Federation of European Accountants

VIEWS



The impact of the audit reform on audit committees in Europe

BRIEFING PAPER

HIGHLIGHTS

The latest EU audit reform has expanded the audit committee's role substantially. The audit committee is now instrumental in strengthening confidence in the statutory audit and in financial information as a whole. Overall, the audit committee is expected to become a key factor within the corporate governance framework of EU Member States.

This FEE briefing paper highlights the developing role of the audit committee in Europe and provides an overview of the related changes to corporate governance best practice. The paper also provides for a number of FEE recommendations. For the sake of completeness these recommendations have been summarised at the end of the paper.

As the deadline for transposing the legislation is getting closer (16 June 2016), a high level of coordination amongst all stakeholders (board and audit committee members, audited company management, shareholders, and auditors) will facilitate achieving the desired outcomes. Working towards consistent functioning of audit committees across Europe remains crucial in order to achieve the desired outcomes.

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Introduction

Objective of this publication

In April 2014 the European Parliament and the Council of Ministers reached an agreement on the European Commission's proposals for a reform of the EU statutory audit[1] (the so called audit reform). Provisions regarding the audit committee are set out both in the Directive 2014/56/EU[2] (the Directive) and the Regulation 537/2014[3] (the Regulation).

The main objective of this publication by FEE is to highlight the developing role of the audit committee, particularly following this latest audit reform, and to provide an overview of the related changes to corporate governance best practice.

Background

The audit reform brings sweeping changes to the role of the audit committee. Overall, one can claim that it sets this committee on a path towards becoming a key factor within the corporate governance framework of all EU Member States.

Despite already existing requirements of the 2006 Statutory Audit Directive (SAD) and of corporate governance standards and best practices across Europe, there are still distinct differences between countries regarding the composition and functioning of the audit committee. Over time, Member States have attached cultural and historical perspectives to its role, while some countries remain less advanced than others in the importance they attribute to this committee. In addition, corporate governance is organised differently across Europe − for instance with respect to one-tier or two-tier boards − and this has a clear impact on audit committee functioning.

As already included in the 2006 SAD, Member States are expected to ensure that each Public Interest Entity (PIE) has an audit committee. In the new legislative text, the definition of PIEs has not changed significantly as compared to the 2006 SAD. However, it is now crucial to determine which entities fall under the Regulation. The definition varies between Member States and is expected to be revised in a number of Member States[4]. As a result, some entities are likely to have to establish an audit committee for the first time[5].

Overall, the audit committee assumes responsibilities in various key areas of corporate governance[6], including:

- monitoring the work of the external auditor
- monitoring the financial reporting process and propose recommendations

[1] As revised, the final text includes the Directive 2014/56/EU applicable for every statutory audit in the EU and the Regulation (EU) No 537/2014 with requirements specifically relating to statutory audits of Public Interest Entities (PIEs).
[2] Official text available on: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32014L0056.
[3] Official text available on: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32014R0537.
[4] Amongst other reasons because article 39 of the SAD is no longer valid: "Member States may exempt public-interest entities which have not issued transferable securities admitted to trading on a regulated market within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and their statutory auditor(s) or audit firm(s) from one or more of the requirements in this Chapter."
[5] Further information on the definition and its application in the FEE survey *Definition of public interest entities in Europe,* available on: http://www.fee.be/images/publications/auditing/PIE_definition_survey_outcome_141008.pdf.
[6] Despite the changes in the new wording of the Directive, there are only specific points which change the monitoring activities of the audit committee. All new parts are specified in the relevant section.

- overseeing organisational matters, namely the internal control[7] and risk management systems

Particularly following the global financial crisis, some boards have set up risk committees of their boards and this is now a European requirement for some banks. This is likely to impact the extent to which the audit committee is relied upon to oversee risk management and internal control as required by the Directive and Regulation. Care must be taken to ensure that the composition of a board's risk committee (with respect, for instance to non-executive membership and appropriate competencies) corresponds to the composition of the audit committee when the risk committee is being relied upon to discharge some of the audit committee's responsibilities[8].

As the deadline for transposing the legislation is getting closer (16 June 2016), all relevant stakeholders including board and audit committee members, audited company management, shareholders, auditors need to prepare for the new challenges ahead. Although the requirements relating to the audit committee in the Directive and Regulation are only mandatory for PIEs, other entities should consider the extent to which they amount to best practice for them.

