DECEMBER 2013

WAITING IS THE MOST DIFFICULT BIT

AN ANALYSIS OF AUDIT COMMITTEE REPORTING

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"Waiting is the most difficult bit"[1]

An analysis of Audit Committee Reporting 2013

1. Paul Coelho, Eleven Minutes

INTRODUCTION

This is the third year we have carried out our analysis of Audit Committee reporting and, consequently, we are starting to see some trends emerging from the data and are gaining a better understanding of the nuances of the reporting language that companies use. We have also re-introduced a sample of AIM companies to this survey, given that we expect some reaction there to changes for listed companies.

2014 is going to see major changes in the reporting listed companies undertake under the revised UK Corporate Governance Code. The introduction of the statement regarding the annual report being 'fair, balanced and understandable' will be delegated to the Audit Committee in the first instance more often than not. The disclosures regarding audit tenure, appointment and effectiveness will be lengthy. The material relating to significant issues (and the way that this interacts with expanded audit reporting) will require care in drafting. Given the changes have been coming for some time we were keen to see how much they would be anticipated by preparers.

The answer is – not greatly. There are some worthy exceptions to this but in the round, few had the confidence to describe their report as fair, balanced and understandable. Otherwise we saw a lot of cherry picking with what might be termed the "easy bits" of the revised code being addressed. A number of companies mentioned audit tendering – and then explained they weren't going to until it was 'all a bit clearer'.

Overall, this year saw no increase in the quality of reporting. The slight fall in quality, seen in the FTSE 100 companies sampled, and indicated in the detailed analysis, is not significant and, being qualitative, rising expectations cannot be excluded from possible explanations. However it remains disappointing and one hopes it does not herald an approach to improved reporting that will be characterised by a reliance on the comfort provided by boilerplate language.

It was noticeable that the reports were particularly weak in terms of dealing with internal audit and in describing how Audit Committees' responsibilities in relation to the annual report had been discharged.

Whilst we wait for Audit Committee reports to come of age, it is difficult not to reflect on how far it is that they need to come, within a pretty narrow window. Waiting is, indeed, difficult.

James Roberts
Partner, BDO LLP
December 2013

1. EXECUTIVE SUMMARY

There is a lot of change coming which will increase the burden on Audit Committees. The effective remit of the Audit Committee is widening in the light of the "fair, balanced, and understandable" statement that is required under the new code and they will be coming under greater scrutiny from stakeholders and regulators.

Attempts to de clutter the annual report have not worked to date and companies will have to go back to the drawing board to make real changes. There is a need to identify the audience and tailor reports to their needs, rather than trying to be everything to everyone. We need some pioneers to blaze a trail.

Annual reports need to tell the company's story and Audit Committee reports need to tell the story of the committee's activities for the year, what they did, how they did it and the decisions they have made. We have concluded, once again, that Audit Committee reporting does not do this, so it doesn't achieve its full potential.

Audit Committees must be waiting on change and not taking the opportunity to establish the shape and colour of that change before they have to.

Most Audit Committee reports disclose comprehensively what the Audit Committee's responsibilities are but do not explain well enough how they have discharged these responsibilities. We have identified some simple steps that Audit Committees could take to ensure that their report contains the information stakeholders are looking for and presents it in a user friendly manner.

1. EXECUTIVE SUMMARY

HIGHLIGHTS

- Overall the results are generally consistent with our research findings in the previous year. The average quality scores have remained consistent or fallen slightly in the case of the FTSE 100. However scores are still not high and there is considerable room for improvement
- We were surprised to see that few companies made reference to their accounts being '"fair, balanced and understandable" and few adopted the new code early. We expected that more would do so given the amount of publicity on narrative reporting, the changes to the structure of the accounts and the changes to the code
- The monitoring of the integrity of the financial statements and the review of significant financial reporting issues and judgements is a fundamental role undertaken by the Audit Committee. However in the Audit Committee report there is often a lack of specific discussion which would aid the reader to understand what particular issues were reviewed by the Audit Committee and how they gained comfort around matters such as the disclosures in the financial statements
- The Audit Committee report focuses heavily on the relationship and communication with the external auditor but the relationship and communication with internal audit (where such a function exists) does not get as much air time and the absence of disclosure of key areas of internal audit focus and discussions with the Audit Committee is very apparent
- There has been a significant increase in the disclosure around non audit services this year. In particular Audit Committee reports are disclosing more about the relationship with the external auditor and how independence is maintained when non audit services are provided
- Our review of AIM company reporting showed that many AIM companies have not really moved on in respect of the level of detail they provide in their annual report from the position of two years ago. However the average qualitative scores have improved slightly and there has been an increase in the amount of disclosure in respect of non audit services, the effectiveness of external auditors and whistleblowing. It is possible that voluntary compliance with the Corporate Governance code may reduce given the introduction of the new style audit report and the fact that such companies may not want to 'risk' being caught within the enhanced reporting rules.

The Audit Committee report is a key part of the Corporate Governance report in the annual financial statements and it is critical that the Audit Committee takes the opportunity to present meaningful information in a more concise and user friendly way. This should enable them to have a greater connection with investors and, ultimately, help to restore trust in large companies.

2. RESEARCH OBJECTIVES AND METHODOLOGY

RESEARCH OBJECTIVES

The main objectives of the research were to ascertain:

- What reporting listed companies and some AIM companies, have included in their annual reports in respect of the work of the Audit Committee
- Whether conclusions could be drawn on the quality of reporting in this area and whether the quality of reporting has improved year on year
- If there were practical observations that could be made to help Audit Committees achieve better reporting outcomes.

METHODOLOGY

The annual reports of 133 listed companies with year ends spanning March 2012 to June 2013 were reviewed to determine the current state of play (2012 – 138, 2011 -145). The companies were split by size giving:

CATEGORY	NO. OF ACCOUNTS REVIEWED 2013	NO. OF ACCOUNTS REVIEWED 2012	NO. OF ACCOUNTS REVIEWED 2011
FTSE 100	51	51	51
FTSE 250	45	47	48
FTSE All-Share	37	40	46

FTSE 250 describes the companies ranked from 101-350 in terms of market capitalisation

FTSE All-Share is the aggregation of the FTSE100, FTSE250 and FTSE Small cap indices, with our sample taken from outside the other categories listed.

The FTSE 100 and FTSE 250 listings were taken as at 14 April 2011. All reports and data used for the research were in the public domain. In order to make direct comparisons the same sample was used for the research in 2013 as in 2012 and 2011. There was a reduction in accounts reviewed due to acquisitions and subsequent delisting.

There are certain disclosures for which a numerical analysis is appropriate – either the disclosure was there or it was not. However, the power of disclosure is in the value it can add by virtue of the quality of the information provided and the emphasis of the research was on how detailed and informative the disclosures were. A scoring system was used to grade the quality of disclosures giving each a score out of five with five being the most, one and zero being the least comprehensive and insightful.

2. RESEARCH OBJECTIVES AND METHODOLOGY

AIM COMPANIES

These require a special mention as we included 92 AIM companies in our research in 2011. Our results showed that all but four of the AIM companies sampled followed the Corporate Governance Guidelines for Smaller Quoted Companies published by the Quoted Companies Alliance[2]. As a result of this we did not include AIM companies in our research in 2012.

However we wanted to analyse whether the situation had changed from 2011 and selected a sample of 34 AIM companies this year and their results are shown in a separate section at the end of the analysis of results below.

