DECEMBER 2015

A GATHERING STORM

AN ANALYSIS OF AUDIT COMMITTEE REPORTING

BDO

CONTENTS

INTRODUCTION

We have noted an appreciable improvement in the overall quality of audit committee reporting in 2015. This may be partially reflective of the brief period of stability in reporting requirements that are effective this year but it cannot have happened without effort on the part of the preparers of annual reports. It is heartening that companies have, in general, focussed on how they can better represent the increasingly important work being carried out by their audit committees.

In particular, in this survey we have identified improvements in the descriptions of how audit committees assess external audit effectiveness and their work on appointing the auditor and safeguards on non-audit services. Material around the advice given to the whole board on the assertion that the annual report is fair, balanced and understandable has also improved.

It was also interesting to note that the average number of meetings held by audit committees continues to creep up, surely reflecting their increasing remit, and that the proportion of female committee members has, once again, increased significantly.

There are, however, areas where disclosures remain disappointing:

- Material on the work of the internal auditors, and their effectiveness, continues to be sketchy in many reports
- There remains much generic or boilerplate language, for example around whistleblowing policies and the committee's role in that process
- Reports continue to be predominantly backward-looking, with few making reference to significant future changes in GAAP which may have a considerable effect on the financial statements (for example, those relating to leasing or revenue recognition) or to the further significant changes in governance-related reporting requirements (such as the longer-term viability statement).

Whilst it is a criticism that can be levelled at many of the sections of the annual report, it remains that the audit committee report is still largely disconnected from the other material in the publication as a whole and rarely refers to or discusses other matters dealt with in the wider document which may be relevant to the work of the committee.

The brief period of stability in reporting requirements enjoyed by audit committees this year is coming to an end; the storm clouds of regulatory change are once again gathering on the horizon. Some real challenges await for the audit committee next year, as the new 2014 UK Corporate Governance Code comes into force, and beyond, as the significant reforms introduced by the Audit Directive begin to take effect. The requirement for a longer-term viability statement and for more material around risk management and wider internal control matters, and their review, in particular will test committees' commitment to transparency and emphasise their increasing accountability. It will be fascinating to see how they respond.

JAMES ROBERTS
PARTNER, BDO LLP

December 2015

1. EXECUTIVE SUMMARY

In this year's survey we have taken a look at whether and how audit committees have improved upon the disclosures they made for the first time last year in response to the initial application of the UK Corporate Governance Code (September 2012)[1] (the 2012 Code). We have also continued to assess some of the more established areas of audit committee reporting.

In common with previous years, we have awarded a quality score to the audit committee reports that we have reviewed. We have found that, after the difficulties in the initial application of some of the 2012 Code's requirements we reported last year, the average quality score for an audit committee report has shown an appreciable increase. This indicates that companies may be beginning to come to terms with the dramatically changed expectations that arose from the first-time adoption of the 2012 Code and, more particularly, from the publication of the Financial Reporting Lab's Lab Project Report: Reporting of Audit Committees (the Lab Project Report).[2]

1. https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf
2. https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Lab-Project-Report-Reporting-of-Audit-Committees.pdf

This year's survey results show that:

- The composition and workload of audit committees remains broadly consistent with previous years, albeit with evidence of continuing progress in terms of the gender diversity of their membership
- Audit committee reports continue to provide relatively little information about the focus of the internal audit function, its relationship with the audit committee or other stakeholders, or the testing of its effectiveness
- Discussions of whistleblowing policies and the audit committee's role in the process were generally good although sometimes generic and prone to boilerplate language
- Descriptions of significant financial reporting issues continue to be disappointing. We found that the auditor's report remained the more consistently reliable source for information on risks and how they affect the financial statements
- The information on the assessment of external audit effectiveness and appointment of auditors was generally good, and is improving
- The disclosures regarding the provision of non-audit services by the company's auditors were sometimes a little boilerplate, simply repeating the restrictions that exist in auditors' ethical standards
- The disclosure of what involvement the audit committee had in the board's assertion that the annual report is fair, balanced and understandable has seen some improvement but sometimes overemphasise generic process-oriented information.

Our key action points, which we believe audit committees could consider in order to make improvements in their future reporting, remain the same as last year and require companies to truly embrace the spirit of transparency and openness that the Lab Project Report championed in 2013. In summary, audit committee reports should:

- Be more integrated with other parts of the annual report
- Be forward-looking as well as retrospective
- Explain why and how things have been done, as well as just what has been done.

2. RESEARCH OBJECTIVES AND METHODOLOGY

THE OBJECTIVES OF THIS YEAR'S SURVEY ARE TO:

- Identify whether and how companies with a Premium listing on the London Stock Exchange (FTSE-listed companies) have adopted the recommendations of the 2012 Code in respect of the work of the audit committee.
- Measure the quality of audit committee reporting compared to expectations set for the period to which they relate.
- Identify ways in which audit committee reporting could be improved.

FTSE-LISTED COMPANIES

In this survey, we have reviewed the annual reports of 90 FTSE-listed companies with year ends falling between 30 September 2014 and 31 July 2015, gathering objective information such as the number of audit committee meetings held during the year as well as assessing the quality of the information presented in the audit committee report. The comparative information for the two prior years is in respect of those same companies.

This year, as in previous years of this survey, we have divided our sample into three categories: FTSE 100, FTSE 250 and FTSE All-share, with FTSE 100 describing companies ranked in the first 100 on the main market of the London Stock Exchange in terms of market capitalisation, FTSE 250 describing those ranked from 101 to 350 and FTSE All-share describing those ranked from 351 downwards. The categorisation of each company, in each of the three years included in this survey, is based on its position in the December 2014 index.

Where we have made an assessment of quality, a score out of five has been awarded. As this assessment is both subjective and based on expectations set for the period to which the information relates, a substantially unchanged audit committee report may achieve a lower mark in the current year than it achieved in previous years. This factor was particularly relevant in last year's survey as our expectations had been significantly raised by the publication of the 2012 Code and its associated guidance and the Lab Project Report.

AIM-LISTED COMPANIES

We have also examined the audit committee reporting of 30 of the top 100 AIM-listed companies by market capitalisation with year ends falling between 30 September 2014 and 30 June 2015. Whilst we sought to ensure as much consistency as possible, the 2013 and 2014 samples do not contain the same 30 companies as we have looked at in 2015. This variation has been caused by the greater volatility in the composition of the AIM 100 index than the FTSE indices.

Whereas our review of the FTSE-listed companies' audit committee reporting was generally restricted to the information contained in their annual reports, our review of the information provided by AIM-listed companies extended to their corporate website. This is because, unlike the Listing Rules, the AIM Rules do not require the disclosure of corporate governance information in the annual report.

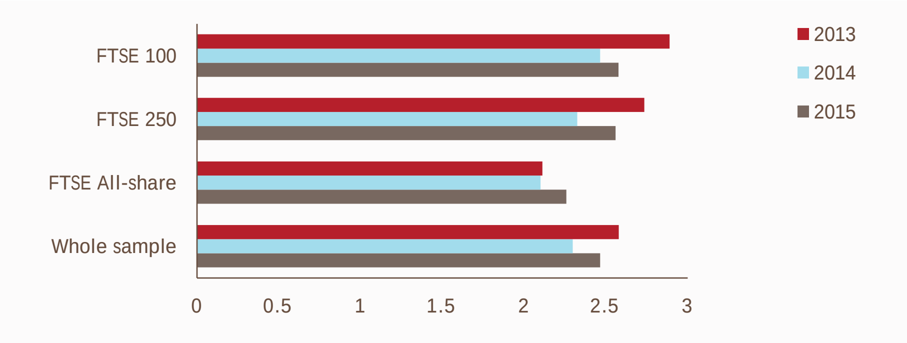
Unlike with the FTSE-listed companies in our sample, we have not made a quantitative assessment of the quality of the AIM-listed companies' audit committee reporting. The lack of a mandated governance code for AIM-listed companies makes it more difficult to differentiate between those that have undisclosed corporate governance structures and policies in place and those companies that simply have less well developed corporate governance processes, making the assessment less meaningful. Instead, we have made some broader observations about the quality of audit committee reporting of companies in this bracket.

3. WHAT THE RESEARCH IS TELLING US: FTSE-LISTED COMPANIES

3.1 OVERALL QUALITY OF AUDIT COMMITTEE REPORTING

Code provision C.3.8 recommends that a separate section of the annual report should describe the work of the committee in discharging its responsibilities.

What is the average quality score awarded to an audit committee report?

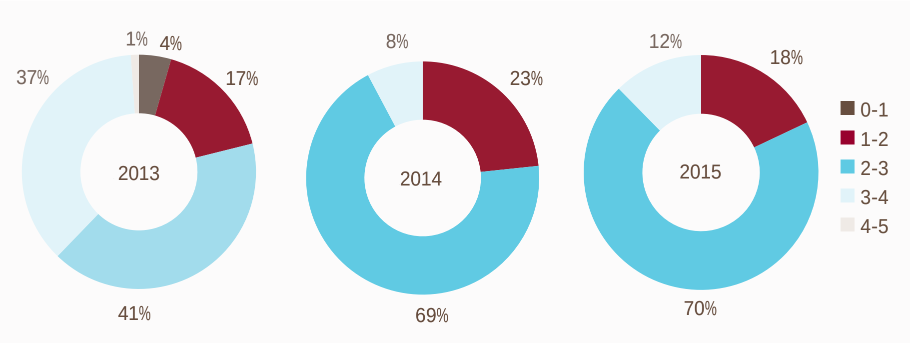


The average quality score for an audit committee report has increased across the board this year (Average mark: 2.47, 2014: 2.30, 2013: 2.58). The most marked improvement has been seen in the FTSE 250 bracket, where there were some notable advances in the disclosures relating to internal audit; appointing the auditor and safeguards on non-audit services; and fair, balanced and understandable.

This year's improvement is in contrast to the significant drop in the average score that we observed last year, showing that companies are beginning to come to terms with the dramatically changed expectations that arose from the first-time adoption of the 2012 Code and, more particularly, from the publication of the FRC's Lab Project Report. As we noted last year, the former added some new requirements which increased the risk of boilerplate disclosure and/or were simply difficult to draft due to their potential sensitivity and the latter raised the bar in terms of the nature and quality of information that was expected to be included in an audit committee report.

Whilst we applaud the efforts many companies have made in trying to meet these enhanced expectations, and the improvements that we have seen this year resulting from those efforts, all companies in our survey can make further improvements.

What was the distribution of the average quality scores across our sample?



In last year's report we observed that many of the companies that were awarded quality scores of between one and two scored in the 'high ones' so did not need to improve on much to move up a classification. This has been borne out this year with a number of relatively modest changes having had the effect of pushing the whole distribution upwards; the fall in the number of companies occupying the 1-2 bracket being broadly matched by the increase in numbers in the 3-4 bracket. The more prescriptive audit committee report requirements in the 2012 Code continue to have a disproportionately positive effect on the companies with previously poorer quality reporting. Modest changes can only take you so far though. If we are to see continuous improvement, companies will have to truly embrace the spirit of transparency and openness that the Lab Project Report has championed.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

In 2014, we identified two general ways in which we thought that audit committee reporting could be improved, these remain key areas for improvement this year and are described to the right. In addition to these more general improvement areas, we have also identified some more specific ways in which audit committee reports could be improved; these are described in the subsequent sections of this survey.

