

ecoDa

European Confederation of Directors' Associations
The European Voice of Directors

Audit Committee Guidance for European Companies



KPMG

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This document is a practical tool for Audit Committees developed by the European Confederation of Directors' Associations (ecoDa), "the European voice of board directors".

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About ecoDa

ecoDa, the European Confederation of Directors' Associations, is a not-for-profit association acting as the European voice of board directors, active since March 2005 and based in Brussels.

Through the main national institutes of directors in Europe, ecoDa represents around fifty-five thousand board members from across the EU, ensuring that their views on Corporate Governance are clearly communicated to policymakers in the EU institutions. EcoDa's member organisations represent board directors from the largest public companies to the smallest private firms, both listed and unlisted.

ecoDa acts as a high-level forum for debate and for the exchange of experiences to promote high standards for directors. It acts as a standing body where national experiences are shared and discussed in detail.

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This document has been overviewed by ecoDa's board of directors, which is composed of:

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Introduction

Corporate governance standards are high on the agenda throughout Europe. The expectations of stakeholders have never been greater, and the scrutiny by regulators and investors never more stringent – and as a consequence, the role of the audit committee has rapidly increased in importance and expanded in scope. However, it was the Statutory Audit Directive (Directive 2006/43/EC), published by the European Commission in 2006, that set audit committees on the path to becoming a key feature of the corporate governance framework of all EU Member States.

In an effort to help ensure that investors and other interested parties could rely fully on the accuracy of audited accounts, the Statutory Audit Directive required each Member State to enact legislation requiring public-interest entities – essentially companies whose securities are admitted to trading on a regulated market – to have an audit committee composed of non-executive directors or supervisory directors and/or members appointed by the shareholders in general meeting. The requirements further stipulate that at least one member of the audit committee must be independent and have competence in accounting and/or auditing.

The role of the audit committee, as required by the Directive, was broadly consistent with that set out in many long-established corporate governance codes, namely to:

- monitor the financial reporting process;
- monitor the effectiveness of the company's internal control and risk management systems;
- monitor the effectiveness of the company's internal audit function (where such a function exists);
- monitor the statutory audit of the annual and consolidated accounts (including the independence of the statutory auditor); and
- make a recommendation to the board on the appointment of the statutory auditor.

In today's complex and evolving business environment, audit committees can make a strong contribution to a 'no surprises' environment. An effective audit committee can be a key feature of a strong corporate governance culture and bring significant benefits to an organisation. Such committees are supported by fundamental building blocks: an appropriate structure and foundation, reasonable and well-defined responsibilities, an understanding of current and emerging issues, and a proactive, risk-based approach to its work.

Carefully designed practices can also help an audit committee to maximise its contribution to an organisation. However, it is important that each board and audit committee should assess its own circumstances – governance structure, financial complexity, maturity and business issues – when defining its specific audit committee practices. Practices that work best for one organisation may not be ideal for another – especially in a governance environment where culture, risk and governance needs can vary dramatically from company to company. Nevertheless, certain guiding principles underlie the effectiveness of every audit committee and the right principles can help to ensure that 'company specific' practices are applied effectively – that is, by the right people with the right information, processes and perspectives.

This publication articulates the principles underlying the audit committee's role and aims to help steer organisations through the new requirements set out in the Statutory Audit Directive. In so doing, it provides non-prescriptive guidance to help audit committees (and those who support

them) gain a better understanding of the processes and practices that help create effective audit committees

The composition of the audit committee is addressed in chapter one, while audit committee procedures – the procedures and practices that provide the support and structure necessary to discharge audit committee responsibilities – are looked at in chapter two. Chapters three to six focus on the duties of the audit committee – monitoring the financial reporting process; monitoring the effectiveness of internal control and risk management systems; monitoring the effectiveness of internal audit; and monitoring the statutory audit. Chapter seven addresses audit independence and non-audit services; and chapter 8 looks at the appointment of the auditor.

It should be noted that as EU directives are implemented via national regulation, each Member State may have taken a slightly different approach in accommodating the requirements within national legislations. Some of these differences are identified within the guidance, but readers should be aware that this guidance has not attempted to identify all such differences and, as a result, readers should have due regard to applicable national legislation (and appropriate Codes) when applying the guidance within this publication.

EcoDa believe all audit committees, even those that have been established for some time, can benefit from comparing their practices to the practices described in this publication in an effort to critique, tailor and improve their own agendas.

We hope this publication will help audit committees to identify and achieve their objectives and add value to the board of directors, the organisation and its stakeholders.

Chapter 1: Composition of the audit committee

Each public-interest entity shall have an audit committee. The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing.

Article 41(1) 8th Company Law Directive of the European Union

What is a public interest entity?

The definition of ‘public interest entity’ varies across the EU, but generally they are entities that are of significant public relevance because of the nature of their business, their size or their number of employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings.

The EC 8th Company Law Directive defines a public interest entity as:

“entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of Article ..., credit institutions within the meaning of Article ... and insurance undertakings as defined in Article Member States may also designate other entities as public interest entities, for instance entities that are of significant public relevance because of the nature of their business, their size or the number of their employees.”

What does independent mean?

The EU 8th Company Law Directive requires that audit committee’s should include at least one member who is ‘independent’ – though local codes and/or regulations often recommend/require a greater proportion of independent members and some require that audit committees be solely comprised of independent non-executive directors. The precise meaning of ‘independent’ is not prescribed within the Directive – but it is generally accepted that a director should only be considered independent if he/she is free from any relationship that might impair, or might appear to impair, their judgement.

As the Directive requires a minimum of only one independent audit committee member, it is possible for an audit committee to comprise a majority of executive, rather than independent, directors. In practice, this would be unusual in those Member States where audit committees have long been a part of the established governance framework because local codes and/or regulation normally set a higher hurdle with regard to independence.

However, the presence of executive directors can be beneficial, as individuals like the CEO, CFO and others often have valuable insights to share. Nevertheless, in such circumstances, the chairman of the audit committee should be careful to ensure sure that their presence does not inhibit open discussion and challenge.

Local codes and/or regulations may also make recommendations or have requirements regarding the meaning of ‘independence’. But the determination of what constitutes independence is fundamentally an issue for the board itself to determine. The board may consider that, although a particular director meets all the criteria laid down for the assessment of independence, the director cannot be considered independent owing to the specific circumstances of the individual or the company, and the converse also applies.

