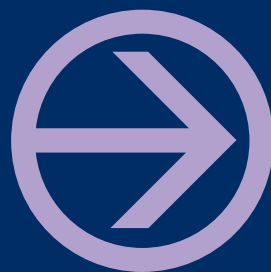


Guidance for audit committees

Whistleblowing arrangements



March 2004



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 & 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.

Whistleblowing arrangements

The revised Combined Code issued in July 2003 includes a provision (C.3.4) that:

'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.'

These arrangements are commonly referred to as 'whistleblowing' procedures. This publication has been prepared to assist non-executive directors in reviewing and assessing a company's internal whistleblowing procedures by providing background information on whistleblowing, key aspects of whistleblowing procedures, and examples of activities which may be undertaken by audit committees to fulfil the review requirement in the revised Combined Code.

Each company is unique and audit committees will need to apply the Code proposals and guidance in a manner that is appropriate to them. This publication does not provide guidance on how to deal with individual situations, nor does it provide a complete description of relevant legislation. Reference may need to be made to the legislation and other pronouncements mentioned in the text and to the company's professional advisers for detailed information.

Rationale for whistleblowing arrangements

In March 2003, the formal report of the Special Investigative Committee of the Board of Directors of WorldCom, Inc., issued after the reorganisation of the company, stated:

'That the fraud continued as long as it did was due to a lack of courage to blow the whistle on the part of others in WorldCom's financial and accounting departments...'

This lack of courage typically arises from employers not promoting the benefit of whistleblowing, and employees believing that they will be disadvantaged if they raise concerns. Therefore the option to remain silent is often perceived as the option of least risk by the individual and the malpractice continues undetected. As evidenced in WorldCom's case, and numerous other cases, this can have catastrophic consequences.

A company's workforce represents a valuable source of information that can be utilised to identify a potential problem, and deal with it, before it causes significant damage to the company's reputation or its stakeholders.

The audit committee should be aware that, in addition to the voluntary process referred to in the Smith Guidance, employees have significant legal protection under the Public Interest Disclosure Act 1998 where they blow the whistle internally and, in certain circumstances, outside the company. They may also have a legal duty to report suspicions of criminal or regulatory misbehaviour. In particular, individual employees as well as their employers may need to report suspected laundering of criminal proceeds or terrorist funds, usually internally to the company's Money Laundering Reporting Officer or otherwise externally. Senior employees in the regulated financial services may need to report regulatory defaults internally or direct to the Financial Services Authority (FSA). The guidance in this publication refers to systems for and the encouragement of voluntary reporting, though consideration could be given to merging these with systems for money laundering or other compulsory reporting. An outline of relevant legislation is provided in the appendix.

Effective whistleblowing arrangements should act as a deterrent to malpractice, encourage openness, promote transparency, underpin the risk management systems of the company and help protect the reputation of the company and senior management. Also an appropriate and effective whistleblowing mechanism should provide some support to the audit committee's other review and monitoring work, for example in relation to the integrity of the financial statements.

Whistleblowing should be considered an essential safety valve within the internal control environment. In most situations the traditional

internal reporting lines will be sufficient to prevent malpractice. However where fraud, corruption or other malpractice has served to undermine the company's internal controls and lines of reporting, whistleblowing can be an effective safeguard.

A culture which encourages employees to raise concerns will only be successful where two difficult challenges are overcome:

- whistleblowing procedures may be viewed as a 'sneak's charter'. Employees need to view it as a valuable contribution to the company's efficiency and long-term success and to their own future; and
- employees may believe they will be disadvantaged or victimised when they raise concerns. Employees need to be assured that they will be treated fairly and that concerns will be properly considered.

Successful whistleblowing procedures require strong leadership from the board and senior levels of management to develop a culture in which staff are encouraged to raise their concerns, both internally and through the firm's whistleblowing procedures. The whistleblower should be seen essentially as a witness, not as a complainant.

There are a number of key elements that should be covered in all whistleblowing procedures and formalising them may help to ensure that a company obtains maximum benefit from its whistleblowing arrangements.

Role of the audit committee

The audit committee has an important role in the management of risks to the company's reputation. This includes ensuring that the culture is appropriate so that whistleblowing procedures are successful.

As with other aspects of its review functions, the audit committee should seek to satisfy itself that there are proper arrangements in place. The committee's function is a high-level one but the committee needs to be aware that there may be circumstances in which more detailed work is required, e.g. if there are signs that the arrangements are inadequate or ineffective. It is not the duty of the committee to be responsible for the arrangements or their operation although audit committees may wish to allow whistleblowers to contact the audit committee chairman directly as an effective method of demonstrating the board's commitment to the success of the process and its independence.

