



Financial Reporting Council

AUDIT COMMITTEE REPORTING

AUDIT & ASSURANCE LAB PROJECT
DECEMBER 2017

WHAT IS THE AUDIT & ASSURANCE LAB?

The Audit & Assurance (A&A) Lab seeks to promote best practice on audit related issues in a safe and collaborative environment, by engaging with stakeholders, including audit committees, companies, investors and auditors. It does not form part of policy, and does not interpret or monitor requirements.

This two phase project explores how investors' confidence in audit is enhanced by, and supported through:

- the external reporting by audit committees in the annual report (Phase 1); and
- auditors' reports to audit committees (Phase 2).

This Phase 1 report focuses on the good practice elements of existing audit committee reporting, and encourages audit committees to consider adopting them.

Do you have suggestions to share?

Please contact us on:

AuditandAssuranceLab@frc.org.uk



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The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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1 PROJECT INTRODUCTION

Project objectives

The FRC is undertaking a pilot project setting up an Audit and Assurance Lab (A&A Lab). The first project of the A&A Lab is audit committee reporting, and will be covered in two phases.

The first phase explores how investors' confidence in audit is enhanced by, and audit quality promoted through, external reporting by audit committees in the annual report and accounts, as well as updating views of good practice on other aspects of audit committee reporting.

The second phase will review external auditors' reports to audit committees, including how they can better support external reporting by audit committees.

The audit committee report (ACR) introduced in 2012 through the UK Corporate Governance Code (the Code)¹, is the means through which the audit committee reports to shareholders, and provides insight into the work that the audit committee has done to promote a high quality audit (see description on page 2).

The legal and regulatory context is set out in detail in Appendix A (see page 45) which includes *The Statutory Auditors and Third Country Auditors Regulations 2016* (SATCAR)².

This report completes Phase 1. Phase 2 will be reported on during the first half of 2018.

Scope of the project report

This report provides feedback on the views of audit committee chairs (ACCs), companies, investors, representatives of audit firms, and officers from a professional body who participated in the project.

The report covers:

- questions to assist ACCs and investors (see page 5);
- the role of audit committees, engagement and writing the report (see page 7);
- external auditor - appointment and tendering (see page 11);
- external auditor – independence and objectivity (see page 19);
- external auditor – effectiveness (see page 23);
- reporting on significant issues (see page 29);
- internal control, risk management systems and internal audit (see page 35); and
- the regulatory context (see Appendix A, page 45).

Participating ACCs and companies ranged in size across the FTSE 350. Company participants included members of Finance, Company Secretarial (Co Sec) and Investor Relations teams. Investment community participants included retail investors, buy-side and sell-side analysts, and fund managers. See page 51 for a list of the participants.

The report provides examples of audit committee communication favoured by those taking part.

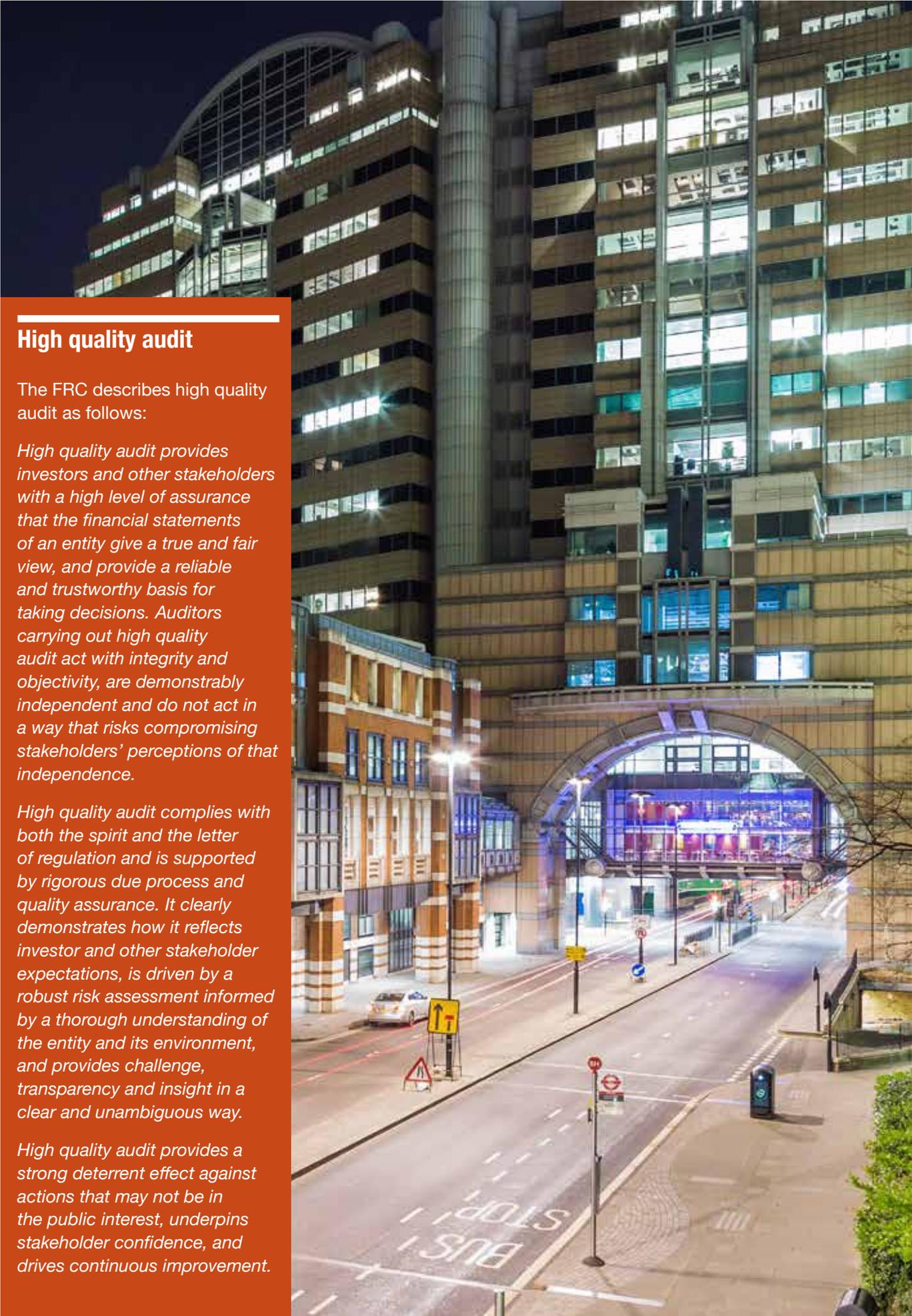
Companies can use this report to consider which elements to adopt in the context of their own circumstances, and reporting objectives.

The findings will also be of relevance to public interest entities (PIEs)³ and companies that voluntarily adopt the Code.

¹ The FRC is currently consulting on the Code.

² UK Statutory Instrument in respect of the EU Audit Regulation and Audit Directive 2014.

³ PIEs are companies listed on a regulated market, unlisted credit institutions and insurance companies.



High quality audit

The FRC describes high quality audit as follows:

High quality audit provides investors and other stakeholders with a high level of assurance that the financial statements of an entity give a true and fair view, and provide a reliable and trustworthy basis for taking decisions. Auditors carrying out high quality audit act with integrity and objectivity, are demonstrably independent and do not act in a way that risks compromising stakeholders' perceptions of that independence.

High quality audit complies with both the spirit and the letter of regulation and is supported by rigorous due process and quality assurance. It clearly demonstrates how it reflects investor and other stakeholder expectations, is driven by a robust risk assessment informed by a thorough understanding of the entity and its environment, and provides challenge, transparency and insight in a clear and unambiguous way.

High quality audit provides a strong deterrent effect against actions that may not be in the public interest, underpins stakeholder confidence, and drives continuous improvement.

2 QUICK READ

This report focuses on those aspects of audit committee reporting that participants say it would be most helpful to improve.

Role

- ACCs stress their commitment to what is a wide-ranging and demanding role, and want to ensure that they represent the interests of shareholders. They believe this should be demonstrated in the ACR.
- Investors value the role played by the audit committee and place reliance on its work. Some investors regard the content of the ACR as providing valuable insight into the quality and rigour of the audit committee. This creates trust and provides them with confidence that the audit committee is effective.

Engagement

- Some investors read the ACR in preparation for meeting the ACC. Investors who do not read the ACR cite boilerplate disclosure as their main reason for not doing so.
 - ACCs are willing to engage with investors, although in general, dialogue with non-executive directors is limited to the company chairman and the senior independent director. Both ACCs and investors recognise that there is scope for further engagement. Some investors see the work of the audit committee as being as important as the remuneration committee, so would welcome meeting the ACC during governance roadshows and/or on an ongoing basis.
- Several ACCs said they had written to their largest shareholders prior to tendering the audit to seek input. Although the response rate was low, ACCs found that those investors who did reply made thoughtful contributions, which assisted the audit committee in the tender process.

The audit committee report

- Investors look to the ACR to give them confidence in the committee's work in important areas, such as the appointment of the external auditor and monitoring the auditor's independence and objectivity. This includes highlighting any significant issues.
- Some investors consider that the ACR provides insight into the quality and rigour of the committee itself, from which trust and confidence can be derived.
- ACCs recognise the importance of disclosing the key decisions and judgements made by the audit committee during the year. Some investors believe more could be done to bring out key messages and suggest this could be done in an ACC's introduction.
- Investors want significant issues regarding the financial statements to be easily identifiable and understandable. ACCs need to have the reader in mind and avoid excessive jargon.
- Some investors say that there is still an attitude of 'comply and

explain' rather than 'comply or explain'. This can lead to excessive description of process in the ACR, which is often boilerplate and uninformative. Investors say it is easy to miss key information in a long report.

- Some investors highlight the annual effectiveness review of the audit committee and ask that detailed results be reported, including how the audit committee intends to respond to areas requiring improvement.

External auditor - appointment and tendering

(see best practice examples on pages 15 to 18)

- Audit committees recommend to the board the appointment or removal of the external auditor. They are responsible for leading the tender process, negotiating the fee, and overseeing the scope and effectiveness of the audit.
- ACCs and investors overwhelmingly agree that audit quality should be the key selection criterion. Investors want confirmation in the ACR that quality is paramount.
- Investors look for information on fees in the ACR. The majority are not concerned about the level, although some say that a low fee may raise questions about the quality of the audit.
- Some tenders are conducted 'fee blind'; others take fees into

‘An audit committee report is a fundamental part of the checks and balances process.’

Investor

account, although they are not a deciding factor. A small number of ACCs state that the fee is higher on the list of criteria for smaller companies.

- Investors want to understand how any conflicts of interest have been mitigated or removed on appointment, to offset any impact on auditor independence. They expect this issue to be addressed in the ACR.
- Investors want to understand the audit committee’s plans for tendering as early as possible. They want to ensure that the audit committee is driving the process and there is a level playing field for all potential candidates, including those outside the Big Four.

External auditor - independence and objectivity, effectiveness (see best practice examples on pages 21 to 22 and 25 to 28)

- In reporting on the audit committee’s assessment of objectivity, the ACR is encouraged to discuss how the external auditor has demonstrated an appropriate mindset, including professional scepticism.
- Companies are required to have a policy on non-audit services (NAS). In addition to stating compliance with the policy, investors would like the amount of NAS fees to be disclosed in the ACR, along with the ratio to audit fees. In the event that the external auditor has provided material NAS, investors want audit committees to explain why they concluded that the external auditor was best placed to provide these services.

- ACCs say that the level of NAS is one aspect of their assessment of auditor independence, but not the only one.
- Investors expect audit committees to provide insight into the factors considered during their annual assessment of the external auditor’s effectiveness.
- Some investors find the discussion on effectiveness focuses too much on the relationship between the external auditor and management. They consider the relationship between the audit committee and the external auditor to be the most important, and would like to see this made clear.

Reporting on significant issues

(see best practice examples on pages 32 to 34)

Investors want disclosures on significant issues to:

- Provide the context of the issue, for example quantification.
- Describe the audit committee’s actions in the year.
- Clearly describe the conclusion.
- Explain the rationale for that conclusion.
- Include cross-references to where other information can be found.
- ACCs consider that describing how they addressed significant issues is more important than the active or passive nature of the language used to describe their work.
- Investors consider that the audit committee has a key role in reviewing and challenging the Alternative Performance

Measures (APMs) presented by management. They are satisfied with disclosures reconciling APMs to Generally Accepted Accounting Principles, but are more concerned about understanding whether APMs represent economic value.

Internal control, risk management systems, and internal audit

(see best practice examples on pages 38 to 43)

- ACCs and companies agree that disclosures must be consistent with audit committee oversight duties. If the audit committee is only delegated responsibility by the board for monitoring and reviewing certain aspects of internal control and risk management, then this should be made clear in the ACR.
- Investors expect cross-references in the ACR to other areas of the annual report where internal control and risk management are covered.
- ACCs recognise that any significant failings or weaknesses in internal controls and/or risk management systems should be disclosed.
- The Code includes a provision⁴ requiring the audit committee to review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee’s objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

⁴ C.3.5.

3 QUESTIONS TO ASSIST AUDIT COMMITTEE CHAIRS AND INVESTORS

Based on participants' preferences, the A&A Lab has set out some high-level questions to assist ACCs and investors.

1. Overall

- Does the ACR highlight the main issues that arose during the year?
- Is there a personal introduction from the ACC?
- Is it clear how the work of the audit committee links to other areas of the annual report and accounts?