It is not possible to list comprehensively all threats to directors’ independence; however, a number of situations are frequently recognised as relevant in helping the board to determine whether a director may be regarded as independent, notwithstanding that the independence assessment should be based on substance rather than form. The EC Recommendation on the role of non-executive directors (2005/162/EC) and other guidance produced by various EC Member States note that situations that indicate a potential loss of independence might include:

- (a) has been an executive director of the company or group within the last five years;
- (b) has been an employee of the company or group within the last three years (except when the director does not belong to senior management and has been elected to the board in the context of a system of workers’ representation recognised by law);
- (c) has, or has had within the last year (or maybe up to three years), a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- (d) has been a partner or employee of the present (or former external) auditor of the company or an associated company within the last three years;
- (e) has received or receives additional remuneration from the company apart from a director’s fee, participates in the company’s share option or a performance-related pay scheme, or is a member of the company’s pension scheme. (This does not include compensation under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent in any way on continued service);
- (f) holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- (g) represents a controlling or otherwise significant shareholder;
- (h) has served on the board for more than three terms or, alternatively, more than 12 years from the date of their first election where national law provides for normal terms of a very small length; or
- (i) a close family member of an executive director, or of persons referred to in (a) to (h) above.

France: The French Corporate Governance Code (“AFEP/MEDEF” Code) sets out that at least two thirds of the audit committee members shall be independent and that none of the audit committee members shall be executive directors.

What is competence in accounting and/or auditing?

The audit committee should include at least one member who has competence in accounting and/or auditing. This is the minimum, and more than one member with competence in accounting and/or auditing is often advantageous. In any event, it is advisable that the other members are at

least financially literate. The precise meaning of ‘competence in accounting and/or auditing’ is not prescribed – each board should determine its own criteria based on the individual circumstances of the company and the nature and complexity of the business. A professional qualification from one of the professional accountancy bodies might be considered as an indicator of ‘competence’. But recent and relevant experience as a result of past employment in a significant financial/ auditing role or one that included oversight responsibilities for financial reporting is highly desirable.

Local codes and regulations may also make recommendations or have requirements regarding the degree of ‘financial expertise’ of audit committee members.

United Kingdom: The Financial Services Authority (FSA) rules implementing the 8th Company Law Directive require that “at least one member of the [audit committee or body responsible for carrying out the functions of an audit committee] must be independent and at least one member must have competence in accounting and/or auditing. The requirements for independence and competence in accounting and/or auditing may be satisfied by the same member or by different members of the relevant body.” This requirement differs from the Directive which requires that independence and competence be embodied in one individual. As a (perhaps unintended) consequence, the ‘competent’ member may be an executive director (e.g. the finance director), whereas the independent member may have little practical experience of financial, accounting and auditing matters.

Belgium – With regard to financial institutions, the Belgian Act sets out that while at least one member of the audit committee should be independent and have competence in accounting *and/or* audit; the members of the audit committee should, in addition, have *collective expertise* in the activities of the relevant financial institution and in accounting *and* audit. For *all* quoted companies the Act requires that at least one member of the audit committee shall be independent and shall have competence in accounting *and* audit. It is not clear why the Belgium legislator did not insist upon a similar *collective expertise* requirement for audit committees in quoted companies; or why the requirement regarding the accounting/audit expert is more demanding for the audit committees of quoted companies than for the audit committees of financial institutions (through the fact that many financial institutions are also quoted may negate this difference in practice.)

The Belgian legislator has also stated in his preliminary work that competence in accounting and audit means a degree of higher education in economics or finance or a significant professional experience in these matters. The expertise of the members of the audit committee

France – There are no legal requirements as regards the criteria to be used to assess the competence of the audit committee member. A recommendation from the French Stock Exchange Authority (AMF) is that it could be appreciated considering academic education, professional experience (e.g. a significant experience as CFO, CEO or in auditing) or knowledge of the company. According to this recommendation, a specific attention might also be paid to a competence in internal control and risk management.

The French law (art. L823-19 of the French Commercial Code) requires from the Board to publicize the elected competence and independence criteria, prior to the setting up of the audit

Other skills and experience

In determining the composition of the audit committee, it is important to balance accounting/auditing expertise with a consideration of other experience relevant to the company and the industry within which it operates.

Furthermore, it is also important to balance experience in a number of different areas with a wide range of knowledge, skills and personal attributes such as:

- sound business judgement
- strong interpersonal skills
- integrity and probity
- the ability to question intelligently and debate constructively
- the ability to challenge rigorously and decide dispassionately
- the time and personal commitment to perform effectively
- the trust and respect of directors, senior management and staff

The audit committee should be empowered to procure specialist advice at the expense of the company on an ad-hoc basis to support the committee in relation to specific matters.

The audit committee chairman

The essential characteristics of a strong audit committee chairman are often personal attributes. The chairman should be recognised for his or her leadership and vision, and be perceived by other committee members and management as able to set and manage the audit committee's agenda. The chair should be acknowledged as having the personal courage to raise and deal with tough issues and support other members to do the same.

Whilst formal meetings are at the heart of the audit committee's work, audit committee chairmen and, to a lesser extent, the other audit committee members, should keep abreast of relevant matters by meeting regularly with the board chairman, the chief executive officer, the chief financial officer, the external audit partner and the chief internal auditor. A successful audit committee chair not only understands the importance of the audit committee's relationships with these individuals but also has the interpersonal skills to build and maintain effective working relationships.

The chairman's role is to engage the other audit committee members in the work of the committee and ensure their contribution is maximised and effective rather than fulfilling a specific 'expert' role. Nevertheless, the chairman should ensure that all the specialist skills required are made available to the committee and are present at audit committee meetings when required.

How many members?

The size of the audit committee will vary depending on the needs and culture of the company and the extent of responsibilities delegated to the committee by the board. Too many members may stifle discussion and debate. Too few may not allow the committee chair to draw on sufficient

expertise and perspectives to make informed decisions. Committees of three to five individuals are generally most appropriate.

Local codes and regulations may make recommendations or have requirements.

United Kingdom: The UK Corporate Governance Code recommends that there should be at least three members (two, for smaller companies) who must be independent non-executive directors.

Belgium: There are no legal requirements as to how many members an audit committee should have, however, the Belgian Corporate Governance Code 2009 states that the audit committee should be “composed of at least three members” and that “at least a majority of the audit committee’s members should be independent.”

