Grant Thornton

An instinct for growth™

# *Knowing the ropes*

# Key messages

**Size**: 3-5 members is an ideal size for an audit committee

**Frequency**: meetings should be regular and the length should adapt to content
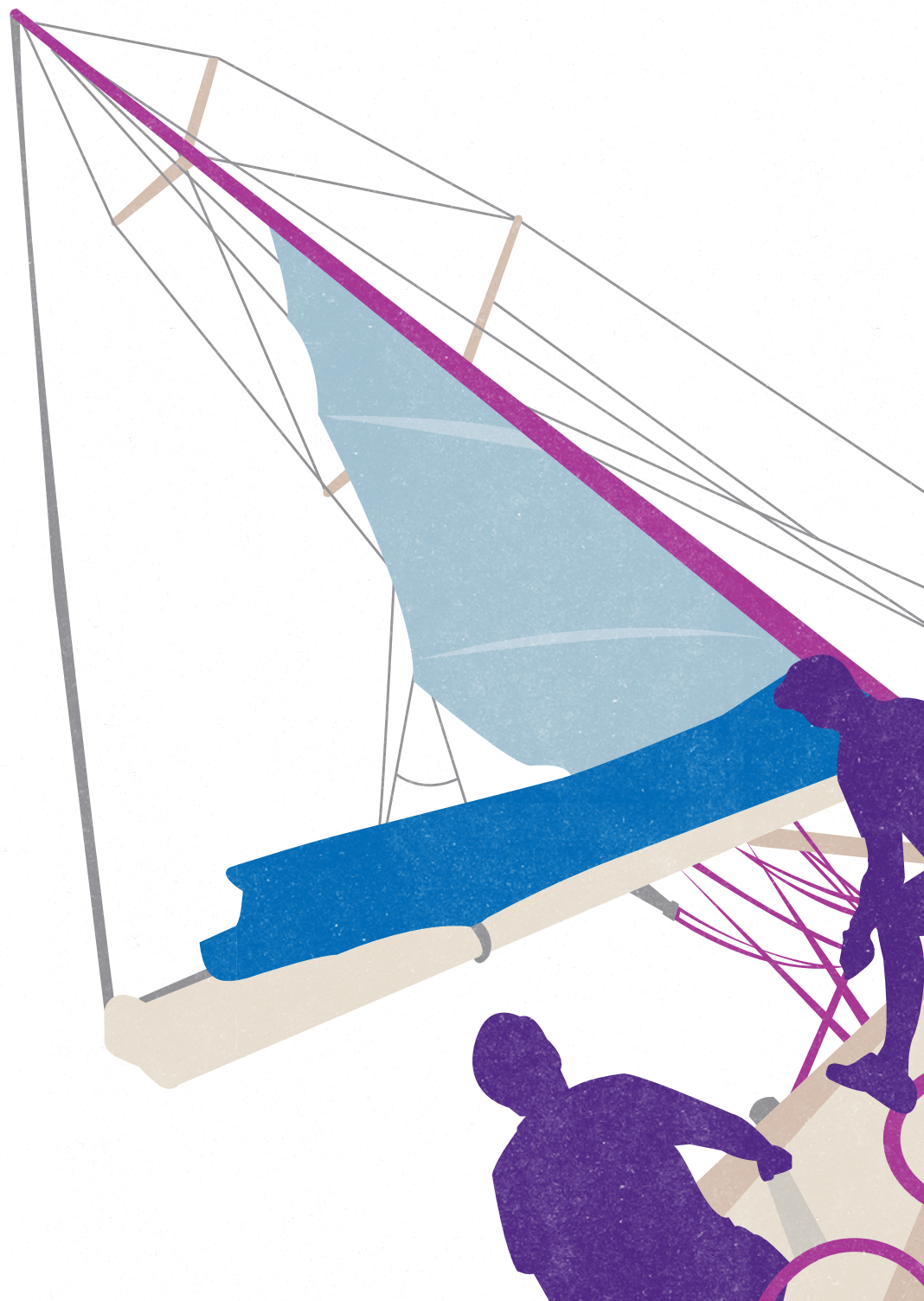
**Relevance**: audit committee members should be selected based on the skills and experience they bring

**Clarity**: the role of the audit committee and its relationship with other committees, should be clearly defined

**Communication**: papers should strike the balance between detail and length

**Ability**: training should be provided for audit committee members

**Evolution**: audit committees should continually develop

*The two key things that audit committee members should be asking are:*

**1** What is expected of the audit committee and does it reflect the specific nature of the industry in which the organisation sits?

**2** Does the audit committee have clear terms of reference in place? Audit committees should set themselves targets for what they want to achieve and define how these will be measured to ensure they are operating effectively.