2. Corporate Governance code for Smaller Quoted Companies 2012

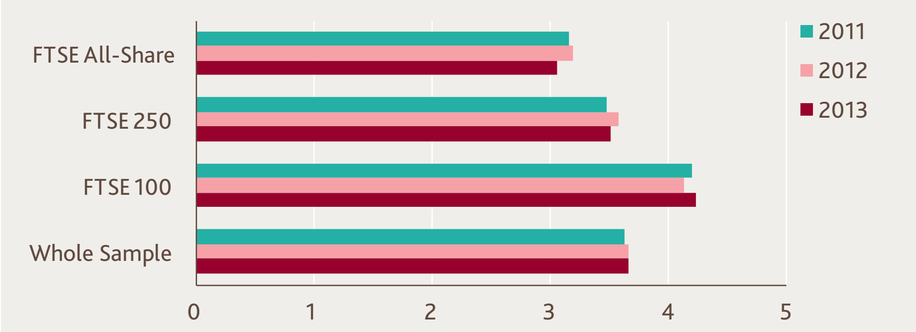
3. WHAT THE RESEARCH TELLS US

3.1 HOW AUDIT COMMITTEES OPERATE: COMPOSITION AND MEETINGS

The Code provides that each board should establish formal and transparent arrangements for considering how they should apply the corporate reporting risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.

We analysed the total numbers of non-executive directors serving on Audit Committees and this ranges from seven to two, with averages in each market segment as follows:

What is the average number of Audit Committee members?

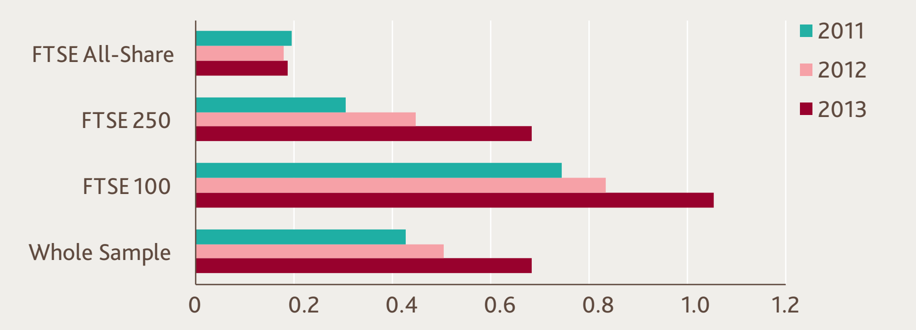


The results have remained largely consistent, which was to be expected given Audit Committees are unlikely to change their structure significantly year on year. The highest number of Audit Committee members was 7 and the lowest number was 2 which is the same as in the previous two years.

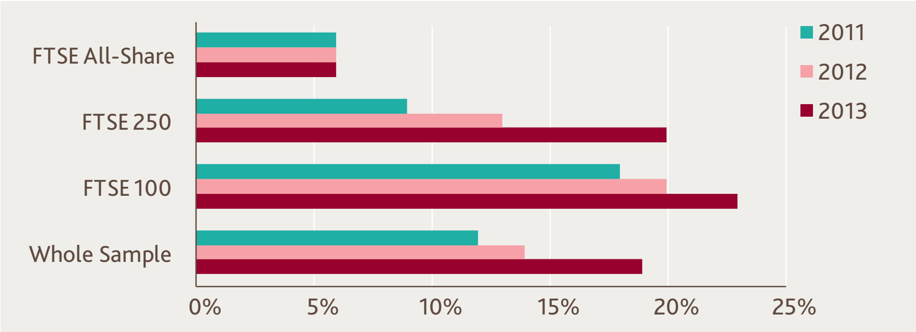
3. WHAT THE RESEARCH TELLS US

From the research we can see that there has been an increase in overall female representation on Audit Committees, but progress has been slow. A recent survey by the Cranfield School of Management indicated that although the proportion and number of female directors in the FTSE continues to increase the rate of that increase has slowed. Given the press on this subject has not abated since Lord Davies released his report, it is surprising that we have not seen more of an increase. It is a difficult task for Nominations Committees, as they have to consider gender diversity amongst a number of other issues when choosing the right candidate for the board or its committees and this may justify the lengthy pace of change.

What is the average number of female Audit Committee members?

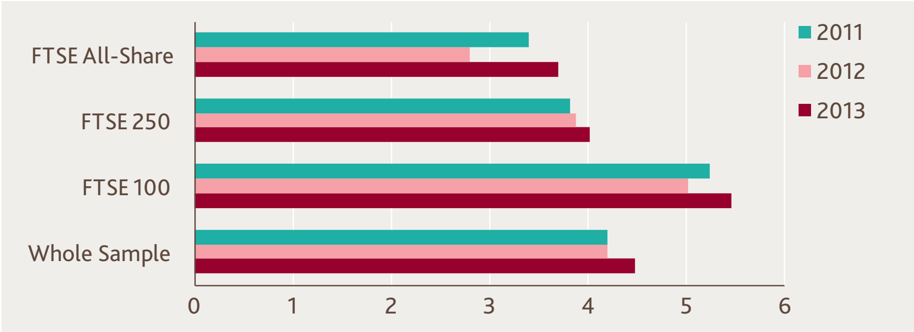


What is the average number of female members as a percentage of Audit Committee members?



The highest number of meetings held per year was 13 and the lowest number was 2 with the average in each segment as follows:

What is the average number of Audit Committee meetings?



Again the research shows that the number of Audit Committee meetings in a year has remained consistent with the previous year. The additional reporting required by Audit Committees in the future may require that the number of meetings increases to cope with the expanded role.

3. WHAT THE RESEARCH TELLS US

KEY OBSERVATIONS FROM THE SURVEY SAMPLE

Generally Audit Committee reports are very good at disclosing the number of Audit Committee meetings that took place in the year. Given the disparity in the number of Audit Committee meetings between companies it would be very useful to understand why it was felt the number of and timing of meetings were appropriate to that particular business and whether the number of meetings to be held was annually re-assessed.

As well as attending formal Audit Committee meetings members also perform duties throughout the year. Many Audit Committee reports were unclear as to the time and effort spent in discharging the Audit Committee's responsibilities. Some reports addressed this issue well by showing in graphical form the percentage of time they spend, for example, on areas such as financial reporting.

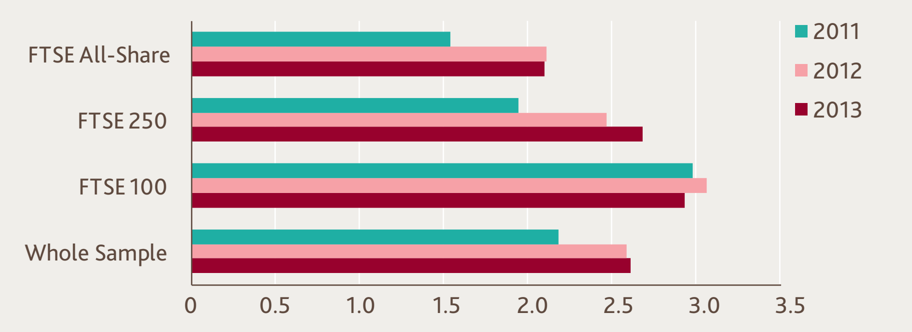
A number of reports disclosed the meetings in the form of a calendar which detailed the standard agenda items for each meeting and it was clear these generally reflected the company's reporting cycle. This is an easy and concise way to show that the 'basics' are covered in each meeting.

3.2 QUALITY OF AUDIT COMMITTEE REPORTING

The Disclosure and Transparency Rules (DTR) stipulate that each issuer must make a statement available to the public disclosing which body carries out the functions required by DTR7.1.3R and how it is composed. The code also provides that a separate section of the annual report should describe the work of the Audit Committee in discharging the role delegated to it by the board.

The average quality score (out of 5) was as follows:

What is the average quality score?