Rotation of audit committee members

Rotation of audit committee members can provide a practical way to refresh and introduce new perspectives to audit committee processes. Rotation also creates the opportunity for more board members to gain a first-hand understanding of the important issues dealt with by the audit committee, thus contributing to greater understanding on the board as a whole. However, given the complex nature of the audit committee’s role, rotation needs to be balanced with the desire to have members who possess the necessary skills and experience to discharge their responsibilities effectively.

The term of audit committee membership should not be longer than the term of board membership.

Chapter 2: Audit committee procedures

Terms of reference

The role and duties of the audit committee should be set out in written terms of reference which should clearly outline the committee's duties and responsibilities, including structure, process and membership requirements; and should reflect the company's specific assurance needs, mapped to any regulatory requirements and best practice recommendations. As a minimum, the terms of reference should include the duties specified in the 8th Company Law Directive:

- to monitor the financial reporting process;
- to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- to monitor the statutory audit of the annual and consolidated accounts;
- to review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity; and
- to recommend the appointment of the statutory auditor or audit firm shall be based on a recommendation made by the audit committee.

The committee should also ensure that its terms of reference are co-ordinated with the duties of the board and other relevant committees – governance committee, risk management committee, and other committees focused on a particular risk (e.g. credit committee, investment committee or environment, health and safety committee). These committees may be required to consider similar issues from different perspectives. Care should be taken to define clearly the roles and responsibilities of each committee, when collaboration is required, whether cross-membership is allowed, and whether the audit committee chair or members might attend other committee meetings as an observer (and vice versa).

The terms of reference should be detailed enough to clarify roles and responsibilities, and include items that can be reasonably accomplished. However, audit committees should be mindful of the implications of accepting unrealistic workloads and responsibilities that rightfully reside with the board/supervisory body as a whole. The audit committee is not a body that makes binding decisions in its own right: the committee exists exclusively to assist the board/supervisory body in discharging its duties.

To ensure that audit committee effectiveness is maintained and improved, the audit committee should review the terms of reference on an annual basis. A robust annual assessment of the audit committee's duties and its terms of reference should highlight any changes to the company's circumstances and any new regulations or leading practices that may affect the committee's duties.

Setting the audit committee agenda

The chair of the audit committee should maintain accountability for setting the audit committee agenda and not delegate it to executive management. However, it is good practice for the audit committee agenda to be set with input from those individuals with whom the committee has significant contact, in particular the secretary to the committee, CFO and the internal and external auditors.

Meeting agendas ultimately drive the work that the committee does and should therefore be carefully linked to the audit committee's terms of reference, and map across to significant related requirements and persuasive recommendations such as those set out in local codes and regulation.

A detailed work plan helps audit committee members to stay focused on their role. However, the nature of the audit committees' duties and the ever-changing environment in which companies operate may make it difficult to determine a fixed agenda for each meeting. The committee should assess what is currently important and develop its agenda accordingly, where necessary restricting agenda items to those that require consideration or a decision by the committee.

The secretary to the audit committee should ensure that the committee receives the meeting agenda and supporting materials in a timely manner, to enable committee members to give full and proper consideration to the issues. This would usually be at least one week prior to the meeting. Additional procedures may be necessary if important issues arise between meetings or after the 'regular' audit committee papers have been distributed.

Frequency and timing of meetings

The audit committee should meet as often as its role and duties require. On average, most audit committees meet between four and five times a year.

Timing meetings to coincide with key dates within the financial reporting and audit cycle enables the audit committee to make timely and influential decisions. Equally, having sufficient time available at each meeting is critical. The committee must be able to cover all agenda items, hold as full a discussion as may be required, and enable all parties to ask questions or provide input.

An appropriate interval should be allowed between audit committee meetings and other related meetings (such as board meetings) to allow any work arising from the audit committee meeting to be carried out and reported on as appropriate. This may be difficult, particularly for international boards - nevertheless, the audit committee chairman should endeavour to plan for an appropriate interval where practicable.

Meeting attendees

No one other than the audit committee members should be 'entitled' to attend audit committee meetings though the audit committee would normally choose to invite specific directors or executives or others because of their knowledge and perspective on the issues being discussed.

Most audit committees regularly invite the CFO, the external audit partner, chief internal auditor, and perhaps the CEO to attend committee meetings. These individuals often have valuable insights to share, but the chairman of the audit committee should make sure that their presence does not inhibit open discussion and challenge.

Notwithstanding the audit committee's right to decide who ought to be entitled to attend any particular meeting, the internal and external auditors should have unrestricted right of access to the audit committee and/or its chair and the right to ask the chair to convene a meeting if necessary.

In camera or private meetings

It is good practice to at least once a year hold part of an audit committee meeting with only the audit committee members present (i.e. no executives or auditors in attendance). Holding such meetings *in camera* gives the audit committee members a good opportunity to discuss any issues or concerns among themselves, and positions them to better understand and challenge management and the auditor. It is also good practice to hold separate *in camera* or private meetings with the internal and external auditors.

Typically, there should be few matters to discuss *in camera* – all key matters related to risk management, financial reporting and internal control should usually be reviewed in a candid, robust manner with the executives, audit committee and auditor during the formal audit committee meeting. However, the audit committee can use the private *in camera* session to address other matters (such as issues relating to the attitude of management, resources and relationships) or to probe for additional assurance where members were not satisfied with the answers given at the committee meeting, or if they thought the discussions were too guarded or uneasy.

Reporting to the board on audit committee activities

The audit committee chair should report to the board after every audit committee meeting, in sufficient depth to enable the board to fulfil its oversight responsibilities. The minutes of each audit committee meeting should be prepared on a timely basis and drafted in such a manner so as to clearly:

- summarise the work undertaken by the audit committee, explaining if necessary the importance of the work and any conclusions drawn or actions taken; and
- advise the chairman of the board on any relevant matters, including any matter on which the audit committee believes the board should be taking action.

Practical difficulties can arise when the audit committee meeting and board meeting are held such that there is little time to prepare formal minutes. In such circumstances it is normal for the chairman of the audit committee to report orally to the board with the formal report sent to board members at a later date.

Audit committee minutes are normally copied to the head of internal audit and the external audit partner.

