



Guidance for audit committees

Evaluating your auditors



November 2003



The Combined Code on Corporate Governance – July 2003

C.3 Audit Committee and Auditors

Main Principle: The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- 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;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm;

and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should 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.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

Introduction

This publication is part of a series which has been prepared by the Institute of Chartered Accountants in England and Wales to assist non-executive directors on audit committees to gain an understanding of the provisions of the Combined Code on Corporate Governance – July 2003 (The Combined Code) relating to Audit Committees and Auditors and the guidance set out in Guidance on Audit Committees (The Smith Guidance). The Guidance is based on the proposals set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

Evaluating your auditors

The revised Combined Code sets out the following requirements with respect to the Company's relationship with its external auditors:

- The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of external auditors. This recommendation should be made to the board.
- The audit committee should assess the qualification, expertise and resources, effectiveness and independence of the external auditors annually.

This publication explains how these responsibilities might be addressed by audit committees and how they relate to legal requirements and Auditing Standards. In practical terms, there needs to be a structure for the annual appraisal and recommendation processes that is agreed and understood by all concerned. As with other aspects of the role of audit committees, these responsibilities should not be seen in isolation and it may be helpful to refer to other publications in this series, such as *Reviewing auditor independence* and *Company reporting and audit requirements*.

Each company is unique and audit committees will need to apply the Smith Guidance in a manner that is appropriate to them and reference may need to be made to the various pronouncements mentioned in the text for more detailed information.

Background

Although the recommendation to appoint auditors is made to the board and, if agreed, will be included in a resolution in the notice of the annual general meeting, the appointment decision is one for the shareholders at the AGM and not the audit committee or the board. If the board does not accept the audit committee's recommendation, it shall include in the directors' report a statement from the audit committee explaining their recommendation and setting out why the board has taken a different position. The recommendation to shareholders is that of the board and not the audit committee.

Appointment or reappointment of the incumbent auditor is required annually under the Companies Act 1985 (s384 and s385). The report of the joint DTI/HM Treasury Co-ordinating Group on Audit and Accounting issues also decided against any requirement for the mandatory rotation of audit firms or mandatory re-tendering. There are, however, requirements for the rotation of lead audit engagement partners and other key audit partners (see *Reviewing auditor independence*).

Although for many listed companies, the appraisal of the auditor's effectiveness will not be new, the process will change to make it overtly an audit committee responsibility to be carried out annually and probably more formally than in the past. Audit committees should now also oversee the selection process for appointing a new firm.

In practice, most audit appointments are re-appointments. Putting audits out to tender is a time-consuming process and the frequent appointment of new auditors will be very costly financially and in terms of management time. Thus, the annual review process is as much about improving audit quality, audit effectiveness and the relationship between the company and the external auditors, as about the basis of the recommendation to the board. It will help to identify ways in which both the company and the external auditor can improve and respond to developments in the next audit cycle. It should be an exercise that both parties learn from.

Assessment

The Smith Guidance requirement that 'The audit committee should assess the qualification, expertise and resources, effectiveness and independence of the external auditors annually' adds that 'The assessment should cover all aspects of the audit service provided

by the audit firm, and include obtaining a report on the audit firm's own internal quality control procedures' (para 4.16).

Who should perform the assessment?

The audit committee should oversee the appraisal of the auditor and the chairman of the audit committee should present the results to the board. In practical terms the audit committee will not have the time to be involved in a detailed review and much of the information will be provided by management. The committee will also need to obtain information from the external auditor. However, the audit committee has to retain control of the process to ensure that it is performed objectively and fairly, to remove any potential for management bias and to enable it to make the recommendation to the board on appointment or reappointment.

Timing of the assessment?

There will be several specific occasions during the year when members of the committee and representatives of the auditors meet or communicate with each other and from which the committee will gain insight into the performance of the auditors. For example, the committee and auditors will communicate with each other during the review of the auditor's independence and objectivity and during the audit process.

