presentations by management, external auditors and internal auditors for audit committee members should cover operational and financial issues specific to the company and the industry, and updates on new accounting and auditing standards. Companies should offer, and committees should insist on, the kind of training that will enhance their financial literacy and make it possible for them to fulfil their fiduciary responsibilities. This is especially true of new members, who should receive a complete orientation that allows them to function effectively from the very beginning.

## Audit Committee Meetings

A detailed agenda is vital for keeping the committee focused. Effective agendas are set with input from the CEO, finance director and the internal and external auditors. The audit committee chairman, however, should maintain accountability for the agenda and not delegate it to management. The audit committee agenda for the year should ideally originate from a detailed work plan. In turn, the detailed work plan would originate from the terms of reference. Appendix I: Exhibit 2 includes a sample of audit committee agenda topics that should be considered when developing detailed audit committee agenda for the year. A sample audit committee agenda for the year is presented as Appendix I: Exhibit 3.

There should be as many meetings as the audit committee's role and responsibilities require. Smith's report recommends that there should be no fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle. However, audit committee chairmen may wish to call more frequent meetings. There should be sufficient time permitted to cover all agenda items and allow time for all parties to ask questions or provide input. There should also be sufficient time for the committee members only to have a private session at each meeting.

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.

This is all very much common sense but should questions of substance be raised for the first time at the final audit committee meeting? Serious problems may result if such questions are answered in a way different from that in which might be expected. If the final audit committee meeting is to be conducted effectively, then the chairman should be entering into communication with both the finance director and internal and external auditors some time in advance of the audit committee meeting and bringing matters of concern to the attention of the audit committee members. The relationship with the auditor should be such that any serious concerns are brought to the audit committee's attention promptly, though in a non-adversarial way.

No one other than the audit committee members should be entitled to attend any meeting of the audit committee. It is the audit committee itself that should decide who should attend any particular meeting (or part of a meeting). It is to be expected that the external audit lead partner, head of internal audit and the finance director will regularly be invited to attend meetings as well as perhaps the CEO or group chairman. Others may be invited to attend. The CEO often has vital insights to share; however, the audit committee chairman should ensure that the CEO does not inhibit open discussion at the meeting.

Management should be expected to discuss key accounting estimates and subjective adjustments for each interim period. External auditors should periodically discuss the appropriateness of accounting, including accounting alternatives and choices made by management. Private executive sessions should be held with the external auditors at least once a year. Leading practice would also suggest private sessions with the head of internal audit.

*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.*

Opinions differ as to when private sessions with the auditors should be held. Most often such sessions are held at the end of scheduled audit committee meetings. The executives are asked to leave and the committee then invites comments from, and asks questions of, the external auditor. However, there is an emerging practice whereby the committee meets with the external auditor before the executives are invited to attend - i.e., at the beginning of the audit committee meeting. The advantage is that the committee can be fully briefed on all the issues and therefore in a better position to both understand and challenge management.

Formal meetings of the audit committee are at the heart of its work. However, they will rarely be sufficient. Audit committee chairman, and to a lesser extent the other members, may need to keep in touch with the board chairman, the chief executive, the finance director, the external audit lead partner and the head of internal audit on a continuing basis.

Formal minutes should be prepared, circulated to external and internal auditors as appropriate, approved by the audit committee and then reviewed by the full board of directors. Important documents related to the meeting should be attached to the minutes, including the agenda.

## **Communications Policies**

The content, timing and manner in which information is released both internally and externally by the company requires levels of accountabilities and approvals that should be defined, documented and approved by the board. Such policies should consider guidelines to help ensure communications are not selective. Policies should also consider crisis communications and electronic communication risks and controls. While these policies should be set at board level, the audit committee should, as a minimum, actively contribute to setting the policies as they relate to communication of financial information.

*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.*

## Audit Committee Compensation

Audit committee members must be adequately compensated for their services. In most public companies, deciding on the amount of compensation is usually the responsibility of the remuneration committee. It is reasonably well established in practice that the committee chairman receives more remuneration than other members, reflecting their increased responsibilities. Moreover, the board may acknowledge that the audit committee service warrants higher compensation than other board committees in recognition of the responsibilities and increased time commitment. 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. In addition to a yearly fee, some companies may offer payment for each meeting attended.

Remuneration for service can sometimes pose a dilemma for both management and committee members. While compensation should be enough to recognise the time commitment required and the liabilities accepted in order to attract good and responsible directors, the amount should not be excessive such that a conflict may be perceived.

## Audit Committee Resources

The audit committee should be provided with sufficient resources to undertake its duties. It should have access to the services of the company secretary 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. 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.

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.

## Assessing Audit Committee Effectiveness

Each year, the board should review the audit committee's effectiveness by requesting feedback on the committee's performance from senior management, and the internal and external auditors. In addition, the audit committee should assess its own effectiveness and the adequacy of its terms of reference, work plans, and forum of discussion and communication by:

- questioning the board about its satisfaction with the committee's performance;
- comparing the committee's activities to the recommendations of the Smith report and the guidelines of the relevant securities exchanges;
- comparing the committee's activities to leading practices;
- comparing the committee's activities to the terms of reference and any other objectives the board set for the committee; and
- consulting with external auditors on ways to improve the audit committee's performance.

Each of these steps would not necessarily be performed annually, but all steps should be performed every two to three years. Any necessary changes should be recommended to the board. An example audit committee self-assessment is set out in Appendix I: Exhibit IV.

*The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board. The board should review the audit committee's effectiveness annually.*

The chairman of the audit committee should assess the performance of individual committee members on an annual basis. The audit committee in conjunction with the board should develop a formal and rigorous assessment process. This process may include interviews with the member being assessed, self-assessment by the member and the assessment of members against standard criteria.

*What marks a member who is successful?* Someone who is dedicated to the committee's work and responsibilities, someone who is willing to devote the time necessary to understand the company and prepare for, attend and participate in meetings and deliberations, someone with an inquiring attitude, objectivity, independence and sound judgment.

The result of this assessment should be a recommendation to the board as to whether the member should be appointed for an additional term. The evaluation of the chairman would be done by the board based upon similar criteria. Evaluations that are well performed demonstrate the committee's intention and commitment to achieve its responsibilities in an effective and diligent manner.

# DISCLOSURE



## Disclosure

*The audit committee should report, as part of the annual directors' report, on the committee's activities for the year, including (but not limited to) the discharge of its duty to monitor the performance and quality of the auditor's work and the auditor's independence.*

Given the importance of audit committees to good governance, shareholders need to understand the scope of the committee's terms of reference and the way in which key aspects of their responsibilities are discharged.

Compliance with the Combined Code requires that the audit committee's terms of reference, including its role and the authority delegated to it by the board, should be made available on request and included on the company's website. The 2003 Act's provisions will require that boards formally approve the terms of reference and that they are made available to shareholders at the Annual General Meeting. Furthermore, both the Combined Code and the 2003 Act provide for reporting on the audit committee's activities.

Both the Combined Code and the 2003 Act envisage that there should be public reporting of the audit committee's work.

In the case of the Combined Code, a separate section of the annual report should describe the work of the audit committee in discharging those duties and in particular should:

- explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded;
- where the board does not accept the audit committee's recommendation on the appointment or re-appointment of the auditor, explain the committee's recommendation and the reasons why the board has taken a different position;
- where no internal audit function exists, set out the reasons for the absence of such a function.

To this list, the Smith guidance adds the number of audit committee meetings and the names and qualifications of all members of the audit committee during the period.

The 2003 Act's requirements are less detailed, specifying that the directors' report must include a report from the committee on its activities and allowing the committee to determine the extent and detail of that report, provided that it at least includes comment on its monitoring of the audit independence and quality.

Specimen audit committee disclosures can be found in Appendix I: Exhibit 12.

*The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board, on the report of the committee's activities and matters within scope of the committee's responsibilities.*

# CURRENT AND EMERGING ISSUES



## Current and Emerging Issues

The need to address current and emerging issues is a fundamental requirement for effective management because the issues can have a direct or indirect effect on a company's control environment, financial reporting, and the audit process. Understanding how the organisation responds to the challenge is fundamental to an audit committee in discharging its responsibilities. An audit committee must be mindful of what is happening within a company now and, at the same time, what may happen in the future. In today's global economy and formidable business environment, being prepared - staying ahead of the curve - is a major ingredient for success.

Audit committee members do not need a crystal ball to be aware of the many business issues that could influence a company's future and thus the committee's work. While the issues, including their nature and relative importance, vary by company, we believe that the questions in the box below should, at a minimum, be on every audit committee's radar screen. With intense interest from both regulators and the investing public in the financial reporting process, prudent audit committees are sharpening their focus on current and emerging issues and responding accordingly.

### Current and emerging issues shaping the audit committee agenda

Is the board of directors adequately overseeing management's process for identifying and monitoring principal business risks? What risks are acceptable to the company, and through what process are they being managed? Is enterprise risk management being used to manage an organisation's key business risks and opportunities with the intent of maximising shareholder value?

Is the audit committee contributing to a "no surprises" environment? Is the audit committee alert to the indicators contributing to the company's risk profile?

Is management reporting operations in a clear and responsible way? Could the company satisfactorily respond to a securities regulator inquiry into earnings management?

Are plans for moving to financial reporting under International Financial Reporting Standards adequate and is expected progress being maintained? Is the Board implementing an effective communication programme in relation to expected changes?

Is the audit committee alert to factors increasing the risk of fraud and illegal acts? Does the audit committee understand how to minimise the risk of loss arising from fraud?

Has the board put in place effective procedures to meet upcoming regulatory requirements (including those deriving from Sarbanes-Oxley Act, if applicable)? Is the board well-placed to meet (when brought into effect) the new requirements introduced by the 2003 Act for reports relating to compliance with relevant obligations?

Have management and the audit committee remained abreast of recent developments in financial reporting and recent regulatory actions? Have the complexities of new financial reporting requirements, and in particular issues arising on conversion to International Financial Reporting Standards (IFRS), been fully understood and evaluated in the context of the company's business and business transactions?

Do the processes and controls adequately support the organisation's complexity and international reach? Are controls and systems keeping pace with the company's growth?

Have the control implications for enterprise-wide solutions been adequately addressed? Have controls been enhanced through the introduction of new systems?

Are any dominant executives adequately governed?

Does the audit committee tailor its responsibilities to reflect specific industry considerations? Has management addressed specific industry regulations and requirements?

Are members of the audit committee fulfilling their responsibilities as directors and thereby mitigating potential liability?

## Enterprise Risk Management

Is the board of directors adequately overseeing management's process for identifying and monitoring principal business risks? What risks are acceptable to the company, and through what process are they being managed? Is enterprise risk management being used to manage an organisation's key business risks and opportunities with the intent of maximising shareholder value?

As business leaders seek new ways to build shareholder value, they are discovering a connection between value management and risk management. Enterprise risk management (ERM) has emerged as an important means of identifying the critical risks the organisation faces - including, for example, reputation, ethics, e-business and health, safety and environmental risks (not just financial or insurable hazards) - and then managing and optimising that portfolio of risks such that commensurate financial rewards are realised.

Business risks that are not managed have clear consequences for an organisation - potential shareholder wealth erosion, exposure to the viability and success of the organisation, and exposure to financial consequences of unexpected events - all of which can affect a company's financial reporting. ERM can provide businesses with tools for monitoring the processes in place to identify significant business risks at the organisation, ensuring that those risks are being managed and reporting the organisation's risk management activities to shareholders.

### Emerging ERM model

Early models of risk management viewed risk as a market imperative - something to be understood and analysed for its own sake. The new models are clearly linked to the organisation's business strategy - which encompasses an organisation's vision, mission, and objectives; its process for defining operational imperatives; and its philosophies, policies, plans and initiatives for growth and development. Emerging ERM models, such as the one outlined below can provide an organisation with new action steps they may use to enhance business decision-making and, potentially, shareholder value.

**Risk strategy** - Aligning ERM resources and actions with the business strategy are necessary to maximise organisational effectiveness. Both the board and senior management must understand strategic-level risks and related systems of control. Risk management should always be on the board and, where appropriate, audit committee's agenda, and a formal risk and control review should be performed at least annually.

**Risk portfolio** - A “risk portfolio” represents the range and degree of business risks appropriate for the organisation at any given time. Processes must determine whether the risk portfolio is consistent with the expectations of the board and senior management.

**Risk optimisation** - An appropriate level of risk can help achieve corporate objectives. Risk optimisation involves evaluating and adjusting the risk response currently being made by the organisation. When benchmarked against risk appetite, an optimisation model can identify where the best “return on control investment” can be achieved.

**Measuring and monitoring** - Measuring and monitoring to enhance value should be an ongoing means of understanding and reporting on the status and impact of risks. A strong process for capturing information and reporting it to the board and, where appropriate, audit committee is essential to an ERM approach. Measuring and monitoring activities could include using performance measures, tracking risk management investment, using the internal audit function as an objective quality assurance yardstick and use of technology to access key business indicators.

**Risk structure** - Once an organisation understands its risk strategy and gives risk “top-down” priority, the organisational structure must often be adjusted to ensure that it can respond. For example, a well-defined risk structure will incorporate an assessment structure, where management is able to assess risks across the organisation's divisions, regions, functions and hierarchy.

How can the audit committee help in this regard? Audit committees can assist the board and management through its diagnosis of risk management activities. By asking probing questions in regard to risk management, the audit committee can help bring clarity to the assessment of the processes used to manage risk:

*Is risk management always on the board agenda? Has ERM education been provided at the board level? Is there clear “ownership” of risk management oversight by the board?*

*Has management created a high-level risk strategy (policy) aligned with strategic business objectives? Has a risk management framework been established with clear reporting lines and assignment of responsibilities for risk management?*

*Does the company have a common risk culture, including the use of common risk language and concepts? Are communications about risk using appropriate channels and technology?*

*Are risk management activities embedded into ongoing business processes?*

*Are appropriate measurements and monitoring of risks being performed? Have key performance indicators and critical success factors related to risk been identified and success measures for risk strategy and activities established?*

## Risk Indicators

Is the audit committee contributing to a “no surprises” environment? Is the audit committee alert to the indicators contributing to the company's risk profile?

The environment in which an organisation operates can have a direct impact on the way a company is managed. By understanding the environment and the pressures the organisation and its management are facing, the audit committee can evaluate whether risks are being identified and, most importantly, being mitigated. Such an approach enables the committee to exercise its responsibilities in an active rather than a reactive manner, and minimises “surprises.”

*What influences the company's environment?* Every company is different and will be subject to its own risks, but the risks will be driven by a number of basic factors. The interaction of many elements - the organisation's control environment; management's capabilities; the industry, market conditions and expectations; the organisation's operating and financial stability; and the nature of its assets - all contribute to a unique risk profile. This profile directly affects the audit committee's core responsibilities - assessing the company's processes relating to its risks and control environment, overseeing its financial reporting, and evaluating its internal and independent audit processes.

*What are the indicators to look for?* Some examples are contained in the box below. To facilitate identifying risk indicators, the company's senior executives should report regularly to the audit committee and board of directors to keep them informed of the risks and exposures facing the company. In addition, the committee should be briefed on the company's strategic objectives, procedures for achieving them, and evaluations of the progress toward meeting them. Such meetings will often be at the full board level; however, where appropriate, audit committees should request additional meetings to address issues of importance to their responsibilities, or to obtain a more detailed understanding. The committee should also seek the observations of the internal and external auditors, and draw upon its members' own business acumen.

### Examples of Risk Indicators

- inappropriate “tone at the top”;
- frequent organisational changes;
- high turnover of senior management;
- lack of succession plans;
- inexperienced management;
- lack of management oversight;
- management override;
- autocratic management;
- untimely reporting and responses to audit committee enquiries;
- excessive or inappropriate performance-based compensation;
- unrealistic earnings expectations by the financial community;

- over-ambitious growth goals;
- unusually rapid growth;
- inappropriate focus on the importance of maintaining trends and achieving forecasts;
- unusual results or trends;
- lack of transparency in the business model and purposes of transactions;
- exposure to rapid technological changes;
- industry “softness” or downturns;
- interest rate and currency exposures;
- overly complex organisational structures or transactions;
- late surprises;
- ongoing or prior investigations by regulators or others.