Belgium: The Belgian Act requires that: “the audit committee shall report regularly to the board on the exercise of its duties, and at least when the board sets up the annual accounts, the consolidated accounts, and where applicable the condensed financial statements intended for publication.” (Condensed financial statements are obligatory for financial institutions.)

Audit committee resources

The audit committee should be provided with sufficient resources to undertake its duties and make effective use of its time. It should have access to the services of the company secretary, in-house legal counsel (or equivalent) on all audit committee matters including supporting the chair in

planning the committee's work and drawing up meeting agendas, maintaining minutes, drafting material about the committee's activities for the annual report (if applicable), co-ordinating the timely collection of supporting papers and distributing them, and other support as needed.

The audit committee should also be able to draw on other expertise within the organisation as appropriate. This might include tax specialists, risk specialists or the head of compliance.

The board should also make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so.

Induction and professional development

The company should provide an induction programme for new audit committee members. This should cover the role of the audit committee, including its terms of reference and expected time commitment by members; and an overview of the company's business, identifying the main business and financial dynamics and risks. It should also include meeting some of the company staff.

Professional development should also be provided to members of the audit committee on an ongoing and timely basis and should include an understanding of the principles of and developments in financial reporting and related company law. In appropriate cases, it may also include, for example, understanding financial statements, applicable accounting standards and recommended practice; the regulatory framework for the company's business; the role of internal and external auditing and risk management.

Luxembourg: A recommendation from the Luxembourg Stock Exchange is that for new members of the audit committee, the training programme should include an overview of the company's internal control and risk management systems. In particular, they should receive comprehensive information on accounting, financial and operational matters and have contact with the external and internal auditor.)

Assessing the audit committee

The audit committee (and/or board/supervisory body) should consider the regular assessment of audit committee effectiveness and the adequacy of the committee's terms of reference, work plans, on-going practices and communication. Regular assessment may identify areas in which the committee and its processes might be more effective, or may highlight skills and/or knowledge gaps in the committee.

France: The French Corporate Governance Code ("AFEP/MEDEF" Code) sets out that the board should, from time to time, review its membership, organisation and operation - which suggests a corresponding review of the board's committees. Accordingly, each board should think about the desirable balance in its membership and that of its committees; and consider the adequacy of its organisation and operation for the performance of its tasks.

Assessment of the audit committee may lead to a request for additional development (for its members), refinements to committee processes and procedures or, in exceptional circumstances, require the audit committee chairman to begin discussions on the possible recruitment of a new member with the chairman of the board or nomination committee. The audit committee chairman needs to ensure that the committee has the requisite knowledge to discharge its responsibilities at all times. For this to be achieved, the audit committee chairman, working with the chairman of the board or nomination committee, should annually review the status of succession to the audit committee and aim to ensure that there is continuous access to suitable candidates.

When assessing its performance, the audit committee should consider:

- ascertaining whether the board/supervisory body is satisfied with the committee's performance;
- comparing the committee's activities to any relevant national/international guidelines or recommendations;
- comparing the committee's activities to leading practices adopted by other organisations;
- comparing the committee's activities to any previously established 'success' criteria;
- comparing the committee's activities to any previously identified shortcomings; and
- comparing the committee's activities to the terms of reference, the committee's aspirations and any objectives set by the board/supervisory body.

The committee should also consider requesting feedback on its performance from management, internal and external auditors and other stakeholders.

Questionnaires are one mechanism that audit committees can use to facilitate the assessment. However, face-to-face discussions including informal meetings and *in camera* sessions with the auditors during regular audit committee meetings can enrich the assessment process and ensure the process focuses on:

- what the committee is for and what success looks like;
- whether others within the company understand what the audit committee is supposed to do;
- outcomes rather than activities – not what the committee did, but how it did it;
- whether time is spent in the right areas;
- what impact the committee has had; and
- whether the committee has added value to the governance process.

The output from the assessment process and any recommendations arising should be reported to the board/supervisory body.

Chapter 3: Monitoring the financial reporting process

Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia*.....

(a) monitor the financial reporting process.

Article 41(2) 8th Company Law Directive of the European Union

It is the role of management to prepare complete and accurate financial statements in accordance with financial reporting standards and applicable rules and regulations. The audit committee plays an important ‘oversight’ role in providing the board/supervisory body with assurance as to the propriety of the financial reporting process.

To perform their role effectively, the audit committee needs to understand the context for financial reporting, and in particular:

- management’s responsibilities and their representations to the committee;
- management’s remuneration plan, especially any incentive arrangements;
- the external auditor’s responsibilities under generally accepted auditing standards;
- the nature of critical accounting policies, judgements and estimates; and
- any significant or unusual transactions where the accounting is open to different approaches.

Audit committees should be confident that they are being made aware of any relevant accounting policy or disclosure issues or changes, and that this information is communicated to them early enough to enable appropriate action to be taken. A regular two-way dialogue between the audit committee and the CFO should take place. The audit committee should also look to the statutory auditor for support, using the auditor’s insights to help to identify potential issues early and assist the committee to oversee the quality and reliability of financial information.

At the core of the audit committee’s discussions with management and the statutory auditor should be its assessment of the appropriateness of the institution’s accounting policies, underlying judgements and estimates, and the transparency of the financial disclosures in reflecting financial performance.

Critical accounting policies, judgements and estimates

In order to properly understand and assess the quality of critical accounting policies, judgements and estimates the audit committee should:

- consider the appropriateness of management’s selection of accounting principles and critical accounting policies. Have they changed in the current period? Why have they changed? How might the changes affect current and future financial statements?

- assess management’s judgements and critical accounting estimates. What are the key assumptions behind those estimates? How sensitive are current and future financial statements to changes in those assumptions?
- question the degree of aggressiveness or conservatism surrounding management’s judgements and estimates. Is there potential for management bias in developing the estimates?
- consider any alternative accounting treatments. What are other companies doing in similar circumstances?
- ensure the statutory auditor is satisfied that managements accounting policies, judgements and estimates reflect an appropriate application of generally accepted accounting practice.

When considering the impact on the financial statements of any changes to accounting standards or generally accepted accounting practices, the audit committee should satisfy itself that:

- management has sufficient resources devoting appropriate attention to understanding recent developments in financial reporting; and
- the application of new requirements is appropriate in light of the nature of the institution’s operations and significant transactions.