The assessment needs to be completed between effective completion of the annual accounts and audit and the recommendation to the board. This timing window is likely to be short and therefore the year-end reporting timetable should include how and when the committee's assessment will be carried out.

The above examples relate to the audit of the financial statements. The auditor may provide other services that are closely related to the statutory audit and which the audit committee may wish to take into account when assessing not only the competence of the auditors but also, for example, how to improve the company/auditor relationship in areas such as:

- Reporting on the relevant part of the Corporate Governance statement by the board.
- Reporting to regulatory bodies such as the Financial Services Authority and industry regulators.

- Work on prospectuses and other documents to shareholders, e.g. in connection with the purchase or sale of major subsidiaries.

Should the audit firm be involved?

The assessment process will be more efficient and effective for all parties if there is openness, both in procedural terms and in spirit, between the committee and the auditor. Both parties should agree and, to minimise or avoid subsequent misunderstandings, document their needs and expectations during the audit and related work for the coming year. This will largely come through the agreement of the terms of engagement and the review of the overall audit plan as set out in the Smith Guidance.

If performance criteria are set, they should also be documented and agreed to avoid the risk of subsequent misunderstandings, both within the audit committee and with the external auditors. The criteria should be balanced and appropriate to the company; they should not stress one or two factors to the exclusion of others. They should also be challenging but achievable. Some criteria might be specifically measurable, such as meeting agreed deadlines, but most will be qualitative.

How should the committee report to the board?

The audit committee reports to the board and has primary responsibility for making the recommendation on the appointment, reappointment and removal of external auditors. The mechanics of this process, such as timing, content and the extent to which it is written or oral, are determined by the company. The recommendation and the suggested section on the audit committee's activities for the directors' report should preferably be dealt with at the same time as the latter will address the relationship with the external auditors.

If the recommendation is that a new firm of external auditors should be appointed, then this could require additional disclosure, for example explaining why a change is proposed and reporting on the selection process.

Framework for appraisal

The Smith Guidance identifies four criteria:

- Qualification.
- Expertise and resources.
- Effectiveness.

- Independence.

These are not explained in detail and the purpose of the following comments is to provide guidance on how they could be interpreted by companies. It should be noted that there are already many requirements and pronouncements applicable to auditors that cover these criteria. The requirements are drawn from a mixture of primary and secondary legislation (i.e. Acts and Statutory Instruments), from the requirements of regulatory bodies and from standard setters such as the Auditing Practices Board (APB). The guidance below suggests how these requirements and other related pronouncements can be used by audit committees to appraise an audit firm, be it the incumbent or a potential new appointment. The guidance is, of necessity, general and needs to be applied in a manner appropriate to the company's circumstances. Taking each in turn:

Qualification

'Qualification' should not be a problem. The firm will be a 'Registered Auditor' and required to comply with the Audit Regulations which cover matters such as:

- Independence and integrity.
- Maintaining competence.
- Compliance with technical standards, i.e. legal requirements and auditing standards.
- Monitoring compliance with the Regulations.

Although different terminology is used in the Regulations and the Smith Guidance, they cover the same areas.

The audit engagement partner is a 'Responsible Individual' under the Regulations. The rest of the audit team will normally comprise a mixture of Chartered Accountants and those under training contracts. The team may also include specialists who have qualifications in their field of expertise but are not necessarily Chartered Accountants, e.g. tax specialists and IT specialists.

The audit committee might wish to consider inter alia:

- *The qualifications of key members of the audit team.*
- *Confirming with the auditor that there are no issues concerning its status as a Registered Auditor or the designation of the audit engagement partner as a Responsible Individual.*

Expertise and resources

The Regulations on maintaining competence apply again at two levels – individuals and the firm as a whole. First, firms have to ensure that individuals are competent to carry out the audits for which they are responsible. This includes:

- Assessing individual competence on recruitment and annually thereafter through appraisals and appropriate training to update and develop the skills and experience of individuals at all levels, including partners.
- Individuals complying with the guidelines attached to the Regulations and their Institute's continuing professional education guidelines. These specify the required amounts of structured training (e.g. course attendance) and unstructured training (e.g. reading). The training would also need to be appropriate to the type of audits undertaken, for example individuals working on bank audits would be expected to have received training on accounting and auditing matters relevant to the banking industry.
- Directing and supervising the work delegated to individuals to ensure that it is carried out in accordance with Statement of Auditing Standards (SAS) 240 *Quality control for audit work*.