Looking at the average scores above we can see that the scores have remained consistent or have fallen in the case of the FTSE 100. It is fair to say that this is not entirely unexpected given we have changed some of the criteria and judged companies on whether they had adopted the new code or not. Having said that, the scores are still not high and there is considerable room for improvement.

3. WHAT THE RESEARCH TELLS US

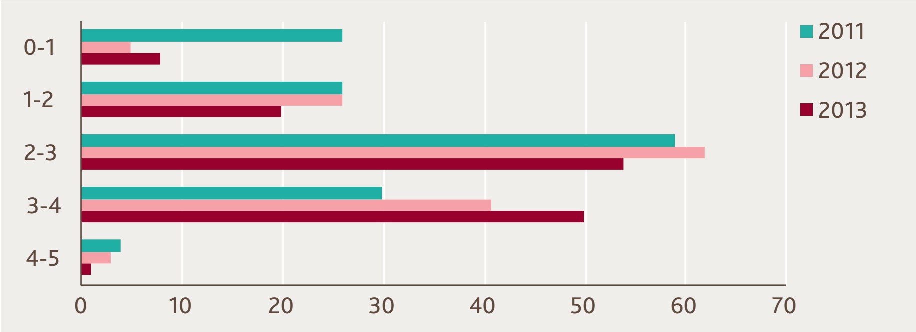
We analysed how many companies had scores of 5, 4 and above, 3 and above, 2 and above, 1 and above and between 0 and 1. The results show that the majority of companies had a score of between 2 and 3 which is consistent with 2012.

It is a surprise that we still see so few of our sample that score 4 out of 5 given the focus narrative reporting has had over the last few years. It appears that no one is prepared to radically overhaul their reporting and focus on quality informative reporting rather than the safe 'boilerplate' disclosures they have always given.

It would be unfair not to acknowledge that there has been a move into the 3 to 4 range from the 2 to 3 range and that we have seen improvements in certain sections of the Audit Committee report, particularly around non audit services, independence and the evaluation of external auditors. However this depth of disclosure is not seen across the board.

The overriding concern we still have over the quality of the reports remains the same as in the past which is that the reports detail 'what' the committee does but not 'how' they do it. Although the disclosure is improving in the areas noted above it is not consistent and the reports still contain boilerplate lists of responsibilities which add clutter without being particularly informative.

How did FTSE companies score on quality?



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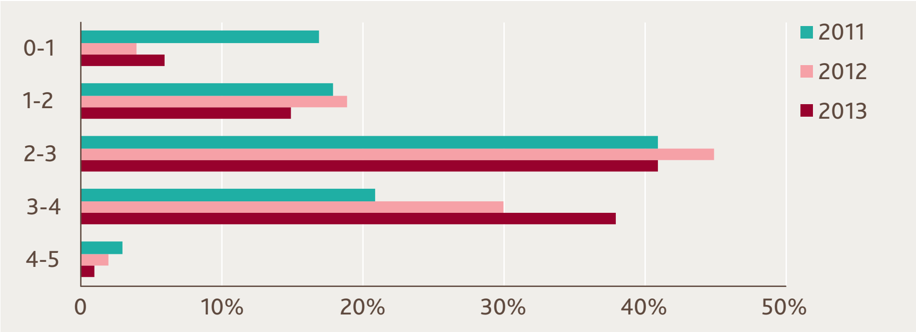


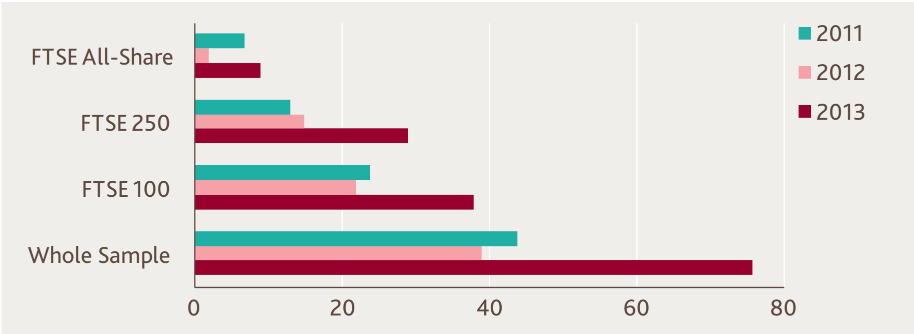
We remain ever hopeful that we will see significant improvements next year as companies fully adopt and report against the new code. The preface to the code asks companies to consider and improve the granularity of their narrative reporting and increase the usefulness for the reader. If they accept the gauntlet thrown down by the FRC we should see a dramatic increase in quality scores next year.

Of the 133 sets of annual reports reviewed 76 had a separate Audit Committee report which was written by the Audit Committee chairman to the shareholders. The vast majority of Audit Committee reporting was included and embedded within the corporate governance report.

We were delighted to see that there has been a significant increase in the number of separate Audit Committee reports this year in every sample group. We have recommended this change a number of times. Separate, personal Audit Committee reports have also been recommended by the Financial Reporting Lab in their recent publication on Audit Committee reporting.

We analysed how many companies provided a separate Audit Committee report:

How many companies provided a separate Audit Committee report?



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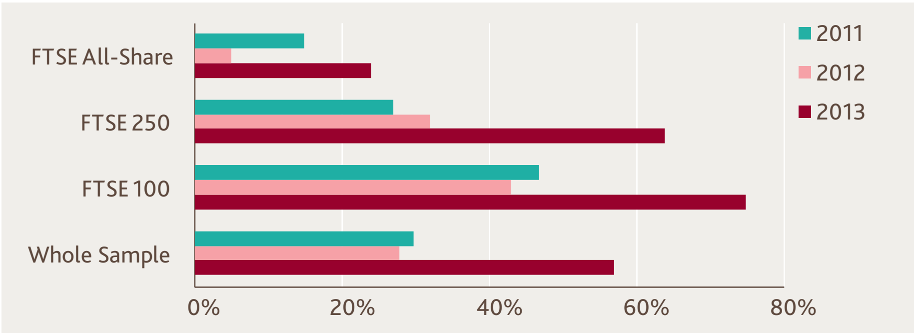


3. WHAT THE RESEARCH TELLS US

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

We were surprised to see that few companies made reference to their accounts being “fair, balanced and understandable” and few adopted the new code early. We expected that more would do so given the amount of press on narrative reporting, the changes to the structure of the accounts and the changes to the code have had over the last year or so.

It should be noted that those reports that state the accounts are fair, balanced and understandable did not discuss the additional work the committee has done to enable them to make this assertion. We hope this will be disclosed more fully in the reports issued next year.

It appears that companies are cherry picking the areas of the code that they are choosing to comply with rather than adopting an all or nothing approach. A high proportion of the sample mentioned the FRC’s guidance on tendering and indicated that it was something they were aware of but were not committing to a tender process as yet.

Those audit reports written by the Audit Committee chairman, speaking ‘directly’ to the reader provide a more compelling and comprehensible account of their conduct, as well, it more directly shows the Audit Committee’s independence. The Audit Committee chairman’s comments also set the context of the whole Audit Committee report clearly.

The monitoring of the integrity of the financial statements and the review of significant financial reporting issues and judgements is a fundamental role undertaken by the Audit Committee. Throughout the year a significant portion of the Audit Committee’s focus will be on this area however in the Audit Committee report there is often a lack of specific discussion which would aid the reader to understand what particular issues were reviewed by the Audit Committee and how they gained comfort around the disclosures in the financial statements. In particular, reference ought to be made to the audit risks that were communicated to them via the external auditor and how these risks were satisfactorily addressed.

Another key role of the Audit Committee is the review of the company’s financial accounting policies as well as the general disclosure in the accounts. The disclosure in the Audit Committee report is however often weak in this area with no details of the assessment that was undertaken and the changes if any that were made to the financial statements as a result. Some Audit Committee reports did however make reference to a process of ‘cutting the clutter’ in the financial statements.