# Contents

*Definition of categories*

**Private sector**
- Co-operatives/Mutuals
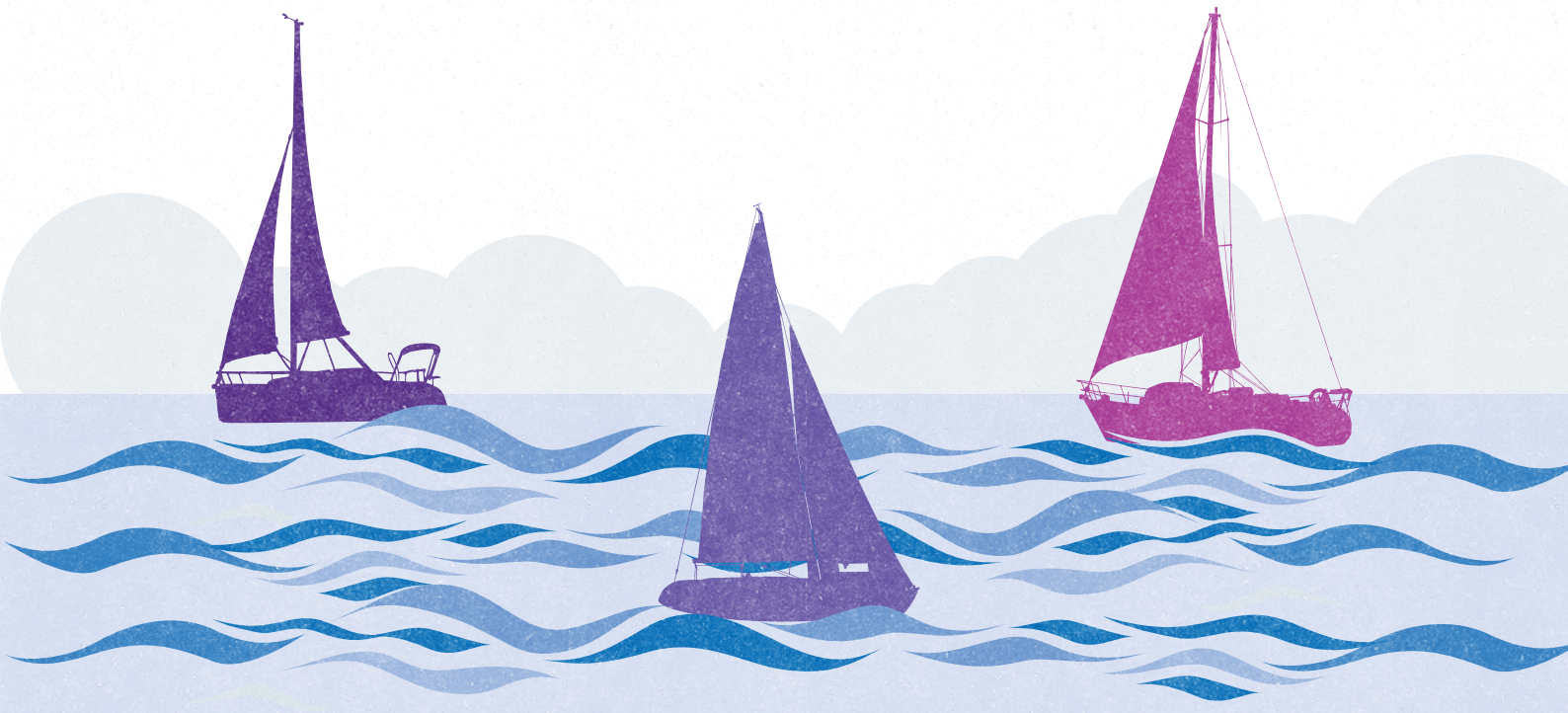- Private companies
- AIM listed
- Fully listed

**NFP**
- Charities
- Social Housing
- Education

**Public Sector**
- Local Government
- Government & regulatory bodies
- NHS providers and commissioners

# Introduction

The UK Corporate Governance Code, issued in September 2014 by the Financial Reporting Council (FRC), outlines the main purpose of an audit committee, saying that "the board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors."

In previous years Grant Thornton have issued reports on governance and effectiveness of audit committees in particular sectors. This is our first foray into a cross-sector review of audit committee effectiveness encompassing the corporate, Not for Profit and Public sectors together in one review. For the first time we can compare governance arrangements in very different types of organisations and highlight and share the lessons that can be learned.

This report seeks to gain insight into the ways in which audit committees can create an effective role within an organisation's governance structure and to understand how they are perceived more widely. It will also tease out those qualities and actions necessary for an effective audit committee.

The report is structured around four key issues:
- What is the status of the audit committee within the organisation?
- How should the audit committee be organised and operated?
- What skills and qualities are required in the audit committee members?
- How should the effectiveness of the audit committee be evaluated?

It will also raise key questions that audit committees, board members and senior management should ask themselves to challenge the effectiveness of their audit committee.

## The Survey

The survey consisted of 30 questions across five areas:
- Organisation
- Status of audit committee
- Membership
- Operation
- Effectiveness

The 343 respondents came from the following sectors:
- Fully listed companies
- AIM companies
- Private companies
- Government and regulatory bodies
- Co-operatives/mutuals
- Local Government
- NHS provider (those that deliver services for the NHS)
- NHS commissioner (bodies that plan, procure and monitor services for the NHS)
- Social housing
- Education (includes universities, further education colleges, schools and academies)
- Charities

# What is the status of the audit committee within the organisation?

The broad role of the audit committee is set out within the UK Corporate Governance Code (the Code), and within other specific sector codes where applicable, although the interpretation of the role differs from organisation to organisation. Above all, the role needs to be both clear to the committee and understood throughout the organisation.

**THERE IS CLARITY OVER THE ROLE OF THE AUDIT COMMITTEE WITHIN THE ORGANISATION'S GOVERNANCE ARRANGEMENTS (%)**



- Strongly agree
- Tend to agree
- Tend to disagree
- Strongly disagree
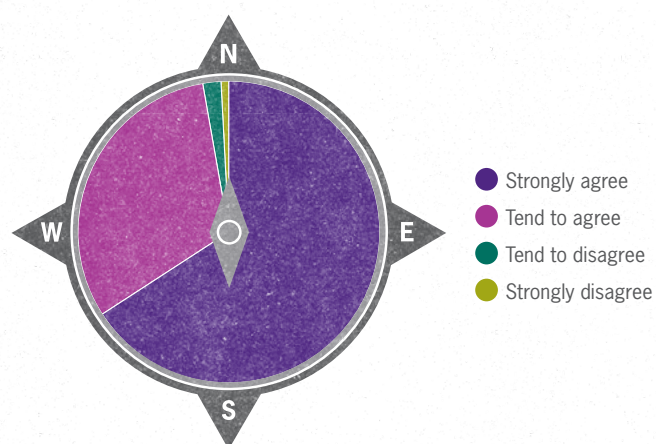
There was overwhelming agreement (over 97%) that the role of the audit committee within the organisation's governance arrangements is clear. It was noted, however, that there are differing degrees of clarity and understanding of the role of the audit committee as one moves down through the organisation and away from the main board.