## Earnings Management

Are management reporting operations in a clear and responsible way? Could the company satisfactorily respond to a regulator's inquiry into earnings management?

Recent high-profile irregularities reported in the press have been attributed to various earnings management practices. These include questionable revenue recognition; inappropriate deferral of expenses; and misconstrued recognition, reversal, or use of reserves without events or circumstances to justify such actions. These practices have come to the attention of securities regulators and others in companies' accounting policies and procedures and have led to questions about the quality of reported earnings.

Information is the lifeblood of the capital markets. If a company fails to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate; and the trust that is the bedrock of capital markets is severely tested.

Earnings management is a problem that is perhaps, more widespread than we might think. Everyone, in whatever field, who has information to impart wishes to manage the way in which the information is communicated and the particular message or 'spin' that it is to be given. Management is not immune from this temptation, and earnings management is one of the ways in which this is done.

It is important that audit committees recognise the circumstances where the pressure arises. It could be that:

- market expectations are unrealistic; or
- targets are not being met; or
- management are heavily incentivised.

The pressure to achieve earnings targets can place a heavy burden on senior management, in terms of both job security and remuneration. Unfortunately, this pressure can all too often lead to the consideration of aggressive and sometimes incorrect financial reporting interpretations.

Audit committees need to know enough about their company to recognise when these conditions are present and, in that case, they need to receive what they hear with some scepticism. If audit committees do not do this, many of the improvements in the quality and reliability of financial reporting in recent years will be undermined just when they are most needed.

Auditors also must play their part. No auditor should be unaware of the problem. The traditional audit qualities of rigour and scepticism will be needed, but they may not be enough. Even if the auditor recognises what is going on, there may be little that can be done about it, if it falls within certain bounds. The auditors' role is to express an opinion on the truth and fairness of the accounts, and these are usually tested by reference to accounting standards and other requirements having regard to materiality.

Accounting standards do not, however, produce financial statements that are 'right' in the sense that there is only one possible answer. They are not a straight jacket, but based on principles which allow them to adapt to changing circumstances. Their application can sometimes produce a range of possible answers. For example, valuations and estimates, which inevitably require judgment, are needed in relation to many elements of the financial statements - particularly in relation to transactions that span the year-end or several years.

The benefit of this inherent flexibility is that it allows accounting to keep pace with business innovations. The downside is that abuses such as earnings management can occur when people exploit this pliancy. This is why the highest standards of objectivity, integrity and judgment must be the rule, not the exception.

*How should audit committee members respond?* Audit committee members must fulfil their fiduciary responsibility; they should understand the company; they should be briefed and stay up to date; they should ask insightful questions and be active participants in the oversight function.

Specific areas of accounting "hocus-pocus" that may obscure financial volatility and adversely affect the quality of reported earnings are:

- **Revenue recognition** - Recognising turnover before a sale is complete, or at a time when the customer still has options to terminate, void or delay the sale - has assumed great importance in recent years. This is particularly so for "new economy" companies where the focus is often on revenue rather than profit.
- **Changing estimates** - Changing estimates to make the numbers is another frequently used method for managing earnings. While this may be perfectly acceptable when supported by real economic facts, all too often estimates are altered when the underlying economics of the business do not support the change, and without any disclosure to investors. As such, investors end up using numbers for investment decisions that lack transparency, consistency and comparability.
- **Abuse of the materiality concept** - The intentional recording of errors under the assertion that their impact on the bottom line is not significant; however, given the market's reaction to small changes in earnings per share, what is significant and what is not?

- **Capitalisation and deferral of expenses** - Capitalising and deferring costs that should be accounted for as a cost of the period through, for example, ambiguously defined capitalization criteria for property, plant and equipment and intangible assets, unreasonable amortization periods, or through the capitalization of costs for which future economic benefits are not reasonably assured.
- **Non-GAAP measures** - This is a device that some companies can use to disseminate an idealised version of their performance that excludes any number of costs and expenses yet still suggests reliability and comparability. In effect, spinning straw into gold!

Often undue emphasis is placed on results before exceptional items, or start up operations, or earnings before interest tax and depreciation (EBITDA), and even marketing expenses as if some costs were somehow capable of being ignored. This may be perfectly appropriate, and consistent with what is done in the industry, but the impression given can be of a lack of balance.

## Fraud and Illegal Acts

Is the audit committee alert to factors increasing the risk of fraud and illegal acts? Does the audit committee understand how to minimise the risk of loss arising from fraud?

The nature of fraud risk is expanding. The globalisation of business means that management may find it is doing business with people it doesn't know in countries it has never visited, employing cultural standards it doesn't understand. As well, technological advances have changed the speed and ways business transactions are recorded; these advances have enhanced opportunities for fraud and have greatly increased the potential quantum of losses arising from fraud.

*How can the audit committee ensure that appropriate procedures are in place to minimise the risk of losses arising from fraud?* Unpalatable though it may be, the audit committee has to address the risk of fraud head-on. The identification of the risk of losses arising from fraud through diagnostic studies of the risk of fraud and misconduct in the business should be considered an important first step. The audit committee should question whether management has considered those risks likely to have greatest financial, reputational or regulatory impact on the business. The assessment should include identifying fraud risks and a rigorous assessment of any relevant internal controls and their ability to prevent and or detect fraud.

The audit committee should determine whether a consistent approach is taken across the business, whether those risks assessed as high are dealt with appropriately and whether management is engaged in the process.

It is important that staff at all levels receive some training in fraud awareness relevant to their business sector. A common theme arising from the investigation of many frauds is the fact that countless people in the affected organisation knew or suspected that irregularities were occurring, but were not given the skills to identify the signs of fraud or provided with an opportunity to communicate their concerns. The committee should enquire as to whether the company has an effective awareness programme which is updated as appropriate and is provided in a relevant format to different levels of management and staff (including new joiners).

The audit committee is not involved in day-to-day management, and therefore not closely involved with the detail on matters related to fraud and unethical activities. However, it can usefully focus attention on the need for proper policies and procedures to help prevent fraud and unethical activities. The committee should question whether appropriate policies have been issued and whether they are user friendly and adopted by all relevant business units. Policies which might be considered include a fraud response plan and a whistle blowing policy (see below). The committee should consider not just whether these are appropriate but whether they are effective and how the business units have confirmed this. 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 - therefore an oversight role.

The committee should ensure management is providing clear direction to the business on fraud and is requesting and receiving relevant information on suspected fraud and risks.

The following are, among other factors, sometimes seen as symptomatic of a potential for fraud to occur:

- an overly dominant chief executive with unfettered powers;
- frequent changes in finance or other directors, auditors or other professional advisers;
- implausible explanations as to the source of profits or projections that are too good to be true;
- individuals who have expensive lifestyles or habits that are potentially at variance with the remuneration they receive from the company;
- people who have a reputation for 'sharp' practices; and
- over-complicated corporate structures involving havens of secrecy.

## Compliance with relevant legal obligations

Guidance from the Director of Corporate Enforcement suggests that for boards of directors to be in a position to report that they have made all reasonable endeavours to ensure compliance, they will need to demonstrate the way they have exercised judgment having regard to the extent to which they have, *inter alia*:

- identified all of the company's obligations under the Companies Acts and tax law (irrespective of whether non-compliance may materially affect the company's financial statements);
- identified the company's legal framework (i.e., other than company and tax law) and determined those elements in respect of which non-compliance may materially affect the company's financial statements;
- documented the company's 'relevant obligations';
- developed policies respecting the company's compliance with its 'relevant obligations';
- communicated those company's policies to staff and management;
- designed financial and other procedures for the purposes of securing compliance with those obligations;
- implemented financial and other procedures for the purposes of securing compliance with those obligations;

- monitored and examined on an ongoing basis the effectiveness of those procedures in achieving their objective of providing reasonable assurance of compliance in all material respects with the company's relevant obligations;
- assessed the impact of any actual instances of non-compliance that have occurred or come to light during the course of the period in respect of which they are reporting;
- in instances of non-compliance or control weakness or failure, taken appropriate corrective and/or remedial action in an expeditious manner; and
- conducted an annual review of control effectiveness based, *inter alia*, on reports received during the year.

### Whistle blowing policy

The Smith report states that audit committees should review arrangements by which employees may, in confidence, raise concerns about possible improprieties in matters of financial reporting and other matters - in short, ensure appropriate whistle blowing policies are in place. When considering this issue, relevant questions for the committee to consider include:

- Are whistle blowing procedures documented and communicated throughout the organisation?
- Does the policy make clear that it is both safe and acceptable for employees to raise concerns about wrongdoing?
- Where whistle blowing procedures arrived at through a consultative process? Do employees buy-in to the process?
- Are concerns raised by employees responded to within a reasonable time frame?
- Are procedures in place to ensure all reasonable steps are taken to prevent the victimisation of genuine whistle blowers?
- Are there procedures to ensure all reasonable steps are taken to keep the identity of whistle blowers confidential?
- Has account been taken of confidentiality clauses in contracts of employment?
- Has a senior person to whom confidential concerns can be disclosed been identified? Does this person have the authority and determination to act if concerns are not raised with - or properly dealt with by - immediate line management?
- Are success stories publicised?
- Do managers understand how to act if a concern is raised? Do they understand that employees have the right to blow the whistle?
- Has consideration been given to the use of an independent advice centre as part of the whistle blowing procedure?

Appendix I: Exhibit 10 contains an example of a whistle blowing policy.

## Financial Reporting Environment

*Have management and the audit committee remained abreast of recent developments in financial reporting and recent regulatory actions? Have the complexities of new financial reporting requirements been fully understood and evaluated in the context of the company's business and business transactions?*

Recent years have been marked by rapid and widespread developments in financial reporting. These developments reflect the increasingly complex and innovative business transactions in today's business world, and address the growing information needs of the users of financial statements. In addition, changes in financial reporting have also been promulgated by the international harmonisation and convergence of accounting standards as a result of globalisation.

Listed groups in the European Union are required to apply International Financial Reporting Standards (IFRS) in their financial statements for accounting periods beginning on or after 1 January 2005.

While accounting standards in Ireland and the UK share much in common with IFRS, in more complex areas, and in the detail, there remain significant differences that can lead to both increased volatility (e.g., accounting for derivatives, share options, pensions and investment properties) and step changes on conversion (e.g., accounting for development costs, convertible debt and preference shares).

Staying abreast and fully understanding the implication of developments in financial reporting has become increasingly difficult, especially for companies that engage in a wide variety of business transactions or have reporting responsibilities in both UK and the US. For example, a company that employs stock-based compensation, engages in derivative or off-balance sheet transactions, sells products through innovative sales channels, and that has recently completed one or more business acquisitions faces stringent and complex accounting requirements - with even more on the horizon. In addition to new accounting developments, government legislation and securities exchange regulations are expanding the reporting requirements of public companies. The revised Combined Code significantly expands corporate governance disclosures. In addition, UK company law reform now requires the annual report and accounts of significant economic entities to include a statutory Operating and Financial Review (OFR) and Irish listed companies may also wish to apply the new provisions in order to demonstrate a commitment to best practice.

Audit committees must satisfy themselves that management has devoted sufficient attention to understanding recent developments in financial reporting and that the application of new requirements is appropriate in light of the nature of the company's business and significant transactions. *What steps can the audit committee take in preparing for this challenge?* First and foremost, audit committee members must educate themselves appropriately - this is often achieved by asking management or the external auditors to describe and explain recent developments in financial reporting. Armed with this knowledge, audit committees should ask probing questions of management as to how new reporting standards influence and affect the financial reporting of the company, and how any unique or unusual aspects of significant transactions are being captured and portrayed in the company's financial statements and earnings releases.

## Complex Corporate Structures

*Do the processes and controls adequately support the organisation's complexity and international reach? Are controls and systems keeping pace with the company's growth?*

Mergers, acquisitions and reorganisations often involve welding organisations not only with distinct corporate cultures but also from different industries and different areas of the world. In today's business environment, companies frequently cross borders for every aspect of their business. This environment presents management and the audit committee with unique oversight challenges. While governance practices in such environments are slowly evolving, the influence of global business needs to be carefully considered. A number of questions may need answering:

*How are management's reporting, control, and compliance responsibilities integrated? Is there effective oversight of local boards? How does the committee evaluate domestic and international audit results, both internal and independent? How does management ensure compliance with various countries' rules and regulations?*

Reorganisations often mean downsizing and outsourcing. When downsizing, controls are often removed or weakened. As companies focus on core competencies, non-core activities and specialised skills are often outsourced to third-party providers. *Has the organisation carefully evaluated the ongoing internal control impact of such decisions?*

Audit committees' responsibilities do not stop at national or organisational boundaries - they extend to the company as a whole. There needs to be coordination and communication between audit committees of parent companies and subsidiaries. There should be a common appreciation of the control frameworks and cultures of the entities, and substantial sharing of information.

## Emerging Companies

*Are any dominant entrepreneurs adequately governed?*

Fast-growing entrepreneurial companies often lack a formalised management structure and may not have well-established corporate governance programmes. Policies, procedures, and processes may be evolving haphazardly to meet demands. The dominant role of an individual executive also may overshadow the need to foster a strong control environment and can potentially affect the financial reporting and audit processes.

As companies grow, a more standardised corporate governance process becomes a necessity, regardless of the entity's public aspirations. For companies considering an initial public offering, the need for a formalised structure becomes obvious. While the risks described in this publication represent important issues in today's marketplace for public companies, they also apply to entrepreneurial and other companies that remain private. Responding to these risks is equally important to companies that wish to deter fraud and improve the quality of their financial reporting.

Dominant or autocratic management can also be a cause for concern in an established company. Such leadership can put a strain on the enterprise's controls and corporate governance processes and set the wrong "tone at the top." Ensuring that management fosters an atmosphere that supports a strong control environment is a core audit committee responsibility.

## Specialised and Regulated Industries

*Does the audit committee tailor its responsibilities to reflect specific industry considerations? Has management addressed specific industry regulations and requirements? What is the relationship between the audit committee and industry regulators?*

Companies may operate in one or several industries. The more diverse the company, the more attuned the audit committee should be to different industry risks, accounting practices, laws, regulations, and reporting and disclosure requirements. An audit committee must consider management's response to the risks inherent in these specialised practices and incorporate them into its agenda. While the core responsibilities described in this publication are relevant to most audit committees, the manner of their execution and the specifics of audit committee activities should be tailored to meet the needs of each specific industry. An understanding of the industry and the organisation will enable the audit committee member to identify and react to industry-specific requirements such as those in depository institutions, health care organisations, not-for-profit organisations, investment companies, insurance companies, or governmental entities.

In considering industries that are regulated, audit committees should be acquainted with the scope of the regulation and the authority of the regulators. They should understand the demands regulators place upon the business and management's attitude towards them and relationship with them.

# APPENDICES



# Appendices

## Appendix I: Audit Committee Toolkit

### Exhibit 1: Audit Committee Terms of Reference

Audit committees play a critical role in a company's financial reporting system by overseeing and monitoring management's and the external auditors' participation in the financial reporting process. It is expected that the preparation and disclosure of the audit committee terms of reference will help shareholders assess the role and responsibilities of the audit committee and help committee members focus on their responsibilities.

An example audit committee terms of reference is included in Exhibit 1 of this appendix. Our intention is not to advocate an exhaustive mandate. Rather, this example terms of reference is intended to help audit committees, and senior management, in evaluating the completeness of their mandates in relation to their specific circumstance. Audit committees should also be mindful of the increasing demand for disclosure of corporate governance practices. Accordingly, care in crafting the terms of reference must be exercised so that audit committees are not exposing themselves to undue liability.

All audit committees should establish terms of reference that not only meet the minimum requirements, but are also tailored to their specific needs and circumstances. Audit committees governing smaller companies, for example, may require fewer meetings per year and may not be need to address certain responsibilities for oversight of internal audit or monitoring compliance with a code of ethics if these items are not a part of the company's governance structure. Accordingly, the terms of reference should be a 'tailored fit' to the circumstances of the entity.