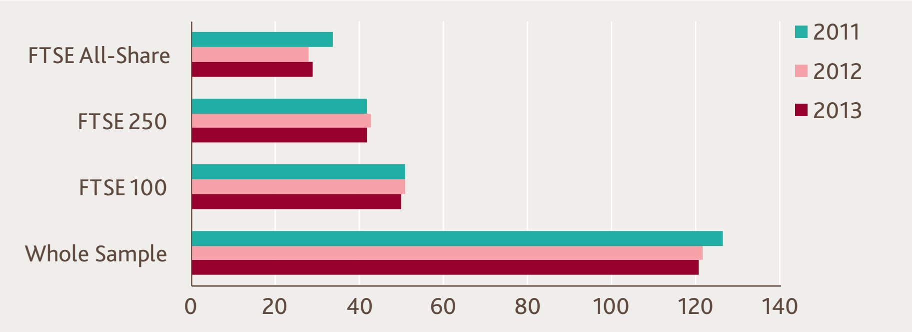
Some of the reports included a future plans section which indicated what topics would be on the Audit Committee’s agenda for next year. This is particularly useful as they often disclosed activities that had taken place post year end and sets the tone for next year.

3.3 INTERNAL AUDIT

Code provision C.3.5 stipulates that 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. The reasons for the absence of an internal audit function should be explained in the relevant section of the annual report.

We analysed how many companies had an internal audit function and asked of those in the sample that had an internal audit function 'how many were outsourced?'

How many companies had an internal audit function?



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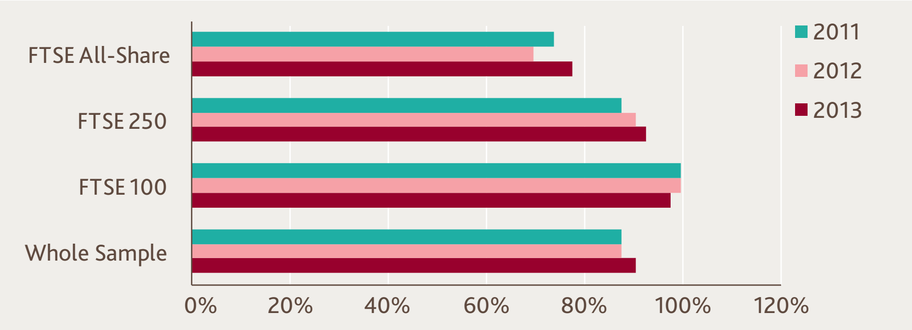
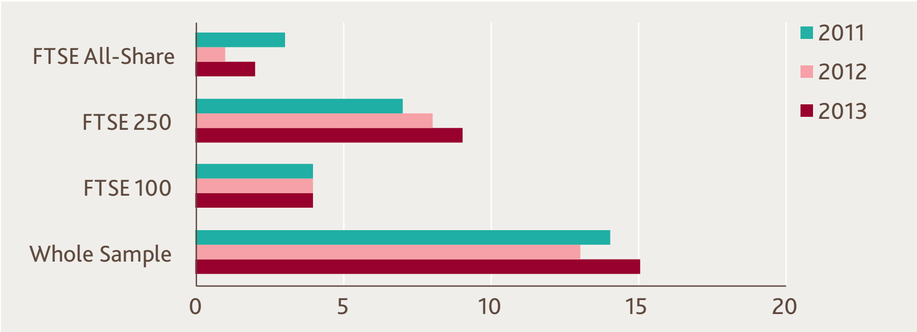


The number of companies with an internal audit function has remained high with an overall increase driven by an increase in the FTSE all share.

The need for an internal audit function will vary depending on company-specific factors as well as cost/benefit considerations and as expected there was considerable variation in the level and type of disclosure.

3. WHAT THE RESEARCH TELLS US

Of those in the sample that had an internal audit function how many were outsourced?



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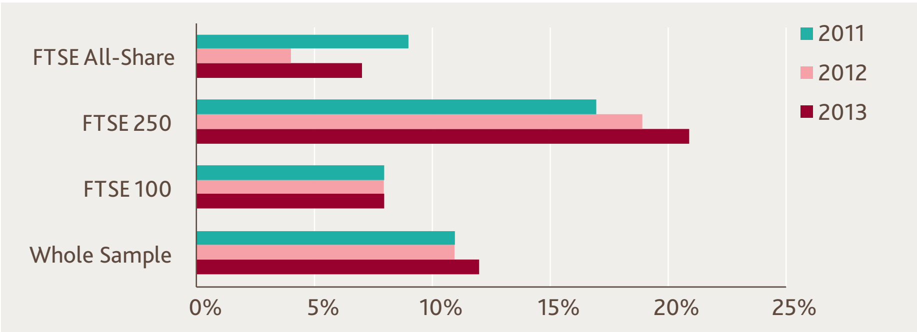


Again results are similar year on year. Outsourcing is clearly more common outside the FTSE100 given the resource constraints of smaller companies.

The results refer to a fully outsourced internal audit function. We have seen a trend towards companies having an internal audit function supported by outsourced internal auditors for specific projects or a 'co-sourced' function. This trend may increase over time as the board requires additional assurance over, for example, certain aspects of its control environment or narrative reporting.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

Our research found that disclosure on the subject of internal audit and the interaction with internal auditors is still poor and is worse when the internal audit is outsourced. Audit Committee reporting concentrates much more on the relationship with the external auditor, but internal audit can be critical to the overall control environment and to the risk monitoring processes.

Internal audit appears to be a necessity rather than a luxury now as directors are requiring more assurance over risk and controls compliance. Internal audit appears to be gaining in importance and as a result should be more prominent within the report but it is still not clear exactly how Audit Committees interact with the internal auditors.

As we mentioned earlier the Audit Committee report focuses heavily on the relationship and communication with the external auditor. The relationship and communication with internal audit does not get as much air time and the absence of disclosure of key areas of internal audit focus and discussions with the Audit Committee is very apparent.

It would be very useful to understand how the Audit Committee interacts with both the external and internal auditor and to compare the priorities of both lines of assurance. No companies have disclosed anything about the interaction between internal and external audit and how that provides value or comfort to the committee.

Very few Audit Committee reports stated that they had completed an assessment of the effectiveness of the internal audit function and there was even less detail about how this was carried out and the conclusions reached.

3. WHAT THE RESEARCH TELLS US

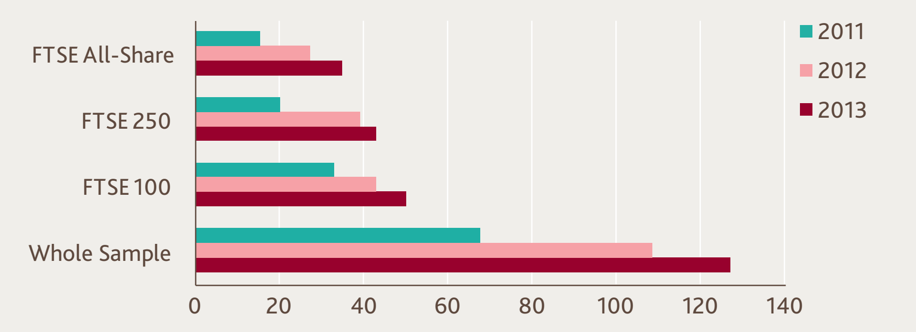
3.4 EXTERNAL AUDIT AND NON-AUDIT SERVICES

Code provision C.3.6 states that the Audit Committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditor. In addition Code provision C.3.7 states that the annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence are safeguarded.

