Enter

Audit Committee Guide

International considerations for audit committees

October 2024

Shape the future with confidence

Foreword

Audit committees are a crucial component of modern corporate governance. As a subcommittee of the board*, they hold both the organization and the board itself accountable to stakeholders.

As well as providing critical oversight around their company's corporate reporting processes, audit committees oversee internal controls, risk management and the external audit process. Additionally, they may have responsibilities in relation to cybersecurity, taxation and legal compliance, among other areas. In fact, their remit is wide, varied and continually evolving - as we see currently with the advent of mandatory sustainability reporting and assurance in many markets.

Being an audit committee member is an important and often pressured job that requires a substantial time commitment. The nature of the work demands that audit committee members are diligent and proactive, with independent mindsets. They should be willing and capable of asking hard questions of management, as well as tenacious in their pursuit of answers. Additionally, they need to support and challenge those who report to them, including internal and external auditors.

This guide aims to help new audit committee members get to grips with their role. It explains what it means to be a member of an audit committee, which responsibilities they will have, where they can add value, and how they can work effectively with their colleagues as part of a highly performing leadership team. Thanks to its jurisdiction-agnostic approach, the guide is relevant irrespective of where an individual audit committee member is based.

By providing a broader overview of the audit committee's role, this guide will also be useful to existing audit committee members who are looking to refresh their knowledge and skills. Furthermore, it will be a valuable aid to anyone who is interested in finding out more about how audit committees contribute to effective corporate governance.

Enjoy reading the guide. We hope you find it useful and informative.

Andrew Hobbs
EY EMEIA Center for Board Matters Leader

Maria Kępa
Ernst & Young LLP Director of Governance and Public Policy

Acknowledgments

We are very grateful to the following people who provided their insights and support for the benefit of this guide: Anja Pissarczyk, Claire Cesari-Walch, Govind Ahuja, Jayant Kumar, Jeremy Thurbin, Martijn de Jong, Matteo De Luca, Mikko Järventausta, Omar Abaalkhail, Rachel Savage, Sarah Kokot, Sarah Lyon, Søren Skov Larsen.

*Note: "Board" refers to supervisory board in the case of a dual-board structure.

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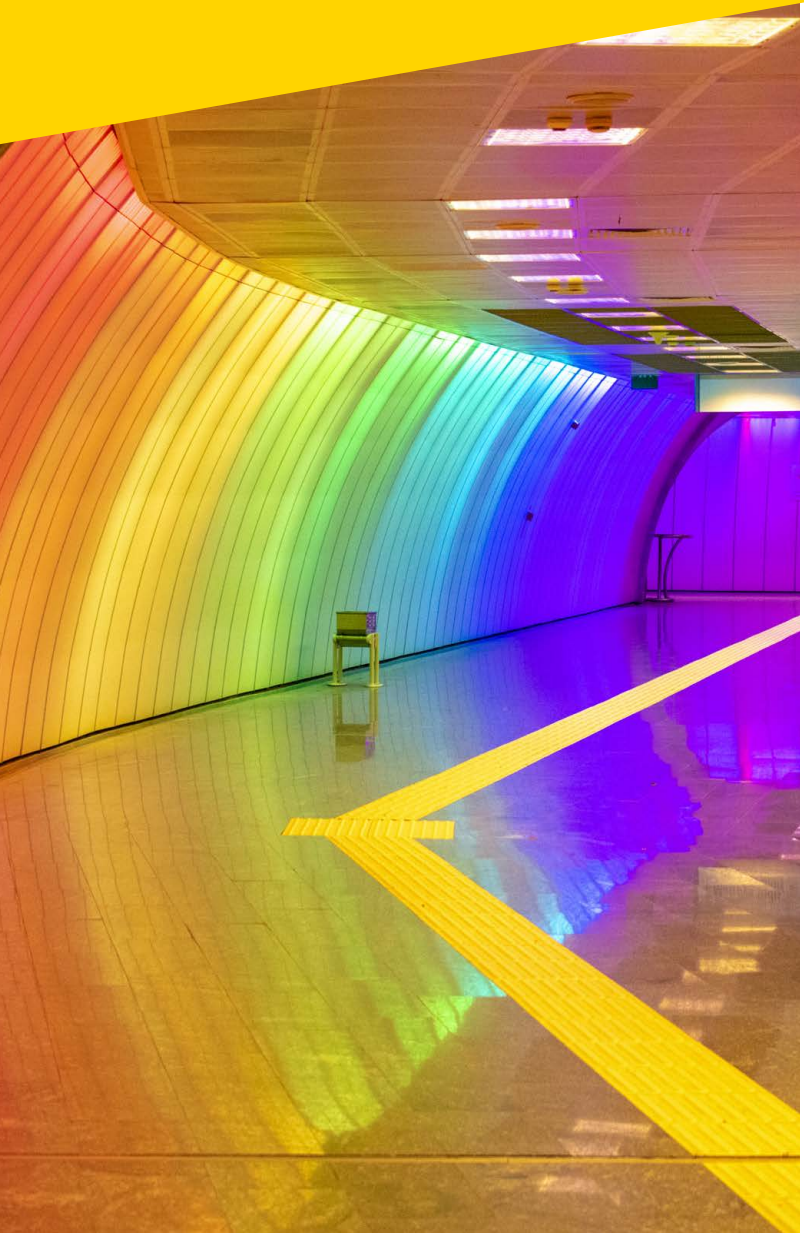


1.1 Historical background

The concept of audit dates back to ancient times. In ancient Egypt and Rome, it was common for official auditors to scrutinize public spending across provinces.

Over time, audit also began to be applied to the activities of certain private businesses, including those engaged in long-distance international trading on a large scale. Businesses needed the ability to measure their performance and demonstrate value creation in order to take informed decisions and secure funds. To secure funds, their measures of performance had to be reliable.

The accounts of many large companies were therefore scrutinized, first by a group of directors or by those providing the funding. Later this practice evolved toward employing auditors that were unconnected with the business. A good example was the Massachusetts Bay Company, a venture formed to trade in New England that was granted a royal charter by King Charles I of England in 1629. The company voluntarily employed eight auditors to give its London-based financiers confidence in their investment in the New World.

By the 19th century, companies were increasingly becoming larger, with more complex operations. Meanwhile, funding providers were not only less involved in the operational management of the companies they invested in, they were also geographically more distant. Financial accountability and control were therefore vital to protecting their investment.

The 1844 Joint Stock Companies Act in the UK made it mandatory for companies within scope to appoint auditors to prepare a report on their financial statements for the annual general meeting of shareholders. As some board members became more interested and involved in the work of those auditors, they formed what could be considered rudimentary audit committees that focused on the accuracy of the company's bookkeeping.

This approach became more formalized in Italy, as early as 1882, with the establishment of an internal board of statutory auditors (named **collegio sindacale**). The commercial code of the day required that either three or five statutory auditors, acting as shareholders' agents, be appointed at the shareholders' meeting. The statutory auditors could not have any family affiliations to company directors. The main functions of the board of statutory auditors were to audit the company's financial statements and to oversee the company's operations.

The modern concept of audit committees, appointed as a board subcommittee, first appeared in the US in the first half of the 20th century. Following the stock market crash of 1929, the US government passed the Securities Act of 1933, the first federal law to regulate the securities industry. The Act aimed to bring more

transparency to financial statements, allowing investors to make better informed decisions. All companies newly listing on the New York Stock Exchange (NYSE) were required to have independent audits, with the auditors typically appointed by the executive directors.

The McKesson & Robbins accounting scandal of the late 1930s, which involved a major fraud, highlighted the risks of management arranging the audit instead of the board. The Securities and Exchange Commission (SEC) subsequently endorsed the concept of establishing an audit committee made up of nonexecutive directors, whose role would be to nominate the auditor and agree the scope of its engagement. This became an NYSE listing requirement in 1977, by which point the establishment of audit committees in large US public companies had started to proliferate. Ten years later, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) issued a report recommending that all public companies establish audit committees composed solely of outside directors.

This corporate governance mechanism gained international popularity and became adopted as good practice in Europe. In the UK, the 1992 Cadbury Code recommended that the board should establish an audit committee of at least three nonexecutive directors with written terms of reference that deal clearly with its authority and duties. In its Resolution of 21 April 2004, the European Parliament called on the Commission of the European Communities to propose rules to eliminate and prevent conflicts of interest. In particular, it stressed the need for listed companies to have an audit committee whose functions should include overseeing the external auditor's independence, objectivity and effectiveness.

1.2 Evolution of remit

By then, traction was starting to build behind the argument that a sole focus on financial performance and reporting does not allow for decision-making that considers the social and environmental consequences of a company's activities. In 1987, the World Commission on Environment and Development, a suborganization of the United Nations, had published a paper that came to be known as the "Brundtland Report." This report developed the guiding principles for sustainable development as it is generally understood today.

In 1994, John Elkington coined the concept of the "Triple Bottom Line," a framework that measures business performance according to the "Three Ps (people, planet and profit). The framework expanded traditional performance metrics by encouraging businesses to track and manage the economic (not just financial), social and environmental value they create — or destroy. Three years later, the Global Reporting Initiative (GRI) was founded to provide a common reporting language that would help organizations to communicate their impacts. In 1998, the launch of the Greenhouse Gas Protocol would provide standardized frameworks for measuring greenhouse gas emissions.

Many commentators see the global financial crisis of 2007–2008 as a pivotal moment in terms of bringing widespread recognition that profitability was being achieved at the expense of future generations. This recognition highlighted the need for a reporting methodology that combined financial data with sustainability-related information.

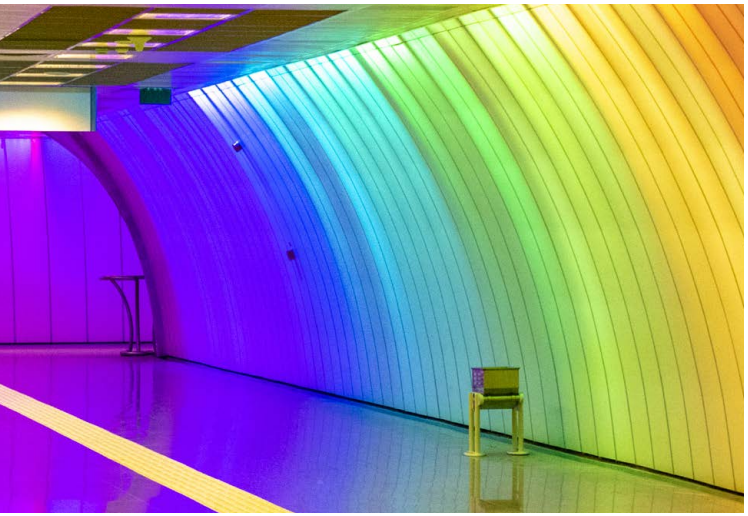
In response, the Sustainability Accounting Standards Board was founded in 2011. Then, in 2013, the International Integrated Reporting Council published its international framework for presenting information on the creation, preservation or erosion of value over time. in 2016, the GRI published its first set of sustainability reporting standards. Another major milestone was reached in 2018 when the Nonfinancial Reporting Directive (NFRD) came into effect in all EU member states. The NFRD introduced mandatory reporting for many companies on environmental matters, social and employee topics, and anti-bribery and anti-corruption issues. In 2021, the European Commission launched its proposal for a Corporate Sustainability Reporting Directive, which would exponentially expand the reporting requirements of the NFRD.

As the concept of value expanded — and performance measurement moved away from a pure focus on financials — corporate reporting also expanded. At the same time, there was an increase in expectations of what audit committees needed to oversee. In some countries, new requirements became enshrined in governance codes or listing rules. In others, the responsibilities were taken on voluntarily.

This trend, often referred to as "scope creep," has been a feature of audit committee remits over time. As businesses became more complex, and bookkeeping became more reliant on technology, it was no longer enough for audit committees to look at the numbers alone. It became necessary for them to understand the processes that led to their recording, and the risks that could have a negative impact on those numbers. Similarly, large-scale IT implementation projects and

the far-reaching consequences of cyber incidents are now common topics for audit committee deliberations. Many new and emerging matters (including, most recently, artificial intelligence) that did not naturally sit on the agendas of other committees have been allocated to the audit committee.

Scope creep is hardly surprising since most risks, opportunities, advances and incidents will end up impacting a company's performance and be reflected in its corporate reporting. It does, however, impact on audit committees' ability to perform their role effectively.



1.3 Responsibilities

Today, it is the norm for listed businesses globally to have an audit committee and they are not an uncommon feature in large, private companies. Historically, the driver for public companies to establish audit committees has been to protect investors by providing them with accurate financial reporting. Nevertheless, society is becoming more aware of the impacts that businesses have on their broader stakeholder base. So, this has created a stronger case for private companies — those that are family-owned, founder-managed, backed by private equity or simply not listed — to also consider establishing an audit committee.

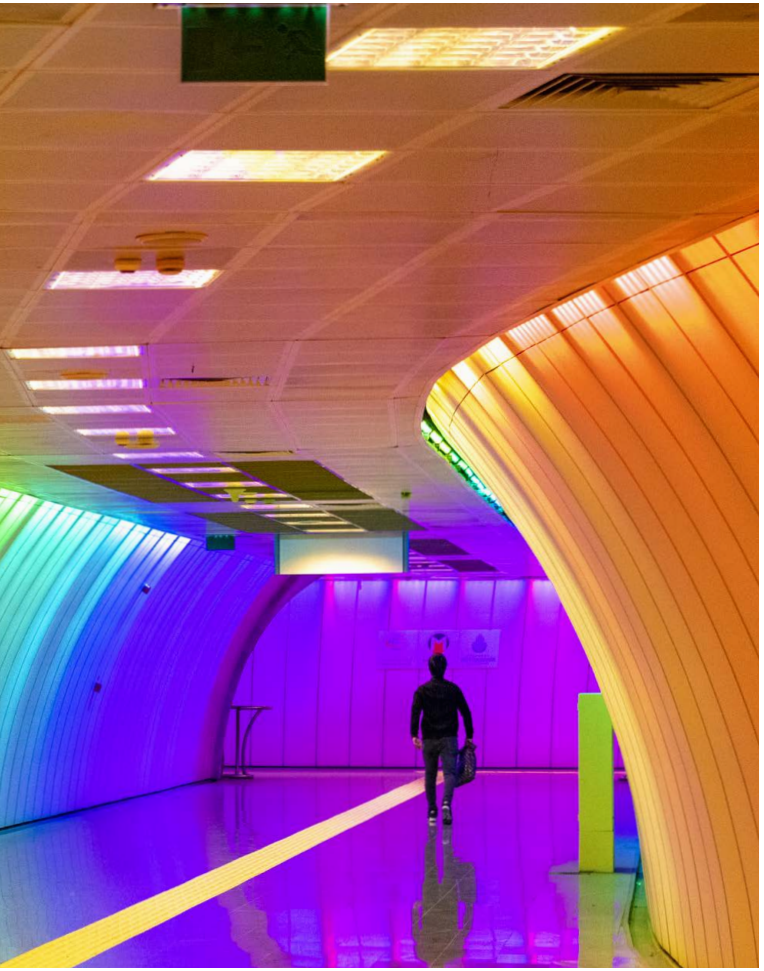
As private companies create boards to help them set strategy and manage complexity and risk, the audit committee is typically the first subcommittee to be formed. Some jurisdictions require audit committees for private companies that meet certain criteria. Interestingly, a 2022 change to company law in Saudi Arabia removed the mandatory requirement that had previously been in place for joint stock companies to have an audit committee, making this optional instead. Yet the majority of large joint stock companies in Saudi Arabia have not dissolved their audit committees.

For listed companies, the requirements and limitations relating to the roles of audit committees are set by national laws and stock exchange requirements. These will vary by jurisdiction. European Union (EU) member states have implemented local laws based on the 2014 Audit Regulation and related Audit Directive, collectively known as the ARD. The ARD expanded the role and mandatory responsibilities of audit committees and introduced stricter requirements on the statutory audits of public interest entities, such as listed companies, credit institutions, and insurance undertakings. Additional detail is often provided in national governance codes that represent a so-called "soft law" approach. With these codes, provisions are applied on a "comply or explain" basis, meaning that where a company deviates from a provision, it needs to explain why it has done so.

Audit committees will also respond to the evolving expectations of the role of a public company director in their country of listing. As greater input is sought from nonexecutives on an increasing number of areas, audit committees are likely to expand their remit of their own accord.

Private companies that choose to voluntarily set up an audit committee will decide for themselves the priority areas they want to cover, and the listed company practices they wish to adopt, based on what is most appropriate in their context.

Regardless of whether a company is public or private, being an audit committee member will often feel like a part-time job that is a full-time commitment.



1.4 Oversight

Differing national board structures influence how audit committees operate and the breadth of role they take on. There are two main types of board structure: a unitary board comprised of executive and nonexecutive directors; and a two-tier board that distinguishes between the executive "management board" and the nonexecutive "supervisory board." The audit committee is a subcommittee of the board or supervisory board.

In Italy, the vast majority of listed companies adopt the so-called "traditional" corporate governance system, whereby the shareholders appoint the board of directors and the **collegio sindacale**. The **collegio sindacale** discharges a similar role to that of an audit committee, but is situated outside the board of directors. Additionally, there is a board committee on risk and internal control that interacts with the **collegio sindacale** to fulfil its duties.

Regardless of how a company's board is structured, the role of senior management relates predominantly to the everyday operational execution needed to run a business. On the other hand, nonexecutive directors are tasked with providing oversight and monitoring management's activities, bringing constructive challenge as the need arises.

This division is starker for two-tier boards. The supervisory board is more focused on supervision and ensuring proper compliance, governance, internal control structures and risk management. In a unitary board system, executive and nonexecutive directors work as part of one board and therefore see their role as being more collaborative, providing strategic input to the executive, and setting risk appetite and objectives around risk management and internal control frameworks. They also oversee the delivery of the resulting plans.

The boards of private companies can differ quite significantly in nature from those of public companies. Often, they include the business owners, who have access to considerable information due to their close engagement with management. As a result, the directors of private companies might probe management to a level of detail that public-company directors could see as stepping into the realm of the executive. Private-company boards can also act more quickly, because of the control they exercise.

Due to their ever-growing remit and the complexity of the issues they face, it can be tempting for audit committees to become operationally involved. Yet the oversight role of the audit committee is critical to safeguard the veracity of information used by stakeholders, both external and internal, in their decision-making.

So, audit committees – even those of private companies – must resist the urge to roll up their sleeves and step into the shoes of management since this can lead to a loss of objectivity. Objectivity is essential for dealing with disagreements between management and the auditor on matters of judgment relating to corporate reporting and for acting as an effective sounding board for the CFO.

2 About this guide

Requirements and obligations for audit committees vary not only by sector and type of organization, but also by country. The ambition for this guide is to address common expectations for audit committees of public businesses in a manner that is jurisdiction-agnostic.

2.1 Jurisdiction-agnostic

This guide is structured around the governance framework developed by the Embankment Project for Inclusive Capitalism.[1] The framework groups corporate governance mechanisms into categories, each of which is attributed to one of four dimensions: who, how, what and constraints. While this framework was designed to address board-level considerations, it is equally as relevant for audit committees.

[1] **The Embankment Project for Inclusive Capitalism**, The Coalition for Inclusive Capitalism, 2018.

Governance framework developed by the Embankment Project for Inclusive Capitalism

Constraints

Operating environment

Existing ownership structures of the company and the laws and regulations of a particular jurisdiction

Who?

Right individuals on the board at the right time

People with the right skills, experience, knowledge, and time or capacity to effectively discharge their obligations.

Categories

- Board composition

How?

Working together effectively as a highly performing leadership team

An effective team, using the right information, which is cognitively diverse and supportive of the sharing of dissenting or challenging views to avoid the risk of group think.

Categories

- Board dynamics
- Board diversity
- Board structures
- Provision of information to the board

What?

Focusing on activities that will positively impact long-term value creation

Set the tone at the top and provide the right balance between effective oversight over culture, strategy and risk and monitoring activities.

Categories

- Tone at the top or leading by example
- Stakeholder engagement
- Strategy oversight
- Risk oversight
- Monitoring
- Remuneration or compensation
- External audit and audit committee oversight

Who: relates to having the right individuals on the audit committee, at the right time. An effective audit committee needs members with the right skills, experience, knowledge and time or capacity to effectively discharge their obligations. This is discussed in chapter 3.

How: reflects these individuals working together effectively as a highly performing team. To be effective, audit committees require the right information, cognitive diversity and a culture that is supportive of the sharing of dissenting or challenging views to avoid the risk of group think. This is discussed in chapter 4.

What: considers activities that will positively impact long-term value creation. The audit committee needs to contribute to setting the tone at the top, stakeholder engagement and strategic thinking. At the same time, it should provide effective oversight in its core focus areas of corporate reporting, risk management and internal controls. This is discussed in chapters 5 to 9.

For each of these dimensions, the guide includes questions that the audit committee may want to consider in evaluating its own performance, presented in the following manner:

Being an audit committee member is not the same as being a chair. Audit committee chairs shoulder more responsibilities and undertake multiple activities between formal meetings. For this reason, the guide brings out additional considerations relevant to audit committee chairs:

Audit committee chair considerations

Constraints: refer to the environment in which a company operates and include existing ownership structures of the company, as well as the laws and regulations of a particular jurisdiction. Often, constraints do not fall within in the direct control of a company. To be effective, the "who," "how" and "what" mechanisms must be responsive to the "constraints" relevant to a company, but also evolve in response to change. Links to key regulatory or similar requirements related to the UK have been provided in Appendix B. The most relevant "constraints" related to the UK are referenced across the various sections in the following manner:

Constraints and local requirements

Nonetheless, all readers should carefully check the requirements specific to their jurisdiction, since this guide will not cover off all eventualities.

Additionally, the guide includes examples of practices that are less common or not relevant to all jurisdictions, but which could be interesting for audit committees to consider:

Discussion points and interesting observations

2.2 Public versus private companies

This guide has been written with public companies in mind, although many of the expectations are also relevant to other public interest entities. While other private businesses may find certain aspects of this guide insightful, they should not necessarily aim for listed standards of governance or use definitions applicable to listed companies.

The right level of governance can bring significant value and risk focus to organizations by bringing more outside-in views, but it is not a "one-size-fits-all." Trying to enforce certain listed requirements may have a counterproductive effect. At worst, it could introduce burdensome bureaucracy, slow down growth and needlessly increase costs.