2. External auditor - appointment and tendering

- Does the report explain:
 - the audit committee's approach to the (re)appointment of the external auditor;
 - the length of tenure of the current audit firm, the audit partner's name and how long the partner has held the role;
 - when a tender was last conducted; and
 - retendering plans (including earlier tenders for subsidiaries due to local jurisdiction laws and regulations)?
- If a tender has occurred during the year, does the report explain:
 - the criteria for the selection of the external auditor;
 - the number of audit firms that chose to tender and why certain firms did not participate;
 - how the audit committee dealt with any conflicts of interest (perceived or actual);
 - the reasons why the audit committee recommended the appointment of a particular audit firm to the board, and to be voted on by shareholders; and
 - any transitional arrangements?

3. External auditor - independence and objectivity

- Does the audit committee explain how it has assessed the independence and objectivity of the external auditor? Does the assessment of objectivity refer to the external auditor's professional scepticism?
- Is the level of reliance placed on the external auditor's internal independence controls explained?
- If non-audit fees have been incurred, does the ACR disclose the amount and the ratio of audit to non-audit fees?
- For any significant NAS engagement, does the report explain what the service is and why the audit committee concluded that selecting the external auditor was in the best interests of the company?



4. External auditor - effectiveness

- Does the ACR explain how the audit committee has evaluated effectiveness of the external audit process?
- Where a company's audit has been reviewed by the FRC's Audit Quality Review (AQR) team, does the report discuss the findings, and the actions the company and the auditor have taken/plan to take, in response?

5. Reporting on significant issues

- Has the audit committee reported on significant financial reporting issues and judgements?
- Are significant issues quantified wherever possible?
- Are the conclusions clear and the rationale explained?
- Is the nature and extent of any interaction with the FRC's Corporate Reporting Review (CRR) team disclosed?
- Does the narrative differentiate between the roles of management and the audit committee?
- Is it clear where else in the annual report (e.g. external auditor's report, notes to the financial statements) information can be found on the significant issues?

6. Internal control and risk management

- Does the report clearly explain the audit committee's delegated areas of responsibility?
- Does the audit committee disclose how it has assessed the effectiveness of those internal control and risk management systems within its remit?

7. Internal audit

- Is it clear that the audit committee has approved the role, mandate and plan for internal audit?
- Does the report explain the focus of internal audit, including highlighting any significant issues raised, and how the committee has addressed them?
- Does the audit committee disclose how it has evaluated the effectiveness of internal audit?

4 ROLE, ENGAGEMENT AND WRITING THE REPORT



Role of the audit committee

ACCs stress their commitment to what is a wide-ranging and demanding role, and want to ensure that they represent the interests of shareholders. They believe this should be demonstrated in the ACR.

Investors value the role played by the audit committee and place reliance on its work. A few investors were surprised at the extent of the audit committee's remit, which they thought only involved monitoring the integrity of the financial statements.

Some investors regard the content of the ACR as providing valuable insight into the quality and rigour of the audit committee. This creates trust and provides them with confidence that the audit committee is effective.

ACCs highlight the substantial preparatory work they do before audit committee meetings (which can vary between four and ten per annum). This usually entails separate meetings with the company chairman, management, internal audit and the external auditor, so that they can understand the different perspectives. The time commitment for the audit committee, and the ACC in particular, increases substantially during a tender period. A description in the ACR, of how and on what the audit committee spent its time during the year can be useful, although this needs to avoid simply repeating the terms of reference.

‘I believe that we need to work to reduce the length of our reporting to ensure that what gets written, gets read, which isn’t always the case now.’

Audit committee chair

Some investors commented on the ability of ACCs to fulfil their commitment given that (in a small number of cases) they have other high-profile roles (e.g. Chief Finance Officer of a FTSE 350 company). Disclosures in the ACR do not currently address this.

Investors want to understand the nature and extent of the interaction between the audit committee and other board committees.

Some investors highlight the effectiveness review of the audit committee and say that the detailed results should be reported, including how the audit committee intends to respond to areas requiring improvement.

Engagement

ACCs are willing to engage with investors, although in general dialogue with investors is limited to the company chairman and senior independent director. Some investors read the ACR in preparation for meeting the ACC. Those who do not read it cite boilerplate disclosure as their main reason. Both ACCs and investors recognise that more can be done here.

Some investors admit that they do not place enough focus on the work of the audit committee and the ACR. The remuneration report gets the most attention, as seen during the annual general meeting (AGM)

season. Some see the ACC as being as important as the Remuneration Committee Chair, and would welcome meeting the ACC during governance roadshows and/or as part of ongoing engagement with the company.

Several ACCs said they had written to their largest shareholders prior to tendering the audit to seek input. Although the response rate was low, ACCs found that those investors who did reply made thoughtful contributions, which assisted the audit committee in the tender process.

Writing the report

The first draft of most ACRs is written by the Co Sec or Finance teams. Investors prefer that this is carried out by the Co Sec team, and that it is helpful if the report is drafted by someone who attends the meeting.

ACCs find they are better able to influence content when involved early in the drafting process. ACCs and companies consider it important to be able to validate the information using the underlying records.

Some investors say that there is still an attitude of ‘comply and explain’ rather than ‘comply or explain’. This can lead to excessive description of process in the ACR, which is often boilerplate and uninformative. Investors say it is easy to miss key information in a long report.

Important information

ACCs consider it important to disclose the key decisions and judgements made by the audit committee during the year.

Some investors consider that more could be done to bring out important information. An introduction from the ACC is a good way to communicate key messages and to highlight important issues. Investors who may not always read the full ACR would find this a useful tool for identifying issues that are dealt with more fully in the rest of the ACR, and that may require subsequent engagement with the ACC.

Some investors compare the ACR to the external auditor’s report in order to understand any differences in viewpoints, in particular in relation to significant issues.

Investors want significant issues regarding the financial statements to be easily identifiable and understandable. ACCs need to have the reader in mind and avoid excessive jargon.

Clear cross-referencing

(See best practice example on page 10)

The ACR sits within the governance section of the annual report and accounts. If the ACR is not separately listed on the contents page, it lacks prominence, so a listing might be helpful.

Clear cross-referencing and linkage reduces repetition. Investors suggest that this enhances the usefulness and understandability of the ACR, within the wider annual report and accounts.

ACCs and companies are open to the concept of putting more information on the website. This is not common practice and some are wary of doing this without additional guidance. One ACC suggests that the audit committee could review the relevant website disclosures annually as part of its responsibilities.

s.172 of the Companies Act

Under s.172, the directors of a company must act in the way most likely to promote the success of the company for the benefit of its members as a whole, and have regard to several matters, including the interests of other stakeholders (see Appendix A, page 45).

Given the wide focus of s.172, and the reporting changes which may be made by the UK government, ACCs expect to include in the ACR, more specific disclosures on how these duties are carried out.

FRC Guidance on Audit Committees

While all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.





Summary of work and cross-referencing

Investors find it useful when ACRs clearly identify the key activities in the year.

Investors consider that clear cross-referencing and linkage enhance the usefulness and clarity of the ACR, within the wider annual report and accounts.

A&A Lab comment

GKN includes a summary of the work done in the year under each sub-heading in the ACR. The company also provides links to other parts of the annual report.

Example: GKN PLC Annual Report and Accounts 2016

External audit

We have:

- ◆ considered the FRC’s Audit Quality Review of PwC’s audit of the Group’s 2015 financial statements and communicated the review to Deloitte as the current auditors;
- ◆ monitored the handover from PwC to Deloitte;
- ◆ approved Deloitte’s audit plan, terms of engagement and fee for the audit of the 2016 financial statements;
- ◆ reviewed the independence, objectivity and effectiveness of Deloitte;
- ◆ recommended to the Board the re-appointment of Deloitte for 2017; and
- ◆ noted the non-audit fees payable to Deloitte, having regard to the transitional policy on the provision of non-audit services.

The Committee is responsible for making recommendations to the Board in relation to the appointment of the external auditors. We also approve the terms of engagement and fees of the external auditors, ensuring that they have appropriate audit plans in place and that an appropriate relationship is maintained between the Group and the external auditors.

Area of focus	Committee action
<p>Post-employment obligations</p> <p>Determining the current value of the Group’s future pension obligations requires a number of assumptions. These assumptions relate principally to life expectancy, discount rates applied to future cash flows, rates of inflation and future salary increases.</p>	<p>Key matters reviewed included the appropriateness of valuation assumptions such as discount rates, mortality and inflation. The Committee also reviewed the impact of certain pension de-risking activities on the financial statements.</p> <p>Valuation assumptions, prepared by external actuaries and adopted by management, were considered in the light of prevailing economic indicators and the view of the external auditors. The approach adopted by management was accepted as appropriate.</p>

> **See Note 24 to the financial statements**

6 EXTERNAL AUDITOR - APPOINTMENT AND TENDERING

Recent changes in regulation

(See best practice examples on pages 15 to 18)

Audit committees recommend to the board the appointment or removal of the external auditor. They are responsible for leading the tender process, negotiating the fee and scope of the audit, and influencing the firm's choice of engagement partner. The legal requirement is that at least two firms are recommended to the full board by the audit committee, with a justified preference for one firm.

In 2016, SATCAR introduced the requirement for companies that are PIEs, to rotate their auditor at least once every 20 years, and retender at least once every 10 years. This follows on from the Competition and Markets Authority (CMA) Order issued in 2014, which requires FTSE 350 UK companies to conduct a tender every 10 years.

The recent changes in the regulations on tendering and rotation have prompted a lot of activity.

FRC Developments in Audit 2016/17

As at June 2017, 213 (61%) of the FTSE 350 have announced they have completed a tendering exercise in the past 6 years. 74% of tenders have resulted in the appointment of a new audit firm.

Audit quality

ACCs confirm that audit quality is central to the outcome they are looking to achieve through the tendering process. As part of this process, audit committees ask the external audit firm for information about the FRC's AQR assessment of the firm, partner and team, in addition to the firm's own internal results.

Investors want confirmation in the ACR that quality is paramount. They are more concerned with ensuring that a robust process is in place to deliver high quality audit, than with the amount paid for the service. They look for evidence of this in the ACR.

Some investors comment that they have voted against the appointment of the external auditor at the AGM when they believe the audit fee to be too low, as this indicates that the firm is not planning a sufficiently rigorous and high quality audit.

FRC Developments in Audit 2016/17

The evidence that we have suggests that whilst the Big Four audit firms continue to dominate the FTSE 350 audit market, there has been greater competition based on quality between the firms within that market. There is no evidence to suggest that competition has led to a simple downwards pressure on audit fees.

Appointment criteria

Investors want to understand the criteria against which the audit firm is being assessed. ACCs agree that disclosing the criteria is very important.

In addition to audit quality, sector knowledge and experience, ACCs highlight the competency, communication skills and working style of the partner and team, as key considerations. One had expressly requested to meet less senior members of the team to understand how they would interact with the company. However, this desire for 'cultural fit' is something that ACCs say is difficult to explain in the report.

The relevance of the audit fee to selection decisions varies between tenders. Some tenders are conducted 'fee blind', while others take the fee into account without making it the deciding factor. A small number of ACCs state that the fee is higher on the list of criteria for smaller companies.

The majority of investors are not concerned about the fee and want confirmation that it is not key to the final decision. Some say that a low fee may raise concerns about the quality of the audit.

Conflicts of interest

Investors want an explanation of how any conflicts of interest have been mitigated to offset any impact on auditor independence.

They raise the issue of conflicts that could damage independence as a key concern when the firm selected has been providing NAS. Investors want to understand the safeguards put in place when there is a change in role.

ACCs say that audit firms generally have good controls in place to provide confirmation of their independence. Several ACCs question whether some audit firms are too conservative when

interpreting the independence rules, which deter them from entering the tender.

Some investors question whether audit firms have taken sufficient account of the need to assess their independence using the Objective, Reasonable and Informed Third Party Test.

Timing

ACCs realise that it is important to manage carefully both the timing of the tender and the handover from one auditor to another. For some companies, plans are made up to two years in advance.

Investors want to have early notice that a tender will take place. Several highlight as good practice a clear description of the timeline to be followed. They would also like to understand how the tendering timetable coincides with the tenure of the current auditor.

ACCs of financial services or other complex companies and multinational groups say that choice is a challenge for them. They may require several years of preparation to ensure that they can appoint an independent external auditor.



Process

ACCs and companies invest a considerable amount of time and aim to be transparent in the tendering process⁵.

Investors want to ensure that the audit committee is driving the process and there is a level playing field for all potential candidates, including those outside the Big Four. This is particularly important when rotation is not mandatory and the current external auditor is tendering.

ACCs recognise the importance of setting out the robustness of the process and say that the disclosure should focus on the key judgements, namely:

- that the decision is driven by audit quality, not fee level (potentially fee blind);
- the criteria and reasons for selecting the firm are disclosed (this is particularly important if the incumbent is reappointed); and
- how the audit committee has dealt with any conflicts of interest.

ACCs observe that there are lots of rules and detailed guidance that need to be followed. They think that explaining the entire process does not add value and may cause confusion, but believe there is an expectation that the process will be described.

Investors assume that the audit committee complies with all the rules, and some do not find much of interest in detailed disclosure of the process.

Under the law, the company is free to invite any audit firm to tender. Investors want to understand the reasons for the incumbent or other firms not being invited to bid, or declining to bid (especially if this is because appointment as external auditor would restrict them from lower profile NAS).

In practice, although companies invite a wide range of firms to respond to the tender, not all of the firms will proceed to the final stage.

Several ACCs confirm that they write to their largest shareholders in advance of a tendering process, requesting their views and input. Although the general response rate is low, ACCs find that those investors who do reply make thoughtful and helpful contributions.