The Audit Committee is the body responsible for overseeing the company's relationship with the external auditors.

We analysed how many companies either stated the extent of non-audit services provided by the auditor in the Audit Committee report or cross-referenced to the relevant disclosure in the accounts:

How many companies cross referred to non-audit services in the Audit Committee report?



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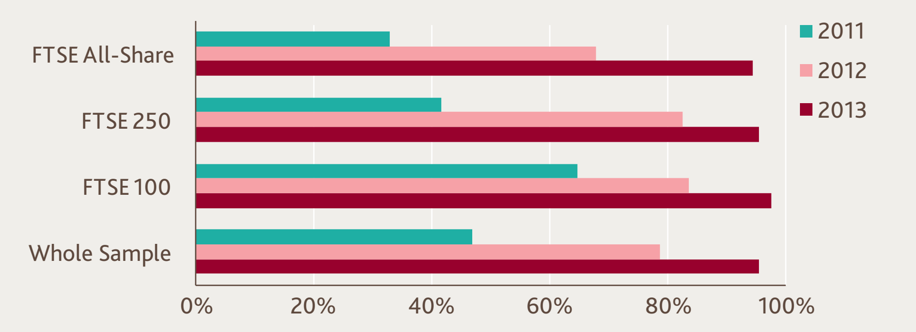


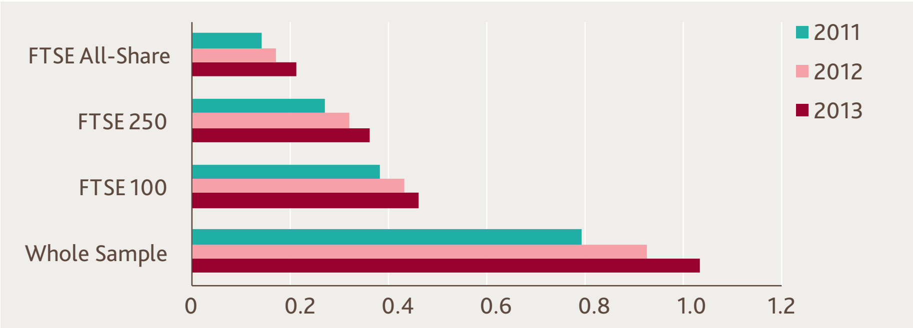
There has been a significant increase in the disclosure around non audit services this year. In particular Audit Committee reports are disclosing more about the relationship with the external auditor and how independence is maintained when non audit services are provided. It is possible that there has been more discussion around independence in the light of the FRC guidance on tendering, which supplements the new code and the Competition Commission inquiry.

Non audit services and the relationship with the external audit has been an area of negative press coverage and subject to challenge by shareholders at AGMs in the recent past and it appears that companies are finally realising that they need to have adequate and informative disclosure on this subject.

3. WHAT THE RESEARCH TELLS US

We also analysed how many companies referred to a review of the effectiveness of the external auditor in the Audit Committee report:

How many companies referred to a review of the effectiveness of the external auditors?



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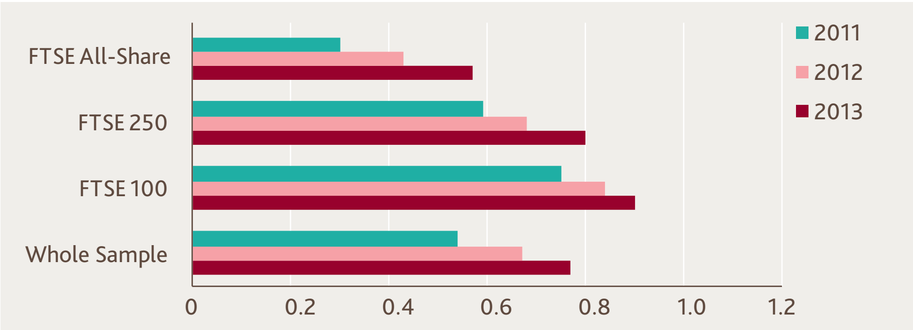


We can see that there has been a significant increase across the board as to the number of Audit Committee reports that discuss the review of the effectiveness of the external auditor. It is reassuring to see this increase in the amount of disclosure but the level of detail disclosed varies greatly across the sample. Some reports detail the process the committee carried out, such as the use of questionnaires, interviews and Audit Quality Review Team (AQRT) reports whilst others simply state a review has been undertaken.

KEY OBSERVATIONS FROM THE SAMPLE SURVEYED:

More detail could usefully be included on effectiveness reviews of the Audit Committee into both the external auditor and the internal audit function, where one exists. The current reporting is often bland and does not delve into the specific assessment criteria chosen to reach the effectiveness conclusion.

A key responsibility of the Audit Committee is the annual recommendation to appoint the external auditor, or not. Despite this key function the disclosure in relation to this appointment recommendation is in many cases poor, with even the Market Participation Group (MPG) recommendations, of many years ago, remaining rarely applied.

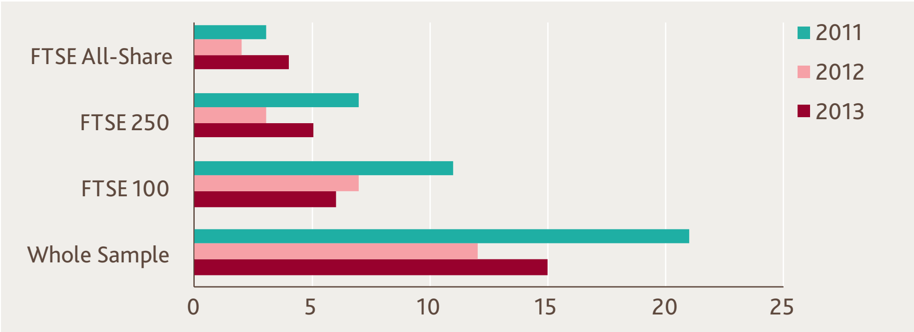
3. WHAT THE RESEARCH TELLS US

3.5 RISK AND INTERNAL CONTROL

Code provision 2.1 states that the board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.

We analysed how many companies had a separate risk committee. As expected practice varied here:

How many companies had a separate risk committee?



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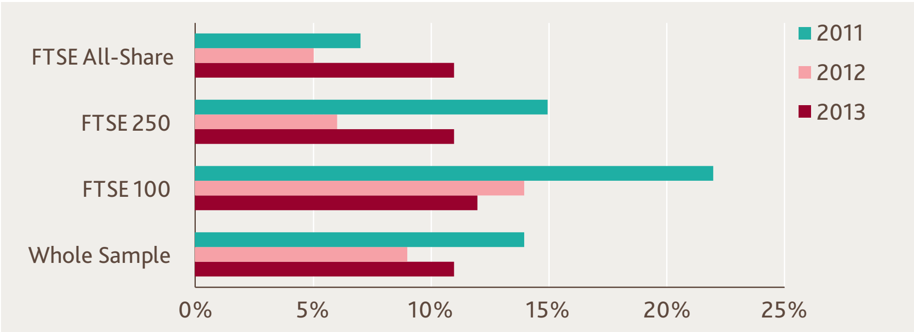


It is difficult to tell from the annual reports why the levels of separate risk committees have changed. Initially we thought we would see more risk committees established over time but this has not been the case and the reason for this may be because it is difficult to manage two committees with similar or overlapping remits. Many others have alluded to risk being an 'all board' focus. There is a risk that dividing up responsibilities could mean that issues fall between the cracks.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

Many companies appear to favour a structure where there is a risk committee that sits below the board with executive board members on the committee with non board members. This committee would report directly to the Audit Committee which ensures the Audit Committee takes responsibility for the overall review of risk.