*Key question*

Does everyone involved in running the organisation know the role of the audit committee?

In most instances, the audit committee is one of a number of boards and committees responsible for oversight and governance of the organisation. 93% of responses agreed that there was effective communication between the board and committees. However, from the additional narrative responses and confirmed by our experience, it was recognised that the relationship between committees is often not formalised. Furthermore, although those on the committees clearly understood the relationship, it was often not clear to others within the organisation.

**TYPICAL BOARD AND COMMITTEE STRUCTURE**



**BOARD**

**AUDIT COMMITTEE**  **NOMINATION COMMITTEE**  **REMUNERATION COMMITTEE**
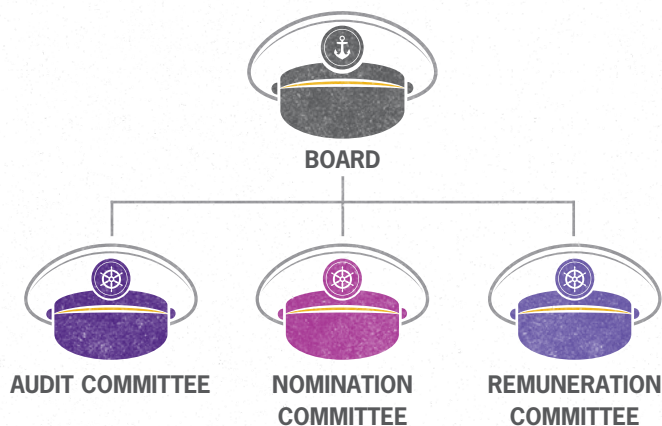
There was agreement over structure and communication within public sector organisations. One board member for a Government & regulatory body said that there is "no formally organised discussion between committee chairs" and an audit committee member from an NHS provider said that "the key role of the audit committee in relation to other board committees is not well recognised especially by executive team members".

Questions were also raised regarding the scope of the audit committee role and its recommendations.

*"Clarity on the audit committee role is documented and understood well by the Board but less so by non-board management."*

**Audit committee member**, AIM company

## Scope too broad?

*"The audit committee (and directors) are now signing off everything that once was the domain of the external auditor and I don't feel the reduction of external auditors to box ticking and emphasis on work being done by junior staff is in shareholders' interests."*

**Company secretary**, fully listed company

## Scope too narrow?

*"In my experience the committees rarely make recommendations to the wider organisation"*

**Head of internal audit,** Local Government

*Key question*

How many committees are required and what should they each cover? How should communication be formalised between them to ensure maximum efficiency and minimum overlap?

# How should the audit committee be organised and operated?

## Size of committee

The Code stipulates that "the board should establish an audit committee of at least three, or in the case of smaller companies (outside the FTSE 350) two, independent non-executive directors."

The size of audit committees among public sector (6.6) is almost double the size of committees in the private sector (3.5), with NFP organisations in the middle (5.3). A large part of this difference is due to local government audit committees, which are made up of elected members and have an average size of nine.

It is important that the size of the audit committee is proportional to the size of the board, as if the audit committee is too big in comparison then there is a risk of it becoming a pseudo-board. If the audit committee is too small in relation to the board, then its influence with the board may be impaired. In our experience, a ratio of around three board members to every audit committee member is a sound guide.

**NUMBER OF MEMBERS**

● Private sector   ● NFP   ● Public sector



**3.5**          **5.3**          **6.6**
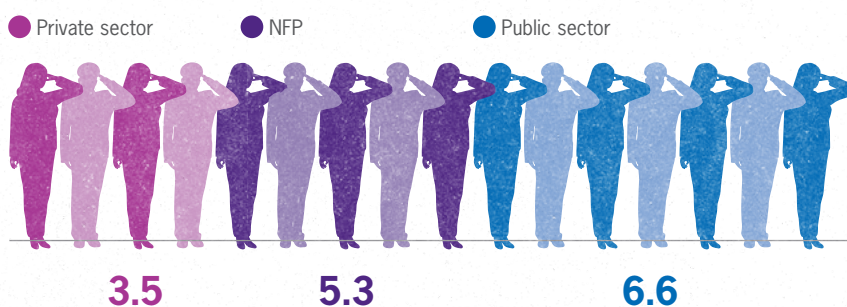
## Meetings

The average meeting length reported was two hours, which was also the most frequently reported length. The majority of meetings (60%) were between one and a half and two hours.

AIM companies reported high levels of disagreement (38%) when asked whether meetings provide sufficient

time to enable each required item of business to be debated with the appropriate level of detail and rigour. One AIM company audit committee member explained this by saying "there is always greater depth of enquiry and discussion that would add value than the time reasonably available. The holding of management to account for their internal governance disciplines and especially cost/effectiveness of controls involves dialogue and not compliance box ticking." The average length of an AIM audit committee is 1.5 hours, which is below the average.

Government & regulatory bodies and fully listed companies also reported higher than average levels of dissatisfaction with the length of their meetings (25% and 22% disagreement – perhaps a reflection of the increasing burden being placed on audit committees in the listed arena). While fully listed companies' meetings are also shorter than average, Government & regulatory bodies meetings last over two hours. This raises the question about efficiency, focus, agenda and chairmanship.
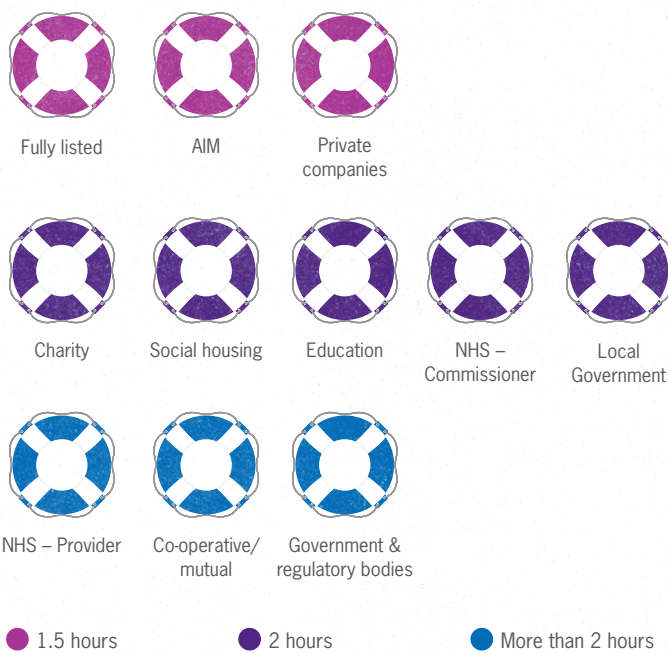
**LENGTH OF MEETING (%)**



