

September 28, 2012

Federation of European Accountants  
Avenue d'Auderghem 22-28  
B - 1040 Bruxelles

By email: [secretariat@fee.be](mailto:secretariat@fee.be)

## **THE FUNCTIONING OF AUDIT COMMITTEES, JUNE 2012**

Dear Sir/Madam:

The International Federation of Accountants (IFAC) values the opportunity to provide a response to the Federation of European Accountants (FEE) Discussion Paper, *The functioning of Audit Committees*, June 2012.

Through its membership, currently 167 professional accountancy organizations in 127 countries and jurisdictions, IFAC represents approximately 2.5 million accountants in public practice, industry and commerce, government, and education. As the global organization for the accountancy profession, IFAC is committed to contributing to the highest quality professional services by the accountancy profession around the world. IFAC, through the independent standard-setting boards that it supports, and in conjunction with the international regulatory community, sets international auditing and assurance, ethics, education, and public sector accounting standards. IFAC also issues guidance to encourage high-quality performance by professional accountants in business.

### **General Comments**

IFAC recognizes the important role that a well-functioning audit committee plays in governance, risk management, and internal control arrangements for a wide range of different entities. In particular, the outcomes of the global financial crisis, and the responses to it, have highlighted that appropriately structured and well-operated audit committees promote good governance and financial reporting practices within organizations, and improve the quality of reported financial (and potentially, non-financial) information.

Critically, with respect to their relationships with external auditors, audit committees that are comprised of competent and independent members also play a key role in promoting and enhancing audit quality. Competence and independence are essential elements for all audit committee members regardless of the type of approach taken to the establishment of committees—that is, regardless of whether they are formed as a subcommittee of the board or a separate committee independent of the board.

IFAC believes that audit committees should be seen as a necessary part of the organizational governance arrangements for all public interest entities.



**Q1. Do you support the aim of strengthening the role of audit committees in general, also in relation to whether the audit committee is a subcommittee of the board or a separate committee independent of the board?**

IFAC recognizes the important role that audit committees play in promoting and enhancing audit quality, and encourages initiatives aimed at strengthening this role. IFAC believes that a governance model whereby the audit committee is a subcommittee of the board is appropriate and acceptable for most countries. However, it appreciates that in some jurisdictions a separate committee structure may be favored.

As noted previously, what is essential for well-functioning audit committees is the competence and independence of committee members, whatever approach is taken. IFAC is of the view that requisite levels of both independence and competence can be attained where the audit committee is a subcommittee of the board, and where there are appropriate safeguards and other measures in place to enhance independence. This includes requirements for: members of the committee to be independent directors; the committee to have its own separate charter; and periodic assessments of the performance of the committee to be performed.

IFAC understands that in some jurisdictions in Europe, the governing board can assume the role of the audit committee, rather than having a separate committee established. This is something which IFAC believes should not be permitted to occur under any circumstances. Furthermore, IFAC recognizes that in a supranational environment, it may be difficult to develop a single set of recommendations for strengthening the audit committee given legal and cultural differences between jurisdictions; and as such, principles-based recommendations may be most appropriate.

**Q2. Do you have any comments on the FEE Recommendations on the composition of the audit committee, especially on the:**

- a. Composition of audit committees in general?**
- b. Whether all members of the audit committee should be members of the board?**
- c. Whether appointment of audit committee members should be restricted to be performed by the shareholders or by the board?**
- d. Whether appointment of audit committee members by the board or by the shareholders should be decided at national level by each EU Member State or by the individual company?**

IFAC considers it good practice that, as a minimum, a majority of members of the audit committee are independent, including the committee chair, who is not the chair of the board. Ideally, all members of the audit committee should be independent; and the committee should not include any executives or management/employees of the organization. It is important therefore, that the distinction between non-executive directors and independent directors is clearly defined and understood. In fulfilling these requirements, IFAC is of the view that not all committee members need to be members of the board; they may be competent third parties with no direct relationship



with the organization. Indeed, it may be more appropriate for companies to appoint persons from outside of the organization to achieve the requisite level of independence.

Differences in legal and cultural environments of different jurisdictions make it difficult to prescribe one approach to appointing members of an audit committee. Where the audit committee operates as a subcommittee of the board, appointment by the board would be expected. However, if the audit committee is a separate committee independent of the board, it is possible to envisage a process of appointment that involves shareholders. An important point to consider when the audit committee is a separate committee independent of the board, is the reporting and accountability arrangements that exist to ensure that the board is kept apprised of the work and decisions of the audit committee.

**Q3. Do you have any comments on the FEE Recommendations in relation to Independence of audit committee members, especially whether all or the majority of the audit committee members should be independent?**

IFAC recognizes the importance of having members of the audit committee who are independent. Where the committee is a subcommittee of the board, IFAC considers it good practice that at least a majority of members of the committee are independent, including the committee chair, who is not the chair of the board. Ideally, all members of the audit committee should be independent; and the committee should not include any executives or management/employees of the organization. As noted previously, it is important that the distinction between non-executive directors and independent directors is clearly defined and understood.

**Q4. Do you have any comments on the FEE Recommendations on competence of the audit committee and its members, and especially how to ensure sufficient diversity in the competences needed in audit committees?**

The competence of the audit committee is an important consideration when assessing the effectiveness and functioning of the committee. IFAC agrees that the collective competence of the committee should reflect the appropriate skills needed to fulfill the committee's responsibilities. Importantly, this includes having appropriate skills with respect to financial reporting, auditing, internal control, and risk management. Additionally, members of the audit committee should be provided with necessary training and information to ensure that they have a good knowledge of the business.