INTEGRATION WITH OTHER PARTS OF THE ANNUAL REPORT

Perhaps one of the most disappointing findings from our 2015 survey is that there continues to be a lack of integration between the audit committee report and the other parts of the annual report. In many cases, the only reference the audit committee report made to information in other parts of the annual report was to direct the reader to the auditor's remuneration disclosures in the notes to the financial statements. Only in exceptional cases did even the best examples cross-refer to more than just the relevant notes to the financial statements when identifying a significant financial statement risk that was discussed by the audit committee.

By referencing information in other parts of the annual report, including the strategic report as well as the financial statements and, importantly, by describing how the matters raised in the audit committee report have affected or might affect the company and its reporting, the audit committee will be able to demonstrate better that they have a good understanding of the matters they discuss both in financial reporting and operational terms. They will be able to demonstrate that they have a more holistic view of the company and will help the reader navigate to the information that might have the greatest bearing on their assessment of risk and governance.

FUTURE ISSUES

We also once again found that the audit committee reports tended to be historical records of what the committee had done during the year. They rarely included overt reference to future plans or matters that, whilst minor in the year under review, might become important in years to come. This gives a probably false impression that audit committees are more reactive than proactive.

It is particularly surprising, for example, that there was almost no mention of the potential effects of new International Financial Reporting Standards (IFRSs) such as IFRS 15 ‘Revenue’ and IFRS 9 ‘Financial instruments’ and the proposed changes to lease accounting. Whilst these changes may appear a long way off yet (subject to EU-endorsement, IFRS 9 and IFRS 15 will be effective for periods beginning on or after 1 January 2018), their sometimes complex and detailed requirements may have a profound effect on the results and financial position of some companies (particularly those entering into longer-term contracts with their customers and those that hold longer-term financial assets) and may necessitate some system improvements in order to allow the company to capture the information needed comply with them.

There were however, some notable exceptions to this rule:

> The Committee is aware of the International Accounting Standards Board (IASB) proposal for bringing all leases on to the balance sheet. The Chairman of the Committee and Group Finance Director have had meetings with representatives of accounting standard setters, and other interested parties, to express the Group’s opposition to the current proposals. Implementation of the IASB proposal would fundamentally change the Group’s balance sheet by bringing on some £2bn (undiscounted) of theoretical “right to use” assets, together with broadly matching lease liabilities. The proposals would have no impact on the Group’s cash flows; but would add volatility, complexity and assumptions to the balance sheet as the Group actively manages the 500+ properties from which it trades or leases, as well as adding compliance costs.

(Next Plc, January 2015)

Similarly, whilst it was mentioned more often than the up-coming accounting changes, it was also rare to see any reference to the forthcoming changes to the Code, such as the introduction of the longer-term viability statement to the annual report. By including reference to future and/or emerging issues, audit committees will be able to demonstrate that they are taking a longer-term view and will help to reduce surprises in subsequent years.

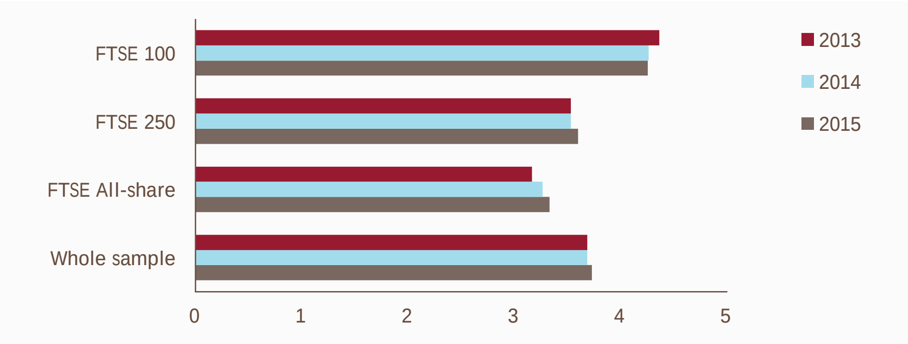
3.2 COMPOSITION AND WORKLOAD OF THE AUDIT COMMITTEE

Code provision C.3.1 recommends that the board should establish an audit committee of at least three, or in the case of companies outside of the FTSE 350 two, independent non-executive directors.

The description of the composition and workload of the audit committee may appear to be one of the more mundane parts of the audit committee report but it is also one of the most important. In our view, there are two critical elements that lead to an effective audit committee: (a) That it comprises people with the appropriate mix of personal qualities, skills and experience; and (b) That those people devote appropriate time to their duties. No amount of structure or procedure can compensate for a lack of either or both of those factors.

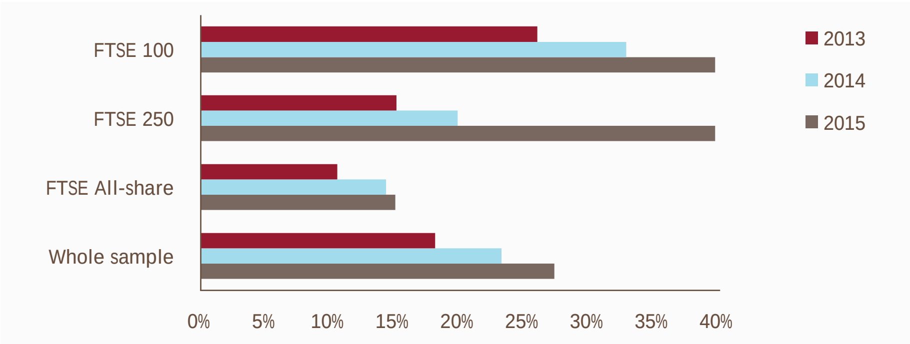
With that in mind, it was encouraging to find that this was an area in which scores remained relatively high (Average mark: 2.83, 2014: 2.91). Generally speaking, we found good information on the composition of the audit committee and the matters that they considered. The marginal drop from last year has resulted from our increased expectations in terms of the directors' biographies, which we explain in more detail below.

What is the average size of an audit committee?



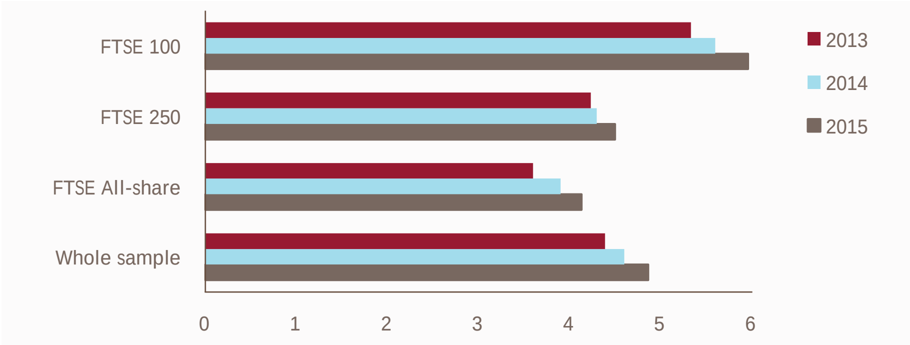
As expected, the absolute size of the average audit committee has remained broadly consistent over the past three years. Also broadly consistent with previous years' findings, the largest audit committee in the FTSE 100 had seven members (2014: eight, 2013: seven) and the largest committees in the FTSE 250 and FTSE All-share categories had five members (2014: five, 2013: five). As in previous years, only two companies (both from the FTSE 250) had fewer than the Code's recommended minimum number of members. It was very much the exception to find an audit committee that did not comprise entirely of independent non-executive directors.

What proportion of the audit committee is female?



Boardroom diversity is a subject that continues, for very good reason, to attract interest. The concern is that company boards comprising only members with similar educational and professional backgrounds, age and/or gender may be dominated by 'groupthink', which can lead to management decisions not being challenged effectively and to innovative ideas not being taken on board. The 2012 Code acknowledges this by its reference to 'the benefits of diversity on the board, including gender' and so it is good to see that the fast rate of change in the proportion of female members serving on audit committees appears to be continuing. It is also particularly pleasing to see the large improvement in the FTSE 250 category this year; one can only hope that the smaller listed companies follow suit in the coming years as there is a significant gap opening up both in terms of absolute numbers of female audit committee members and in terms of the rate of improvement in this area.

How often does the audit committee meet?



The number of audit committee meetings held each year also continues to creep slowly upwards. We predicted that this might be the case in our 2013 report, citing the expanded role of the audit committee and the additional reporting requirements to which they are subject. As shown in the table below, however, the average number of meetings hides a wide range of results:

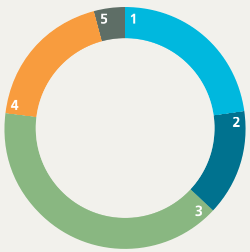
KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

The relatively high quality score notwithstanding, there are still a number of ways in which companies might consider enhancing their disclosures in this area:

WORKLOAD OF THE AUDIT COMMITTEE

It is very easy to ascertain how many audit committee meetings took place during the year. The matters covered at these meetings are also now commonly evidenced by agenda-style descriptions of varying levels of detail. An increasing number of companies are enhancing the clarity of this information by disclosing it in tabular form or by including a graphical analysis of the allocation of the audit committee's time to each topic area:

THE BOARD'S TIME



1.	Financial	23%
2.	Operational developments	14%
3.	Strategy	40%
4.	Corporate governance	19%
5.	Training	4%

(Hikma Pharmaceuticals Plc, December 2014)

The approaches noted to the left are an easy and concise way to show that the 'basics' are being covered by the audit committee. It is still, however, difficult to judge the amount of time and effort audit committees actually spend in discharging their responsibilities. For example, as well as attending formal meetings, audit committee members will spend time preparing for those meetings and engaging with the business in other ways. As in previous years, we identified only one company that disclosed the amount of time they expected their non-executive directors to spend on their role:

Time allocation

Each of the non-executive directors has a letter of appointment which sets out the terms and conditions of his or her directorship. The Chairman and the non-executive directors are expected to devote such time as is necessary for the proper performance of their duties. This is expected to be approximately 20 days each year for basic duties. The Chairman and Senior Independent Director are expected to spend additional time over and above this to discharge their added responsibilities.

(Burberry Group Plc, March 2015)

No companies gave an indication of the amount of time they actually spent. We believe that the inclusion of this information would provide a clearer indication of the level of scrutiny provided by the audit committee than a list of agenda items alone.

COMPOSITION OF THE AUDIT COMMITTEE

It is very common for directors' biographies to be included in the annual report but the nature of the information included in them can vary widely from a short list of recent and current appointments to a concise but more complete picture that includes reference to industry and subject experience and qualifications as well, as shown opposite:

11. Minnow Powell Independent Non-Executive Director

Age	60
Nationality	British
Appointment	Minnow Powell became a Non-Executive Director in April 2011.
Committee membership	Chairman of the Audit Committee and member of the Nomination Committee.
Key skills & experience	Minnow has extensive experience in external and internal audit, risk management, financial controls and corporate/financial reporting in a wide variety of sectors.
Career	During his 35 years at Deloitte, Minnow became a senior partner and concentrated on looking after Deloitte's major clients including BAA, Hammerson, Reed Elsevier, Anglo American and BSkyB. He was also a member of the UK's Audit Practices Board for six years.
External appointments	Non-Executive Director and Chairman of the Audit Committee of SuperGroup PLC.

