Audit committee reporting in 2005

A survey of FTSE 100 annual reports

The Combined Code and Sarbanes-Oxley (and soon perhaps the EU as well) have put a lot of responsibility on audit committees. Audit committee reporting hasn't had the same attention as board reporting. But it's beginning to catch up, as some of the better committees seek to show their quality and differentiate themselves from weaker peers.

This survey covers the 84 FTSE 100 annual reports published between the beginning of November 2004 and the end of June 2005. These are the first reports to be subject to the new Code.

A step in the right direction

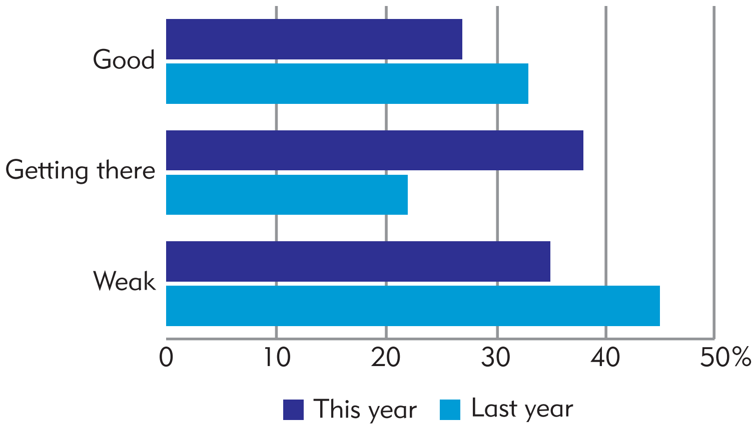
- Reporting on audit committee activity has improved but the quality continues to vary considerably. Many committees still cling to their terms of reference rather than try to give any real insight into what they've actually done.
- Most audit committees meet at least four times a year – more often if the company is SEC registered.
- Nearly all companies say they reviewed the effectiveness of their audit committees. In most cases, this was done as part of the board review. A handful followed the trend of board reporting and referred to the findings.
- 81% of committees reported having at least one member with recent and relevant financial experience, but only 40% provided the information needed by readers to weigh that experience.
- Only half of audit committees said they assessed the effectiveness of the external audit process, and only a third of these explained how. Three-quarters touched on the question of their external auditors' independence but many equated this solely with the issue of non-audit fees, overlooking other influences on independence.
- Less than a third of committees said they reviewed the effectiveness of internal audit.

Reporting on activity

The Code requires audit committees to describe their work in discharging their responsibilities. We have assessed these reports on a number of criteria, primarily on whether they give a clear picture of what the committee actually did.

Not surprisingly, all companies prepared some type of report. But there is considerable variation in quality, with reports more or less evenly split between good, weak and somewhere in between. The benchmark set by the best reports is higher than last year, but slightly fewer companies have made it into the top category. There has been a marked shift from "weak" to "getting there". The worst examples barely justify being called reports.

Figure 1: Improvement in the quality of reporting



Of the good ones, Man Group and Prudential produced reports that stand out by making a marked attempt to provide information that helps the user understand the relevance of their membership and what the committee actually did. Legal & General achieved the same through intelligent combination of the annual report and website. AstraZeneca, Alliance Unichem and ITV are also better than most, with Rentokil Initial getting the prize for the greatest improvement on last year.

Reports were longer, with nearly half of them exceeding one page (see Figure 2). Some companies used the extra space to provide useful content, while others used it for padding. There was limited correlation between length and quality: usually the good ones were longer but not always, and longer ones were not always good. But in general using up a bit more space made a big difference in the quality of communication.

The best reports describe what the committee actually did, rather than listing what it is expected to do. The former were written in the past tense, the latter in the present tense. Less than a third of reports used the past tense well, the rest using it sporadically or, in most cases, poorly or not at all.

