

## **THE COMPOSITION AND DUTIES OF AUDIT COMMITTEES**

### **1. This response**

This response to the Consultation Paper you published on 7 June 2002 is confined to your request for comments on the composition and duties of Audit Committees although some of the comments may also have a wider relevance.

The views expressed are my own and draw on my experience

- as a business man and a former partner in one of the big firms of chartered accountants
- as a former Chairman of the Practice Regulation Directorate of the Institute of Chartered Accountants in England & Wales
- as a former Secretary General of that Institute

and from my recent contacts with Finance Directors of a number of FTSE 100 companies, senior partners from the major audit firms and senior management of a number of institutional investors.

### **2. Introduction**

In the current debate about the independence of external auditors and non-executive directors the role of the Audit Committee has received considerable attention. There has been a lot of support for an increase in the powers of the Audit Committee, in particular over the external auditor.

I am pleased that the importance of the Audit Committee now seems to be much better recognised but I am concerned that as a result of the current reviews its role might be changed for worse rather than for better. This response makes some suggestions that aim to bring about the latter.

### **3. Status of the Audit Committee**

*All quoted companies should be required to have an Audit Committee based on principles contained in Company Law*

The requirement for an Audit Committee is already contained in the Combined Code. I believe that this requirement should be strengthened by giving it formal legal backing together with a statement of principles on which it should be formed and operate. These should be brief and state that the Audit Committee should

- be independent of the executive management of a company
- have oversight of all of a company's activities so as to ensure that they are appropriately audited and reported to shareholders in accordance with company law, relevant accounting standards and other regulatory requirements.

*The Audit Committee should continue to be a committee of the full company board*

Although I believe that the Audit Committee should be wholly independent of the executive management of a company it should not be independent of the board as a whole.

The UK unitary board model has withstood the test of time. To create an independent sub group with its own powers would be a break with this tradition and might set one part of the board against the another or allow directors not on the audit committee to absolve themselves of responsibility for its decisions. All board members should share all their responsibilities.

#### **4. Membership of the Audit Committee**

*All members of the Audit Committee should be non-executive directors with independent non-executive directors in the majority and with one of them in the Chair*

This is already a requirement of the Combined Code but there is no generally accepted definition of the meaning of the word "independent". The National Association of Pension Funds has however produced some useful guidance on this.

I believe the Combined Code should incorporate guidance along similar lines. This should not be a legal requirement so as to enable the guidance to be relatively easily changed to reflect changing circumstances over time.

There should continue to be at least three members of the Audit Committee for all listed companies of whatever size.

*At least one member of the Audit Committee should have relevant audit and accounting experience*

This experience might involve membership of one of the professional accounting bodies and be registered in a similar way to the requirement for auditors to be registered as Recognised Individuals under the terms of the 1989 Companies Act and embodied in Audit Regulations.

*The Nomination Committee should chose members of the Audit Committee and their performance and contribution monitored on an annual basis*

I will not make suggestions here about the composition of the Nomination Committee other than to say that its role and membership should also be formalised.

*Audit Committee members should be drawn from as wide a pool as possible of appropriately experienced business people*

The personal qualities of the members of the Audit Committee are of critical importance. Members need to be able to stand up to powerful company executives – especially Executive Chairmen, Chief Executives and Finance Directors. They also need objectivity and courage.

I am sure you will be giving consideration to the need for a larger pool of talented non-executive directors than there seems to be available at present. I suggest a requirement, perhaps under the Combined Code, for public advertisement of all listed company non-executive director positions.

## **5. Transparency**

*The Audit Committee should provide a formal written report to shareholders on an annual basis*

For years the Audit Committee has been the ugly duckling of UK corporate governance. If it is to become a swan then it needs to do something to improve its appearance. I believe it can achieve this by being much more open about the work it does.

The terms of reference of the Audit Committee should be reported to shareholders as a part of the Annual Report and Accounts together with a summary of its key activities during the previous year. The Chairman of the Audit Committee should be prepared to answer questions from shareholders about the Committee's work at the AGM.

It is possible that the full board might not accept an important recommendation of the Audit Committee. In such a case it would be vital that the circumstances were publicly explained to all shareholders through this formal report. If the process were working properly the need for such disclosure would be the exception and not the general rule.

## **6. External auditors**

*The terms of reference of an Audit Committee should include responsibility for*

- *agreeing the main strategic risks facing the business and then, in the light of those risks, the scope of the audit with the external and internal auditors*
- *recommending to the board the appointment and remuneration of the external auditors (which the board then recommends to the shareholders)*

- *regularly reviewing the effectiveness of the external audit and recommending change and/or competitive tendering as appropriate*
- *regularly reviewing external auditor independence and anything that might impair that independence such as the nature and extent of the non-audit services carried out by the external auditor*
- *ensuring that all of the company's activities are appropriately reported to shareholders in accordance with company law, relevant accounting standards and other regulatory requirements*

The Audit Committee should not take over the role of the executive directors who should manage the day-to-day relationship with the external auditors on its behalf and on behalf of the full board.

Model terms of reference could be included in the Combined Code so as to retain flexibility in the light of changing circumstances. There should be no need for specific, detailed rules although a list of proscribed non-audit services to supplement general principles might be included. Again this list should be in the Combined Code and subject to change in the light of experience.

## **7. Other matters**

Not only should all listed companies have an Audit Committee but many larger private companies and other public interest bodies should too. Whilst this is beyond the scope of your current review I believe the government should consider ways of encouraging or requiring such bodies to adopt the same sort of practices as are required for listed companies.

I am also concerned that any new provisions should not bear too heavily on smaller listed companies. I therefore favour wherever possible a flexible approach so that Audit Committees

- add value and enhance confidence
- are not another burden on business
- do not generate more “boiler plate” reporting in company annual reports.

**JOHN COLLIER**