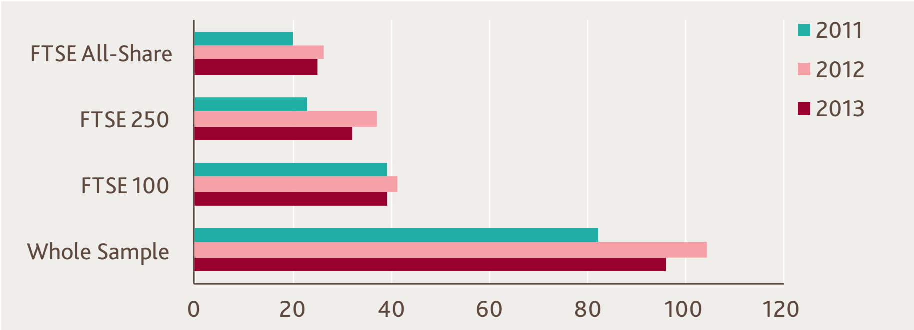
Our reviews of the annual reports indicate that there are often long discussions about risk in the other key reports forming the front end of the financial statements e.g. business review, but often much less in the Audit Committee report itself. As with a number of elements of the Audit Committee report most committees could go further to explain 'how' they discharge their responsibilities in this area, particularly where there is a risk committee in place.

3. WHAT THE RESEARCH TELLS US

3.6 WHISTLEBLOWING

Code provision C.3.4 provides that each 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 objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for the appropriate follow up action.

How manage companies referred to or noted their whistleblowing policy?



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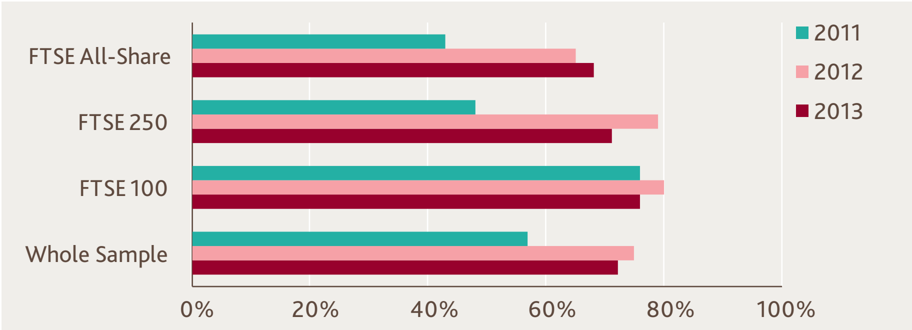


Overall the research indicates that the amount of material referring to whistleblowing policies has decreased and it is difficult to tell from the sample surveyed why this is the case.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

Some companies disclosed the policy and how it is reviewed and monitored in some detail and others just mention that the company has a policy. Very few reports disclosed the whistleblowing policy in enough detail for the reader to understand the Audit Committee's role in following up matters.

A number of companies have taken to referencing to the policy on the corporate governance section of the website presumably to save on the volume of words in the annual report. This makes sense as long as the website remains current.

This is an important disclosure which is often overlooked possibly because there is no guidance on how the relevant code provision is to be interpreted. However given the Audit Committees remit to monitor the effectiveness of internal control and risk management systems it is surprising that this disclosure is not more widely given.

3. WHAT THE RESEARCH TELLS US

3.7 AIM COMPANIES

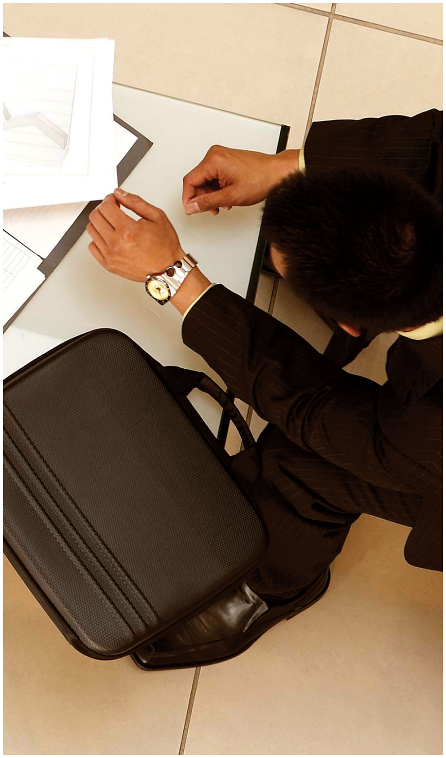
Question	2013 Number	2013 Percentage	2011 Number	2011 Percentage
Average number of Audit Committee members	3.00		2.68	
Average number of female Audit Committee members	0.09		0.15	
Average number of female members as a percentage of average number of Audit Committee members		3%		8%
Average number of Audit Committee meetings	2.71		1.97	
How many companies had a separate risk committee (number and percentage)	0	0%	1	1%
How many companies had an internal audit function (number and percentage)	8	24%	15	16%
Of those who had an internal audit function how many were outsourced? (number and percentage)	2	25%	3	20%
What is the average qualitative score?	0.68		0.14	
How many companies provided a separate Audit Committee report?	3	9%	0	0%
How many companies cross referred to non audit services in the Audit Committee report?	14	41%	7	8%
How many companies referred to a review of the effectiveness of the external auditors?	9	26%	0	0%
How many companies referred to or noted their whistleblowing policy?	9	26%	2	2%

Our review of AIM company reporting showed that many AIM companies have not really moved on in respect of the level of detail they provide in their annual report from the position two years ago. However the average qualitative scores have improved slightly and there has been an increase in the amount of disclosure in respect of non audit services, effectiveness of external auditors and whistleblowing.

Only three companies in our sample provided a separate Audit Committee report and the majority gave a series of boiler plate disclosures within a short governance section. In a number of cases we had to search through the company's website to find the information required to answer the questions we posed above.

This is not entirely unexpected as AIM companies are not required to follow the corporate governance code and therefore the disclosures would be over and above that required by statute and their listing. However we had hoped that AIM companies would react to the level of interest in the quality of narrative reporting that has been generated over the last few years and up their game.

4. SIMPLE STEPS TO IMPROVE THE QUALITY OF AUDIT COMMITTEE REPORTING



Through our research we wanted to find out how listed companies (and in part this year AIM companies) are reporting on the work of the Audit Committee in their annual reports and to conclude on the quality of disclosures in this area.

Having undertaken the research we propose some practical steps to help Audit Committees achieve better reporting. Some of these are quite simple to achieve but have significant impact on the reader of the report. Key areas where Audit Committee reporting could be enhanced are as follows:

- As with all areas of the Annual Report care needs to be taken, not only with the content, but the presentation of information. Audit Committee reports laid out with clear headings, charts, box presentations and spacing create a more friendly environment for a user to absorb the report. The use of questions and answers is an easy way to lead the reader through the report, break up the text and put it into context.
- The monitoring of the integrity of the financial statements and the review of significant financial reporting issues and judgements is a fundamental role undertaken by the Audit Committee. Throughout the year a significant portion of the Audit Committee's focus will be on this area however in the Audit Committee report there is often a lack of specific discussion which would aid the reader to understand what particular issues were reviewed by the Audit Committee and how they gained comfort around the disclosures in the financial statements. In particular reference ought to be made to the audit risks that were communicated to them via the external auditor and how these risks were satisfactorily addressed.

FOR EXAMPLE

KEY AREAS OF JUDGEMENT:

Key risk and judgement areas are reviewed in assessing the external auditor's plan, their areas of audit focus and the internal audit plan. In advance of approval of each set of published financial statements, the Committee considers the key assumptions and judgements made and review these with the Group Finance Director. The treatments proposed are also discussed with the external auditor and explanations of how the external auditor gained comfort over these areas are obtained. The committee considers all of the significant inputs into the judgements made as well as undertaking sensitivity analysis on the area if this is appropriate to do. In the current year via the external audit strategy and report the following were considered significant judgement areas and the Audit Committee also considered these to be the only significant areas.