● less than 1 hour   ● 2 hours
● 1 hour             ● More than 2 hours
● 1.5 hours
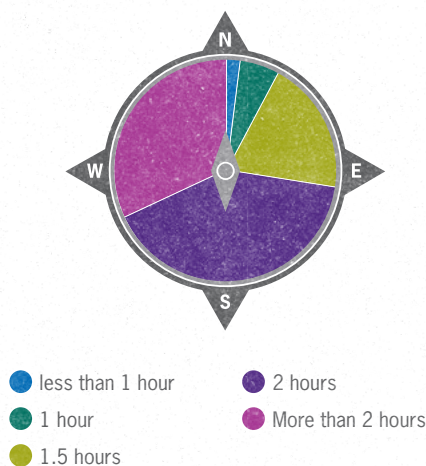
### Key question

If your audit committee has more than three members, what additional benefit are the extra members bringing?

## LENGTH OF MEETING BY SECTOR

Fully listed

AIM

Private companies

Charity

Social housing

Education

NHS – Commissioner

Local Government

NHS – Provider

Co-operative/ mutual

Government & regulatory bodies

● 1.5 hours          ● 2 hours          ● More than 2 hours

One audit committee member from local government said that having longer meetings was not necessarily the answer to having more detailed discussions, but that a smarter overall approach to papers and meetings was required. This was corroborated by a company secretary from a fully listed company who said that "Papers submitted to the committee should be sufficiently prepared to not require lengthy debate."

*Key question*

Is the length of the meeting driven by the content or is it prescribed?
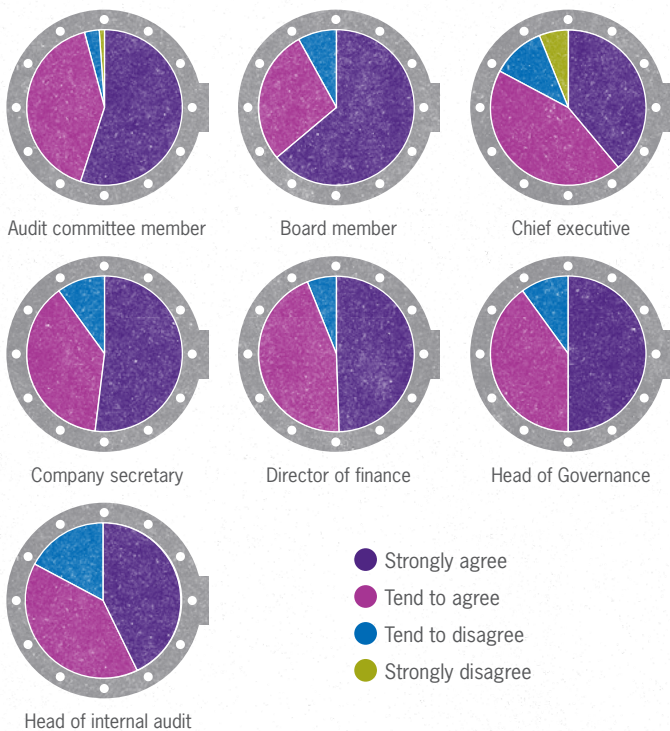
## Preparation for meetings

While there was widespread satisfaction with the issuing of papers and the time allocated to read these (over 90%), some significant sector-specific exceptions were noted. Government & regulatory bodies and AIM companies both reported dissatisfaction with the issuing of papers and fully listed companies and local government reported an insufficient level of commitment to preparing for and attending meetings. An audit committee member from an NHS provider admitted that "sometimes papers are onerous", but a local government audit committee member said that "for me, the ability/time to read and understand the paperwork is essential."

Dissatisfaction with attaching the appropriate level of commitment and time was more prevalent amongst the executive than audit committee members, again showing the higher level of expectation for members among management than the members themselves. This is perhaps due to the difference in role and the expectation that comes with this.

The executive expect to prepare papers and to respond to them, as they are the ones being challenged. Members expect to review the papers and be the ones doing the challenging. The executive expect to spend more time preparing for meetings and therefore expect others to spend more time. Management could therefore be questioning the level of challenge coming from the audit committee, as well as the level of commitment to the role.

The main levels of dissatisfaction were within local government and fully listed companies, however these both reported that papers always went out early enough to give sufficient time to review. Conversely, AIM companies and Government & regulatory bodies reported issues with the distribution of papers but reported no issues with the time given by members to prepare for meetings. This suggests there is not a direct link between the quality and issuing of papers and the time and commitment given to preparing for meetings.

**AUDIT COMMITTEE MEMBERS ATTACH THE APPROPRIATE LEVEL OF COMMITMENT AND TIME TO BOTH PREPARING FOR, AND ATTENDING MEETINGS (%)**



Audit committee member

Board member

Chief executive

Company secretary

Director of finance

Head of Governance

Head of internal audit

- ● Strongly agree
- ● Tend to agree
- ● Tend to disagree
- ● Strongly disagree

**Key question**

How much time is required to fully commit to an audit committee role? How is this amount of time determined, and by whom?