Figure 2: Size of reports

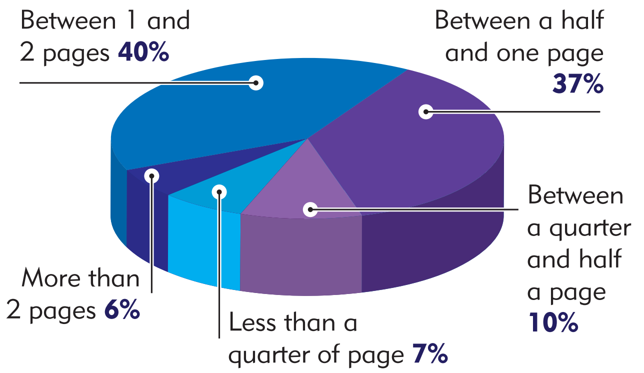
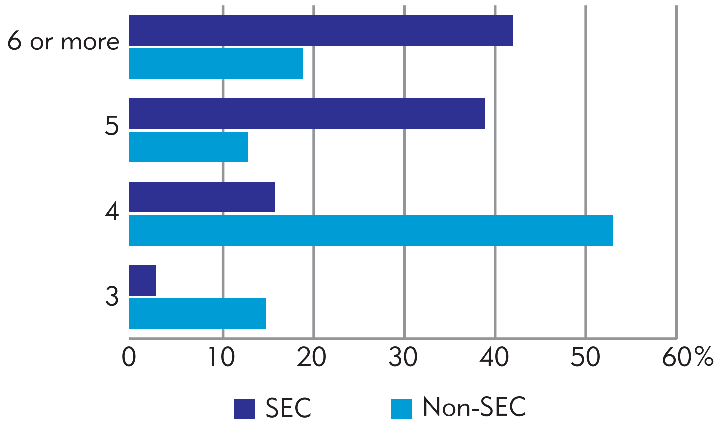


Figure 3: Number of meetings



Since most committees' roles follow closely the requirements of the Code and, where relevant, Sarbanes-Oxley, dreary policy statements do little to support a judgement of how effective they have been.

One indicator of activity (but not necessarily of quality) is the number of times committees meet. Most FTSE 100 audit committees now meet four or more times a year. The impact of a reporting crisis can be heavy – the record was 23 meetings.

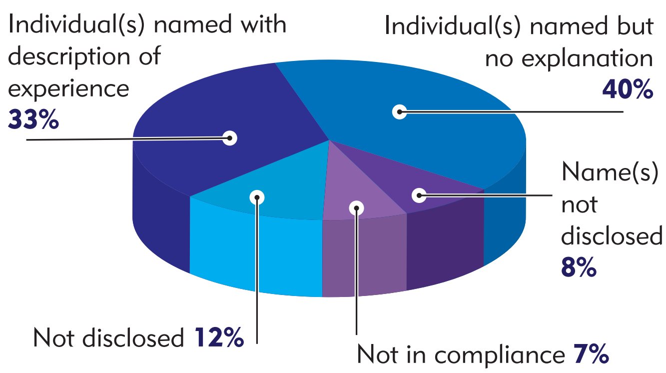
The Sarbanes-Oxley influence is already being felt, with SEC registrants as a class meeting more frequently.

Financial experience

The Code requires at least one member of the audit committee to have recent and relevant financial experience. 81% of committees reported that they had such experience, a marked increase on last year's 60%. All but seven named the individuals concerned.

Of the other companies, three explicitly stated their non-compliance and three others dodged the issue by referring to "collective" experience. Marks & Spencer score points for being candid in spelling out that it is actively seeking to recruit a suitable person. Surprisingly, given the increasingly technical nature of the financial reporting and control issues faced by audit committees, ten failed to report at all on their financial experience.