Some investors suggest that the section in the ACR on appointment and tendering should describe how all tendering firms have performed. However, ACCs consider that this information is too sensitive and would not be supported by the audit firms.

Most ACCs note a general improvement both in the tendering process and the approach taken by the external audit firms.

There is often little to choose between the final two auditors recommended to the board.

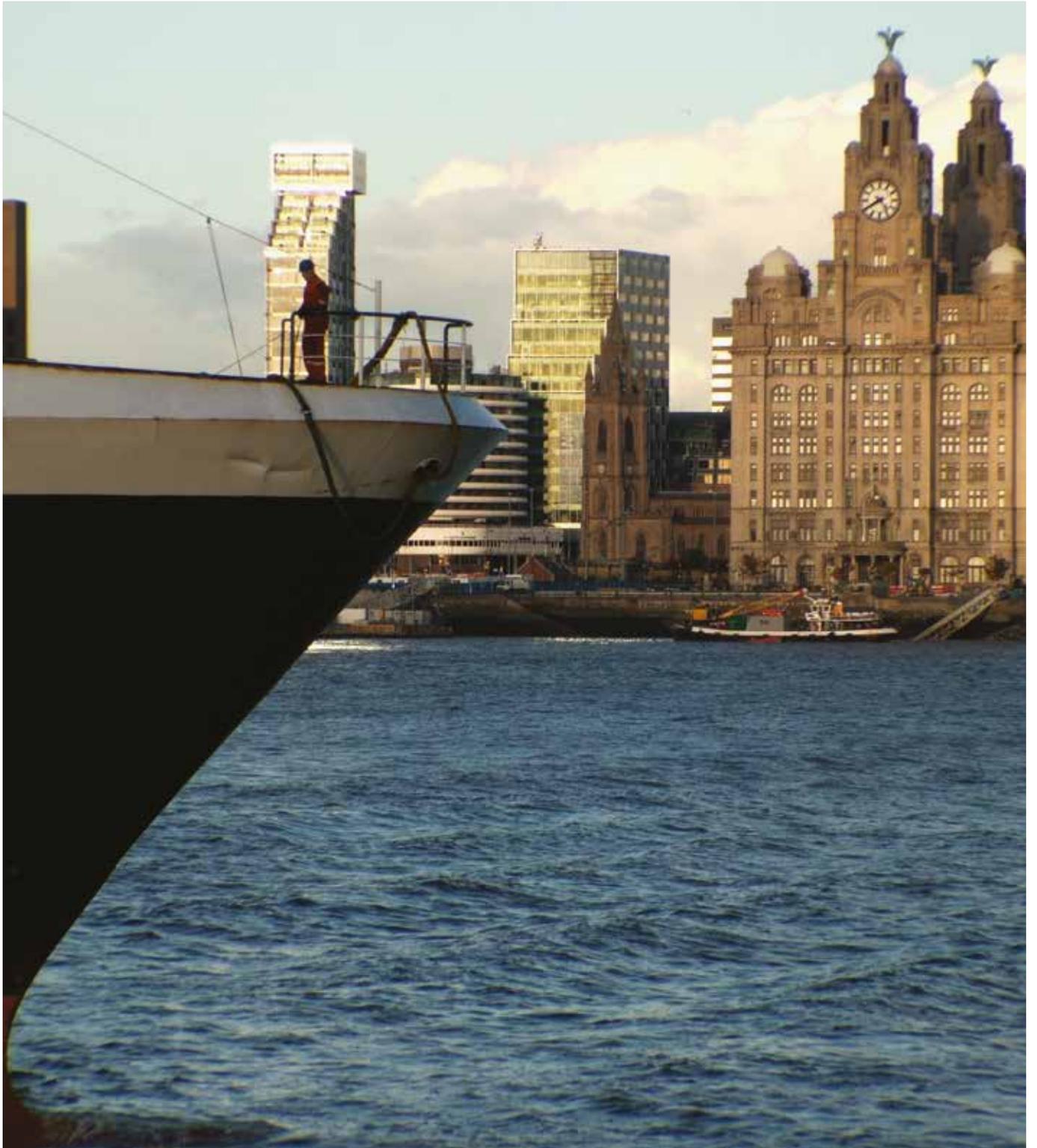
‘During the tender, all the firms had significant exposure to a lot of our management. It’s the quality of those interactions, the way they responded and conducted themselves – these were the things we were looking for.’

Audit committee chair

CMA Order

The CMA Order requires audit committees to disclose the timing of the next audit tender (if one has not been undertaken in the last five years).

⁵ FRC Audit Tenders: Notes on Best Practice guidelines.





Criteria, rationale for selection, and process

Investors are keen to understand the criteria for the audit tender and rationale for selection of the preferred firm. They want comfort that audit quality is central to the process.

Investors welcome the ACC writing to shareholders to invite input.

Some investors want sight of the timetable.

A&A Lab comment

The Fresnillo evaluation criteria demonstrate what its audit committee is looking for during the tender process.

Example: Fresnillo plc Annual Report and Accounts 2016

Fresnillo external audit tender evaluation criteria

Following the submission of the written proposals, the Audit Committee unanimously concluded that Deloitte and EY demonstrated better the resources, expertise, quality control and audit approach to deliver a high quality audit service to Fresnillo and were invited to give oral presentations, following which, a formal recommendation to re-appoint EY as the external auditor was made to the Board and accepted in October 2016.

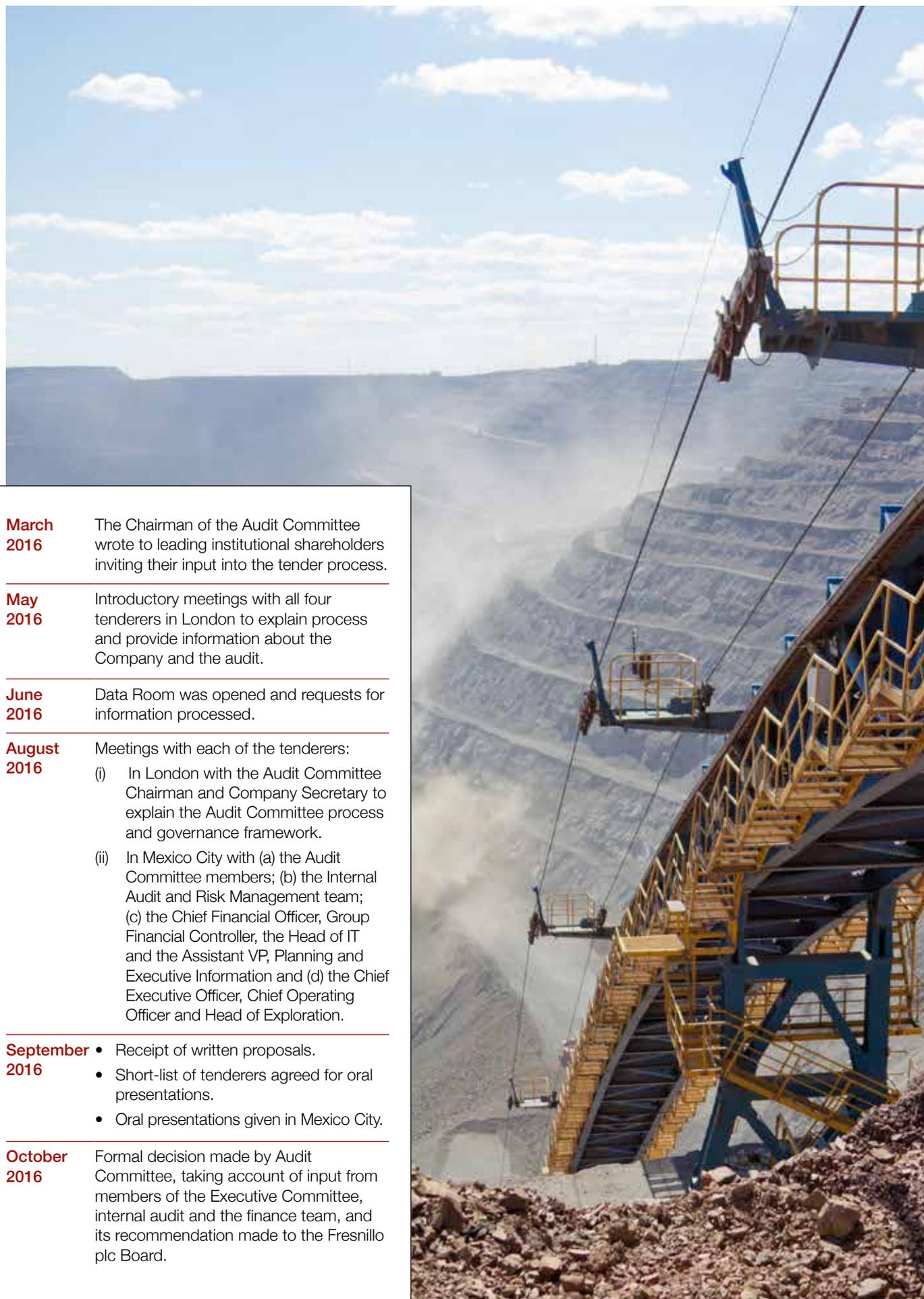
External audit tender

All of the stakeholders involved in the process were invited to rank/score each of the tenderers against each of the following criteria. These marks were taken into account as part of the evaluation process.

- Experience in mining, with precious metals expertise preferred, in companies of a similar size and complexity.
- London team experienced with FTSE 100 companies and associated regulation and governance (preferably with some who can speak Spanish) supported by local Mexican team.
- Quality of partners in UK and Mexico and quality of their teams, evidenced by firm and external evaluations. Issues from the FRC's Audit Quality Review (AQR) of the firm relevant to audit of Fresnillo and details of internal processes used for quality assurance. Quality and experience of other technical resources that may be used on assignments.

- How the audit approach would be aligned to Fresnillo's specific circumstances.
- Communication skills.
- Expected continuity of team.
- Proposed hours and fees in detail with methodology for future years.
- Independence of firm and details of internal practices to ensure continuing compliance with independence requirements and freedom from conflicts of interest.
- Plan for transition and experience of such transitions with similar companies.
- Experience of co-ordination with Parent Company management and auditors and methodology for doing so.

BEST PRACTICE EXAMPLE



March 2016 The Chairman of the Audit Committee wrote to leading institutional shareholders inviting their input into the tender process.

May 2016 Introductory meetings with all four tenderers in London to explain process and provide information about the Company and the audit.

June 2016 Data Room was opened and requests for information processed.

August 2016 Meetings with each of the tenderers:

- (i) In London with the Audit Committee Chairman and Company Secretary to explain the Audit Committee process and governance framework.
- (ii) In Mexico City with (a) the Audit Committee members; (b) the Internal Audit and Risk Management team; (c) the Chief Financial Officer, Group Financial Controller, the Head of IT and the Assistant VP, Planning and Executive Information and (d) the Chief Executive Officer, Chief Operating Officer and Head of Exploration.

September 2016

- Receipt of written proposals.
- Short-list of tenderers agreed for oral presentations.
- Oral presentations given in Mexico City.

October 2016 Formal decision made by Audit Committee, taking account of input from members of the Executive Committee, internal audit and the finance team, and its recommendation made to the Fresnillo plc Board.



ST. JAMES'S PLACE

WEALTH MANAGEMENT

Tender process, including choice of audit firms

During this project, both investors and ACCs raised the issue of auditor independence, especially as it affects the choice of firms that can be invited to tender.

Investors also expressed interest in understanding whether there are any nuances to auditor selection across a group, for example if a subsidiary is required to tender earlier due to a requirement in the local jurisdiction.

A&A Lab comment

The St James's Place report sets out the issues faced during the tender concerning auditor independence. There is also clear disclosure of the timing for the tender of the auditor in Dublin, and the requirement to change the senior statutory auditor.

This demonstrates that the audit committee plans several years in advance for a tender.

Example: St James's Place plc Annual Report and Accounts 2016

- The Audit Committee established an internal sub-committee to manage the process, chaired by the Chair of the Audit Committee and including the Chief Financial Officer. Each member of the sub-committee disclosed their interests before a formal process was established to identify and manage potential conflicts of interest that existed between selected audit firms and the Group;
 - Four short-listed audit firms were invited to express an interest in tendering and objective criteria were established to ensure a thorough and consistent process was followed when assessing the tender proposals. The criteria were weighted to take account of their relative importance to the overall outcome and included the audit firms understanding of the Group and its market, its technical capability and the quality of its employees. A broad range of factors were identified under each criteria to assist with the assessment process;
 - Following the withdrawal of two of the short-listed audit firms due to their own independence and capacity issues, the remaining candidates PwC and Deloitte were asked to submit an initial summary proposal. These proposals were assessed by reference to the criteria referred to above and material differences in the proposals were identified;
 - Following consideration of the proposals, and assessment, the sub-committee recommended that PwC be retained as the Auditor. Both firms demonstrated they had the technical capabilities and people to deliver a high quality audit. However, due to the nature of SJP's business, achieving independence can be challenging and in this context PwC was able to achieve (continued) independence from the Group with less disruption and impact on the SJP community and business; and
 - The Audit Committee considered a report setting out the sub-committee's consideration of both firms and endorsed its sharing with the Board, together with the recommendation that a resolution be put to shareholders at the next AGM, proposing the reappointment of PwC as the Company's external auditor.
- Having undertaken a tender process in 2016 (in respect of the 2017 audit), PwC's appointment as the Group's external auditor meets the relevant requirements and recommendations relating to the tenure of appointment set out in The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 (the 'Order'), Regulation (EU) No 537/2014 and the FRC's revised Ethical Standard June 2016.
- Having confirmed the proposed reappointment of PwC we will need to change our audit firm by no later than the 2027 audit. The slightly different rules in Dublin, which limit auditors to a maximum of ten years mean that we will have to change our auditor in Dublin for the 2019 audit, although we will ensure appropriate arrangements for the new auditor to liaise with the Group auditor for purposes of Group reporting.
- In relation to the service provided by PwC, having rotated our Senior Statutory Auditor to be Jeremy Jensen in 2014, we are expecting rotation of this key role by 2019.



