



Audit committee effectiveness

This is the third of five pieces from an internal audit perspective on the 2018 UK Corporate Governance Code: **Non-executive recruitment** (1), **Viability statements** (2), Audit committee effectiveness (3), **Culture** (4) and the **Workforce voice** (5).

Scandals and organisational failuhs continue to steal headlines away from good works. Corporate governance remains under the microscope. It is incumbent on audit leaders to take an active role in the effectiveness of governance within their own organisations to help rebuild trust in the world of commerce.

We look at what practical steps you can take as an audit leader to directly influence the effectiveness of your audit committee, the backstop of good governance. It is about taking action to make a difference not assessing effectiveness, providing assurance or creating an audit programme to test elements.

RECAP. On 16 July 2018 the Financial Reporting Council (FRC) published its long awaited update to the **UK Corporate Governance Code** together with revised **Guidance on Board Effectiveness**.

The revisions support the government's vision of restoring trust in the corporate organisations and the broader social reform agenda which aims to improve the standard of living and quality of life for ordinary working people.

Expectations

The audit committee operates under the delegated authority of the board. Its tasks include reviewing the company's internal controls, governance and risk management systems. To do this, it utilises subject matter experts to provide assurance and information ideally using the three lines of defence model not simply internal and external audit. Of this internal audit is the only independent source of information. An effective audit committee works in partnership with their internal audit function, agreeing the scope of its work, level of assurance sought, priorities and resources.

The value of independent oversight at board level is commented on widely and regularly. Likewise the role of the audit committee is recognised as being central to good governance. The latest version of the Code refers readers to the FRC paper **Guidance for Audit Committees** (latest update 2016) for detailed narrative on effectiveness.

However, the section on establishment and effectiveness is basic focusing predominantly on format; terms of reference, agenda, timely papers, quorate, minutes recorded etc. rather than the effectiveness of the committee.

This isn't the type of efficiency that audit leaders should be concerned with.

Establishment	Effectiveness
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<ul style="list-style-type: none"> Collectively the skills of the committee are relevant to the sector/organisation 	<ul style="list-style-type: none"> A documented terms of reference relevant to the organisation
<ul style="list-style-type: none"> At least one member has recent/relevant financial experience 	<ul style="list-style-type: none"> No fewer than three meetings a year, scheduled according to the financial reporting cycle
<ul style="list-style-type: none"> At least three independent members (or two for companies outside the FTSE350) 	<ul style="list-style-type: none"> Sufficient interval between board and audit committee meetings to enable work to be done
<ul style="list-style-type: none"> Appointments made by the board (including ac chair and nomination committee) 	<ul style="list-style-type: none"> Papers are provided with sufficient time to allow for full and proper consideration of issues
<ul style="list-style-type: none"> Committee members having an independent mind-set 	<ul style="list-style-type: none"> Funds are made available to obtain independent subject matter expertise where necessary
<ul style="list-style-type: none"> Members commit to 'keep in touch' with governance leaders ongoing 	<ul style="list-style-type: none"> Attendance is by invitation only
<ul style="list-style-type: none"> Robust induction programme for new members 	<ul style="list-style-type: none"> At least annually meet internal and external auditors without management present
<ul style="list-style-type: none"> Ongoing training for committee members on topics relevant to its duties 	<ul style="list-style-type: none"> Annual review of effectiveness by board and audit committee

Summary of Section 2: FRC Guidance on Audit Committee

Defining effective

In the absence of formal statements to define audit committee effectiveness, the Chartered Institute of Internal Auditors suggests the definition below, that it is far more than ticking the boxes for regulatory compliance; it is about holding the board to account and protecting the interests of all stakeholders relevant to organisational activities.

An effective audit committee understands the assurance needs of the organisation ensuring that they are appropriately undertaken and results acted upon accordingly.

Achieving this requires each member to contribute their skills, experience and personality. Like internal auditors, members of the audit committee must retain their individuality, their independence while operating within the boundaries of their charter.