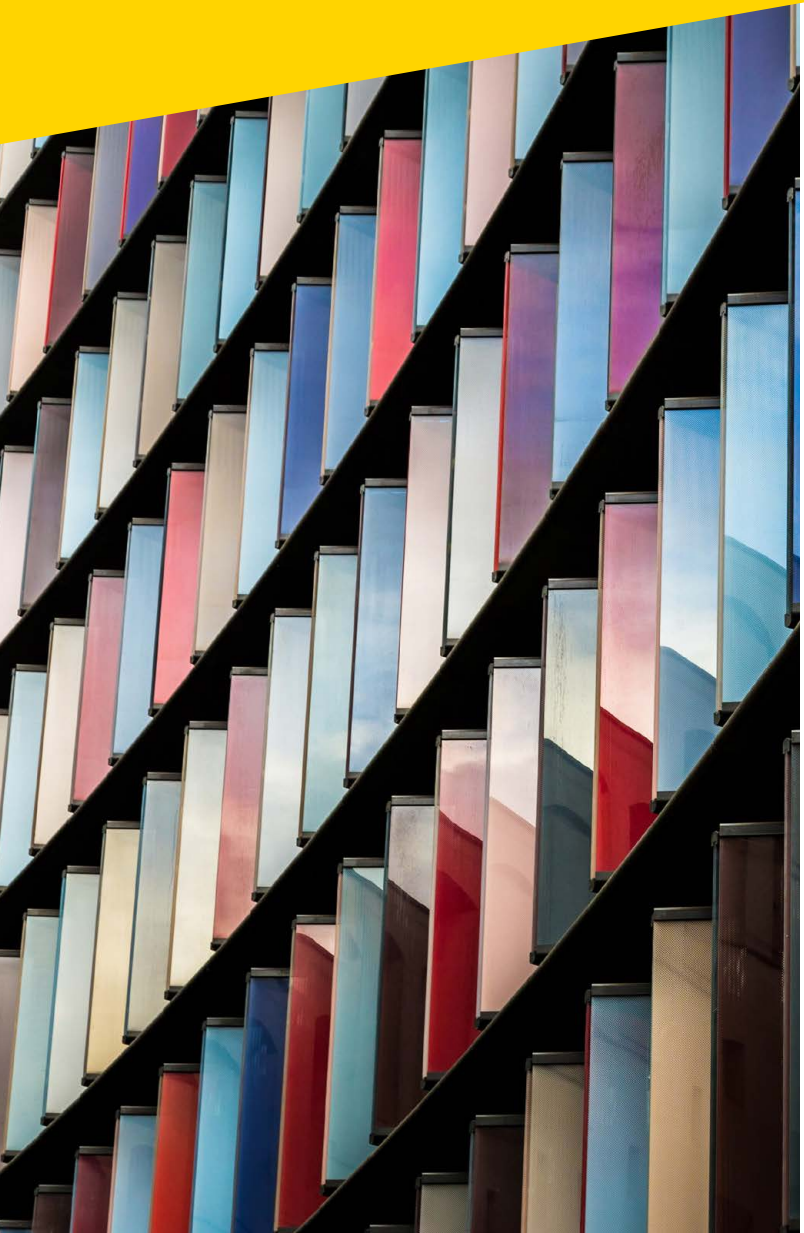
It could also result in a private business setting up an audit committee that does not address the true needs of the organization. The set-up and needs of private businesses can be significantly different from those of listed businesses. Private equity-backed businesses will often have audit committees made up of investor representatives while a founder-managed business will have a different perspective again. Private businesses will often look to the audit committee to provide a more advisory role and share experiences gained from across other businesses that the committee members are involved in.

The audit committee can play a crucial and value-enhancing role in helping future-proof the business, especially by elevating the quality of risk discussions. Audit committee members can also provide management with access to their networks and recommend advisors or even candidates to hire.

In due course, as the business continues to grow, the audit committee can support the gradual implementation of controls, the introduction of a more formalized risk focus, and the maturation of the finance team. In some cases, it can also support the journey toward listing.

Audit committees of private businesses may wish to consider the self-evaluation questions included throughout this guide. Many of these questions will apply to them, even if the response is different from that of a listed company.

3 Who: right individuals on the audit committee at the right time



In April 2000, academics working on a research paper sent questionnaires directly to the audit committee chairs of all UK **Financial Times** 500 companies.[2] The responses demonstrated that:

- Independence was overwhelmingly seen as the most significant attribute of an audit committee member.
- Lack of time was perceived to be the greatest impediment to effectiveness.

Over two decades later, these attributes continue to ring true across all jurisdictions.

3.1 De facto independence

Audit committee member independence is the key safeguard for stakeholders when there is information asymmetry between stakeholders and management. It could be said that the audit committee underwrites the reliability of the information contained in the annual report, as well as other corporate information that is used by stakeholders for decision-making. Audit committee members must therefore be in a position to report any problems they find, without being unduly influenced by the potentially difficult consequences for the company and its executives. Being part of the executive would result in the audit committee marking its own homework.

So, it is no wonder that independence ranks very high in the expectations of audit committee members, and is a common requirement. In fact, in the US, independence requirements for audit committee members are higher than for other board members.

Independence, most broadly, is considered in the context of material relationships with the company. Some jurisdictions impose bright-line criteria. Others treat these criteria more as factors to be considered and assessed. Common criteria include:

- Any form of executive involvement or employment at the company or businesses linked to it.
- Significant business relationship with the company or an associated company.

[2] B Windram & J Song, "Non-Executive Directors and the Changing Nature of Audit Committees: Evidence from UK Audit Committee Chairmen," Corporate Ownership & Control Vol 1 (3), 2004.

- Family members who may be similarly associated with the company.
- Having recently been a partner at the firm that is conducting the external audit.

The cooling-off period (the duration of time that needs to pass after any of the above relationships has been terminated) can be as long as five years in some cases.

Independence considerations also result in restrictions related to remuneration other than receiving a director's fee. These can include participation in share-based payments, performance-related measures (although some jurisdictions allow a small proportion of variable pay), or even being a member of the company's pension scheme.

Views differ on the subject of owning a significant number of shares. Generally, this is considered to be a material relationship. The prescribed threshold for a holding to be considered significant varies greatly or is left as a matter of judgment. Similarly, affiliation with major shareholders may render a director non-independent in some countries. In others, not having a link to a major shareholder is seen as an additional level of independence. This distinction is especially relevant in the context of the requirement in some jurisdictions for independent members of the audit committee to scrutinize related party transactions (see section 9.2).

The Finnish Corporate Governance Code explicitly requires that at least one audit committee member should be independent of the significant shareholders. A significant shareholder is a shareholder who holds at least 10% of all company shares.

The perception of independence is also essential. Deep social relationships between supposedly independent directors and management can be seen as compromising independence, as can deep social relationships within the committee. Tenure on the committee, or more broadly on the board, may therefore factor into independence considerations. Cross-directorships (when two or more directors sit on the board of another company) may also have independence implications if they lead to greater affinity between some of the audit committee members.

According to the UK Corporate Governance Code, serving on the board for more than nine years is likely to impair, or could appear to impair, a nonexecutive director's independence.

? How has the audit committee assessed whether each member designated as independent, is independent – both in form and appearance?

Provision 10 of the UK Corporate Governance Code sets out circumstances that are likely to impair, or could appear to impair, a nonexecutive director's independence.

3.2 Challenging and skeptical mindset – independence of mind

Independence is seen as the prerequisite for demonstrating a skeptical mindset. De facto independence does not amount to much if a director is unwilling to challenge management. Audit committee members need to have a predisposition for asking probing questions and testing unsubstantiated statements.

Directors also need to recognize their own biases, however. Audit committee members are often distinguished individuals who have spent years building their reputation. With very little, if any, financial upside linked to the company outperforming, they may be overly influenced by their own levels of risk aversion. A director's personal approach to risk-taking being misaligned with the risk appetite set by the board (as discussed further in chapter 6) can be seen as an impairment to objectivity and therefore independence.

3.3 Time commitment

The official remit of the audit committee is ever-increasing, reflecting the expansion of core responsibilities and numerous ad hoc issues that it is expected to handle. As a result, the committee's capacity to discharge its role adequately can become an issue.

The New York Stock Exchange requires the board to determine whether serving simultaneously on the audit committees of more than three public companies does not impair the ability of the audit committee member to effectively discharge their duties.

In India, a director cannot be a member of more than 10 audit or stakeholder's relationship committees, or chair more than five audit or stakeholder's relationship committees of public limited companies, whether those companies are listed or not.

The need for work to be conducted between official meetings is growing, especially for the audit committee chair.

? How has the audit committee assessed that each member has been able to dedicate adequate time to discharging their responsibilities? How has the audit committee reasonably satisfied itself that each member continues to have the capacity to do so going forward?

3.4 Financial skills, knowledge, qualification or competence

Financial expertise and skills are the most common prerequisite for audit committee members, with many jurisdictions expecting that at least one of the committee members will be financially savvy. Where independence is not required of all members, financial expertise can often be required of the member who is deemed independent.

According to Canada's **National Instrument 52-110 — Audit Committees**, every audit committee member must be financially literate, i.e., able to read and understand a set of comparably complex financial statements. An audit committee member who is not financially literate may only be appointed provided they become financially literate reasonably quickly.

What financial expertise means is not always defined, but it broadly entails experience of accounting, finance or statutory audit and an understanding of financial statements and related internal controls. Competence can be obtained through significant professional experience, studies or research. Some countries have specific qualification criteria, such as:

- A university degree in economics or finance, or significant professional experience
- A professional qualification from a professional accountancy body or other relevant professional organization

Given the pace of change impacting accounting standards and audit techniques, the importance of experience being recent and relevant cannot be overstated.

In its rules implementing section 407 of the Sarbanes-Oxley Act, the US Securities and Exchange Commission decided to use the term "audit committee financial expert" instead of the term "financial expert." This term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee.

An audit committee financial expert is a person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements.
- Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable with the estimates, accruals and reserves, if any, used in the registrant's financial statements
- Experience preparing or auditing financial statements that present accounting issues that are generally comparable with those raised by the registrant's financial statements
- Experience with internal controls and procedures for financial reportingAn understanding of audit committee functions.

A person must have acquired such attributes through any one or more of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions.
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions.
- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- Other relevant experience.

A thorough analysis of how the definition was arrived at can be found in the text of the **final rule.**[3]

The German Stock Corporation Act ('Aktiengesetz') and the German Corporate Governance Code require that at least one member of the audit committee must have expertise in the field of accounting and at least one other member of the audit committee must have expertise in the field of auditing. The expertise in the field of accounting shall consist of special knowledge and experience in the application of accounting principles and internal control and risk management systems, and the expertise in the field of auditing shall consist of special knowledge and experience in the auditing of financial statements. Accounting and auditing also include sustainability reporting and assurance.

If not required of all members, it is often a requirement for the audit committee chair to be the member with financial expertise.

As noted in **point 4.1.6**, financial skills need to be kept up to date, especially in light of continually evolving accounting standards.

[3] Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, US Securities and Exchange Commission, 2003.

3.5 Other competence and experience

The industry in which a company operates has a fundamental impact on the accounting policies, judgments and estimates that shape its financials (and therefore also on the external audit plan), as well as on the risks it faces. Hence competency in the given sector is also an important factor for audit committee members.

The UK Corporate Governance Code requires that at least one member of the audit committee has recent and relevant financial experience. It also stipulates that the committee, as a whole, has competence relevant to the sector in which the company operates.

Given the general expansion of the audit committee's remit, financial competence alone is therefore unlikely to suffice. While member expertise may not necessarily have to be very deep outside of the core oversight duties, the expectations around competence and experience are growing. Increasingly, technology is seen as an area of additional knowledge that is vitally important to the effectiveness of an audit committee, with cybersecurity being one of the rapidly evolving risks that audit committees need to oversee. On the one hand, adding a single-issue director – one with narrow and deep expertise in a particular topic – needs to be weighed up against diluting the overall breadth of expertise on the committee. On the other, members that do not have a background traditionally associated with audit committees will increase the committee's diversity of thought.

? How has the audit committee satisfied itself that both individually and in combination members have sufficient recent and relevant financial expertise and industry understanding and any other competence relevant to the company's context?

As discussed in point 4.3.7.3, audit committees need to consider how their competence can be supplemented by the involvement of specialists.

3.6 Personal qualities

Integrity and high ethical standards are integral attributes for all audit committee members. They also need the mindset to raise and address challenging issues, probe management and encourage open and frank debate. Tenacity in asking questions and pursuing answers is a must.

To effectively lead the audit committee, the chair needs strong communication, interpersonal and leadership skills, as well as an ability to coach, challenge and build consensus.

3.7 Chair of the board

Many jurisdictions explicitly prohibit the chair of the board from being an audit committee member. Even if regulations stay silent on this matter, consideration needs to be given to the already substantial responsibilities associated with the role and whether they would have the capacity to also be an active audit committee member.

According to the UK Corporate Governance Code, the chair of the board should not be a member of the audit committee.

3.8 Onboarding

Management should not be involved with identifying potential audit committee candidates, to avoid the perception of impaired independence. Following a successful appointment, the new member will need to be onboarded quickly and effectively. A formalized and tailored process needs to be responsive to the member's experiences and skills, including previous experience of being a nonexecutive director. First-time nonexecutives can find it a challenge to transition from a senior executive role, like that of a CFO, to an oversight role.

Many aspects of onboarding — such as meetings with key people across the business, site visits, briefings on logistics — will be of relevance to all new directors. Nevertheless, the program for new audit committee members needs to be supplemented to cover areas such as the intersection of accounting policies with judgmental areas of the company's financial statements, the internal control and risk management framework, meetings with internal and external auditors and, where relevant, regulatory considerations applicable to the sector.

? How did the audit committee evaluate the adequacy of topics covered as part of the onboarding of any new members?

3.9 Networking

Groups such as Tapestry's European Audit Committee Leadership Network meet regularly and serve as a mechanism for networking and staying current with audit and compliance trends, including across borders and systems. Membership of such groups can be an effective means for the sharing of views and best practice.

The **Audit Committee Chairs Independent Forum** (ACCIF) is an independent forum focused on FTSE 350 company audit committees. Its overall objective is to promote good governance by enhancing the leadership of audit committee chairs through the sharing of experiences and the establishment of best practice.

Networking opportunities can also arise through training and accreditation courses.

In France, the Institut Français des Administrateurs accredits board members through several courses during the year.

4 How: working together as a highly performing leadership team

4.1 Diversity and dynamics

In an article titled "Corporate Governance: The New Paradigm," lawyer Martin Lipton wrote: "A board works best when it functions as a unified whole, without factions and without internal divisions. While qualities such as mutual respect, trust, sense of common purpose, energy, business sense and openness may be difficult to quantify or describe with precision, they are very much at the heart of effective board functioning ... The quality of team dynamics may have a significantly greater impact on firm performance than the sum of individual director contributions."[4] The same can be said for the functioning of the audit committee.

[4] Lipton, M, "Corporate Governance: The New Paradigm," Harvard Law School Forum on Corporate Governance, 11 January 2017.

4.1.1 Dissenting and challenging views being encouraged

While the audit committee requires collegiality to function well, this should not be mistaken for homogeneity. Audit committees, more than any other board committee, need to create an environment that is conducive to disagreement, challenge, and skepticism. Dissenting views need to be heard out, contrarian positions debated, and open discussion encouraged. Diversity of thought should be cultivated. Disagreements need to be constructive, however, and challenge should not be raised for the sake of challenge.

Audit committee chairs play an important role in promoting dynamics and ensuring that the voices of all members are heard.

? How do the audit committee dynamics enable dissenting views to mitigate against "groupthink" or an atmosphere of overwhelming consensus?

4.1.2 Committee size

On average, audit committees have three to five members. Some jurisdictions set a three-member minimum for reasons of quorum and to ensure that there are multiple perspectives and sufficient expertise on the committee. Upper limits on membership are less common, but consideration needs to be given to ensuring the committee can function efficiently and effectively, with all members able to participate and contribute meaningfully. An audit committee that is too large can inadvertently become a board within the board.

The size of the committee will influence how quorum is defined, as well as how a casting vote will be considered. These matters should be clearly set out in the terms of reference.

Saudi Arabia's Capital Market Authority Corporate Governance Regulations stipulate that the number of members on an audit committee shall not be less than three or more than five, with at least one independent board member.

Following the enactment of the EU's Corporate Sustainability Reporting Directive into local law, countries like Finland are starting to see an increase in the number of audit committee members, as committees seek to broaden their competence to address the requirements for assurance over sustainability information.

Actions and areas of oversight need to be allocated across all audit committee members and not rest disproportionately with the chair.

? How has the audit committee assessed whether the number of members remains optimal for the committee to discharge of its remit and allow for an equitable distribution of members' efforts?

The UK Corporate Governance Code requires the audit committee to have a minimum membership of three, or in the case of smaller companies, two. A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

4.1.3 Committee membership

Overall audit committee membership will differ across jurisdictions. It is common for the board of directors to nominate all audit committee members from within its ranks. Where regulations mandate stakeholder representation on the board, the audit committee may be required to reflect a proportion of stakeholder representation.

Some jurisdictions require or allow audit committee members to be nominated directly by shareholders at the general assembly. This is similar to the ethos of the Italian **collegio sindacale**.

While the **collegio sindacale** is made up solely from investor-nominated members, some jurisdictions allow a mix of board and shareholder-nominated members. In such cases, including at least one board member within the audit committee ranks, preferably as the chair, can have significant benefits:

- It helps to provide alignment between the board and the audit committee and create appropriate channels for escalation.
- It avoids the audit committee becoming isolated from the business and ensures that the committee has an understanding of the overall business strategy. Without this, the audit committee may not be sufficiently informed to connect its risk oversight responsibilities with the relevant areas of the company's growth and focus.

4.1.4 Proportion of independent directors

As discussed in section 3.1, independence is a critical characteristic for audit committee members. Jurisdictions vary greatly regarding the proportion of independent directors on an audit committee — ranging from at least one, through to the majority, to all. Where non-independent directors are permitted to be on the audit committee, membership is generally prohibited for executive directors and the audit committee chair is expected to be independent.

? How has the audit committee assessed whether the proportion of independent directors is sufficient to robustly challenge management?

The UK Corporate Governance Code requires the board of a premium listed company to establish an audit committee of only independent nonexecutive directors.

According to the Financial Conduct Authority Handbook DTR7.1, a UK incorporated standard listed company must have an audit committee with at least one independent member.

4.1.5 Tenure (on the committee, on the board)

It is important to ensure that perspectives on the audit committee remain fresh. Given the complexity of the issues that audit committees deal with, however, it is critical to maintain a breadth of understanding of the business at the committee level. As such, audit committees may want to avoid having a high proportion of directors who have only recently joined the board and rotation/succession needs to be carefully managed.

As the UK Corporate Governance Code implies that directors with a tenure beyond nine years may no longer be independent, tenure on the audit committee is, in practice, limited to nine years.

4.1.6 Complementary and up-to-date skills

The audit committee, as a whole, needs to have the financial expertise and industry understanding to effectively discharge its core duties. Where only a single member holds a particular competence, the impact of their non-attendance at a particular meeting needs to be carefully considered. These considerations may also need to be factored into aspects such as what constitutes a quorum.

To address their evolving remit, audit committees should consider using a skills matrix to identify the competencies needed beyond financial and industry-related topics. Understanding of environmental and social reporting (see point 7.2.3) is an increasingly common area, as is cybersecurity (see point 9.3.2). These considerations will feed into succession planning.

Directors' skills and competence will be considered during the process of making appointments to the audit committee. Given the pace of change and evolving remit, committee members' existing skills need to be kept current and their knowledge requirements should be constantly re-evaluated. Certain aspects of ongoing professional development can be delivered via the company, but all directors should display curiosity and take personal ownership of their own development. This can be through formal, structured learning, but also through interactions with other audit committee members, e.g., through relevant networks (see section 3.9). This is especially relevant when some members are appointed as representatives of particular stakeholder groups and drawn from within their ranks, for example, the workforce.

? How are the audit committee members keeping their skills up to date? How are they determining which future skills the committee may need in light of the company's changing circumstances, its business model, risks and sector?

4.2 Structures – terms of reference or charter

The terms of reference, also referred to as the audit committee charter, document key considerations regarding how the audit committee is structured and how it functions.

4.2.1 Setting out and periodically reassessing core responsibilities

Terms of reference should set out the core responsibilities of the audit committee. They need to provide clarity on the committee's scope of responsibilities and protect the audit committee from scope creep or becoming the default committee for dealing with all new matters that arise. They also need to be tailored to the company, especially in respect of any industry-specific requirements and, where relevant, listing obligations.

At the same time, terms of reference cannot be so prescriptive, detailed or exhaustive that they create a compliance mindset that may limit the audit committee's independence in the way it chooses to deal with issues.

Terms of reference need to be revisited on a regular basis to make sure they remain fit for purpose and adapt to changes in regulations and the company's context. Similarly, audit committees may want to periodically reflect those responsibilities that the committee has taken on in practice, to ensure that the terms of reference accurately reflect the extent of what the committee does. An annual review is a requirement across many jurisdictions.

? How does the audit committee ensure that its terms of reference are being kept up to date so that they reflect not just the committee's mandatory responsibilities as specified in regulations or guidance, but also its de facto ones?

4.2.2 Interactions with other committees

An important consideration is making sure that terms of reference clearly delignate the role of the audit committee from that of other committees and the board. As discussed in point 7.2.3, in the context of sustainability there is an increasing overlap between topics covered by various committees. So, the terms of reference need to be clear about which aspects of a topic is within the audit committee's remit and which elements rest with other committees.

Another example relates to remuneration. The remuneration or compensation committee oversees incentive plans, but incentive plans impact on financial statements and also draw on a variety of financial and nonfinancial metrics, the accuracy of which is often overseen by the audit committee. Where overlap exists, care must be taken to ensure that activities are coordinated and that there is no unnecessary duplication or gaps.

? How clear are the protocols for the audit committee interacting with other board committees on overlapping topics, e.g., where human capital metrics impact executive remuneration?

Another area where responsibilities can be split relates to risk. This is prevalent within financial services, where it is not uncommon for there to be a requirement, or good practice guidance, that the board establishes a separate risk committee. This is discussed further in point 6.2.3.

Where overlap exists, the audit committee chair needs to ensure work is coordinated across the committees. This can be achieved, for example, through discussion between chairs, cross-committee membership or by periodically holding joint meetings.

4.3 Provision of information

Nonexecutive directors rely heavily on information shared with them by their executive colleagues and on the timing of that information. Audit committees require high-quality information that is prioritized and filtered, but not sanitized, and shared at the right time to allow for meaningful interventions. It is not uncommon for the CFO to take a leading role in providing administrative support to the audit committee in this regard. Nevertheless, there is clear benefit to the company secretary being involved. The company secretary has visibility of the activities of the other committees, can advise on governance trends and changes, and is less likely to be biased in respect of the information being provided.

References to the company secretary that follow should be deemed to refer to whomever is providing secretariat support to the audit committee.

4.3.1 Calendarizations, frequency and timing of meetings

The term calendarization refers to fixing forward agendas for the year ahead, reflecting the structure of the audit committee's annual workplan. A calendarization will tend to cover matters set out in the terms of reference, with a focus on meeting all regulatory and compliance requirements, and reflect routine matters. Typically, audit committees plan for between three to six meetings a year.