Criteria for selection, including consideration of fees

Investors are very interested in the criteria being used in the selection process. The majority are not concerned about the audit fee.

ACCs highlight competency, communication skills and working style of the partner and team as key considerations.

A&A Lab comment

BP sets out the criteria succinctly, and make clear that the proposals were evaluated on a 'fee blind' basis.

Example: BP Annual Report and Form 20-F 2016

Evaluation

Prior to the RFP being formally launched, briefing meetings were held with each firm covering key BP segments, functions and geographies; in addition the audit committee held introductory meetings with the lead and senior partners from each firm.

In preparation for the tender, BP sought assurance that each firm would be capable of being independent in the time frame required by applicable law or regulation before being appointed auditor. The due-diligence activities conducted as part of the tender included a review of firm independence.

The proposals from the three firms were evaluated by the audit committee against the following criteria, as well as the combined performance as a whole:

- Audit quality.
- Business knowledge.
- People, behaviours and cultural fit.
- Planning and project management, including transition.
- Innovation and insight.

- Independence.
- Commercial and contractual structure.

At the request of the audit committee chair, the commercial and contractual structure elements were assessed separately from the other aspects of the firms' proposals. Evaluation of the proposals was conducted on a 'fee blind' basis.



7 EXTERNAL AUDITOR - INDEPENDENCE AND OBJECTIVITY

Assessing independence and objectivity

(See best practice examples on pages 21 to 22)

The audit committee assesses the independence and objectivity of the audit process annually⁶, taking into consideration UK law and the auditor's independence requirements as set out in the *FRC Revised Ethical Standard*⁷.

ACCs say that explaining how they have assessed the objectivity of the external auditor can be a challenge. This should include an assessment of such characteristics as mindset and culture of the auditor, for example:

- demonstrating that they have exercised professional scepticism and an appropriate degree of challenge to management; and
- communicating contentious issues or why extra work has been performed.

The assessment of objectivity is partly done through the review of effectiveness, but is also based on the audit committee's experience of the external auditor, gained through meetings.

The audit committee should discuss with the auditor the threats to independence and mitigating safeguards.

FRC Revised Ethical Standard

The need for objectivity in performing the engagement arises from, among other things, the fact that many of the important issues involved in the performance of the engagement, including those arising in the preparation of the subject matter information, do not relate to questions of fact, but rather to questions of judgment.

Integrity or objectivity (and therefore independence) would be compromised if it is probable ... that an objective, reasonable and informed third party would conclude that the threats, arising from any conditions or relationships that exist ... would impair integrity or objectivity to such an extent that it would be inappropriate for the firm to accept or continue to perform the audit ... unless the threats were eliminated or further reduced or unless more, or more effective, safeguards were implemented.

Companies are required to have a policy on NAS. Investors consider it important to state compliance with the policy. Although many companies summarise the policy in the ACR, investors and ACCs suggest this could be published on the company website to reduce repetition in the ACR.

Companies say that a robust NAS policy assists in ensuring independence. Audit committees need to regularly monitor the level of NAS procured to ensure there is no threat to independence.

FRC Audit Quality – Practice Aid for audit committees

Assessing the objectivity of the auditor may in part be influenced by the level and type of NAS. The audit committee should also consider mindset and culture, judgement, skills and knowledge, and quality control.

⁶ FRC Audit Quality Practice Aid for audit committees.

⁷ Updated in 2016 for the EU Audit Regulation and Audit Directive.

Some investors highlight that NAS are less of a concern due to recent changes in the law (reflected in the *FRC Revised Ethical Standard*), which establish a 70% cap on the ratio of NAS to audit fees. This will take full effect in 2020. However, other investors want to see how companies deal with the transition, and say that the existence of the cap will not reduce their interest in the level of NAS provided by the auditor.

Although there is a statutory requirement to disclose NAS in the financial statements, investors want the audit committee to also disclose, consistent with the *FRC Guidance on Audit Committees*, specifically the amount of NAS paid and the ratio of audit fees to NAS fees, as well as explanations of significant

non-audit engagements (as defined in the policy). If the company's policy does not allow the external auditor to provide NAS, this should be stated.

In the event that the external auditor is providing NAS, investors would like audit committees to explain why they consider the external auditor is best placed to do this.

One investor suggests that audit committees should state that the auditor has been objective and independent. When confirming that the external auditor is independent, the audit committee relies in part on the external auditor's own internal controls on compliance with independence rules.



The FRC Revised Ethical Standard

Key changes introduced in 2016 include:

- specific prohibitions on NAS that can be provided to PIEs, which include the provision of tax advice;
- the maximum NAS fees that the auditor of a PIE can provide in any one year is limited to 70% of the average of the audit fees paid to the firm in the last three consecutive years; and
- that an engagement partner of a PIE is limited to a five-year period.

The calculation of the cap requires a three year history of audit fees and is applicable from June 2016. For a December year end company, the cap for the year ending 31 December 2020 will be 70% of the average audit fees for the years ending 31 December 2017, 2018 and 2019.

Standard Life

Non-audit services policy and fees

Investors look for disclosures by the audit committee that analyse the ratio of audit to NAS fees, and provide explanations of NAS engagements.

In the event that the external auditor is providing NAS, investors would like to know why the external auditor is best placed to provide the service and why the audit committee does not feel that independence has been impaired.

A&A Lab comment

The Standard Life report provides the audit/NAS fee ratio, and explains why the auditor has been selected to provide the NAS.

It also includes a commentary on services that are 'clearly trivial' and so do not need specific approval by the audit committee.

A company's NAS policy should specify the types of service for which use of the external auditor is pre-approved. Such approval should only be in place for matters that are 'clearly trivial'.

Example: Standard Life plc Annual Report and Accounts 2016

Auditor independence

During 2016, the Committee approved a revised non-audit services policy talking into account the revised Ethical Standards. The revised policy sets out an updated list of prohibited services which applies to KPMG LLP (subject to shareholder approval, our auditors for the 2017 financial year), in line with the Ethical Standards. This updated list of prohibited services is more restrictive than the current list and, in particular, prohibits KPMG LLP from providing almost all taxation services.

Audit and non-audit fees

The Group audit fee payable to PwC in respect of 2016 was £4.1m (2015: £3.7m). In addition fees payable were £0.8m (2015: £0.7m) in relation to the audit of investment funds which are not consolidated by the Group, and £0.8m (2015: £1.6m) was incurred on audit related services. Fees for audit related services are primarily in respect of Solvency II regulatory reporting, client money reporting and the half year review. The reduction in these fees compared to 2015 largely relates to lower Solvency II assurance services and no longer also requiring audit reporting under the previous regulatory regime. The Committee is satisfied that the audit fee is commensurate with permitting PwC to provide a quality audit and monitors regularly the level of audit and non-audit fees. Non-audit work can only be undertaken if the fees have been approved in advance in accordance with the Board's policy for non-audit fees. Unless fees are clearly trivial (which we have defined as less than £50,000), the approval of the whole Committee is now required.

Non-audit fees amounted to £1.4m (2015: £1.3 million). This includes tax compliance fees of £0.4m (2015: £0.4m) which are primarily services provided to Standard Life Investments' funds. Tax advisory fees were £0.2m (2015: £0.1m) and related to areas that the Committee was comfortable did not impact auditor independence. Non-audit fees also included £0.5m (2015: £0.5m) relating to control assurance reports, in particular those provided to Standard Life Investments' clients, which are closely associated with audit work. Other non-audit services of £0.3m (2015: £0.3m) included a review of internal credit ratings and support provided to fund mergers. The External auditors were considered the most suitable supplier for these services taking into account the alignment of these services to the work undertaken by external audit and the firm's skill sets.

Further details of the fees paid to the External auditors for audit and non-audit work carried out during the year are set out in Note 9 of the Group financial statements.

The ratio of non-audit fees to audit and audit related assurance fees is 25% (2015: 22%). The level of non-audit fees is expected to reduce in 2017 as a result of the revised non-audit services policy discussed above.

The Committee is satisfied that the non-audit fees do not impair PwC's independence.

CRODA

Objectivity assessed as part of the annual review of auditor effectiveness

The assessment of objectivity is usually part of the annual review of external auditor effectiveness performed by the audit committee. As this looks at the mindset and the approach taken by the external auditor, investors are interested in how the audit committee has performed this assessment, and what factors were taken into account.

Investors highlight professional scepticism as a key element of objectivity, and like this to be acknowledged by the audit committee in its report.

A&A Lab comment

Croda's audit committee looks at the manner in which the auditor has 'applied constructive challenge and professional scepticism'.

Example: Croda International Plc Annual Report and Accounts 2016

External auditors' effectiveness

The Committee considered:

- Quality of planning, delivery and execution of the audit
- Quality and knowledge of the audit team
- Effectiveness of communications between management and the audit team
- Robustness of the audit, including the audit team's ability to challenge management as well as demonstrate professional scepticism and independence.

The Committee also considered the quality of reports from PwC and the additional insights provided by the audit team, particularly at partner level. It took account of the views of the Group Finance Director and Group Financial Controller, who had met local audit partners when visiting some of the Group's businesses, to gauge the quality

of the team and their knowledge and understanding of the Business.

The Committee considered how well the auditors assessed key accounting and audit judgements and the way they applied constructive challenge and professional scepticism in dealing with management.



8 EXTERNAL AUDITOR - EFFECTIVENESS

Assessing effectiveness

(See best practice examples on pages 25 to 28)

Investors expect the ACR to set out the factors considered in the assessment of the effectiveness of the audit process⁸.

Some investors find the discussion on effectiveness focuses too much on the relationship between the external auditor and management. They consider the relationship between the audit committee and the external auditor to be the most important, and would like to see this made clear.

Investors and ACCs agree that the report should include evidence that the external auditor has exhibited professional scepticism, although in practice, this is not often clearly disclosed. Investors appreciate insight into the criteria used in the assessment, and would like to understand the process (including how the views of those outside the finance department have been taken into account).

If ACCs have met privately with the external auditor, this should be disclosed. Although it is a common event, investors are not always aware that it happens.

⁸ C.3.2 UK Corporate Governance Code.

ACCs note that the tendering process provides them with detailed insight into the audit process, and helps provide a benchmark for assessing effectiveness. In reviewing the effectiveness of a recently appointed auditor, investors expect audit committees to include a reference to the original tender, so that they can understand if the auditor has met expectations in the first year of the audit.

Investors also want confirmation that the auditor is effective in the last year of their appointment. It is not always clear if this has been assessed.

External evidence

Investors are interested in knowing what the audit committee has done to obtain external evidence of the auditor's effectiveness.

ACCs read the FRC's AQR team report on the audit firm, and receive the results of individual engagement reports where the audit has been reviewed by AQR. Investors would like the audit committee to disclose their response to the results of these individual reviews.

Investors also want to know whether there has been any interaction with the FRC CRR team, and how this has fed into the assessment of auditor effectiveness. An example of this would be whether the audit committee compares the points raised by the external auditor with those of the CRR team.

FRC Audit Quality Practice Audit for audit committees

During a roundtable to develop the practice aid:

'...participants generally suggested that the assessment should not be a separate compliance exercise, or an annual one-off exercise, but rather should form an integral part of the audit committee's activities. These allow it to form its own view on audit quality, and on the effectiveness of the external audit process, based on the evidence it can reasonably obtain during the year. This should both improve the effectiveness of their assessment and reduce the burden of their year-end activities.'



M&S

EST. 1884

Effectiveness process, including the name and tenure of the lead partner

Investors find it useful when the audit committee discloses the outcome of their work.

A&A Lab comment

M&S describes the outcome of the effectiveness review, how the auditor had improved over the previous year, and areas for development.

Example: Marks and Spencer PLC Annual Report and Accounts 2017

EFFECTIVENESS

The effectiveness of our external auditor is assessed in accordance with a process agreed by the Audit Committee, which is divided into ten structured components setting out the key areas of the audit process for the Committee to consider.

This framework also recognises the contribution of management in being fully engaged with, and thereby enhancing the effectiveness of, the external audit process. It enables the Audit Committee to form a view of management's role in an effective audit process by considering whether it believes in a culture of 'right first time', produces high quality papers, ensures robust internal systems and controls are maintained, respects and values the independent audit process and examines any audit adjustments proposed by the external auditor with appropriate rigour.

This framework provides a robust process for monitoring auditor effectiveness and can be measured against the findings of future external auditor effectiveness surveys. The approach to the assessment is tailored to enable senior management to answer

detailed questions on the Company-wide audit process, and provide the Audit Committee with sufficient detail to establish an informed view on the overall efficiency, integrity and effectiveness of the external audit.

Questionnaires were tailored to the following target groups:

- 1. Chief Finance Officer and Director of Group Finance:** A full questionnaire was completed, covering all areas of the audit process, while taking account of the questionnaires completed by the Directors of Finance for Food and Clothing & Home and Head of Finance, International.
- 2. Directors of Finance: Food, Clothing & Home and Head of Finance, International:** Shorter questionnaire, focussing on the audit team, planning, challenge and interaction with the business.
- 3. Audit Committee:** A high-level set of questions with specific focus on the planning, execution, value, communication and challenge of the audit and audit partner. The Committee had access to copies of the completed management questionnaires (sections 1 and 2 above) to assist with its own considerations.