### Exhibit 2: Audit Committee Agenda

A comprehensive agenda helps members stay focused on their mission. However, the nature of audit committee responsibilities and the ever-changing environment in which the company operates make it difficult to determine a set agenda for each meeting. The committee should assess what is currently important and develop its agenda accordingly. An example audit committee agenda is included in Exhibit 2 of this appendix.

### Exhibit 3: Audit Committee Meeting Agenda for Year

It is important to review the completeness of the audit committee terms of reference as well as the agenda established for each meeting. Exhibit 3 of this appendix provides an example of topics that could be covered in each audit committee meeting for a committee that meets four times per year.

### Exhibit 4: Audit Committee Self-assessment

The audit committee should annually assess its own effectiveness and the adequacy of its terms of reference, work plans, and forum of discussion and communication. A suggested framework for such a review - an audit committee self assessment - is set out in Exhibit 4.

The results of the self assessment and any action plans arising should be reported to the board after discussion with the chairman of the board. The board should also make its own assessment of the audit committee's effectiveness on an annual basis.

## Exhibit 5: Audit Committee Evaluation of External Auditors

The audit committee plays a key role in keeping under review the scope and results of the external audit, its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money.

In the current environment, many audit committees are considering how they should discharge their responsibilities in relation to the effectiveness and efficiency of the external audit arrangements. Tendering the audit is by no means the only available option under this responsibility - audit committees are capable of evaluating the performance of their independent auditors and holding them accountable for the performance of their professional duties.

Exhibit 5 suggests a checklist framework for an audit committee to carry out a formal review of the effectiveness and efficiency of their external auditors. Such a review provides the audit committee with a disciplined approach to keeping the auditors' performance under review.

## Exhibit 6: Audit Committee Evaluation of Internal Auditors

The audit committee should evaluate internal audit based on its own experiences and consider asking management and external audit to provide their own assessments. Where the group has subsidiaries or distinct business units, it may be appropriate to make enquiries of the management of such entities. In addition to these assessments, the head of internal audit would generally be expected to self-assess the internal audit department's performance. When the audit committee has studied the answers, other issues may become evident including matters relating to the audit committee's own performance, the performance of management or the performance of external audit.

Exhibit 6 provides a four-part checklist of questions to consider as part of a complementary framework for the assessment of the internal audit function that should be completed by the following:

- audit committee (initial assessment);
- management;
- external auditor;
- head of internal audit.

The audit committee should ensure they have the appropriate qualified resource to provide answers to these questions and to consider the implications of the findings.

## Exhibit 7: Example Policy on the use of External Auditors for Non-audit services

To ensure that non-audit services provided by the auditor do not impair, or appear to impair, the auditor's independence or objectivity, audit committees should develop, and recommend to the board, a policy in relation to the provision of non-audit services. Exhibit 7 provides an example of such a policy.

## Exhibit 8: Example Questions - Identifying and Assessing Risk

In view of the different approaches boards may take in referring powers to the audit committee in respect of risk management and the control framework, it is vital that there is an unambiguous understanding of what the audit committee is responsible for.

Audit committees need to assess whether they are getting appropriate risk management information regularly enough and in a format that meets the needs of members. Exhibit 8 contains a number of high-level questions that may be used in framing discussions with management. The list is not exhaustive and will require tailoring based on the audit committee's terms of reference as well as the particular circumstances of the organisation.

### **Exhibit 9: Warning Signals**

Managing risk is about much more than managing the risk of business failure. Nevertheless, the maintenance and regular review of a list of warning signals can be a useful oversight tool. Some warning signals are very company specific, others will be more general. Exhibit 9 includes a list of some of the warning signals audit committee members should be aware of.

### **Exhibit 10: Example Whistle Blowing Policy**

Audit committees should ensure management has in place proper policies and procedures to combat fraud and unethical activities. They should also ensure that arrangements are in place for proportionate and independent investigation and for appropriate follow-up action. An example whistle blowing policy is included in Exhibit 10.

### **Exhibit 11: Example Policy on the Employment of Former Employees of the External Auditor**

Audit committees should agree a policy for the employment of former employees of the external auditor, taking into account the relevant ethical guidelines governing the accounting profession. Particular attention should be paid to those individuals who were part of the audit team and moved directly to the company. Exhibit 11 contains an example policy on the employment of former employees of the external auditor.

### **Exhibit 12: Example Audit Committee Disclosures**

Compliance with the Combined Code requires that a separate section of the annual report should describe the role and responsibilities of the audit committee and how it has discharged those duties; a similar obligation is established by the 2003 Act. Illustrative audit committee disclosures are provided in Exhibit 12.

### **Exhibit 13: Example Internal Audit Plan**

Where an internal audit function exists, the audit committee should be involved in developing and approving the internal audit department's mandate, goals and mission. The internal audit work plan should be reviewed, in collaboration with management, to ensure it covers the right areas - a proper balance between the assessment of internal controls related to financial reporting and other special projects, operational efficiency and risk management responsibilities. A specimen internal audit plan is included in Exhibit 13.

### **Exhibit 14: Example Risk Summary and Register**

Audit committees should determine that management has implemented policies that ensure the company's risks around financial reporting (and, where applicable, the wider sphere of business risk) are identified and that controls are adequate, in place, and functioning properly. As part of its assessment, the audit committee should consider requesting from management an overview of the risks, policies, procedures, and controls in order for it to gain meaningful insight into the key sources of risk and how such risks are managed. An example risk summary, designed to give audit committee members a quick insight into the key risks and the effectiveness of the controls in place, is included in Exhibit 14.

## Appendix I - Exhibit 1

### Audit Committee Terms of Reference

#### Membership

The board shall appoint the committee. All members of the committee shall be independent non-executive directors of the company. The committee shall consist of not less than three members. A quorum shall be two members.

The board shall appoint the chairman of the committee from amongst the independent non-executive directors.

One member of the audit committee should have recent and relevant financial experience.

#### Secretary

The secretary of the company shall be the secretary of the committee.

#### Attendance at meetings

No one other than the audit committee members shall be entitled to attend audit committee meetings.

The chairman, other non-executive directors, CEO, finance director, head of internal audit, representatives of the external auditors, or other persons shall attend meetings at the invitation of the committee.

There should be at least one meeting a year, or part thereof, where the audit committee meets the external and internal auditors without executive board members present. This need not be the same meeting.

#### Frequency of meetings

Meetings shall be held not less than four times a year (to coincide with key dates in the company's financial reporting cycle).

External auditors or internal auditors may request a meeting if they consider that one is necessary.

#### Authority

The committee is authorised by the board to:

- investigate any activity within its terms of reference;
- seek any information that it requires from any employee of the company and all employees are directed to cooperate with any request made by the committee;
- obtain outside legal or independent professional advice, at the company's expense, and secure the attendance of outsiders with relevant experience and expertise if it considers this necessary.

## Duties

The duties of the committee shall be:

### *Financial reporting*

- to review, and challenge where necessary, the actions and judgments of management, in relation to the company's financial statements, operating and financial review, interim reports, preliminary announcements and related formal statements before submission to, and approval by, the board, and before clearance by the auditors. Particular attention should be paid to:
  - critical accounting policies and practices, and any changes in them;
  - decisions requiring a significant element of judgment;
  - the extent to which the financial statements are affected by any unusual transactions in the year and how they are disclosed;
  - the clarity of disclosures;
  - significant adjustments resulting from the audit;
  - the going concern assumption;
  - compliance with accounting standards;
  - compliance with stock exchange and other legal requirements;
- *to determine whether the financial statements have been prepared following appropriate accounting standards and give a true and fair view;*<sup>7</sup>
- *to make a recommendation to the board as to whether to approve the financial statements;*
- to consider other topics, as defined by the board.

### *Internal control and risk management*

- to review the company's procedures for detecting fraud and whistle blowing and ensure that arrangements are in place by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any other matters;
- to review management's and the internal auditor's reports on the effectiveness of the systems for internal financial control, financial reporting and risk management;
- *to review the arrangements for maintaining books of account and to assess, on an annual basis, whether, in the committee's opinion, proper books have been maintained in the manner required by company law;*
- to monitor the integrity of the company's internal financial controls;
- to review the statement in the annual report and accounts on the company's internal controls and risk management framework;

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<sup>7</sup> *Items in italics consist of specific matters required by section 205B of the Companies Act 1990, as inserted by the 2003 Act, in addition to requirements of the Combined Code. This section has not yet been commenced.*

- *to review the process for reviewing the company's procedures to secure compliance with relevant legal obligations and the proposed annual statement of compliance and:*
  - *determine whether the statement is made after due and careful enquiry and is fair and reasonable, and*
  - *make a recommendation to the board as to whether to approve the statement;*
- to assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non-financial risks. [Note: the board retains responsibility for the review of the effectiveness of the system of internal control and must form its own opinion despite aspects of that review being delegated to the audit committee.]

#### *Internal audit*

- to consider annually whether there is a need for an internal audit function where no such function exists;
- to review the internal audit programme and ensure that the internal audit function is adequately resourced and has appropriate standing within the company;
- to ensure that the internal auditor has direct access to the board chairman and the audit committee and is accountable to the audit committee;
- to receive a report on the results of the internal auditors' work on a periodic basis;
- to review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- to monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system;
- to appoint or dismiss the head of internal audit.

#### *External audit*

- to oversee the company's relations with the external auditor;
- to consider, and make recommendations on the appointment, reappointment and removal of the external auditor;
- to approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided;
- to assess the qualification, expertise and resources, effectiveness and independence of the external auditors annually. Steps to consider include:
  - seeking 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);
  - seeking 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;

- monitoring the external audit firm's compliance with applicable 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;
- agreeing with the board and monitoring the company's policy for the employment of former employees of the external auditor;
- to discuss with the external auditor, before the audit commences, the nature and scope of the audit;
- to review with the external auditors, the findings of their work, including, any major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved; key accounting and audit judgments; 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;
- to review the audit representation letters before consideration by the board, giving particular consideration to matters that relate to non-standard issues;
- to assess, at the end of the audit cycle, the effectiveness of the audit 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;
  - consideration of the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgments identified and in responding to questions from the audit committees, and in their commentary, where appropriate, on the systems of internal control;
  - obtaining feedback about the conduct of the audit from key people involved;
- to 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;
- to develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor and ensure that the provision of such services does not impair the external auditor's independence or objectivity. In doing so, the audit committee should:
  - consider whether the skills and experience of the audit firm make it a suitable supplier of the non-audit services;
  - consider 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;
  - consider the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee;
  - consider the criteria that govern the compensation of the individuals performing the audit;and

- 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.

### *Reporting*

The secretary shall circulate the minutes of meetings of the committee to all members of the board, and the chairman of the committee shall, as a minimum, attend the board meeting at which the accounts are approved.

The audit committee shall annually review its terms of reference and its own effectiveness and recommend any necessary changes to the board.

The audit committee shall prepare a report on its role and responsibilities and the actions it has taken to discharge those responsibilities for inclusion in the annual report and accounts. Such a report should specifically include:

- 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 and attendance by each member; and
- the way the audit committee has discharged its responsibilities, *including those relating to monitoring audit quality and independence.*

Where disagreements between the audit committee and the board cannot be resolved, the audit committee shall report the issue to the shareholders as part of the report on its activities in the company's annual report.

If the board does not accept the audit committee's recommendation regarding the appointment, reappointment and removal of the external auditors, the audit committee shall include a statement explaining its recommendation and reasons why the board has taken a different stance in the annual report.

The audit committee chairman shall attend the AGM and shall answer questions, through the chairman of the board, on the audit committee's activities and their responsibilities.

## Appendix I - Exhibit 2

### Audit Committee Agenda

Our experience suggests that the following topics deserve consideration when establishing the detailed agendas for the audit committee meetings during the year.

#### Risk Assessment

- Risk management process and control (particularly financial reporting risks)
- Operating reviews
- Budget reviews
- Industry and market updates
- Review financial community expectations
- Information technology changes
- Legal briefings
- Understand senior management compensation programs
- Executive sessions with appropriate senior management
- Current and emerging risk issues

#### Assess Processes Relating to the Company's Control Environment

- Compliance with code of ethical conduct
- Control policies and procedures (including earnings management, error and fraud)
- Management's assessment of key third-party providers
- Internal and external auditor internal control observations and recommendations
- Compliance with specific industry regulations
- Control policies and procedures relating to compliance with relevant obligations

#### Oversee Financial Reporting

- Financial statements and earnings releases
- Recommend approval of financial statements to board of directors
- Recommend approval of the directors' annual compliance statement to board of directors
- Periodic reports and filings
- Management overview of financial results for quarter/year
- Critical accounting policies (including appropriate application of GAAP)
- Significant and unusual transactions and accounting estimates

- Current developments in auditing, accounting, reporting, and tax matters
- Executive session with senior management

### Evaluate the Internal and External Audit Processes

- Coordination of the internal and external audit effort and definition of responsibilities
- External auditors
  - Engagement letter
  - Audit engagement team
  - Independence letter
  - Consider all significant non-audit services to be performed by the external auditor
  - Scope, procedures, and timing
  - Audit results
  - Audit reports
  - Quarterly review results
  - Meeting with external auditors
  - Management's responsiveness to audit results
  - Assess effectiveness
- Internal audit department
  - Assess need for internal auditing
  - Mandate and objectives
  - Appointment and compensation of chief auditor
  - Budget, staffing, and resources
  - Scope, procedures, and timing of the audits
  - Audit results
  - Audit reports
  - Meeting with internal auditors
  - Management's responsiveness to audit results
  - Assess effectiveness

### Audit Committee Structure

- Update mandate
- Assess audit committee performance

## Appendix I - Exhibit 3

### Audit Committee Meeting Agenda for a December Year End

	Scheduled Meetings			
	April / May	July / Aug	Oct / Nov	Jan / Feb
<b>Constitution</b>				
Review audit committee's terms and reference	■			
Review code of conduct		■		
Assess independence, financial literacy skills and experience of members			■	
Establish number of meetings for the forthcoming year		■		
Audit committee chair to establish meeting agenda and attendees required	■	■	■	■
Enhance financial literacy – update on the current financial events	■	■	■	■
<b>Assessment of financial information</b> <small>(discuss with management &amp; external auditors where applicable)</small>				
Review and recommend approval of annual financial statements				■
Review and recommend approval of annual compliance statement				■
Review and recommend approval of half-year financial statements		■		
Review and recommend approval of quarterly financial information	■		■	
<b>External auditors</b>				
Recommend appointment and review performance	■			
Approve audit fees and terms of engagement		■		
Consider policy in relation to non-audit services	■			
Consider objectivity/independence and obtain confirmation from auditor	■		■	
Review audit plan and scope of audit work		■		
Review external audit findings		■		■
Discuss appropriateness of accounting policies, estimates and judgments	■	■	■	■
Discuss external auditors views on control environment including fraud risk management	■	■	■	■
Discuss with auditor in absence of executives and management	■	■	■	■
Ongoing communication (written/oral) of external auditor with audit committee	■	■	■	■
<b>Internal auditors</b>				
Where no internal audit function, consider the need for an internal audit function			■	
Recommend appointment and review performance			■	
Review internal audit plan			■	
Review significant internal audit reports and findings	■	■	■	■
Review progress on actions taken in response to the committee's representations	■	■	■	■
Discuss with the auditor in absence of the executive and management	■	■	■	■
<b>Other responsibilities</b>				
Consider financial risks and internal controls (and other controls if applicable)	■	■	■	■
Review progress on actions taken in response to the representations of the auditors	■	■	■	■
Review whistle blowing arrangements	■			
Review legal and compliance developments	■	■	■	■
Review report to shareholders on role and responsibilities of the committee				■
Perform self-assessment of audit committee performance			■	
Review financial personal succession planning		■		
Review director and officer expenses and related party transactions	■	■	■	■
Conduct special investigations and perform other activities as appropriate	■	■	■	■
Maintain minutes and report to board	■	■	■	■

■ Recommended Timing

■ As Required

## Appendix I - Exhibit 4

### Audit Committee Self-assessment

The self-assessment has been prepared on the basis that each audit committee member will complete it independently. The audit committee chairman would then lead discussion on the results of the questionnaire, focusing on those areas which clearly need improvement or where there is great variation in answers. Alternatively, the self assessment could be undertaken as a facilitated group activity led by the audit committee chairman or an external party.