The preparation of financial statements requires numerous judgements and estimates. Each judgement or estimate can significantly impact a company’s financial statements and each estimate has a range of possible and supportable results. Understanding the company’s business, as well as the industry in which it operates, will help the audit committee to focus on the appropriateness of the company’s approach.

Audit committees should understand the circumstances in which management may feel pressure to engage in inappropriate earnings management. It could be that: market expectations are unrealistic; targets are not being met; or management remuneration incentives are heavily weighted to earnings measures. The audit committee should recognise when these conditions are present and where necessary receive what they hear with professional scepticism.

Unusual and complex transactions

The audit committee should assess the treatment of any unusual or complex transactions. In addition to the considerations with respect to critical accounting policies, judgements and estimates, the audit committee should understand:

- the business rationale for the transaction;
- how the transaction disclosed in the financial statements and whether such disclosure is appropriate;
- the impact on the comparability of financial position and performance with respect to past and future periods; and

- any factors surrounding the accounting for any unusual transaction.

Luxembourg: A recommendation from the Luxembourg Stock Exchange states that each director should consult the chairman of the audit committee or, if not, the chairman of the board in the event of uncertainty as to the nature of an operation or transaction likely to result in a conflict of interest. In the event of a declared conflict of interest, the operation or transaction concerned should be submitted by the director concerned, after the chairman of the board, the audit committee, the auditor or an external expert have been informed, if possible prior to its realisation. The opinion of the latter should be communicated to the board.

Completeness, clarity and transparency

The audit committee should assess the completeness, clarity and transparency of the financial statements and related disclosures, by considering and making enquiries as to whether the financial disclosures consistently reflect the institution's financial position and performance; and whether the financial statement note disclosures are clear and complete?

Management and the external auditor can greatly assist the audit committee in understanding and assessing these matters by providing the committee with clearly written communications, augmented with face-to-face discussions.

In addition to the financial statements, the audit committee should review, wherever practicable, other statements containing financial information where supervisory board approval is required (for example, summary financial statement, significant financial returns to regulators and release of price sensitive information such as analysts presentations). The audit committee should adopt the same approach to reviewing these disclosures as it does to assessing the financial statements.

France – The French Stock Exchange Authority (AMF) clarified the nature of the information included in the Company's "financial communication". It notably includes information to regulators, press releases and accompanying presentations on interim information or on sensitive/significant operations, forecasts, information about the risks whatever the document is.

According to this clarification, the audit committee should check the existence of preparation procedures relating to the issuance of press releases on interim financial information. The Board might request the audit committee to review the releases. In this case, the audit committee should check the consistency of the released financial information with the financial statements. The Board might also ask the audit committee for its opinion on the content of the different documents (MD&A, report of the chairman of the board on the operations of the Board and on internal controls), where information about the risks are disclosed. The audit committee should

Chapter 4: Monitoring the effectiveness of internal control and risk management systems

Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia*.....

(b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems.

Article 41(2) 8th Company Law Directive of the European Union

It is important that risk management and control are not seen as a burden on the institution, but rather the means by which opportunities are maximised and potential losses associated with unwanted events reduced.

Risks manifest themselves in a range of ways and the effect of risks crystallising may have a positive as well as a negative outcome for the institution. It is vital that those responsible for the stewardship and management of an institution be aware of the best methods for identifying and subsequently managing such risks.

Internal controls are one of the principal means by which risk is managed. Other devices used to manage risk include the transfer of risk to third parties, sharing risks, contingency planning and the withdrawal from unacceptably risky activities. Institutions can accept risk, but need to do so objectively and transparently and within the governing body's policy regarding risk appetite.

The risks facing institutions are continually changing and the system of internal control should be responsive to such changes. Effective risk management and internal control are therefore reliant on a regular assessment of the nature and extent of risks.

Reviewing the effectiveness of internal control and risk management systems is an essential part of the board's/supervisory body's responsibility. The audit committee can and, as required by the Directive, should assist the board in fulfilling that responsibility.

Traditionally, audit committees have been concerned with the oversight of internal financial controls. However, the requirement in the Directive is drawn much wider in that it imposes a duty on the audit committee to monitor the effectiveness of internal control and risk management systems in their entirety. This goes beyond the financial reporting process and encompasses the system of risk and control associated with other areas such as operational matters and compliance with laws and regulation.

The precise role of the audit committee in the review process should be for the board / supervisory body to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the significant risks that the company faces. In practice many boards create risk committees to look at aspects of risk management. Often this is an executive (or management) committee reporting directly to the board or audit committee; but non-executive board/supervisory board committees are becoming more common in some Member States. In such circumstances it is usual for the board risk committee to (on behalf of the board) concern itself with issues associated with risk strategy and

risk appetite; whereas the audit committee would continue to provide oversight over the systems and processes providing assurance over the systems of risk management and internal control. Whatever the precise arrangements are, it is important that the audit committee liaises closely with any risk committee or other relevant body such as a compliance committee or credit committee etc.

To the extent that the audit committee does monitor the effectiveness of the company's internal control and risk management systems on behalf of the board, the results of the committee's deliberations should be reported to, and considered by, the board. The board will need to form its own view on effectiveness based on the information and assurances provided to it by the audit committee, exercising the standard of care generally applicable to directors in the exercise of their duties.

The company's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the board that it has done so. The audit committee's role as set out in the Directive is to monitor the effectiveness of the company's internal control and risk management systems – this is not an executive function that properly belongs to management; rather the committee is aiming to satisfy itself that management has properly fulfilled its responsibilities.

The audit committee should, on a regular basis, receive reports from management on the effectiveness of the systems they have established and the conclusions of any testing carried out by internal and external auditors. In assessing the adequacy of such arrangements, the audit committee needs to establish:

- the degree to which management has assumed ownership for risk and control;
- how key business risks are identified, evaluated and managed;
- whether the controls are fit for purpose and working as intended; and
- the rigour and comprehensiveness of the review process.

By asking probing questions about risk management, the audit committee can help bring clarity to the process used to manage risk and the assignment of accountabilities to monitor and react to changes in the organisation's risk profile.

Monitoring the effectiveness of internal control and risk management systems

The audit committee should define the process to be adopted for its review of the effectiveness of internal control and risk management systems. This should encompass both the scope and frequency of the reports it receives from management, internal audit and the statutory auditor.