Role and responsibilities of the audit committee

Responsible for auditor selection

Key words: selection process, auditor appointment, transparency, criteria

Directive – Article 39.6 (f)

> *"[The audit committee shall] be responsible for the procedure for the selection of statutory auditor(s) or audit firm(s) and recommend the statutory auditor(s) or the audit firm(s) to be appointed in accordance with Article 16 of Regulation (EU) No 537/2014 except when Article 16(8) of Regulation (EU) No 537/2014 is applied."*

Regulation – Article 16

> *"2. The audit committee shall submit a recommendation to the administrative or supervisory body of the audited entity for the appointment of statutory auditors or audit firms.*
>
> *[…] In its recommendation, the audit committee shall state that its recommendation is free from influence by a third party and that no clause of the kind referred to in paragraph 6 has been imposed upon it […].*
>
> *3. (e) […] The audited entity shall prepare a report on the conclusions of the selection procedure, which shall be validated by the audit committee. The audited entity and the audit committee shall take into consideration any findings or conclusions of any inspection report on the applicant statutory auditor or audit firm referred to in Article 26(8) and published by the competent authority pursuant to point (d) of Article 28."*

According to the Regulation, the audit committee has to make a reasoned recommendation for the appointment of the auditor – following a structured selection process – and submit the recommendation to

[7] While the EU legislative text uses the phrase "quality control", FEE considers that in this context it should be interpreted as meaning "internal control" rather than the narrower meaning usually associated with the phrase "quality control".

[8] Board risk committees should not be confused with risk committees that often exist at executive level, such as credit risk committees.

the administrative, supervisory body or directly to the shareholders[9] of the audited entity. The recommendation has to contain at least two auditors and the justified preference for one of them.

Entities are changing their auditors more frequently than in the past, in response to market and other demands. In addition, as per the Regulation, PIEs are now required to change their auditor after a certain maximum number of years, namely ten years renewable for ten years after a tendering process. Member States may have chosen to apply different durations as authorised by options available in the legislative text[10].

FEE agrees that the audit committee is best placed to be responsible for the selection[11]. The key issues are:

- to ensure that the auditor is independent of the management of the audited entity (see below)
- as part of securing audit quality, to make sure that the selection criteria are fit for purpose

Assessing audit quality can be a challenge for the audit committee. Available information on this topic for the audit committee remains limited. FEE has published a specific paper on the auditor selection process *Auditor Selection - Towards Best Practices*. This paper provides a list of criteria to be assessed when selecting an auditor (see the list of criteria in the Appendix to this publication).

The audit committee should seek more dialogue with the auditor. This can provide more insight into how the auditor is committed to delivering high quality audits and, based on suitable criteria, how this is best achieved. Article 16.3(e) specifically refers to consideration of the inspection reports by competent authorities. Any individual inspection reports, if available, are part of the evidence to be taken into account when considering audit quality.

The auditor selection responsibility and procedure are now defined by legal requirements. It will bring further objectivity and consistency in the selection procedure across Europe.

Particular attention should be drawn to the written report providing the conclusions on the selection procedure. The report is prepared by the audited entity, validated by the audit committee and should include the rationale for the selection of the auditor or the renewal of the incumbent auditor.

Increased transparency of the auditor selection process is a means to safeguard the quality of the selection. FEE welcomes the Regulation requirements for further transparency and reporting on the selection procedure towards and from the audit committee[12]. The auditor selection procedure is now defined by legal requirements. This is considered as a positive development compared to the past and it allows for further objectivity and consistency in the selection procedure across Europe.

[9] Article 16.8 of the Regulation: "Where the audited entity has a nomination committee in which shareholders or members have a considerable influence and which has the task of making recommendations on the selecting of auditors, Member States may allow that nomination committee to perform the functions of the audit committee […]."
[10] For more information: *The appointment of the auditor and the duration of the Audit engagement: Striving for a workable Single Market in the EU*, available on: http://www.fee.be/images/BP_140825_-_Appointment_of_the_Auditor.pdf.
[11] For more information: *Auditor selection. Towards best practices,* available on: http://www.fee.be/images/Auditor_selection_Towards_best_practices_1310.pdf.
[12] ibid

A central role in overseeing the independence of the auditor

Key words: independence, monitor, conflicts of interest

Directive – Article 39.6 (e)

> *"[…] the audit committee shall, inter alia: […]*
>
> *(e) Review and monitor the independence of the statutory auditors or the audit firms in accordance with Articles 22, 22a, 22b, 24a and 24b of this Directive and Article 6 of Regulation (EU) No 537/2014 […]."*

Regulation – Article 6.2

> *"A statutory auditor or an audit firm shall:*
>
> *(a) Confirm annually in writing to the audit committee that the statutory auditor, the audit firm and partners, senior managers and managers, conducting the statutory audit are independent from the audited entity;*
>
> *(b) Discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats […]."*

Article 39.6 of the Directive and Article 6 of the Regulation require the audit committee to monitor auditor independence. A key issue linked to auditor independence is the provision of non-audit services (see below).

Monitoring auditor independence was already assigned to the audit committee. Further clarity and new criteria have now been added.

The responsibility for monitoring auditor independence was already assigned to the audit committee in the 2006 SAD, including the responsibility to receive the auditor's annual confirmation on their independence and to discuss any possible threats. Nevertheless, the revised text now goes a step further by providing further clarity to previously existing requirements, and also by adding some new criteria for auditor independence[13].