Audit committee chairmen may wish to give more weight to some aspects of the self-assessment than others. Appropriate weighting will be influenced by a number of factors including, but not limited to:

- the committee's charter;
- the organisation's strategies and risk assessments;
- its control environment;
- the outcomes of previous self-assessments;
- the stage of maturity of the audit committee;
- the views of stakeholders on the organisation's corporate governance performance; and
- current and emerging business and economic factors.

The results of the self-assessment and any action plans arising should be reported to the board after discussion with the chairman of the board. The board should also make its own assessment of the performance of audit committee's effectiveness on an annual basis.

	Rating					Comment
	Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	

#### Terms of reference

Have the audit committee's terms of reference been approved by the board?

Does the audit committee annually review its terms of reference and recommend any necessary changes to the board?

Do the terms of reference (audit committee charter) include:

- monitoring the integrity of the financial statements;

	Rating					Comment
	Excellent		Poor			
	1	2	3	4	5	
Yes / No / N/A						
<ul style="list-style-type: none"> <li>■ reviewing the company's procedures for maintaining accounting records and its internal financial control system;</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<ul style="list-style-type: none"> <li>■ recommending to the board whether to approve the financial statements and directors' annual compliance statement;</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<ul style="list-style-type: none"> <li>■ unless addressed by another board sub-committee or by the board itself, reviewing the company's risk management systems;</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<ul style="list-style-type: none"> <li>■ monitoring and reviewing the effectiveness of the company's internal audit function;</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<ul style="list-style-type: none"> <li>■ recommending to the board the appointment of the external auditor and approving their remuneration and terms of engagement following appointment by the shareholders in General Meeting;</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<ul style="list-style-type: none"> <li>■ monitoring the effectiveness of the external auditor's performance and their independence and objectivity;</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<ul style="list-style-type: none"> <li>■ developing and implementing a policy on the engagement of the external auditor to supply non-audit services?</li> </ul>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Membership and appointments</b>						
Does the audit committee consist of independent non-executive directors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Is the board chairman excluded from audit committee membership?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Are audit committee members appointed by the board on the recommendation of the nomination committee (where there is one) in consultation with the audit committee chairman?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Is audit committee membership restricted to a term no longer than three years (extendable by no more than two additional three year periods)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Yes / No / N/A	Rating					Comment
	Excellent			Poor		
	1	2	3	4	5	
<b>Meetings</b>						
Does the audit committee meet regularly (at least three times a year to coincide with key dates in the financial reporting and audit cycle)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Are audit committee meetings well attended?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Do audit committee meetings allow sufficient time for discussion and questions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Are meeting agendas and related background information circulated in a timely manner to enable full and proper consideration to be given to the issues?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Is sufficient time allowed between audit committee meetings and board meetings to allow any work arising to be carried out and reported to the board as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee invite non-members to attend meetings where necessary? (Only the audit committee members should be entitled to attend audit committee meetings.)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Are arrangements in place for the audit committee to meet with external and internal auditors during the year without the presence of management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee chairman, and to a lesser extent the other members, keep in touch on a continuing basis with the key people involved in the company's governance e.g., the board chairman, the chief executive, the finance director, the external auditor and the head of internal audit?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Yes / No / N/A	Rating					Comment
	Excellent 1	2	3	Poor 4	5	
<b>Training and resources</b>						
Does the audit committee have sufficient skills, experience, time and resources to undertake its duties?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does at least one audit committee member have recent and relevant financial experience?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Is an induction programme (covering the role of the audit committee, its terms of reference and expected time commitment by members; an overview of the company's business; and the main business and financial dynamics and risks) provided for new audit committee members?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Do audit committee members receive relevant training in financial reporting and related company law on an ongoing and timely basis?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Do audit committee members have the opportunity to attend formal courses and conferences, internal company talks and seminars, and briefings by external advisers such as the company's auditors and lawyers?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee have access to the services of the company secretary and staff?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Are funds available to enable the audit committee to take independent legal, accounting or other advice when it reasonably believes it necessary to do so?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

	Rating					Comment
	Excellent				Poor	
Yes / No / N/A	1	2	3	4	5	
<b>Financial reporting</b>						
Does the audit committee review the significant financial reporting issues and judgments made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Where an accounting treatment is open to a different approach, does the audit committee consider whether the company has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgments?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee review the clarity and completeness of disclosures in the financial statements, interim reports, preliminary announcements and related formal statements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting, does it report such views to the board and seek changes?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Internal financial controls and risk management systems</b>						
Does the audit committee monitor the integrity of the company's internal financial controls?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee assist in the board's assessment of the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non-financial risks?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Yes / No / N/A	Rating					Comment
	Excellent		Poor			
	1	2	3	4	5	
In carrying out such an assessment, does the audit committee receive and review reports from management on the effectiveness of the systems they have established and the results of any testing carried out by internal and external auditors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee review and approve the statements included in the annual report in relation to the process for managing risk and the boards review of the adequacy of that process?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Internal audit process</b>						
Where no internal audit function exists, does the audit committee annually consider whether there is a need for one and make a recommendation to the board?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee review and approve the appointment or termination of the head of internal audit?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee review and assess the independence and objectivity of the internal audit function?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee review and approve the internal audit function's remit?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee ensure that the internal audit function has the necessary resources and access to information to enable it to fulfil its mandate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee review and assess the annual internal audit work plan?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

	Rating					Comment
	Excellent		Poor			
	1	2	3	4	5	
Does the audit committee receive a report on the results of the internal auditors' work on a periodic basis, and monitor management's responsiveness to the internal auditor's findings and recommendations?						
Does the audit committee meet with the head of internal audit at least once a year without the presence of management?						
Does the audit committee monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system?						
Does the audit committee make appropriate enquiries about the coordination and cooperation between internal and external audit?						
Does the audit committee ensure that the internal audit function follows the Standards for the Professional Practice of Internal Auditing issued by the Institute of internal Auditors?						
<b>External audit process</b>						
Is the audit committee responsible for overseeing the external auditor?						
Does the audit committee make recommendations to the board (and thence to shareholders) on the appointment, reappointment and removal of the external auditors?						
Does the audit committee annually assess the qualification, skills and resources, effectiveness and independence of the external auditors?						

	Rating					Comment
	Excellent		Poor			
	1	2	3	4	5	
Yes / No / N/A						
Does the audit committee annually assess the procedures in place to ensure the independence and objectivity of the external auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee seek reassurance that the external auditors and their staff have no family, financial, employment, investment or business relationship with the company (other than in the normal course of business)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee regularly seek information from the external auditor about its policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Did the audit committee agree with the board the policy for the employment of former employees of the external auditor, and does the audit committee monitor application of that policy (including the number of former employees of the external auditor currently employed in senior positions in the company)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee monitor the external audit firm's compliance with applicable 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?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Yes / No / N/A	Rating					Comment
	Excellent		Poor			
	1	2	3	4	5	
Does the audit committee have a policy specifying 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?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee keep the nature and extent of non-audit services provided by the auditors under review?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee review and agree the engagement letter issued at the start of each audit and, where necessary, ensure that it has been updated to reflect changes in circumstances arising since the previous year?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee 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?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
At the start of each annual audit cycle, does the audit committee 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?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee: discuss with the external auditor major issues that arose during the course of the audit; review key accounting and audit judgments; review levels of errors identified during the audit, obtaining explanations as to why certain errors might remain unadjusted?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

	Rating					Comment
	Excellent				Poor	
Yes / No / N/A	1	2	3	4	5	
Does the audit committee review the audit representation letters before signature by management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
At least annually, does the audit committee meet with the lead audit partner, and other members of the audit team as necessary, without the presence of management, to discuss issues arising from the audit, and any other matters that the auditor might wish to raise with the audit committee and vice versa?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
As part of the ongoing monitoring process, does the audit committee review the management letter (or equivalent) and monitor management's responsiveness to the external auditor's findings and recommendations?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
At the end of the annual audit cycle, does the audit committee assess the effectiveness of the audit process?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Whistle blowing</b>						
Does the audit committee review the arrangements by which staff may raise concerns in confidence about possible improprieties in matters of financial reporting, financial control or related matters?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Relationship with the board</b>						
Does the committee report to the full board after each meeting?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Where there is disagreement between the audit committee and the board, is adequate time set aside for discussion of the issue with a view to resolving the disagreement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Where disagreements between the audit committee and the board cannot be resolved, does the audit committee have the right to report the issue to shareholders?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Yes / No / N/A	Rating					Comment
	Excellent		Poor			
	1	2	3	4	5	

**Communications with shareholders**

Does the audit committee ensure that a report on its role and responsibilities, and the actions taken to discharge those responsibilities is included in the annual report and accounts? Does such a report provide sufficient detail to enable shareholders to understand how the audit committee has discharged its duties?

If the board did not accept the audit committee's recommendation regarding the appointment, reappointment or removal of the auditors, did the audit committee ensure the annual report and accounts included a statement explaining its recommendation and the reasons why the board took a different stance?

Does the chairman of the audit committee attend the AGM and, where necessary, answer questions on matters within the scope of audit committee's responsibilities?

**Recommendations for improvement**

How can the committee improve its performance?

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## Appendix I - Exhibit 5

### Audit Committee Evaluation of External Auditors

There follows a suggested checklist framework for an audit committee to carry out a formal review of the effectiveness and efficiency of their external auditors. Such a review provides the audit committee with a disciplined approach to keeping the auditors' performance under review. It will also help to ensure that the auditors remain alert to the company's needs and to maintaining an appropriate relationship with the executive management, the audit committee and the board as a whole.

#### Calibre of external audit firm

What is the reputation of the external audit firm? Are there recent or current litigation cases against the firm?

What is the reputation and presence of the external audit firm in this industry?

Does the external audit firm have the size, resources and geographical coverage required to audit this company?

#### Quality processes

What are the quality control processes in the external audit firm?

Factors to be considered include the level and nature of review procedures, the approach to audit judgments and issues, independent quality control reviews and the external audit firms approach to risk.

How are key audit individuals at the external audit firm compensated and evaluated, and do these compensation and evaluation schemes run the risk of impairing the external auditor's independence?

What is the external audit firm's process for internal review of accounting judgments, including an understanding of the key issues?

What relevant specialists does the external audit firm employ and how are these linked to the audit process?

#### Audit team

Do the individuals assigned to the external audit team have the requisite expertise, including industry knowledge, to effectively audit this company?

Are sufficient resources allocated to the audit?

What is the scope of the engagement partner's/other senior personnel's involvement in the audit process and is this sufficient?

Does the external audit firm have adequate key team member succession plans in place, which meet the relevant audit partner rotation requirements and facilitate the maintenance of objectivity?

### Audit scope

- Is the external audit scope adequate to address all of the financial reporting risks facing the company?
- Factors to be considered include the geographical coverage, the allocated resources, the level of audit testing and the nature of the audit reports issued at each location.
- Does the external audit firm agree the audit scope and plan with the audit committee?
- Is specialist input to the audit in areas such as taxation, pensions and regulation at an appropriate level?
- Are all key operations covered by the external audit?
- How are overseas audits controlled and is audit effectiveness regarded as consistent internationally?
- Are the reporting processes for subsidiary audit teams effective?
- What is the external audit firm's approach to seeking and assessing management representations?
- Does the external auditor have an effective working relationship with internal audit?

### Audit fee

- Is the external audit fee reasonable given the scope of the external audit, and how does the audit fee compare with other similarly sized companies in this industry (a fee that is either too high or too low can be of concern)?
- How are differences between actual and estimated fees handled?
- Is an assessment made of the amounts and relationship of audit and non-audit fees and services?

### Audit communications

- Does the external audit firm advise the audit committee about significant issues and new developments regarding risk management, corporate governance, financial accounting and related risks and controls on a timely basis?
- Does the external auditor discuss the critical accounting policies and whether the accounting treatment is conservative or aggressive?
- Does the external audit firm meet freely, regularly, and on a confidential basis with the audit committee?
- Does the external audit firm resolve accounting issues in a timely manner?
- Does the external audit firm seek feedback on the quality and effectiveness of the service they are providing?

### Audit governance and independence

- Is the relationship with the external auditor controlled by the audit committee or does management control the relationship?
- Does the external audit firm have open lines of communication and reporting with the audit committee?
- Are unadjusted audit differences and significant weaknesses in internal controls appropriately communicated?
- Do the individuals assigned to the audit demonstrate a high degree of integrity in their dealings with the audit committee?
- Does the external audit firm discuss their internal process for ensuring independence with the audit committee?
- Do management respect the external auditors as providers of an objective and challenging audit process?
- Is the level and nature of entertainment between the external audit firm and management appropriate?
- Does the nature of non-audit services provide any potential to impair audit independence?

## Appendix I - Exhibit 6

### Audit Committee Evaluation of Internal Auditors

There follows a four-part checklist of questions to consider as part of a complementary framework for the assessment of the internal audit function.

#### Section A

*This part of the checklist should be completed by the audit committee prior to feedback from other areas of the organisation.*

#### Understanding

How well does internal audit demonstrate that it:

- Recognises its direct reporting responsibility to the board of directors and the audit committee;  
Strong  Adequate  Needs improvement
- Has a strong understanding of the responsibilities and operation of the audit committee;  
Strong  Adequate  Needs improvement
- Understands the expectations of the audit committee and the chairman;  
Strong  Adequate  Needs improvement
- Understands the organisation's business and risk environment?  
Strong  Adequate  Needs improvement

Does internal audit consistently demonstrate a realistic and commercial view of the business?

Yes  No

Comments

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## Charter and structure

Do the terms of reference for internal audit define:

- Roles and responsibilities, including those in relation to other internal functions; Yes  No
- Expectations of management; Yes  No
- Scope of internal audit work; Yes  No
- Access to information? Yes  No

Has internal audit's terms of reference been reviewed within the last 2 years? Yes  No

Evaluate internal audit's terms of reference in light of the organisation's current needs.

Strong  Adequate  Needs improvement

Evaluate internal audit's current terms of reference in light of the organisation's future needs.

Strong  Adequate  Needs improvement

Are internal audit's terms of reference visible to everyone in the organisation? Yes  No

Does the structure of internal audit facilitate:

- Consistency in the quality of service to the organisation; Yes  No
- Understanding of the organisation's business issues; Yes  No
- The delivering of value to the organisation? Yes  No

Comments

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## Skills and experiences

How well does internal audit's staffing reflect its roles and responsibilities?

Strong  Adequate  Needs improvement

On the basis of the work performed by internal audit over the past 12 months, does internal audit appear to have the right staff mix and competencies in specialist areas such as IT and Treasury and the necessary geographical coverage? Yes  No

Does the internal audit team have an appropriate programme of continuing education? Yes  No

Evaluate internal audit's independence from the activities it audits.

Strong  Adequate  Needs improvement

How would you assess the committee's confidence in internal audit?

Strong  Adequate  Needs improvement

Comments

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### Communication

Has internal audit attended all the audit committee meetings it was scheduled to attend?

Yes  No

Has internal audit made itself available for consultation outside of audit committee meetings?

Yes  No

Evaluate internal audit's responsiveness to requests from the audit committee, including requests for special investigations.

Strong  Adequate  Needs improvement

Evaluate internal audit's frankness and candour with the committee.

Strong  Adequate  Needs improvement

Evaluate internal audit's handling of difficult or contentious issues.

Strong  Adequate  Needs improvement

Does internal audit ensure that the chairman of the audit committee is fully briefed on significant findings or developments prior to audit committee meetings? Yes  No

Evaluate the usual level of preparation for audit committee meetings demonstrated by internal audit.

Strong  Adequate  Needs improvement

Evaluate the quality of internal audit reports and papers tabled with the audit committee. Consider their relevance and clarity.