Figure 4: Relevant financial experience

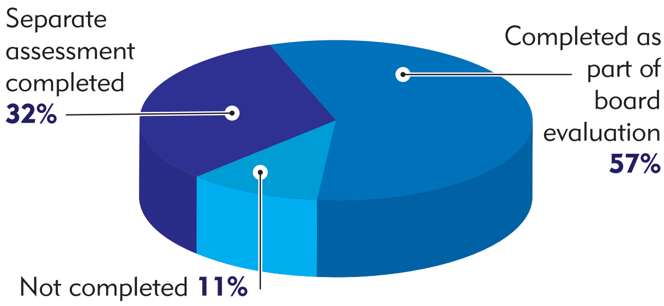


Reed Elsevier, GUS and Shire Pharmaceuticals make it easy to understand the nature and relevance of their audit committee members' experience. By contrast, over half of those naming individual(s) leave the reader to piece together information of very varying usefulness from biographical summaries, often in other parts of the annual report.

Audit committee evaluation

Almost 90% of companies reviewed the effectiveness of the audit committee. However, only a third said this was done separately from the board review. It is possible to do a thorough combined review, but it's also possible merely to tack on a few questions that don't do justice to the specific issues relating to audit committees. The reporting leaves you guessing which was the case.

Figure 5: Audit committee evaluation



Around a third gave no clue as to how their effectiveness had been reviewed. The remainder didn't give much information, but questionnaires and/or interviews seem to have been favoured methods. The clear explanations given by William Hill, BAE Systems and BP show that they took the evaluations seriously. Approximately 20% of companies engaged an external consultant. But with so many audit committee reviews being wrapped up in board reviews, the actual level of the external involvement in a focused review of audit committee performance is unclear.

External audit effectiveness

Nearly 60% of audit committees said they assessed the effectiveness of their external audit process. Another 13% noted it as part of their role but left what they actually did to the reader's imagination. Given the importance of this responsibility, and the audit committee's own dependence on a quality audit, it's rather surprising that over a quarter make no reference to it. Only a third of reports gave some description of the evaluation method used.

Figure 6: External audit evaluation reporting

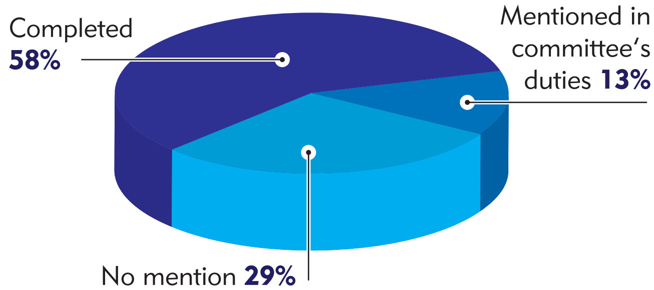
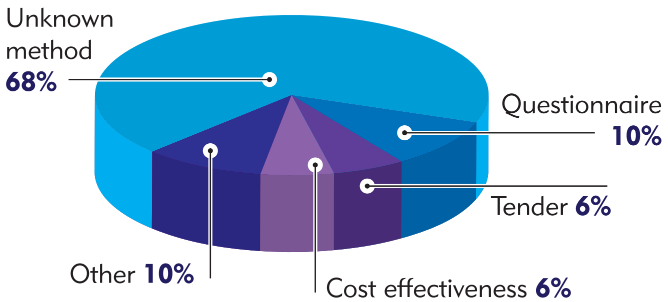


Figure 7: External audit evaluation methods



The most popular approach was a questionnaire. Aviva, Man Group and Rentokil Initial provide good examples of how better reporting on what was done can give the reader greater confidence that it was done properly.

Three audit committees appear to have decided to improve on the Code by reviewing "cost effectiveness", which isn't quite the same thing.