The proposed schedule for meetings will typically be aligned to a company's reporting cycle and linked to the timing of the audit committee chair's presentations to the full board. A calendarization will highlight whether the frequency of meetings is appropriate to allow sufficient interval for agreed actions to be addressed and delivered on. For example, the timing of the meeting at which the audit committee will be discussing the annual report and accounts needs to be planned sufficiently in advance of final approvals to allow for any arising actions to be taken forward. If not, this can create a sense of urgency and therefore pressure that could result in identified concerns not being properly dealt with.

Creating a calendarization helps to ensure that all known activities are being undertaken at the right time, and within the intended timeframe, and to balance the known workload across the planned meetings. If a forward agenda looks too heavy from the outset, it is unlikely to be flexible enough to address ad hoc issues that may arise and should be reworked. If it looks light, it might create an opportunity to incorporate a deep dive session.

? How does the audit committee challenge the calendarization to ensure that the number of planned meetings allows for all material topics and issues to be robustly debated?

4.3.2 Pre-audit committee discussions and briefing calls

A significant amount of effort is required to ensure that topical and ad hoc matters find their way onto the agenda and are adequately addressed. Very importantly, any concerns the external auditor may have in respect of internal controls and financial reporting need to be brought to the audit committee's attention ahead of the meeting.

The audit committee should regularly engage with management, internal audit and external audit between official committee meetings. In addition, one-on-one meetings may need to be held with those involved in delivering presentations, to inform them about the types of questions and challenges they should expect so that they can be well prepared.

Pre-meeting discussions are often held by the audit committee chair, giving them an opportunity to gain deeper knowledge of the areas to be discussed. In actual committee meetings, the audit committee chair should be conscious not to glide over matters that other members may not have a similar understanding of.

4.3.3 Agendas with time for white space and deep dives

Given the ever-expanding nature of regulatory obligations and regular monitoring requirements, it can be easy for the entire duration of an audit committee meeting to be taken up by purely routine matters set out by the calendarization alone.

Nevertheless, the compliance-related activities that rest with the audit committee cannot take precedent over matters of strategic importance. As discussed in point 4.3.1, actual meeting agendas need to refine the calendarization to include specific issues that have arisen and be responsive to critical topics. This may require the postponement of lower-priority, calendarized matters.

Agendas need to be set by the audit committee chair. Management plays a dominant role in preparing the information presented to nonexecutives, therefore the CFO or other members of management should input into the process. The audit committee chair needs to drive the priorities, however, and be purposeful in not allowing time to be taken up unnecessarily.

The positioning of topics on the agenda should take into account their priority and the availability of those presenting.

4.3.4 Length of meetings

When finalizing the agenda, the company secretary should liaise with the presenters to determine how much time they require and then hold the presenter to the allotted slot. For meetings to function efficiently, presenters should not be expected to summarize their papers — they need to be taken as read to allow sufficient time for robust discussion.

A balance needs to be struck between recognizing that brief meetings may not allow the audit committee to get to the crux of a particular matter and that energy levels, attention span and the ability to engage meaningfully will wane in meetings that are overly long. It is not unusual for meetings to last as long as four hours.

The audit committee chair plays an important role in enforcing the agreed timeframes. This includes keeping the discussion focused and not allowing the committee to get side-tracked. From time to time, the audit committee chair may need to recommend that further discussion takes place at a subsequent meeting or suggest that a particular topic should be debated further by the full board.

? How does the audit committee ascertain whether the meeting calendarization will allow time for white space and deep dives without making meetings overly long?

4.3.5 Format of meetings

Ideally, there would be ample time between the audit committee meeting and the board meeting to allow for progress to be made on at least the key actions that arose during the committee meeting. Companies can, however, be faced with an imperative to cluster all committee and board meetings around the same time, often on consecutive days, to minimize directors' travel time and costs. Online interactions that became prevalent during the COVID-19 pandemic removed this consideration. Virtual meetings can make cross-committee working easier and, in some cases, more effective, since actions from one committee that fall into another committee's remit could be addressed if their meetings were spaced out. They do, however, create the risk of reducing site visits and personal connectivity between members.

If permitted by local requirements and the terms of reference, the audit committee chair should consider a combination of virtual, physical or hybrid meetings that corresponds to the needs of the annual cycle.

It may also be beneficial to periodically hold in-person meetings outside the head office, in regional locations, allowing the audit committee to interact with different stakeholders.

4.3.6 Timely, focused pre-read material

Familiarizing themselves with all reading material ahead of meetings is a core responsibility for all audit committee members. The quality of the audit committee pack is fundamentally important to their ability to effectively prepare for meetings.

The purpose of including each paper in the pack needs to be evident. Audit committee members should be clear whether a pre-read is for information only, whether the matter is up for general debate, or whether their views are being sought on particular matters or aspects of the topic. There should be clarity that documents shared for information only do not receive tacit approval from the audit committee merely by virtue of having been included in the pack. Other documents need to clearly set out the questions and asks of the audit committee.

Where papers are being shared for information only, the audit committee chair should challenge their overall relevance to the committee and the level of detail being provided. For example, if management considers it important to inform the audit committee about a new policy that has been issued, a summary of key changes may be sufficient in place of sharing the entire policy.

Papers need to be provided in a timely fashion, allowing all members ample time to read them ahead of the meeting. This will mean that presenters can assume all papers are read and that key questions and concerns can be raised in advance.

For that to be feasible, the papers cannot be overly long or complex. It is not enough for there to be an executive summary, followed by reams of detail. Papers need to provide the granularity that is appropriate for the oversight role held by the audit committee and not stray into management territory. They need to include information, not raw data, and should not include jargon that impedes understandability. The company secretary should ensure that papers are provided in a consistent, standardized format.

If the pre-read materials were not made available sufficiently in advance to allow members time to prepare, the audit committee chair needs to consider whether a scheduled meeting should be deferred.

? How often does the audit committee receive the pre-read material in sufficient time to allow members to read and analyze the content, come prepared for active discussion and have action-oriented meetings?

? To what extent does the information in the meeting pack allow the audit committee to challenge management's views?

On new, critical and particularly challenging topics, the audit committee chair may need to engage upfront with those responsible for preparing the pre-reads, in order to clearly communicate the expectations and needs of the committee and ensure that the papers are appropriately targeted.

4.3.7 Attendance of nonmembers

Nonmembers attend the meeting at the invitation of the audit committee. Some invitees are present for the entire duration of the meeting, or its vast majority. Others are invited to contribute to specific topics only. It is important, however, for audit committee members to also have time to meet alone, without any others present.

? How does the audit committee intervene if the way in which attendees present does not facilitate effective debate and discussion on material issues or if debate and discussion are impeded by the presence of any nonmembers?

4.3.7.1 Attendance of nonexecutive directors who are not audit committee members

Due to the importance of topics on the agenda, directors who are not members are often keen to participate in audit committee meetings. The presence of the full board could have some negative consequences, however. It could inhibit the ability of the audit committee to function effectively, especially if the chair of the board inadvertently assumes a leading role in the meeting, resulting in undue influence over the independent work of the audit committee.

Additionally, when the audit committee chair presents the committee's findings to the board, those conclusions are again up for potential debate by the whole board. An often-overlooked consequence of all directors being in attendance at audit committee meetings is that this "double-challenge regime" is removed.

Healthy dynamics between the audit committee chair and the chair of the board are fundamental to the quality of governance and overall effectiveness of the board. There needs to be clear, open and timely communication between the two chairs and collaboration based on mutual respect and trust. This requires clarity on each other's roles and responsibilities and a willingness to engage in the constructive resolution of any disagreements that may arise.

4.3.7.2 Executive directors and other members of management

It is common for the CFO (or equivalent) to have a standing invitation to audit committee meetings. The CFO will often stay for the entire duration, except for time allocated specifically for the committee to meet without management present. This reflects the ongoing importance of finance-related topics to the committee's agenda. It is also not uncommon for the CEO to attend large parts of the meeting — especially when risks and internal audit activities are being discussed. In the case of a dual-board structure, audit committee meetings can sometimes be attended by the entire management board.

Other members of management tend to be invited for specific sessions only — as part of a deep dive or a topical presentation. Invitees can include the head of the risk

function, the chief information officer and the head of sustainability. In some jurisdictions, there is a legally binding right for some key function heads to attend the audit committee.

The audit committee chair must be cognizant of reporting lines between management providing input to the audit committee and the executive directors who may be present. While there are some standing topics where the audit committee meets without management present (e.g., with the external auditor), the audit committee chair needs to consider whether the presence of the CFO or CEO could compromise the willingness of members of management to speak freely and bring concerns to the audit committee.

4.3.7.3 Auditors and external specialists

Giving access to the entire audit committee meeting provides the external auditor with visibility into areas of the business that are fundamentally important to conducting a high-quality audit. It also signals to other attendees the strength of the relationship between the audit committee and the external auditor. Similar considerations apply to the head of internal audit.

The audit committee may also want to seek specialist views on specific matters and invite subject matter experts, either internal or external, to attend the meeting and provide a topical briefing to the members.

? Through what means does the audit committee obtain independent insights on specific topics to allow for robust challenge of management?

4.3.7.4 In-camera or executive sessions

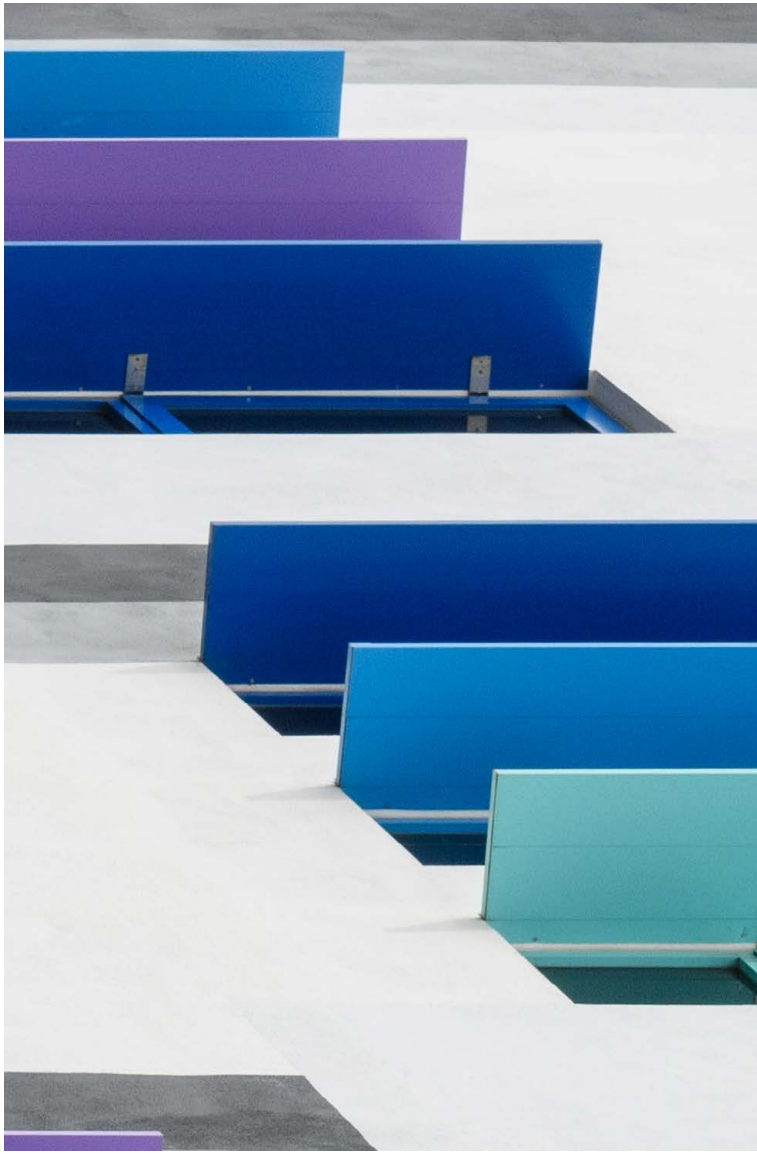
An in-camera or executive session is part of the audit committee meeting that specifically excludes certain attendees — for example, executives.

Audit committees tend to hold executive sessions with the external and internal auditor as a means of reinforcing their independence. In-camera sessions should also be held as a follow-up to matters discussed during the core meeting, if the audit committee chair felt that discussion had been inhibited and an unfiltered interaction is required. In-camera sessions may also be necessary when very sensitive matters are being discussed.

Executive sessions can create an air of secrecy, so allocating time for these as part of the calendarization normalizes the practice. For example, meetings with the external auditor without management present should be added as standing item at least for the audit committee meeting during which year-end results are being discussed.

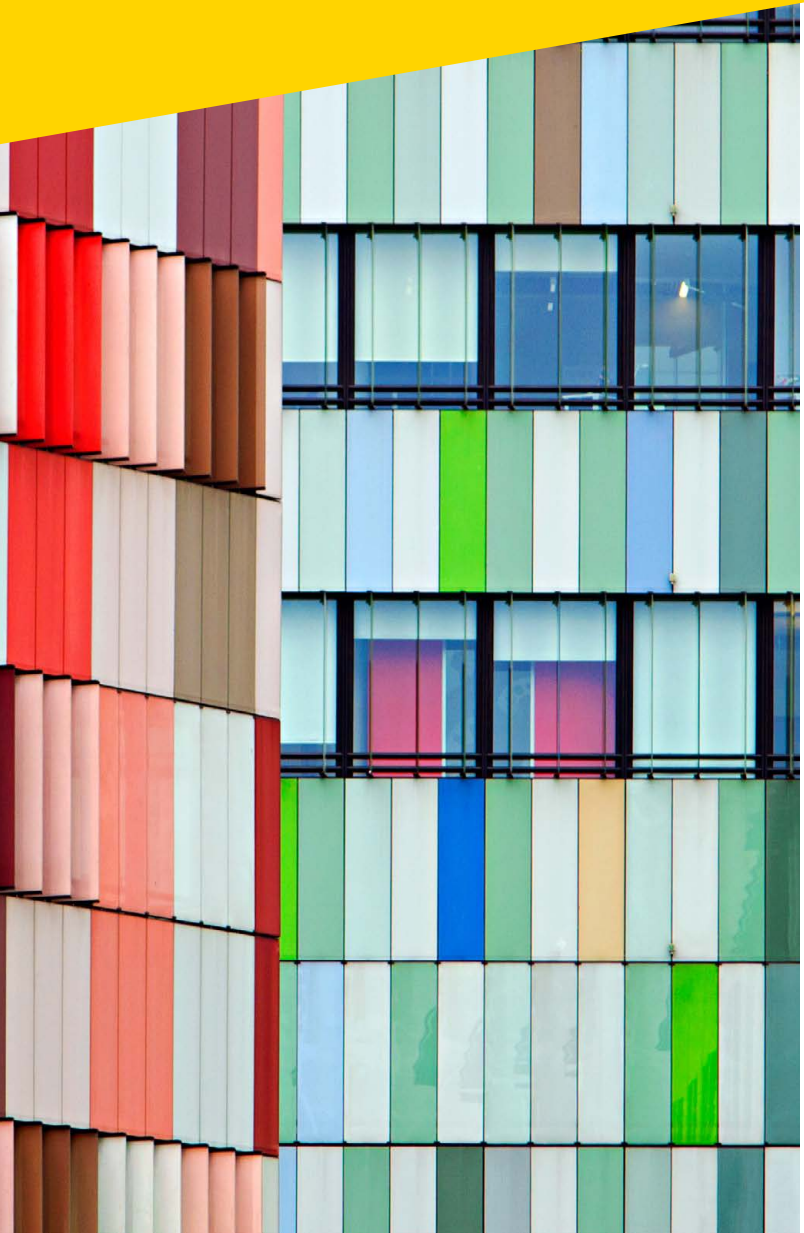
4.3.8 Working and connecting between meetings

Not all of the audit committee's work can be completed during its scheduled meetings. Members may need to connect on an ad hoc basis to deal with pressing matters that may arise. They may also need to remain involved with monitoring how actions agreed during a meeting are being taken forward. This requires open and effective communication with management and the capacity to participate in informal meetings when the need arises.



What: focusing on activities that will positively impact long-term value creation

5 What: tone at the top and stakeholder engagement



5.1 Tone at the top — a culture of integrity and compliance

Formalized processes and controls may not be able to keep up with the ever-increasing pace of change in the external environment. The right tone at the top and company culture, supported by a code of conduct (or equivalent), need to provide a framework within which to operate.

Corporate culture is the reflection of the organization's values, and the behaviors these values translate into. These behaviors, in turn, should support the achievement of strategic objectives. Companies will also foster a compliance culture, which acts as a set of guardrails for what is considered to be acceptable, ethical behavior. Typically, the whole board will oversee corporate culture, but the audit committee will often be tasked with oversight of the compliance aspects of culture and with promoting the importance of risk management, often referred to as risk culture and control consciousness.

The audit committee is uniquely placed to support the board with setting the right tone at the top, including through its own ethos, emphasizing the importance of good corporate governance. The audit committee needs to champion a culture of integrity, compliance and speak-up. It should also promote an environment where people can admit mistakes — learning, not blaming, needs to be the adopted mindset.

? How does each audit committee member champion integrity and accountability through their own words and actions?

5.1.1 Ethics and doing the right thing

The audit committee should promote adherence to the organization's code of conduct. The code should not only be readily accessible across the organization, but actively promoted to employees. Audit committees often want to be informed about completion rates for training in, or certification of compliance with, the code of conduct, where these are required.

As discussed in chapter 6, the audit committee plays an important oversight role in respect of risk management and internal controls. This contributes to creating an environment of consciousness around controls and managing risks within agreed tolerance levels.

? What visibility does the audit committee have into how the code of conduct (or its equivalent) is promoted and enforced across the organization?

5.1.2 Fraud, bribery, corruption and misuse of data

The definition of fraud, as per the Association of Certified Fraud Examiners publication "Fraud 101: What is Fraud?" is "any activity that relies on deception in order to achieve a gain."[5] Transparency International defines corruption as the "abuse of entrusted power for private gain."[6] Bribery is a type of corruption commonly considered to involve offering, promising or giving something to influence an official or other individual holding a public or legal duty. Often this is linked to obtaining or retaining business. Large-scale fraud is mostly very well thought through and very difficult to detect; it can involve collusion across various levels of management.

The audit committee needs an understanding of the incentives and pressures that may lead to management or employees committing fraud, especially in respect of financial reporting, or becoming involved in bribery and corruption. It also needs to understand which measures have been put in place by management to prevent and detect fraud.

By promoting integrity and bringing together insights from various aspects of its work — risk assessment, internal controls monitoring, whistleblowing oversight and insights from external and internal audit — the audit committee creates a culture that discourages negative behaviors.

In a similar vein, as companies collect increasing amounts of data about their internal and external stakeholders, audit committees may need to pay more attention to how that data is being collected and handled, as well as the potential incentives for misusing that data. The risk posed to organizations by abusive behaviors has increased significantly with the introduction of laws such as the EU's General Data Protection Regulation (GDPR).

? How has the audit committee analyzed outcomes of the organization's fraud risk assessment and considered implications for its remit?

5.1.3 Whistleblowing or speak-up

Regardless of regulatory requirements, audit committees should encourage the company to set up arrangements that allow individuals to raise concerns about unethical behavior in a confidential manner, protected from the risk of retaliation.

Many large organizations have official whistleblowing or speak-up hotlines, sometimes administered by external third parties. Originally, such arrangements were established with the primary aim of enabling employees to report allegations of management fraud or corruption. As such, oversight of the efficacy of the arrangements, and how cases were being dealt with, sat naturally with the audit committee. In recent years, however, increasingly more reports involve code of conduct violations relating to harassment and bullying. While these reports provide valuable insight into company culture, they may not be as directly linked to the audit committee's remit as allegations relating to fraud and corruption.

Audit committees need to agree protocols regarding the reporting of whistleblowing cases, including the types of complaints that may require immediate reporting. The audit committee should also oversee the overall effectiveness of the speak-up arrangements, including the efficacy and timeliness of the follow-up process and the means through which employees and other stakeholders are made aware of the reporting channels and encouraged to use them.

According to the UK Corporate Governance Code, the board should routinely review the arrangements by which the workforce can raise concerns in confidence, as well as the reports arising from the operation of these arrangements. In practice, this task is often delegated to the audit committee.

? How has the audit committee assessed the implications of whistleblowing cases on internal controls and corporate reporting? How has the audit committee considered what they may imply about the company's culture more broadly and about overall adherence to the code of conduct?

[5] "Fraud 101: What Is Fraud?" Association of Certified Fraud Examiners website, acfe.com/fraud-resources/fraud-101-what-is-fraud.
[6] "What is Corruption?" Transparency International website, transparency.org/en/what-is-corruption.

5.2 Stakeholder engagement

Where internal or external stakeholders wish to engage with the audit committee, the engagement will typically be undertaken by the audit committee chair, especially in respect of formalized communications.

5.2.1 Reporting to the board

It is customary for the minutes of audit committee meetings to be shared with the full board. When committee and board meetings are held close together, however, these minutes may not always be ready in time.

Even when minutes are available, the audit committee chair will commonly be expected to give the board an oral briefing on significant matters that came out of the recent audit committee meeting. While boards are typically less interested in the routine aspects of their audit committee's work, the level of detail in the reporting may need to be greater if the committee's work involves multiple members who are not also company directors.

? How does the audit committee chair keep the board informed about the material activities of the audit committee and its key decisions and judgments?

The Audit Committees and the External Audit: Minimum Standard, published by the Financial Reporting Council, stipulates that the audit committee's reporting to the board and the members of the company should explain how the committee has discharged its responsibilities with respect to the external audit.

5.2.2 Audit committee report in the annual report

An important means of stakeholder communication is the inclusion of an audit committee report within the annual report, although in dual-board jurisdictions there may just be a single report from the supervisory board covering the work of the audit committee.

In some jurisdictions, regulators specify elements that must be included in the report. Examples might be significant issues relating to the financial statements, an overview of how an external audit tender was conducted, or an explanation of how the internal audit function was assessed. Some audit committees choose to expand their reports beyond what is required.

The audit committee chair will work closely with the company secretary to draft the audit committee report, ensuring that it addresses any mandatory requirements and is an accurate reflection of the work undertaken by the audit committee over the course of the year.

The UK Corporate Governance Code requires that the annual report should describe the work of the audit committee, including the matters set out in the Audit Committees and the External Audit: Minimum Standard. Also, where there is no internal audit function, there should be an explanation for this absence, along with an explanation for how internal assurance is achieved, and how this affects the work of external audit.

5.2.3 Interactions with shareholders

The audit committee chair is responsible for addressing shareholders' concerns effectively and transparently. Anecdotally, interactions between audit committees and shareholders are rare.