The reports from management should, in relation to the areas covered by them, provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks. Any significant control failings or weaknesses identified should be addressed, including the impact that they have had, or may have, on the company and the actions being taken to rectify them. It is essential that there be openness of communication by management with the audit committee on matters relating to risk and control.

When reviewing reports from management the audit committee should consider:

- what the significant risks are and assess how they have been identified, evaluated and managed;
- the effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses in internal control that have been reported;
- whether necessary actions are being taken promptly to remedy any significant failings or weaknesses;
- whether the findings indicate a need for more extensive monitoring of the system of internal control; and
- the extent and frequency by which matters are communicated to the committee and whether it enables the committee to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed.

The committee should also consider the incidence of significant control failings or weaknesses that have been identified at any time during the period – whether by management, auditors or other – and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the company’s financial performance or condition.

Should the audit committee become aware of any such significant failing or weakness in the internal control or risk management systems, it should (unless the expressly addressed by the board/supervisory body or other relevant board committee) determine how the failing or weakness arose and reassess the effectiveness of management’s ongoing processes for designing, operating and monitoring the internal control and risk management systems.

Assurance

As well as receiving reports from management, the audit committee should ensure that appropriate assurance exists in respect of the effectiveness of material aspects of the internal control and risk management systems – here the audit committee will look to internal audit, the statutory auditor and other assurance providers.

Fraud and whistleblowing

As part of its wider remit to monitor the effectiveness of internal control and risk management systems, the audit committee should review arrangements by which employees (and others) 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.

When reviewing whistle-blowing procedures, the audit committee might consider the following questions:

- Are whistle-blowing procedures documented and communicated throughout the institution?

- Does the policy make clear that it is both safe and acceptable for employees (and others) to raise concerns about wrongdoing?
- Were whistle-blowing procedures arrived at through a consultative process? Do employees buy in to the process?
- Are concerns raised by employees responded to with a reasonable time frame?
- Are procedures in place to ensure that all reasonable steps are taken to prevent the victimisation of genuine whistle-blowers?
- Are there procedures to ensure that all reasonable steps are taken to keep the identity of whistle-blowers confidential?
- Has a senior person been identified to whom confidential concerns can be disclosed? Does this person have the authority and determination to act if concerns are not raised with, or properly dealt with, by management?
- Are success stories publicised?
- Do senior management understand how to act if a concern is raised? Do they recognise that employees have the right to blow the whistle?
- Has consideration been given to the use of an independent advice centre as part of the whistle-blowing procedure?

Chapter 5: Monitoring the effectiveness of internal audit

Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia*.....

(b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems.

Article 41(2) 8th Company Law Directive of the European Union

The audit committee should annually review the need for an internal audit function and, where such a function exists, its effectiveness. Designed and deployed effectively, internal audit can have a positive impact on the control environment of an organisation and the effective design and operation of internal control. Internal audit can also play a significant role in supporting the audit committee through the provision of assurance as to whether the controls implemented by management are fit for purpose and working as intended.

The need for an internal audit function will vary depending on company specific factors including the scale, diversity and complexity of the company's activities and the number of employees, as well as cost/benefit considerations. When undertaking its assessment of the need for an internal audit function, the audit committee should also consider whether there are any trends or current factors relevant to the company's activities, markets or other aspects of its external environment which have increased, or are expected to increase, the risks faced by the company. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.

In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself, the audit committee and the board that the system of internal control is functioning as intended. In these circumstances, the audit committee will need to assess whether such processes provide sufficient and objective assurance.

Belgium: With respect to financial institutions, the Belgian Act states that “the audit committee has to monitor the effectiveness of the internal audit.” This implies that financial institutions should have an internal audit as audit committees can only monitor the effectiveness of the internal audit if it exists.

Establishing and maintaining an effective internal audit function

Internal audit can be resourced either through an in-house function or an external service provider. The decision as to which is appropriate will usually be driven by the availability of appropriate skills and the breadth and depth of experience to cover the company's business operations adequately. The cost implications of each approach may differ significantly.

Where an internal audit function exists, the audit committee should participate in the appointment, promotion or dismissal of the chief internal auditor, and help determine the required qualifications, reporting obligations and compensation. The audit committee should also help to ensure internal audit has access to all appropriate persons both at board level and within the company.

The audit committee should be involved in developing and approving internal audit's remit, goals and mission, to be certain of its proper role in the oversight function. Collaboration with both management and internal audit in developing internal audit's remit should help ensure a proper balance between the assessment of internal control over financial reporting and any responsibilities for operational efficiency, risk management and other special projects.

The audit committee should also ensure that the internal audit function has adequate resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors. The audit committee should pay particular attention to the experience and resources within the internal audit function in times of crisis and ensure the internal audit budget and activities are not inappropriately curtailed as a result of cost cutting exercises.

Reviewing the work of the internal audit function

In its review of the work of the internal audit function, the audit committee should, inter alia:

- ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee;
- Internal audit should retain a degree of independence from management. The chief internal auditor should report directly into the executive board, i.e. to the CFO or ideally the CEO; but also have a clear line of responsibility to the audit committee. The audit committee should have processes in place to facilitate confidential exchanges with the internal auditor, with regular meetings scheduled between the audit committee and the chief internal auditor.
- review and assess the annual internal audit work plan;
- receive a report on the results of the internal auditors' work on a periodic basis;
- review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- meet with the head of internal audit at least once a year without the presence of management; and
- monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

Relationship with the statutory auditor

The audit committee should ensure that there is a constructive relationship between the internal audit function and statutory audit. While each audit function provides independent assurance, the audit committee should, where appropriate, seek to ensure that the internal audit function and statutory auditor co-ordinate their audit effort and avoid duplication.

Chapter 6: Monitoring the statutory audit

Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia*

(c) monitor the statutory audit of the annual and consolidated accounts.

Article 41(2) 8th Company Law Directive of the European Union

Monitoring the statutory audit and the relationship with the statutory auditor is an important part of the audit committee's role.

Maintaining an effective relationship

The statutory auditor and audit committee should have a strong and candid relationship – anything less may limit the committee's effectiveness in achieving its oversight responsibilities. The audit committee should establish that the auditor is directly accountable to the audit committee and, through it, to the board/supervisory body and ultimately the company's shareholders. The audit committee should make sure its actions and communications with the statutory auditor are consistent with this accountability – the statutory auditor should never feel that its primary responsibility is to executive management.