Going concern – The Committee examined the impact of sensitivities around future cash flows and other risks in considering the appropriateness of the going concern assumption. Particular attention was focused on the bank borrowing which is due for renewal within two years.

Impairment – Detailed impairment reviews were undertaken on all material intangible asset balances. In particular special attention was paid to the Exploration and Evaluation asset within Subsidiary B Limited. As a result of the rising costs incurred and the falling price of Coke Coal an impairment of £25million has been made in the current year. The assumptions included in the cash-flow model were considered appropriate and the external auditors agreed with this treatment.

Employee benefits (IAS19) – This is in relation to employee benefits and the assumptions made. The assumptions and rationale were discussed with management and specialists that were engaged by the Group. The assumptions as well as the resulting disclosure were agreed as reasonable. All of the assumptions made were within the range considered acceptable by the external auditors.

4. SIMPLE STEPS TO IMPROVE THE QUALITY OF AUDIT COMMITTEE REPORTING

FOR EXAMPLE

ACCOUNTING POLICY CONSIDERATIONS:

An aspect of considering the integrity of the financial statements is ensuring that suitable and compliant accounting policies are adopted and applied consistently on a year-on-year basis and across the Group. On an annual basis the Audit Committee undertake such a review with the involvement of management as well as the findings from the external auditors, considering in this process any new changes to regulatory requirements or changes to accounting standards that are significant to the Group. In the current year the Audit Committee undertook a ‘cutting the clutter’ exercise on the accounting policies to ensure that they were specific to the transactions that are undertaken by the Group. The only new accounting policy added in the current year was in relation to the treatment of a customer list intangible as a result of the acquisition of Subsidiary X Limited that took place during the year. From a review of the accounting standards that are due to take effect next year the Audit Committee do not consider any will have a significant effect on the Groups’ accounting policies.

Another key role of the Audit Committee is the review of the company’s financial accounting policies as well as the general disclosure in the accounts. The disclosure in the Audit Committee report is however often weak in this area with no details of the assessment that was undertaken and the changes if any that were made to the financial statements as a result. Some Audit Committee reports did however make reference to a process of ‘cutting the clutter’ in the financial statements.

A similar structure should be followed in relation to general accounts disclosures with the Audit Committee commenting on the process undertaken and then specific disclosure items that were considered in detail due to their significance and any change in circumstances in the year.

- Those audit reports written by the Audit Committee chairman, speaking 'directly' to the reader provide a more compelling and comprehensible account of their conduct. As well, it more directly shows the Audit Committee's independence. The Audit Committee chairman's comments also set the context of the whole Audit Committee report clearly.
- Financial statements where the more boiler plate areas such as the 'terms of reference' were kept away from the main Audit Committee report meant that the core report itself was reserved for the interesting and informative dissemination of the committee's activities.
- Audit Committee reports are very good at disclosing the number of Audit Committee meetings that took place in the year. Given the disparity in the number of Audit Committee meetings between companies it would be very useful to the reader to understand why it was felt the number of and timing of meetings was appropriate to that particular business and whether the number of meetings to be held was annually assessed.
- As well as attending the Audit Committee meetings the members are performing their duties throughout the year. From the many Audit Committee reports it was unclear what time and effort was spent in discharging the Audit Committee's responsibilities. Some reports addressed this issue in a high degree by showing in graphical form the percentage of time they spend on areas such as financial reporting.

FOR EXAMPLE

ALLOCATION OF AUDIT COMMITTEE TIME:

Area	Proportion of time
Risks	15%
External audit	20%
Internal audit	20%
Financial statements	15%
Internal controls	15%
Training	10%
Other	5%
Total	**100%**

Note – The allocation of time above is for illustration purposes only and is not an indication of the amount of time that an Audit Committee is expected to spend on each area.

4. SIMPLE STEPS TO IMPROVE THE QUALITY OF AUDIT COMMITTEE REPORTING

- A majority of the reports deal well with the responsibilities of the Audit Committee but it is also important to the user to understand fully how the Audit Committee sits within the overall governance structure of the company as well as clearly explaining its importance.
- More detail could usefully be included on effectiveness reviews of the Audit Committee, the external auditor and the internal audit function, where one exists. The current reporting is often bland and does not delve into the specific assessment made to reach the effectiveness conclusion.
- A key responsibility of the Audit Committee is the annual recommendation to appointment the external auditor. Despite this key function the disclosure in relation to this appointment recommendation is in many cases poor with the Market Participant Group (MPG) recommendations remaining scantily applied. The need for clarity and understanding in this area has been further highlighted by the introduction of the mandatory retendering guidelines that have been introduced.

MARKET PARTICIPATION GROUP (MPG) RECOMMENDATIONS INCLUDE:

- Disclose tendering frequency
- Tenure of incumbent auditor
- Contractual obligations that restrict choice
- Factors considered regarding using firms from more than one network
- Explanation of the risk to the company of withdrawal of auditor from the market
- Explanation as to why it was in the interest of the company to purchase non audit services from the external auditor

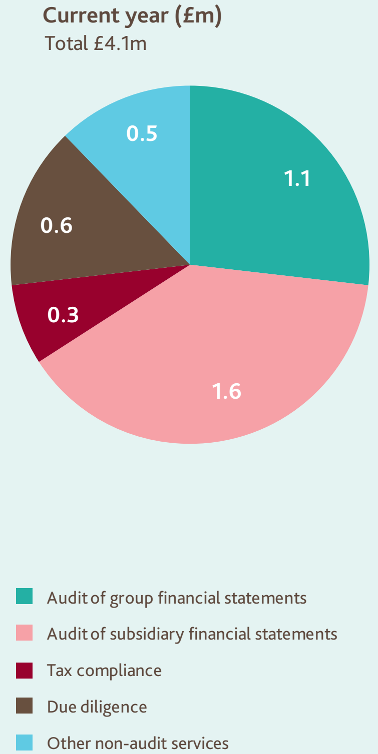
The Audit Committee must than also give the reasons why the external auditor was considered best placed to undertake the non-audit services work, examples include but are not limited to:

- Most efficiently provided by the external auditors as much of the information used in preparing computations and returns is derived from audited financial information
- As a result of their given in depth knowledge of the business and the control environment
- Timing restrictions that were in place.

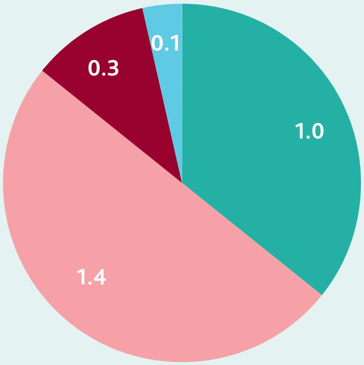
In each case, details of how independence and objectivity of the external auditors was maintained should also be disclosed.

FOR EXAMPLE

AUDIT AND NON AUDIT FEES:



Prior year (£m)
Total £2.8m



"The Audit Committee recognises that in the current year the fees for non audit services are significantly greater than the fees for non-audit services in the prior year. The reason for this increase is a result of the external auditors performing the due diligence on the acquisition of Subsidiary X Limited that took place during the year. The 'other' non-audit services were a result of the external auditors involvement in the introduction of a new HR system."