The UK Corporate Governance Code notes that in addition to formal general meetings, the board chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against the organization's strategy. Committee chairs should seek engagement with shareholders on significant matters related to their areas of responsibility.

Furthermore, the Audit Committees and the External Audit: Minimum Standard notes that the audit committee should engage with shareholders on the scope of the external audit, where appropriate.

5.2.3.1 Annual general meeting

The audit committee chair will be on hand at the general assembly/annual general meeting to answer shareholder questions about the audit committee's activities. Unless a company has faced internal control issues, financial problems or accounting irregularities, it is unlikely that many questions will be directed at the audit committee chair.

In a dual-board structure, there may be regulatory restrictions on the supervisory board engaging at annual general meetings. For example, in Germany, it is the management board that addresses shareholders. This scenario has been evolving in recent years, with the chair of the supervisory board discussing topics related to supervisory board activity, including, if relevant, the activity of the audit committee.

5.2.3.2 One-on-one meetings

Direct engagement with investors on financial topics is typically handled by the CFO. Audit committee chairs may be brought into meetings to address specific issues within the audit committee's remit and some jurisdictions encourage audit committees to engage with investors on their views regarding external audit tendering. Anecdotally, direct dialogue between audit committee chairs and investors has been rare, however.

A comprehensive assessment of the state of key dialogues between UK companies and investors, conducted in 2023, concluded that while investors may not require a regular dialogue on audit and assurance processes, they are interested in maintaining an open line of communication and are prepared to engage when necessary.[7] Therefore, there is value in proactively communicating the availability of audit committee chairs for discussion.

5.2.4 Contact with the regulator

Audit committee chairs may be required to interact with regulators when there is an inspection of the annual report or if the external audit is ongoing. Interactions can range from submitting a written response to queries raised, to holding one-on-one calls to provide views on the external auditor.

A formal dialogue with the regulator on matters of policy is typically held either through an audit committee chair network set up in a given jurisdiction or through the audit committee's involvement in consultation responses submitted by the company.

5.2.5 Workforce interactions

The audit committee naturally interacts with a cross-section of employees due to the broad spectrum of presenters at its meetings. The committee may also want to consider conducting structured visits to different parts of the business, including international locations. Visits can help the committee to gain a better understanding of risks, as well as build relationships across the organization that encourage a speak-up culture.

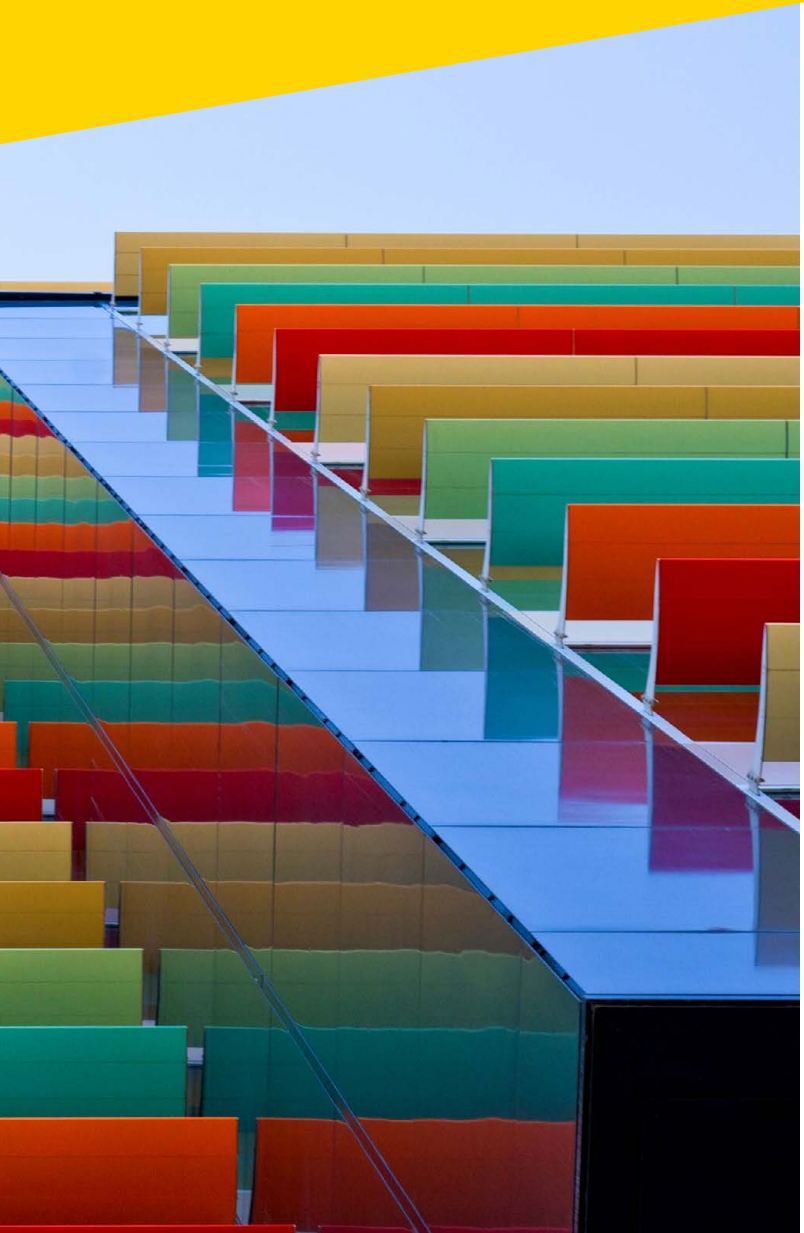
5.3 Strategy oversight and remuneration

Strategy is firmly in the purview of the board. By overseeing the accuracy of financial information, however, the audit committee enables the board and management to make informed strategic decisions. The audit committee may also oversee the reliability of other nonfinancial metrics that track progress against strategy. Financial outcomes and other metrics will often feed into executive remuneration.

? How has the audit committee sought to understand the effects of executive remuneration plans on management's behaviors?

[7] Shaping Tomorrow's Dialogues: Bridging the Gap between Companies & Investors, The Investor Forum, 2024.

6 What: oversight of risk management and internal controls



> Organizations of all types and sizes face internal and external factors and influences that make it uncertain whether and when they will achieve their objectives. The effect this uncertainty has on an organization's objectives is "risk."
>
> **The International Organization for Standardization (ISO), Standard ISO 31000 on risk management**[8]

Multiple definitions of risk exist. It is therefore important to distinguish between the concept of risk itself and the assessment of the amount of that risk a company is willing to take in order to meet its objectives. This attitude to a particular risk is known as risk appetite.

At a high level, risk management involves the following core components:

- First, risks need to be **identified**.
- Next, their **severity is evaluated**, often by reference to the impact and likelihood of the risk manifesting, and the risks are prioritized.
- Then, **responses** to the risks need to be developed. These can involve mitigating, avoiding, transferring or accepting the risks.
- Once response plans are put in place, these plans need to be **monitored** to make sure that they are working as intended. To increase confidence in the process, additional **assurance** can be sought over the effectiveness of the responses.
- Outcomes of monitoring and assurance need to be **communicated and reported** to those responsible for risk management and to the relevant governance body, with clarity on any improvements that may be needed.

[8] "ISO 31000:2018(en) Risk management – Guidelines," International Organization for Standardization website, iso.org/obp/ui/#iso:std:iso:31000:ed-2:v1:en

6.1 The Three Lines Model

In 2013, the Institute of Internal Auditors designed the Three Lines of Defense Model to provide a standardized corporate governance and risk management framework for the financial services sector. In 2020, the framework received a makeover. Now called the Three Lines Model, it is aimed more broadly at helping all organizations to implement risk management.[9]

The original model saw managing risk as being focused on protecting the business from outside threats through creating three distinct barriers. The updated approach is not just about defense, but also about how value can be added through managing risk. It focuses less on the distinct barriers and more on risk management principles. A summary of the model's six principles is provided for context.

6.1.1 Principles 1 and 2: governance and governing body roles

The governing body sets the direction by determining the organization's appetite for risk. It delegates the achievement of organizational objectives, including the management of risks to management (first and second lines of defense). Additionally, it establishes and oversees an internal audit function (third line of defense).

In order to exercise oversight and achievement of its objectives, for which it is accountable to stakeholders, the governing body relies on reports from management, internal audit and others.

6.1.2 Principle 3: management and first- and second-line roles

In more mature organizations (especially those in highly regulated industries), the first- and second-line roles will be clearly separated. In less mature organizations, it is more common to find overlap between the first and second lines.

The first line consists of operational management, which is responsible for identifying risks, evaluating them, and putting in place responses, which will be a combination of controls and other mitigating actions. It provides attestations on the planned, actual and forecast risk-related outcomes. The first line also operates internal controls, which are designed to manage risk within the organization.

The second line has multiple capabilities that will vary across organizations:

- It provides complementary risk management and internal control expertise to the first line.
- It monitors the controls implemented and operated by the first line and provides a degree of management (not independent) assurance over their effectiveness.
- It encompasses the risk function, which is responsible for compiling a company's risk register. A risk register lists out a company's risks, along with their levels, allocates the accountable risk owners, and specifies the key actions being taken in response. The leader of the risk function is often referred to as the chief risk officer (CRO).

Accountable risk owners can be from within the first or second line.

6.1.3 Principles 4 and 5: third-line roles and third-line independence

Internal audit forms the organization's third line and its role, among others, is to provide independent assurance on the effectiveness of the first and second lines. Internal audit does not make decisions or take part in risk management as such. As discussed in section 6.6, internal audit is primarily accountable to the governing body, although this can differ between jurisdictions.

Because of internal audit's independence from management, the internal assurance it provides carries the highest degree of objectivity and confidence. Further independent assurance may also be drawn from external providers.

6.1.4 Principle 6: creating and protecting value

The governing body, management and internal audit have their distinct responsibilities, but all activities need to be aligned with the objectives of the organization. It is only with all roles working collaboratively, and in alignment with stakeholder interests, that value is both protected and created.

[9] **The IIA's Three Lines Model: An update of the Three Lines of Defense**, The Institute of Internal Auditors, 2020.

6.2 Allocation of risk oversight to the governing body

The Three Lines Model makes it clear that the governing body is not involved in everyday risk management. Rather, it needs to be actively engaged in its oversight and provide top-down input into its components. To do so, responsibilities should be appropriately allocated between the board and its committees.

6.2.1 Role of the board

Moving away from the mindset that managing risk is predominantly about protecting the business from threats strengthens the critical link between risk and strategy. It is therefore generally accepted that it is the board that needs to be responsible for setting the risk strategy. The board needs to establish its appetite for major risks and translate this into risk tolerance levels. For nonfinancial risks, setting quantified thresholds may not be possible, and qualitative, detailed, directional guidance will be required.

The board needs to be satisfied that the risk management policies and procedures put in place by management are effective, i.e., that the company is operating within the designated risk appetite and tolerance levels, and that an enterprise-wide culture that supports appropriate risk awareness has been embedded.

The breadth and range of risks that boards must oversee is growing, as is the interconnectedness of these risks. Furthermore, the boundaries of risk are expanding to include third-party risks, most notably environmental and social impacts within the supply chain and cyber risks presented by the use of service providers. The full board is responsible for monitoring execution of the strategy. Accordingly, it should determine which risks need to be discussed by the full board, taking into account the magnitude of the organization's exposure to those risks and their potential to disrupt strategy. It should also determine which risks can be delegated to subcommittees, with the board nonetheless maintaining overall responsibility.

? How clearly do the audit committee's terms of reference delineate its responsibilities regarding risk management from those of the full board and other committees?

6.2.2 Role of the audit committee

Traditionally, audit committees were concerned with oversight of risks related to financial reporting and the related internal controls over financial reporting. Today, however, the role of many audit committees extends beyond this, with the audit committee taking on a role more significant than that played by other board committees. So much so that many audit committees are, in fact, called the "audit and risk committee." Nevertheless, if the audit committee takes on oversight of too many risks beyond those directly related to reporting, it may struggle to adequately discharge its other core duties.

For this reason, oversight of some risks may be delegated by the board to other committees. Even in those situations, the audit committee will typically act as the integrator of most, if not all, risks. This reflects the fact that all principal risks can potentially impact on the financial results and on the viability of the business. This also aligns with the role the audit committee plays in relation to internal audit (see section 6.6) and assurance more broadly.

To remain apprised of the risk universe, the audit committee may occasionally hold joint meetings with the other committees, organize joint deep dives into a particular risk area, and recommend to the board that overlapping members be nominated to the relevant committees.

6.2.3 Separate board risk committee

Financial services industry supervisory bodies, especially related to banking, may require or highly recommend that boards set up separate board risk committees. A board risk committee can both reduce the burden on the audit committee and focus all its attention on risk oversight, with members having a narrower skill set than that required of the audit committee.

The remit and functioning of a board risk committee is less universally consistent than that of an audit committee, given it is not one of the prevalently mandated committees. Board risk committees are not common outside of financial services, although they are sometimes established at other organizations with complex market, credit, liquidity, commodity pricing and regulatory risks –for example, energy companies or organizations within the health care sector.

Most critically, the board risk committee will focus on understanding how the organization's operational risks manifest, and their impact on strategy, with the aim of ensuring that the approach to risk is not only reactive. The board risk committee will be responsible for understanding the inherent risk, agreeing the

level of residual risk that will marry up with the agreed risk appetite, and challenging whether the proposed mitigating activities will achieve this level of residual risk.

Typically, the board risk committee will focus on the first and second line, with the audit committee maintaining the relationship with internal audit. The audit committee will therefore challenge internal audit's plan, making sure it is aligned to the key risks. It will also consider the assurance obtained from internal audit in the context of the broader assurance landscape. As such, the board risk committee may rely on the audit committee to oversee the effectiveness of the overall control environment.

? Where there is a separate risk committee, how clear is the division of responsibilities between the audit committee and the board risk committee?

One of the main roles and responsibilities of the audit committee under the UK Corporate Governance Code is reviewing the company's risk management and internal control framework. This is unless these matters are expressly addressed by a separate board risk committee composed of independent nonexecutive directors, or by the board itself.

6.3 Oversight of risk identification and evaluation

Risks can be broadly categorized into those that occur at the process level and enterprise risks that can impact at the level of the business model and strategy. Process-level risks will typically be captured in process or functional risk registers, with multiple process-level risks often rolling up into a single enterprise risk.

Given that risks are continually changing, they need to be reassessed on an ongoing basis within the first and second line. The audit committee should act as a fulcrum between the board and management by understanding the outcomes of bottom-up risk assessments and overlaying these with a top-down view on the evolution of strategic objectives, as well as on current and emerging enterprise risks. In doing so, the audit committee will need to challenge the prioritization of risks. Audit committees may also encourage management to conduct scenario analysis in order to understand the amplified impact of correlated risks.

? How regularly does the audit committee interact with the head of the risk function? To what extent is this occasionally supplemented with reporting from other representatives of the first and second lines, e.g., when the audit committee commissions a deep dive into a particular risk area?

Differing perspectives on board risk committees

Several members with experience of separate board risk committees said that they should be considered only when circumstances truly necessitate it. They cited challenges with overlap. "Issues of risk and audit are inextricably linked," one said. Another advised, "You want to be very thoughtful about forming a risk committee and think about what the scope of the committee would be, so it is not overly duplicative with the audit committee and avoids overlap with the full board. It's tricky. I have some caution about creating one in a nonfinancial institution. I could see it in a company with a complex, global manufacturing and supply chain environment where the risk committee could be very focused." One member stated, "We have enough committees and, practically, the information needs are covered by one or the other. Why should audit and risk be separated?"

Other members were more supportive of establishing a separate risk committee and pointed out the benefits it can provide. One noted that risk discussions require a different mindset from traditional audit matters, explaining, "There's a fundamental difference between the audit committee, which is there to oversee the reporting on what has happened, versus the risk committee, which is looking forward and scenario planning. This helps each committee focus on its primary responsibility and helps the relevant committee members make informed decisions. The thinking, analysis, and precision of information is different in the two committees."

Tapestry Networks, December 2023[10]

[10] **Audit Committees in a dynamic era of risk**, Tapestry Networks, December 2023.

6.3.1 Principal risks

Those enterprise risks identified as being of highest priority, tend to be referred to as principal risks. Many jurisdictions require public disclosure of principal risks (see point 7.2.1).

The audit committee will need to devote time to understanding the profile of principal risks, how various risks are interconnected, and how the connections are being tracked. Not only can the impact of multiple interconnected risks converging exceed the sum of each part, but interconnectedness can also accelerate the speed with which the risks materialize.

? How confident is the audit committee that it understands both the evolution of principal risks and their interconnectedness?

6.3.2 Emerging risks

New or future risks, with a potential impact that is not yet reliably understood or known, but where the assessment indicates it could be high, are often referred to as "emerging risks." The implications of emerging risks are difficult to assess, and the expectation is that they will evolve over time. They may dissipate altogether, they may exacerbate existing principal risks, or they may evolve into stand-alone risks. Time horizons for emerging risks can change rapidly and they are also very volatile, with significant changes possible in a relatively short period.

Companies need to put in place specific processes to identify emerging risks and monitor their evolution. Often, this involves horizon scanning by the second line and the use of future-back scenarios. Audit committee members, by virtue of not being embedded within the business, can bring fresh perspectives to the emerging risk assessment.

? How does the audit committee ensure that the discussion of principal risks leaves sufficient time to debate emerging ones?

6.3.3 Fraud risk

The impact of fraud on the economy is significant. According to the Association of Certified Fraud Examiners 2022 Report to the Nations, organizations lose 5% of their revenue to fraud each year.[11] Projected against 2021 gross world product (US$94.94 trillion, according to the report), this makes an annual global loss of more than US$4.7 trillion.

The magnitude of the loss, combined with the context provided in section 5.1 and increasing scrutiny over fraudulent activity from investors, regulators and other stakeholders, has implications for audit committees. Audit committees should ensure that in addition to an overall risk assessment, management has conducted a specific fraud risk assessment.

The UK government's Economic Crime and Corporate Transparency Act makes an organization criminally liable if it fails to prevent a fraudulent act perpetrated by one of its associated persons for its benefit.

6.4 Oversight of risk responses

Part of the role of the audit committee is to oversee the risk responses implemented by management.

The audit committee must challenge management over whether, in light of any changes to the nature and extent of risks, risk responses remain appropriate to ensure that the company is operating within the risk appetite set by the board. To enable this, the audit committee should oversee that management has identified relevant metrics for tracking risks and established clear accountability by identifying risk owners.

Where the design of the risk responses is adequate, the audit committee must satisfy itself that they are operating as intended. It should receive regular reporting from management on the outcomes of its monitoring of risk responses and commission internal and external assurance over management's conclusions. Periodically, it may also wish to obtain benchmarking of the practices against industry norms or peers.

6.4.1 Risk mitigation and the operation of effective internal controls

Risk mitigation is about accepting a risk but undertaking actions to reduce its severity to tolerable levels (within risk appetite).

Effective risk mitigation needs to be grounded in the right culture, underpinned by the right structure, and executed by the right people who operate based on policies and processes relevant to the context of the organization.

The overall culture of the organization, and its focus on integrity and compliance, is one of the most important risk mitigations. As discussed in section 5.1, the audit committee has an important role to play in fostering a risk-aware and control-conscious culture.

[11] **Occupational Fraud 2022:** A Report to the Nations, Association of Certified Fraud Examiners, 2022.

The mitigation of enterprise risks will vary depending on the nature of the risk. For example, external risks that are outside of the direct control of the organization may be mitigated by ensuring that effective business continuity, disaster recovery, and crisis management plans are in place. Downside risks, where there is limited to no appetite for risk, will be managed through policies, procedures and internal control systems, including entity-level controls as discussed in section 6.5.

At a process level, the principal means of mitigating risks is through the operation of a system of effective internal controls. The role of the audit committee in overseeing internal controls is also discussed in section 6.5.

6.4.2 Other risk responses

Where risks have been transferred rather than mitigated, the audit committee may occasionally ask to receive updates from management on major insurance programs.

Some risks cannot be successfully mitigated or insured against in a cost-effective manner. In such cases, the audit committee may need to recommend to the board an orderly withdrawal from certain activities. When that is not an option, the audit committee may require management to provide more frequent and detailed confirmations that contingency and disaster recovery plans are being kept up to date.

6.5 Internal controls

Internal controls are often categorized as:

- Entity-level controls — these are controls that pervasively impact an entity's environment and operations. They include rules, standards of conduct, policies and procedures. These controls are the foundation that allow all other controls, processes and programs to function effectively and will include, among other controls, some of the aspects discussed in section 5.1, such as the code of conduct.
- Transaction-level controls — these are controls embedded within individual processes and can be manual, dependent on information technology (IT), or automated.
- General IT controls — these controls provide a set of directives for controlling how IT solutions, systems and resources are used and managed.

The audit committee considers management's evaluation of whether the design of the controls is effective and requests reporting to assess whether those controls have been implemented and are working. It should understand any failures or weaknesses identified during a given period and hold management to account for timely remediation. The audit committee should take special interest in any instances of controls override.

? What reporting does the audit committee receive so that it can challenge management's view on the design and operational effectiveness of internal controls across its areas of responsibility? Is this reporting sufficiently regular and timely?

6.5.1 Internal controls over financial reporting

Effective internal controls over financial reporting are critical to producing accurate and reliable financial reporting. In evaluating internal controls over financial reporting, the audit committee needs to consider all categories of controls. It should also understand the role of any outsourced arrangements, such as payroll, and the role of any internal shared service functions.

To create a reference point against which to build a picture of what good looks like and judge effectiveness, the audit committee can choose to refer to a recognized internal controls framework. One such example is the so-called COSO framework, developed by the Committee of Sponsoring Organizations of the Treadway Commission.[12]

The audit committee should request regular information on the functioning of internal controls over financial reporting from the finance team, internal audit and potentially the CEO. It should also get views from the external auditor and specifically understand whether the auditor is taking a controls reliance or a substantive approach in the audit and, if relevant, why a controls approach cannot be adopted.

Duties of the audit committee may be more specifically defined where legislation requiring formal management attestations over internal controls over financial reporting is in force.

? Where management is required to make an attestation on the effectiveness of internal controls over financial reporting, how satisfied is the audit committee with the reporting it receives from those within the second line who test first-line controls?

Where management is not required to make such an attestation, what evidence does the audit committee receive to understand whether management has implemented effective internal controls over financial reporting? Which actions has the audit committee taken as a result?

[12] **Internal Control — Integrated Framework**, Committee of Sponsoring Organizations of the Treadway Commission, 2013.

6.5.2 Policies and procedures to prevent and detect fraud

Fraud risk is typically addressed by a hybrid of different functions such as procurement, human resources and compliance. As a result, oversight can be quite challenging. The audit committee should ensure that management has established programs and policies to both prevent and detect fraud and has clear protocols on what to do if potential fraud is detected.