## Role of the chair

One of the key messages that came out of the survey was that the effectiveness of an audit committee is highly dependent upon the quality of the chair's management. Most responses were very complimentary about their chairperson, with 93% agreeing that the audit committee chair ensures appropriately balanced input to meetings from all members

One finance director, within the education sector, even went as far as to say that the chair guided the whole committee: "the role of the audit committee is not intuitive and some members do not find it easy to grasp. However we have a very strong chair who is able to guide the committee."

The only sector which was significantly less positive about the chair was fully listed companies, with 22% disagreeing that their chair managed the committee well.

**Key question**

What is the selection process for the chair of the audit committee? Is sufficient consideration given to the scope of the role and the skills required?

*"If there is not a strong chairman then meetings can be taken over by one or two of the more forceful members."*

**Head of internal audit**, local government

## Risk management

One of the most common responses for what makes an effective audit committee was the level of focus on the management of key risks. The survey revealed that understanding of risks and risk management was considered good amongst audit committees, with 96% agreeing that the audit committee understands those principal risks which might have a significant impact on the organisation's strategy and how these are managed.

But some of the responses seemed to question where the focus should be placed, with one member from an AIM company questioning whether it was the audit committee's role to understand the risks or to understand the risk management process. Such observations seem to question whether the scope of the audit committee is evolving faster than its documented purpose and whether the remit needs to be refreshed and clarified.

*Key question*

Should the scope of the audit committee include understanding risks or the risk management response? Does the role overlap with management? How often is there a separate risk committee?

*"Given the requirement for committees to challenge risk profiles and to fully discuss horizon risks, the meetings are becoming more risk focussed in terms of time allocated."*

**Head of internal audit**, Housing
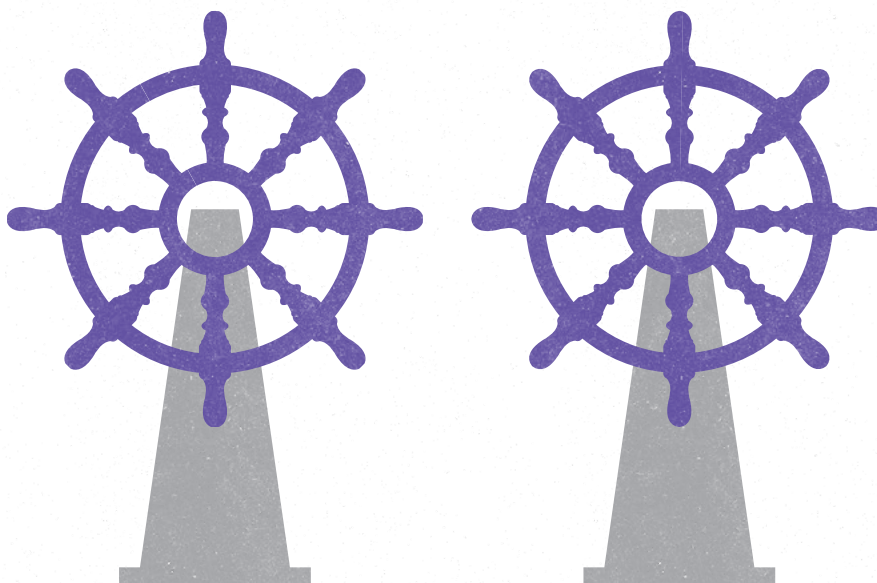
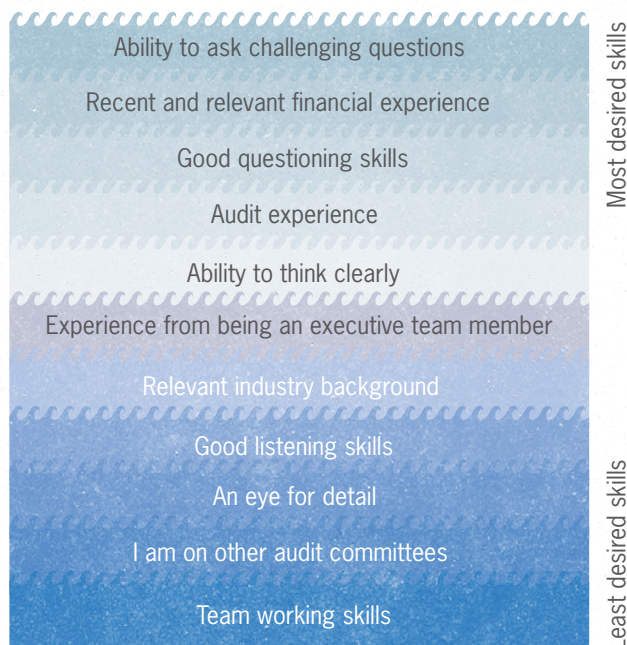# What skills and qualities are required of the audit committee members?

## Skills

The number one response to "what makes your audit committee effective" was the skills and experience of members. Three of the top qualities required of members reported were:

- ability to ask challenging questions;
- recent and relevant financial experience; and
- audit experience.