At the second level, i.e. that of the firm as a whole, there is a need to maintain continuity and consistency through audit manuals, programmes, checklists, etc., and to record work so that a body of knowledge is maintained that can cater for changing personnel. The firm as a whole should also have arrangements to ensure that it has sufficient resources of the right calibre so that it can carry out its audits effectively. In other words, firms need to ensure that they have both procedures and resources.

The quality of the people on an audit is central to the effectiveness both of the audit and of the relationship with the audit committee. It is important that there is an appropriate level of continuity from year to year, but it is not possible to have the same team every year nor is it desirable from the point of view of maintaining objectivity.

At partner level, firms will need to rotate 'key audit partners' in order to comply with ethical pronouncements. These now require that, depending on the partner's role, a partner may only serve for a limited period of time followed by a quarantine period when he or she may not act (see Appendix 4 of *Reviewing auditor independence*).

The audit committee might wish to consider inter alia:

- *The independence and objectivity of the audit partner and senior audit staff.*
- *The quality of the audit partner and audit staff from a technical accounting and auditing perspective, including their industry knowledge and their specialist technical expertise.*
- *The numbers of partners and staff involved during the audit, especially at critical times.*
- *Whether issues were raised at the right time by the appropriate level of audit staff with the appropriate level of client staff.*
- *The relevance and appropriateness of the auditor's procedures.*
- *Continuity of partners and audit staff taking into account arrangements for key audit partner rotation.*

Effectiveness

Effectiveness can be regarded as a composite of competence, procedural arrangements, quality control and quality assurance. The procedural arrangements can be regarded as the tools used by firms and individuals to ensure that audits comply with technical standards, i.e. legal requirements, regulators' requirements and auditing standards set by the APB, and taking into account the supplementary material in APB Practice Notes and Bulletins.

Firms' procedures are contained in:

- Audit manuals and programmes setting out the firm's approach to audits – there is no single system for carrying out and recording audit work and each firm has developed a methodology for applying auditing standards. The methodology has to be flexible so that it can take account of the needs of different sizes and types of companies.
- Checklists used, for example, to check compliance of the annual accounts with statutory and other requirements.
- Quality control procedures.

The Smith Guidance states that audit committees should obtain 'a report on the audit firm's own internal quality control procedures'. The auditing standard SAS 240 *Quality control for audit work* requires firms to have procedures covering:

- acceptance and continuance of audit engagements, including competence, independence and integrity of the company;

- assigning sufficient partners and staff with the appropriate competencies to the audit;
- consultation requirements, i.e. procedures and resources to ensure that consultation takes place on difficult and contentious matters and that it is recorded;
- arrangements for directing, supervising and reviewing audit work;
- for listed companies, a review by an independent partner; and
- resolution of conflicting views.

The independent partner review is carried out by a partner independent of the audit who has the necessary experience and authority. The review, which takes place before the audit report is issued, covers matters such as objectivity (including independence), the rigour of the audit planning, the results of the audit work and the proposed audit report. The purpose of the review is to provide an independent assessment within the firm of the quality of the audit and the key decisions and significant judgements made. The review should preferably not be a single review and part is normally carried out before or at the planning stage, e.g. the review of independence and planning.

Both Audit Regulations and SAS 240 require the monitoring of the quality of audits carried out by firms. Monitoring includes the independent review of a sample of completed audit files by partners and staff not connected with the audit. The reviews provide information about the overall quality of audits carried out by the firm.