To assess possible conflicts of interest, the following key criteria are mentioned in the legislative text:

- the auditor holding:
  - a financial interest (referred to as "own financial instruments" in the Directive) within the audited entity or any entity related to it
  - professional or personal relationships with the audited entity
  - employment or economic dependence with the audited entity during the period of the audit and the period covered by the financial statements
- the auditor accepting pecuniary or non-pecuniary gifts from the audited entity or any entity related to it

These criteria included in the revised Directive provide for further clarification as to what "direct or indirect financial, business, employment or other relationship" implies (as previously included in the 2006 SAD).

Statutory auditors have to take all reasonable steps to ensure that their independence is not affected by any existing or potential conflict of interest. Should the audit committee identify any conflict of interest which may impair auditor independence, it should discuss this further with the statutory auditor and decide on a course of action to safeguard auditor independence.

[13] Requirements set out in articles 22, 22a, 22b, 24a, 24b of the Directive.

To assess possible threats to auditor independence, the audit committee is expected to evaluate whether the auditor (this being new compared to the 2006 SAD):

- has sufficient time and resources to conduct the audit (article 24a (h))
- is staffed with sufficiently experienced personnel (article 24a (c))
- has an internal quality control system in place to ensure the quality of the audit (article 24a (b))
- has adequate remuneration policies providing sufficient performance incentives to secure audit quality (article 24a (j))

In addition, the Regulation includes a specific provision[14] which requires the auditor to monitor the level of fees that the audited entity represents in all of the firm's fee income. If this level reaches 15% for three consecutive years – which could be seen as a dependency of the firm towards this specific client – it needs to be discussed with the audit committee that needs to assess 1) whether this constitutes a threat to auditor independence, and 2) whether there are safeguards to be applied to mitigate the threat. When the level of fees is more than 15%, as a first step the audit committee shall consider whether the audit should be subject to a quality control by another audit firm. Should the fees continue to exceed this level, the audit committee should determine whether the auditor can continue to conduct the audit for an additional period which shall not exceed two years.

The Directive also places new restrictions on the employment of former auditors by the audited entity. According to the text, a former auditor would not be allowed to take any key management position in the audited entity before one year had elapsed since he/she had been involved in the audit. In the case of PIEs, two years need to have passed before the auditor can be recruited by the audited entity ('cooling off' period). To recall, the 2006 SAD required a period of two years for auditors of all audited entities.

Relevant guidance on equivalent provisions included both in the International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants[15] and in the European Commission (EC) Recommendation 2002/590/EC[16] are useful references for assessing auditor independence.

Provision of non-audit services

Key words: non-audit services, approval, independence, guidance

Directive – Article 39.6 (e)

> *"Review and monitor […] the appropriateness of the provision of the non-audit services to the audited entity in accordance with article 5 of the Regulation."*

Regulation – Article 5

> *"1. A statutory auditor […] shall not directly or indirectly provide to the audited entity, to its parent undertaking or to its controlled undertakings within the Union any prohibited non-audit services in:*
>
> *(a) the period between the beginning of the period audited and the issuing of the audit report; and*
>
> *(b) the financial year immediately preceding the period referred to in point (a) in relation to the services listed in point (g) of the second subparagraph.*
>
> *4. A statutory auditor […] may provide to the audited entity non-audit services other than the prohibited non-audit services subject to the approval of the audit committee after it has properly*

[14] Article 4 of the Regulation.
[15] Available on: http://www.ethicsboard.org/iesba-code.
[16] Available on: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32002H0590.

> *assessed threats to independence and the safeguards applied in accordance with Article 22b of Directive 2006/43/EC."*

In its role in overseeing the independence of the external auditor, the audit committee is tasked with the review and monitoring of the statutory auditor's provision of non-audit services to the audited entity[17], and thus required to:

- Ensure that the auditor does not provide services that are prohibited according to the Regulation or any national laws and regulations. Guidance may need to be issued by the audit committee, especially in cases where the entities operate cross border. The prohibition of non-audit services is not expected to be strictly the same in all Member States, given the options offered in the legislation to add to the list or to authorise some services, such as tax or valuation services (if specific criteria are followed[18]);
- Establish an approval process using a threat and safeguard approach to commission permissible non-audit services by the statutory auditor; and
- Monitor the level of the permissible non-audit services to ensure that it does not go beyond the 'ceiling' cap established by the Regulation[19]. This cap limits the amount of permissible non-audit services that can be provided by the statutory auditor in a financial year. It is up to the audit firm to calculate this cap, but the audit committee may need to set up a specific process to monitor it. The calculation of such a cap is not straightforward as it takes into account the permissible services provided by the audit firm during three consecutive years.

In overseeing the auditor independence, the audit committee should review and monitor the statutory auditor's provision of non-audit services.

Neither the Directive nor the Regulation includes detailed provisions on how the audit committee should be organised to carry out this monitoring of non-audit services. The legislative text states that the provision of non-audit services requires the approval of the audit committee after it has properly assessed any threat to the auditor's independence. This seems to suggest that prior approval by the audit committee of each instance is called for.