Strong  Adequate  Needs improvement

Have reports been received from internal audit on a sufficiently timely basis? Yes  No

Does internal audit promptly advise the audit committee about significant issues and significant developments, including on special projects such as fraud investigations? Yes  No

Does internal audit promptly advise the committee about significant changes to the internal audit plan? Yes  No

Evaluate the strength of internal audit's process to monitor the status of open matters/recommendations.

Strong  Adequate  Needs improvement

Did internal audit contribute to the committee's understanding of the overall assurance framework within the organisation and the role internal audit plays in this framework? Yes  No

Does the internal audit function proactively share its learning widely with the business i.e., outside the strict reporting channels? Yes  No

Comments

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## Performance

*This section should include questions that focus on the KPIs for the internal audit team.*

Assess the quality of the internal audit plan in terms of its:

- Comprehensiveness, clarity and timeliness;

Strong  Adequate  Needs improvement

- Coverage of priority and high risk areas;

Strong  Adequate  Needs improvement

- Focus on testing the control framework.

Strong  Adequate  Needs improvement

Did the original internal audit plan leave unanswered any significant issues of concern to the audit committee?

Yes  No

What was your assessment of the scope of the internal audit as outlined in the plan?

Strong  Adequate  Needs improvement

Was it clear from its reporting to the committee that internal audit:

- Delivered the services outlined in the plan;

Yes  No

- Were in accordance with the agreed timetable?

Yes  No

Is there evidence of effective coordination of internal and external audit work?

Yes  No

Are success measures used for evaluating the performance of the internal audit function?

Yes  No

Does the internal audit function offer adequate career progression opportunities for its employees?

Yes  No

Are there sufficient performance based reward mechanisms to motivate internal audit employees?

Yes  No

Do you consider that internal audit has added value to the organisation?

Yes  No

In what way has internal audit added value to the organisation?

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How would you assess internal audit's overall performance?

Strong  Adequate  Needs improvement

Overall comments

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*Name*

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*Position* *Audit Committee Chairman*

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*Signed*

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*Date*

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## Section B

*This part of the checklist should be completed by heads of major business units and the chief financial officer/finance director. Where significant subsidiaries or major business units are subject to internal audit, consider asking leaders of these businesses to complete the survey.*

### Planning

Are internal audit's terms of reference sufficiently visible to everyone in your business?

Yes  No

Was there sufficient pre-planning and coordination by the internal auditors with the department before each phase of the internal audit or special project commenced?

Yes  No

Did internal audit discuss its approach and major areas of audit focus with you? Yes  No

Did you raise any major areas of concern that were not reviewed by the internal audit team? Yes  No

Comments

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### Skills and experience

Do you consider the internal audit team have sufficient professional experience, project management, inter-personal skills and seniority to effectively carry out the work required? Yes  No

Do you consider the internal audit team have sufficient expertise in the functional specialisations (e.g., IT, risk assessment, treasury) to effectively carry out the work that was required? Yes  No

Assess the strength of internal audit's understanding of the organisation and its risk involvement.  
Strong  Adequate  Needs improvement

How strongly did the senior members of the internal audit team demonstrate an appreciation of the issues key to your role and responsibilities?  
Strong  Adequate  Needs improvement

Did members of the internal audit team consistently demonstrate independence in all their deliberations? Yes  No

In your view, does the way in which internal audit is funded impair its independence? Yes  No

Do you believe the members of the internal audit team are independent of the activities they audit? Yes  No

Were members of the internal audit team adequately supervised? Yes  No

Comments

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### Work programme

Was effective cooperation achieved between the internal auditors and your department, including the avoidance of undue disruption to normal activities?

Yes  No

Was there a formal process to ensure internal audit kept you up to date with audit/project progress?

Yes  No

Did internal audit provide early identification and advice of contentious issues, problem areas and delays?

Yes  No

Did internal audit suggest how such issues could be resolved?

Yes  No

Were suggestions realistic, robust and presented clearly and on a timely basis?

Yes  No

How responsive was internal audit to the business's needs, including requests for special investigations?

Strong  Adequate  Needs improvement

Were internal audit reports:

■ Relevant, clear and constructive;

Yes  No

■ Sufficiently detailed to enable effective management action;

Yes  No

■ Issued on a timely basis?

Yes  No

Were internal audit findings discussed with you prior to being tabled with the audit committee?

Yes  No

Did internal audit follow up recommendations to see whether they had been implemented?

Yes  No

Do you have any major unresolved disagreements with internal audit?

Yes  No

### Overall performance

Did internal audit add value to your business?

Yes  No

In what ways did internal audit add value to your business?

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### Overall comments

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*Name*

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*Position*

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*Signed*

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*Date*

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### Section C

*This checklist should be completed by the external auditor of the parent organisation and of subsidiaries, major business units or regions if appropriate.*

#### Terms of reference

Evaluate internal audit's current terms of reference given your understanding of the organisation's business, complexity, risk environment and the current developments in internal audit.

Strong  Adequate  Needs improvement

From your knowledge of internal audit and industry best practice, do you consider internal audit's current terms of reference are maintained at a high quality level?

Yes  No

Comments

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### Skills and experience

Do you consider the internal audit team have the professional experience, technical skills, inter-personal skills and seniority to effectively carry out the internal audit work required?

Yes  No

Evaluate the senior members of the internal audit team's understanding of the organisation, its business and its risk environment.

Strong  Adequate  Needs improvement

Assess the internal audit team's experience in key functional specialisations, in the context of what is needed for the proper discharge of their roles and responsibilities:

- |                    |                                 |                                   |  |
|--------------------|---------------------------------|-----------------------------------|--|
| ■ IT;              | Strong <input type="checkbox"/> | Adequate <input type="checkbox"/> | Needs improvement <input type="checkbox"/> |
| ■ Risk management; | Strong <input type="checkbox"/> | Adequate <input type="checkbox"/> | Needs improvement <input type="checkbox"/> |
| ■ Treasury;        | Strong <input type="checkbox"/> | Adequate <input type="checkbox"/> | Needs improvement <input type="checkbox"/> |
| ■ Accounting;      | Strong <input type="checkbox"/> | Adequate <input type="checkbox"/> | Needs improvement <input type="checkbox"/> |
| ■ Tax;             | Strong <input type="checkbox"/> | Adequate <input type="checkbox"/> | Needs improvement <input type="checkbox"/> |
| ■ Supply chain.    | Strong <input type="checkbox"/> | Adequate <input type="checkbox"/> | Needs improvement <input type="checkbox"/> |

Other (specify)

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From your dealings with members of the internal audit team and your knowledge of internal audit and industry best practice:

- Do you consider internal audit have sufficient resources to satisfy their terms of reference? Yes  No
- Evaluate the sufficiency of internal audit's resources to adequately deliver the services outlined in its internal audit plan in the timeframes identified.  
Strong  Adequate  Needs improvement

Does the structure of internal audit appear to facilitate understanding of the organisation's business issues? Yes  No

Does internal audit's staffing appear to adequately reflect its roles and responsibilities? Yes  No

In your assessment, is the internal audit methodology robust and does it reflect the latest thinking in internal audit? Yes  No

Comments

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### Work programme

Are there regular discussions between internal and external audit on internal and external strategies, assessment of risks and the implications of audit findings/audit work? Yes  No

Has progress against plan been monitored jointly by internal and external audit regularly throughout the year? Yes  No

Did you receive copies of all internal audit reports issued by internal audit? Yes  No

Were copies of internal audit reports received on a timely basis? Yes  No

Are internal audit reports of a standard comparable to best practice in other organisations? Yes  No

To the best of your knowledge, are there any major areas of risk or concern that internal audit did not appear to cover? Yes  No

Overall comments

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*Name*

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*Position*

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*Signed*

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*Date*

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## Section D

*This checklist should be completed by the head of internal audit (self assessment).*

### Understanding

Evaluate internal audit's understanding of:

- The responsibilities and operation of the audit committee;

Strong  Adequate  Needs improvement

- The organisation's business;

Strong  Adequate  Needs improvement

- The organisation's risk environment;

Strong  Adequate  Needs improvement

- The organisation's control framework.

Strong  Adequate  Needs improvement

Comments

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## Charter and structure

Do the terms of reference for internal audit define in sufficient detail, for the purposes of directing internal audit:

- Roles and responsibilities, including those in relation to other internal functions; Yes  No
- Expectations of management; Yes  No
- Scope of internal audit work; Yes  No
- Access to information? Yes  No

Evaluate internal audit's current terms of reference in light of the organisation's current needs.

Strong  Adequate  Needs improvement

Evaluate internal audit's current terms of reference in light of the organisation's future needs.

Strong  Adequate  Needs improvement

Assess the structure of internal audit in terms of enhancing its:

- Objectivity; Strong  Adequate  Needs improvement
- Understanding of the organisation's business issues; Strong  Adequate  Needs improvement
- Ability to respond to business needs. Strong  Adequate  Needs improvement

Comments

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## Skills and experience

How well does internal audit's staffing reflect its roles and responsibilities?

Strong  Adequate  Needs improvement

Assess the staff mix and competencies of the internal audit team.

Strong  Adequate  Needs improvement

Evaluate internal audit's independence from the activities it audits.

Strong  Adequate  Needs improvement

Comments

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Communication

Evaluate internal audit's responsiveness to requests from the audit committee, including requests for special investigations.

Strong  Adequate  Needs improvement

Evaluate internal audit's frankness and candour with the committee.

Strong  Adequate  Needs improvement

Evaluate internal audit's handling of difficult or contentious issues.

Strong  Adequate  Needs improvement

Over the last 12 months, has the chairman of the audit committee been fully briefed on significant findings or developments prior to audit committee meetings? Yes  No

Evaluate internal audit's process to monitor the status of open matters/recommendations.

Strong  Adequate  Needs improvement

Comments

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**Performance**

*This section should be developed to focus on the KPIs set for the internal audit team.*

In what way has internal audit added value to the organisation?

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How would you assess internal audit's overall performance?

Strong  Adequate  Needs improvement

Overall comments

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*Name* \_\_\_\_\_

*Position* \_\_\_\_\_

*Signed* \_\_\_\_\_

*Date* \_\_\_\_\_

## Appendix I - Exhibit 7

### Policy on the use of External Auditors for Non-audit services

#### Introduction

This paper sets out the policy for the appointment and remuneration of the external auditors for any work undertaken on behalf of XYZ Plc and outlines the control processes that will be put in place to ensure compliance with this policy.

#### Statutory audit

The group finance director in conjunction with the relevant member of the group management board will negotiate the annual audit fee for each division and subsidiary. The group finance director will recommend the overall fee for the statutory audit to the group audit committee. It is the responsibility of the audit committee to review the proposed statutory audit fee and recommend it to the XYZ Board for approval.

The audit committee will review the independence and effectiveness of the external auditors on an annual basis.

#### Other work as auditors or reporting accountants

While it is difficult to be precise regarding the definition of work that the external auditor may undertake as auditor or reporting accountant, it includes the following:

- interim results and any other review of the accounts for regulatory purposes;
- assurance work related to compliance and corporate governance, including high level controls;
- work in connection with listing particulars and prospectuses;
- regulatory reviews or reviews commissioned by the audit committee; and
- accounting advice and reviews of accounting standards.

The group chief accountant must clear the appointment of the external auditor for any such work in advance. Any assignments in excess of €x will require the approval of the group finance director, who will consult with the chairman of the audit committee in respect of any assignment over €y.

The audit committee will receive a quarterly report analysing fees paid for other work as auditors or reporting accountants, with additional commentary on assignments agreed during the quarter.

#### Tax advisory

The external auditor may provide tax advisory services, including tax planning and compliance, provided that such advice does not conflict with the external auditor's statutory responsibilities and ethical guidance.

The head of group tax will determine whether the appointment of the external auditor for any tax work would conflict with their statutory duties and, if in any doubt, request approval from the group chief accountant. Any tax assignment in excess of €x requires the approval of the group finance director who will consult with the chairman of the audit committee in respect of any assignment over €y. The audit committee will receive a bi-annual report on the tax advisory services provided by the external auditor.

## Merger and acquisition support

It is permissible for the external auditor to be appointed to undertake specific activities on behalf of XYZ Plc. However, the external auditor cannot be appointed to undertake merger and acquisition work without the prior approval of the group finance director who will consult with the Chairman of the audit committee in respect of any assignment that could involve fees in excess of €x. Any fees paid in respect of merger and acquisition activity will be reported quarterly to the audit committee.

## Other accounting advisory and consultancy work

There may be occasions when the external audit firm is best placed to undertake other accounting, advisory and consultancy work on behalf of XYZ Plc due to its in-depth knowledge of the company. However, the following are specifically prohibited:

- work related to accounting records and financial statements that will ultimately be subject to external audit;
- management of, or significant involvement in, internal audit services;
- secondments to management positions that involve any decision-making;
- any work where a mutuality of interest is created that could compromise the independence of the external auditor; and
- any other work which is prohibited by the Auditing Practices Board's Ethical Standards.

Any assignment in excess of €x can only be awarded to the external auditor after competitive tender. The inclusion of the external auditor on a tender list requires the prior approval of the relevant member of the group management board and the group finance director. The group finance director will consult with the chairman of the audit committee regarding any tender for work in excess of €y. Details of all such work and fees paid will be reported quarterly to the audit committee.

## Implementation arrangements

The Policy outlined above in respect of new assignments applies with immediate effect. Any issues relating to the application of the policy in particular instances should be raised with the chairman of the audit committee.

## Appendix I - Exhibit 8

### Example Questions - Identifying and Assessing Risk

In view of the different approaches boards may take in referring powers to the audit committee in respect of risk management and the control framework, it is vital that there is an unambiguous understanding of what the board of directors, other board committees and the audit committee are responsible for in this important area of corporate governance. The audit committee's responsibilities should be reflected in its terms of reference.

So as to meet its responsibilities under its terms of reference, the audit committee needs to assess whether it is getting appropriate information relating to financial reporting and risk management regularly enough and in a format that meets the needs of members. It needs to evaluate at least annually the adequacy and timeliness of management reporting to the committee on financial, non-financial, current and emerging risk trends. The audit committee needs also to discuss risk management with senior executives, internal and external audit. The scope of those discussions should have reference to the audit committee terms of reference.

The following are high-level questions the audit committee may like to consider in framing discussions with management. The list is not exhaustive and will require tailoring based on the audit committee's terms of reference as well as the particular circumstances of the organisation.

