

SMITH'S CODE OF PRACTICE FOR AUDIT COMMITTEES

The provisions of the Smith Report (The Combined Code Guidance on Audit Committees) are due to apply for accounting periods starting on or after 1 July 2003, and suggest how audit committee activities should be reported to shareholders in a separate section within the directors' report in the annual financial statements.

The report's template covers the following areas:

Describing the role of the audit committee

- to monitor the integrity of financial statements
- to review the internal financial control and risk management systems
- to monitor the effectiveness of the internal audit function
- to manage the relationship with the external auditor including dealing with appointment, remuneration, terms of engagement, monitoring the auditor's independence, objectivity and effectiveness and developing policies on the provision of non-audit services from the auditor.

Detailing the membership of the audit committee, including

- the names of members, including dates of appointment and resignation. Audit committees should include at least three members who should all be independent non-executive directors. [The report

acknowledges smaller quoted companies may struggle on this]. The chairman of the company should not be an audit committee member.

- the appointment process
- the numbers of meetings and a report on attendance. The FD, head of internal audit and the external auditor may attend if invited. There should be one meeting a year where the external auditor attends without management being present.
- Meetings should be held at least three times a year and should coincide with key dates in the company's financial reporting process.
- specific policies in relation to audit committee members' remuneration. Audit committee members may get paid more to recompense them for their extra responsibilities.
- the relevant qualifications, expertise and experience of each member. At least one member of the audit committee should have significant recent and relevant financial experience, for example as an auditor or a finance director of a listed company. It is highly desirable for this member to be a professionally qualified accountant. The need for a degree of financial literacy among the other members will vary according to the nature of the business.

Main activities of the committee in the year

- *Financial statements* – describing the activities carried out in order to monitor the integrity of the financial

statements. The audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the financial statements, interim reports and preliminary announcements. The audit committee should also review the clarity and completeness of disclosures in the financial statements. The audit committee should have the right and the resources to enable it to take independent legal, accounting or other advice.

- *Internal financial control and risk management systems* – describe the activities carried out in order to review the integrity of the company's internal financial control and risk management systems. Except where the board or a risk committee is specifically charged with the responsibility, the audit committee should receive reports from management on the effectiveness of the internal control and risk management systems they have established and the results of any testing carried out by internal and external auditors.
- *Internal audit function* – the audit committee should review the internal audit programme and ensure that the internal audit function is adequately resourced and has appropriate standing within the company. It should also:
 - consider management's response to any internal audit recommendations
 - approve the appointment or dismissal of the head of internal audit
 - review the company's procedures for handling allegations from whistleblowers.

External auditors

- At the start of each annual cycle, the audit committee should ensure that appropriate plans are in place for the audit. The audit committee should consider whether the

auditor's overall workplan, including planned levels of materiality and proposed resources are adequate.

- The audit committee should review, with the external auditor, the findings of their work. This should include major issues that arose including whether and how they were resolved; reviewing key accounting and audit judgements; and reviewing the level of errors found during the audit and reviewing explanations from management. The committee should also review the audit representation letter before signature by management considering whether the information, based on its own knowledge, is complete and appropriate. At the end of the annual audit cycle, the committee should assess the effectiveness of the audit process.

Relations with the board

- Where there is disagreement between the audit committee and the board, adequate time should be made available to discuss the issue with a view to resolving it. If there is no resolution, the audit committee should have the right to report the issue to the shareholders as part of its activity report.
- As well as the written communication, the chairman of the committee should be present at the annual general meeting to answer questions on the activities of the committee.

Peter Williams.

www.financialdirector.co.uk/briefing

Useful links

- Electronic copies of the Smith Report are available for download at www.frc.org.uk/publications