All of these qualities relate to the ability to challenge the finance team and the audit function, including the requirement for recent and relevant financial experience, which is a requirement of the UK Corporate Governance Code.
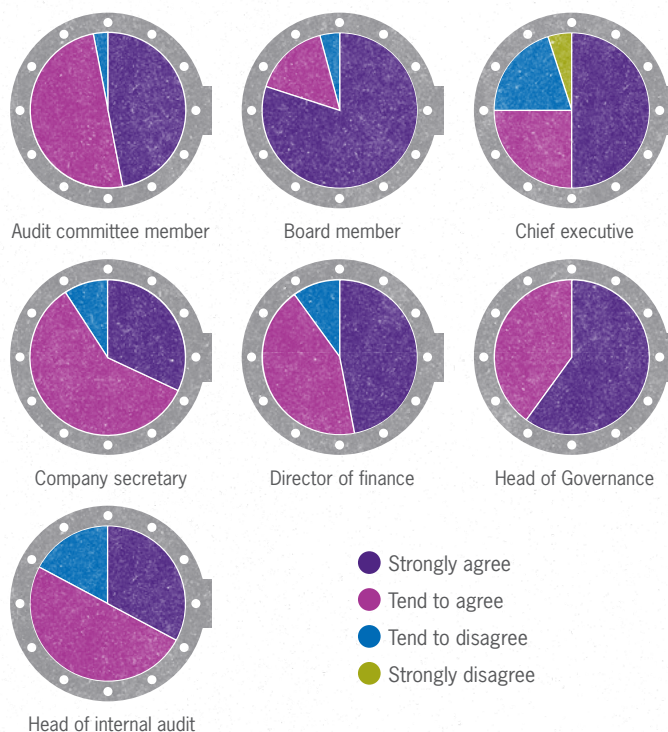
**AUDIT COMMITTEE SKILLS**



Most desired skills

Ability to ask challenging questions

Recent and relevant financial experience

Good questioning skills

Audit experience

Ability to think clearly

Experience from being an executive team member

Relevant industry background

Good listening skills

An eye for detail

I am on other audit committees

Team working skills

Least desired skills

91% of respondents considered that the audit committee has the appropriate skills and expertise to fulfil its role effectively. The only sectors varying from this significantly were private companies and local government, with the main challenge coming from finance directors, who represented over 40% of all respondents in disagreement.

This suggests that the expectation of audit committee members, and the skills that they possess, is greater among

**THE AUDIT COMMITTEE HAS THE APPROPRIATE SKILLS AND EXPERTISE TO FULFIL ITS ROLE EFFECTIVELY (%)**



Audit committee member        Board member        Chief executive

Company secretary        Director of finance        Head of Governance

Head of internal audit

- ● Strongly agree
- ● Tend to agree
- ● Tend to disagree
- ● Strongly disagree

qualified finance professionals than others. It raises a number of questions as to whether finance directors should be involved in the selection of audit committee members, or at least setting the requirements for members and perhaps, whether those who do not have financial experience know what questions to ask? The support for those members with less financial experience is paramount, as one housing audit committee member identified: "Not all audit committee members can have the relevant audit / financial experience - key is having that support and being astute enough to question where appropriate."

One AIM company audit committee member summed up the need for all members to bring skills to the table, saying "the audit committee role is now multi skilled and it is rarely ideal if members do not share most of the relevant skills. Reliance on one 'expert' weakens the governance function of the committee as a major subset of the non-executive directors on the board.".

There was much less importance placed on experience of the audit committee role and relevant industry background, suggesting that the role of the audit committee is seen very much as a challenge to the audit function and the organisation, rather than a key part of identifying issues within the organisation and building solutions. It was noticeable from the polarisation of the types of skills, that respondents did not consider the blend of skills that an audit committee might require, but rather the skills that one of the more dominant members of the committee should have.
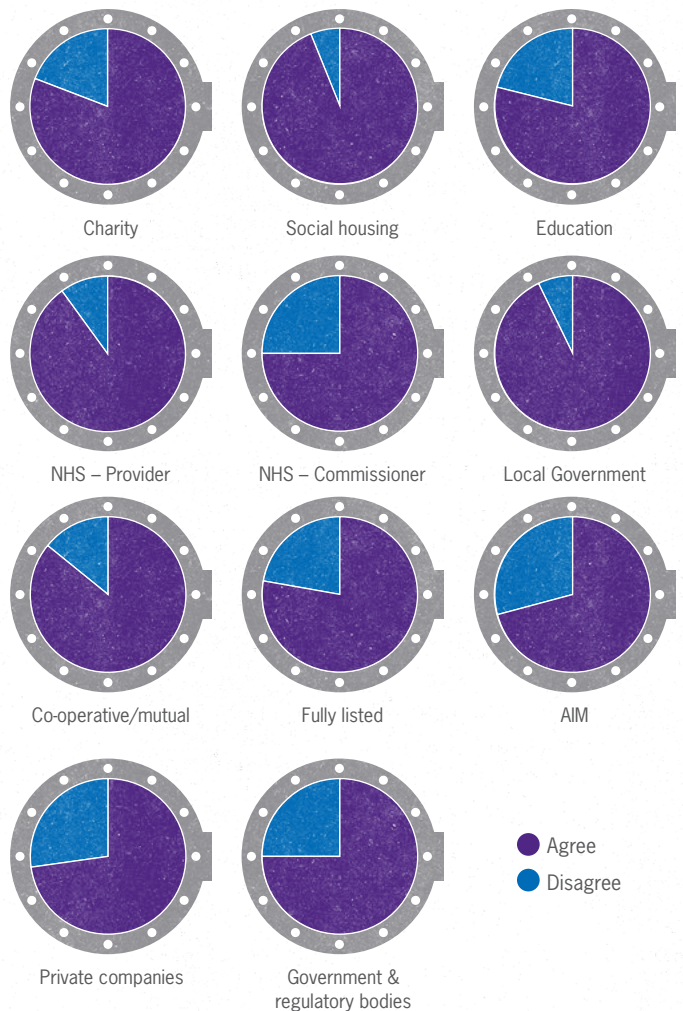
Interesting therefore to note the FRC's recent proposed amendment to the Audit Committee Guidelines. The Guidelines, which already encourage the inclusion of recent, relevant financial expertise on the committee, now state the committee also should include competence relevant to the sector in which the company operates.

## Training

While the skills brought to the table by audit committee members are deemed to be critical, there was a mixed response to the question as to whether members receive sufficient, timely and appropriate training and briefings on key issues relevant to their responsibilities. 86% of respondents agreed that there was sufficient training, with the strongest agreement coming from social housing and local government where 94% of respondents agreed. There was however, relatively strong disagreement from AIM companies, with 29% disagreeing that sufficient training was provided.