Different senior audit partners will usually be responsible for the separate functions of establishing and monitoring quality control procedures.

Following Government recommendations, with effect for years starting on or after 1 January 2003, many of the major firms have agreed to publish annual reports that will cover, inter alia, audit quality and auditor independence. Some firms already publish such information but these reports will become more widely available in 2004.

In addition to any published report, the key accounting and auditing judgements together with issues affecting auditor independence will be discussed during the committee's monitoring and review of the external auditor relationship. The discussions are likely to be part of the communications required by SAS 610 and will touch on quality

control issues. An oral report and discussion, supplemented if necessary by written information, should meet the requirements set out in paragraph 4.16 of the Smith Guidance for a report on the audit firms' quality procedures. It should not be a laborious exercise.

Finally, compliance with the Audit Regulations is monitored externally, currently for listed company audits by the Joint Monitoring Unit but in future by the proposed independent audit monitoring unit under the Professional Oversight Board and the Financial Reporting Council.

The audit committee might wish to consider inter alia:

- *Did the audit partners and senior audit staff have an up-to-date understanding of the business?*
- *How effective was the focus of the audit work on major issues and did the work deal appropriately with those areas?*
- *What recommendations were made for improvements to internal controls and other areas and were they useful?*
- *To what extent did the auditors use technology effectively in their audit work?*
- *(If applicable) Did the auditors gain appropriate assurance over parts of the group not audited by the main team, for example operations audited by other offices or other firms?*
- *(If applicable) How good was the relationship between the auditors and other firms involved in the audit?*
- *Did the auditors make appropriate use of experts in auditing technical items?*
- *What was the quality of comments and reports on any non-statutory items, for example reporting on the board's corporate governance statement?*
- *Were appropriate management representations obtained?*
- *Was the work of internal audit used appropriately?*
- *How effective did the independent partner review(s) and other reviews appear to be? Were there any late surprises or changes in view that could have been avoided?*
- *Were formal audit documents, for example audit plan and management letters, of sufficient quality?*
- *Were the right numbers and quality of partner and staff used on the audit?*

- *Did the auditors appear to be unduly influenced by management during the audit?*
- *Did the auditors communicate with the committee properly and on a timely basis on the matters set out in the Smith Guidance and in SAS 610 Communication of audit matters to those charged with governance?*

Independence

The last criterion is mainly covered in *Reviewing auditor independence* which discusses the principles and provides guidance on specific aspects of auditor independence and how it is achieved during the audit process. As part of the audit committee's overall assessment, it might wish to consider, inter alia:

- *Did the auditors disclose in writing and discuss as appropriate all relationships that might be thought to bear on the firm's independence and objectivity? Did the auditors confirm their independence and objectivity?*
- *Where non-audit services were provided, did these comply or appear to comply (a) with statutory and ethical pronouncements and (b) with the company's policy for the provision of such services?*
- *Where any permitted non-audit services were performed, were the agreed safeguards properly applied?*
- *If there were any breaches of policy regarding the provision of non-audit services, key audit partner rotation or other aspects of the auditor independence requirements (including company policy) were these communicated to the committee in an appropriate and timely manner?*

Leadership

Overarching all of the above is 'leadership'. The leadership of the engagement team sets the tone for the audit. The audit committee might wish to consider inter alia:

- *The quality of leadership demonstrated by the audit partner and effective implementation of the agreed audit strategy.*
- *The quality of thought leadership provided by the auditors in areas of relevance to the client.*
- *The personal authority, knowledge and integrity of audit partner(s) and staff to interact effectively with and robustly challenge management.*
- *The quality of succession planning and management of the rotation of key audit partners.*

To retain or change auditors?

As stated in the Smith Guidance, the audit committee has primary responsibility for making recommendations on appointing, reappointing and removing the external auditors. The guidance below deals with the first two: removal is not covered as it is unusual and the situation would need to be dealt with on a case-by-case basis. The guidance does not deal specifically with situations where the auditor resigns, i.e. ceases to hold office between AGMs.