In challenging management on the adequacy of its anti-fraud programs, the audit committee should draw on the insights it obtains from monitoring themes arising from whistleblowing arrangements, discussed in section 5.1.

6.5.3 Controls over other risk areas

The audit committee's work in respect of entity-level controls, as part of the internal controls over financial reporting oversight, will be relevant to many other risk areas, given the prevalent impact such controls have over the company. Similarly, oversight over IT general controls will also contribute to the oversight of controls relating to aspects of cyber risk.

To obtain additional evidence regarding controls over other risk areas, the audit committee may want to speak to owners of specific risks, have regular interactions with the chief risk officer, and request specific assurances from internal audit. The audit committee may also choose to receive reporting on the status of any certifications or affirmations provided by risk owners, if relevant. Where specific risks have been allocated to other committees, the audit committee may draw on their work and views. Close cooperation will be needed to make sure work is not being duplicated and that no material risk areas fall through the cracks.

6.6 Internal audit

There is no universal requirement for companies to have an internal audit function. Nevertheless, as the role of internal audit is to evaluate and improve the effectiveness of risk management, internal controls and governance processes, a well-implemented function is a great asset to an audit committee. Not only can the audit committee use the provided assurances in discharging its duties, internal audit is also often the audit committee's eyes and ears on the ground, able to bring cultural insights from across the organization. Where such a function exists, a good working relationship between the audit committee and internal audit is of fundamental importance and the audit committee is commonly responsible for overseeing internal audit.

? Where no internal audit function exists, which alternative sources of information does the audit committee obtain to effectively discharge its oversight of risk management and internal controls?

The following considerations are applicable to organizations that have an internal audit function.

6.6.1 Internal audit function

There are three main models of sourcing the internal audit function: in-house, outsourced or co-sourced. Inevitably, there are trade-offs associated with the choices. An internally resourced function is likely to be a lower-cost solution, with employees having a thorough understanding of the business, but likely a narrower breadth of expertise. Full outsourcing may give access to a better pool of specialists, but this may come at a price. The company will also have limited discretion over individual team members, although this will naturally increase their independence. A hybrid approach may be the best of both worlds.

? How does the audit committee ensure that internal audit sourcing arrangements remain appropriate for the organizational context and allow for adaptability and responsiveness?

In any case, the audit committee will need to be comfortable with the number and quality of internal audit staff – their skills, competence, continuing education and professional experience, as well as with their objectivity. It will also need to challenge whether they have an adequate budget and access to the right tools and technologies to carry out high-quality work. The audit committee should foster a constructive relationship between internal audit and the external auditor, recognizing that the degree of coordination between the two will vary depending on the jurisdictional context.

? What information does the audit committee receive that allows it to assess the caliber of internal audit resources – both staff and technology?

6.6.2 Head of internal audit

The internal audit activity is managed by a chief audit executive or head of internal audit. While this role may be outsourced in some cases, keeping it in-house provides greater control over internal audit and stronger accountability.

It is not uncommon for this role to have a dual reporting line — primarily to the audit committee, with a dotted line to the CEO.

In a two-tier board structure, such as in the Netherlands and Germany, it is not uncommon for the internal auditor to report to the management, with the supervisory board or its audit committee as the secondary reporting relationship. This potentially gives audit committees less influence over the internal audit function. Changes to corporate law in Germany guaranteed that the audit committee chair is able to approach the head of internal audit directly, but the management board has to be informed.

The audit committee chair should be involved not only in the selection of the head of internal audit but also in their appraisal and termination or replacement.

Certain factors can have an actual or perceived impact on the independence of the head of internal audit. For example, in some organizations, the head of internal audit also holds a joint role as the CRO. The Global Internal Audit Standards recommend that, in such cases, the responsibilities, nature of work, and established safeguards must be documented within the internal audit charter and alternative processes to obtain assurance over the work of the risk function must be established.[13] The audit committee will need to assess the adequacy of the safeguards and the alternative assurance processes. A hybrid model can be helpful in such circumstances.

Unlike the partner responsible for the external audit, who is subject to mandatory rotation, there is no regulatory limit to the tenure of the head of internal audit. The audit committee may wish to implement such a limit, however. Common practice is to base limits on those applicable to the external auditor, i.e., five to seven years.

? How confident is the audit committee that the head of internal audit will bring all potential matters of significance involving management to its attention?

6.6.3 Internal audit activities

Given the reliance that the audit committee places on internal audit, it is critical that it properly understands which activities are undertaken by internal audit and how it undertakes them. The Global Internal Audit Standards enable effective internal auditing and serve as a basis for evaluating and elevating the quality of the internal audit function. If the audit committee does not require internal audit processes and practices to align with these standards, it will need to consider on what basis it will assess the function's effectiveness.

Even when the standards are adhered to, the levels of testing and underlying methodologies are not necessarily equivalent to external audit. Therefore, the audit committee needs to be clear about the level of assurance it wants. Internal assurance maps need to be thoroughly assessed, and there needs to be clarity on what evidence the audit committee expects to see.

6.6.4 Internal audit plan

The audit committee should critically assess the scope of the internal audit mandate and whether it has unfettered access across the organization. An internal audit plan needs to address key business risks and related controls through the right combination of assessing the reliability of management's monitoring observations and performing its own assurance activities. The audit committee should evaluate the scope and coverage of the plan, rotation of activities, and alignment of activities to the highest priority risk assurance needs of the organization.

The effective use of available resources requires a periodic reassessment of the balance between internal and external assurance activities that may have been layered on over time. This may potentially allow for the release of internal audit capacity and its reallocation to other risk assurance needs.

The audit committee needs to ensure that there are adequate resources and sufficient budget in place to deliver on the plan.

? How well does the audit committee understand the levels of assurance provided by internal audit activities over the course of the year and the risk coverage that these achieved?

[13] "Complete Global Internal Audit Standards," The Institute of Internal Auditors website, theiia.org/en/standards/2024-standards/global-internal-audit-standards/free-documents/complete-global-internal-audit-standards

6.6.5 Internal audit reporting

The audit committee needs to have confidence that internal audit's reported findings were not in any way filtered by management. Reports should include a clear rating scale and set out the potential consequences of the findings. They should include a root cause analysis in relation to the findings and make practical recommendations to address issues that have arisen. Additionally, they should allow the audit committee to conclude whether the company is operating within risk tolerance levels that are in line with the risk appetite set by the board.

The audit committee should monitor progress against recommendations, with a specific emphasis on any matters noted as red flags. The timeliness of action being taken is an important culture indicator and evidence of management's commitment to improving risk management.

As an additional safeguard, the audit committee needs to hold separate executive sessions with the head of internal audit (see point 4.3.7.4) and may want to consider direct engagement with members of the internal audit team.

? What does management's attitude toward actioning internal audit recommendations tell the audit committee about the risk culture within the organization?

How does the audit committee hold management to account for promptly actioning internal audit's recommendations?

6.6.6 Assessing the quality of internal audit work

The audit committee needs to regularly assess the quality of the work undertaken by internal audit. In doing so, it should consider the following, among other considerations:

- How the audit plan meets the committee's assurance needs while considering effective use of resources
- How internal auditors are assigned to tasks and projects and also supervised
- Adherence to recognized standards and policies, while using up-to-date and innovative methodologies, including data analytics and metrics
- Delivery on plan and the clarity of written reports and relevance recommendations

Periodically, the audit committee may also wish to commission an external quality assessment. This can include an evaluation of conformance with the Global Internal Audit Standards. It should be noted that the Global Internal Audit Standards have recently been updated, with the new standards taking effect from January 2025. Under the updated standards, internal audit functions must be assessed against the International Professional Practices Framework.[14]

? How has the audit committee assessed the quality of internal audit's work? How is it monitoring whether any recommendations are being adequately implemented?

The audit committee chair plays a pivotal role in addressing conflicts that may arise between management and internal audit — especially with respect to budgetary or resource requests and the assessment of the magnitude and priority of findings. The strength of the chair's relationship with both the CEO or CFO and the head of internal audit is fundamental in this context.

Where there is no internal audit function, companies applying the 2024 UK Corporate Governance Code are required to provide an explanation for this absence, how internal assurance is achieved, and how this affects the work of external audit. In such circumstances, audit committees are required to annually consider whether there is a need for an internal audit function and make a recommendation to the board.

[14] "Complete Global Internal Audit Standards," The Institute of Internal Auditors website, theiia.org/en/standards/2024-standards/global-internal-audit-standards/free-documents/complete-global-internal-audit-standards.

7 What: oversight of corporate reporting

All public corporate information should be reliable. The range of what companies publish is very broad, however, and encompasses multiple voluntary documents that external stakeholders rely on — not all of which can be subject to the same level of oversight and scrutiny.

The annual report is probably the most important and comprehensive communication document for any public company. In many jurisdictions, it is made up of two distinct sections — the narrative commentary on the business and its performance, and the financial statements. The breadth of information included in an annual report, alongside the audited status of the financial statements, makes it the one version of the truth that should provide the basis and guide rails for all other communications.

Oversight over the audited financial statements is a core aspect of every audit committee's remit, often extending to aspects of the narrative disclosures included within the annual report. The audit committee's terms of reference need to be very clear as to whether the committee's remit also covers any reporting beyond the annual report, such as preliminary announcements, and interim reporting to the stock exchange.

> The US Securities and Exchange Commission recommends that companies set up management-level disclosure committees with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. As is implicit in section 302(a)(4) of the Sarbanes-Oxley Act, such a committee would report to senior management, including the principal executive and financial officers, who bear express responsibility for designing, establishing, maintaining, reviewing and evaluating the issuer's disclosure controls and procedures.
>
> Where a disclosure committee has been constituted, it is common for it to report to the audit committee about its meetings and activities. In some cases, the audit committee chair is invited to participate in the disclosure committee's meetings.

7.1 Financial reporting

For the purpose of this guide, financial reporting encompasses the audited financial statements in the annual report (and preliminary announcement, where relevant) and the quarterly and/or half-yearly announcements to the stock exchange.

The main roles and responsibilities of the audit committee under the UK Corporate Governance Code include monitoring the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance. The audit committee must also review significant financial reporting judgments contained within this information, providing advice (where requested by the board) 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 position and performance, business model and strategy.

7.1.1 Financial reporting process

Management prepares the financial statements (and any other financial information). The role of the audit committee is to oversee the financial reporting process and, in doing so, provide the board with confidence that the financial statements are true and accurate and present the performance of the business in a fair and balanced manner. The financial reporting process consists of:

- The posting of individual transactions in line with accounting standards and adopted policies
- Application of judgment and computation of estimates
- Preparation of financial statements, which include primary financial statements (e.g., statement of financial position, statement of profit or loss) and disclosure notes

All of the above, as discussed in point 6.5.1, are underpinned by internal controls over financial reporting: accounting processes, IT systems and internal controls.

? How has the audit committee challenged management on any voluntary changes to accounting policies, readiness for future mandatory changes in accounting standards, and the accounting for any material one-off or unusual transaction, if relevant?

What information, including external sources where relevant, did the audit committee use to challenge management over judgments underpinning material estimates? This could include independent specialist input.

7.1.1.1 Accounting policies

For the purpose of preparing and presenting financial statements, companies have to adopt a set of generally accepted accounting principles (GAAP) allowed in their jurisdiction. For example, over the past two decades, International Financial Reporting Standards (IFRS) have become widely adopted in capital markets worldwide and are now a globally recognized accounting framework. Many jurisdictions that maintain their local GAAP base it on IFRS. As such, the below approach draws on concepts embedded within IFRS.

As a general premise, the whole purpose of GAAP is to specify required accounting policies, presentation and disclosure. Nevertheless, judgment is involved in several circumstances:

- An accounting policy may relate to an area where an entity is required to make significant judgments or assumptions in applying that policy (apart from those involving estimations).
- Some standards allow an accounting policy choice.
- When there is a choice, an entity may be allowed to voluntarily change its accounting policy if it results in the financial statements providing reliable and more relevant information.
- In the absence of a standard that specifically applies to a transaction, other event or condition, management will have to use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. In the first instance, this involves considering the requirements in the applied GAAP that deal with similar or related issues. Secondly, management should look to definitions, criteria and concepts from the GAAP Conceptual Framework for Financial Reporting (if one is available). To the extent they do not conflict with these sources, pronouncements from other standard-setting bodies and accepted industry practice can also be considered.

The selection and application of accounting policies is crucial to the preparation of financial statements. Accounting policies should be selected and applied consistently for similar transactions, other events and conditions, unless an accounting standard specifically

requires or permits categorization of items for which different policies may be appropriate. Entities need to disclose material accounting policy information, including the choices and judgments applied.

Audit committees need to assess the overall appropriateness of accounting policies, especially where management has applied judgment, challenging any departures from GAAP and industry norms. Any voluntary change to accounting policies needs to be scrutinized. In its oversight role, the audit committee should focus on those policies that are most material to the financial statements and those that relate to judgments and estimates.

The audit committee should also ensure that management assesses the impact of any future, required changes to GAAP sufficiently in advance to ensure a smooth implementation of any resulting changes.

Under IFRS, an entity achieves a fair presentation by compliance with applicable standards in virtually all circumstances. It may be permissible to depart from the requirements of a standard only in extremely rare cases, when management concludes that compliance would be so misleading that the reported result would not faithfully represent the transactions, other events and conditions it purports to. Some regulatory frameworks may prohibit such departures altogether. Audit committees should robustly challenge management on such conclusions and expect that the auditor and regulators will do likewise.

Finally, audit committees should ensure that appropriate disclosures are provided on material accounting policies.

7.1.1.2 Estimates

An accounting policy may require items to be measured at monetary amounts that cannot be observed directly and must instead be estimated in a way that involves measurement uncertainty. Developing such accounting estimates involves a number of judgments:

- Selecting and applying a method or model for computing the monetary amount
- Identifying and/or developing assumptions and inputs for use in the method or model, based on the latest available, reliable information
- Selecting and interpreting data to develop the assumptions and inputs, which can be of a specialized, often nonfinancial nature

Depending on the extent of judgment involved, accounting estimates will have varying degrees of uncertainty, complexity and subjectivity. By their very nature, they will be prone to management bias. Intentional bias may be driven by pressures or incentives to achieve certain results and may lead to fraud; unintentional biases may be the result of management optimism or overconfidence.

As accounting estimates are approximations, they will need to be revisited and potentially updated as additional information becomes known, the circumstances on which they are based change, new developments arise, or more experience is gained. By its nature, a change in an accounting estimate does not relate to prior periods and is not a correction of an error.

For material estimates, the audit committee will need to understand the judgments made by management in arriving at the proposed measurement and related internal controls. In doing so, the audit committee should, among other considerations, remain cognizant of fraud factors and bias, ensure that judgments or assumptions are based on the latest available, reliable information, use objective and credible external data points where available, and probe management that appropriate specialist input was sought, if relevant. The audit committee should also understand how management reviewed the outcome of previous accounting estimates and responded to the results of that review.

Finally, audit committees should ensure that appropriate disclosures are provided on the assumptions made about the future and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

7.1.1.3 Other complex accounting issues and principal risk implications

Generally, the audit committee will not scrutinize the accounting for regular transactions and business-as-usual events, relying rather on the strength of internal controls over financial reporting. Matters with material impacts that are likely to require audit committee oversight include:

- Accounting for one-off events, such as acquisitions or disposals, or other non-reoccurring items.
- Unusual transactions, with a complex structure or business rationale.
- Off-balance sheet arrangements or special purpose entities.

Audit committees also need to ensure that management has adequately reflected the extent to which principal risks affect the financial statements.

? How has the audit committee satisfied itself that management has adequately accounted for complex accounting issues, principal risk implications and non-reoccurring items?

An evolving area of risk implications relates to the impact of environmental risks. As explained in the EY publication, Connected financial reporting: Accounting for Climate Change, there is no single explicit standard on climate-related matters under IFRS.[15] Nevertheless, climate risk and other climate-related matters may impact a number of areas of accounting. While the immediate impact on the financial statements may not necessarily be quantitatively significant, stakeholders increasingly expect that entities explain how climate-related matters are considered in preparing their financial statements to the extent they are material from a qualitative perspective. Stakeholders also expect robust disclosures on the most significant assumptions, estimates and judgments related to climate change.

? How did the audit committee assess the congruence between any narrative regarding climate change and the impacts of climate change accounted for in the financial statements?

7.1.2 Financial narrative outside of the financial statements

The narrative section of the annual report will often include a review of financial performance and a variety of metrics — both GAAP and non-GAAP measures. The audit committee should read these areas of the report and, with the context obtained through its oversight of the financial reporting process, advise the board whether the tone and messaging are consistent with its own understanding and the information contained within the financial statements.

7.1.2.1 Non-GAAP or alternative performance measures (APMs)

The European Securities and Markets Authority (ESMA) defines alternative performance measures (APMs) as financial measures of historical or future financial performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework.[16] APMs are usually derived by adding or subtracting certain amounts from the figures presented in financial statements.

The International Organization of Securities Commissions (IOSCO) defines a non-GAAP financial measure as a numerical measure of an issuer's current, historical or future financial performance, financial position or cash flow that is not a measure derived from generally agreed accounting principles (GAAP).[17]

APMs are different from physical or nonfinancial metrics such as number of employees or number of subscribers, and from social and environmental measures such as greenhouse gas emissions and breakdown of workforce by demographic diversity.

These modified measures of financial performance, often presented in the narrative section of the annual report or in other communications, can be useful to issuers and investors. In fact, they are often used as key performance indicators (KPIs) to track progress against strategic objectives. For example, it is common to see an adjustment to profits to remove one-off material impacts, in order to present an underlying profit that is deemed to be reflective of "business as usual." As these measures are not standardized, they can create problems, however. When inadequately defined, presented inconsistently, or given undue prominence over measures based on accounting principles, they can result in misleading messages. Using the prior example, as there is no universal agreement on what adjustments are appropriate to arrive at underlying profit, determining the amounts to exclude can be prone to bias or outright manipulation.

To address this risk, ESMA has issued guidelines on APMs and IOSCO has published its Statement on Non-GAAP Financial Measures, with the aim of assisting issuers in providing clear and useful disclosures that are understandable and reliable.

[15] Applying IFRS — Accounting for Climate Change (Updated August 2023), EY, 2023.
[16] "ESMA updates its Q&A under the Alternative Performance Measures guidelines," European Securities and Markets Authority website, esma.europa.eu/press-news/esma-news/esma-updates-its-qa-under-alternative-performance-measures-guidelines.
[17] Statement on NON-GAAP Financial Measures, International Organization of Securities Commissions, 2016.

Audit committees play an important role in overseeing how such measures are selected, calculated and displayed. They should also challenge whether their use does, in fact, improve transparency and contribute to presenting a balanced view of the company's performance.

Audit committees should be aware that Accounting Standard IFRS 18 **Presentation and Disclosure in Financial Statements**, effective from 1 January 2027, sets out new overall requirements for presentation and disclosures in the financial statements, which will impact the presentation of APMs.

? How has the audit committee challenged management on its selection and use of non-GAAP measures?

7.1.3 Competency and strength of the finance function

Internal controls over financial reporting are critical to producing accurate and reliable financial reporting. Nevertheless, even the most sophisticated systems and processes cannot operate effectively without an appropriately resourced and competent finance function.

To oversee the accuracy of financial reporting, the audit committee must understand the organization's finance resource model and make sure that there is adequate budget for people and infrastructure.

The audit committee needs to draw on a variety of sources to form its assessment, as well as on the financial competence of its members. The external auditor can provide multiple insights — for example, by producing bespoke analysis on the volume of late journal entries posted by management. Similarly, discussing audit adjustments, including those recorded by management, can be a useful point of reference. The audit committee should also seek specific feedback from internal audit as part of its executive sessions.

? On which sources of feedback did the audit committee base its assessment of the overall strength of the finance function?

In conjunction with the nomination committee, the audit committee should also monitor whether succession plans are in place, not just for the CFO, but also for at least one level below.

7.1.4 Regulatory inspections

Regulators conduct inspections of the financial statements of companies within their supervisory remit. Typically, the chair of the board and/or the audit committee chair will be informed of the review and will receive an enquiry letter setting out the regulator's initial questions.

The audit committee chair will need to be involved in the working group that responds to the enquiry from the regulator. The working group will typically bring together members of the finance team and the external auditor.

Following the receipt of responses, the regulator will likely issue its findings letter. Depending on the severity of the findings, and the statutory powers of the regulator, the company may be asked to improve its disclosures in future years or, in the case of more serious noncompliance, remediate the reporting through restatements. The audit committee will need to consider the broader implications of any such findings, including on the effectiveness of internal controls over financial reporting and management's approach to judgments and estimates.

7.2 Nonfinancial reporting

Nonfinancial reporting encompasses narrative reporting and nonfinancial metrics. These aspects are typically interwoven to provide a holistic narrative about the business in a manner that is both interesting and useful for a variety of stakeholders.

7.2.1 Narrative reporting

Companies and their boards use the annual report as an opportunity to tell their story — often setting out the business model, strategy, market trends, etc. The extent of the narrative that is included can reflect a combination of voluntary and mandatory disclosures. For example, some jurisdictions require the narrative within the annual report to describe the company's principal risks and/or approach to risk management.

As much of the narrative provides context for the company's financial results, the audit committee members should scrutinize the entire annual report to ensure that there are no inconsistencies with the assumptions embedded within the financial statements. The audit committee should pay particular attention to those disclosures that address its areas of oversight and assess whether the narrative is consistent with its own understanding, obtained as part of its role.

Some jurisdictions designate the audit committee as responsible for reviewing certain areas of mandatory reporting.

The Finnish Corporate Governance Code suggests that the duties of the audit committee could include reviewing the corporate governance statement and proposing it to the board for approval. While this is not mandated, it is common practice for Finnish audit committees.

Where there are mandatory disclosure requirements, the audit committee needs to be clear whether its remit involves overseeing the completeness of associated disclosures.

? Having read the narrative in the annual report, which potential inconsistencies with the information contained in the financial statements, or with the picture of the company it was presented with throughout the year, did the audit committee query with management?

7.2.2 Nonfinancial metrics

Nonfinancial metrics are those numerical disclosures that are not derived from a company's financial records, e.g., operational metrics. Some of these, such as client satisfaction measures (net promoter score), can be industry-agnostic. Others, like volumes of reserves and resources for mining companies, can be sector-specific.

Audit committees will need to be clear as to whether the board expects the audit committee to oversee the accuracy of nonfinancial metrics, including metrics on environmental and social topics. The audit committee's general knowledge of assurance concepts makes it well placed to support the board in this respect, but the proliferation of the metrics included in annual reports can make this a very time-consuming task.

? To what extent is the level of oversight that the audit committee has over the accuracy of prominent nonfinancial metrics commensurate with the reliance placed on those metrics by stakeholders?