WHAT WAS THE OUTCOME?

Feedback from each of the target groups was positive overall, particularly in respect of the technical insight and challenge provided by the audit team; its level of interaction with the business; its strong understanding of M&S's culture and values; and the valuable guidance provided for the Company's strategic initiatives. It was felt that areas identified during the 2015/16 review had improved during the year, specifically the communication between the business and Deloitte during the audit process; however, it was felt that further improvements could still be achieved.

Areas for development identified in this year's review were encouraging a more joined-up approach during the audit and ensuring the timely provision of accurate information by M&S to the auditor. Additionally, it was felt that further work by both M&S and Deloitte would improve the efficiency of the overseas audit process.



Effectiveness process, including AQR findings

In addition to how the audit committee assesses the effectiveness of the auditor, investors are interested in the outcome of the AQR team's work, including the impact on the current financial statements.

A&A Lab comment

The audit committee has been transparent in its effectiveness disclosure.

The FRC Guidance on Audit Committees states that ACRs should include disclosure where the audit has been reviewed by the AQR team.

The Johnson Matthey report includes specific information on the results of the 2015/16 AQR review, and it makes clear that the audit committee has concluded that they have no concerns about the overall quality of the reviewed audit.

Example: Johnson Matthey Plc Annual Report and Accounts 2017

How we reviewed KPMG's performance and the effectiveness of the external audit process

Towards the end of the 2016/17 external audit, a feedback questionnaire was circulated to the executive directors and senior management. They were asked to rate how satisfied they were with KPMG, including its level of planning and coordination, ability to meet delivery dates and objectives, industry / specialist knowledge, preparedness and organisation, ability to firmly challenge management, independence, level and quality of communication and value for money.

The results showed an overall level of satisfaction with KPMG and that action had been taken on points arising from last year's feedback. There are areas where further improvements can be made and at our next meeting, Stephen Oxley, our lead audit partner, will explain how he intends to adapt the audit approach for the current year to take into account the findings. We will also consider any relevant issues as part of the external audit tender process which will be conducted in 2017/18.

On a continuous basis throughout the year, we look at the quality of KPMG's reports and the performance of Stephen Oxley both in and outside committee meetings. We pay particular attention to the way Stephen and the team interact with and challenge management as well as the effectiveness of the relationship between the internal and external audit teams. We also obtain feedback from the Chief Executive, the Chief Financial Officer and the Group Reporting Controller, all of whom have extensive interactions with KPMG. As noted earlier, I have regular one to one update meetings with Stephen to discuss agenda items and other matters which either Stephen or I feel are important.

We also reviewed findings from the FRC's Audit Quality Review team on KPMG's audit of Johnson Matthey's Annual Report and Accounts for the year ended 31st March 2016. We were pleased to find that the feedback was reassuring. Points were raised on post-employment benefit plans and, at component level, revenue. These points were fully discussed by the committee and, together with KPMG, we have agreed a number of actions to be taken in order to refine the audit approach. The committee was comfortable that whilst the proposed changes would improve the quality of the audit going forward they were not such as to give us concerns as to the audit of the 2016 accounts.

Following the above, we concluded that KPMG continues to provide an effective audit and therefore we recommended to the board its reappointment for 2017/18. A resolution proposing its reappointment is included in the notice of the 2017 AGM.



Effectiveness and audit quality

Investors are looking for succinct disclosure, which identifies key aspects of the effectiveness review and clearly articulates the conclusions reached.

A&A Lab comment

ITV uses the FRC Audit Quality Practice Aid for audit committees, in its review of audit quality and sets out the specific areas considered, including materiality.

Example: ITV plc Annual Report and Accounts 2016

Audit quality is reviewed throughout the year and in 2016 the Committee used the Financial Reporting Council's (FRC) Audit Quality Practice Aid help structure its review of audit quality. When making its assessment of audit quality, the factors the Committee focused on included:

External audit quality reports	The audit strategy for the year addressed thematic concerns that the FRC had highlighted.
Auditor Interaction with management	Reviewing the auditor's understanding of business progress against the strategy and emerging industry themes, as well as the auditor's discussion with management on key corporate transactions.
Auditors own view of effectiveness	Enquired with regards to: <ul style="list-style-type: none"> • their audit methodology and its effective application to ITV; • their robustness of challenges and findings on areas which require management judgement; • whether there had been an internal peer review of the ITV audit and what the findings were; and • the experience of the senior members of the audit team.

Further in its assessment of audit quality the Committee took into account:

- the detailed audit strategy for the year, including the coverage of emerging risks;
- Group materiality and component materiality;
- how the auditor communicated any key accounting judgements and conclusions; and
- feedback from management of the performance of the auditor.

There were no significant findings from the evaluation this year and the Committee considers the external audit to have been robust and effective.

The Committee also considered the FRC Audit Quality Review feedback from their review of our 2015 audit and agreed with KPMG the changes in audit procedures they will make and how we will support their implementation.



Audit quality

In addition to how the audit committee assesses the effectiveness of the auditor, investors are interested in the outcome of the FRC AQR team's work. The FRC Guidance on Audit Committees states that ACRs should include disclosure where the audit has been reviewed by the FRC's AQR team.

The audit committee receives a copy of the AQR team's report. Where the audit requires more than limited improvements, the AQR report will identify the key drivers for the category. Consistent with the guidance, investors would like audit committees to disclose the findings and the actions they plan to take.

A&A Lab comment

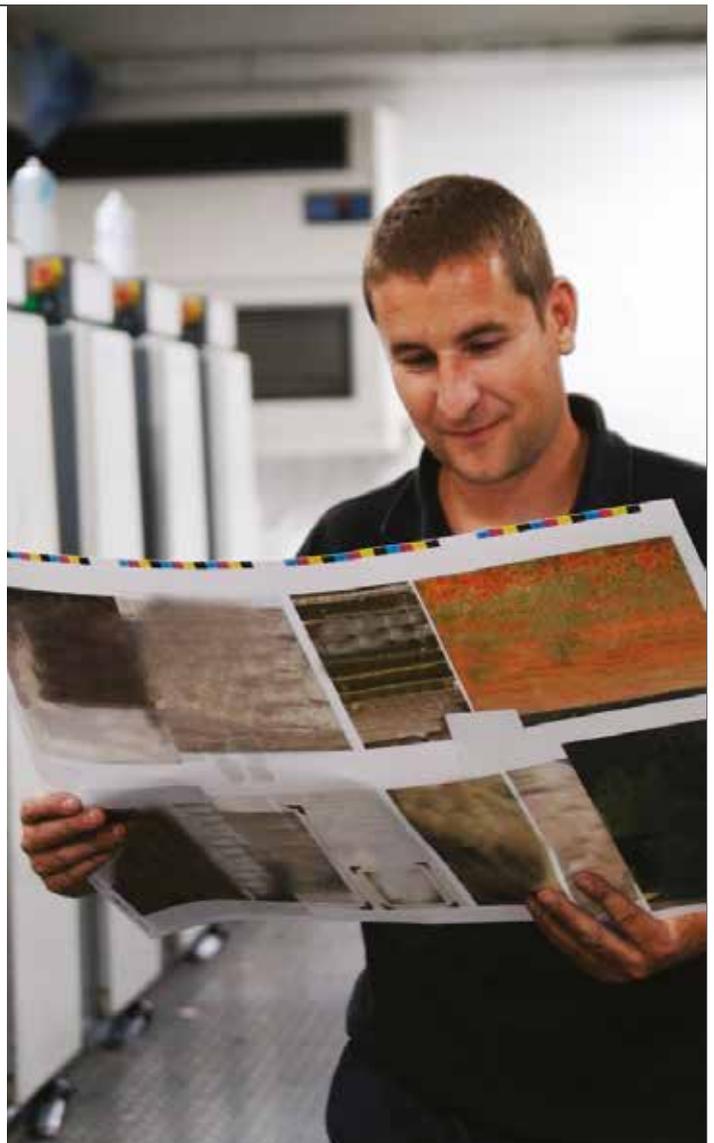
The disclosure states that the audit committee is satisfied that there are no matters which affect the appointment of the auditor.

Example: Mondi plc Annual Report and Accounts 2016

Interaction with regulators

UK Financial Reporting Council (FRC) Audit Quality Review

The FRC's Audit Quality Review team selected to review the audit of the 2015 Mondi plc financial statements as part of their 2015 annual inspection of audit firms. The focus of the review and their reporting is on identifying areas where improvements are required rather than highlighting areas performed to or above the expected level. The chairman of the audit committee received a full copy of the findings of the Audit Quality Review team and has discussed these with Deloitte. The audit committee confirms that there were no significant areas for improvement identified within the report. The audit committee is also satisfied that there is nothing within the report which might have a bearing on the audit appointment.



9 REPORTING ON SIGNIFICANT ISSUES

Significant issues and judgements

(See best practice examples on pages 32 to 34)

The audit committee should review, and report to the board, significant financial reporting issues and judgements made during the preparation of the financial statements. The audit committee is also required to report on any other significant issues that they considered during the year.

ACCs aim to report the most significant issues tackled by the committee during the year. These issues will be material and, in most cases, are likely to be judgemental.

Outcomes are important

ACCs are of the view that describing the outcomes of the committee's discussion of significant issues is more important than the tone of the language used. Most investors want the audit committee to be open and specific in their reporting of significant issues. They expect the audit committee to state clearly their conclusion, and explain the rationale for their conclusion on each significant issue. Most ACCs agree with this expectation.

ACCs are looking to provide comfort to shareholders and insight into the process that has taken place.

Investors agree with this – most say that they have some interest in the process (especially if review and challenge from the audit committee

has resulted in management performing additional work), but they do not want, and are unlikely to read, disclosures that are heavy with detail.

The greatest consensus among investors comes in their desire to see quantification of the significant issues. One said that it was helpful if companies disclosed information specific to their circumstances, covering the key points of concern.

In considering the extent of disclosure, ACCs said they had to apply judgement in view of the possible commercial sensitivity.

Some investors express a desire for the audit committee to disclose more information about the significant estimates or judgements that were considered, and the range of possible outcomes that resulted.

ACCs say that the audit committee is often delegated the task of advising the board on whether, taken as a whole, the annual report and accounts is fair, balanced and understandable (FBU), and whether it provides the information necessary for shareholders to assess the company's position and performance, business model and strategy. The board then confirms this in the annual report, as well as stating that the financial statements are true and fair. Neither of these statements is made on an issue-by-issue basis.

Several investors highlight the different roles of management and the audit committee in the preparation and review of the annual report and accounts. They would like to understand better the different

roles and the impact of the work performed by the audit committee. The report should clearly identify the work done by each.

Financial Reporting Lab: Reporting of Audit Committees

The FRC Financial Reporting Lab issued a report in 2013 which identified key aspects which investors want from audit committee significant issues disclosures:

- Provide the context of the issue, for example quantification.
- Describe the audit committee's actions in the year.
- Clearly describe the conclusion.
- Explain the rationale for that conclusion.
- Include cross-references to where other information can be found.

These aspects continue to remain relevant in current reporting.

'It makes a significant difference if an audit committee report is confident and assertive.'

Investor

Use of language

When it comes to the language used in the ACR, some investors think that the description of the audit committee's work could be more 'active'. Other investors pay less attention to the language used, instead being more interested in the results of the audit committee's work.

ACCs do not want the choice of language they use in the disclosure to become an impediment to effective discussions during audit committee meetings. Several ACCs say that their choice of language is intended to avoid the suggestion that meetings were confrontational when they were not.

'We try and use the language that reflects best what we do, rather than just grab for the thesaurus to come up with another word for 'review'.'

Audit committee chair

Consistency between ACR and the external auditor's report

Investors expect some consistency between the audit committee's disclosure of significant issues and the areas of focus covered in the external auditor's report, but do not expect them to be the same. ACCs agree, pointing out that they identify issues from a different perspective.

Investors would like cross-references to where they can find additional information in the annual report on the significant issues raised in the ACR.

ISA (UK) 720

Under ISA (UK) 720, the auditor shall consider whether, or not, matters communicated to the audit committee have been appropriately addressed in the ACR. If these matters have not been appropriately communicated, the auditor will report this.

Alternative Performance Measures

Investors consider that the audit committee has a key role in reviewing and challenging the APMs presented by management. They are satisfied with disclosures reconciling APMs to Generally Accepted Accounting Principles, but are more concerned about understanding whether APMs represent economic value.

Thematic Review on APMs

The FRC CRR team issued a thematic review on APMs in November 2017. AQR will be conducting a thematic in 2018 on auditors' responsibilities for areas of the annual report beyond the financial statements.

Phase 2 of this project will cover reporting by auditors to audit committees, including APMs.

FRC FAQ's on European Securities and Markets Authority Guidelines on APMs

The choice of APMs, if any, is a matter of judgement of those responsible for providing the information, such as the directors in respect of the Annual Report.

This judgement should be applied to ensure the APMs provided are relevant and understandable for users within the context of wider reporting responsibilities such as the provision of an Annual Report that is fair, balanced and understandable.

Future issues

ACRs disclose the impact of a new accounting standard if it will have a material impact on the company's financial statements. Some investors say this is important because it provides them with confidence that the audit committee is looking at how the company will be positioned for the future.