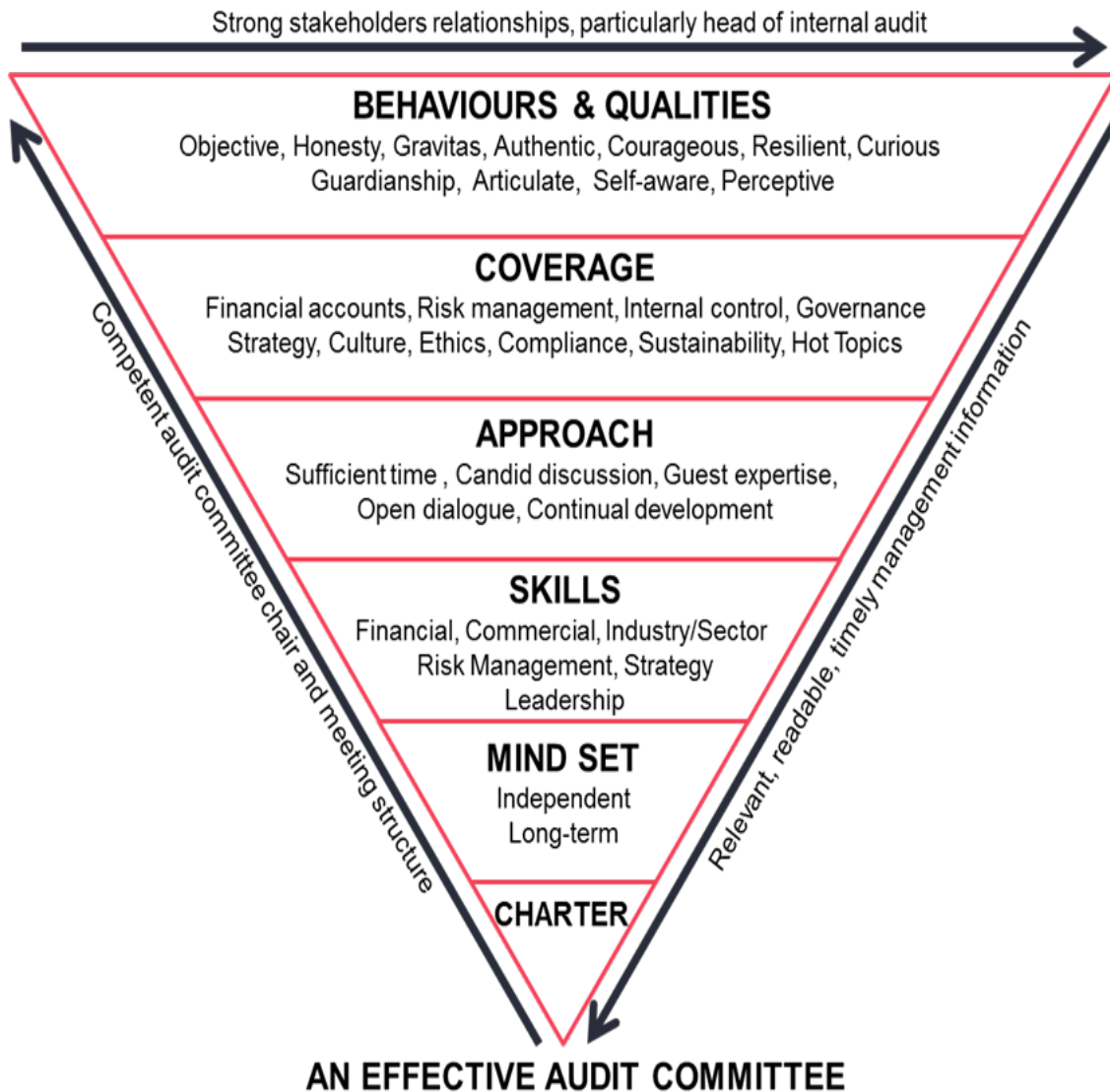
The audit committee's ways of working are made up of key elements that complement each other.

No single element is more important than another, for example;

- A **charter** provides the rules of engagement

- A **skills matrix** ensures members are active contributors
- The long-term mind set is essential to ensure organisational sustainability and reflects the requirement for **viability statement** in annual reports of listed companies.
- Acknowledgement of coverage safeguards against being unduly finance focused which can occur due to meetings being scheduled in line with financial reporting cycles

Audit leaders have a role in this, not as attendees at meetings but as influencers.



Partnering with governance leaders

Chief audit executives (CAEs) can influence the effectiveness in a variety of ways through their relationship with the audit committee. Does limiting this to the chair support effective governance? Should CAEs be better acquainted with all non-executives?

Influencing sustainable change that committee members understand has a lasting impact beyond the tenure

of the CAE and extends to other organisations that members are involved with. Improving effective governance and rebuilding trust. As a CAE who doesn't want to be part of that?

Induction

It's imperative that CAEs are part of the induction for non-execs. This gives the opportunity for informal appraisal of their skills and understanding of key topics together with ensuring they have a positive outlook on the role of internal audit. CAEs can then act on any identified issues through ongoing discussion and training programmes.