How has the audit committee considered the adequacy of assurance over these metrics?

7.2.3 Environmental and social reporting

Environmental and social (E&S) reporting is a combination of narrative and nonfinancial metrics. In recent years, the prevalence of reporting on E&S topics has been expanding. This is both in response to the expectations of investors and other stakeholders, as well as in response to regulatory reporting requirements.

While E&S issues are increasingly explored within the annual report, many companies have developed an entire suite of reports focused on sustainability. Some of these are dedicated to a single topic and some, often referred to as sustainability reports, cover all E&S matters considered to be material.

Governance practices over E&S matters have been evolving for a number of years, without specific regulatory requirements. Usually either the full board or a dedicated sustainability committee will be responsible for determining the materiality of an E&S topic, selecting metrics to track progress, setting targets and establishing plans to achieve those targets. The more importance boards place on sustainable business strategies, the more the control environment underpinning the production of E&S metrics and goals will need to become as strong as internal controls over financial reporting. Audit committees' experience of business risks, risk management systems, reporting processes and assurance makes them uniquely placed to oversee:

- Whether the processes for data collection that underpin reporting are robust and lead to reliable, quality reporting (the COSO framework was updated in 2023 to address internal control over sustainability reporting – ICSR)[18]
- Data provenance
- The reasonability of underlying assumptions
- What external assurance, if any, may be appropriate

The importance of these considerations cannot be underestimated. Consumers, investors and regulators are increasingly demanding ethical and sustainable business practices. The commercial benefits that can be gained from meeting this demand can also lead to companies portraying services and products as "green," even if the underlying business activities do not strictly warrant these claims.

[18] Achieving Effective Internal Control over Sustainability Reporting (ICSR), **Committee of Sponsoring Organizations of the Treadway Commission, 2023.**

Greenwashing can be defined as the act of making inaccurate, misleading, or unsubstantiated claims about the sustainability benefits of products or services offered, or about a company's strategic aspirations and actions.

There is alignment between this definition and the definition of fraud according to the Association of Certified Fraud Examiners (see point 5.1.2). When a company makes such claims, this could be considered as making a false representation or failing to disclose the true nature of the sustainable aspects of the product or service.

While guidance for regulations under the UK government's Economic Crime and Corporate Transparency Act is not yet available, it is likely that greenwashing meets the definition of fraud under the new failure to prevent fraud offense.

In addition, audit committees must consider whether:

- All regulatory reporting requirements have been complied with.
- The interconnectivity between these topics and the financial statements, and the integration between E&S considerations and financial reporting — for example, the impact of climate transition risks on recoverability of certain assets (as noted in point 7.1.1.3).

? How clear is the division of responsibilities between the audit committee and any other relevant committee regarding oversight of narrative reporting, including on environmental and social matters?

The EU Corporate Sustainability Reporting Directive (CSRD)

The EU CSRD introduces legislative requirements for the audit committees of in-scope companies. They must oversee company sustainability reporting in line with European Sustainability Reporting Standards (ESRSs), as well as related processes and related assurance. Audit committees' terms of reference will need to reflect the requirements to:

- Monitor the company's sustainability reporting and related processes, including the process to identify the information reported according to the relevant sustainability reporting standards.
- Submit recommendations to ensure the integrity of the sustainability information.
- Explain how the committee contributed to the integrity of the sustainability reporting and what its role in that process was.
- Monitor the effectiveness of the company's internal control and risk management systems, and its internal audit function, particularly in relation to the risks of fraud and greenwashing.
- Monitor the assurance of annual and consolidated sustainability reporting.
- Inform the company's administrative or supervisory body about the outcome of the sustainability reporting assurance.
- Review and monitor the independence of the statutory auditors and audit firms.

Corporate Sustainability Due Diligence Directive (CSDDD)

The EU CSDDD will require in-scope companies to implement due diligence activities aimed at addressing the actual and potential adverse impacts of their activities on human rights and the environment. Due diligence will need to cover not just the companies' own operations, but extend across their entire value chains, covering both direct and indirect business relationships.

Audit committees will need to consider how these activities dovetail into the broader risk management framework and, therefore, the role the audit committee will need to play in supporting management's process for compliance with CSDDD.

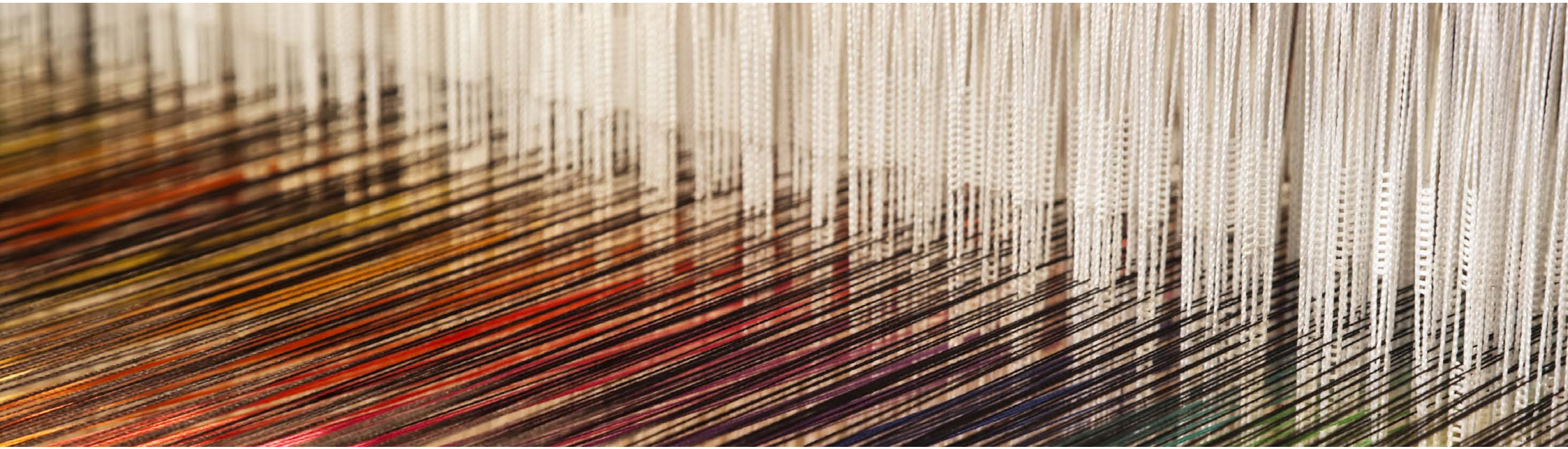
7.3 Electronic tagging

In simple terms, electronic tagging is the electronic communication of structured business data, by providing a machine-readable tag. Tags allow information to be read and understood by a computer, enabling quick and effective peer comparisons, reviews of cross-sectional or time series data for patterns or variances, updating of forecasts with as-reported information, and more. Reports generated from tagged information are used by regulators, companies, governments, data providers, analysts, investors and accountants.

eXtensible Business Reporting Language (XBRL) is an open, international standard for the tagging of financial and nonfinancial information in digital form. It is used in more than 50 countries. The conversion of information into XBRL involves tagging so called "concepts." These concepts are defined in a taxonomy that acts like a dictionary. Since national jurisdictions have differing underlying requirements, they have developed taxonomies to address their varying reporting needs. A commonly used taxonomy, based on IFRS and applicable to EU issuers, is the European Single Electronic Format (ESEF), developed in 2019 by ESMA.

The scope and extent of requirements for XBRL tagging vary across jurisdictions. In many countries, such as India, filing of annual reports using XBRL is mandatory for some, but not all, companies. In the United Arab Emirates, all listed companies are required to file financial reports in a machine-readable format. Within the EU, the CSRD requires companies to digitally tag reported sustainability information in XBRL format, based on a taxonomy being developed by the European Financial Reporting Advisory Group.

To ensure the accuracy of XBRL tagging, it is necessary to have an understanding of the tags available within the relevant taxonomy and of the annual report itself. Unnecessary custom tagging reduces the comparability of data, while the use of incorrect tags is misleading. Despite this, assurance over tagging is not universally required. In most EU member states, the independent auditor provides an opinion on whether financial statements comply with ESEF RTSs. Furthermore, anecdotally it seems there is limited to no involvement from audit committees in overseeing the accuracy of electronic tagging.



8 What: overseeing the external audit

Shareholders and other stakeholders use information provided in annual reports when making economic decisions. The primary objective of an external audit is to provide independent assurance, based on professional standards, that a company's financial statements are free from material misstatement, give a fair representation of its financial performance and position, and are therefore a good basis for decision-making.

Fundamental to this objective is the external auditor's independence, which requires a direct reporting line between the auditor and the audit committee. The audit committee, not the CFO, owns the relationship with the external auditor and is responsible for the appointment, remuneration and oversight of the external auditor.

To enable an effective, quality audit, the audit committee must set the proper tone at the top by establishing the expectation of open, candid and direct communication between management, the external auditor and the audit committee, as well as ensuring unfettered access to information relevant to the audit's execution.

The audit committee's role in respect of oversight of the external audit is set out in the Financial Reporting Council's Audit Committees and the External Audit: Minimum Standard.

Joint audits

Since 1966, French regulations have obliged companies with consolidated accounts to be subject to a joint audit. Some countries require joint audits for specific industries or sectors. In South Africa, for example, joint audits are mandatory for banking groups.

A joint audit is where more than one auditor is jointly and severally responsible for the audit opinion. The joint responsibility stems from the auditors' acceptance of their joint appointment, as evidenced by the audit engagement letter. Special provisions exist in the event of disagreement between the joint audit firms as to the formulation of their audit opinion.

This is different from a shared audit, which involves the primary auditor subcontracting parts of a group audit to one or more firms which report back their results, with the primary auditor solely signing off the group audit opinion.

> "In joint audits, two (or more) audit firms are appointed to share responsibility for a single audit engagement and to produce a single audit report. Joint audits typically involve joint planning, fieldwork allocated between the firms, and a cross-review by each firm of the other's work. The firms jointly report to the audit committee and are both party to the audit report.
>
> International Federation of Accountants[19]

When dealing with joint audits, audit committees need to be conscious of the heightened complexity of navigating independence requirements and managing rotation. In the EU, the Audit Regulation and Directive (ARD) encouraged the adoption of joint audit by allowing a maximum auditor tenure of 24 years with no tendering required, compared with sole audits being subject to tendering after 10 years and a maximum tenure of 20 years. It is not common to rotate the joint auditors at the same time.

In respect of auditor interaction, representatives of all involved firms attend critical meetings, including all audit committee meetings, and written communications will also be issued jointly. Audit committees may, however, be faced with disagreement between the joint auditors, although this is a rare occurrence. The ability to compare the performance of the joint auditors can provide the audit committee with a live benchmark that can aid in the assessment of auditor effectiveness and audit quality.

[19] Joint Audit: The Bottom Line — The Evidence is Unclear, International Federation of Accountants, 2020.

8.1 Independence and objectivity

To have confidence in the audit opinion, stakeholders want to know that the work was performed to appropriate standards. They also want certainty that it was provided by a third party that is fully independent and therefore objective and unbiased. For these reasons, external auditors are subject to laws or professional standards regarding independence. The International Ethics Standards Board for Accountants (IESBA) Code of Ethics provides a global benchmark for independence and a foundation for many local requirements.[20]

Common issues that may impact on independence include providing certain types of non-audit services, the relative value of fees earned from services other than the audit, relationships between the auditor and the organization, and the length of involvement of the audit firm and individual audit team members in the particular engagement.

In the UK, auditors have to comply with the Financial Reporting Council's Revised Ethical Standard 2024, which introduces additional restrictions compared with the IESBA Code of Ethics.

The auditor must be independent in fact, as well as in appearance. It is not enough for the auditor to abide by all the de facto independence requirements set out in legislation and professional standards. The auditor also needs to avoid any actions that could create a perception that independence might have been impaired. While the onus is on the external auditor to police its own independence, the audit committee has a crucial role to play in challenging and supporting how the auditor goes about doing this.

8.1.1 Non-audit services

Any services provided by the auditor in addition to the external audit are referred to as non-audit services. They typically fall into three categories, as follows:

- The external auditor is not banned from performing certain non-audit services, but equally these can be provided by others.
- The external auditor can be prohibited from providing certain services. For example, it is universally unacceptable for the auditor to be involved in designing or implementing internal controls over financial reporting since it would then be marking its own homework when testing those controls as part of the audit.
- Some services can only reasonably be provided by the external auditor because of the overlap with procedures that form part of the financial statement audit, e.g., the review of publicly available interim financial information (see point 8.5.1).

Audit committees of public interest entities are required to approve non-audit services to be performed by the auditor. It is best practice for all audit committees to have a policy in such regards that is reflective of local requirements and recognizes the need to maintain the perception of the auditor's independence. Such a policy will typically set out the types of services the auditor may be allowed to perform, value thresholds for approval, and the circumstances in which pre-concurrence or pre-approval is required. As permissibility alone is not sufficient to justify awarding non-audit work to the external auditor, the policy may set out the criteria for awarding work to the auditor when it could be reasonably performed by another provider.

As any permissible non-audit service has the potential to impact on the auditor's independence, the auditor must assess the threats to independence arising from such services and which safeguards should be put in place to mitigate those threats. The audit committee must consider the nature of the potential service to ensure that it is within its policy and does not jeopardize the external auditor's independence. The audit committee may request that the auditor prepares a written assessment to support its considerations.

An important consideration of the overall assessment is not only the nature of the services, but also their individual and cumulative value. If a high proportion of the overall fees earned by the audit firm are from non-audit services, this on its own could create the perception of impaired independence on the basis that the auditor may be unwilling to robustly challenge management during the audit for fear of losing lucrative non-audit opportunities. The audit committee must therefore closely monitor the level of non-audit revenues earned by the auditor.

In the EU, the ARD caps the total fees that an audit firm can receive from a public interest entity for non-audit services at 70% of the average of the audit fees received from that company in the last three years.

Some jurisdictions have introduced ratios related to audit and non-audit fees in a single year. These may require additional independence considerations.

[20] International Code of Ethics for Professional Accountants, International Ethics Standards Board for Accountants website, ethicsboard.org/iesba-code.

Even when a service is within policy and fee thresholds, the audit committee should take a step back and ask how the awarded service could be perceived by a reasonable person looking in from the outside.

? How comprehensive is the policy covering the awarding of non-audit services to the external auditor?

8.1.2 Financial, business and employment relationships

Audit regulations apply restrictions on investments held by professionals employed by the audit firm in an audited entity. It is the responsibility of the audit firm and the individuals involved to ensure compliance with such restrictions.

Similarly, direct and in some cases, material indirect business relationships — such as joint investments and alliances, sponsorships and other go-to-market activities, or other cooperative business relationships — are restricted. Purchase of goods and services as a consumer may be permissible if it is in the ordinary course of business, but consideration needs to be given to the overall frequency and nature of such purchases.

The audit committee should obtain an understanding of how the auditor manages adherence with personal independence requirements and of its approach to tracking and assessing business relationships. The committee should also have an awareness of the auditor's systems underpinning these processes.

Furthermore, there are different employment restrictions on immediate and close family members for professionals employed by the auditor, as well as cooling-off periods for former members of the audit engagement team. The audit committee should make sure that the company has relevant hiring policies that reflect these considerations.

8.1.3 Partner and key engagement team members rotation

Long association of audit team personnel with the entity can also be considered a threat to independence. On the one hand, continuity improves the audit team's understanding of the business, but on the other, it can create a level of familiarity that impedes robust challenge.

For this reason, and to periodically refresh perspectives, the lead audit partner and certain other key engagement team members are subject to rotation requirements. These will differ by type of involvement and type of entity. After a team member has rotated off, they will be subject to a cooling-off period before they can re-join the team.

The audit committee should monitor the auditor's reporting on adherence to these requirements and periodically discuss the succession plans that the team has put in place. This is most important in respect of the lead audit partner and the audit committee may want to assess the shortlist of potential candidates in advance. While the entity cannot decide on the change of the lead audit partner, its input into the lead partner selection process can, to a great extent, mirror the approach taken as part of an audit tender (see point 8.2.3.2), with interviews, input from management and the taking of references.

8.2 Auditor tendering and appointment

It is common for local legislation to require the tendering of the statutory audit of public interest entities. Where such a requirement does not exist, it is still considered to be good practice.

Audit committees are more directly involved in tenders than nonexecutive directors typically are in any other company business and, in this respect, they exercise authority over management. Given the long-term nature of the relationship with the auditor, advising on the appointment of the external auditor is one of the audit committee's most important tasks.

Refer to Appendix B for sources of UK requirements in relation to audit tendering.

Audit chairs typically have individual responsibility for aspects of a tender process and lead the process.

While audit committees lead the tender, management's role is vital to the project's ultimate success and goes beyond administrative tasks. Executives, including the CFO, and often the broader finance function, should be involved in recommending criteria and conducting their own evaluations.

At the end of the tender process, the audit committee is commonly expected to present the board with two choices and its preference.

8.2.1 When to change auditor

The maximum tenure of an external auditor, and therefore the requirement for when the audit needs to be tendered and rotated, varies between jurisdiction, and will depend on type and size of company and whether or not there is a joint audit in place.

In the UK, PIEs are currently required to put their audits out to tender every 10 years, and to rotate auditors every 20 years.

Nothing prohibits a firm from tendering or switching audit firms before it is legally required to do so. In fact, audit committees should consider having a set of potential triggers to consider out-of-cycle rotation, such as inadequate audit quality, independence breaches or significant mergers with a company audited by another firm. Other events can accelerate a timeline aligned to legal requirements — for instance, a change to the audit committee chair, lead engagement audit partner rotation, or anticipated retirement of the CFO. Where an organization has multiple public interest entities, it may be preferable to align tender activity across the various audit committees.

8.2.2 When to run the tender process

Audit committees need to determine the year in which they want the new auditor to be in situ. They may also want to consider how far in advance of that date they want the process to run in order to manage independence and other supplier relationships.

Running the tender in advance allows competing firms that are providing prohibited services to finish or unwind the contracts in an orderly fashion. Certain services are subject to a cooling-in period. Typically, this means that a new external auditor cannot have provided these services in the 12 months prior to the start of the first period for which they are external auditor.

In the UK, the following services are subject to a 12-month cooling-in period: implementing internal control or risk management procedures related to the preparation or control of financial information; designing and implementing financial information technology systems; and internal audit.

Audit committees may also want to consider the broader tendering landscape. In some sectors and countries, there may be a limited number of auditors with the necessary experience and skills to perform an audit in a particular industry. As such, audit committees sometimes consider when another company will be rotating its audit when developing their timelines.

? What is the audit committee's indicative time frame for when the next audit tender process will be run and for which financial year end?

How is the audit committee overseeing the ways in which management is factoring in independence considerations when awarding service contracts to potential future external audit providers?

8.2.3 Tender timeline

Once an audit committee has elected to launch a tender, the first step is to agree to an overall timeline. The timeline should allow sufficient time for a thorough assessment, but not be so long as to create an ongoing distraction for management and the audit committee. Proper planning is necessary to minimize the timeline.

The timeline for a tender consists of two major phases:

- Phase 1: internal activities undertaken ahead of the company issuing the official request to tender
- Phase 2: post-issuance activities

8.2.3.1 Phase 1 considerations

As part of phase 1, the audit committee should establish the approach to governance and stakeholder management for the tender and determine the selection criteria to be used consistently when evaluating participating firms across all components of the process.

Selection criteria can be divided into essential and preferred criteria and can include:

- Accounting and auditing technical ability, combined with experience in the industry
- Geographical presence
- Application of technological advancements to audit methodology
- Caliber of proposed lead partners and engagement teams, considering both competence and chemistry
- Value for money

Once these have been established, an initial request for expression of interest can be sought from potential audit firms, asking for a confirmation of capacity, capabilities, and ability to become independent by the time of appointment.

The selection criteria can subsequently be used in the process of the ongoing assessment of audit effectiveness and quality, discussed in section 8.4.

8.2.3.2 Phase 2 options

Options to consider as part of phase 2 can include:

- Partner interviews (by audit committee and by management)
- Visits to locations by participating bidders
- Management meetings at the head office
- Technical challenge
- Written submissions
- Oral presentations

Once a request for tender has been issued, and the participating audit firms have signed a nondisclosure agreement, they should be granted access to a data room, with information on the company, to allow them to submit a tailored proposal. This may include reporting from the incumbent auditor.

The audit committee chair should work with management to decide what information the audit firms can access to ensure prospective firms have a proper understanding of the business.

Many audit committee chairs meet with the lead partners of bidding firms early in a tender process. They also take references for the lead engagement audit partner and the audit partners in each major geography. The firms should also meet relevant stakeholders within the business. Site visits to key locations support the development of the proposed audit approach and allow for feedback so that the participating firms can refine their propositions. Since the COVID-19 pandemic, site visits have increasingly been held virtually, especially with respect to overseas locations. At the head office, site visits can be organized in the form of carousel meetings for efficiency reasons. With carousel meetings, all key stakeholders are brought together on one day, with firms rotating between meetings. This is as much an opportunity for audit firms to learn about the business as it is for management to observe the prospective auditors.

Technical tests, or workshops, can also be a valuable part of the process and provide a practical means of demonstrating how the proposed core audit team will work with specialists and management. Example topics could include an assessment of challenge and professional skepticism through a workshop on a historic audit or accounting issue. A data challenge could involve providing firms with access to financial data and asking what conclusions can be drawn, or what questions need to be asked. In setting such challenges, the audit committee needs to be conscious of any potential consequences should previous accounting be deemed incorrect. It should also be mindful of perceptions that this could be seen as "opinion shopping" by the incumbent auditor.

The audit committee and management assess the written submissions and then typically select two candidates to present to the audit committee, often with the CFO in attendance. The oral presentation is the opportunity for the participating firms to present their proposition and to answer questions from the audit committee. Despite advances in virtual meeting technology, the current prevailing view is that there is still a strong preference for the final oral presentation to be in-person.

Based on this oral presentation, the audit committee will make a decision and typically present two firms and its preference to the full board.

8.3 Annual audit cycle

A typical audit cycle involves the following core stages: planning; execution of interim procedures, including consideration of processes and controls testing where relevant; year-end testing, including procedures relating to the annual report; and sharing of observations on areas for potential improvement noted during the audit, including those relating to internal controls over financial reporting.

8.3.1 Audit planning and the scope of audit

The audit process begins with detailed planning. During this phase, the audit team will perform multiple risk assessments to develop the audit strategy that determines the scope of work and the procedures necessary to arrive at the audit opinion.

When scrutinizing the audit plan, the audit committee should, among other considerations, ensure that:

- The reasons for any divergence between the auditor's assessment of the company's risk profile and the audit committee's own understanding are clearly explained and that no risks of concern to the audit committee have been missed.