(TUI Travel Plc, September 2014)

Ian Barlow (63)
Independent Non-executive Director

Appointed Independent Non-executive Director in March 2010 and Chairman of the Audit Committee in May 2010. He was appointed a Member of the Ethics & Compliance Committee on 2 October 2014.

Career and Experience

Ian is a Chartered Accountant with considerable financial experience both internationally and in the UK. He was a Partner at KPMG, latterly Senior Partner, London, until 2008. At KPMG, he was Head of UK tax and legal operations, and acted as Lead Partner for many large international organisations operating extensively in North America, Europe and Asia. Ian's previous appointments include Non-executive Director and Chairman of the Audit Committee of PA Consulting Group and Non-executive Director of Candy & Candy. He was Chairman of WSP Group plc and of Think London, the inward investment agency. He is currently Lead Non-executive Director chairing the Board of Her Majesty's Revenue & Customs; Non-executive Director of The Brunner Investment Trust PLC; Non-executive Director of Foxtons Group plc; Board Member of the China-Britain Business Council and Chairman of The Racecourse Association.

Skills and Competencies

Ian's longstanding financial and auditing career and extensive board experience add value to his role as Chairman of the Audit Committee. It was of particular benefit when leading the selection process for the new external auditor in 2014. His appointment as an additional member of the Ethics & Compliance Committee recognises the close links between the activities and oversight role of both committees. His work for a number of international companies gives added insight when reviewing our global businesses.

Nationality

British

(Smith & Nephew Plc, December 2014)

As noted previously, boardroom diversity is a subject that is attracting increasing interest. Whilst the main focus is on gender diversity, this is only one aspect of the issue, with true board diversity requiring a mix of personal qualities, skills and experience. It is difficult to demonstrate that the audit committee membership (and the board membership more generally) is appropriately diverse but a concise and clear biography such as those shown on the previous pages, coupled with a summary of some of the more measurable aspects of diversity (such as that shown to the right) can go some way towards demonstrating whether this is the case.

Board balance

Chairman	1
Executive Directors	3
Non-executive Directors	4

Board tenure

0–2 years	1
2–4 years	1
4–6 years	2
6+ years	4

Board geography

UK	6
Americas	2

Board diversity

Male	7
Female	1

Non-executive Directors – significant strengths

	Strategic development	Operating performance and delivery	Mergers and acquisitions	Business integration	Financial management and planning	Sector-specific
Philip Aiken	●	●	●	●		
Robert Amen	●	●	●		●	
Iain Ferguson	●	●				
Maureen Kempston Darkes	●		●	●		
Graham Roberts	●		●		●	

	Experience of international markets	Health and safety	Risk management and assurance	HR management	Stakeholder engagement	Ethics, values and culture
Philip Aiken	●	●	●		●	●
Robert Amen	●	●		●	●	●
Iain Ferguson	●	●		●	●	●
Maureen Kempston Darkes	●	●		●		●
Graham Roberts			●		●	

(Balfour Beatty Plc, December 2014)

RISK AND RISK COMMITTEES

There appears to be an emerging practice favouring a structure where there is a risk committee, comprising executive directors and/or other senior management, which sits below the board. This committee often reports directly into the audit committee which ensures the audit committee takes responsibility for the overall review of risk.

Our review of audit committee reports indicates that there are often long discussions about risk within the front end of the financial statements but 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.

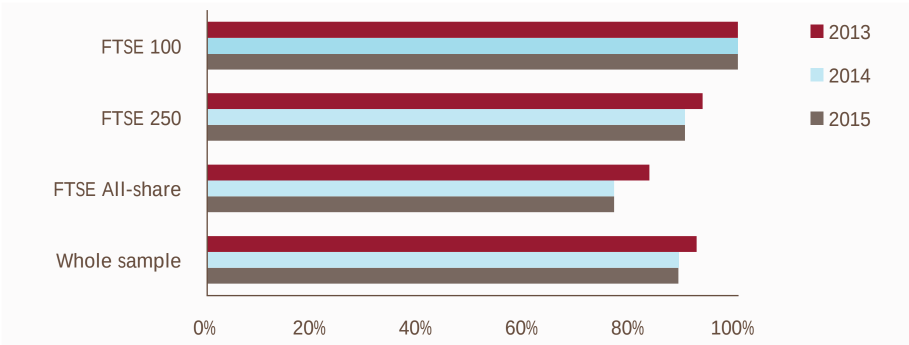
3.3 INTERNAL AUDIT

Code provision C.3.6 recommends 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, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

The environment in which companies are operating is becoming increasingly complex and competitive and, in consequence, an efficient and effective internal audit function has, for most companies, become an important part of the 'third line of defence'. It is critical that those tasked with the independent challenge of key controls are provided with appropriate reporting lines in order to maintain their independence and objectivity. This will normally mean that they work very closely with the audit committee.

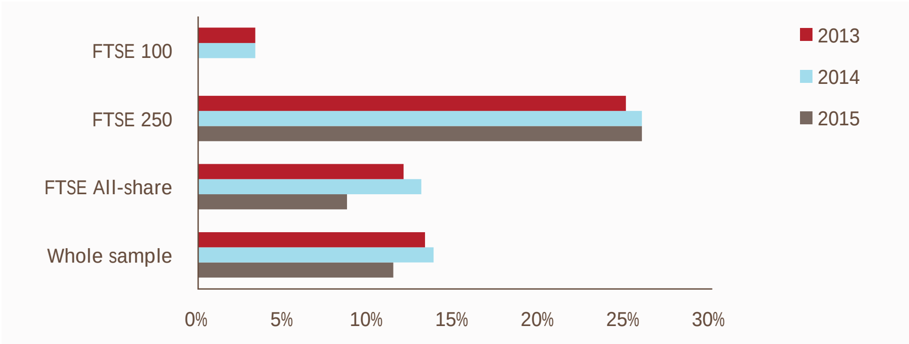
With that in mind, it was surprising to find that, although there has been some marked improvement in this area of disclosure, audit committee reports continue to score consistently low marks in their description of the focus of the internal audit function, its relationship with the audit committee and the external auditors and the testing of its effectiveness (Average mark: 1.92, 2014: 1.65).

What proportion of companies have an internal audit function?



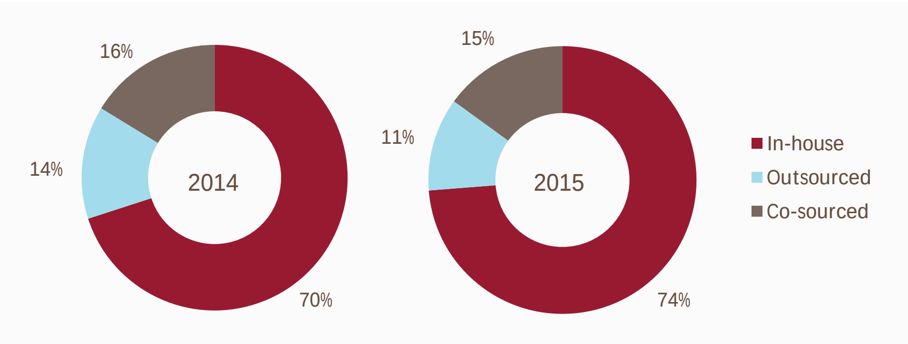
The need for an internal audit function will vary depending on company-specific factors such as geographical reach, volume of transactions and business complexity. For smaller companies, cost/benefit considerations will also have more of a bearing. Despite this, the number of companies with an internal audit function has remained both constant and high.

What proportion of internal audit functions were fully outsourced?



Again, the results are similar year on year. Full outsourcing is relatively rare in the FTSE 100; the one remaining example of a fully outsourced model in our sample moved to a co-sourced arrangement during the year under review. Outside of the FTSE 100, and particularly in the FTSE 250 companies we looked at, the fully outsourced model is more common. This perhaps indicates the more pressing resource constraints within smaller companies and a greater need for flexibility.

Whilst fully outsourced internal audit functions remain the exception, however, a number of companies supplement their in-house internal audit function with outsourced help. This 'co-sourced' model has been seen to be used both for specific project work where the in-house team does not have the necessary specialist skills and for the more day-to-day delivery of internal audit work. The proportion of companies explicitly acknowledging the use of a co-sourced model this year was:



KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

The key ways in which we believe that the audit committee report's description of the focus of the internal audit function, its relationship with the audit committee and the external auditors, and the testing of its effectiveness could be improved are as follows:

INTERNAL AUDIT FOCUS

In the most part, the discussion of the internal audit function's work during the year was either too generic (eg statements such as 'our internal audit function focuses in particular on higher risk areas of the group's business') or non-existent. Without a more specific description of the most significant areas addressed in the year, it is difficult to form a judgement on the appropriateness of the internal audit function's focus compared to the readers' perception of parts of the business that give rise to the greatest risk.

The description of the internal audit function's focus need not be extensive in order to provide this greater insight, as the following examples demonstrate:

Internal controls
The Committee considered a revised internal audit approach in 2014 and approved a plan that replaced internal audit peer reviews with subsidiary level commercial and operating reviews. The plan was assessed on the basis of providing responses to some of the key risks faced by the Group, as identified on the Group's risk register. Subsidiary businesses were required to self-assess their compliance with Group-wide policies; these assessments were validated by a combination of external auditor and internal auditor activity. The internal audit team took a more risk-based approach to the internal control environment. This included contract and project management, procurement and supply chain management, sales and credit management, compliance and financial reporting, thus giving the Committee a balanced overview across the Group, taking into account the level of risk and previous coverage. At meetings throughout the year, progress against this plan was reviewed. Additional areas of review were added to the plan as required, where circumstances gave rise to an increased level of risk.

(Hill & Smith Holdings Plc, December 2014)

Internal audit

The Group has a risk and internal audit function which reports to the Audit Committee. The risk and internal audit function reviews internal controls and reports to the Audit Committee on whether such controls are in place and are being operated effectively. The function covers Intu Properties plc, subsidiaries (including intu Retail Services) and joint ventures.

The most significant areas reviewed in 2014 were: shopping centre healthchecks (or follow up reviews) at six centres, corporate responsibility reviews at four centres, integration of the major assets acquired in the year (intu Merry Hill and intu Derby), a review of the transactional services operation (including accounts payable, expenses, accounts receivable and cashiers), review of intu Experiences' commercialisation processes, a review of cash exposures, centre demise reviews, data identification, service charges, payroll outsourced service provider review and a review of self-certification at the centres and head office. Additionally, annual assurance activities were performed, including a review of gifts and hospitality and Executive expenses.

The Audit Committee regularly reviews the effectiveness of the risk and internal audit function and in particular ensures that the function remains sufficiently independent of the wider business to ensure it can carry out its work effectively. An independent review of the risk and internal audit function is carried out every five years and was last performed at the end of 2013.