In deciding on the appointment or reappointment of auditors, there are three options:

- To recommend the reappointment of the incumbent.
- To consider appointing a new auditor, by putting the audit out to tender to other firms and then making a recommendation.
- To put the audit out for tender to firms including the incumbent and then making a recommendation.

In the second case, a change may be due to any of a number of reasons, e.g.:

- The auditor may not be able or be the most suitable firm to provide the quality audit that the company requires – for example, the company has outgrown the firm or vice versa and might be better served by another firm.
- The relationship between the company and auditor may have deteriorated to such an extent that they cannot work with each other as a result of actual or perceived failings. The committee will need to understand why there has been a deterioration and form its own objective views as to the reasons and whether these can only be resolved through a change in auditor or whether there are other factors to be addressed.
- The company may simply decide that the time has come to appoint a new firm.

The appointment to change auditors is not one to be taken lightly. It is costly for both firms and companies, it requires a significant amount of management time (as well as that of the audit committee) and can lead to a short-term deterioration in audit quality while a new firm accumulates knowledge of the company's business, management and key issues. This does not mean that there should never be any change, but frequent change would be undesirable.

Timing

If a recommendation is made to retain the incumbent firm, the process should be straightforward, assuming that the board accepts the committee's recommendation, with the proposal being included as an item on the agenda for the AGM.

If the committee recommends considering a possible change, it should oversee the selection process and make the assessments outlined above. The process needs to be properly timed. Working backwards and assuming no complications:

- The committee's recommendation to the Board, their discussion and agreement need to be completed in time for inclusion in the notice and agenda of the AGM, which in turn means allowing sufficient time for drafting of the relevant parts of the annual report and printing. It is preferable if the recommendation is not a last minute one.
- The selection process, such as a formal tender process to ensure that enough information is obtained by the committee, is time consuming. It requires the potential auditors to be given enough time to acquire sufficient knowledge of the company and its executive management to be able to outline an audit strategy, identify key issues and how they should be dealt with, and estimate the time required and cost of the audit. This could be carried out around year end, in time for the recommendation to the board. However, for many companies' finance departments this would add significantly to their workload at a time when they are preparing the annual accounts and dealing with the auditors. The audit committee will also have its own year end pressures. There is therefore an argument for the selection process being started early enough so that it is, at least, substantially complete before the company's year end.

These timings do not rule out the possibility that there may be sufficient time between completing the majority of the work on the year end accounts and audit, and the issuing of the notice of the AGM. However, this depends on the size of this window and how easy or difficult it is to obtain realistic tenders.

Committees should also be aware that auditors are required to make a statement when they cease to hold office (whether by resignation or by not seeking reappointment) of any circumstances that should be brought to the attention of shareholders or creditors, or state that there are no such circumstances (Companies Act s394). This should

not divert the committee from a decision about appointing a new auditor, but it can occasionally be a difficult area in which advice may need to be sought.

Selection process

If it is decided to put the company's audit out to tender, there are a number of stages that the audit committee will need to oversee from planning through proposals and presentations to deciding the recommendation to be put to the board. These are explained in more detail in the Appendix.

Changing auditors

When a new firm is appointed there are a number of steps to be taken:

- If the incumbent firm resigns or does not seek reappointment, it is required to make a statement under the Companies Act s394 that there are no matters that should be brought to the attention of shareholders or creditors or, if this is not the case, state the matters. This statement is a matter of public record and is filed at Companies House.
- Before accepting a new appointment, a firm is required by the Institute's ethics pronouncements to seek from the previous auditor any information that is necessary to enable them to decide whether to accept the appointment. It is preferable if this is covered during the selection process, but may not always be possible.
- A smooth handover from one auditor to the successor is desirable. For example, it is desirable that the predecessor auditor completes any audit-related work, such as a report to an industry regulator on the last year's accounts. The predecessor should also complete any management letters.
- A smooth handover should ensure that the successor auditor is given sufficient detailed information to enable the firm to 'pick up the story' on key accounting and auditing matters.