FEE considers a sense of proportion should be applied. It would be reasonable for management to approve minimal instances of non-audit services, in accordance with prior principles and procedures adopted by the audit committee. The audit committee could also pre-define a list of non-audit services and a threshold where its involvement in the approval process would not be necessary. What constitutes a 'minimal instance' will need to be defined by the audit committee. Each audit committee needs to reflect further how to proceed, keeping in mind that the ultimate objective of this exercise is to safeguard auditor independence while remaining principles-based in order to minimise the administrative burden of such a procedure.

FEE recognises the need for flexibility when it comes to implementing EU legislation at Member States' level. However, FEE is concerned that cross-border differences in defining which non-audit services can be provided by the statutory auditor may lead to substantial divergence that would be detrimental to the EU audit market. The absence of a common approach on this could end up with unnecessary administrative burdens for businesses, as well as diverse interpretations of auditor integrity and independence. FEE

[17] According to national laws and regulations.

[18] For more information on these criteria: *Provision of non-audit-services to public interest entity statutory audit clients: A need for clarification and consistency (*page 4), available on: http://www.fee.be/images/publications/auditing/BP_140825_-_Provision_of_NAS.pdf.

[19] For more information on the ceiling cap: *Provision of non-audit-services to public interest entity statutory audit clients: A need for clarification and consistency,* available on: http://www.fee.be/images/publications/auditing/BP_140825_-_Provision_of_NAS.pdf.

suggests addressing this at group level to ensure common best practice. All in all, there is a definite need for further coordination among Member States on this.

Internal communication and other responsibilities of the audit committee

Key words: communication, internal quality control, effectiveness

Directive – Article 39.6 (a)

> *"[…] the audit committee shall, inter alia:*
>
> *(a) NEW: inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and explain how the statutory audit contributed to the integrity of financial reporting and what the role of the audit committee is in this process.*
>
> *(b) Monitor the financial reporting process and NEW: submit recommendations or proposals to ensure its integrity.*
>
> *(c) Monitor the effectiveness of the undertaking's internal quality control and risk management systems […].*
>
> *(d) Monitor the statutory audit of the annual and consolidated financial statements […]."*

Better communication channels between the auditor, the audit committee and the audited entity were one of the key objectives of the European Commission while drafting its proposals. The revised Directive now provides for the audit committee to inform the administrative or supervisory body on the outcome of the audit contributing to the integrity of financial reporting and to explain the audit committee's role in this process.

Although already part of the 2006 SAD, it is worth highlighting some particular responsibilities of the audit committee, especially when it comes to its monitoring activities (points 39.6 (b)[20], (c) and (d)). On top of monitoring the financial reporting and statutory audit processes, the audit committee is also expected to monitor the effectiveness of the internal control and the risk management systems of the audited entity. This is particularly important as it assigns greater responsibility and accountability to the audit committee than before. Monitoring the effectiveness could lead to organisational efficiencies, better decision making and more timely financial statements.

FEE considers that, according to the Directive, the audit committee should monitor all systems of internal control, including financial, accounting, operational, and compliance controls. The quality assurance process is an important element of internal control. All these control arrangements remain important aspects of risk management.

It is likely that while discharging these audit committee responsibilities, the committee will determine whether it should receive regular reports from the PIE's risk management, compliance, quality assurance, and internal audit functions. These reports will be more valuable if they also include the audited entity's views on effectiveness of these functions. In addition, the committee should allocate sufficient time to discuss with the senior managers of the

FEE supports provisions reinforcing the audit committee's evaluation of internal controls, internal audit and risk management functions.

[20] Please note that the EU legislative text on the monitoring of the financial reporting progress includes now **new provisions** in which the audit committee is expected, on top of supervising, to come up with recommendations in order to ensure its integrity.

entity as well as to ensure that there is satisfactory communication between its members and the chair of the committee in between committee meetings. It should be determined to what extent the committee is committed to the oversight of these responsibilities.

FEE suggests below some key points to be considered by the audit committee while undertaking this monitoring activity[21]:

- to check whether the risk management systems have identified meaningful risks to the audited entity's objectives
- to propose 'key controls' to improve the effectiveness of internal controls
- to collect information that indicates in a persuasive manner whether the controls are operating effectively or not

Other issues to be taken on board by the audit committee could include:

- to assess the objectivity of the evaluators of internal control and risk management
- to assess the appropriateness of the time scale and the means by which the entity considers the adequacy of information to support conclusions that internal control is, or is not effective
- to determine the sufficiency and suitability of information used in monitoring
- to propose ways in which the organisation can make monitoring more efficient without reducing its effectiveness[22]

FEE supports provisions reinforcing the audit committee's evaluation of internal controls, internal audit and risk management functions[23]. They reinforce the role of the audit committee, especially by making the link between the statutory audit and the internal controls, internal audit and risk management functions. FEE also believes that if controls are not working properly, the audit committee should – in consultation with the external auditor – provide recommendations for remediation.

What good audit committees should look like?