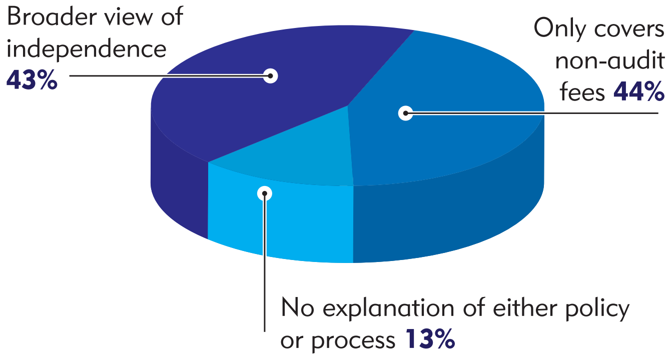
Auditor independence

Audit committees are required to review and monitor the independence of the external auditor. Most made some form of reference to it. But in the majority of cases this came down to a statement about non-audit fees. This suggests that many audit committees equate auditor independence with restricting non-audit fees, a severe oversimplification.

The Code asks audit committees to explain how auditor objectivity and independence are safeguarded when non-audit services are allowed. 40% made an attempt but most of these were little more than a passing reference. Legal & General did better than most.

Two-thirds reported holding meetings with the auditors without management present. We must hope that the other third simply forgot to report on this important issue.

Figure 8: Reporting on auditor independence

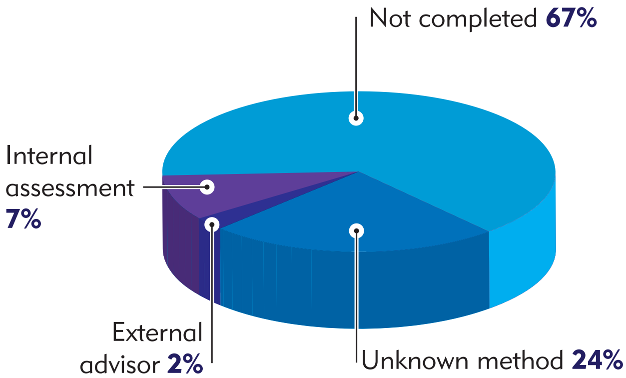


Internal audit effectiveness

The Code requires the audit committee to review the effectiveness of internal audit annually. A third reported having done so, a marginal improvement on last year. Considering how dependent on internal audit an audit committee is, this omission is surprising. It's also surprising that no company explained why they didn't do it or even reported this as an area of non-compliance.

Just eleven companies provided any explanation as to how the review was carried out, with Prudential and William Hill making a particular effort. Only two companies reported undertaking an external review, despite the existence of an international professional standard which says that an independent review of internal audit should be undertaken at least every five years.

Figure 9: Internal audit evaluation



What next?

Accounting errors, major control failures and the company going bust are plausible indicators of a weak audit committee, but come a bit late in the day to be very useful. And it certainly doesn't follow that an absence of reported accounting errors or control failures means the audit committee must be a good one.

Understanding whether the committee is complying with the Code is a step in the right direction, but not all of this year's reports make even that clear. Even when they do, they don't necessarily communicate quality. The most important factors that make an audit committee effective are its members' attitudes, skills and enthusiasm. These aren't so easy to assess as structural things like the independence of the committee's membership, and certainly aren't easy to report.

But audit committee reports give away more than their authors might intend, and far too many of them portray attitudes which don't inspire confidence. They continue with tired formulas, lists of duties and badly tweaked reworks of last year's text, wrapped up in legalistic boilerplate which demonstrates attention to form rather than to substance.

Good committees don't distinguish themselves by statements of compliance. They stand out by explaining to shareholders how they went about their duties, and doing so in clear English which shows they are describing real activity rather than aspirations. They leave the reader with a sense that the committee understands its role and what being effective means, and that they care enough about what they have been doing to want the reader to understand it.

There are better examples this year than last, and the contrast between good and bad is much clearer. Audit committees who produce embarrassingly poor reports next time round will be either remarkably determined or remarkably dozy.

Independent Audit Limited specialises in working with companies to get value out of governance. We help boards and their committees solve problems and improve effectiveness, and we advise on governance mechanisms such as audit or risk management.

If you would like to discuss this survey, or require further copies of it or the companion survey on board reporting, please contact us:

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