- Compared with the prior year, the plan has adequately evolved in response to changes in the business.
- The resourcing of the engagement assumes adequate involvement from executive team members.
- There will be sufficient involvement of specialists and that the audit committee will have access to those specialists it may wish to hear from directly.
- The proposed timing of the procedures allows for reporting of issues early enough to enable their orderly resolution.

Separately, the audit committee should evaluate the mix of proposed procedures (i.e., controls testing, data analytics, use of forensic capabilities, etc.) and locations where these will be performed. While these procedures will be designed to obtain the evidence required to arrive at the audit opinion, the audit committee may request that they are expanded on to additionally address matters where the audit committee would value insights.

Some jurisdictions recommend that the audit committee chair obtains views from stakeholders, most notably shareholders, on the audit plan.

? How did the audit committee oversee the audit plan to ensure that it will facilitate the delivery of a high-quality, effective and efficient audit?

How did the audit committee assess whether the audit fee is commensurate with the planned effort?

8.3.2 Interim procedures

Interim procedures refer to activities performed by the auditor ahead of the company's financial year end. Commonly, interim procedures include work related to the understanding of processes and testing of internal controls over financial reporting as part of the interim phase. Auditors are also increasingly applying analytics to test data populations partway through the year and topping up the procedures later on.

Interim procedures reduce the amount of work to be performed at the year end and help to identify potential issues early, allowing more time for their orderly resolution. Performing some audit procedures earlier in the audit cycle can minimize the risk of any delays to the finalization of the audit. Spreading the workload can also be beneficial to the finance team. The audit committee should engage with the auditor on auditing significant one-off transactions ahead of the year end.

? How did the audit committee hold management to account for addressing any findings from the interim phase of the audit in a timely manner and ahead of the year end? What reporting did it receive regarding adjustments made to the audit plan in response to any such findings?

8.3.3 Year-end procedures

Regardless of the amount of work completed in advance, the effort that goes into finalizing the audit once the books have been closed at the year-end is substantial and typically time-pressured.

The audit committee chair should maintain open lines of communication with the CFO and the lead engagement audit partner during the execution of the year-end audit to ensure that any issues are discussed and hopefully resolved in advance of the audit committee meeting.

The auditor will officially communicate the results of the audit to the audit committee in a written report that remains private and is presented at the year-end audit committee meeting. This report typically includes an overview of the execution of the audit in respect of key risk areas and assessment of going concern, as well as any findings and conclusion, including audit differences.

Audit differences are the known and projected misstatements identified during the audit process. As long as both the individual and combined impact of the adjustments is not considered by the auditor to result in a material misstatement of the financial statements, leaving the differences unadjusted will not impact the audit opinion. The audit committee should, nonetheless, challenge management as to why it has chosen not to process all the misstatements identified by the auditor and consider their impact on its own conclusion about the financial statements.

Any differences that remain unadjusted are reflected by the auditor in the so-called letter of representation. This letter is provided to the auditor by management, confirming that management has fulfilled its responsibility for the preparation and fair presentation of the financial statements and for the completeness of the information provided to the auditor. The auditor may also request that the letter includes

representations in support of other audit evidence relevant to the financial statements or specific assertions in the financial statements. The audit committee should scrutinize this letter and understand the reasons for any non-standard representations being requested in a given year.

If not included in the auditor's report, the audit committee should also ask to see a list of the differences that had been reflected in the financial statements. It should understand the reasons why these errors had arisen and what steps management will take to address similar errors going forward.

The auditor will also prepare a public "auditor's report," which includes the audit opinion on the financial statements to be included in the annual report. The format and content of the report are governed by auditing standards and must adhere to certain reporting requirements. For many companies, this report will set out key audit matters – those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. The audit committee should understand any divergence between key audit matters and its own understanding of risk areas and judgments. It should consider the interaction between the key audit matters and the related commentary in its own report (see point 5.2.2), if relevant.

? How confident is the audit committee that the audit plan was effectively executed and that procedures performed were sufficient to reach an audit opinion?

8.3.4 Management letter points

Throughout the annual cycle, the auditor will make numerous observations about matters such as the effectiveness of internal controls over financial reporting, the strength and competence of the finance function personnel, the financial statement close process, preparedness for upcoming changes to accounting standards, and qualitative observations on narrative reporting, along with other observations.

The auditor will share any significant observations directly with the audit committee. Additionally, a summary of other observations arising from the audit may be included in a document addressed to management, often referred to as the "management letter points report." All items within this document should be clearly rated, with indications of expected remediation timelines where relevant. The audit committee should monitor how management addresses the findings.

? What role does the audit committee take in overseeing management's response to observations provided by the external auditor and any audit differences that were identified?

8.4 Monitoring auditor effectiveness and audit quality

Assessing audit quality cannot be a purely backward-looking, formalized process conducted after the audit has been finalized. It needs to be an ongoing endeavor to ensure that the audit committee can make timely interventions. The assessment should be carried out in parallel with the audit and be informed by timely input from management.

Audit quality is difficult to define and even more difficult to measure. It is for the audit committee to decide which data points and other inputs, commonly referred to as audit quality indicators (AQIs), it wants to consider in performing its assessment. As set out in the May 2022 Accountancy Europe factsheet, there are multiple global initiatives aimed at standardizing AQIs that audit committees can look to for inspiration.[21]

Generally, AQIs can be split between those that relate to the audit practice of the firm (in some cases, at firm-wide level) and those that relate to the specific engagement. Some AQIs may warrant looking at through both lenses – for example, overall staff turnover rates for the firm and the degree of continuity of the engagement team.

? What process has the audit committee put in place to assess audit quality throughout the year? Which data points and other inputs support the assessment?

[21] **Audit Quality Indicators: A global overview of initiatives,** Accountancy Europe, 2022.

8.4.1 Audit practice or firm-wide AQIs

AQIs that are not specific to the engagement may only be available at certain points in the year when the relevant data for the audit practice is collated and published. Examples include:

- Tone at the top determined by audit firm survey results
- Annual revenue per audit partner
- Levels of training and professional development
- Results of regulatory inspections
- Results of firm-wide independence testing
- Investment in innovative technology

The Financial Reporting Council expects the UK's largest audit firms to publish 11 firm-wide AQIs relating to perceived culture within an audit firm, audit quality inspection results, staff workloads, and the level of partner involvement in audits.

8.4.1.1 ISQM 1

The International Auditing and Assurance Standards Board's (IAASB's) International Standard on Quality Management 1 (ISQM 1) includes robust requirements for the governance, leadership and culture of professional accountancy firms. It also introduces a risk assessment process to focus the firm's attention on mitigating risks that may impact the quality of the engagement. Additionally, the standard requires firms to more extensively monitor their system of quality management to identify deficiencies that require corrective actions and to provide a basis for evaluating its overall effectiveness.

ISQM 1 also requires firms to evaluate their system of quality management, on an annual basis. Firms are required to make public the outcome of the evaluation and audit committees may want to understand any findings that had arisen during the year and their potential implications on the audit engagement.

In the UK, the Financial Reporting Council adopted the IAASB's ISQM 1 and issued the International Standard on Quality Management (UK) 1 in July 2021 (subsequently updated in March 2023). Effective from 15 December 2022, the standard expanded the scope of the IAASB's standard to include additional services and other specific requirements.

In its Audit Committees and the External Audit: Minimum Standard, the Financial Reporting Council recommends that as part of its effectiveness assessment, the audit committee should ask the auditor to explain the risks to audit quality that it has identified and how these have been addressed.

8.4.2 Engagement-level AQIs – engagement team indicators

Engagement-level AQIs need to be agreed between the audit committee, the auditor and management, clearly setting out everyone's respective roles and expectations. Auditor selection criteria and other commitments agreed as part of the tender process (see point 8.2.3.1) should be considered in determining the appropriate measures. These can include:

- Technical expertise in accounting and auditing
- Engagement team experience of the sector/industry
- Engagement team continuity
- Partner workload and responsiveness
- Audit hours by risk, audit phase or level of staff
- Offshore shared service center delivery as a percentage of total hours
- Topics and level of specialist engagement
- Timing of audit execution, including progress against milestones
- Effective use of technology
- Internal quality control results or results of regulatory inspections of the audit

In its Audit Committees and the External Audit: Minimum Standard, the Financial Reporting Council recommends that as part of obtaining evidence of the effectiveness of the external audit and the auditor, the audit committee may want to consider engagement-level AQIs. These AQIs would be agreed with the audit committee and the auditor would report against them on a regular basis.

8.4.3 Other sources of information

There are multiple sources of information that the audit committee may wish to consider, many of which can be quite subjective. These include:

- Timely, proactive communication that prevents problems from escalating
- Degree of skepticism and challenge demonstrated by the team
- Caliber of insights delivered as part of the core audit

8.4.4 Management's role

Audit committees may also want to consider management's role in audit quality, by assessing aspects such as:

- Timeliness and quality of management deliverables to the auditor
- The strength of internal control
- Remediation of control deficiencies

8.5 Non-audit assurance

Financial information can be subject to an audit or to a review. In contrast to an audit, a review is not designed to obtain reasonable assurance that the financial report is free from material misstatement. Its objective is to enable the auditor to express a conclusion around whether anything had come to its attention that caused it to believe that the financial report was not prepared, in all material respects, in accordance with an applicable financial reporting framework. This is achieved by the auditor making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other higher-level procedures. While providing a lower level of assurance than an audit, a review opinion adds credibility.

Nonfinancial information can be subject to limited or reasonable assurance. Limited assurance is the equivalent of a review; reasonable assurance is the equivalent of an audit.

The audit committee needs to consider the level of internal assurance that exists over reporting and determine whether any form of external assurance, beyond what may be legally required, should be obtained to meet stakeholder expectations.

8.5.1 Assurance over mandatory quarterly or half-yearly financial reporting

Half-yearly or even quarterly reporting of financial results is required by many listing authorities. Some jurisdictions require such reporting to undergo a review by the external auditor.

Where a review is not mandated, the audit committee should consider whether one should nonetheless be commissioned. Even though it is lighter touch than an audit, a review may bring significant matters affecting the interim financial report to the auditor's attention. Any such issues can be addressed at that time and avoid surprises at the year end, such as the need to amend how a transaction had been accounted for in the first half of the year when preparing the year-end financial statements.

Alternatively, the auditor could perform targeted procedures in respect of material, complex transactions that were executed in the interim period being reported on.

? Has the audit committee thoroughly considered the extent of procedures the external auditor should perform over interim financial information, if any?

8.5.2 Assurance over nonfinancial reporting

As noted in section 7.2, companies can include a significant amount of important nonfinancial information in their annual reports. This is often supplemented with additional stand-alone reporting.

In determining the most appropriate assurance strategy, the audit committee will need to carefully consider the relevant regulatory framework across all reporting locations, as well as the interconnectivity between elements of the nonfinancial information and the financial statements, e.g., the impact of environmental risks on asset valuations and provisions (see point 7.1.1.3).

? How has the audit committee considered the expectations of external stakeholders when assessing the adequacy of assurance obtained over nonfinancial disclosures in the annual report and accounts?

9 What: other areas of responsibility

9.1 Financial condition and projections

Many judgments and estimates, such as asset valuations, have to take into account the company's financial condition and financial projections. Oversight of these aspects of financial reporting will contribute to the audit committee's understanding of matters related to solvency.

? How has the audit committee satisfied itself that, where relevant and to the extent this is appropriate, there is consistency in the financial projections and models underpinning the various disclosures, both within the financial statements and in the narrative section of the annual report?

9.1.1 Going concern and solvency considerations

Financial statements are normally prepared on the assumption that the company has neither the intention, nor the need, to enter liquidation or to cease trading. Rather, it will continue in operation for the foreseeable future and will therefore be able to realize and discharge its assets and liabilities in the normal course of business. This is referred to as the "going concern" basis of accounting.

There may, however, be circumstances that cast doubt on this assumption and directors are required to consider all the facts and circumstances that may be relevant. Management therefore prepares a going concern assessment with sufficient detail to explain the basis of its conclusion with respect to the entity's ability to continue as a going concern. The audit committee has to scrutinize this assessment and consider factors including:

- Has management prepared monthly cash flow forecasts and monthly budgets for a period of at least 12 months from the date of the financial statements? Is there a known cliff edge soon after the end of the analyzed period?
- Are assumptions underpinning the monthly forecasts and budgets reasonable and adequately supported?
- Have forecasts been tested by sensitivity analyses on the significant assumptions, particularly in relation to levels of activity? Is the range of reasonably possible outcomes wide enough in the context of market volatility?
- Do cash outflows accurately reflect the timing of known liabilities, commitments and repayment dates?
- How feasible are any assumptions regarding new sources of finance or capital? Has the risk of breaching any loan covenants been adequately assessed?
- Has consideration been given to any contingent liabilities or high-velocity risks that could materialize over the assessment period?

The audit committee will also have to make sure that the disclosures in the annual report and accounts are a fair reflection of the assessment undertaken by management and its outcomes, especially where material uncertainties had been identified.

The UK Corporate Governance Code requires the board to state whether it considers it appropriate to adopt the going concern basis of accounting. The code also requires the board to prepare what is referred to as a "viability statement." To prepare this statement, the board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so, and why it considers that period to be appropriate. Most boards choose a three-year period, although some extend this to five or even seven years.

The board should state whether it has 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.

The audit committee is responsible for reviewing the viability statement and challenging management's assumptions. It should establish whether there has been modeling of sufficiently severe, but plausible, scenarios of principal risks.

? How has the audit committee challenged management's assessment of the company's ability to continue in operation?

9.1.2 Funding and ability to make dividend payments

Capital allocation is a strategic issue for the full board. Some boards rely on the financial expertise of the audit committee to oversee funding and liquidity, however. This may involve regularly assessing how debt is being managed, how compliance with covenants is being monitored, and what funding options are being considered by management.

In other cases, the board may ask the audit committee to perform a treasury deep dive when a material new funding arrangement is being considered, or advise the board on liquidity considerations as part of any dividend distribution proposals.

The Dutch Corporate Governance Code explicitly states that the audit committee should monitor the management board regarding the funding of the company. The Finnish Corporate Governance Code suggests that the duties of the audit committee could include monitoring the company's funding position.

9.2 Monitoring related party transactions

The concept of related parties in financial reporting standards and corporate governance regulations typically encompasses:

- A person or a company that controls, or has significant influence over, the company
- Entities that are under the control of the company, or that are under common control with the company, particularly in group structures
- Key management personnel

Entering into related party transactions is not generally prohibited, but related party transactions do create the potential for abuse, e.g., controlling owners taking advantage of minority shareholders by extracting private benefits. The Organisation for Economic Co-operation and Development's G20/OECD Principles of Corporate Governance[22] establish monitoring of related party transactions and managing conflicts of interest as an important board function:

V.D.7. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

V.E.1. Boards should consider assigning a sufficient number of independent board members capable of exercising independent judgment to tasks where there is a potential for conflicts of interest. Examples of such key responsibilities are ensuring the integrity of financial and other corporate reporting, the review of related party transactions, and nomination and remuneration of board members and key executives.

How this is enshrined into the corporate governance landscape varies greatly by jurisdiction and is also often dependent on the nature and materiality threshold of a particular transaction. Certain related party transactions may require board approval in line with statutory legislation, others the approval of (non-interested) shareholders under listing rules.

It is recognized that the controlling owners' potential influence over the board could limit the effectiveness of the board's role in the process. This is why many jurisdictions require the involvement of independent directors, including

[22] "G20/OECD Principles of Corporate Governance," Organisation for Economic Co-operation and Development website, oecd.org/corporate/principles-corporate-governance.

those independent from majority shareholders, in the process of approving related party transactions.

Effective from 2023, the Securities and Exchange Board of India strengthened the approval and disclosure processes relating to related party transactions. Not only have the amendments expanded the scope of related party transactions, they have also significantly increased the obligations on audit committees.

Among other obligations, relevant related party transactions and their subsequent material modifications now require the prior approval of the independent members of the audit committee. In response to corporate scandals where material fraudulent related party transactions were undertaken at a subsidiary-level to escape regulatory scrutiny, listed entities' audit committees have to approve certain subsidiary transactions. Furthermore, independent directors need to verify that the company has a robust process in place to ensure that related party transactions are carried out on an arm's-length basis and in the ordinary course of business.

In fact, in some cases, the level of involvement expected of independent directors could even be seen as stepping into the shoes of the executive.

The related party transactions regulation in Italy (issued by CONSOB) includes a special procedure for material related party transactions, which:

- Requires the involvement of a committee of independent directors in its negotiation
- Requires approval of the transaction by the board of directors, subject to a clean opinion from the above-mentioned committee

This is not the norm, however, and a more common approach is a formal requirement for the audit committee to review RPT transactions. The audit committee's role will be distinct from the board's role in that it will be less focused on the commercial merits of the transaction and more on the risks that it carries.

Where such a requirement does not exist, it is still common for the board to seek the audit committee's views, given the overlap of related party transactions with many aspects of the work the audit committee undertakes as a matter of course:

- Related party transactions carry a heightened risk of fraud. So, as part of its oversight of risk management and internal controls, the audit committee should ensure that there are robust policies and procedures in place governing related party transactions outside of the ordinary course of business. These need to cover identification, valuation, approval and reporting of related party transactions and should set out the types of transactions that must be reviewed, the timeline for review, and the process for obtaining relevant approvals.
- In respect of individual transactions, the audit committee should challenge management if, among other considerations, the transaction is overly complex, has unusual terms, lacks an apparent logical business reason, or is processed in an unusual manner. The audit committee should also remain vigilant about the aggregate impact of transactions that may, individually, not meet materiality thresholds set out in the relevant policy.
- Accounting standards generally require the disclosure of related party transactions in the annual report while the audit committee oversees the completeness and accuracy of the disclosures as part of its role in respect of the financial statements. The audit committee therefore needs to be confident that all related party relationships had been identified and all relevant transactions disclosed. If management states that transactions were carried out at arm's length, the audit committee should scrutinize this assertion.
- Furthermore, the external auditor is also required to obtain sufficient appropriate audit evidence about whether the related party transactions have been appropriately identified, accounted for and disclosed in the financial statements. As part of its oversight of the external audit, the audit committee needs to make sure that the external audit plan is sufficiently robust in addressing related party transactions.
- The audit committee may also direct internal audit to review the framework for related party transactions or to scrutinize particular transactions.

? How thorough is the audit committee's understanding of management's policies and procedures underpinning the identification and disclosure of related party transactions?

9.3 Mandated topic areas and deep dives

Some governance codes enumerate additional specific topics that should be overseen by the audit committee, including matters such as:

- Tax planning or policy, related risks and controls, accounting and disclosures
- Monitoring of the processes and risks relating to IT security, specifically cybersecurity
- Broader technology risks and opportunities

In other jurisdictions, these topics may be addressed at the board level or alternatively covered by the audit committee through deep dives that can, in time, become part of the regular calendarization.

9.3.1 Taxation

The tax landscape is being impacted by increasing complexities in global tax policies, including the tax rules proposed by the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting initiative.[23] It is also affected by national governments looking for new sources of funding and introducing new taxes, such as those related to funding a green transition.

> "Strong and effective tax governance has rapidly become essential for all businesses. This is partly because tax authorities around the world are using the absence or presence of good governance principles in tax as a way to segment taxpayers into different risk categories. It's also because tax functions are recognizing that a good tax governance framework offers them many opportunities to help their organizations build long-term value for stakeholders, including in the important ESG space.
>
> Luis Coronado, EY Global Tax Controversy Leader

Tax issues, especially tax strategy, are often a matter for the whole board, although a natural role for the audit committee exists given both the risk management and financial reporting consequences of taxation.

Audit committees often get involved with analyzing effective tax rates, overseeing ongoing tax audits conducted by tax authorities and challenging the reporting consequences of major changes to tax structures. This role is set to become more onerous given expectations that, in the coming years, tax audits will become more intense, information requests from authorities more thorough, and disclosure requirements more detailed.

9.3.2 Cybersecurity

Cybersecurity is no longer seen as an information technology issue. It is a pervasive, rapidly evolving and interconnected enterprise risk. Due to the increasingly sophisticated nature of attacks, cybersecurity is now considered to be a principal risk for many businesses and a priority issue for the boardroom, not in a small part due to the reputational damage that can arise from a major cyber incident.

> "Effective boards approach oversight of cybersecurity as an enterprise-wide risk-management issue. While including cybersecurity as a stand-alone item on board or committee meeting agendas is now a widespread practice, the topic should also be integrated into a wide range of issues to be presented to the board, including discussions of new business plans and product offerings, mergers and acquisitions, new market entry, deployment of new technologies, major capital investment decisions such as facility expansions or IT system upgrades, and the like. As corporate assets have increasingly become digital assets, virtually all major business decisions before the board will have cybersecurity components to them.
>
> **Director's Handbook on Cyber-Risk Oversight**, Principle Three: Board Oversight Structure and Access to Expertise
>
> National Association of Corporate Directors and the Internet Security Alliance

[23] "International collaboration to end tax avoidance," Organisation for Economic Co-operation and Development website, oecd.org/tax/beps.

Cyber risk has become a fixture on the agenda of many audit committees due to their risk oversight role. Nevertheless, some organizations have established an independent cybersecurity risk committee, focused exclusively on cybersecurity, data management and IT systems.

To ensure there is clear management responsibility for cyber risk and that the approach to cybersecurity is not siloed, but embedded into relevant business processes, many organizations have established the position of chief information security officer (CISO), who is the executive responsible for the enterprise-wide operation of cybersecurity risk management.

In such cases, the audit committee should receive regular reporting from the CISO on the state of cybersecurity, the risk responses and contingency plans. It may also commission an external security rating assessment from independent cyber experts that could, on the one hand, uncover previously undetected vulnerabilities and, on the other, provide a benchmark against best practice and peer organizations. The National Institute of Standards and Technology Cybersecurity Framework is one of the internationally recognized scoring methodologies.[24]

The Securities and Exchange Commission adopted rules to enhance and standardize disclosures by requiring registrants to make timely reports on cybersecurity incidents and describe material aspects. These aspects include the nature, scope and timing of the incident, and the impact or reasonably likely impact on the registrant's financial condition and operations.[25]

Registrants also need to make disclosures about their cybersecurity risk management, strategy and governance in annual reports. Registrants need to, among other considerations, explain the role of the board or its committees in overseeing risks from cybersecurity threats and disclose processes to assess, identify and manage risks from cybersecurity threats in sufficient detail for a reasonable investor to understand those processes.

Regardless of the role of the audit committee, the entire board should receive regular updates on cyber risk, including on the threat landscape, the business impacts of an attack, and the state of the control environment and mitigation responses, preferably directly from the CISO. Boards should also consider participating in a mock breach exercise that simulates a crisis.