Appendix: Guidance on the process for selecting auditors

The selection process, which is usually a tender process, can typically be broken down into a number of stages:

- Planning the process – audit committee identifies what is required and expected of the company's auditors, and a plan of what needs to be done, by whom and when.
- Identification of potential candidates – audit committee draws up an initial list of firms that appear to have the ability to provide what is required and expected, leading to an invitation to tender.
- Information gathering by potential candidates – firms meet company's management and audit committee to obtain sufficient relevant information upon which they can submit a written proposal to the company.
- Consideration of written proposals – audit committee considers written proposals and decides which firms should be invited to make a formal presentation.
- Presentations – firms make separate presentations to audit committee and answer questions.
- Decision – committee decides which firm it will recommend to the board to be appointed or, if appropriate, re-appointed.
- After the decision – assuming that the committee's recommendation for a new firm is accepted by the board and agreed by the shareholders, the committee should ensure that, there is a smooth handover to a new firm.

These stages are discussed below. The points are only indicative of aspects that may be considered; they should not be used as a checklist. Committees will need to consider what is appropriate to their company.

Planning the process

Before the selection process is started, it is advisable for the committee to identify its requirements and wishes such as:

- What the role of the company's auditor should be, e.g. statutory requirements and regulatory requirements.
- What the committee and executive management expect of the auditors in terms of service levels, etc.
- What other services the committee and executive management would expect the firm to provide (subject to statutory and ethical pronouncements concerning non-audit services).
- What things work well with the incumbent auditor and the attributes and characteristics that the committee and executive management wish to retain.
- Conversely, what does not work well and which should, if possible, be avoided.

A plan should be developed to cover matters such as the timescales for covering the stages listed above. In practice, the details may be developed by one or more of the executive directors and senior managers, but it will be under the committee's oversight and, in order to demonstrate this, the committee should formally agree the requirements and plan. It will provide

a benchmark against which to track progress and compare the proposed recommendation.

Identification of potential candidates

The number and identity of the firms suitable to be invited to tender should be identified. If the incumbent is not a candidate and the termination of the relationship is on good terms, it may be appropriate to involve the incumbent in providing information or comments to the audit committee. The audit committee should consider each candidate's credentials in the industry and geographical areas in which it operates and whether the infrastructure of the firm is likely to be sufficient to produce a properly co-ordinated audit, e.g. where there are overseas subsidiaries.

The audit committee should also consider the reputation of the firm and the company's and individual directors' experience from any previous engagements for audit or non-audit services. Potential issues should also be considered, for example whether the invited firm's concentration in a specific industry is an advantage (e.g. in-depth knowledge of industry issues) or a disadvantage (e.g. concerns about a conflict of interests or shared information). If there are any disadvantages, for whatever reason, the committee may wish to consider whether these can be managed, before ruling out a firm from appointment.

The audit committee might also consider seeking the views of major institutional or individual shareholders and taking note of informed press comment. However, and as with any executive management input, care needs to be taken to ensure that these comments are objective.

A shortlist should be drawn up and approved by the audit committee. Sufficient firms should be invited to tender so that it is a competitive process, enough options are presented to give a range of choice and at least one, preferably more, realistic candidates emerge.

An invitation to tender is issued to the potential candidates. The invitation should include the reason for the tender, requirements and expectations of the auditors, background information about the company, the timetable and any other information that is germane to the selection process.

Information gathering by potential candidates

The firms invited to tender should be allowed a period to meet key members of management, for example the managing director and finance director, and obtain information to allow them to develop a written proposal. The firms would want to meet a number of company representatives to understand the business and its management structure, systems and controls and to identify the key risks and management's controls for managing these risks. The audit committee should ensure that adequate time and access to management is provided to all firms to enable them to submit realistic proposals. Lack of information can lead to problems later after the new auditor is appointed.