FRC Guidance on Audit Committees contains several paragraphs on the reporting of significant issues:

'The committee needs to exercise judgement in deciding which of the issues it considered in relation to the financial statements were significant. The audit committee should aim to describe the significant issues in a concise and understandable form whilst reporting on the specific circumstances of the company.'

When reporting on the significant issues, the audit committee would not be expected to disclose information which, in its opinion, would be prejudicial to the interests of the company (for example, because it related to impending developments or matters in the course of negotiation).

The section need not repeat information disclosed elsewhere in the annual report and accounts, but could provide signposts to that information.'

This extract from the guidance is very much consistent with the messages heard from both ACCs and investors during the project.



Significant issues – quantification of issues, conclusions and rationale

In respect of significant issues, most investors want some quantification of them as well as the action taken by the audit committee. They also expect the audit committee to state its conclusions and explain the rationale for any judgements.

A&A Lab comment

Barclays uses a tabular format that clearly sets out the work done by the audit committee. It provides quantification of the issue, including the total cumulative provision.

Example: Barclays PLC Annual Report and Accounts 2016

Area of focus	Reporting issue	Role of the Committee	Conclusion/action taken
<p>Conduct provisions (see Note 27 to the financial statements).</p>	<p>Barclays makes certain assumptions and estimates, analysis of which underpins provisions made for the costs of customer redress, such as for Payment Protection Insurance (PPI).</p>	<ul style="list-style-type: none"> Regularly analysed the judgements and estimates made with regard to Barclays’ provisioning for PPI claims, taking into account forecasts and assumptions made for PPI complaints and actual claims experience for Barclays and the industry as a whole. Debated the potential impact on the future range of provisions arising from the FCA’s proposed timebar on claims and the expected deadline of June 2019, discussing the level of uncertainty in the projections. Discussed the potential range of outcomes that might arise from the Plevin case (the 2014 UK Supreme Court ruling in Plevin v Paragon Personal Finance Ltd) and whether any increase in provisions was required. Evaluated proposed additional provisions for PPI and whether the analysis performed by management was consistent with prior periods and reflected known trend data and whether Barclays’ approach was consistent with that taken by industry peers. Assessed provisions for alternative PPI (card protection and payment break plan insurance) and the claims experience compared to the range of reasonable high and low end scenarios that had been determined. 	<p>The Committee and management continue to monitor closely any changes in customer or claims management companies’ behaviour in light of the Plevin case and the proposed FCA timebar. Over the course of 2016, having assessed actual claims experience and the potential impact of the proposed timebar and the Plevin case, the Committee agreed to recognise the additional provisions of £1,000m in 2016, bringing Barclays’ total cumulative provisions against the cost of PPI redress and associated processing costs to £8.4bn, of which £2.0bn is remaining.</p>



Significant issues – clear identification of audit committee conclusion

Investors are looking for a clear conclusion that the audit committee is satisfied with the treatment of the significant issues.

A&A Lab comment

The audit committee of Fresnillo provides a clear statement (in bold) confirming their conclusion. They also provide linkage to additional information in the financial statements.

Example: Fresnillo plc Annual Report and Accounts 2016

Significant judgement areas in 2016

Mineral reserves and resources

The estimation of mineral reserves and resources requires significant judgement not only in respect of mineral physically in place but also metal price and cost assumptions determine the cut-off grade for identifying economically viable ore bodies.

Reserves and resources are a primary driver of Fresnillo's market valuation and a significant input into assessments of depreciation and impairment. As a result, inaccuracies in the estimation of reserves and resources would lead to broad implications across the Annual Report and Accounts.

The Committee reviewed the report by SRK Consulting (the Company's independent reserves and resources auditor) on the reserves and resources (excluding Silverstream) and considered the year-on-year changes in SRK's estimation of reserves and resources quantities. The Committee also reviewed the methodology used by EY to assess the SRK reporting and the commentary on reserves and resources within the Annual Report.

The Audit Committee is satisfied that the review process itself and that the Company's disclosures are appropriate.

 [See pages 242 to 246](#)

Silverstream

The Silverstream contract is a derivative financial instrument which must be reflected at fair value at each balance sheet date. The fair value is most sensitive to the timing and volume of forecast production derived from the reserves and resources and production profile of the Sabinas mine, the estimated future silver price and the discount rate.

The Silverstream contract represents a large asset on our balance sheet which can also, as a result of movements in metals prices, give rise to large, albeit non-cash, amounts in our income statement.

The Audit Committee reviewed the inputs into the estimation of the valuation at the balance sheet date and associated sensitivity analysis. It also reviewed the disclosures relating to the Silverstream contract and discussed with EY their procedures for auditing the accuracy of the model used in the valuation and the key assumptions therein.

The Audit Committee is satisfied that the related gain on the Silverstream Contract is acceptable and that the accounting treatment and disclosure in the financial statements is appropriate.

 [See note 14 to the financial statements](#)



APMs are considered as part of FBU

The audit committee is often delegated the responsibility by the board of advising them whether the annual report and accounts, taken as a whole, is FBU and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy.

A&A Lab comment
 Investors value the audit committee's review of Barclays APMs, which have been assessed as part of their work on FBU.

Example: Barclays PLC Annual Report and Accounts 2016

Fair, balanced and understandable reporting
 (including country-by-country reporting and Pillar 3 reporting).

Having evaluated all of the available information and the assurances provided by management, the Committee concluded that the processes underlying the preparation of Barclays' published financial statements, including the 2016 annual report and financial statements, were appropriate in ensuring that those statements were fair, balanced and understandable.

In assessing Barclays' financial results statements over the course of 2016, the Committee specifically addressed and provided input to management on the disclosure and presentation of:

- alternative performance measures in view of new guidance from the European Securities & Markets Association



7 INTERNAL CONTROL, RISK MANAGEMENT SYSTEMS, AND INTERNAL AUDIT

Board can assign responsibility

(See best practice examples on pages 38 to 43)

The Code allows the board to:

- assign to the audit committee the responsibility of reviewing the company's internal financial controls; and
- delegate the review of internal control and risk management systems to the audit committee.

Where a company has a separate risk committee composed of independent directors (as required in financial services), the risk committee may undertake part or all of this review. Alternatively, the audit committee may take responsibility.

Some ACCs and company representatives comment on the difference in internal control and risk management systems between many prudentially regulated banks and insurers, and other companies. The general view from participants is that regulated banks and insurers have more sophisticated and complex systems.

The nature of internal controls and risks will differ between companies. Internal controls may include financial, operational and compliance controls. The risk management systems may cover financial, operational, reputational, organisational, third party, or external risks, such as market, credit or regulatory risks.

While responsibility is delegated by the board to its committees, the board remains ultimately responsible for the monitoring and review of effectiveness of internal control and risk management systems.

ACCs and companies agree that disclosure must be consistent with the oversight arrangements in place. If the audit committee is only delegated responsibility by the board for monitoring and reviewing a part of the internal control and risk management system, this ought to be made clear in the ACR.

ACCs say that difficulty in describing succinctly the design of and responsibility for internal control and risk management systems may reflect a lack of clarity within the company in these areas. Similarly, investors say that they look for clear disclosures. A lack of it in this area may raise doubts about the effectiveness of internal control and risk management systems.

Effectiveness of internal control and risk management systems

Investors expect audit committees to explain how they have included strategic considerations in their review of effectiveness of risk management and internal controls. Investors say that too often this disclosure describes process without giving any company specific insight, or demonstrating how governance activities support the company's strategy.

ACCs agree that disclosures ought to refer to the strategic aims of the company, and how the audit committee plans to ensure that internal control and risk management systems can cope with growth.

Investors also expect clear linkage to where other aspects of internal control and risk management are discussed in the annual report (e.g. principal risks, work of the risk committee). They highlight that inconsistency between these disclosures is a cause for concern.

FRC Guidance on Audit Committees

The board has overall responsibility for an organisation's approach to risk management and internal control and nothing in the guidance should be interpreted as a departure from the principle of the unitary board. Any disagreement within the board, including disagreement between the audit committee's members and the rest of the board, should be resolved at board level.

Investors would like to understand how the audit committee has obtained assurance over risk management and internal control, and how it plans to address any significant failings or weaknesses. ACCs recognise that they have to exercise judgement when assessing significance. However, they acknowledge that such failings or weaknesses should be disclosed.

ACCs confirm that they are usually responsible for assessing the outcomes of monitoring and reviewing activities, but need to balance disclosure against threats to the company from competitors and malicious agents. The main example raised is weakness in cyber security: ACCs and companies say that disclosure of weakness in this area would make them a target for hackers.

However, several ACCs point out that this should not prevent commentary on the company's aspirations for internal control and risk management systems.

In respect of internal controls, some investors note that it is possible to read between the lines of the external auditor's report, in order to understand how much reliance is placed on the company's controls for the purposes of the audit. These investors compare disclosures in ACR to those in the wider annual report and accounts.

FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting

Paragraph 43 of this guidance says the annual review of effectiveness should consider:

- *the company's willingness to take on risk (its "risk appetite"), the desired culture within the company and whether this culture has been embedded;*
- *the operation of the risk management and internal control systems, covering the design, implementation, monitoring and review and identification of risks and determination of those which are principal to the company;*
- *the integration of risk management and internal controls with considerations of strategy and business model, and with business planning processes;*
- *the extent, frequency and quality of the communication of the results of management's monitoring to the board which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed or mitigated;*
- *issues dealt with in reports reviewed by the board during the year, in particular the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have, or could have, resulted in unforeseen impact; and*
- *the effectiveness of the company's public reporting processes.*

Audit committees can use these points when determining the extent of disclosure in the annual report and accounts as a whole, and their report in particular.

Viability statement

The viability statement was introduced in the 2014 update to the Code. In some companies, the risk committee will take the lead. In others, the audit committee may be tasked with reviewing the work underpinning the viability statement.

As with other areas of reporting, investors are interested in understanding what role the audit committee has played when performing this review (see the Financial Reporting Lab's recent report on *Risk and Viability Reporting*)⁹.

Effectiveness of internal audit

Internal audit has a wide range of responsibilities. ACCs say that they spend a significant proportion of their time engaged on the work of internal audit as the audit committee is responsible for the establishment of and directing the work of internal audit. Investors state that this is not always evident in the ACR.

Most investors consider the role of internal audit as a key source of information for the audit committee. Investors know that the internal audit mandate and team is driven by the audit committee, and that internal audit will usually spend more time than external audit in implementing their plan for the year.

Investors expect the internal audit team to have a clear and direct reporting line to the audit committee, so as to avoid any possibility of management influence on activities and results.

In a similar way to internal controls, ACCs do not see much value in disclosing internal audit issues and ratings, unless they are significant. One ACC raised a concern that public disclosure might result in reduced escalation of issues within the company and, in particular, to the internal audit function.

Consistent with the Guidance on Audit Committees, investors expect the audit committee to review the effectiveness of internal audit, and are interested in the outcome. Investors say that too often disclosure on this lacks specificity.

Whistleblowing

The Code includes a provision¹⁰ requiring the audit committee to review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

In financial services companies, ACCs are appointed Whistleblower's Champion as part of the Senior Managers Regime.

Investors are interested in disclosure on whistleblowing, especially over time which allows for better comparison of progress made by the company.

Some ACCs commented that disclosures which present details, for example those that quantify the number of concerns raised, should have accompanying narrative order to provide context.

⁹ Risk-and-Viability-Reporting.pdf.

¹⁰ C.3.5.



Internal controls

As with other areas of the annual report, investors welcome disclosures that provide insight and information specific to the company.

A&A Lab comment

Barclays clearly sets out the action taken by the audit committee in respect of internal control. There is a clear distinction between what the committee reacted to (“welcomed”/ “endorsed”) and where it was proactive or pushing (“required enhancement”/ “proposed that”).

Example: Barclays PLC Annual Report and Accounts 2016

Area of focus	Matter addressed	Role of the Committee	Conclusion/action taken
<p>Internal control</p> <p>Read more about the Barclays’ internal control and risk management processes on pages 88 and 89.</p>	<p>The effectiveness of the overall control environment, including the status of any material control issues and the progress of specific remediation plans.</p>	<ul style="list-style-type: none"> • Evaluated and tracked the status of the most material control issues identified by management via regular reports from the Head of Operational Risk and latterly from the Chief Controls Officer. • Evaluated the status of specific material control issues and associated remediation plans, including in particular those relating to Security of Secret and Confidential Data; Infrastructure Access Management; Group Resilience; IT Security; Data Governance; Model Risk Management; and Unsupported Infrastructure and Applications, all of which remained open at the end of 2016. • Discussed lessons learned from specific control incidents and how these could be applied to Barclays’ business globally, via an enhanced lessons-learned process. • Debated any regulatory reports or other feedback received from regulators on Barclays’ overall control environment. • Assessed the status of the enhancements being made to Barclays risk and control self-assessment (RCSA) process to support disclosures in Barclays annual report. 	<p>The Committee requested enhancements to reporting to make clear where operational risk was outside appetite and the actions being taken. The Committee welcomed the improvements made to the lessons-learned process and proposed that the new Group Controls Committee should play a role in setting standards for lessons-learned exercises and deciding when they should be conducted. The Committee endorsed the work being taken forward, under the leadership of the Chief Controls Officer, to address any feedback from regulators on Barclays’ control environment, noting that the Board would directly oversee the progress being made to address specific regulatory feedback. The Committee also challenged management to ensure that the RCSA process was sufficiently robust in light of some specific control issues that had emerged after certain RCSAs had been completed.</p>



vodafone

Internal controls & risk management

Investors look for disclosures specific to the company and with clearly described outcomes.