- In the Audit Committee reports the disclosure around the provision of audit and non-audit services by the external auditor is generally of a good quality. In many instances however a graphical presentation of the fees would be a simpler way of presenting the information and show the user more easily the split between these two types of services. Although the disclosure of these services is generally good, improvement could be made on the explanations of why the external auditor was considered to be the most appropriate firm to undertake these other services.
- The skills, experience and continued training of the Audit Committee members is of fundamental interest to investors, yet many reports make minimal disclosure in this respect. Greater emphasis on the description of Audit Committee members would be helpful, specifically in how their previous experience results in skills and expertise that will benefit the Audit Committee in its role. Tabulating such information within the directors' biographies would make this much easier to read and distinguish between current and previous roles. How Audit Committee members keep up to date is generally not well explained and this is an area where greater disclosure would be useful.

From the 'simple steps' illustrated above it is clear that many of the key areas of the Audit Committee report that have scope for improvement remain similar to those highlighted in 2012 with some companies still needing to make, in some instances, just minor changes that will have a significant impact on the presentation, content, and usefulness and usability of the report from a stakeholder perspective.

5. WHAT THE FUTURE HOLDS

REVISED CORPORATE GOVERNANCE CODE AND AUDIT COMMITTEE GUIDANCE 2012

The new edition of the Code was published in September 2012 and applies to reporting periods beginning on or after 1 October 2012. Companies reporting on periods beginning before 1 October 2012 should continue to report against the June 2010 edition of the Code, although they are encouraged to consider whether it would be beneficial to adopt some or all of the new provisions in the revised code earlier than formally required. As mentioned in the introduction our research indicates very few companies have early adopted and even where this has been applied it seems some cherry picking of the "easy bits".

The areas that specifically affect the Audit Committee and their reporting in the financial statements are:

FAIR, BALANCED AND UNDERSTANDABLE ANNUAL REPORT

The updated code states that the board should confirm that it considers the annual report and accounts taken as a whole as fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

It also states that the board should establish arrangements that will enable it to make this assessment. Boards can decide what role the Audit Committee should play in these arrangements.

PUBLIC REPORTING BY AUDIT COMMITTEES

The wording of the code and associated Audit Committee guidance has been changed to clarify that committees are being encouraged to report the process by which they have assessed the effectiveness of the external audit, rather than state whether they believe the audit to have been effective. In addition the guidance has been updated to encourage Audit Committees to provide information on how they have discharged their responsibilities and addressed significant issues.

The FRC's Financial Reporting Lab has very recently published a project report on Audit Committee reporting which gives useful insights for preparers looking to implement changes in Audit Committee reporting to encompass the new requirements.

AUDIT TENDERS

The code and associated Audit Committee guidance has been revised to include a provision that the audit should be put out to tender at least every ten years for FTSE 350 companies. The decision to put the audit out to tender and the appointment of the auditor rests with the company and will fall within the Audit Committee's remit. The FRC has recommended transitional arrangements to minimise the risk of the audit market being unable to cope with a large number of listed companies going out to tender at the same time. These suggested arrangements are not binding and companies should put the audit contract out to tender at a time that is appropriate for their needs. The FRC have stated in their feedback statement that they would encourage companies to state when they first report under the 2012 code whether or not they anticipate putting the audit contract out to tender in due course. It is interesting to note that this is not inconsistent with the Competition Commission remedies (discussed later) which also recommend a period of ten years although with disclosures after five years.

ISA 700 The independent auditor's report on financial statements

For any entities with accounting periods beginning on or after 1 October 2012 who apply the UK Corporate Governance Code (the Code) a new style of audit report will be required under ISA (UK & I) 700. This will essentially include all Premium Listed and AIM listed companies who voluntarily comply with the full requirements of the Code and give a compliance statement.

The revision will require auditors to explain more about their work in the audit report by:

- Providing an overview of the scope of the audit, showing how this addressed the risk of material misstatement in the financial statements and related materiality considerations.
- Describing the risks that had the greatest effect on the overall audit strategy, the allocation of resources in the audit and how the efforts of the audit team were directed.
- Providing an explanation of how they applied the concept of materiality in planning and performing the audit.

These extended audit reports are a significant change and will potentially attract significant public scrutiny. In view of this interest it is likely to be a particular focus for the Audit Committee over the forthcoming year.

COMPETITION COMMISSION

In October 2013 The Competition Commission concluded their work on the Statutory Audit Services for Large Companies Market Investigation. Their final recommendations or 'remedies' have significant implications for Audit Committees.

Probably the item which has gained the most press attention is the need for FTSE 350 companies to put their statutory audit engagement out to tender at least every ten years. The Competition Commission considers that many companies would benefit from going out to tender every five years but if they choose not to then the Audit Committee Report should state in which financial year it next plans to go to tender and why going out to tender in that year is in the best interests of shareholders. In the mean time it may be interesting to note that the EU is moving closer to imposing mandatory auditor rotation every fifteen years for banks and systemically important companies and every twenty years for other companies.

There are also significant remedies in relation to the work of the Financial Reporting Council and the work that they do to monitor the quality of audits via their Audit Quality Review team. The AQRT should review every audit engagement in the FTSE 350 on average every five years. The Audit Committee should then report to shareholders on the findings of any AQRT report concluded on its company during the reporting period, stating the grade awarded and how both the Audit Committee and auditor are responding to the findings.

A further remedy is that a shareholder advisory vote should be introduced on the sufficiency of the disclosures in the Audit Committee report section of the Annual Report and amendments to the UK Corporate Governance Code and Stewardship Code made to further encourage shareholder engagement.

Finally the Competition Commission decided that measures should be introduced to strengthen the accountability of the external auditor to the Audit Committee, including a stipulation that only the Audit Committee is permitted to negotiate and agree audit fees and the scope of audit work, initiate tender processes and make recommendations for appointment of auditors and authorise the

5. WHAT THE FUTURE HOLDS

external audit firm to carry out non-audit services. The Audit Committee may receive submissions from executive management regarding these matters. It may establish a materiality threshold below which executive management may instruct the audit firm to conduct Non Audit Services.

DEPARTMENT FOR BUSINESS INNOVATION & SKILLS (BIS)– A NEW STRUCTURE FOR NARRATIVE REPORTING IN THE UK

BIS has been consulting over the last two years on a new structure for annual reporting in the UK in order to re-energise reporting and to encourage the preparation of transparent and useable reports that meet shareholders needs. This is part of a wider government agenda to improve the transparency and corporate governance of UK companies.

The regulations put forward by BIS and approved by Parliament require companies to produce a strategic report where quoted companies will be required to report, to the extent necessary for an understanding of the business, on their strategy, their business model, human rights issues and, in their directors' report, disclosures on greenhouse gas emissions. Quoted companies will also be asked to report on the number of men and women on their board, in executive committees and in the organisation as a whole.

The regulations came into force for financial years ending on or after 30 September 2013.

As discussed above the Audit Committee's remit has been widened to report on whether the financial statements are fair, understandable and balanced and this will have to take into account matters that are discussed in the strategic report.

BIS note "While the new regulations represent a relatively modest change to the existing legal requirements, we hope that our proposed guidance will act as a catalyst for companies to publish more relevant narrative reports, facilitating communication and engagement with investors. Investors tell us that they want information to be forward-looking and focussed on strategy and the business model; highlighting relationships and interdependencies between information presented in different parts of the annual report; and with an emphasis on materiality and conciseness. ..... the guidance is aimed at "cutting clutter" and improving relevance of corporate reporting to investors. In drafting the guidance we have borne in mind developments in integrated thinking and reporting."

FOCUS ON THE AUDIT COMMITTEE

Audit Committees are under greater scrutiny than before and that scrutiny is increasing. Recent attention at large has been focused on remuneration reporting but the aftershock of the financial crisis and the general economic uncertainty means that the spotlight is being focused once again on the Audit Committee. This, combined with other initiatives to reduce clutter in corporate reporting, are likely to lead to further changes for Audit Committee reporting over the course of the next few years.

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