Reviewing the audit plan

The audit committee should determine that an appropriate audit plan is in place. It should carefully consider the appropriateness of the business risks identified by the statutory auditor and whether, because of the audit committee's own knowledge of the organisation's risk environment, other risks should also be taken into account.

This focus applies both at a strategic level – those risks that are fundamental to the achievement of the entity's strategy – and at the more detailed operational level: those risks that affect day-to-day operations, the recognition of revenue and costs, the custody and value of assets, and the completeness of recognition of liabilities.

In general terms, the audit committee should understand:

- the areas where the statutory auditor intends to perform detailed substantive testing and those areas where the auditor intends to rely on internal controls;
- whether divisions or subsidiaries receive adequate coverage, particularly those that are remote either geographically or culturally; and
- whether other audit firms are involved in auditing specific geographic locations or group entities.

The audit committee should also seek to understand whether, and to what extent, the statutory auditor is content to rely on the work of the internal auditors in support of their audit work; and whether they will be reviewing the work of the internal auditor.

The audit committee and the statutory auditor should agree upon an appropriate audit timetable. Major issues should not be raised for the first time at the meeting at which the audit committee intends to recommend the approval of the financial statements – rather audit findings should be reviewed on an ongoing and timely basis, for example, after the interim audit work. The chairman of the audit committee should talk with the statutory auditor in advance of each meeting so that audit committee members can be directed to matters of substance. One would expect the relationship with the auditor to be such that, if there are serious concerns, the auditor will bring them to the audit committee’s attention promptly.

Management representations

During an audit, the auditor receives many representations, either unsolicited or in response to specific enquiries. The audit committee should review written representations by management or by the supervisory board as a whole. Representation letters may cover matters such as:

- confirmation that all accounting records have been made available, all transactions properly recorded in the accounting records, and all other records and related information made available;
- management’s plans or intentions that may affect the carrying value of assets and liabilities;
- knowledge of events that have occurred subsequent to the balance sheet date that would require adjustment to the financial statements;
- presentation and disclosure of the fair value measurement of material assets, liabilities and components of equity;
- knowledge of fraud, or suspected fraud, affecting the company;
- confirmation that the effects of uncorrected financial statement misstatements are immaterial;
- confirmation that all information provided regarding related parties is complete.

The audit committee should give particular consideration to matters that relate to non-routine or unusual issues. It should consider whether the information provided is complete and appropriate based on its own knowledge.

Reviewing the audit findings

The statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.

Article 41(4) 8th Company Law Directive of the European Union

The audit committee should review the statutory auditor’s findings, including any changes in audit approach or any modification to the statutory audit report. In particular, the audit committee

should discuss with the statutory auditor both major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved – obtaining explanations about why certain errors might remain uncorrected. Consideration of those issues that have subsequently been resolved and uncorrected misstatements that are not material in the context of the financial statements, can provide insight into the appropriateness of the system of internal control, or be indicative of management’s approach to the preparation and presentation of financial information.

The audit committee should also have a frank and open dialogue around the quality and acceptability of corporate reporting, including, for example:

- the appropriateness of the accounting policies to the particular circumstances of the company;
- the timing of transactions and the period in which they are recorded;
- the appropriateness of accounting estimates and judgements;
- the potential impact of any uncertainties, including significant risks and exposures, such as pending litigation;
- material uncertainties that may cast doubt on the company’s ability to continue as a going concern;
- the extent to which the financial statements are affected by unusual transactions;
- inconsistencies between the financial statements and any other information in the document containing the financial statements for example, narrative reporting;
- the overall balance and clarity of the financial statements; and
- the design and operation of the company’s internal control and risk management systems (see below).

Belgium: The Belgian Act explicitly requires that the audit committee monitors the statutory audit of the annual and consolidated accounts “including the follow-up of questions raised by the statutory auditor.”

France – The French Stock Exchange Authority (AMF) sets out that the audit committee should also discuss with the statutory auditors any difficulties they have potentially faced during the course of their audit.

Internal control

The statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.

Article 41(4) 8th Company Law Directive of the European Union

The EU Directive requires the statutory auditor to report to the audit committee on key matters arising from the audit including any material weaknesses in internal control in relation to the financial reporting process.

A 'material weakness' is not defined in the Directive, but it is thought that the intention of the legislation is consistent with requirements set out in International Auditing Standards (see below). The key consideration is that the auditor is reporting on matters that arose during the course of their financial statements audit rather than an audit specifically designed to enable the auditor to express an opinion on management's assessment of the effectiveness of the company's internal controls such as that required by section 404 of the Sarbanes Oxley Act (SOX 404).

International Auditing Standards acknowledge that statutory auditors only consider internal control and risk management systems to the extent necessary for them to form their opinion of the financial statements. However, where the auditor identifies deficiencies in internal control during their audit and judge such deficiencies to be significant, International Auditing Standards require the auditor to report their findings in writing to the audit committee on a timely basis.

In this context, a significant deficiency in internal control is a deficiency or combination of deficiencies in internal control that, in the auditor's judgment, is of sufficient importance to merit the attention of the audit committee. A deficiency in internal control exists when:

- A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

It should be noted that in relation to SOX 404, both the SEC and PCAOB define a material weakness as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis" - a more 'high-level' test than the significant deficiency definition within International Auditing Standards.

Where significant deficiencies in internal control are identified by the statutory auditor, the audit committee should expect to receive a description of the deficiencies and an explanation of their potential impact - including sufficient information to enable the audit committee (and management) to understand the context of the report, such as:

- The purpose of the audit was for the statutory auditor to express an opinion on the financial statements;
- The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
- The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to the audit committee.

The audit committee should also expect the statutory auditor to report the following to management at an appropriate level of responsibility on a timely basis:

- o significant deficiencies in internal control that the auditor has reported (or intends to report) to the audit committee (unless it would be inappropriate to communicate directly to management in the circumstances); and
- o any other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

Management should provide written responses to any recommendations made or issues raised by the statutory auditor and, as part of the ongoing monitoring process, the audit committee should review and monitor management's response to the auditors' findings and recommendations, to ensure that appropriate action is taken in a timely manner.

Chapter 7: Audit independence and non-audit services

Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia*

- (d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

Article 41(2) 8th Company Law Directive of the European Union

The audit committee should, at least annually, consider the statutory auditor's independence and carry out procedures to help ensure their independence and objectivity, taking into consideration any relevant local professional and regulatory requirements.