A&A Lab comment

Vodafone discloses the areas where it performed an in-depth review and describes the coordinated approach involving internal audit. The outcome of the review is clearly set out, including reference to the guidance used for the review.

Example: Vodafone Plc Annual Report and Accounts 2017

Assessment of Group's system of internal control, including risk management framework

The Committee also maintains a programme of in-depth reviews into specific financial, operational and regulatory areas of the business. These reviews are critical to the role of the Committee, as they allow us to meet key business leaders responsible for these areas and provide independent challenge to their activities. During the 2017 financial year, the areas reviewed included:

- technology failure, including a review of the Group's technology resilience risk management plan, policy compliance across both the Group's mobile and fixed networks, cyber-threat resiliency and user access management;
- tax risk mitigation strategy, including proactive engagement with key stakeholders, external publication of the updated "Tax Risk Management Policy" to meet new UK legislative requirements and internal policies to manage tax fraud risks;
- unstable economic conditions and the impact on the Group's treasury operations including the setting of debt maturities, fixed/floating interest rate mix and counterparty credit risk;
- the impact on the framework for risk and compliance in Vodafone India following changes in competition driven by the new market entrant and the demonetisation introduced by the Indian Government in November 2016;
- the integration of Vodafone Netherlands and Ziggo into the merged 50:50 joint venture and the transition to common governance standards;
- a review of the monitoring work being done to assess the impact of the referendum vote that Britain should leave the EU; and
- a review of PricewaterhouseCoopers' data security and confidentiality arrangements.

The Group has in place an internal control environment to protect the business from the material risks which have been identified. Management is responsible for establishing and maintaining adequate internal controls over financial reporting and we have responsibility for ensuring the effectiveness of these controls. Last year, these controls were enhanced through the application of a co-ordinated assurance approach which provides a framework that allows a comprehensive assessment of the assurance and compliance activities for the Group's significant risks.

The Committee has completed its review of the effectiveness of the Group's system of internal control, including risk management, during the year and up to the date of this Annual Report, in accordance with the requirements of the Guidance on Risk Management, Internal Control and related Financial and Business Reporting published by the FRC.

It confirms that no significant failings or weaknesses were identified in the review for the 2017 financial year and allowed us to provide positive assurance to the Board to assist them in making the statements required by the 2014 UK Corporate Governance Code. Where areas for improvement were identified, processes are in place to ensure that the necessary action is taken and that progress is monitored.

**Internal controls & risk management**

Investors want to understand the linkage between different aspects of internal control and risk management.

A&A Lab comment

Johnson Matthey provides insight into the work it does to obtain comfort over all its sites, describing the link between principal risks and the internal audit plan.

Example: Johnson Matthey Plc Annual Report and Accounts 2017**Corporate Assurance and Risk Annual Plan**

We spend a significant amount of time reviewing the corporate assurance and risk annual plan, which is presented to us by the Group Assurance and Risk Director, to ensure it is comprehensive, well targeted and provides the appropriate level of assurance. In particular, we want to know the factors taken into account in devising the plan, the risk profile of auditable sites and businesses influenced by the key control assessment process, the scope and depth of each type of audit and the plan's coverage across the group. It is just as important for us to understand what is not covered by the plan, either by way of business activity or geographic coverage. Where there is no coverage at certain sites or businesses, we discuss what other mechanisms are in place to check the adequacy of controls, such as sector management oversight or external audit activity. These other sources of assurance are important when assessing the level of assurance we require from this plan. In reviewing the 2017/18 plan, we were pleased to see that additional data had been analysed in building the plan, including concerns raised via speak up (whistleblowing) reports, the results of investigations and legal team health check findings. The plan was also mapped against the principal risks which allowed us to see how much coverage there would be on each risk.

We believe the 2017/18 plan addresses Johnson Matthey's key risks and its coverage is appropriate for the size and nature of the group. On that basis, we approved the plan.



Rolls-Royce®

Going concern and viability statements

Investors want to understand what the audit committee has done on going concern and viability statements.

A&A Lab comment

Rolls-Royce sets out what the audit committee has considered as part of the review of going concern and viability statements. The Financial Reporting Lab published a report on Risk & Viability in November 2017, where issues around the reporting of the viability statement are looked at in more detail.

Example: Rolls-Royce Holdings plc Annual Report 2016

Going concern and viability statements

We reviewed the processes and assumptions underlying the statements set out on page 53. In particular, we considered:

- The Group's forecast funding position over the next five years.
- An analysis of impacts of severe but plausible risk scenarios, ensuring that these were consistent with the risks reviewed by the Board as part of its strategy review.
- The impact of multiple risks occurring simultaneously.
- Additional mitigating actions that Group could take in extreme circumstances.
- The current borrowing facilities in place and the availability of future facilities.

As a result, we were satisfied that the going concern and viability statements have been prepared on an appropriate basis.





Whistleblowing

Investors are interested in disclosure on whistleblowing, in particular over time. It provides them with insight into the working practices of a company. Some ACCs commented that when making disclosure with such detail, accompanying narrative may be helpful in order to provide context.

A&A Lab comment

Johnson Matthey provides statistics on the nature and volume of 'speak up' reports*.

Disclosure on whistleblowing is likely to be included in the audit committee report, in particular

in financial services companies, where the ACCs are appointed Whistleblower's Champion as part of the Senior Managers Regime.

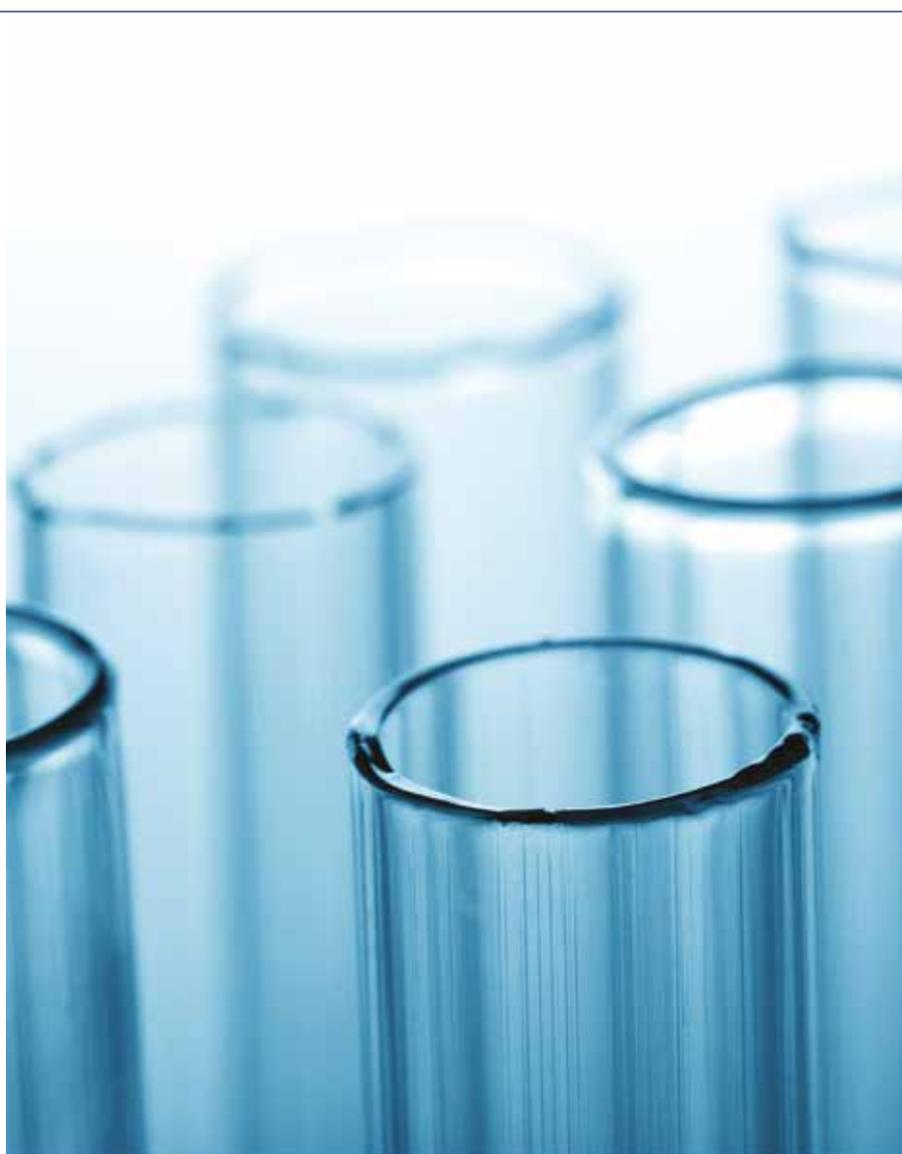
** Disclosed in 'Our People' section of the annual report.*

Example: Johnson Matthey Plc Annual Report and Accounts 2017

Speak Up Reports

In 2016/17 there were a total of 75 speak up reports, an increase of 42% (see page 56). 63% of these were closed in the year. We view the uplift as a positive reflection of a greater awareness and understanding of the benefits of speaking up, and that our people know that raising concerns is valued and investigations are taken seriously.

Concern raised	Number of cases
Bribery and corruption	8
Business and financial reporting	6
Business integrity	10
Competition/ anti-trust	1
Confidential information and intellectual property	4
Conflict of interest	2
Discrimination or harassment	33
Environment, health and safety	8
Other or general enquiry	3





Internal Audit

Investors want to understand where internal audit is spending its time.

A&A Lab comment

Fresnillo provide insights into the areas on which internal audit is focused.

Example: Fresnillo plc Annual Report and Accounts 2016

 **Internal Audit**

The Audit Committee has continued its regular dialogue with internal audit during the year:

Frequency	Activity
Annually	<ul style="list-style-type: none"> • Review Internal Audit Plan and its resourcing for the following year. • Evaluation of internal audit.
Twice a year	<ul style="list-style-type: none"> • Meeting between the Audit Committee and internal audit without management present.
Every meeting	<ul style="list-style-type: none"> • Review of significant internal audit findings (including progress with red flags) based on the audits conducted during the most recent quarter.

The Head of Internal Audit attends all meetings of the Audit Committee. The Chairman of the Audit Committee met separately with the Head of Internal Audit and Internal Audit Manager six times during 2016.

The internal audit team seek to complete audits of all the operating risks across all of the Fresnillo Group’s mining assets on a regular basis. During the year, the Audit Committee have worked with internal audit to focus on three particular areas:

- 1. New mines:** Following the emphasis on auditing the Company’s new mines which was initiated in 2015, internal audit continued to examine that proper procedures are implemented from the beginning in those new operations. This review particularly focused on the effectiveness of the processes adopted when building and commissioning the San Julián mine.
- 2. Red flags:** At each meeting during the year, the Audit Committee has focussed on the progress made by management in dealing with ‘red flag’ items raised during internal audit visits to ensure that the management responses to remediation are appropriate and timely. Significant progress has been made during the year to reduce the number of issues requiring long-term remedial work that remained outstanding at the end of 2015.
- 3. IT issues (including Cyber Security and Data Protection):** During 2016, the Audit Committee has received presentations from the Head of IT setting out the Group IT Strategy for the year and demonstrating how this supports the overall Group Strategy. Within these presentations, the Audit Committee has

considered the steps being taken by management to: (i) deal with cyber security threats, and (ii) ensure appropriate levels of procedural compliance with the requirements of Mexican data protection legislation. The Audit Committee understands the steps being taken by management to deal with these matters and is satisfied with the progress being made. In addition, the Audit Committee has also monitored the quality of the dialogue between internal audit and the Executive Committee in reviewing internal audit findings and agreeing action plans with appropriate levels of operational buy-in to deal with the points raised. The Audit Committee met with the Chief Executive Officer and Chief Operating Officer during the year to review this and is satisfied with the progress achieved through this dialogue.

The members of the Audit Committee evaluate the performance of the Internal Audit team annually and in 2016 this process was facilitated by the Chairman of the Audit Committee who discussed the findings of that review with the Head of Internal Audit and Internal Audit Manager. When reviewing the Internal Audit Plan for the year, the Audit Committee also considered the personnel available within the Internal Audit team, their expertise and experience. In 2016, the Audit Committee particularly considered the specialisms within the internal audit team in key areas of risk such as IT and safety.

APPENDIX A: THE REGULATORY CONTEXT

APPENDIX A

THE REGULATORY CONTEXT



Regulatory requirements

The updated *EU Statutory Audit Directive*¹¹ which came into effect on 17 June 2016, requires PIEs to have an audit committee. These requirements have been introduced into UK law through the Financial Conduct Authority's (FCA's) *Disclosure Guidance and Transparency Rules* (DTR) for listed companies and the Prudential Regulatory Authority (PRA) Rulebook which applies to PRA authorised firms. The *UK Corporate Governance Code* (the Code) includes provision C.3.1 to establish an audit committee.

A majority of the members of the audit committee must be independent¹². For companies applying the Code, provision C.3.1 requires at least three¹³ independent¹⁴ non-executive directors as members.

The audit committee was formally introduced into the UK's corporate governance framework through the Cadbury Report in 1992. The FRC introduced a requirement, through the Code in 2012, for a separate section of the annual report to describe the work of the audit committee in discharging its responsibilities.