The committee's review comprises two types of activity, which can be described as direct and indirect. The direct aspect could include questions to senior management, directors and the relevant employees about the arrangements and issues that have come to

light. The indirect aspect can be described as the committee becoming aware from its other functions of matters that indicate that the arrangements may not be effective.

The key elements of effective whistleblowing arrangements

Culture

The board and senior management should set the tone by clearly stating that the company undertakes to take seriously any matters raised in good faith by individual employees, to deal with them, where requested, in confidence (as far as practicable) and to protect their interests. Management should state that they:

- are against any form of impropriety; and
- encourage employees to draw attention to breaches of company policy and procedures.

The audit committee might wish to consider:

- *does the board and senior management set the right tone through its policy statements, communications and general actions?*
- *have particularly serious allegations been brought to the attention of the entire Board of Directors?*

Awareness of external regulations and requirements

The board and senior management should ensure that they are aware of the whistleblowing requirements in legislation and in regulations that apply to the company, if applicable, so that these can be communicated to employees. An outline of relevant legislation is provided in the appendix.

Applicable regulations will depend on the business itself, but could include health and safety, hygiene, FSA requirements are tax or licensing regulations.

The audit committee might wish to consider:

- *is there a mechanism to identify changes in legal and regulatory requirements?*

Policy awareness

A clear system of reporting is required so employees know what to raise and when, and the people in the company with whom they may safely raise the matter. There are good reasons why employees should

also know of external bodies such as the external auditors, professional bodies or relevant regulators with whom they can properly raise the matter. Employees may also need reassurance about confidentiality and protection from adverse consequences.

The audit committee might wish to consider:

- *do there appear to be sensible written policies and procedures that are appropriate to the company's size, organisation and the industry(ies) in which it operates?*
- *is there evidence that these policies have been communicated to new and existing employees, consultants and temporary staff?*
- *is there evidence that these policies have been communicated to staff of all levels?*

Feedback

In order to encourage employee support, there should be a procedure for reporting back the outcome of any subsequent enquiry and as far as possible any remedial action taken or to be taken. Failing to give feedback may be interpreted as failing to act, which could undermine the company's culture and discourage employees from raising concerns in future.

The audit committee might wish to consider:

- *do the arrangements include the provision of timely and constructive feedback?*

Access to confidential advice and procedures

The company may want to designate a senior individual whom employees can approach on a confidential basis. Employees should also be made aware of the independent charity Public Concern at Work (PCaW) which can provide advice to individuals on whistleblowing in the public interest on a strictly confidential basis. PCaW can also advise organisations on their procedures and can supply checklists/toolkits for both small and large companies. A similar service may be available through the company's professional advisers or through other organisations.

The audit committee might wish to consider:

- *are staff aware of the availability of confidential advice either through a confidential internal adviser or an outside body such as PCaW?*

Procedures for effective dealing with wrongdoers

As with any case where an employee is found to be involved in wrongdoing, they will need to be dealt with effectively in accordance with employment law and contracts of employment.

The audit committee might wish to consider:

- *have wrongdoers been dealt with in an appropriate manner, in accordance with employment law and contracts of employment?*

Reported concerns not upheld

If the policy is to succeed, whistleblowing that is not upheld but was in good faith must not be a cause for action against the whistleblower, although management should recognise that it may have consequences for relations between employees.

Review of effectiveness

The board ought to consider the effectiveness of whistleblowing policies and procedures on a regular basis. It should provide input to the board's review of the system of internal control. The review arrangements should be appropriate to the size of the company, the industry(ies) in which it operates, the nature of its activities, organisational structure and internal control and risk management systems. For some companies, the internal audit function may provide relevant assurance.

The audit committee might wish to consider:

- *is there evidence that the board regularly considers whistleblowing procedures as part of its review of the system of internal control?*
- *are there issues or incidents which have otherwise come to the board's attention which they would have expected to have been raised earlier under the company's whistleblowing procedures?*
- *where appropriate, has the internal audit function performed any work that provides additional assurance on the effectiveness of the whistleblowing procedures?*
- *are there adequate procedures to track the actions taken in relation to concerns made and to ensure appropriate follow-up action has been taken to investigate and, if necessary, resolve problems indicated by whistleblowing?*
- *are there adequate procedures for retaining evidence in relation to each concern?*
- *have confidentiality issues been handled effectively?*
- *is there evidence of timely and constructive feedback?*
- *have any events come to the committee's or the board's attention that might indicate that a staff member has not been fairly treated as a result of their raising concerns?*
- *is a review of staff awareness of the procedures needed?*

Appendix – Relevant legislation and other guidance

Legal requirements

Proceeds of Crime Act 2002 and Money Laundering Regulations 2003

The Proceeds of Crime Act 2002 requires employees of firms operating in the regulated sector⁽¹⁾ to disclose suspicions of money laundering to a designated employee of that firm (the Money Laundering Reporting Officer) or to the National Criminal Intelligence Service (NCIS).