Background, composition and expertise of audit committee members

Key words: sector competence, non-executive members

Directive – Article 39.1

> *"[The audit committee] shall be composed of non-executive members of the administrative body or members of the supervisory body of the audited entity or members appointed by the general meeting of shareholders of the audited entity […]*
>
> *The committee members as a whole shall have competence relevant to the sector in which the audited entity is operating."*

[21] *Guidance on Monitoring Internal Control Systems*, Committee on Sponsoring Organizations of the Treadway Commission.
[22] Ibid.
[23] For more information: *The functioning of Audit Committees*, available on: http://www.fee.be/images/Discussion_Paper_on_Audit_Committees_120615.pdf.

Directive – Article 39.1 (points carried over from the 2006 SAD)

> *"At least one member of the audit committee shall have competence in accounting and/or auditing."*

FEE considers as a positive development the requirement for the audit committee to have collectively a competence on audit committee matters which is relevant to the PIE and the sector. This will facilitate the audit committee's consciousness of the sector's characteristics and complexities. Although there is no clarification in the Directive on what "competence" may involve, FEE considers that it is important for the shareholders of the audited entity to assess whether the audit committee members collectively will be able to grasp the sectors' complexities. Competence criteria may vary per sector; a one-size–fits-all approach is not recommended.

The legislative text also does not specify what "competence in accounting and/or auditing" entails. FEE considers that PIEs should not necessarily rely on just one audit committee member to have all the competence required: that is the minimum. In certain financial PIEs it is unlikely that the requisite expertise can be vested in one individual – an insurance PIE is likely to need an actuary as well as a financial reporting expert on their audit committee. Every audit committee should collectively possess the needed skill sets, and those members being relied upon in this regard should conscientiously exercise those skills and have the necessary time to do so.

What good audit committees should look like? Communicative chair, composed by non-executives independent in character and judgement, include members with competences in the sector and at least one in accounting and/or auditing.

In contrast to the 2006 SAD[24], the 2014 Directive states that the audit committee "shall be composed of non-executive members" appointed by the board and/or members appointed by the shareholders. FEE considers it to be crucial that audit committee members are always non-executive directors. This requirement will safeguard committee members' integrity and their actual and perceived independence from the company's management[25].

Independence of audit committee members

Key words: independence, principle-based approach

Directive – Article 39.1

> *"A majority of the members of the audit committee shall be independent of the audited entity."*

Directive – Article 22a

> *"[…] a statutory auditor […] [will not become a member of the audit committee of the audited entity] before a period of at least one year […] has elapsed since he or she ceased to act as a statutory auditor […]."*

According to the 2014 Directive, more than 50% of the audit committee's members should be independent, which is an improvement compared to the 2006 SAD that required one independent committee member as a minimum.

[24] The 2006 SAD provided flexibility for Member States to decide on whether the audit committee be composed of non-executive members or not.

[25] Based on the 2012 FEE paper *The functioning of Audit Committees,* available on: http://www.fee.be/images/Discussion_Paper_on_Audit_Committees_120615.pdf.

It is not an easy task to define independence in this context, an attribute that is referred to in several articles. The Directive in article 22(a) prohibits an active auditor from becoming an audit committee member before one year has passed ('cooling-off' period) since he/she ceased to act as a statutory auditor or key audit partner in connection with the audit engagement (two years in case of statutory audits of PIEs). Apart from that, neither the Directive nor the Regulation gives further clarification on what independence of audit committee members means. FEE considers that the assessment of the independence of audit committee members should remain principles-based. The following criteria are amongst those that the board might find useful in weighing up whether an individual should be regarded as an independent non-executive director:

- is independent in character and judgement
- has no business or other relationships with the company's management[26]
- has no material business relationship with the company[27] directly, or as a partner, shareholder, director or employee of a body that has such a relationship with the company
- has, where applicable, completed an appropriate 'cooling-off' period[28] in the case of an individual who used to serve as a member of the management board, as employee of the company, as external auditor, etc.
- is not involved in any other conflicting directorship or has other significant link(s) with other directors through involvement in other companies or bodies
- is not closely related (direct offspring, spouses, life partners, parents, uncles, aunts, sisters, nieces, nephews) to members of the management board or to management level staff of the company
- does not receive any other remuneration from the company apart from a director's fee, and does not participate in the company's share option or other performance related pay schemes, and is not a member of the company's pension scheme

At EU level, the European Commission issued in 2005 a Recommendation on the role of non-executive directors (2005/162/EC)[29].

The specific role of the audit committee chair

Key words: chairmanship, independence

Directive – Article 39.1

> *"The chairman of the audit committee shall be appointed by its members or by the supervisory body of the audited entity, and shall be independent of the audited entity.*
>
> *Member States may require the chairman of the audit committee to be elected annually by the general meeting of shareholders of the audited entity."*

Considering the role of the chairman of the audit committee, the Directive provides for two requirements relevant to his/her election. These provisions aim to protect the chair's integrity and independence. It is interesting to note that the Directive offers the option for shareholders to elect the chair.