One finance director within local government said that "whilst training is offered, it is not always taken up and we are contemplating making it a compulsory requirement that members undertake the training before they may serve on the committee." The issue of training was even greater within the education sector, with one finance director saying there was a "need for more training to ensure members are aware of legislative and regulatory requirements and changes therein."

**AUDIT COMMITTEE MEMBERS RECEIVE SUFFICIENT, TIMELY AND APPROPRIATE TRAINING AND BRIEFINGS ON KEY ISSUES RELEVANT TO THEIR RESPONSIBILITIES (%)**



Charity

Social housing

Education

NHS – Provider

NHS – Commissioner

Local Government

Co-operative/mutual

Fully listed

AIM

● Agree

● Disagree

Private companies

Government & regulatory bodies

*Key question*

With so much of governance being about best practice rather than legislation, is there more that can be learned from having audit committee members who are members elsewhere?

# How should the effectiveness of the audit committee be evaluated?

One of the main decisions to be made by the audit committee is to consider whether the financial statements are fair, balanced and understandable. Under the UK Corporate Governance Code there is a requirement "to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them". The responsibility to do this may be delegated by the board, but 12% of respondents reported that this was not happening. Most of those in disagreement were from AIM public companies (25% disagreement), local government (18%) and social housing (15%).

Another of the requirements of the UK Corporate Governance Code is "to report to the board on how it has discharged its responsibilities". However, this was something that was missing in over 10% of cases. Most cases of non-compliance came from private companies, AIM companies and local government.

**THE AUDIT COMMITTEE PERIODICALLY COMMISSIONS AN INDEPENDENT REVIEW OF ITS EFFECTIVENESS (%)**



- Agree
- Disagree
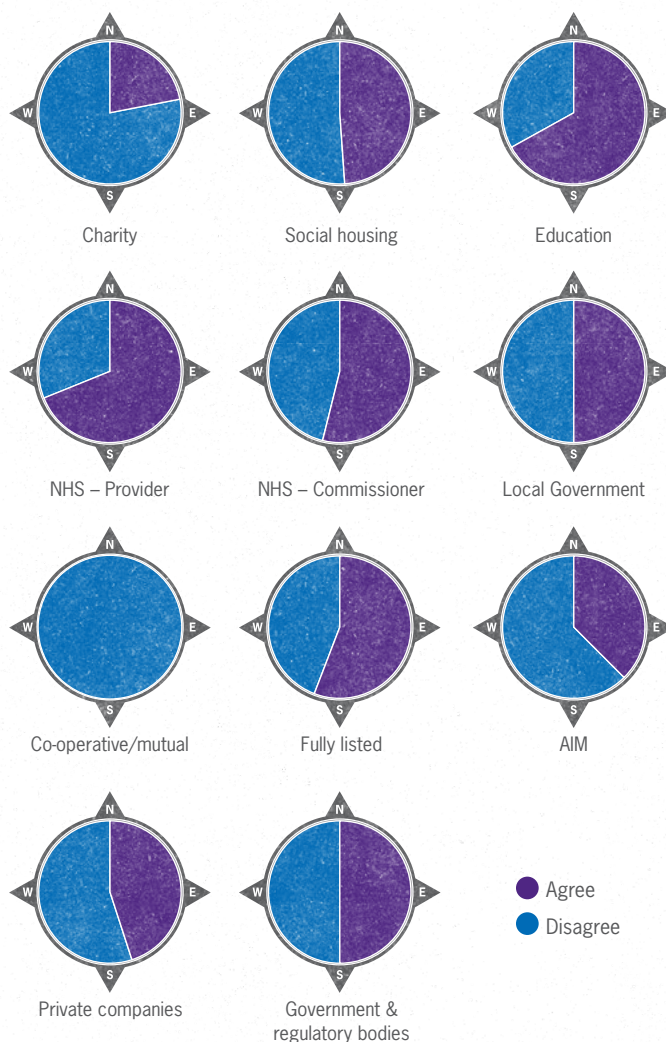
### Key question

Why are the audit committees of AIM companies and local government choosing not to voluntarily comply with the requirements of the UK Corporate Governance Code? Is it because they do not consider the requirements relevant or are they not aware of the requirements? Is more training required?

## Independent review

The UK Corporate Governance Code states that:

- "The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years."

### Key question

How are audit committees currently assessing their own effectiveness?

These are requirements of the board, but should also apply to committees who discharge responsibilities on behalf of the board. It should therefore be considered a requirement to do annual assessments, and best practice to seek external assessment every three years. Yet, when asked if they sought an independent external review, over half the respondents said they did not. As well as compliance with the Corporate Governance Code, the main purpose of the board and, in this case, the audit committee reviewing their effectiveness is to ensure that the committee is working sufficiently well to ensure that good governance practices are in place and operating. While self-assessment is useful, independent assessment has additional benefits by bringing an outside perspective and additional challenge, and allowing for recommendations to be made based on best practice examples employed by other organisations.

There was a noticeable difference between types of entities and positions in terms of the responses to external assessment. The education sector, NHS and fully listed companies responded positively, while the main negative responses were from co-operatives, charities and AIM companies.