(Intu Properties Plc, December 2014)

INTERACTION BETWEEN INTERNAL AND EXTERNAL AUDITORS

It is surprising that there is not more information on the interaction (if any) between the internal and external auditors. Generally speaking, the only evidence of any sort of co-ordination or communication between the two assurance providers is their attendance at the same meetings and, in some cases, a mention of discussions with the internal auditor in the auditor's report. It would be useful to understand in greater detail how the audit committee, the internal auditor and the external auditor interact and to be able to compare the priorities of both lines of assurance. In 2014, one company in our sample provided something close to this sort of information when it alluded to the fact that the external auditor's audit plan had been discussed and co-ordinated with its internal audit function and that 88% of group revenue would be covered by the combination of the two. Nothing like this was identified in our 2015 survey.

ASSESSMENT OF THE EFFECTIVENESS OF THE INTERNAL AUDIT FUNCTION

Few audit committee reports (81% of those with internal audit functions, 2014: 73%) stated that they had completed an assessment of the effectiveness of the internal audit function; this is surprising considering that such a review is required under the Code. Those that did undertake a review provided very little information on how that review was conducted or its findings (other than the rather generic statement that the function was working effectively). A brief description of how the effectiveness of the internal audit function was assessed and an indication of what, if any, improvements could be made to it would be useful in the assessment of its robustness and reliability:

The effectiveness of Internal Audit

Again this year we requested a review on the effectiveness of Internal Audit. The approach was consistent with the previous two years, covering the effectiveness of the function (positioning, processes, systems and people). Effectiveness was assessed both from an internal perspective (through an independent review of the function benchmarked against best practice) and from an external perspective (the perception of 12 senior financial personnel/senior management and seven Board members). We were pleased to note that the function continues to perform strongly.

(TUI Travel Plc, September 2014)

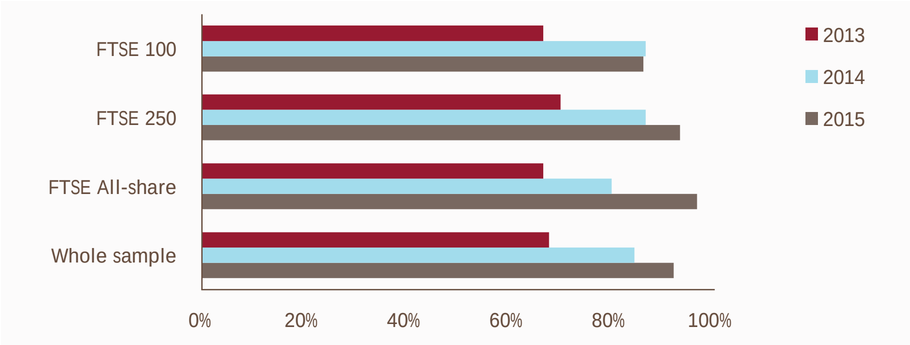
3.4 WHISTLEBLOWING

Code provision C.3.5 recommends that 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 ('whistleblowing'). 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.

The values and culture of a company are essential to effective governance and, in order for them to become properly embedded in the business, employees must be given a confidential and effective way of reporting potential breaches of the company's code of conduct. Whistleblowing 'hotlines' are now very common and are forming an important part of companies' risk management and assurance systems.

This area, perhaps more than any other in this survey, is in danger of giving rise to 'boilerplate' disclosures that add little or no value. A statement that a whistleblowing policy and hotline exists would not be significantly improved by lengthy descriptions of the sorts of issues that might be reported as a result. On that basis we were pleasantly surprised to see that, where companies went beyond a statement of existence, the disclosures were relatively informative (Average mark: 2.60, 2014: 2.43).

What proportion of companies made reference to a whistleblowing policy?



More companies appear to be making reference to the existence of a whistleblowing policy and/or hotline in their accounts but often that is the extent of the disclosure. Only 51% (2014: 49%) of companies that include such a reference go on to make any meaningful disclosure about the operation of the policy.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

It is important that companies are not encouraged to include generic or boilerplate information in their audit committee reports and so our recommendation for improvement is based on making the disclosures around a company's whistleblowing policy more company-specific.

AUDIT COMMITTEE ROLE IN WHISTLEBLOWING

The important aspects of a whistleblowing policy discussion are to provide enough detail for the reader to understand the audit committee's role in receiving whistleblowing reports and any follow-up that might have taken place. The best disclosures made clear whether all whistleblowing reports are communicated to the audit committee, the number and general nature of reports received, any significant issues that the reports had highlighted and if those issues were resolved:

The Standards, and information on the total number of incidents reported under them in 2014 (including established breaches), is available at www.bat.com/governance. The number of incidents is reviewed by Ernst & Young LLP as part of its process for providing assurance of our annual Sustainability Report. Its full assurance statement is available at www.bat.com/assurance.

In the year to 31 December 2014, 56 instances of suspected improper conduct contrary to the Standards (excluding non-material employee fraud and theft against Group companies) were reported to the Committee (2013: 22). The increase is considered to be attributable to an awareness campaign launched following the adoption of the revised Standards in 2014.

Twenty were established as breaches and appropriate action taken (2013: 9). In 31 cases, an investigation found no wrongdoing (2013: 10). In five cases, the investigation continued at the year-end (2013: 3). No instances involved sums or matters considered material to the Group.

Whistleblowing

The Standards also set out the Group's whistleblowing policy, enabling staff, in confidence, to raise concerns without fear of reprisal. The policy is supplemented by local procedures throughout the Group and at the Group's London headquarters, providing staff with further guidance and enabling them to report matters in a language with which they are comfortable. The Committee receives quarterly reports on whistleblowing incidents. It remains satisfied that the Group's policy and procedures enable proportionate and independent investigation of matters raised and ensure appropriate follow-up action is taken.

Of the total number of business conduct incidents reported in 2014, set out above, 42 were brought to management's attention through whistleblowing reports from employees, ex-employees, third parties or unknown individuals reporting anonymously (2013: 18). The increase is also considered to be a result of the increased awareness training offered during 2014.

(British American Tobacco Plc, December 2014)

Instead of including a lengthy but relatively generic description of the policy in their accounts, a number of companies chose to reference the corporate governance section of the company website. We support this approach (which was adopted in the example to the left), as long as the website content remains current and the hyperlink is specific.

3.5 ADDRESSING SIGNIFICANT FINANCIAL STATEMENT REPORTING ISSUES

Code provision C.3.8 recommends that a separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include: The significant issues that the committee considered in relation to the financial statements and how these issues were addressed.

This was probably the most significant of the new disclosures added to the audit committee report by the 2012 Code. It is related to the new auditor's report requirement in International Standards on Auditing (ISA) 700 (introduced in September 2012 alongside the 2012 Code), to describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.

In 2014, we found the general quality of the disclosure was well below our expectations at an average mark of 1.96. In 2015, whilst there has been a marginal improvement (Average mark: 2.05), the quality of these disclosures remains disappointing. The main contributing factor for the marginal improvement was an increased use of a tabular presentation of the information compared to more block text last year; this tended to make the information easier to digest.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

Although the wording of the 2012 Code and ISA 700 requirements is slightly different, we expect a high degree of correlation between the issues identified in the audit committee report and those discussed in the auditor's report. However, although there was indeed a high degree of overlap between the issue identified in the audit committee report and the risks identified in the auditor's report, it was rare for the two parts of the annual report to identify exactly the same issues with the audit committee report often identifying several additional risks compared to the auditors. As with last year, we found that it was the auditor's report that usually gave the more detailed information on the risks and how they affect the financial statements.

We have identified a number of ways in which the disclosures in this area could be improved.

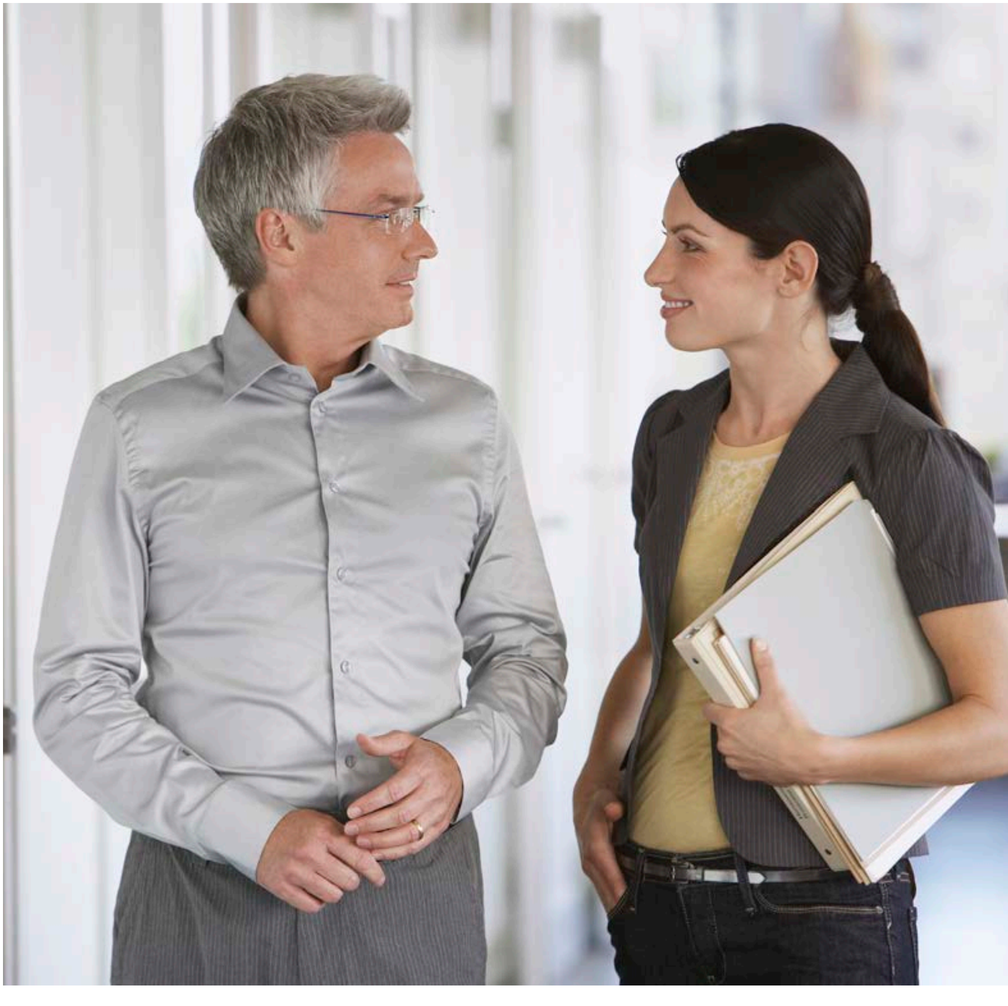
WHY AN ISSUE IS CONSIDERED SIGNIFICANT

We often found that audit committee reports provided a list of significant issues without describing clearly what made those issues significant. A clear and concise description of why the audit committee considered a matter significant would enhance the readers' understanding of that issue, enable them to identify exactly where the risk exists and help explain why there might be a difference between the matters reported in the auditor's report and those disclosed in the audit committee report.

HOW A SIGNIFICANT ISSUE HAS BEEN ADDRESSED

We often found the description of the audit committee's approach to a significant issue to be relatively generic (eg reviewed workings and discussed with management). Some of the better disclosures, however, provided a more personal description of the approach taken by the audit committee and clearly stated the nature of the reports that they reviewed and/or their objective in doing so.