The role of the audit committee chair is pivotal, as he/she needs to be a strong leader to promote the audit committee's effectiveness. As part of best practice, FEE suggests below some key responsibilities that can be

[26] Subsidiaries and group companies should be taken into account when applicable.
[27] Ibid.
[28] The EU legislative text includes one year but some Member States require longer periods namely 3-5 years.
[29] Available on: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32005H0162.

taken up by the chair. This will help to strengthen the role and effectiveness of the audit committee as a whole.

These responsibilities can be divided in two areas:

- Internal communication within the audit committee
    - The chair should ensure that the committee fulfils its mandate and should facilitate the committee's efficiency and coordination;
    - He/she is expected to ensure there is a proper flow of information to enable the audit committee to exercise its responsibilities. He/she should act as a leader within the committee urging members to ask critical questions of management and auditors. These critical questions are essential to the committee's oversight of the financial reporting and external audit processes[30], but also of other aspects including risk management and internal control;
    - The chair can also contribute to making sure that the committee's members have the necessary skills and competencies required; and
    - The chair should ensure that a free and open discussion takes place during meetings of the audit committee.
- External communication by the audit committee
    - The chair should act as an effective link between the audit committee and the board of the company;
    - The chair is expected to develop constructive dialogue with the Board, the CEO, the CFO, the external auditor, as well as the internal auditor[31];
    - He/she should ensure that the audit committee receives appropriate, sufficient, and reliable information and is informed about the company's current risks;
    - The chair should attend shareholders' meetings to give visibility to the audit committee's role and to ensure that the committee is properly aware of shareholder concerns;
    - As appropriate, the chair should invite to audit committee meetings the board chair, the CEO, other executives, the external auditor, and outside parties.

Assessment of the audit committee

Key words: assessment, audit committee performance, sanctions

Regulation – Article 27

> *"The competent authorities designated under Article 20 (1) and the European Competition Network (ECN), as appropriate, shall regularly monitor the developments in the market for providing statutory audit services to public-interest entities and shall in particular assess the following:*
>
> *[…] (c) The performance of audit committees; […].*
>
> *By 17 June 2016, and at least every three years thereafter, each competent authority and the ECN, shall draw up a report on developments in the market for providing statutory audit services to public-interest entities and submit it to the CEAOB, ESMA, EBA, EIOPA and the Commission."*

[30] For more information: *Global observations on the role of the Audit Committee,* available on: http://www.fee.be/images/FEE_ICAA_CAQ_Global_Observations_on_the_Role_of_the_Audit_Committee_130507.pdf.
[31] Ibid.

Directive – Article 30

> *"(a) 1.Member States shall provide for competent authorities to have the power to take and/or impose at least the following administrative measures and sanctions for breaches of the provisions of this Directive and, where applicable, of Regulation (EU) No 537/2014."*

Article 30 of the Directive allows for competent authorities to impose sanctions in case of breaches.

Article 27 of the Regulation requires that competent national authorities and the European Commission Network (ECN) assess the performance of the audit committee.

This is the first time that such a requirement is suggested at EU level. Further guidance and clarifications need to be provided on how the European Competition Network (ECN) and/or national authorities will monitor the audit committee's performance or impose sanctions. The text does not provide further information on how these assessments should be carried out, nor on the means of interaction between the ECN and the audit committee. Some Member States[32] have their own practices in place for the audit committee assessment.

Given the increasingly important role of the audit committee, an interesting matter to consider is whether the committee should rely on its own self-assessment and/or use feedback from external stakeholders (such as the auditor, the board, and the shareholders). The committee's chair can play a significant role in this process and lead the discussion. A recent development is that boards hire externals to perform independent assessments.

Improving communication

In addition to the specific provisions related to communication raised above, it is crucial to underline the importance of all communications from and to the audit committee.

With management and the internal audit function

Management and the internal audit function should ensure that information provided to the audit committee is timely, concise, and of a level of quality that leads to a free and open discussion on all relevant topics. In addition, the audit committee itself should ensure sufficient transparency in the process[33].

With the auditor

FEE believes that enhanced communication between the auditor and the audit committee is beneficial to both parties.

FEE believes that enhanced communication between the auditor and the audit committee is beneficial to both parties especially when it comes to the discharge of their respective duties. Information collected by the auditor during the audit can be directly relevant to those charged with governance responsibilities and can be communicated via the required additional report to the audit committee. This additional

[32] For instance in the UK, the National Audit Office has established a handbook providing a check list to be used by the audit committee when assessing its performance, *Self-assessment check list*, available on: http://www.nao.org.uk/report/audit-committee-self-assessment-checklist-2-2/ .The UK Corporate Governance Code requires boards to assess their performance at least annually with external facilitation of this at least once every three years. This assessment includes an assessment of board committees and of individual members of the board and of the board's committees (https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2, vide B6 Evaluation).