Risk management framework	Evaluation of risk management framework
<p><b>Risk strategy:</b> the approach for associating and managing risks based on the organisation's strategies and objectives.</p>	<ul style="list-style-type: none"> <li>■ What are the risks inherent in our business strategies and objectives?</li> <li>■ How is our risk strategy linked to our business strategy?</li> <li>■ Is our risk management policy clearly articulated and communicated to the organisation? If not, why not? If yes, how has this been achieved?</li> <li>■ Is our risk appetite (the amount of risk the organisation is willing to take) clear? How is it linked to our objectives?</li> <li>■ How has the board's perspective on risk permeated the organisation and culture?</li> </ul>

Risk management framework	Evaluation of risk management framework
<p><b>Risk structure:</b> the approach for supporting and embedding the risk strategy and accountability.</p>	<ul style="list-style-type: none"> <li>■ Is there a common risk management language/terminology across the organisation? If not, why not?</li> <li>■ Is accountability for risk management transparent at the management level? If not, why not? If yes, describe how this has been achieved.</li> <li>■ Are risk management activities/responsibilities included in job descriptions?</li> <li>■ How do our performance management and incentive systems link to our risk management practices?</li> </ul>
<p><b>Measuring and monitoring:</b> the establishment of Key Performance Indicators (KPIs) and continuous measuring and improving of performance.</p>	<ul style="list-style-type: none"> <li>■ Are risk owners clearly identified? If not, why not. If yes, How?</li> <li>■ Are there systems in place for measuring and monitoring risk?</li> <li>■ How are risks, including suspected improprieties, escalated to the appropriate levels within the organisation?</li> <li>■ How is the risk management framework linked to the organisation's overall assurance framework?</li> </ul>
<p><b>Portfolio:</b> the process for identifying, assessing and categorising risks across the organisation.</p>	<ul style="list-style-type: none"> <li>■ Does a comprehensive risk profile exist for the organisation? If not, why not?</li> <li>■ Does the risk profile evidence identification and evaluation of non-traditional risk exposures?</li> <li>■ Are the interrelationships of risks clearly identified and understood?</li> </ul>

Risk management framework	Evaluation of risk management framework
	<p data-bbox="1010 398 1225 432"><b>Operational Risk</b></p> <ul data-bbox="1010 459 1519 806" style="list-style-type: none"> <li data-bbox="1010 459 1519 571">■ What are the risks inherent in the processes chosen to implement the strategies?</li> <li data-bbox="1010 582 1519 683">■ How does the organisation identify, quantify and manage these risks given its appetite for risk?</li> <li data-bbox="1010 705 1519 806">■ How does the organisation adapt its activities as strategies and processes change?</li> </ul>
	<p data-bbox="1010 828 1212 862"><b>Reputation Risk</b></p> <ul data-bbox="1010 884 1519 985" style="list-style-type: none"> <li data-bbox="1010 884 1519 985">■ What are the risks to brand and reputation inherent in the way the organisation executes its strategies?</li> </ul>
	<p data-bbox="1010 1008 1404 1041"><b>Regulatory or Contractual Risk</b></p> <ul data-bbox="1010 1064 1519 1299" style="list-style-type: none"> <li data-bbox="1010 1064 1519 1176">■ Which financial and non-financial risks are related to compliance with regulations or contractual arrangements?</li> <li data-bbox="1010 1198 1519 1299">■ Has the organisation taken reasonable steps to control risk of non-compliance with relevant obligations?</li> </ul>
	<p data-bbox="1010 1321 1189 1355"><b>Financial Risk</b></p> <ul data-bbox="1010 1377 1519 1624" style="list-style-type: none"> <li data-bbox="1010 1377 1519 1444">■ Have operating processes put financial resources at undue risk?</li> <li data-bbox="1010 1467 1519 1534">■ Has the organisation incurred unreasonable liabilities to support operating processes?</li> <li data-bbox="1010 1556 1519 1624">■ Has the organisation succeeded in meeting measurable business objectives?</li> </ul>
	<p data-bbox="1010 1646 1372 1680"><b>Information Technology Risk</b></p> <ul data-bbox="1010 1702 1519 1960" style="list-style-type: none"> <li data-bbox="1010 1702 1519 1769">■ Is our data/information/knowledge reliable, relevant and timely?</li> <li data-bbox="1010 1792 1519 1836">■ Are our information systems reliable?</li> <li data-bbox="1010 1859 1519 1960">■ Do our security systems reflect our reliance on technology, including our e-business strategy?</li> </ul>

## Risk management framework

## Evaluation of risk management framework

## New Risks

- In a business environment that is constantly changing, are there processes in place to identify emerging risks? If not, why not? If yes, describe.

- What risks have yet to develop?

These might include risks from new competitors or emerging business models, recession risks, relationship risks, outsourcing risks, political or criminal risks, financial risk disasters such as rogue traders, and other crisis and disaster risks.

**Optimisation:** balancing potential risks and opportunities based on the appetite to accept risk.

- Does the risk approach include a regular search for new markets, partnering opportunities and other risk optimisation strategies? If not, why not? If yes, how is this achieved?
- Is risk a priority consideration whenever business processes are improved? If not, why not? If yes, describe how this is achieved.

## Appendix I - Exhibit 9

### Warning Signals

Every organisation is different and each board should develop and maintain its own list of warning signals.

Some will relate specifically to the individual circumstances of the organisation and its environment, while others will be more general. The following are some of the signals audit committee members should be aware of:

#### 1 Financial considerations

- exposure to interest and currency fluctuations;
- recent fall in the company's share price;
- overly complex transactions and organisational structures;
- deterioration in the collection of debts and/or quality of debtors;
- increase in amounts owing to creditors;
- ongoing or prior investigations by regulators;
- inadequate information regarding financial performance;
- unusually rapid growth;
- regular deferral of capital expenditure;
- unrealistic earning expectations by financial community;
- explanations for variances from budgets considered to be inadequate;
- excessive or inappropriate performance-based compensation;
- gearing or liquidity forecast to be a problem;
- inadequate review and analysis of budgets against actual performance;
- recognising revenue before sale is complete;
- loan agreement covenants not being complied with;
- results appear unrealistically high given industry and economic conditions;
- key ratios deteriorating;
- significant decline in turnover and market share;
- last minute transactions that result in significant revenues;
- slow-down in the receipt of financial reports;
- financial results consistently meet or closely match budget/forecast;

- unusual results or trends; and
- organisation incurs losses.

## 2 Board of directors and management

- chairman and chief executive officer dominate meetings and make decisions without first consulting the board;
- autocratic management;
- extremely close relationship between chairman and chief executive officer;
- inappropriate “tone at the top”;
- flow of information delayed, especially concerning problem areas;
- inexperienced management;
- inadequate examination of acquisitions and mergers;
- insufficient questioning and enquiry by board members;
- lack of harmony or respect between board members;
- lack of understanding about technology;
- insufficient number of board committees;
- chief executive officer is a dominant entrepreneur;
- managerial and board self-indulgence;
- lack of management oversight;
- poor relationship between directors and senior management;
- reporting to board only through the chief executive officer;
- board and management focused on the past;
- resignation of key management or directors; and
- failure to comply with code of ethics/conduct.

## 3 Audit considerations

- auditors' report and management letters show an increasing number of control problems and areas of disagreement with management;
- external auditors changed due to accounting or financial reporting disagreements;
- internal audit operating under restrictions;
- organisation's accounting principles and practices are aggressive or vary from the industry norm;
- untimely reporting and responses to audit committee enquiries; and

- audit committee not meeting with external and internal auditors without management present.

#### 4 Other warning signs

- abnormally high level of related party transactions;
- exposure to rapid technology changes;
- frequent customer complaints about the quality of goods or services provided;
- increasing stock levels compared to turnover;
- major deterioration in any of the organisation's key markets;
- no policy for managing intellectual capital assets;
- insufficient controls over disposal of pollutants;
- performance of major outsourced providers less than adequate;
- insufficient review of compliance with legislative requirements;
- media commenting adversely on the organisation's performance and products;
- deteriorating morale;
- resistance to abandonment of an unprofitable venture;
- not fully understanding overseas market places;
- shortages of raw material or inventories, resulting in the late delivery of orders and indicating a loss of supply markets or late payment of creditors;
- significant drop in sales order activity, especially with forward sales;
- significant staff turnover;
- significant strategic changes in the organisation's operating environment;
- trend of losses appears continuing;
- unexpected losses have occurred;
- major new projects "out of control" - behind time, significantly over budget, not delivering benefits;
- deteriorating performance on long term projects;
- consideration of high risk strategies;
- deteriorating relationship with the organisation's banker;
- lack of or inadequate succession planning; and
- bad news not floating to the top.

## Appendix I - Exhibit 10

### Example Whistle Blowing Policy

#### Introduction

All employees are encouraged to raise genuine concerns about possible improprieties in matters of financial reporting and other malpractices at the earliest opportunity, and in an appropriate way.

This policy is designed to:

- support our values;
- ensure employees can raise concerns without fear of suffering retribution; and
- provide a transparent and confidential process for dealing with concerns.

This policy not only covers possible improprieties in matters of financial reporting, but also:

- fraud;
- corruption, bribery or blackmail;
- criminal offences;
- failure to comply with a legal or regulatory obligation;
- miscarriage of justice;
- endangering the health and safety of an individual; and
- concealment of any of the above.

#### Principles

All concerns raised will be treated fairly and properly.

We will not tolerate the harassment or victimisation of anyone raising a genuine concern.

Any individual making a disclosure will retain their anonymity unless they agree otherwise.

We will ensure that any individual raising a concern is aware of who is handling the matter.

We will ensure no one will be at risk of suffering some form of retribution as a result of raising a concern even if they are mistaken. We do not however extend this assurance to someone who maliciously raises a matter they know is untrue.

#### Grievance Procedure

If any employee believes reasonably and in good faith that malpractice exists in the work place, then he or she should report this immediately to their own line manager. However, if for any reason they are reluctant to do so, then they should report their concerns to either the:

- group company secretary; or
- director of human resources.

Employees concerned about speaking to another member of staff can speak, in confidence, to an independent third party by calling the **Whistle Blowing Hotline** on [ ]. This is provided through the independent party who provides the Employee Care counselling and legal advice service. Your concerns will be reported to the Company without revealing your identity.

If these channels have been followed and employees still have concerns, or if employees feel the matter is so serious that it cannot be discussed with any of the above, they should contact the senior independent director on [ ].

Employees who have raised concerns internally, will be informed of who is handling the matter, how they can make contact with them and if there is any further assistance required. We will give as much feedback as we can without any infringement on a duty of confidence owed by us to someone else.

Employees' identities will not be disclosed without prior consent. Where concerns are unable to be resolved without revealing the identity of the employee raising the concern, (e.g., if their evidence is required in court), we will enter into a dialogue with the employee concerned as to whether and how we can proceed.

If you are unsure whether to use the procedure or you want independent advice at any stage, you may contact the independent charity [ ]. Their lawyers can give you free confidential advice at any stage about how to raise a concern about serious malpractice at work.

## Appendix I - Exhibit 11

### Example Policy on the Employment of Former Employees of the External Auditor

The audit committee has adopted the following policy regarding the employment of former employees of the company's external auditor.

For purposes of this policy, the 'audit team' means any partner, director, manager, staff, or tax professional associated with the company's external auditor who works on any aspect of the annual audit of the company's consolidated financial statements. For purposes of this policy, 'employee of the company's independent auditing firm' will include any person regularly providing professional services on behalf of the independent auditor, regardless of whether that person is legally an employee of the firm - for example, if the external auditor is a partnership, a partner would be deemed an 'employee of the company's independent auditor'. For purposes of these guidelines, 'company' includes XYZ Plc and its subsidiaries.

- (1) No member of the audit team can be hired into in a financial reporting oversight role, for a period of two years following their association with the audit. A financial oversight role is any position that has direct responsibility for overseeing those who prepare the company's financial statements.
- (2) No former employee of the company's external auditor may be named a company officer for two years after the termination of their employment with the company's external auditor.
- (3) No former employee of the company's external auditor may join the senior executive team without the approval of the human resources director and the chairman of the audit committee.
- (4) Each year, the human resources director shall report to the audit committee the profile of former employees of the external auditor employed by the company in the preceding year.

## Appendix I - Exhibit 12

### Example Audit Committee Disclosures

#### Audit Committee

The audit committee consists of four non-executive directors, considered by the board to be independent. These are [ ] (chairman), [ ], [ ] and [ ]. The committee has at least one member possessing what the Smith report describes as recent and relevant experience. [ ], a chartered accountant, was finance director of [ ] between 1998 and 2002. It will be seen from the directors' biographical details, appearing on pages XX and XX, that the other members of the committee bring to it a wide range of experience from positions at the highest level both in Ireland/UK and the rest of the world.

The committee normally meets four times a year and did so during the year under review.

Both the external auditors and the internal auditor are present at the meetings and, in addition, it is common practice for the committee to meet the external auditors without management present as part of each meeting. There are no members of management on the committee. The chief executive officer, the finance director and other members of management attend audit committee meetings at the invitation of the audit committee chairman.

The main role and responsibilities are set out in written terms of reference which are available for inspection on the company's website and include:

- monitoring the integrity of the company's financial statements and reviewing significant financial reporting issues and judgments contained therein;
- reviewing the company's systems of financial control and risk management;
- monitoring and reviewing the effectiveness of the company's internal audit function;
- making recommendations to the board on the appointment and dismissal of the external auditor and approving their remuneration and terms of engagement; and
- monitoring and reviewing the external auditors' independence, objectivity and effectiveness, taking into account professional and regulatory requirements.

These responsibilities are discharged as follows:

- At its meetings in February and August, the audit committee reviews the company's preliminary announcement/annual report and accounts, and the interim report respectively. The February meeting includes consideration of the directors' statements on compliance with relevant obligations. On both occasions, the committee receives reports from the external auditors identifying any accounting or judgmental issues requiring its attention.
- A quarterly report from the head of internal audit is presented at each of the four meetings. In addition, at the November meeting, the head of internal audit submits the department's audit plans for the coming year.

- The external auditors also present their audit plans at the November meeting. The audit committee also considers at this meeting information relevant to auditor independence. At the May meeting, there is a detailed review of the management letter covering the auditors' findings in respect of the prior financial year and of the performance and quality of the audit.
- Executives are, from time to time, required to make presentations to the audit committee on the subject of risk, its identification, management and controls.
- As a matter of routine, the audit committee is presented with information on material litigation involving the company.

As noted above, one of the duties of the audit committee is to make recommendations to the board in relation to the appointment of the external auditors. A number of factors are taken into account by the committee in assessing whether to recommend the auditors for re-appointment. These include:

- the quality of reports provided to the audit committee and the board and the quality of advice given;
- the level of understanding demonstrated of the company's business and industry;
- the objectivity of the auditors' views on the controls around the company and their ability to coordinate a global audit working to tight deadlines.

The audit committee has put in place safeguards to ensure that the independence of the audit is not compromised. Such safeguards include:

- seeking confirmation that the auditors are, in their professional judgment, independent of the company;
- obtaining from the external auditors an account of all relationships between the auditors and the company;
- monitoring the number of former employees of the external auditors currently employed in senior positions in the company and assessing whether those appointments impair, or appear to impair, the auditors' judgment or independence;
- considering whether, taken as a whole, the various relationships between the company and the external auditors impairs, or appears to impair the auditors' judgment or independence;
- considering whether the compensation of individuals employed by the external auditors who are performing the audit is tied to the provision of non-audit services and, if so, consider whether this impairs, or appears to impair, the external auditors' judgment or independence; and
- reviewing the economic importance of the company to the external auditors and assessing whether that importance impairs, or appears to impair, the external auditors' judgment or independence.

The company has a policy governing the conduct of non-audit work by the auditors. Under that policy the auditors are prohibited from performing services where the auditors:

- may be required to audit their own work;
- participate in activities that would normally be undertaken by management;
- are remunerated through a 'success fee' structure, where success is dependent on the audit;
- act in an advocacy role for the company.

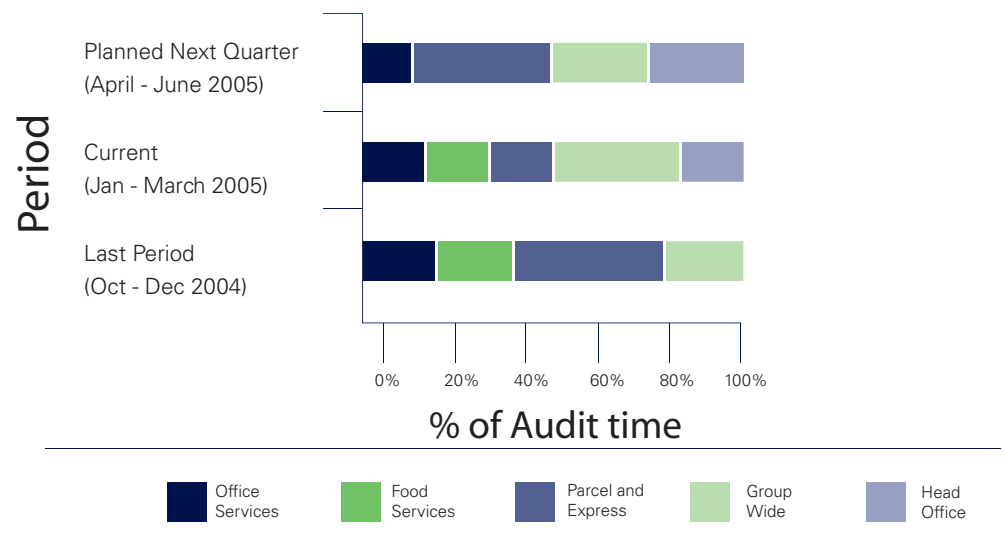
Other than the above, the company does not impose an automatic ban on the company's auditor undertaking non-audit work. The auditor is permitted to provide non-audit services that are not, or are not perceived to be, in conflict with auditor independence, providing they have the skill, competence and integrity to carry out the work in the best interests of the company. A list of these types of services is contained in company's policy which can be found on the company's website. All services that fall into this category where fees are in excess of €x, must be approved by the audit committee. Activities that may be perceived to be in conflict with the role of the external auditor must be submitted to the committee for approval prior to engagement, regardless of the amounts involved. All assignments are monitored by the committee.