This stage will be largely between the potential candidate and the executive management who will inevitably have their own impressions of the audit firms

through the quality of their questioning and understanding of the issues facing the company.

This information is valuable and should be taken into account by the audit committee, but it is not a substitute for the audit committee's responsibility for overseeing the process and making its recommendation to the board.

The firms invited to tender should also spend time with the audit committee to understand the committee's perception of the company, the strength of its governance arrangements and internal control systems, and the key accounting and auditing issues. This should be done at an early stage and, at a minimum, with the chairman of the audit committee, although the committee should decide whether other members or the entire committee should be involved.

Consideration of written proposals

The invitation to tender should indicate the expected content and length of this document. Typically the written proposal should include:

- The firm's assessment of the key business and audit risks and their proposed audit response.
- An overview of the audit approach.
- The key team members that would carry out the audit, including specialists.
- The firm's credentials and experience in the company's industry.
- Indicative audit time and fees.

The committee should consider whether each proposal demonstrates, for example, that the firm:

- Understands the company and its business.
- Understands the statutory and regulatory requirements and what the company needs.
- Has an audit team with the right experience and ability.
- Has the right commitment.

On the basis of the written proposals, the audit committee should identify those firms to be invited to make a presentation to the company. If a firm is clearly not suitable for appointment, it is better that that firm be eliminated, rather than waste everybody's time.

Presentations

There are no requirements about how many firms should be invited to present but, if only one or two firms are invited, the committee should consider whether going ahead can be justified or whether another firm(s) should be invited to tender. This is clearly undesirable as it delays and adds further cost, but the committee will need to be comfortable that its recommendation to the board is sustainable.

The committee will need to decide to whom the presentations should be made. Given that the committee has prime responsibility for the appointment recommendation, it is preferable that the full committee should be present. It would also be sensible if key executives attended, such as one or more

of the finance director, chief accountant and head of internal audit (or equivalents). They are likely to have a more detailed understanding of the company and the issues to be addressed during the audit. As part of any discussion about the written proposal, they will be able to (a) ask questions of the candidates and (b) provide answers and information to committee members and the firms.

The committee should agree with the firm which of their partners and staff should attend. The other partners and staff attending with the lead audit engagement partner will depend on a number of factors including, for example, the extent and complexity of key accounting and auditing issues and the need for the relevant specialist(s) on the proposed audit team to attend.

If there are any matters on which the audit committee or executive would like clarification from the written proposals, the committee should consider advising the firm so that they can be dealt with in the presentation. However, members may wish to assess how good the candidate firm's knowledge is and the ability of the attendees to 'think on their feet'.

Immediately after the presentation, the committee members and, possibly, the executives present should discuss the proposal, presentation and the supplementary questions and answers and assess how well the firm dealt with them. This should ensure that information and impressions are captured while fresh in the mind so that the recommendation decision can be soundly based and not confused with other presentations. This applies both to situations where presentations are held back-to-back or at intervals over several days.

Decision

The committee will next decide whether it has received sufficient information from each firm and whether one or more of the candidates satisfies the committee's criteria for appointment. Assuming that this is the case, the committee will make its recommendation to the board on the firm to be appointed or, if appropriate, re-appointed.

Additional copies may be obtained by calling: +44 (0)20 7920 8634 or downloaded by visiting www.icaew.co.uk/policy.

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Guidance for audit committees

The Institute of Chartered Accountants in England & Wales has issued a series of publications to assist non-executive directors on audit committees gain an understanding of the guidance included in the revised Combined Code on Corporate Governance as 'Audit Committees: Combined Code Guidance'. This is closely based on the proposals originally set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

Originally published in May and reissued in November 2003, the first four titles which are not affected materially by the revised Combined Code of July 2003 are:

- Working with your auditors
- Company reporting and audit requirements
- Reviewing auditor independence
- Evaluating your auditors

A further three titles will be published in 2004:

- Monitoring the integrity of financial statements
- The internal audit function
- Whistleblowing arrangements