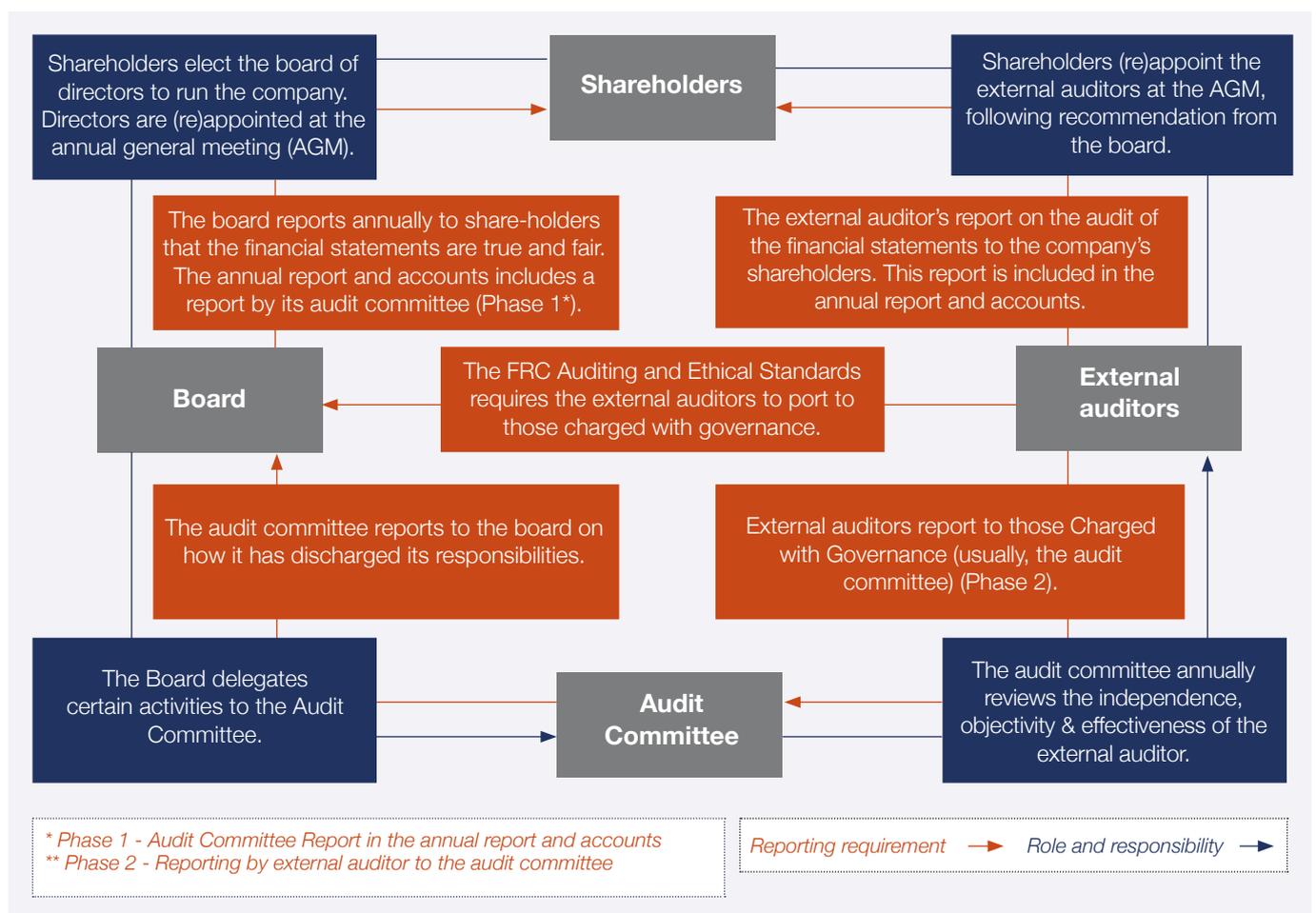
¹¹ Article 39, Directive 2014/56/EU.

¹² DTR 7.1.1A(R).

¹³ Two for smaller companies.

¹⁴ Code Provision B.1.1: 'The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement.'

The current responsibilities of audit committees (and boards) are included across a number of areas of regulation and relevant guidance, as set out below.



The Statutory Auditors and Third Country Auditors Regulations 2016

In 2016, the UK government implemented SATCAR to take account of the *EU Audit Regulation and Audit Directive (EU ARD) 2014*.

SATCAR states that audit committees (or directors) of PIEs must carry out a selection procedure in the appointment of the auditor.

In making a recommendation to the board, the audit committee must identify its first and second choice, give reasons for their selected choice and confirm that the recommendation is free from influence by a third party. If the recommendation is not followed, the board should state the reasons for not following the audit committee's recommendation.

Competition and Markets Authority Order 2014

In 2014, in its reform of the audit market in the UK¹⁵, the CMA ordered that UK companies listed on the FTSE 100 and FTSE 250 markets must put their statutory audit services engagement out to tender at least every ten years. The CMA is of the view that many companies would benefit from going out to tender every five years.

If a company chooses not to, then the audit committee should report the year in which it next plans to go out to tender, and why tendering in this year, is in the best interests of its members.

The CMA Order also stated that only the audit committee is permitted to:

- initiate and supervise a (competitive) tender process;
- negotiate and agree the audit fee and the scope of the audit;
- make recommendations to the board regarding the appointment of the auditor;
- influence the appointment of the audit engagement partner; and
- authorise an auditor to provide any NAS.

The audit committee may specify a policy for the pre-approval of permitted NAS. The audit committee is required to state compliance with the provisions of the Order.

Disclosure Guidance and Transparency Rules 7.1

DTR 7.1¹⁶ requires the majority of audit committee members to be independent (specifically the audit committee chairman), with one committee member having competence in either accounting or auditing or both, and the audit committee as a whole having competence in the sector in which the company operates.

The entity must ensure that the audit committee monitors:

- the financial reporting process and submits recommendations to ensure its integrity;
- the effectiveness of internal quality control and risk management systems and internal audit (if applicable);
- the statutory audit of the financial statements, taking into account, findings from the FRC; and
- reviewing the independence of the statutory auditor, in particular taking account the provision of non-audit services.

The audit committee must inform the board of the outcome of the statutory audit, including how this contributed to the integrity of the financial reporting process.

The FCA consider that the requirements of DTR 7.1 and 7.2 are met if the company complies with the overlapping provisions of the Code.

¹⁵ Requiring FTSE 350 companies to tender their audit at least every 10 years.

¹⁶ Updated in 2016 for the requirements of the EU ARD.

The UK Corporate Governance Code

Board-level responsibilities

The board should present a fair, balanced and understandable assessment of the company's position and prospects.

In 2014, the Sharman inquiry introduced a new provision requiring a broader statement as to the company's viability based on an assessment of the company's principal risks and current position.

Directors should explain in the annual report – taking account of the company's current position and principal risks – how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. They should also state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

The board should undertake an annual review of the effectiveness of the internal control systems to ensure that it has considered all significant aspects of risk management and internal control for the company for the year under review and up to the date of approval of the annual report and accounts.

Audit committee

At least one member of the audit committee is required to have recent and relevant financial experience; and consistent with DTR 7.1, the audit committee as a whole shall have the competence relevant to the sector in which the company operates.

The audit committee report should describe how the audit committee has discharged its responsibilities.

FRC Guidance on Audit Committees

The guidance¹⁷, first introduced in 2003, is designed to assist boards when implementing the Code, and to assist directors serving on audit committees in carrying out their role.

The ACR should include the following matters:

- a summary of the role and work of the audit committee;
- how the audit committee composition requirements have been addressed, and the names and qualifications of all members of the audit committee during the period, if not provided elsewhere;
- the number of audit committee meetings;
- how the audit committee's performance evaluation has been conducted;
- an explanation of how the committee has assessed the effectiveness of the external audit process and of the approach taken to the appointment or reappointment of the external auditor; the length of tenure of the

current audit firm; the current audit partner name, and for how long the partner has held the role; when a tender was last conducted; and advance notice of any retendering plans;

- if the external auditor provides non-audit services, the committee's policy for approval of non-audit services; how auditor objectivity and independence is safeguarded; the audit fees for the statutory audit of the company's consolidated financial statements paid to the auditor and its network firms for audit related services and other non-audit services, including the ratio of audit to non-audit work; and for each significant engagement, or category of engagements, explain what the services are and why the audit committee concluded that it was in the interests of the company to purchase them from the external auditor;
- an explanation of how the committee has assessed the effectiveness of internal audit and satisfied itself that the quality, experience and expertise of the function is appropriate for the business; and
- the significant issues that the committee considered, including:
 - issues in relation to the financial statements and how these were addressed, having regard to matters communicated to it by the auditors;
 - the nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team; and

¹⁷ Updated in 2016 for the requirements of the EU ARD.

- where a company's audit has been reviewed by the FRC's Audit Quality Review team, the committee should discuss the findings with their auditors and consider whether any of those findings are significant and, if so, make disclosures about the findings and the actions they and the auditors plan to take. This discussion should not include disclosure of the audit quality category.
- The committee needs to exercise judgement in deciding which of the issues it considered in relation to the financial statements were significant. The audit committee should aim to describe the significant issues in a concise and understandable form whilst reporting on the specific circumstances of the company.
- The ACR should not repeat information disclosed elsewhere in the annual report and accounts, but could provide signposts to that information.
- When reporting on the significant issues, the audit committee would not be expected to disclose information which, in its opinion, would be prejudicial to the interests of the company (for example, because it related to impending developments or matters in the course of negotiation).
- The chairman of the audit committee should be present at the annual general meeting to answer questions on the separate section of the annual report describing the audit committee's activities and matters within the scope of the audit committee's responsibilities.

FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting

The annual review of effectiveness should, in particular, consider:

- the company's willingness to take on risk (its "risk appetite"), the desired culture within the company and whether this culture has been embedded;
- the operation of the risk management and internal control systems, covering the design, implementation, monitoring and review and identification of risks and determination of those which are principal to the company;
- the integration of risk management and internal controls with considerations of strategy and business model, and with business planning processes;
- the changes in the nature, likelihood and impact of principal risks, and the company's ability to respond to changes in its business and the external environment;
- the extent, frequency and quality of the communication of the results of management's monitoring to the board which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed or mitigated;

- issues dealt with in reports reviewed by the board during the year, in particular the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have, or could have, resulted in unforeseen impact; and
- the effectiveness of the company's public reporting processes.

Companies Act 2006 - s.172 Duty to promote the success of the company

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company.

APPENDIX B: PARTICIPANTS AND PROCESS

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PARTICIPANTS AND PROCESS

Project participants join the A&A Lab project by responding to a public call or through an approach by the A&A Lab team. An iterative approach is taken with additional participants sought during the project to obtain input from various types of investors and analysts, and ensure a range of company examples and input.

It is not intended that participants represent a statistical sample. However, a wide range of listed companies participated; and views were received from a range of UK institutional investors, analysts and retail investor associations.

References made in this report to views of ACCs, 'companies' (includes representatives from Finance and CoSec), and 'investors', refer to the individuals from audit committees, companies and investment community organisations that participated in this project. The term 'investors' includes a broad range of individuals in their capacity as investors or their role in analyst organisations that work in the interest of investors in the UK and overseas markets. Views do not necessarily represent the views of the participants' companies or organisations.

Participants in the project include:

Fifteen audit committee chairs and four company representatives

- 3i Group plc
- AstraZeneca PLC
- Barclays PLC
- BP
- CivilisedBank
- Croda International Plc
- Daily Mail and General Trust plc
- Domino's Pizza Group plc
- FirstGroup plc
- GKN PLC
- Hammerson PLC
- Howden Joinery Group Plc
- Intermediate Capital Group PLC
- ITV plc
- Johnson Matthey Plc
- Legal & General Group Plc
- Wm Morrison Supermarkets PLC
- MS Amlin plc
- National Grid plc
- Nationwide Building Society
- Rolls-Royce Holdings plc
- Royal Bank of Scotland Group plc
- St James's Place plc
- Standard Life plc
- Unum Limited
- Vodafone Group Plc

Twelve members of the investment community

- Aberdeen Standard Investments
- Ballie Gifford
- BMO Global Asset Management
- FIL Investment Management Limited
- Go Investment Limited
- Invesco Asset Management Limited
- Legal & General Investment Management Limited
- M&G Investments
- RPMI Railpen
- Schroder Investment Management Limited
- The National Employment Savings Trust
- Universities Superannuation Scheme

Members three investment associations

- Investor Association
- ShareSoc (UK Individual Shareholders Society)
- UK Shareholders' Association

Representatives of six audit firms

- Baker Tilly International
- Deloitte
- EY
- KPMG
- Mazars
- PwC

Two officers from a Professional Body

- ACCA

Project process

Individual meetings were held with ACCs and company representatives to understand interviewees' perspectives on audit committee reporting. A standard questionnaire was used as a basis for discussion. Each investor was met individually to understand their views on current practice, how they use audit committee reporting, and the information they are looking for in those disclosures.

Two round table meetings were held with investors, ACCs, company, audit firm and professional body participants together, to further explore views and practical solutions. The Lab prepared a discussion pack, which was shared with participants in advance of the roundtable meetings.

This pack contained illustrative reporting excerpts and associated questions for discussion.

The project team were supported by a project working group consisting of:

- Chris Smith (GT and ICAEW Audit and Assurance Faculty)
- Guy Wilson (Audit committee chair, Fresnillo plc)
- Hanif Barma (Board Alchemy)
- Jane Fuller (CFA UK, FRC Audit and Assurance Council)
- Mike Metcalf (KPMG)

The working group contributed ideas and high level direction to the project, as well providing advice on specific issues as they arose.



Financial Reporting Council

**FINANCIAL REPORTING COUNCIL
8TH FLOOR
125 LONDON WALL
LONDON EC2Y 5AS**

+44 (0)20 7492 2300

www.frc.org.uk