Details of the amounts paid to the external auditors during the year for audit and other services are set out in the notes to the financial statements on page XX.

## Appendix I - Exhibit 13

### Example Internal Audit Plan

#### Internal audit work by division



The internal audit plan to be carried out between April and June 2005 is as follows:

Review	Scope	Location	Timetable
Review of procedures to monitor bank covenants	<ul style="list-style-type: none"> <li>Head Office review of monitoring processes and procedures</li> <li>Integrity audit of reported KPI's</li> <li>Review of documentation used by Group Finance to communicate accounting requirements (including impact of IFRS) and monitor compliance</li> </ul>	Dublin	April 2005 1 week
Review of contract accounting and revenue recognition in Office Services Division	<ul style="list-style-type: none"> <li>Review of proposed Contract Controls Framework</li> </ul>	Office Services Division	May 2005 2 weeks

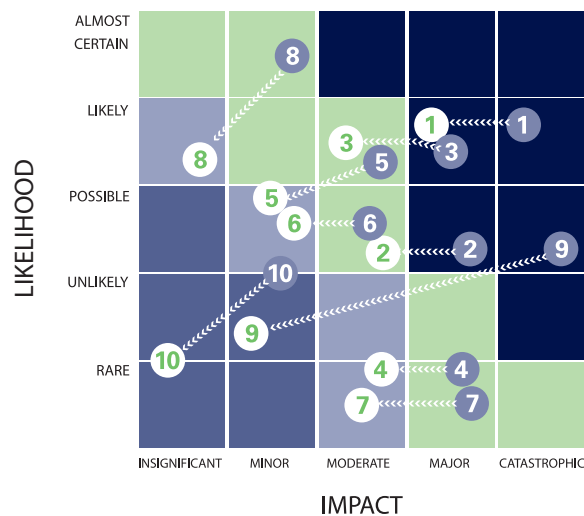
Review	Scope	Location	Timetable
Extension of scope of post-implementation review of Sales Order Processing and Customer Database systems	<ul style="list-style-type: none"> <li>■ Review of Readiness Review checklist</li> <li>■ Review of project management procedures</li> </ul>	European Operations	June 2005 3 weeks
Review of processes to monitor performance of sub-contractors	<ul style="list-style-type: none"> <li>■ Benchmarking with industry best practice of key performance indicators used to measure and monitor performance</li> <li>■ Review of integrity of key performance indicators</li> <li>■ Review of management monitoring procedures</li> </ul>	Germany	June 2005 2 weeks
Review of copyright procedures	<ul style="list-style-type: none"> <li>■ Review of project planning, design and implementation process documentation to ensure compliance with copyright legislation</li> </ul>	Germany	April 2005 2 weeks
Monthly review of operation of key financial controls within Finance Departments	<ul style="list-style-type: none"> <li>■ Using self assessment internal financial controls questionnaire, validate existence and operation of key financial controls</li> </ul>	All Finance Departments	Ongoing and monthly 2 days each month per country
Review of vetting procedures for temporary staff	<ul style="list-style-type: none"> <li>■ Review procedures to ensure that temporary staff are vetted prior to engagement</li> <li>■ Review the updated policy documentation</li> <li>■ Review the proposed guidelines on restrictions to be placed on the role and responsibilities of temporary staff</li> </ul>	Group Finance/ Human Resources	May 2005 2 days

## Appendix I - Exhibit 14

### Example Risk Summary and Register

Significant progress has been made in the development and implementation of the group's risk management policy. The process is to identify, assess and manage the group's key risks, to support the business objectives. The output from the risk management process is now used as a tool to manage the group on an ongoing basis, rather than being seen as a stand alone exercise for the Annual Report. The purpose of this section of our report is to present management's view of the top ten key risks facing the business. Each of these risks has been assessed in terms of potential impact and likelihood of occurrence, using descriptive scales. Quantification criteria for likelihood and impact is set below the risk summary in schedule A.

The grid below has been used to provide a graphical illustration of the likelihood and impact for each of the group's top ten risks, the arrows representing the influence existing internal controls are thought to have on that risk (refer to schedule B for the summary risk register).



#### Top ten key risks:

- 1) Inappropriate acquisition strategy and process
- 2) Fall in investor confidence due to media criticism
- 3) Failure to comply with appropriate regulatory and legal requirements (i.e., cartels)
- 4) Post implementation IT systems failures\*
- 5) Failure to allow current business strategy enough time to develop
- 6) Failure to manage and respond adequately to economic uncertainty
- 7) Inadequate business continuity and disaster recovery plans to manage a major IT network failure
- 8) Inability to protect brand name
- 9) Parcel and Express services division fail to deliver their expected growth strategy
- 10) Loss of key staff and inadequate succession planning

#### Key



Note: Arrows represent effectiveness of controls currently in place

\* Reviews planned in period to 30 June 2005

## Schedule A: Quantification Criteria for Likelihood and Impact

LIKELIHOOD		IMPACT				
		5	4	3	2	1
		ALMOST CERTAIN	LIKELY	POSSIBLE	UNLIKELY	RARE
		>90%	50 - 90%	30 - 50%	10 - 30%	<10%
		Event is expected to occur in most circumstances	Event will probably occur in most circumstances	Event should occur at some time	Event could occur at some time	Event may occur only in exceptional circumstances
		5	4	3	2	1
		Insignificant	Minor	Moderate	Major	Catastrophic
		Resolution would be achieved during normal day to day activity	Resolution would require input from regional management team	Resolution would require input from Executive team	Resolution would require the mobilisation of a dedicated team	Resolution would require input from the Board
		Less than 1% or no impact	1% - 3% impact	3% - 10% impact	10% - 25% impact	Greater than 25%
		Little or no impact	1% - 3% impact	3% - 10% impact	10% - 25% impact	Greater than 25%
		On-site environmental exposure immediately contained	On-site environmental exposure contained after prolonged effort	On-site environmental exposure contained with outside assistance	Off-site environmental exposure contained with outside assistance	Environmental exposure off-site with detrimental effects
		Letters to local/industry press	Series of articles in local/industry press	Extended negative local/industry media coverage	Short term national negative media coverage	Extensive negative national media coverage
		Minor breaches by individual staff members	No fine - no disruption to scheduled services	Fine but no disruption to scheduled services	Fine and disruption to scheduled services	Significant disruption to scheduled services over an extended period of time
		An event, the impact of which can be absorbed through normal activity	An event, the consequences of which can be absorbed but management effort is required to minimise impact	A significant event which can be managed under normal circumstances	A critical event which with proper management can be endured	A disaster with potential to lead to collapse of the business
		MANAGEMENT EFFORT	REGULATORY	REPUTATION	ENVIRONMENT	TURNOVER
		PROFIT	TIME			

## Schedule B: Summary Risk Register

Risk	Gross risk		Board accountability	Control description	Control effectiveness	Net/residual risk		Action	Responsibility	Review date
	Impact	Likelihood				Impact	Likelihood			
1	5	4	Finance Director	Use of external advisors for due diligence.	Weak	4	4	Develop mergers & acquisitions framework aligned with business strategy. Widening of acquisition search function.	Finance Director	Sept 2005
2	4	3	Chief Executive	Annual meeting with key investors.	Poor	3	3	Media training for all executives. Open days. Formal & informal programme of contacts.	Head of Communications	June 2005
3	4	4	Entire Board	Yearly self assessment. Oversight by Legal department.	Poor	3	4	Health check on all procedures regarding regulatory and legal compliance.	Head of Legal	June 2005
4	4	2	Finance Director	Project management procedures. Utilisation of Readiness Review checklist on all projects.	Good	3	2	Maintenance of offsite back ups.	Head of IT	June 2005
5	3	4	Entire Board	Board's continuous review of group strategy.	Good	2	3	Setting of strong KPIs for business strategy and realistic review dates.	Chief Executive	June 2005
6	3	3	Chief Executive, Finance Director, Division MD's	Management monthly review of economic forecast & comparison with the group's forecast financial position.	Good	2	3	Creation of financial models in order to conduct scenario modelling.	Board	Sept 2005
7	4	1	Finance Director	Business continuity & disaster recovery plans reviewed (& update where necessary) & tested half-yearly.	Strong	3	1	Off site back up of systems.	Head of IT	Sept 2005

Risk	Gross Risk		Board Accountability	Control description	Control effectiveness	Net/residual risk		Action	Responsibility	Review Date	
	Impact	Likelihood				Impact	Likelihood				
8	Inability to protect brand name	2	5	Chief Executive, Finance Director	Copyright procedures in place. Quarterly management review process to ensure compliance with copyright legislation. Legal review of all copyrights.	Good	1	4	Review and update (if necessary) copyright procedures.	Head of Legal	Sept 2005
9	Parcel and Express services division fail to deliver their expected growth strategy	5	3	Chief Executive, MD Parcel and Express Services	Growth strategy devised following regional consultation with senior management. Good KPI framework with regular monitoring. Widespread communication of strategy.	Good	2	2	Regular review of strategy and performance against KPIs in management meetings.	MD Parcel & Express services	June 2005
10	Loss of key staff and inadequate succession planning	2	3	Chief Executive, Division MD's	Salary review. Well defined succession planning for key members. Well defined recruitment processes. Strong recruitment processes.	Strong	1	2	Annual benchmarking of salaries compared to industry peer group.	Head of Human Resources	Sept 2005

## Appendix II: Audit Committee Requirements Introduced by the Companies (Auditing and Accounting) Act 2003

Section 42 of the 2003 Act inserts a new section 205B into the Companies Act 1990, containing provisions relating to the appointment of audit committees and their duties. The latter are summarised below.

<b>Overseeing financial reporting</b>	Reviewing the annual financial statements of the company (and, where applicable, the group) before their presentation to the board of directors for approval.
	Determining whether the financial statements have been drawn up in accordance with applicable accounting standards and give a true and fair view.
	Recommending to the board of directors whether to approve the financial statements.
<b>Overseeing the process related to the company's financial risks and internal control</b>	Determining at least annually whether in the committee's opinion, the company has kept proper books of account in accordance with section 202 of the Companies Act 1990.
	Reviewing the directors' annual compliance statement <sup>8</sup> before its approval by the board of directors.
	Determining whether the compliance statement complies with the statutory requirements, is fair and reasonable and is based on due and careful enquiry.
<b>Overseeing the internal and external audit processes</b>	Recommending to the board of directors whether to approve the statement.
	Advising the board on the recommendation to be made to shareholders in relation to the appointment of an auditor.
	Monitoring the auditors' independence.
	Obtaining relevant information from the auditor and monitoring the company's relationship with the auditor Monitoring the performance and quality of the auditors' work.

<sup>8</sup> As required by section 205E of the Companies Act 1990, inserted by section 45 of the 2003 Act.

	Recommending whether or not to award contracts for non-audit work to the auditor or an affiliate of the auditor.
	Considering whether arrangements and resources available for internal audits are suitable.
<b>Disclosure</b>	Reporting, as part of the directors' report, on the committee's activities and discharge of its responsibilities, including at least its duty to monitor audit independence and quality.

Boards of public limited companies must appoint an audit committee whose responsibilities must include all of the items above, though additional duties may be included<sup>9</sup>. Boards of larger private companies, defined as those having turnover and assets in excess of €50 million and €25 million respectively, are required to consider whether to appoint an audit committee with some or all of those responsibilities<sup>9</sup>. That decision - and reasons, if determining not to establish an audit committee or to omit any of the statutory responsibilities - is to be disclosed in the annual directors' report.

Failure by the board to appoint an audit committee as required by the new provision is an indictable offence.

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<sup>9</sup> *New section 205B of the Companies Act 1990, sub-section (16) exempts any company that is a wholly-owned subsidiary of a public listed company.*

## Appendix III: Audit Committee Recommendations within the Combined Code

This appendix sets out the revised Combined Code recommendations specifically related to audit committees.

It should be noted that the Listing Rules of the Irish Stock Exchange and UK Listing Authority require each incorporated listed company to include within its annual reports:

- a statement of how it has applied the Combined Code **principles**, providing sufficient explanation to enable its shareholders to evaluate properly how the principles have been applied; and
- a statement as to whether or not it has complied throughout the accounting period with the Combined Code **provisions**. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.

### Code Principles

No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee. (Principle A.3)

The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities. (Principle A.5)

All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board. (Principle A.7)

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. (Principle C.3)

### Code Provisions

The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties. (Provision A.5.2)

All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole. (Provision A.5.3)

The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors. (Provision A.6.1)

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. (Provision C.3.1)

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 judgments 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. (Provision C.3.2)

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. (Provision C.3.3)

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. (Provision C.3.4)

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. (Provision C.3.5)

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 auditor 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. (Provision C.3.6)

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

## Appendix IV: Comparison of the Smith Guidance to the relevant SEC and NYSE Regulations

This appendix sets out a summary comparison of Sir Robert Smith's *Guidance on Audit Committees* (as appended to the revised Combined Code issued in July 2003) and selected elements of SEC and NYSE audit committee related regulation. This summary is meant to provide a high-level overview of elements of the new requirements that impact audit committees.

This document does not incorporate all of the elements of these requirements, nor does it consider regulations that may have previously existed (such as the stock exchange listing standards and SEC regulations issued in December 1999). Audit committees should consult with legal counsel in the application the stock exchange listing requirements to specific situations.

### Applicability

<b>Smith Guidance for Audit Committees</b>	<b>NYSE Audit Committee Regulations</b>	<b>SEC Audit Committee Regulations</b>
<p>The Smith Guidance is designed to suggest ways of applying the relevant principles and of complying with the relevant provisions of the revised Combined Code. The rules of the UK Listing Authority require UK listed companies to state the extent to which they have complied with the provisions contained within the Combined Code (exemptions exist for companies that have only debt securities, or fixed income shares listed).</p>	<p>The new NYSE listing standards apply to companies listing common equity securities. Controlled companies, limited partnerships and companies in bankruptcy, closed-end and open-end funds, foreign private issuers, and some other specified entities are exempt from specific provisions in the standards.</p> <p>The standards apply to companies that list only debt or preferred securities only to the extent that the listing standards overlap with SEC Rule 10A-3 and for purposes of CEO notifications of known material non-compliance with the listing rules.</p>	<p>The Final SEC rules on audit committees apply to all listed issuers.</p>

<p><b>Compliance date</b></p>	<p>Applies to accounting periods beginning on or after 1 November 2003.</p>	<p>Generally, US listed Companies must comply by the date of their first shareholders' meeting after 15 January 2004, but in any event no later than 31 October 2004. Foreign-private issuers are required to comply no later than 31 July 2005.</p>	<p>Foreign private issuers are be required to comply by the date of their first annual shareholders' meetings after 31 July 2005. US listed issuers are required to comply by the date of their first annual shareholders' meeting after 15 January 2004, but in any event no later than 31 October 2004.</p>
<p><b>Consequences of non-compliance</b></p>	<p>The "comply or explain" principle of the Combined Code applies. Departures from the Combined Code and related Smith guidance will not be automatically treated as breaches.</p>	<p>Violation of the Corporate Responsibility criteria including the rules on audit committees could result in de-listing.</p>	<p>Companies will be de-listed if they fail to implement SEC regulations, and do not successfully cure violations.</p>
<p><b>Purpose</b></p>	<p>The main role and responsibilities of audit committees should be set out in written terms of reference and should include:</p> <ul style="list-style-type: none"> <li>■ to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgments contained in them;</li> <li>■ to review the company's internal financial control system and, unless addressed by a separate risk committee or by the board</li> </ul>	<p>The purpose of the audit committee is to assist the board of directors in the oversight of the:</p> <ul style="list-style-type: none"> <li>■ integrity of financial statements;</li> <li>■ company's compliance with legal and regulatory requirements;</li> <li>■ external auditor's qualifications and independence; and</li> <li>■ performance of company's internal audit function and external auditors.</li> </ul>	<p>The purpose of the audit committee is to assist the board of directors in the oversight of :</p> <ul style="list-style-type: none"> <li>■ accounting and financial reporting processes;</li> <li>■ the effectiveness of financial reporting controls; and</li> <li>■ the independence, accountability and effectiveness of the external auditor.</li> </ul>