The extended definition of money laundering to include the possession of the proceeds of any crime makes this a significant whistleblowing requirement.

There are a number of money laundering offences under the Proceeds of Crime Act 2002, including that of assisting a money launderer. However, a valid defence is to report the matter either to the designated Money Laundering Reporting Officer, or directly to NCIS.

Terrorism Act 2000

The Terrorism Act 2000 requires individuals to report knowledge of the possession of, and other activities relating to, terrorist funds. Terrorist funds include funds which are likely to be used for terrorist purposes as well as the proceeds of terrorism. This requirement applies to all individuals and not just those working in the regulated sector. An internal report to the designated Money Laundering Reporting Officer is also sufficient to comply with this requirement.

Legal rights

Public Interest Disclosure Act 1998

The Public Interest Disclosure Act 1998 was introduced to protect individuals making disclosures in the public interest and to allow such individuals to claim compensation for any victimisation following such disclosure. It provides a framework for the identification of cases in which it is appropriate for employees to make disclosures internally, to an appropriate regulator, or otherwise externally to a third party, and to obtain legal advice⁽²⁾. External regulators specifically mentioned in the Act, to whom protected disclosures can be made, include the FSA, Inland Revenue, the National Audit Office and the Health and Safety Executive.

⁽¹⁾ The regulated sector will include but is not limited to:

- banks;
- insurance firms;
- investment businesses;
- accountants;
- lawyers;
- estate Agents;
- casinos;
- money service businesses; and
- dealers in goods accepting cash payments of 15,000 euro or more.

⁽²⁾ This includes advice from Public Concern at Work.

The Act applies to all workers including contract workers and trainees.

Where a worker is dismissed or otherwise disadvantaged as a consequence of having made a protected disclosure⁽³⁾ they may claim unlimited compensation through an Employment Tribunal.

Confidentiality clauses in contracts of employment are considered unenforceable to the extent that the clauses prohibit disclosures protected by the Act.

Additional guidance

There are external sources of guidance that may be helpful:

- Financial Services Authority (FSA) – high-level guidance entitled ‘Guidance on Public Interest Disclosure Act: Whistleblowing’. This guidance is not binding on companies regulated by the FSA, but it is highly authoritative, and should be of use to both regulated and non-regulated companies. The guidance can be accessed from the whistleblowing section of the FSA’s website www.fsa.gov.uk/whistle/. This section of the website contains other information on whistleblowing, including a copy of the FSA’s whistleblowing procedure for its own staff, and a consultation paper on whistleblowing which contains a good summary of the Public Interest Disclosure Act.
- Public Concern at Work (PCaW) provides a range of guidance and information on its website www.pcaw.co.uk.
- ICAEW has issued guidance for members on whistleblowing and money laundering legislation. This information is publicly available on the ICAEW technical policy website (www.icaew.co.uk/technicalpolicy):

TECH 17/99	– Public Interest Disclosure Act 1998
TECH 8/04	– Anti-Money Laundering (Proceeds of Crime and Terrorism) Second Interim Guidance For Accountants
TECH 16/99	– Receipt Of Information In Confidence By Auditors

⁽³⁾ A disclosure to an employer, made in good faith, of information which in the reasonable belief of the employee tends to show that one of the following has been committed, is being committed, or is likely to be committed:

- a criminal offence;
- a failure to comply with a legal obligation;
- a miscarriage of justice;
- danger to the health or safety of an individual;
- damage to the environment; or
- deliberate concealment of information about the above.

For disclosures to external regulators specified under the Act, the whistleblower must reasonably believe that information disclosed is true and that the matter falls within the regulator’s area of responsibility.

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

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The Institute of Chartered Accountants in England & Wales has issued a series of publications to assist non-executive directors on audit committees to 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.

The following titles are available:

- Company reporting and audit requirements
- Monitoring the integrity of financial statements
- The internal audit function
- Evaluating your auditors
- Reviewing auditor independence
- Working with your auditors
- Whistleblowing arrangements