9.3.3 Artificial intelligence

Artificial intelligence (AI) is both a potential opportunity and a risk, with the ability to completely transform the industries in which businesses operate. Aspects of AI relating to strategy and competitive advantage will naturally be a matter for the whole board. Nevertheless, audit committees are increasingly supporting boards in dealing with AI as a matter of risk.

Audit committees need to consider the risks created by AI that is external to the organization, as well as the risks that can arise from the use of AI within the organization. Many of these risks are interconnected with areas that audit committees are already heavily involved in — fraud, ethics, reputation, data integrity and cybersecurity. Some aspects — such as the risk of bias within internally used algorithms — are relatively new, however. Audit committees will also need to keep a watching brief on the developments around the use of AI in financial reporting and the use of generative AI (GenAI) in narrative reporting. Other potential issues to consider include GenAI foundation models and personal data, and the extent to which a company fine-tunes and deploys these models in line with data protection regulations.

Some audit committees provide oversight around compliance with a variety of laws and regulations. Regulations on the development and deployment of AI vary between jurisdictions and the pace at which they are being introduced is accelerating. Audit committees will have a role to play in overseeing compliance and the extent to which internal policies, procedures and systems are keeping pace with a complex and changing international regulatory landscape.

[24] "Cybersecurity Framework," National Institute of Standards and Technology website, nist.gov/cyberframework.
[25] **Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure**, Securities and Exchange Commission, 2023.

9.3.4 Transactions

Generally, strategic transactions are a matter for the board, with the role of the audit committee typically limited to overseeing any related accounting considerations (see point 7.1.1.3). Additionally, audit committees can support the board by scrutinizing the impact of potential integration challenges relating to major acquisitions, especially those related to risk management and internal control as well as reporting practices. The audit committee may also specifically scrutinize any valuations received as part of the due diligence process.

The board sometimes tasks its audit committee with oversight of tracking synergies after the acquisition by making sure that metrics reported internally by management are reliable.

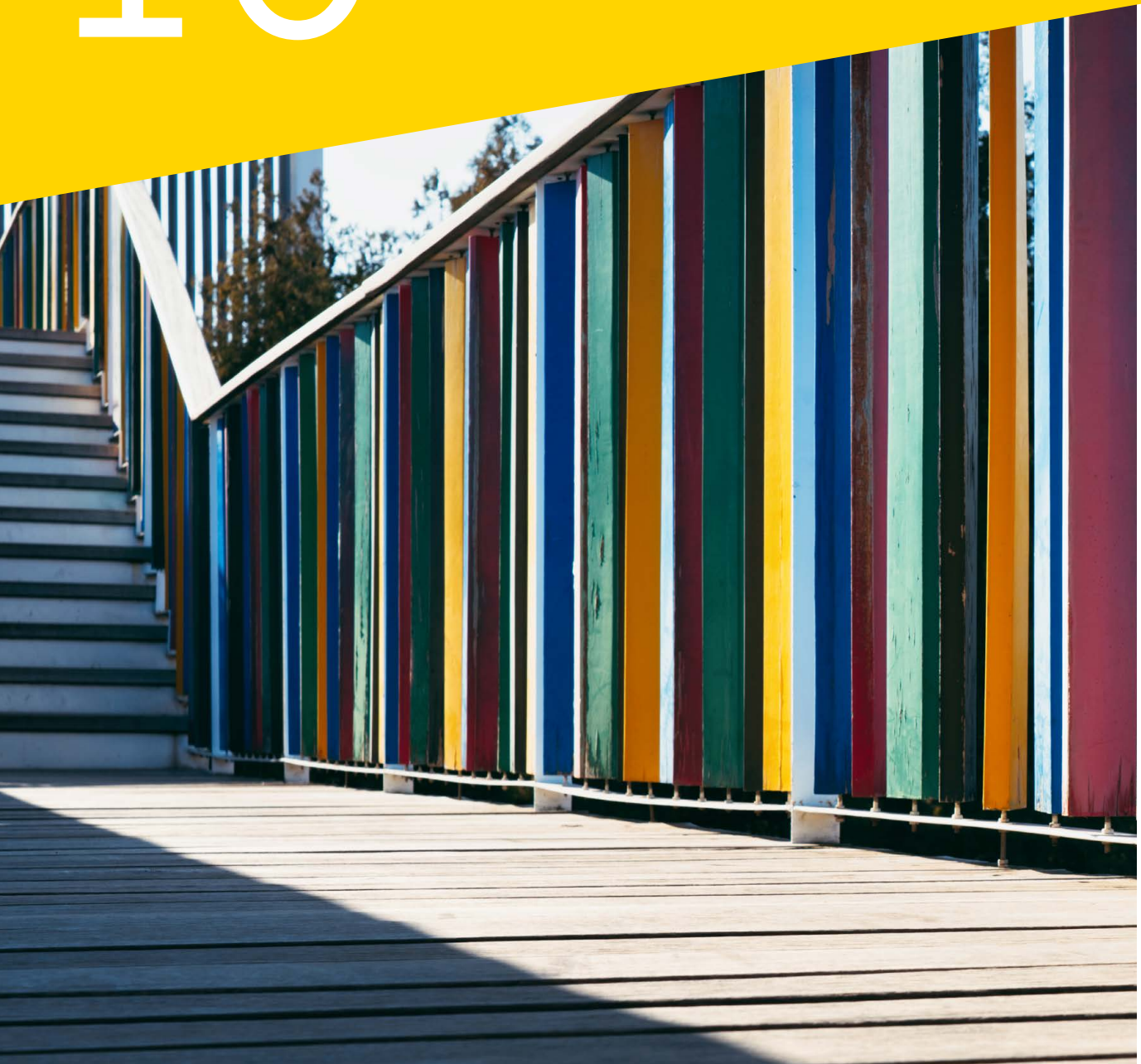
> In India, the Securities and Exchange Board specifically requires audit committees to consider and comment on the rationale, cost benefits and impacts of transactions such as acquisitions, mergers or demergers on the listed entity and its shareholders. As such, audit committees have dedicated meetings to address considerations related to transactions.

9.3.5 Compliance with other laws and regulations

The audit committee may be tasked with oversight of compliance with laws and regulations in addition to those already discussed in this guide.

Furthermore, the audit committee must understand the obligations placed on the auditor by the International Ethics Standards Board for Accountants' International Code of Ethics for Professional Accountants. Under the code, the auditor has obligations should they become aware of actual or suspected noncompliance with laws and regulations.

10 Evaluating the effectiveness of the audit committee



Regardless of whether it is a formal requirement or a recommendation, many boards consider undergoing a regular performance review to be good practice. The review can be internally or externally facilitated. It is not uncommon for the approach to be rotated, with an external evaluation conducted every couple of years.

The audit committee should also undertake a periodic effectiveness evaluation. In a dual-board system, the evaluation of the audit committee may be conducted as part of the evaluation of the supervisory board and not on a stand-alone basis.

The UK Corporate Governance Code stipulates that the annual evaluation of the board should consider its

- Performance
- Composition
- Diversity
- How effectively members work together to achieve objectives

Individual evaluation should demonstrate whether each director continues to contribute effectively.

The annual review of the performance of the board, its committees, the chair and individual directors should be formal and rigorous. The chair should commission a regular, externally facilitated board performance review. In FTSE 350 companies, this should happen at least every three years.

When the evaluation is internally facilitated, it is commonly administered by the company secretary or general counsel. When an external facilitator is appointed, this will generally be done as part of the overall board evaluation processes. Good practice is to consider not only the competence and experience of the external facilitator, but also their independence.

The audit committee chair may be asked to support in assessing the independence of the external evaluator, given their experience in considering the independence of internal and external auditors.

Generally, considerations regarding the overall approach do not differ from those relevant at board level. They include matters such as:

- Setting clear objectives for the review
- Establishing whether the review will cover all aspects of the audit committee's functioning or whether, in a given year, it will focus on a particular deep dive such as adequacy of competence and skills
- Agreeing whether the review will assess the performance of the individual members of the committee, as well as the audit committee itself
- Defining who to ask for feedback
- Determining whether the review will be conducted through the use of evaluation forms or interviews, or a combination of both
- Deciding, in the case of an externally facilitated review, whether the facilitator should attend an audit committee meeting

Key topics to consider as part of conducting the evaluation have been set out across this guide. Appendix A includes a summary of all the questions by section.

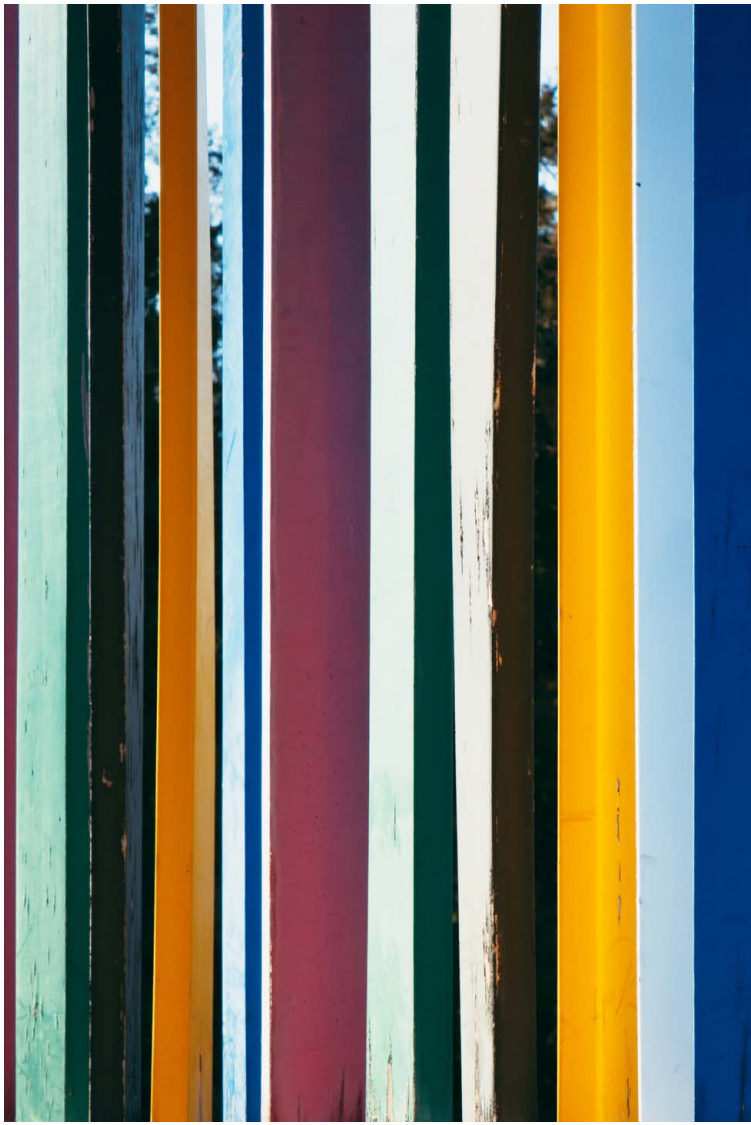
Following the evaluation processes, a summary of the assessment is typically discussed by the audit committee members in a private session before being shared with the board.

The audit committee chair will be responsible for developing a plan to address any findings. With the help of the company secretary, they will monitor that any resulting actions are being addressed on a timely basis.

In some jurisdictions, there is a requirement to disclose the outcomes of the evaluation in the annual report.

The UK Corporate Governance Code requires the annual report to describe how the board performance review has been conducted, the nature and extent of an external reviewer's contact with the board and individual directors, the outcomes and actions taken, and how it has, or will influence, future board composition.

? Has an annual performance evaluation of the audit committee been conducted? Has progress been made against recommendations made during the previous review?



Appendix A
Summary of self-evaluation questions

Section		Question
3.1	Independence	Has a thorough assessment been conducted to confirm that every audit committee member designated as independent, is independent – both in form and appearance?
4.1.4	Proportion of independent directors	Is the proportion of independent directors sufficient to robustly challenge management?
3.3	Time commitment	Has each committee member dedicated adequate time to discharging their responsibilities and continues to have the capacity to do so going forward?
4.1.2	Committee size	Is the size of the audit committee optimal for discharging its remit? Do all members equitably share in areas of oversight?
3.5	Other competence and experience	Individually and in combination, do the audit committee members have the right level of sufficiently recent and relevant financial expertise and industry understanding? Do they have other prerequisite competence relevant to the company's context?
3.8	Onboarding	Did any new member receive appropriate and timely onboarding that adequately addressed topics relevant to their role on the audit committee?
4.1.6	Complementary and up-to-date skills	Are the audit committee members keeping their skills up to date, as well as considering and preparing for the future skills the committee will need?
4.1.1	Dissenting and challenging views being encouraged	Do the audit committee dynamics enable dissenting views?
4.3.7	Attendance of nonmembers	Is the debate and discussion impeded by the presence of any nonmembers?
4.2.1	Setting out and periodically reassessing core responsibilities	Are the audit committee's terms of reference kept up to date? Do they reflect not just the committee's mandatory responsibilities as specified in regulations or guidance, but also its de facto ones?
4.2.2	Interactions with other committees	Is there a clear framework for interaction between committees on overlapping topics, e.g., where human capital metrics impact executive remuneration?
5.3	Strategy oversight and remuneration	Does the audit committee have sufficient input from members of the remuneration committee to understand the pressures that incentives can put on management?
6.2.1	Role of the board	Do the audit committee's terms of reference clearly delineate its responsibilities regarding risk management from those of the full board and other committees?
6.2.3	Separate board risk committee	Where there is a separate risk committee, is the division of responsibilities between the audit committee and the board risk committee clearly defined?
7.2.3	Environmental and social reporting	Is there a clear division of responsibilities regarding oversight of narrative reporting, including on environmental and social matters, between the audit committee and any other relevant committee dealing with these topics?
4.3.1	Calendarizations, frequency and timing of meetings	Did the audit committee hold an adequate number of meetings to ensure that all material topics and issues were covered with sufficient time dedicated to robust debate?

Section		Question
4.3.4	Length of meetings	Does the calendarization include a sufficient number of meetings to allow time for white space and deep dives without making meetings overly long?
4.3.6	Timely, focused pre-read material	Is the meeting pack distributed with sufficient notice to allow the audit committee members to read and analyze the content, come prepared for active discussion and have action-oriented meetings?
4.3.6	Timely, focused pre-read material	Does the information in the meeting pack allow the audit committee to challenge management's views? Is it of adequate granularity and quality without including operational detail not relevant to the oversight role of the audit committee?
4.3.7	Attendance of nonmembers	Does the way in which attendees present at the audit committee facilitate effective debate and discussion on material issues?
4.3.7.3	Auditors and external specialists	Does the audit committee obtain independent insights on specific topics, e.g., from external advisors, to allow for robust challenge of management?
5.1	Tone at the top	Does each audit committee member champion integrity and accountability through their own words and actions, including by coming to audit committee meetings prepared?
5.1.1	Ethics and doing the right thing	Does the audit committee have sufficient visibility into how the code of conduct (or its equivalent) is promoted and enforced across the organization?
5.1.2	Fraud, bribery, corruption and misuse of data	Does the audit committee have a thorough understanding of the outcomes of the organization's fraud risk assessment and has it analyzed the implications for the audit committee's remit?
5.1.3	Whistleblowing or speak-up	Has the audit committee considered the implications of whistleblowing cases on internal controls and corporate reporting? Has it considered what they imply about the company's culture more broadly and about overall adherence to the code of conduct?
5.2.1	Reporting to the board	Does the audit committee chair keep the board informed about the material activities of the audit committee and its key decisions and judgments? Are accurate minutes, which concisely bring out the crux of the meeting, circulated in a timely fashion?
6.3	Oversight of risk identification and evaluation	Does the audit committee have regular interactions with the head of the risk function? Is this occasionally supplemented with reporting from other representatives of the first and second lines, e.g., when the audit committee commissions a deep dive into a particular risk area?
6.3.2	Emerging risks	Rather that it being relegated to an afterthought following the principal risk discussion, is adequate time and prominence being given to the debate on emerging risks?
6.5	Internal controls	Does the audit committee receive sufficient, regular reporting (e.g., from the third line) so that it can challenge management's view on the design and operational effectiveness of internal controls across its areas of responsibility?
6.5.1	Internal controls over financial reporting	Where management is required to make an attestation on the effectiveness of internal controls over financial reporting, does the audit committee receive regular reporting from those within the second line who test first-line controls? Where management is not required to make such an attestation, does the audit committee receive sufficient evidence to understand whether management has implemented effective internal controls over financial reporting?

Section		Question
6.6	Internal audit	Where no internal audit function exists, is the audit committee satisfied that it can effectively discharge its oversight of risk management and internal controls?
6.6.1	Internal audit function	Does the audit committee have the ability to influence internal audit sourcing arrangements to ensure they remain appropriate for the organizational context and allow for adaptability and responsiveness?
6.6.1	Internal audit function	Does the audit committee have sufficient visibility of the caliber of internal audit resources — both staff and technology?
6.6.2	Head of internal audit	Is there is an adequate level of trust between the audit committee chair and the head of internal audit? Does the audit committee have confidence that it is made aware of all potential matters of significance that involve management?
6.6.4	Internal audit plan	Does the audit committee understand the levels of assurance provided by internal audit activities over the course of the year and the risk coverage that these achieved?
6.6.5	Internal audit reporting	Can the audit committee adequately hold management to account for promptly actioning internal audit's recommendations?
6.6.6	Assessing the quality of internal audit work	Has the audit committee conducted a thorough assessment of the quality of internal audit's work? Is it satisfied that recommendations are being adequately implemented?
7.1.1	Financial reporting process	Has the audit committee thoroughly challenged management on any voluntary changes to accounting policies; readiness for future mandatory changes in accounting standards; and the accounting for any material one-off or unusual transaction, if relevant?
7.1.1	Financial reporting process	Has the audit committee challenged management over judgments underpinning material estimates, including by reference to independent specialist input where relevant?
7.1.1.3	Other complex accounting issues and principal risk implications	Is the audit committee satisfied that management has adequately accounted for complex accounting issues, principal risk implications and non-reoccurring items?
7.1.1.3	Other complex accounting issues and principal risk implications	Is the audit committee satisfied that management has adequately accounted for the impacts of climate change in the financial statements and that there is congruence between any narrative regarding climate change and those impacts?
7.1.2.1	Non-GAAP measures	Has the audit committee robustly challenged management on its selection and use of non-GAAP measures?
7.1.3	Competency and strength of the finance function	Has the audit committee discussed with the board the outcome of its assessment of the overall strength of the finance function?
7.2.1	Narrative reporting	Has the audit committee read the narrative in the annual report and satisfied itself that there are no inconsistencies with the information contained in the financial statements or with the picture of the company it was presented with throughout the year?
7.2.2	Nonfinancial metrics	Is the level of oversight that the audit committee has over the accuracy of prominent nonfinancial metrics commensurate with the reliance placed on those metrics by stakeholders? Has the audit committee considered the adequacy of assurance over these metrics?

Section		Question
7.2.3	Environmental and social reporting	Is there a clear division of responsibilities between the audit committee and any other relevant committee regarding oversight of narrative reporting, including on environmental and social matters?
8.1.1	Non-audit services	Does the audit committee have a comprehensive policy covering the awarding of non-audit services to the external auditor?
8.2.2	When to run the tender process	Does the audit committee have an indicative time frame for when the next audit tender process will be run and for which financial year end?
8.2.2	When to run the tender process	Has it informed management of these plans and discussed how awarding service contracts to potential future external audit providers can impact on independence considerations?
8.3.1	Audit planning and the scope of the audit	Did the audit committee adequately oversee the audit plan to make sure that it will facilitate the delivery of a high-quality, effective and efficient audit?
8.3.1	Audit planning and the scope of the audit	Did the audit committee consider whether the audit fee is commensurate with the planned effort?
8.3.2	Interim procedures	Did the audit committee hold management to account for addressing any findings from the interim phase of the audit in a timely manner and ahead of the year end? Was it satisfied that the audit plan was adjusted to adequately reflect any such findings?
8.3.3	Year-end procedures	Does the audit committee have confidence that the audit plan was effectively executed and that procedures performed were sufficient to reach an audit opinion?
8.3.4	Management letter points	Does the audit committee take an active role in overseeing management's response to observations provided by the external auditor and any audit differences that were identified?
8.4	Monitoring auditor effectiveness and audit quality	Is there a structured process in place to assess audit quality throughout the year? Has the audit committee identified data points and other inputs that will support the assessment?
8.5.2	Assurance over nonfinancial reporting	Does the audit committee have a complete and accurate picture of what assurance is obtained over disclosures in the annual report and accounts, the rationale for this, and how this compares with the expectations of external stakeholders?
9.1	Financial condition and projections	Has the audit committee satisfied itself that, where relevant and to the extent this is appropriate, there is consistency in the financial projections and models underpinning the various disclosures both within the financial statements and in the narrative section of the annual report?
9.1.1	Going concern	Did the audit committee robustly challenge management's assessment of the company's ability to continue in operation?
9.2	Monitoring related party transactions	Has the audit committee understood and adequately challenged management's policies and procedures underpinning the identification and disclosure of related party transactions?
9.3	Mandated topic areas or deep dives	Self-evaluation questions have not been developed — audit committees need to consider whether these topics are of relevance in their context.

Appendix B

Legislation, regulation, listing rules and code considerations relevant to audit committees in the UK

UK

Whether a UK company is required to have an audit committee will depend on numerous factors, including specific regulations pertaining to the industry in which it operates, its size and its listing status.

The Financial Conduct Authority Disclosure Guidance and Transparency Rules and the Prudential Regulation Authority Rulebook require a public interest entity to have a body that carries out the role of an audit committee. These rules set out the minimum composition requirements and minimum functions that the audit committee needs to perform.

Part 42 of the Companies Act 2006, the Statutory Auditors and Third Country Auditors Regulations 2017, and the EU Audit Regulation as adopted into UK domestic legislation provide the statutory framework for the regulation of the external audit. This includes consideration of non-audit services and related fees as well as requirements for tendering the external audit. Additional requirements regarding the role of the audit committee in tendering the external audit are also included in the Statutory Audit Services for Large Companies Market Investigation Order 2014.

In addition to the above, those companies with a "commercial companies" listing on the London Stock Exchange are required by the listing rules to apply the UK Corporate Governance Code, issued by the Financial Reporting Council, which sets out further expectations about the composition and duties of the audit committee. The code incorporates, by reference, the Financial Reporting Council's Audit Committees and the External Audit: Minimum Standard, which sets out additional expectations of the audit committee in respect of the external audit, including tendering. The code is supplemented by voluntary guidance, which includes further considerations for the audit committee.

There are other governance codes that some companies may choose to apply, such as the Quoted Companies Alliance Corporate Governance Code, which is popular with companies quoted on the Alternative Investment Market.

Contacts

Alban Aubrée
EY Luxembourg Partner,
Chief Financial Officer
alban.aubree@lu.ey.com

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GA 193935140
ED None

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