It was rare for a description of how an issue was addressed to make reference to key assumptions or ranges of outcomes and, almost without exception, the narrative did not go on to provide further information on the nature of these assumptions, their sensitivity or the span of the range of possible outcomes. This was another recommended disclosure in the Lab Project Report.



CROSS-REFERENCING TO OTHER PARTS OF THE ANNUAL REPORT

As noted earlier, perhaps one of the most disappointing findings in this section of our survey was the continuing lack of cross-reference to, and integration with, other parts of the annual report. This was particularly the case in this part of the audit committee report. Whilst it was very common for the equivalent section of the auditor's report to cross-refer to the audit committee report, the accounting policies and any relevant notes to the financial statements, it was rare for the audit committee report disclosures to take a similar approach. We were expecting the information included in the audit committee report to be more enlightening and integrated into the annual report than was the case in previous years.

By referencing information in other parts of the annual report, particularly the relevant notes to the financial statements and parts of the strategic report that discuss the significant issues identified, and describing the effect or potential effect of the issue on the company's operations and/or financial results, readers would find it easier to understand the relevance and importance of the issue to the company and audit committees would be able to demonstrate that they have taken a more holistic approach to the issues they have identified.

One example that features elements of all three of these aspects of good practice is shown below. In this example, the company not only explains quite clearly why the matter is of significance, it also refers to further explanation in the strategic report and clearly sets out the actions taken by the audit committee and the outcomes of those actions:

Nature of issue
The most significant issue considered by the Audit Committee in 2014 related to the output from the Contract and Balance Sheet Reviews performed during the fourth quarter. This review was undertaken as part of the Strategy Review that was carried out by the Group in 2014. Full details of the outcome of the Contract and Balance Sheet Reviews are given in the Finance Review on page 49 to 55. Given the scale and significance of the resultant impairments and onerous contract and other provisions, the Audit Committee spent a considerable amount of time discussing and challenging management on the significant estimates, assumptions and judgements made by management during the course of the review, and also on the content and outcomes of this review.

Action taken	Outcomes
• Among the elements considered by the Audit Committee was the scope of the review. The Audit Committee supported the engagement of Ernst & Young LLP to provide financial reporting and accounting advice in connection with the Contract and Balance Sheet Reviews, and also challenged the scope of the review to ensure that it was appropriately rigorous. The Audit Committee also considered various principal contract reviews that were being undertaken as part of the Corporate Renewal Programme to ensure that any issues arising from this work were taken into account and included in the Contract and Balance Sheet Reviews.	• The Audit Committee formed the opinion that the initial structured interview and financial review process for segmenting all contracts by risk was appropriate and thorough, and considered, through detailed discussion with Ernst & Young LLP, that the work programme for each category of risk was appropriate.
• The Audit Committee met regularly to review progress and challenge management on the process and results of the Contract and Balance Sheet Reviews. In all, three additional meetings were held prior to the publication of the 2014 Annual Report and Accounts. These meetings reviewed in detail the results of the review and the key accounting papers to assess whether there was any evidence of bias in management's assessment of accounting treatment and determination of the levels of provisioning, and particularly long length and/or complex contracts with inherent uncertain outcomes.	• The Audit Committee considered levels of provisioning including the potential range of outcomes on key contracts and satisfied itself that the overall provisions were appropriately positioned taking account of the range of possible outcomes on long term and complex contracts.

(Serco Group Plc, December 2014)

3.6 ASSESSING EXTERNAL AUDIT EFFECTIVENESS AND APPOINTMENT OF AUDITORS

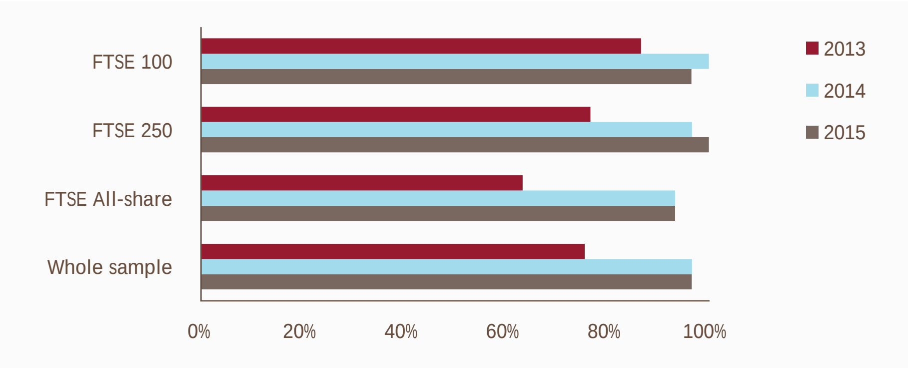
Code provision C.3.7 recommends that the audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board 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 the recommendation and should set out reasons why the board has taken a different position.

Code provision C.3.8 recommends that a separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include: An explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted.

A key responsibility of the audit committee is the annual recommendation to appoint the external auditor. An important factor in making the recommendation is the assessment of the effectiveness of the incumbent auditors during the most recent audit cycle. Layered over this is the policy adopted by the company in respect of auditor appointment and the effect that the length of tenure of the current audit firm might have on their independence, or the external perception of their independence.

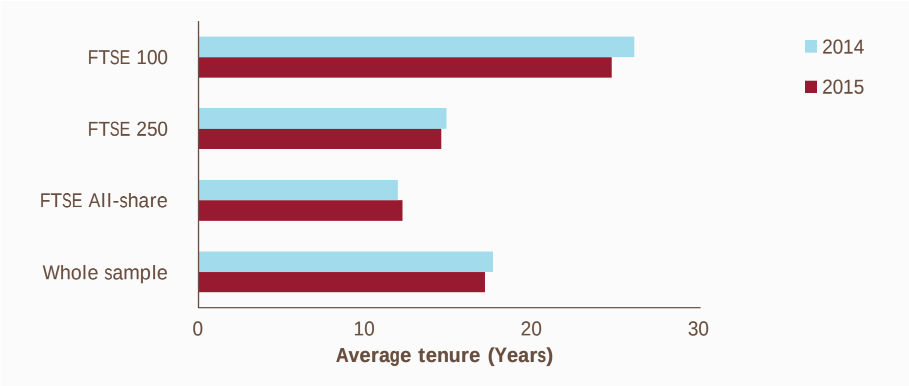
The disclosures provided by audit committees in this area have improved from a generally good starting point, with the average mark climbing from 2.59 to 2.78.

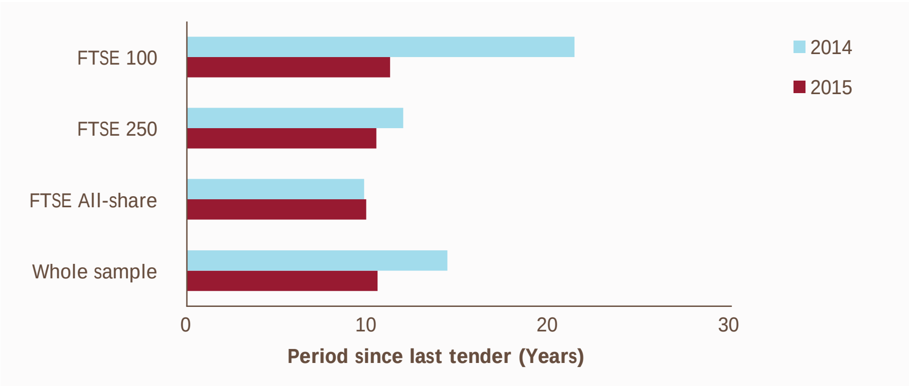
What proportion of companies made reference to a review of the effectiveness of the external auditor?



As expected, as this is now a requirement under the 2012 Code, the majority of companies in our sample have indicated that they undertook an annual review of auditor effectiveness. As with previous years' findings however, the level of detail disclosed varied greatly across the sample. Some reports detailed the process the committee carried out, such as the use of questionnaires, interviews and FRC Audit Quality Review Team reports, whilst others simply stated that a review had been undertaken and concluded that the auditors were effective.

How long have the incumbent auditors been in office and how long has it been since the last audit tender?





As the debate over mandatory auditor retendering and/or rotation is yet to be fully concluded, it was to be expected that the average term of office and period since the last tender for external auditors would remain relatively long. The actual averages for our sample are, indeed, likely to be higher than stated as a number of companies took the approach of disclosing that their auditors had been in place for 'over' a certain number of years. We noted last year that, given the FRC's and EU's work in this area, we expected to see a significant reduction in these numbers over coming years. This trend is already evident in the average period since the last audit tender, which has fallen dramatically at the FTSE 100 level as companies who have been with their auditors for very long periods of time acted before the statutory requirements were put in place. As the tender process may have resulted in a reappointment of the incumbent auditors and because there is likely to be a delay of a year or more before any change of auditor takes effect, we can expect the drop in average tenures to be less pronounced and lag behind the tender statistics.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

Whilst we were generally satisfied with the quality of reporting in this area, as has been the case in other parts of our survey, disclosures could have been further enhanced through the tailoring of more generic information to the company's own circumstances.

LEVEL OF DETAIL IN AUDIT TENDER POLICY DISCLOSURE

The disclosure of the company's policy on audit tendering was one where we saw a wide range of approaches. Several companies continued to avoid the subject, citing the ongoing legislative proposals from the EU and the Competition and Markets Authority, which have effectively superseded the Code's recommendations, and saying that they would adopt a more formal policy on auditor rotation once the regulatory position was clear. However, given that many of these companies have been with their incumbent auditors for over ten years without going to competitive tender, we do not believe that the regulatory uncertainty is a valid reason not to formulate and disclose a more specific policy on audit tendering. The disclosures provided by two companies that have chosen to act before the final requirements have been published are shown below and over:

Audit tender

PwC have been the Company's external auditors since the merger with Lattice Group plc in 2002, having been the incumbent external auditors of both the merging parties and the audit contract has not been put out to tender since then. Their performance has been reviewed annually by the Committee since that time.

The Committee discussed the implications of the Competition and Market Authority Order requiring FTSE 350 companies to hold an audit tender every 10 years as well as the final European Commission (EC) regulations, which came into EU legislation in June 2014. The Committee noted that based on the EC transitional arrangements, the final year in which PwC can be appointed as the Group's auditors is for the year ended 31 March 2020.

At its meeting in May 2015, the Committee considered the timing of a potential tender for the external audit. The Committee considered the continued US financial controls improvement programme and the services we currently receive from other external audit firms that may be considered in a tender process. It concluded that, firstly, in order to ensure an orderly transition and secondly, to ensure compliance with the EC regulations on the provision of prohibited services, an audit tender process will be run later this year for the audit of the year ending 31 March 2018. PwC will not be invited to tender.

No representatives from PwC were present during the Committee's discussion of the options for a tender of the external audit.

There are no contractual obligations restricting our choice of external auditors and we have not entered into any auditor liability agreement.

(National Grid Plc, March 2015)

Reporting Council were also reviewed. The result of this review was considered by the Audit Committee with the overall conclusion that the external auditors provide an effective and independent service.

The last full tendering process took place in 2003. The current lead partner took on the role following rotation after the completion of the 2013 audit. The Audit Committee monitored the transition to ensure it was implemented efficiently. In the Annual Report for the year ended 31 December 2013, the Audit Committee reported that it was keeping the desirability of conducting an audit tender process under review. The Committee has been monitoring the evolving position relating to external audit rotation and tendering.