[33] Based on the 2012 FEE paper *The functioning of Audit Committees,* available on: http://www.fee.be/images/Discussion_Paper_on_Audit_Committees_120615.pdf.

requirement was a prerequisite of the 2006 SAD. The Regulation reinforces and expands the content of this report[34]. It is a tool for the auditor to communicate key matters arising from the statutory audit and in particular on material weaknesses in internal controls with regard to the financial reporting process.

Alongside other practices and discussions between the auditor and the audit committee, this additional report to the audit committee can contribute to strengthening communication between the two parties. Several EU Member States have put in place specific communication policies between the auditor and the audit committee or those charged with governance. Putting aside the formalities that may be involved in the process (e.g. long and formal reports), information sharing between the external auditor and those charged with governance can contribute to the effectiveness of both parties (e.g. by means of presentations to the audit committee). FEE emphasises the following key requirements to enhance communication between the auditor and the audit committee:

- The auditor should be invited regularly to attend meetings of the audit committee;
- The chair of the audit committee and, where relevant, other members of the audit committee, should liaise with the auditor periodically;
- The audit committee should meet the auditor without management present at least annually[35].

Summary of FEE recommendations

The latest EU audit reform has expanded the audit committee's role substantially. The new role for the audit committee is instrumental in strengthening confidence in auditors and in financial information overall. While still being a subcommittee of the board, the audit committee is more accountable with provisions reinforcing its role in the evaluation of internal controls, internal audit and risk management functions. It is important to work towards consistent functioning of audit committee practices across Europe. The legislative text allows for divergent approaches to Member States' implementation. Although it is necessary to provide Member States with flexibility and allow them to come up with tailor-made solutions, businesses should not encounter additional administrative burdens because of different national legal frameworks. A high level of coordination amongst all stakeholders will facilitate achieving the desired outcomes for auditing across Europe.

Role and responsibilities of the audit committee

Responsible for auditor selection

FEE agrees that the audit committee is best placed to be responsible for the auditor selection process. The audit committee should ensure that the selection criteria are fit for purpose (see appendix).

FEE recommends that the procedure for selecting the auditor remain principles-based. This will accommodate flexibility for businesses and avoid possible divergences in interpretation of the Regulation at cross border level. FEE welcomes the Regulation's requirements for further transparency and reporting on the selection procedure towards and from the audit committee. Increased transparency in the auditor selection is a means to safeguard quality in the process.

[34] For more information: *Recent developments in auditor communication*, available on: http://www.fee.be/images/BP_Auditor_Communication_1502.pdf.
[35] International Standard on Auditing (ISA) 260, available on: http://www.ifac.org/system/files/downloads/a014-2010-iaasb-handbook-isa-260.pdf.

Central role in overseeing auditor independence

Under the previous 2006 legislation, the audit committee was involved in safeguarding auditor independence. The revised text provides further requirements, giving additional insight on how to detect conflicts of interest and to evaluate possible threats to independence.

Approval of the non-audit services

Stringent provisions are now part of the legislation which limits the non-audit services provided by the statutory auditor. The audit committee is tasked with approving the services to be provided in light of this legislation. The legislation states that the provision of non-audit services requires the approval of the audit committee after it has properly assessed any threat to the auditor's independence. This seems to suggest that prior approval by the audit committee of each instance is called for. FEE considers a sense of proportion should be applied. It would be reasonable for management to approve minimal instances of non-audit services, in accordance with prior principles and procedures adopted by the audit committee.

Background and expertise of audit committee members

Collective Competence

FEE considers as a positive development the requirement for the audit committee to have collectively a competence relevant to the entity and its sector.

Competence in accounting and/or auditing

The Directive requires at least one member with competence in this domain. FEE believes that entities should not necessarily rely on just one audit committee member to have this competence: that is the minimum. In certain financial entities, it is unlikely that all the requisite expertise can be vested in one individual – an insurance company is likely to need an actuary, as well as a financial reporting expert on the audit committee. Every audit committee should collectively possess the needed skill sets, and those members being relied upon in this regard should conscientiously exercise those skills and have the necessary time to do so.

Independence in character and judgement

FEE suggests ensuring that audit committee members are always non-executive directors independent in character and judgement and free of any relationships or circumstances which might impede, or be perceived to impede, the exercise of independent judgement.

Overall objective: improving communication from and to the audit committee

With management and the internal audit function

The management and the internal audit function should ensure that information provided to the audit committee is timely, concise, and of a level of quality that leads to a free and open discussion of all relevant topics. In addition, the audit committee itself should ensure sufficient transparency in the process.

With the auditor

FEE believes that enhanced communication between the auditor, the audited entity and the audit committee is beneficial to all parties. Information collected by the statutory auditor during the audit work can be directly relevant to those charged with governance responsibilities and vice versa.

FEE emphasises the following key requirements to enhance communication between the auditor and the audit committee:

- The auditor should be invited regularly to attend meetings of the audit committee;
- The chair of the audit committee and, where relevant, other members of the audit committee, should liaise with the auditor periodically;
- The audit committee should meet the auditor without management present at least annually.