Assurance providers

There can be huge pressure on CAEs as the third line of defence.

Using an **assurance map** encourages the audit committee to utilise the second and first line of defence. What relationships do they have with key elements such as the risk function and regulatory compliance?

CAEs may want to consider **integrated assurance**, a challenging but rewarding position where all assurance providers work together with common reporting to improve audit committee effectiveness. A first step could be to facilitate a regular forum of the second line to share insights and issues building towards reporting.

Emerging risk

The audit committee is dependent on quality information. CAEs must provide regular assurance on the processes that effective risk management relies upon, particularly the identification and reporting of emerging risk. Like the board, the audit committee should be aware of emerging risk and any potential material impacts on internal controls and governance.

How explicitly do individual audit engagements validate that operations are within risk appetite? Can internal audit provide better support to the audit committee?

Closed sessions

CAEs have insight into audit committee effectiveness at every meeting during the closed session; a 'protected' environment for non-execs to ask tough questions of their CAEs and for CAEs to raise concerns of a delicate nature such as the behaviour of senior executives. Areas of high risk, sensitivity or subjective judgement should not be avoided. Typical topics include IT integration projects, new strategic ventures, culture, compliance vulnerabilities, delays in completing agreed actions and independence or resource concerns.

It is incumbent on CAEs to raise issues if questions are not asked, to encourage curiosity and prompt investigations. Sessions should always be held regardless of whether there are material issues to discuss so that management are accustomed to the arrangement and do not fear it.

Assessment

An effective committee will look to continually improve. Does the chair conduct a self-assessment similar to that of the board? As a key stakeholder and direct report of the chair, is the CAE asked to input into the review? Consider it 360 feedback, a normal part of performance management!

Audit Committee Chair

CAEs are the only person in the organisation that reports directly to the audit committee chair. A one-on-one relationship which is unique.

If the chair is ineffective in their role this is a problem not only for the governance of the organisation but for the CAE too. How can internal audit demonstrate value if the audit committee is weak?

CAEs are likely to be the first to realise that there is an issue. Is it recoverable? Perhaps a covert training session under the guise of 'meeting the team', propose a joint site visit to encourage commercial insight or use personal networks to identify a good chair within the industry, offer to set up an introduction. If all else fails air concerns sensitively with the chair of the board.

If the audit committee itself presents a risk to the organisation who else is going to raise it?

Foresight

There is no barometer or external measure for audit committees, even the official minutes often desensitise and hide the full story of dialogue that has taken place. How then can CAEs have the foresight to see when the audit committee is off track? There are some common warning signs which shouldn't be ignored.

WARNING SIGNS

- Chair has no time for dialogue outside of meetings
- Members rarely comment on published reports
- Members rarely challenge the proposed audit plan
- Infrequent requests for assurance activity
- Limited challenge of uncompleted audit actions
- Assurance reports are 'noddled through' at meetings
- Chair has 'cosy' relationship with management
- Recruitment is mainly via known networks
- No close session available to HIA
- External audit attends close session with HIA

The [Guidance on Board Effectiveness](#) is an invaluable tool for internal auditors. It includes a set of questions for audit committees that audit leaders should also be asking. CAEs instinctively know how well these are being addressed.

Questions for audit committees

- Are you satisfied that the company has adequate internal controls over risk?
- Is sufficient time allocated on the board to enable a full discussion of the work of the audit committee?
- How has the board assessed whether the audit committee has a balance of skills and competencies necessary to fulfil its remit?
- How is the audit committee managing and monitoring the non-audit work the company's auditors deliver across the group?
- Are there clear procedures and triggers in place to elevate risks to the board quickly?

Extract from FRC Corporate Governance Code 2018

Closing Thoughts

All auditors know that providing independent assurance is not always an easy task. Independent oversight is no different.

An audit committee must be effective to be able to deliver robust challenge. They must be effective to have the confidence to know that their collective mind is right. They must be effective to understand and protect stakeholder interests.

For good governance to be embedded in an organisation, the audit committee and internal audit must work together to be effective.

It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change
Charles Darwin

Further reading to add at the end of the content

2018 [UK Governance Code](#)

2018 [Guidance on Board Effectiveness](#)

2016 [Guidance on Audit Committees](#)

2003 [Higgs Report](#) - Effectiveness of Non-Executive Directors

Oversight of transformation programmes – NAO [guidance for audit committees](#)