The changes introduced in the 2012 UK Corporate Governance Code require that the external audit contract is put out to tender at least every ten years with transitional guidance around deferral of tender until after the next partner's rotation. Rules published by the European Union have been reflected in the final order published by the Competition and Market Authority, which came into force on 1 January 2015.

As a result of rule changes on the audit tender process, the Audit Committee decided in 2014 to conduct a formal audit tender process. A number of firms were approached to tender for the audit including the incumbent auditor, KPMG.

The process involved provision of a data room to provide standard information to all parties, meetings between the audit firms and key stakeholders in the business, written submissions from all audit firms as well as oral presentations from the audit firms shortlisted.

Key selection criteria included sector expertise, geographical spread, the experience and depth of the audit team proposed for Novae's account as well as cultural fit and the added value that each firm was judged to be likely to be able to provide to the organisation as its auditors.

The process was concluded in February 2015 and the Audit Committee recommended to the Board, and the Board concurred, that PricewaterhouseCoopers LLP be appointed as the Group's auditor. Accordingly, a resolution proposing the appointment of PricewaterhouseCoopers LLP as auditor will be put to the shareholders at the 2015 AGM on 13 May 2015.

The Committee was grateful to all four firms for responding so positively to the selection process, and particularly to KPMG who have served the Group with professionalism and skill since their appointment. In recommending the appointment, the Committee are confident that the PricewaterhouseCoopers LLP team is well placed to assist the Group as it meets the challenges of its next period of development.

(Novae Group Plc, December 2014)

ASSESSMENT OF AUDITOR EFFECTIVENESS

Whilst more detail could arguably be included on the assessment of the effectiveness of the external auditor, such disclosure should only be given to the extent that it is not simply a generic repeat of the FRC's Guidance on Audit Committees (September 2012).[3] The most informative disclosures we have seen make clear how the FRC's recommendations have been applied in the company's specific circumstances. This might include whether the company's audit was recently selected for Audit Quality Review (AQR) testing and the broad outcome of that review. We expect to see a further improvement in these disclosures in the coming years as companies become more used to assessing the effectiveness of their external auditors and make greater use of recently published guidance on the subject, such as the FRC's Audit Quality: Practice aid for audit committees - Audit Quality (May 2015).[4]

3. https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-September-2012.aspx
4. https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committee-(1).pdf

Two examples of a more bespoke approach to the disclosure of the assessment of auditor effectiveness are set out below:

Effectiveness of external audit process

In evaluating the effectiveness of the audit process prior to making a recommendation on the re-appointment of the external auditors, the Committee reviews the effectiveness of their performance against criteria which it agrees, in conjunction with management, at the beginning of each year's audit.

In undertaking this review, the Committee considers the overall quality of the audit, the independence of the auditors and whether they have exhibited an appropriate level of challenge and scepticism in their work.

The annual Committee evaluation seeks feedback from Committee members independently on the relationship with the auditors, the quality of insight they provide to the Committee on their work and whether the Committee has sufficient access to the auditors without executive management.

Finally, the Committee considers feedback on the prior year's external audit through a survey that seeks views from the financial management team at corporate and business unit level. It covers four key areas:

- robustness of the audit process;
- quality of the delivery;
- quality of the people; and
- quality of the service.

Having reviewed all this feedback provided through the mechanisms outlined above, and noted any areas of improvement to be implemented in respect of the team or the following year's audit, provided the Committee:

- is satisfied with the effectiveness of the auditors and the external audit process;
- is satisfied with the auditors' independence, appropriate level of qualifications, expertise and resources; and
- has considered whether it is in the best interests of shareholders and the company to initiate or defer a tender.

it will then consider recommending to the Board the re-appointment of the auditors at the forthcoming AGM.

The detailed criteria the Committee uses for judging the effectiveness of the external auditors and their overriding responsibility to deliver a smooth running, thorough and efficiently executed audit are set out below:

Performance expectations for GSK's external auditor

Specific auditor responsibilities	Wider auditor responsibilities
▪ Discuss approach and areas of focus in advance with early engagement on understanding the implications of GSK's new operating model ▪ Ensure Sarbanes-Oxley scope and additional procedures are discussed and endorsed by management and communicated on a timely basis within GSK and PricewaterhouseCoopers LLP (PwC) ▪ Avoid surprises through timely reporting of issues at all levels within the Group ▪ Ensure there is clarity of roles and responsibilities between the auditors and local management ▪ Respond to any issues raised by management on a timely basis ▪ Meet agreed deadlines ▪ Provide continuity and succession planning of key employees of the auditors ▪ Provide sufficient time for management to consider draft auditor reports and respond to requests and queries ▪ Employ consistent communication between local and central audit teams.	▪ Provide up-to-date knowledge of technical issues, providing accurate and timely advice ▪ Serve as an industry resource; communicating best practice and industry trends in reporting ▪ Adhere to all independence policies (including GSK's policies, the Financial Reporting Council's IAS 240 and applicable Securities and Exchange Commission standards) ▪ Deliver a focused and consistent audit approach globally that reflects local risks and materiality ▪ Liaise with GSK's Audit & Assurance team to avoid duplication of work and Global Ethics and Compliance team to ensure common understanding of audit outcomes ▪ Provide consistency of advice at all levels of the organisation.

(GlaxoSmithKline Plc, December 2014)

The Committees have conducted their review of the performance of the external auditors and the effectiveness of the external audit process for the year ended 31 December 2014. The review was based on a survey of key stakeholders across the Group, consideration of public reports by regulatory authorities on key Deloitte member firms and the quality of the auditors' reporting to and interaction with the Audit Committees. Based on this review, the Audit Committees were satisfied with the performance of the auditors and the effectiveness of the audit process.

(Reed Elsevier: Plc (Relx Group),December 2014)

3.7 NON-AUDIT SERVICES

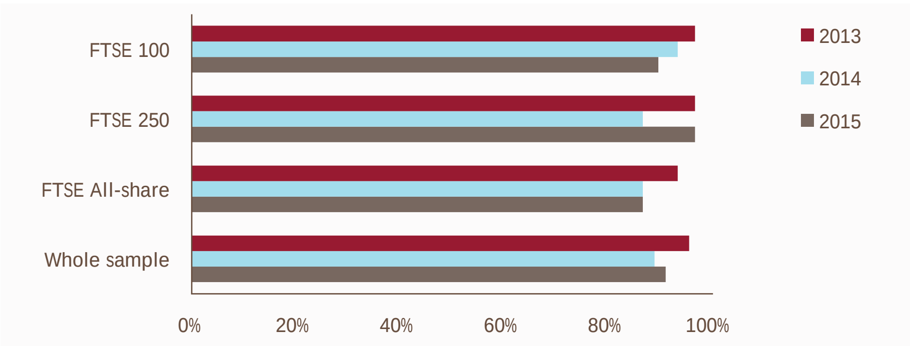
Code provision C.3.8 recommends that a separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include: If the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.

The audit committee is the body responsible for overseeing the company's relationship with the external auditors and, along with the appointment and effectiveness assessment of the auditor, the decision as to whether and which non-audit services can also be provided by them is a key part of the audit committee's role.

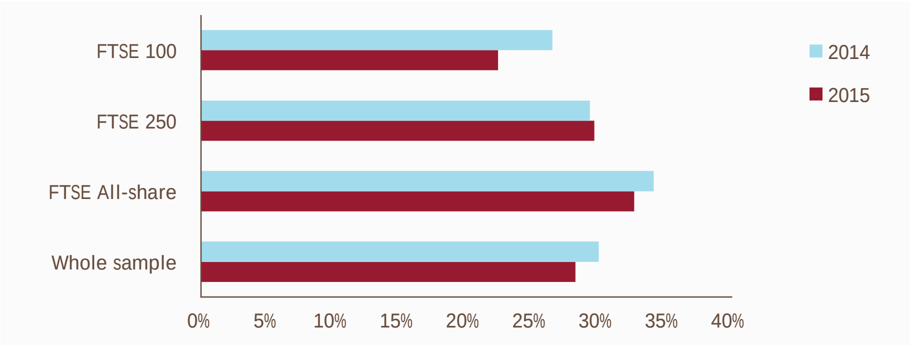
Whilst there is little in the way of guidance included directly in the 2012 Code, the FRC's Guidance on Audit Committees (September 2012) includes extensive information on what the audit committee should consider, and what they should disclose in the annual report in respect of non-audit services.

Given the relatively tight regulation of non-audit services that already exists, it was unsurprising to find that that these disclosures were sometimes a little boilerplate, simply repeating the restrictions that exist in the auditors' ethical standards (Average mark 2.50, 2014: 2.35). Some of the better disclosures added a little more company specific information such as the level of fees that would require audit committee approval; this sort of information can be useful in ascertaining the degree of involvement the audit committee has over the relationship with the auditor.

What proportion of companies make reference to the value of non-audit services provided by its auditor in the audit committee report?



Most companies in our survey have cross-referred to the auditor's remuneration disclosures in the notes to the financial statements in order to illustrate the nature of the non-audit services provided by the auditor. Outside the FTSE 100, relatively few companies provided the ratio of non-audit fees to audit fees recommended in the Lab Project Report (FTSE 100: 79%, Others: 33%). Furthermore, it was clear that the basis of calculation for the ratios disclosed was inconsistent from company to company, meaning that they were an unreliable basis for comparison. A consistently calculated ratio of non-audit fees to total fees (including non-audit, audit-related and audit fees) is shown below:



Whilst it is too early to confirm a trend, we do expect both the disclosure of a ratio to become more common and the relative size of non-audit fees to reduce as the 70% cap on non-audit fees being introduced under the EU Audit Directive brings this information into a starker focus.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

As we have noted previously, it is important that companies are not encouraged to include generic or boilerplate information in their audit committee reports and so our recommendation for improvement is based on making the disclosures around a company's non-audit services policy more company-specific.

DISCLOSURE OF NON-AUDIT SERVICES POLICY

Companies were reasonably good at describing how auditor independence and objectivity was maintained through a description of their policy on the provision of non-audit services, although those disclosures tended to be based on the auditors' own ethical standards and the FRC's guidance in its Guidance on Audit Committees (September 2012). Some companies could have improved their disclosure further by describing company-specific elements of the policy such as approval limits and ways in which the company's policy goes beyond the requirements of the auditor's code of ethics or the FRC's guidance.

JUSTIFICATION OF NON-AUDIT SERVICES PROVIDED BY AUDITORS

Where disclosures could have been improved significantly, however, was the description of why the auditor was considered the best provider of non-audit services. Few companies provided more than a generic explanation of why significant non-audit services were most appropriately supplied by the group's auditor, notwithstanding the fact that the FRC's Guidance on Audit Committees (September 2012) recommends that a company explains: what the non-audit services are; why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor rather than another supplier; and, how auditor objectivity and independence has been safeguarded. One of the clearest examples to implement this recommendation is shown to the right:

During the year, fees for the non-audit service work carried out by PwC were 73% of the annual audit fee. This exceptional level reflects the considerable services PwC has provided relating to the reporting accountant role in connection with the Class 1 Circular for the three-part Novartis transaction. Excluding the Novartis work, PwC's non-audit service fees would have represented 28% of the annual audit fee. The Committee considered that hiring PwC to undertake the Class 1 Circular work was in the best interests of shareholders because:

- PwC possessed the type of expertise, experience, size and international scope required to handle a major Class 1 transaction of this scale and complexity;
- the company benefited specifically from PwC's in-depth knowledge and understanding of our Vaccines, Consumer Healthcare and Oncology businesses and their processes and compliance environment;
- management time, that would otherwise have been devoted to educating another firm on the company's business and operations, could instead be spent on delivering a transaction that will substantially strengthen two of the Group's core businesses and create significant new options to increase value for shareholders; and
- the Committee could leverage PwC's capabilities to negotiate the most advantageous and cost-effective price.