## Membership

<p>itself, risk management systems;</p> <ul style="list-style-type: none"> <li>■ to monitor and review the effectiveness of the company's internal audit function;</li> <li>■ to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor following appointment by the shareholders in General Meeting;</li> <li>■ to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process; and</li> <li>■ to develop and implement policy on the engagement of the external auditor to supply non-audit services.</li> </ul>	<p>The audit committee must also prepare the report required by SEC rules to be included in annual proxy statement (report to shareholders).</p>	
<p>The board should establish an audit committee of at least three or, in the case of companies outside the FTSE 350, two members. Audit committees should be comprised solely of independent non-executive directors.</p>	<p>The board should establish an audit committee of at least three members, all of whom are independent directors.</p>	<p>Each member of the audit committee must be independent, one member must be a financial expert (defined below).</p>

<p>An "independent" director is one who is independent in character and judgment and has no relationships or circumstances that affect his judgment. Such relationships and circumstances would include where the director was an employee within the last five years, where the director holds cross directorships or has significant links with other directors through involvement in other company boards or bodies, and where the director has served on the board for more than nine years.</p> <p>The chairman of the company should not be an audit committee member.</p>	<p>No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organisation that has a relationship with the company). Companies must disclose these determinations. The rules include a number of other detailed provisions relating to previous employment and related remuneration levels.</p>	<p>There are two basic criteria for audit committee member independence:</p> <ul style="list-style-type: none"> <li>■ audit committee members must be barred from accepting any consulting, advisory or compensatory fee from the issuer or any subsidiary, other than in the member's capacity of the board or any board committee; and</li> <li>■ an audit committee member must not be an affiliated person of the issuer or any subsidiary of the issuer.</li> </ul>
<p>At least one member of the audit committee should have recent and relevant financial experience.</p> <p>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.</p>	<p>All members must be financially literate or must become financially literate within a reasonable period of time after becoming audit committee members. At least one member must have expertise in accounting or related financial management.</p> <p>A board may presume that a person who meets the SEC's definition of an "audit committee financial expert" [see SEC column for definition] has the accounting or related financial management expertise required under the new listing standards.</p>	<p>The SEC has defined an audit committee financial expert as a person who has <u>all</u> of the following attributes:</p> <ul style="list-style-type: none"> <li>■ an understanding of generally accepted accounting principles and financial statements;</li> <li>■ the ability to assess the general application of such principles in accounting for estimates, accruals and reserves;</li> <li>■ an understanding on internal controls and procedures for financial reporting;</li> </ul>

Meetings

<p>Only audit committee members should be entitled to be present at audit committee meetings. Others may be invited to attend.</p> <p>The audit committee should, at least annually, meet the external and internal auditors, without management, to discuss issues arising from the audit.</p>	<p>If the audit committee does not have a member who meets the SEC's definition of an "audit committee financial expert" that fact must be disclosed even if the NYSE listing requirement is met.</p> <p>The audit committee should meet separately on a periodic basis with management, internal auditors and the external auditors.</p>	<ul style="list-style-type: none"> <li>■ an understanding of internal controls and procedures for financial reporting;</li> <li>■ experience preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can be reasonably be expected to be raised; and</li> <li>■ an understanding of audit committee functions.</li> </ul> <p>The SEC requires disclosure of whether the audit committee has at least one financial expert. If an audit committee does not have a financial expert the reason why must be disclosed.</p>
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## Resources

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.

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

The audit committee shall have authority and funding to engage independent counsel and outside advisors as appropriate without seeking approval of the board of directors.

Audit committees should be provided with funding to fulfil its responsibilities. This includes money to pay the independent auditor and hire outside advisors.

## Remuneration

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 following:

- the time members are required to give to audit committee business;
- the skills they bring to bear and the onerous duties they take on; and
- the value of their work to the company.

Audit committee members may not accept either directly or indirectly any consulting, advisory or compensatory fees from the issuer or any subsidiary other than the fees related to service on the board of directors or any board committee.

## Training

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.

An induction programme should be provided 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. Meeting some of the company staff is also recommended.

Training should also be provided to members of the audit committee on an ongoing and timely basis and should, at least, 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

The company's corporate governance guidelines must address director orientation and continuing education.

## Relationship with the Board

statements, applicable accounting standards and recommended practice; the regulatory framework for the company's business; and the role of internal and external auditing and risk management.

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.

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.

The audit committee should report regularly to the board of directors any issues concerning:

- quality and integrity of financial statements;
- compliance with legal or regulatory requirements;
- performance and independence of the external auditors; and
- performance of internal audit function.

The audit committee should present its conclusions with respect to the qualifications, performance and independence of the external auditors to the full board.

## Financial reporting

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.

The terms of reference of the audit committee should be tailored to the particular circumstances of the company.

The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board.

The board should review the audit committee's effectiveness annually.

Where disagreements between the audit committee and the board 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.

The audit committee should review the significant financial reporting issues, judgments, and clarity and completeness of disclosures made in connection with the preparation of the company's financial statements, interim reports,

The audit committee must review:

- major issues regarding accounting principles and financial statement presentations, including any significant changes in

The external auditor must report on a timely basis to the audit committee:

- all critical accounting policies and practices applied in its financial statements and the

<p>preliminary announcements and related formal statements such as the Operating and Financial Review recommended.</p>	<p>company's selection or application of accounting principles;</p> <ul style="list-style-type: none"> <li>■ major issues as to the adequacy of company's internal controls and any special audit steps adopted in light of material control deficiencies;</li> <li>■ analysis prepared by management and/or external auditors setting forth: <ul style="list-style-type: none"> <li>■ significant financial reporting issues and judgments;</li> <li>■ effects of alternative GAAP methods on the financial statements;</li> </ul> </li> <li>■ the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements; and</li> <li>■ earnings press releases (paying particular attention to any use of "pro forma" or "adjusted" non GAAP information) as well as the financial information and earnings guidance provided to analysts and rating agencies.</li> </ul> <p>Discuss annual and quarterly financial statements, including the MD&amp;A with management</p>	<p>auditors assessment of managements disclosures regarding such policies and practices;</p> <ul style="list-style-type: none"> <li>■ GAAP alternatives discussed with management and the alternative preferred by the audit firm;</li> <li>■ other material in written communications with management such as the management letter and unadjusted audit differences; and</li> <li>■ initial selection of and changes in significant accounting policies, or their application, occurring during the current audit period.</li> </ul>
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### Internal financial control and risk management

<p>The audit committee should review the company's internal financial controls.</p> <p>The audit committee, unless expressly addressed by a separate board risk committee comprised of independent directors or by the board itself, should review the company's internal control and risk management systems.</p> <p>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</p>	<p>and external auditors.</p> <p>Discuss earnings press releases, financial information and guidance provided to analysts and rating agencies.</p> <p>Discuss risk assessment and risk management policies set by management, and actions taken by management to monitor and control those risks.</p> <p>The audit committee should discuss the policies that govern the company's risk assessment and risk management, including the company's major financial risks and actions taken by management to monitor and control those risks.</p>	<p>No detailed requirements for audit committees, other than their mandate to assist the board in the oversight of accounting and financial reporting processes, and the effectiveness of financial reporting controls.</p> <p>In certain cases, the audit committee's mandate may well extend to cover oversight of the processes adopted in response to Sarbanes-Oxley section 302 (Disclosure controls and procedures) and section 404 (assessment of internal controls and procedures for financial reporting).</p>
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## Whistle blowing

should receive reports from management on the effectiveness of the systems they have established and the results of any testing carried out by internal and external auditors.

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 financial control and the management of risk.

The audit committee should review arrangements by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any 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.

Audit committees must establish procedures for the receipt, retention and treatment of complaints received by the company concerning accounting, internal controls or auditing matters.

The procedures must encompass the confidential, anonymous submission by employees of concerns on questionable accounting and auditing matters.

Audit committees must establish procedures for the receipt, retention and treatment of complaints received by the company concerning accounting, internal controls or auditing matters.

The procedures must encompass the confidential, anonymous submission by employees of concerns on questionable accounting and auditing matters.

## Internal audit

The audit committee should monitor and review the effectiveness of the company's internal audit activities.

Where there is no internal audit function, the audit committee

The audit committee should periodically meet with the internal auditor.

Listed companies must maintain an internal audit function to provide

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.

The audit committee should review and approve the internal audit function's remit, having regard to the need for the internal and external audit functions to complement one another.

The audit committee should approve the appointment or termination of appointment of the head of internal audit.

As part of its review work, the audit committee should:

- 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;

management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. A company may choose to outsource this function to a third party service provider other than its independent auditor.

### External audit - appointment, terms and remuneration

- review and monitor management's responsiveness to the internal auditors' 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 audit committee is responsible for overseeing the company's relations with the external auditor.

The audit committee should have primary responsibility for making a recommendation to the board 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 the reasons why the board has taken a different stance.

The audit committee must oversee the auditor's work.

The audit committee is responsible for the appointment, compensation, and retention of the auditor.

The audit committee must oversee the auditor's work.

The audit committee is "directly responsible to hire, pay and if necessary, dismiss the independent auditor."

### External audit - independence

The audit committee should annually assess the qualification, expertise and resources, effectiveness and independence of the external auditors and the effectiveness of the audit process.

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. It 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.

The audit committee should assess the procedures in place to ensure the independence and objectivity of the external auditor annually.

The audit committee should also assess the independent auditor's qualifications, performance, and independence. In making its evaluation, the audit committee should consider auditor rotation, the opinions of management, and the company's internal auditors. The audit committee's conclusions should be presented to the full board.

The audit committee should obtain and review at least annually a report from the independent auditors that describes: the audit firm's quality control procedures, all relationships between the independent auditor and the company, and material issues raised by the firm's most recent internal quality control review or by any governmental or professional inquiry or investigation in the most recent five years relating to the firm's audits.

### External audit - annual audit cycle

The audit committee should develop and recommend to the board a policy in relation to the provision of non-audit services by the auditor.

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

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.

At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process.

The audit committee must have sole authority to approve all significant non-audit engagements with the external auditors.

The audit committee should meet periodically with the independent auditor.

The audit committee should discuss with the independent auditor any problems or difficulties that were encountered during the course of the audit and any significant disagreements with management. The audit committee may review, for example, waived audit adjustments, communications between the audit team and the audit firm's national office, and internal control matters.

Audit committees must have a written charter that addresses:

- purpose of the audit committee;
- duties and responsibilities of the audit committee.

It is the responsibility of the audit committee to pre-approve all audit and non-audit services provided by the accountant.

The external auditor should report directly to the audit committee.

The audit committee should ensure resolution of disagreements between management and the external auditor regarding financial reporting.

### Communication with shareholders

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.

The audit committee must provide a report disclosing the following:

- the audit committee has reviewed and discussed the audited financial statements with management;

<p>This should include:</p> <ul style="list-style-type: none"> <li>■ a summary of the audit committee's role;</li> <li>■ the names and qualifications of all members of the audit committee during the period;</li> <li>■ the number of audit committee meetings, and who attended them;</li> <li>■ a report on how the committee has discharged its duties; and</li> <li>■ an explanation of how auditor objectivity and independence is safeguarded.</li> </ul> <p>Where disagreements between the audit committee and the board 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 company's annual report.</p> <p>If the board does not accept the audit committee's recommendation regarding the appointment, reappointment and removal of the external auditors, a statement from the audit committee explaining its recommendation and reasons why the board has taken a different stance should be included in the annual report. The annual report should</p>	<p>The charter must be posted on the company web site.</p> <p>The SEC requires disclosure of whether the audit committee has at least one financial expert. If an audit committee does not have a financial expert the reason why must be disclosed.</p>	<ul style="list-style-type: none"> <li>■ discussed certain matters with the independent auditors;</li> <li>■ whether the audit committee is governed by a charter (if so, this should be appended to the proxy statement every three years); and</li> <li>■ whether the members of the audit committee are independent.</li> </ul> <p>In addition the SEC requires disclosure of whether the audit committee has at least one financial expert. If an audit committee does not have a financial expert the reason why must be disclosed.</p>
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<p>explain to shareholders how the policy in relation to the provision of non-audit services by the auditor provides adequate protection of auditor independence.</p> <p>The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board, on the report on the audit committee's activities and matters within the scope of audit committee's responsibilities.</p>	<p>Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards. This certification must be disclosed in the company's annual report to shareholders.</p>	
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## Appendix V: Financial Reporting Deadlines

		Public company				Private limited company
	Reference	ISE and LSE official list	AIM listed	OFEX	Unlisted	
Announce/publish annual report		Preliminary announcement (audited or unaudited) within 120 days of the period end. Publish audited results within six months of the period end. <i>Listing rules: 12.42(e) and 12.48</i>	Publish and send to shareholders audited results within six months of the period end. <i>AIM rules: 16 and 17</i>	Announce audited results within five months of the period end. <i>OFEX rules: 9.9 and 9.10</i>	n/a	n/a
Provide copy of the annual accounts, directors' report, and notice of AGM to the members.	<i>Section 159 of the Companies Act 1963</i>	Not less than 21 days before the general meeting. Combined Code recommends notice and papers to be sent to shareholders at least 20 working days before the meeting.	Not less than 21 days before the general meeting.	Not less than 21 days before the general meeting.	Not less than 21 days before the general meeting.	Subject to exceptions not less than 21 days before the general meeting.
Hold AGM	<i>Section 159 of the Companies Act 1963</i>	Every calendar year not more than 15 months apart.	Every calendar year not more than 15 months apart.	Every calendar year not more than 15 months apart.	Every calendar year not more than 15 months apart.	Every calendar year not more than 15 months apart.
Laying accounts	<i>Section 131 of the Companies Act 1963</i>	9 months	9 months	9 months	9 months	9 months
Lodge annual return with registrar of companies	<i>Section 125 of the Companies Act 1963</i>	Complete within 28 days of the annual return date <sup>10</sup> .	Complete within 28 days of the annual return date.	Complete within 28 days of the annual return date.	Complete within 28 days of the annual return date.	Complete within 28 days of the annual return date.
Announce/publish interim accounts and reports <sup>11</sup>		Publish results within 90 days of the period end <sup>12</sup> .	Prepare and notify results within three months of the period end.	Announce results within three months of the period end <sup>13</sup> .	n/a	n/a

<sup>10</sup> The initial return date is set as the day 6 months following the date of incorporation, and subsequent annual return dates fall on the anniversary of that date (unless changed in accordance with section 127).

<sup>11</sup> It is at the discretion of the company whether their external auditors review the interim statements.

<sup>12</sup> If the company's external auditors review the interim statements, the auditors' report thereon is required to be included in the interim statements.

<sup>13</sup> OFEX start-up companies must produce unaudited results on a quarterly basis during the first three years of the admission.

## About Audit Committee Institute Ireland

Recognising the importance of audit committees, the Audit Committee Institute of Ireland (ACI) has been established to serve audit committee members and help them to adapt to their changing role.

Historically, audit committees have largely been left on their own to keep pace with rapidly changing information related to governance, audit issues, accounting and financial reporting. Supported by KPMG, the ACI provides knowledge to audit committee members and a resource to which they can turn at any time for information or to share knowledge.

Our primary objective is to communicate with audit committee members and enhance their awareness and ability to implement effective audit committee processes.

The ACI aims to serve as a useful, informative resource for audit committee members in such key areas as:

- audit committee governance, technical and regulatory issues;
- sounding board for enhancing audit committees' processes and policies;
- surveys of trends and concerns.

The ACI is now in direct contact with over 1,000 ACI members. For more information on the work of the ACI please click on our Web site: [www.auditcommitteeinstitute.ie](http://www.auditcommitteeinstitute.ie) or e-mail: [info@auditcommitteeinstitute.ie](mailto:info@auditcommitteeinstitute.ie)

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