Appendix: list of criteria to select the auditor[36]

The criteria to select the auditor should be transparent. An equal and fair chance of selection will therefore be ensured for all participating auditors/audit firms, and in particular where the incumbent auditor is invited as well. In addition, a transparent process will help outside parties such as shareholders, investors and regulators assess the process.

Depending on the needs and objectives in the previous steps of the selection process, the selection criteria may include the following (in random sequence):

1. approach to business and operations in general and in relation to specific engagements, audit approach and communication strategy
2. approach to business and operations in general
3. business model and governance of the audit firm
4. internal processes to ensure independence and other relevant rules are correctly applied
5. audit approach
6. description of the methodology to be used by the auditor
7. areas that will receive primary emphasis and the audit approach in such areas
8. comprehensive work plan to ensure an adequate coverage
9. business understanding
10. industry-specific experience, if applicable
11. use of IT tools
12. use of associated or affiliated member firm personnel and third-party experts, if necessary
13. communication strategy
14. additional internal status report, in which the auditors can for instance outline weaknesses in internal controls
15. means put in place to ensure the timeliness of the information
16. policy regarding the availability of partners and managers for miscellaneous (telephone) inquiries and short meetings throughout the year
17. reputation: a good and ethical reputation has to be demonstrated by the auditors/audit firms in the selection process. The evaluation of such a criterion is not straightforward, but it is of the highest importance. Requesting references may help in this evaluation
18. evidence of audit quality
19. system of internal quality assurance: the auditor selection panel needs to understand the basic elements of the auditor's system of internal quality assurance based on the auditor/audit firm presentation and available documentation
20. the auditor's/audit firm's individual inspection reports where available are a part of the evidence to be taken into account when considering audit quality
21. assessment of the individual auditor/audit engagement partner
22. the auditor selection panel should be able to meet the individual auditor/audit engagement partner(s) put forward to be in charge of its entity's audit engagement

[36] Extract from the FEE paper *Auditor selection: towards best practices*, available on: http://www.fee.be/images/Auditor_selection_Towards_best_practices_1310.pdf.

23. the panel will be able to assess whether they meet the professional expectations about the firm as anticipated in the tender documents
24. people management:
    - qualification
        - audit qualifications of the team members
        - involvement of experts on specific subject matters, such as 'tone at the top' and culture and behaviour, etc. Such involvement will enhance audit quality depending on sector specificities
    - training
        - continuing professional development (CPD)
    - experience
        - engagement partner's expertise and knowledge
        - appropriate level of seniority of team members and effective contribution at the relevant level
        - informed audit team with international outreach, when necessary, for the good conduct of the audit
        - relevant industry experience and expertise of the audit firm and/or the audit team
    - availability
        - availability of the engagement partner
        - staff continuity, i.e. staff turnover records from previous years
25. geographical coverage: not all engagements will require wide geographical coverage, but it would be important for audits of multinational entities
26. auditor's/audit firm's insurance coverage should be assessed as compliant with what is required by local legislation or justified by the needs of the business, the sector and the circumstances
27. pricing (i.e. audit fees)

The audit contract should be awarded on the basis of the most economically advantageous offer, not the lowest price. By taking this strategic approach, companies can ensure that they do not compromise the quality of the audit. To identify the most economically advantageous offer, the auditor selection panel should assess the audit fees against:

- the availability of the key members of the team and the resources of the auditor/audit firm as a whole
- the personnel resources, their expertise and qualifications
- the allocation of personnel, i.e. hours to be spent allocated to each type and level of qualified resource
- the risk approach and the audit methodology – these can indeed have a significant effect on pricing on both sides (e.g. gain in efficiency, use of experts, site visits, etc.)

Reasonable fees should be determined to ensure that the audit is carried out in an efficient and effective manner and that the audit team is well equipped to perform the audit to high standards.

28. Relationship management and interpersonal skills: this criterion is principle-based, but there may be key attributes that help the auditor selection panel evaluate the relationship management, the objective being to differentiate auditors/audit firms during the selection process. Different dynamics

have to be taken into account depending on whether the auditor/audit firm applying seems to have compatible personal skills and background with the entity as a whole;

29. The auditor/audit firm applying is able to demonstrate capacity in building objective, independent and transparent working relationships with the management team and task forces, as well as with those charged with governance;

These attributes will be instrumental in achieving an audit of utmost quality. One may refer to the meaningful concept of 'professional working relationship'. A good relationship and positive attitude are not indicative of a lack of independence or conflict of interest on the part of the auditor: the right balance has to be struck between professional scepticism and cooperation.

30. capacity for innovation
    - The auditor should be able to demonstrate his/her ability to improve the audit processes, for instance through the use of technology;
    - These tools can help the auditor to be efficient and effective in his/her audit work. This efficiency can serve the company, helping achieve a more in-depth or better analysis, despite the fact that one may have some concerns that it tools could encourage a 'tick-box' approach.

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