This raises a question as to whether bigger and more regulated entities have better and more established processes, to which the answer is almost certainly yes, but the challenge is whether they are undertaking such evaluations to seek improvements or whether it is viewed purely as a compliance exercise.
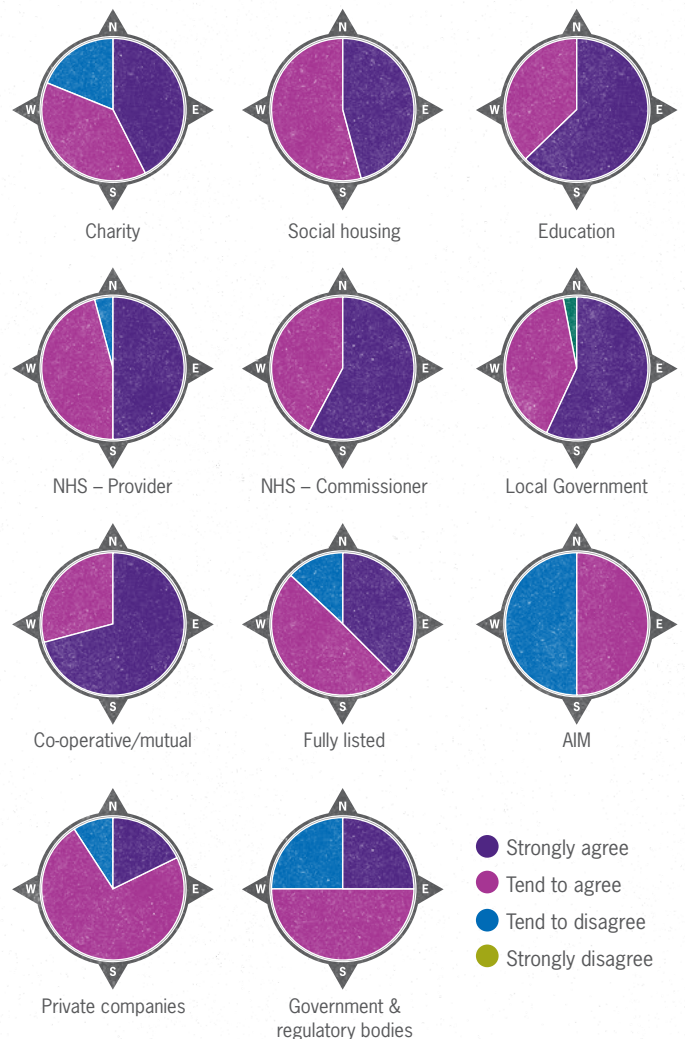
## Monitoring of internal controls

When asked if the audit committee received enough information to effectively monitor internal controls, there was significant dissatisfaction among companies in the private sector.

This raises the question as to whether audit committees in the private sector can operate effectively if they feel they are not receiving sufficient information. One possible response is that they are more aware of what they ought to receive as opposed to the other sectors who are not?

*"A thorough self-assessment of committee effectiveness has taken place, however in 2015 a commitment has been made to seek external challenge."*

**Head of internal audit**, Housing

**THE AUDIT COMMITTEE RECEIVES SUFFICIENT INFORMATION TO ENABLE IT TO MONITOR EFFECTIVELY THE SYSTEMS OF INTERNAL CONTROLS THROUGHOUT THE YEAR (%)**



Charity  Social housing  Education

NHS – Provider  NHS – Commissioner  Local Government

Co-operative/mutual  Fully listed  AIM

Private companies  Government & regulatory bodies

- Strongly agree
- Tend to agree
- Tend to disagree
- Strongly disagree

# *Conclusion*

The vast majority of responses to the survey were positive, which suggests that audit committees see themselves as operating effectively. Within this, there are obviously differences in opinion, and one person's view of an effective audit committee will differ greatly from the next.

The extremely positive results are, in some cases, in contrast to our experience and conversations we have had with and about audit committees, where there is consistent recognition that improvements are required. This raises the question of whether respondents have displayed self-serving attribution bias when completing the survey and further emphasises the need for external independent review of effectiveness. An objective measure of what is good is required, and improvements suggested to reach this level.

In an increasingly busy world, there is a constant strain on people's time. A lack of time is the biggest threat to the effective operation of an audit committee. For example, a shortage of time could lead to papers being of inferior quality or disseminated late, which, in turn, would impact the review of these papers and the level of resulting challenge. Audit committees therefore need to make sure that their systems and processes are robust and efficient, maximising the use of their members' time. Every member needs to commit the time to ensure they are fully prepared in order to provide that effective challenge which ensures a robust governance environment. The role of the chair also becomes increasingly important in making sure that the committee is well directed and uses the limited time available for the maximum impact on the organisation.

One of the many challenges for audit committees will be ensuring that current members bring the right blend of skills and expertise and, further, that they stay fresh, relevant and up to date with changes, both of an operational and regulatory nature. As well as independent assessment, benchmarking against other audit committees can play a major role in improving effectiveness.

For all key areas (including status, organisation and operation, skills and qualities, and effectiveness and evaluation), audit committees need to set an objective and an expectation of what good practice looks like to them. Some of the main issues that we picked up during our survey related to the quality of information, the time input by members and the diversity in size of committees across different sectors. The requirements for these will be different for each individual organisation, so it is important to set benchmarks for performance internally as well as externally.
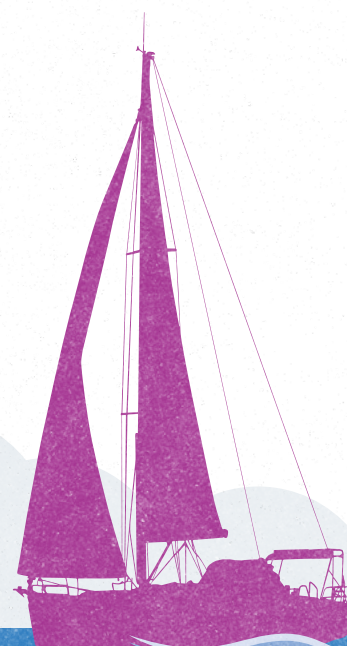
# The Grant Thornton Governance Institute

## Advising on governance

**1** Board training and development

**2** Benchmarking reviews

**3** Governance systems, processes and procedures

**4** Integrated reporting

**5** Leadership and culture

**6** Board evaluation

## Governance matters

Corporate Governance Review 2014

Charity Governance Review 2015

Local Government Governance Review 2015

NHS Governance Review 2015

Housing Governance Review 2015

For further information, visit: **www.grant-thornton.co.uk/governancematters**

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