In addition, it should be noted that £3.6 million of the Novartis-related fees due to PwC arose from work done by Novartis' auditors who are also PwC.

To maintain the external auditors' independence and objectivity, for those Class I Circular workstreams where a self review threat was identified, an independent partner not involved in the audit was appointed to lead them. Management reviewed and considered PwC's findings and PwC did not make any decisions on behalf of management. Additionally, PwC had no input in respect of the production of financial information subsequently used by the audit team.

(GlaxoSmithKline Plc, December 2014)

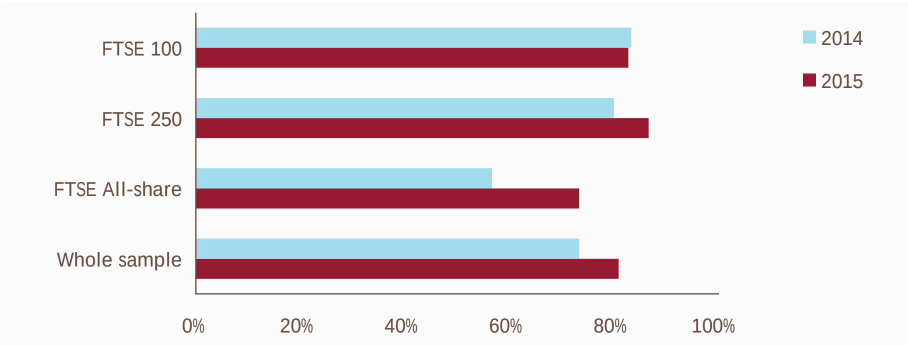
3.8 FAIR, BALANCED AND UNDERSTANDABLE

Code provision C.3.4 recommends that, where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

Although it represents only three words, the requirement for directors to confirm that the annual report is fair, balanced and understandable, was seen as the most significant change brought in by the 2012 Code after the disclosure of significant financial statement reporting issues.

It is perhaps a result of the lack of guidance regarding how objectively to make the determination that, in 2014, we found the disclosures in this area to be sparse and generic, with an average mark of 1.78. We are pleased to say that we have seen some improvement in this score this year with the average score moving to 2.16. Companies still have some work to do, however, to avoid the disclosure of too much generic process information.

What proportion of companies asked the audit committee for advice on whether the annual report was fair, balanced and understandable?



Whilst the proportion of companies asking their audit committees for advice on the fair, balanced and understandable assertion is high we are surprised it is not higher still.

KEY OBSERVATIONS FROM THE SURVEY SAMPLE:

Once again, it is important that companies are not encouraged to include generic or boilerplate information in their audit committee reports and so our recommendation for improvement is based on making the disclosures around an audit committee's input in to the assessment of fair, balanced and understandable more company-specific.

HOW THE AUDIT COMMITTEE ASSESSED FAIR, BALANCED AND UNDERSTANDABLE

Where audit committees did say that they had provided the board with advice on the fair, balanced and understandable assertion, the audit committee report rarely went far beyond a statement of that fact. Those that did provide more detail regarding the processes they went through when formulating their advice tended to focus on the fair and balanced parts of the phrase, rather than how understandable the annual report is. One of the better examples of a description of what the audit committee did to formulate its advice to the board is shown to the right:

Area of focus	Reporting issue	Role of the Committee	Conclusion/action taken
Going concern (see page 73 for further information)	Barclays is required to confirm that the going concern basis of accounting is appropriate	▪ Examined whether the going concern basis of accounting was appropriate by assessing the Working Capital Report prepared by management. This report covered forecast and stress tested forecasts for liquidity and capital compared to regulatory requirements, taking into account levels of provisioning for PPI and possible further conduct and litigation provisions that may be required	▪ After examining the forecast, along with Barclays' ability to generate capital and raise funding in current market conditions, the Committee concluded that the liquidity and capital position of the Group remained appropriate and that there were no material uncertainties
Fair, balanced and understandable reporting (including country-by-country reporting and Pillar 3 reporting)	Barclays is required to ensure that its external reporting is fair, balanced and understandable	▪ At the request of the Board, established, via debate with and challenge of management, whether disclosures in Barclays' published financial reports were fair, balanced and understandable ▪ Evaluated the review and challenge process that is in place to ensure balance and consistency, including the reports from the Disclosure Committee on its assessment of the content, accuracy and tone of the disclosures ▪ Obtained confirmation from the Group Chief Executive and Group Finance Director that they considered the disclosures to be fair, balanced and understandable ▪ Examined the control environment underpinning the integrity of Barclays' financial reports, including the outputs of Barclays' Turnbull assessments and Sarbanes-Oxley s404 internal control process ▪ Confirmed the absence of any indications of fraud relating to financial reporting matters ▪ Assessed disclosure controls and procedures ▪ Asked management to describe and evidence the basis on which representations to the external auditors were made	▪ The Committee requested work to be done to further enhance the presentation of Barclays' disclosures on legal, competition and regulatory matters in Barclays' external financial reports to ensure they remain accessible for a non-expert user ▪ It supported the proposal from management to make changes in the presentation of Barclays' half-year results so that they were easier to understand ▪ It also concluded that additional information on country-by-country tax reporting should be disclosed publicly in the interests of openness and transparency ▪ The Committee satisfied itself that the processes underlying the preparation of Barclays' published financial reports supported the aim of ensuring that those reports were fair, balanced and understandable. In relation to the 2014 Annual Report and Financial Statements, the Committee concluded that the disclosures and process underlying their production were appropriate and recommended to the Board that the 2014 Annual Report and Financial Statements are fair, balanced and understandable

(Barclays Plc, December 2014)

4. WHAT THE RESEARCH IS TELLING US: AIM-LISTED COMPANIES

	2015	2014	2013
What proportion of companies prepared a separate audit committee report?	33%	17%	10%
What is the average size of an audit committee?	3.07	3.07	3.07
What proportion of the audit committee is female?	13%	7%	3%
How often does the audit committee meet?	3.17	2.64	2.67
What proportion of companies had a separate board-level risk committee?	3%	3%	0%
What proportion of companies have an internal audit function?	30%	31%	23%
What proportion of those internal audit functions were fully outsourced?	25%	22%	29%
What proportion of companies made reference to a whistleblowing policy?	33%	27%	27%
What proportion of companies made reference to a review of the effectiveness of the external auditor?	50%	30%	30%
What proportion of companies make reference to the value of non-audit services provided by its auditor in the audit committee report?	29%	25%	43%
What is the ratio of non-audit fees to total fees (including non-audit, audit related and audit fees)?	28%	25%	-

The AIM Rules require all AIM-listed companies to disclose on their websites details of the corporate governance code that it has decided to apply and how it complies with that code. If the AIM-listed company has not adopted a corporate governance code this should be stated together with its current corporate governance arrangements.

It should be noted that the AIM Rules do not stipulate that an AIM-listed company should adopt any governance code, let alone the full UK Corporate Governance Code. It was interesting, therefore, to see that the number of companies in our sample claiming voluntary compliance with the 2012 Code this year increased to four (2014: two) although, of those four, it was obvious that one (2014: one) had not given the required disclosures to make this claim.

What continues to be surprising, given that it is an established code aimed at companies in this market, is that no (2014: one) companies claimed compliance with the Quoted Companies' Alliance (QCA) Corporate Governance Code for Small and Mid-size Quoted Companies[5] (the QCA Code). We did note, however, that, whilst not stating compliance, five (2014: two) companies did note that they made reference to the relevant QCA Code policies when formulating their corporate governance policies.

Our review of AIM-listed company audit committee reporting showed that some companies have sought to embrace some of the newer requirements of the full code this year. Particular areas of improvement included: the increased number of companies not claiming full compliance with the 2012 Code that nonetheless discussed the significant issues that the committee considered in relation to the financial statements (three, 2014: none); the increase from 30% to 50% of companies that made reference to a review of the effectiveness of the external auditor; and the improvement from 33% to 43% of companies that explained how the committee ensured auditor objectivity and independence was safeguarded.

Almost without exception, however, the information given by the AIM-listed companies in our survey sample was factual but without elaboration. For example, a statement that an assessment of auditor effectiveness was undertaken was made but no information about how that assessment was conducted was given or the report listed the significant issues considered in relation to the financial statements but did not describe how the audit committee addressed those issues.

We did observe that there were more forward looking comments this year than previously seen in our AIM 100 sample, with three companies commenting on their policy for audit tendering (all three stated at least every 10 years) and one company that did not claim compliance with the 2012 Code even mentioning that the 2014 Code would become effective next year for Quoted companies and that the audit committee would be considering the implications of this in the coming year.

As with FTSE-listed companies, boardroom diversity has also continued to attract interest in the AIM-listed sector. With this in mind, it was pleasing to note the continued improvement in the gender diversity of FTSE-listed company audit committee membership was also reflected in the AIM companies we looked at.

5. http://www.theqca.com/shop/guides/86557/corporate-governance-code-for-small-and-midsize-quoted-companies-2013-downloadable-pdf.thtml

5. HOW TO IMPROVE THE QUALITY OF AUDIT COMMITTEE REPORTING

We noted last year that companies, especially those listed on the main market of the London Stock Exchange, had been required to contend with a lot of change in their 2013/14 financial year, with new requirements such as the 2012 Code, the strategic report, greenhouse gas emissions reporting and the significantly revised directors' remuneration report requirements coming into force. As some of these new requirements were published very close to their 30 September 2013 effective date, we suggested that many companies could be forgiven for having taken a compliance first approach to their annual reports in the last reporting season. We set out the hope that companies would use the brief hiatus in new regulation to move their reporting further along the spectrum of pure compliance to concise communication of investor-relevant information.

Whilst we have seen some notable advances in the disclosures provided by companies this year, by and large, the same improvement points remain valid for the coming reporting season:

INTEGRATION WITH OTHER PARTS OF THE ANNUAL REPORT

We have found the information contained in the audit committee reports we have surveyed to be relatively disconnected from that in the rest of the annual report. Whilst the 2012 Code recommendation for a separate audit committee report may have had the positive effect of prompting some companies to take a once-off closer look at the content of the audit committee report, this has perhaps come with the negative effect of causing the reports to become too isolated from the other information that is published alongside it. There is an obvious challenge in drafting an audit committee report that is integrated with the rest of the annual report whilst also being a separate distinct section within it but we believe that it is achievable.

As we have noted in earlier sections, by referencing information in other parts of the annual report and, importantly, describing how the matters raised in the audit committee report might affect the company, the audit committee will be able to demonstrate that they have a holistic understanding of the matters they discuss both in financial reporting and operational terms.