**Q5. Do you have any comments in relation to compensation of audit committee members?**

IFAC supports the view that audit committee members should be compensated for the work they perform on the committee. Payment for services provided heightens the potential accountability committee members feel with respect to their role.

However, the structure of the audit committee—that is, whether it is subcommittee of the board or a separate committee independent of the board—may impact the manner in which compensation is determined and disclosed. Regardless of the structure used, given the audit committee's responsibility for overseeing financial reporting and auditing, IFAC discourages compensation of



committee members on the basis of performance based measures linked directly to financial reporting.

When the audit committee is a subcommittee of the board, it can be assumed that members of the audit committee would be compensated in a similar manner to that prescribed for all directors, and would be subject to the same disclosure requirements. Presumably, compensation policies would take account of the various responsibilities that directors may assume, both as subcommittee members or chairs. However, as noted earlier, an essential element of an effective audit committee is independence.

**Q6. Do you have any comments on the FEE Recommendations on responsibilities of audit committees, especially on:**

- a. Whether audit committees should have additional responsibilities in relation to assessing the appropriateness of the company’s internal control systems, risk management systems and the application of financial reporting frameworks?**
- b. Should audit committees more closely monitor day-to-day operations of the company, such as in relation to early warning monitoring (regarding going concern of the company)?**
- c. The frequency of tenders for appointment of the statutory auditor?**

IFAC recognizes that a fundamental responsibility of an audit committee is overseeing—and as such, having responsibility for ensuring the regular assessment of—the appropriateness and effectiveness of the company’s internal control systems, risk management systems, and the application of financial reporting frameworks. It supports initiatives aimed at promoting and enhancing this role. However, it is not clear to IFAC that this necessitates assuming closer day-to-day monitoring responsibilities for the operations of the company. Typically, the responsibilities of boards—including subcommittees such as the audit committee—relate to overseeing management which is charged with day-to-day operational responsibilities. IFAC believes the oversight role played by the board is a crucial role that should not be confused, or compromised, by having greater operational responsibilities.

IFAC has stated previously<sup>1</sup> its views that audit committees and/or shareholders should have the authority to make the decision to change audit firms at any time. If research can demonstrate that periodic tendering will be beneficial to the improvement of audit quality, one area that could be explored is a “comply or explain” mechanism for audit committees in relation to their periodic tendering considerations. Such periodic tendering would typically only be justifiable over long intervals of time, as it could be potentially costly and time-consuming.

---

<sup>1</sup> Refer *IFAC Response to the European Commission Green Paper on Audit Policy: Lessons from the Crisis*, November 2010, [www.ifac.org/publications-resources/ifac-response-european-commission-green-paper-audit-policy-lessons-crisis](http://www.ifac.org/publications-resources/ifac-response-european-commission-green-paper-audit-policy-lessons-crisis)



**Q7. Do you have any comments on the FEE Recommendations on reporting to and from the audit committee, especially on:**

- a. The desirable level of transparency about the work done by audit committees?**
- b. Whether reporting of audit committees (under the responsibility of the board) should focus on historical information related to the financial statements or should also address forward-looking and prospective information about the entity?**
- c. Suggestions on which kind of information that would enhance the quality of the cooperation between audit committees and the auditor?**

IFAC supports initiatives aimed at enhancing audit quality, including those which promote greater transparency of the audit process. As such, it supports suggestions that the audit committee should be more transparent, and disclose information publicly about its operations and considerations, subject to any restrictions pertaining to confidential or commercially sensitive information.

Typically, the primary focus of the audit committee is financial reporting and auditing, which involves an assessment of going concern, and the appropriate use of the going concern assumption in the preparation of financial statements. Therefore, it seems logical to expect that audit committees will need to consider forward-looking and prospective information about the entity in fulfilling its objectives.

**Q8. Should the involvement of the statutory auditor with the audit committee be enhanced, and if so, which particular aspects of the current cooperation could this enhanced involvement relate to?**

A well-functioning relationship between the statutory auditor and the audit committee increases the potential that audit quality will be promoted and enhanced. The work of the audit committee, including recommending the appointment of auditors, assessing auditor performance and independence, and receiving and responding to matters raised by the auditor, can only be performed effectively where a respectful and professional relationship exists with the auditor.

IFAC considers that requirements pertaining to the communication between the statutory auditor and the audit committee are adequately addressed in International Standards on Auditing (ISAs), in particular ISA 260 *Communication with Those Charged with Governance* and ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*. IFAC notes that the European Commission is proposing that ISAs be used for audits within Europe, and believes that the adoption of such a proposal will assist in ensuring a consistent approach to communications across all Member States. IFAC agrees in principle to the proposal that the auditor provide an “additional internal report” to the audit committee, subject to any such proposal being introduced following adequate due process and consultation with affected parties.



**Q9. Do you have any other comments related to audit committees?**

IFAC provides no other comments related to audit committees.

Please contact us should you require further information on any of the information included in this letter.

Sincerely,

A handwritten signature in black ink that reads "Ian Ball". The signature is written in a cursive style.

Ian Ball  
Chief Executive Officer