FORWARD-LOOKING AS WELL AS RETROSPECTIVE

We have also found that the audit committee reports tend to be historical records of what the committee had done during the year; they rarely included obvious reference to future plans or matters which might become important in years to come.

Although the 2012 Code's recommendations have a bias towards the disclosure of retrospective information, most audit committees should be constantly horizon scanning for issues that may have a significant effect on the company over the medium and long-term. By including a more obvious reference to future plans, audit committees will be able to demonstrate that they are taking this longer-term view. It will also help to reduce the possibility of surprises in subsequent years. In view of the significant changes in accounting standards looming on the horizon, we would expect this aspect of audit committee reporting to become increasingly important in coming years.

WHY AS WELL AS WHAT

Audit committees are generally very good at stating what they have done. What is often harder to discern is why they have chosen to do something in a certain way. For example: Why is there a separate board or non-board risk committee? Why is a particular financial reporting issue considered significant? Why does the company want to wait until the finalisation of the auditor rotation debate before disclosing its audit tender policy? Why was the auditor considered the best provider of non-audit services?

Clearly the disclosure of why something has been done in a certain way will only add value if it provides a window into the thought processes involved in the decision. Justifications such as the issue was considered significant because the number was very large may be a statement of fact but it adds little in terms of insight. Highlighting other factors such as the sensitivity of estimates, its effects on remuneration and/or the complexity of accounting or measurement, provides far greater value to the reader.

HOW AS WELL AS WHAT

Similarly to the last point, it is often hard to discern how an audit committee has gone about doing something. For example: How the audit committee assessed 'fair, balanced and understandable'? How was external and internal auditor effectiveness assessed? How was a significant financial reporting issue addressed?

It is important that companies are not encouraged to include generic or boilerplate information in their audit committee reports and that is particularly a risk where policies and procedures are set out in guidance material (such as is the case with auditor independence) or can be common to many companies (such as codes of conduct related to whistleblowing). In consequence, companies should concentrate their efforts in providing disclosures that are more company-specific and including some of the more generic policy information on the company website with a suitably specific hyperlinked reference in the annual report.

6. WHAT THE FUTURE HOLDS

6.1 REVISED CORPORATE GOVERNANCE CODE (SEPTEMBER 2014)

The biennial cycle of UK Corporate Governance Code up-dates resulted in the publication of a new UK Corporate Governance Code[6] in September 2014, which is effective for periods beginning on or after 1 October 2014 (the 2014 Code). Once again, several of the changes that have been introduced are likely to affect the audit committee to some extent:

THE 'LONGER-TERM VIABILITY STATEMENT'

The 2014 Code has introduced into the annual report a new 'longer-term viability statement' that is in addition to and distinct from the accounting going concern statement. The 2014 Code recommends that: 'taking account of the company's current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary'.

6. https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

As noted previously, very few companies in our sample made reference to this new requirement in their 2014/15 annual reports and none have adopted it earlier than is necessary. We are, however, aware of some early adopters of this disclosure, which are highlighted in our publication Reporting on Principal Risks and Longer-term Viability.[7] Further examples will, of course, emerge as 30 September 2015 year-end reporters publish their annual accounts over the coming weeks. The FRC has also published additional information relating to the longer-term viability statement in its revised Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. [8]

RISK MANAGEMENT AND INTERNAL CONTROL SYSTEMS

The 2014 Code has been changed to emphasise that directors are responsible for the internal control systems throughout the year rather than just at the annual effectiveness assessment.The 2014 Code also recommends that the board should include in the annual accounts a 'report' on their review of the company's risk management and internal control systems (rather than a confirmation that it has been done).

As with the longer-term viability statement, the FRC's revised Guidance on Risk Management, Internal Control and Related Financial and Business Reporting contains guidance on these new disclosures.

ASSESSMENT AND DISCLOSURE OF PRINCIPAL RISKS

Finally, the 2014 Code has introduced a new requirement to confirm in the annual report that the directors have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The description of those risks should now also be accompanied by an explanation of the steps taken to manage or mitigate them.

7. http://www.bdo.co.uk/__data/assets/pdf_file/0006/1354425/Reporting-on-principal-risks-and-longer-term-viability.pdf
8. https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf

6.2 REFORM OF THE EU STATUTORY AUDIT MARKET

In May 2014 the European Commission published a new Audit Directive (the Directive) and Audit Regulation (the Regulation), the former establishing requirements for the independence of the auditor and the latter adding further requirements in relation to the audit of Public Interest Entities (PIEs), which includes all companies listed on the main market of the London Stock Exchange. Many of the changes being introduced enshrine best practice into law. The new requirements come into effect on 17 June 2016 and will apply to financial years starting on or after that date.

The full implementation of the Directive and Regulation necessitates, among other things, revisions to the existing company law, regulation and guidance. To that end, both the Department for Business, Innovation and Skills (BIS) and the FRC issued public consultations in December 2014, seeking views on how they should approach the implementation of the new requirements, including how the member state options included in the Directive and Regulation should be addressed.

In September 2015, the FRC issued a further consultation, Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees,[9] which proposed changes to a number of their publications including auditors' ethical standards, the UK Corporate Governance Code and Guidance on Audit Committees. BIS has published a formal consultation,[10] focussing on the definition of a PIE, FRC powers and Professional Bodies' responsibilities, mandatory retendering and rotation of PIE auditor appointments and other issues.

The key aspects of the changes that are likely to have the most direct effect on audit committees are:

MANDATORY AUDIT FIRM ROTATION

PIEs will have to appoint a new firm of auditors every 10 years. However, member states have the option (which we expect the UK to take) to extend this maximum period to 20 years, provided the audit is subject to a public retender carried out after 10 years. Transitional provisions ensure that a large number of retenders are not required immediately after the new requirements take effect.

The new rules will also: formalise the audit committee's role in tendering; set out the requirements for the information that should be made available to all firms tendering for the audit; render 'Big 4 clauses' null and void; and prevent companies from excluding firms that earn less than 15% of their total fees from PIE audits from the tender process.

9. https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Enhancing-Confidence-in-Audit-File.pdf
10. https://www.gov.uk/government/consultations/eu-audit-directive-and-regulation-implementing-the-requirements

EXTENDED LIST OF PROHIBITED NON-AUDIT SERVICES

The list of non-audit services that cannot be provided by a PIE's auditor to the PIE and its controlled undertakings within the EU will be updated and strengthened. For example:

- The new requirements will cover substantially all tax work unless it has no material effect on the financial statements being audited
- Caveats and exceptions that currently apply to a number of non-audit services such as internal audit and corporate finance will be replaced with a virtually complete prohibition
- The current exception for immaterial items will be restricted only to tax and valuation services
- Non-audit services relating to the design and implementation of internal control over financial information and systems will be prohibited in the 12 months before appointment as auditors, as well as during the period of appointment.

RESTRICTION ON THE AMOUNT OF OTHER NON-AUDIT SERVICES

The proportion of non-audit fees that can be earned by the company's auditor will be limited to 70% of the average group audit fee for the preceding three years. As the three-year average will be calculated from 17 June 2016, this provision only comes into effect for 30 June 2019 year ends.

CORPORATE GOVERNANCE RELATED TO AUDITORS

The new rules also:

- Create formal requirements for the composition of the audit committee including: committee members as a whole should have competence relevant to the sector in which the company operates; at least one audit committee member should have competence in accounting and/or auditing; and the majority of the members should be independent
- Enhance the legal framework in which the audit committee operates, covering its composition, its competences and its role. The new requirements, however, are not significantly different from those that currently apply to companies adopting the Code
- Require the auditors to provide the audit committee with an additional report that contains more detailed information on the outcome of the statutory audit, including information on: the methodology and materiality levels used; the possible significant deficiencies identified in the internal control system; any significant difficulties encountered in the course of the statutory audit; any significant matters arising from the audit that were discussed with management; and any other matters arising from the audit that are significant to the oversight of the financial reporting process
- Bring into law the possibility for 5% of the shareholders to initiate action to dismiss a statutory auditor or audit firm together with the introduction of a requirement for PIEs to provide shareholders with information about which statutory auditor the audit committee recommends and why they recommend them.

6.3 COMPETITION AND MARKETS AUTHORITY

In September 2014, the Competition and Markets Authority (the CMA) published formal orders[11] related to its investigation into the statutory audit market for FTSE 350 companies which began in 2011 (under the Competition Commission). Prior to this, the CMA set out a number of proposed remedies in its 2013 report, Statutory audit services for large companies market investigation – A report on the provision of statutory audit services to large companies in the UK.[12]

Several of the CMA's proposals have been superseded by the EU Statutory Audit Market reforms described previously, whereas others have been delayed until the next biennial revision of the UK Corporate Governance Code, which will be effective from 2016. A number of minor changes have, however, been proposed in the FRC's September 2015 consultation noted to the left.

The status of the CMA's proposals that we highlighted in our last survey is as follows:

ADVISORY VOTE ON THE AUDIT COMMITTEE REPORT

The CMA proposed the introduction of a shareholder advisory vote on the sufficiency of the disclosures in the audit committee report and amendments to the UK Corporate Governance Code and Stewardship Code in order to further encourage shareholder engagement.

In its September 2015 consultation, the FRC proposed not to introduce a requirement for an advisory vote on the basis that it considers that shareholders already have sufficient rights to express their opinion on the audit committee report either by the annual re-election of the directors, including the audit committee chairman, or by tabling a specific shareholder resolution.

11. https://assets.digital.cabinet-office.gov.uk/media/54252eae40f0b61342000bb4/The_Order.pdf
12. https://assets.digital.cabinet-office.gov.uk/media/5329db35ed915d0e5d00001f/131016_final_report.pdf

FINANCIAL REPORTING COUNCIL'S AUDIT QUALITY REVIEW

The CMA proposed that the Financial Reporting Council's Audit Quality Review function (the AQR) should review every FTSE 350 audit engagement over a five-yearly cycle. The audit committee should then report to shareholders on the findings set out in the AQR's report, stating the grade awarded and how both the audit committee and auditor are responding to the findings.

In its September 2015 consultation, the FRC proposed to amend the Guidance on Audit Committees to recommend that, where a company's audit has been reviewed by the FRC's Audit Quality Review team, the committee should make disclosures about any significant findings and the actions they and the auditors plan to take. This discussion should not include disclosure of the audit quality category.

POWERS OF THE AUDIT COMMITTEE

The CMA 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 external audit firm to carry out non-audit services. In the latter case, however, the proposals allow executive management to make submissions on these matters and allow the audit committee to establish a materiality threshold below which executive management may instruct the audit firm to conduct non-audit services.

In its September 2015 consultation, the FRC proposed to amend the Guidance on Audit Committees to emphasise the audit committee's expected role managing the company's relationship with its external auditor.

MANDATORY TENDERING

The final CMA proposal, which related to mandatory tendering of FTSE 350 company audits, has been superseded by the mandatory rotation rules introduced by the EU, as described previously.

In its September 2015 consultation, the FRC proposed to remove the Code's requirement for mandatory retendering and, instead, to include a footnote referring to mandatory retendering of external audits under the Regulation and Directive and CMA Orders and also required disclosure of future audit tendering plans.

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