In considering matters that may bear on the statutory auditor's independence, the audit committee should consider whether conflicts exist, such as:

- o the auditor holding a financial interest, either directly or indirectly, in the company;
- o personal and business relationships of the auditor's immediate family, close relatives and partners with the company;
- o the nature of the relationship between the audit partner and the CEO and/or the CFO;
- o economic dependence by the auditor through its relationship with the company; and
- o the nature and extent of services provided by the auditor in addition to the audit engagement.

Each year the audit committee should obtain from the audit firm information about their policies and processes for maintaining independence and monitoring compliance with relevant requirements such as those regarding the rotation of audit partners.

Non-audit services

To help ensure that non-audit services provided by the statutory auditor do not impair, or appear to impair, the auditor's independence or objectivity, the audit committee should develop, and recommend to the board, a policy on the provision and pre-approval of all non-audit services.

In determining the policy, the audit committee should consider:

- whether the skills and experience of the statutory audit firm make it a suitable supplier of the non-audit service;
- whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to audit objectivity and independence (see below);
- the nature of the non-audit services;
- the fees incurred, or to be incurred, for non-audit services both for individual services related fee levels and the fee levels individually and in aggregate, relative to the audit fee; and
- the criteria which govern the compensation of the individuals performing the audit.

Threats to audit objectivity and independence may arise from the statutory auditor (or a member of the engagement team):

- having a financial or other interest that might cause them to be reluctant to take action that would adversely impact their interests (self-interest threat);
- performing non-audit services that have a material impact on the company's financial statements and result in the auditor auditing their own work (self-review threat);
- undertaking work that involves making judgements and taking decisions that are the responsibility of management (management threat);
- undertaking work that involves acting as advocate for the company or supporting a position taken by management in an adversarial context (advocacy threat);
- being predisposed, for example because of a close personal or family relationship, to accept or not sufficiently question the company's point of view (familiarity threat); and
- being influenced by fear or threats (intimidation threat).

The non-audit services policy devised by the audit committee should formally specify the types of non-audit work from which the external auditor should be excluded and the types of work for which the statutory auditor can be engaged. Where the statutory auditor can be engaged, the audit committee should set and apply a formal policy specifying the types of non-audit service (if any) for which:

- the use of the statutory auditor is pre-approved (i.e. approval has been given in advance as a matter of policy, rather than the specific approval of an engagement being sought before it is contracted)
- specific approval from the audit committee is required before they are contracted.

Pre-approval of the use of the statutory auditor may be appropriate where the threats to auditor independence are considered low.

The audit committee should consider disclosing a summary of the non-audit services policy in the annual report.

Former employees of the statutory auditor

The audit committee should agree on a policy for the employment of former employees of the statutory auditor, taking into account the relevant ethical guidelines governing the accounting profession and any local regulation or recommendations.

The audit committee should monitor application of the policy, including the number of former employees of the statutory auditor currently employed in senior positions in the company, and consider whether, in the light of their employment, there has been any impairment, or appearance of impairment, of the auditor's judgement or independence.

Particular attention should be given to members of the audit team moving directly to the company and former employees moving into financial oversight positions within the company. In both cases, the audit committee might consider 'cooling off' periods to be necessary.

Chapter 8: Appointing the statutory auditor

In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee.

Article 41(3) 8th Company Law Directive of the European Union

Recommending the appointment of the statutory auditor

Making recommendations to the board/supervisory body on the appointment (and reappointment and removal) of the statutory auditor is an important part of the audit committee's role. The audit committee's recommendation should be based on its assessment of the qualifications, expertise and resources of the auditor and the effectiveness of the audit process. Independence (see chapter 7) should also be considered.

The audit committee should approve the terms of engagement and recommend (or approve) the compensation to be paid to the auditor in respect of audit services provided. In doing so, it should satisfy itself that the level of fees in respect of the audit is appropriate and that an effective audit can be conducted for such a fee.

If the audit committee recommends considering the selection of possible new appointees as statutory auditors (an audit tender), it should oversee the selection process and assume responsibility for making the recommendation to the board/supervisory body which in turn would be submitted to shareholders in General Meeting. If the existing statutory auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

Local codes and regulations may contain recommendations or have requirements (such as auditor rotation rules) that impact the audit committee's selection of statutory auditor. Contractual obligations may also act to restrict the audit committee's choice of statutory auditor.

Assessment of audit effectiveness

In determining the appropriateness of a statutory auditor the audit committee should have full regard to the auditor's competence, the quality and efficiency of the audit, and whether the audit fee is appropriate in relation to size, complexity, and risk and control profile of the company.

When considering the appointment (or reappointment) of the statutory auditor, consideration is normally given to a range of factors including:

- understanding of the company's risks and needs (including strategic management issues);
- proposed fee and value for money considerations;
- perceived value added;
- experience of sector and existing client list;
- staff experience and number of planned partner/senior staff hours; and

- geographical coverage.

In making its recommendation the audit committee should also have regard to the effectiveness of the current audit process. This might include:

- ensuring the statutory auditor has met the agreed audit plan. Understanding the reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditor to address those risks;
- considering the robustness and perceptiveness of the auditor in handling the key accounting and audit judgements identified, responding to questions from the audit committee, and commenting where appropriate on the systems of internal control;
- obtaining feedback about the conduct of the audit from key stakeholders such as the CFO and chief internal auditor;
- considering the timeliness and quality of communication between the statutory auditor and the audit committee - including, where appropriate, audit highlights memorandum, reports on control weaknesses, conduct during audit committee meetings and ad hoc communications between meetings. Good statutory auditors will identify issues early and brief the audit committee on the available options in a timely manner;
- considering the 'value-added' by the audit process; and
- considering the degree to which the statutory auditor has been able to engage with the committee on broad business and strategic issues.

To assist in the assessment, the audit committee should each year request from the statutory auditor information about their internal quality control procedures.

Chapter 9: Exemptions within the Statutory Audit Directive

The Statutory Audit Directive contains a number of exemptions from the requirement for a public interest entity to have an audit committee. Individual member states have adopted these exemptions to a greater or lesser extent. These are set out below and discussed in greater detail in Appendix 2.

- **Small and medium-sized companies** - Public interest entities that qualify as small or medium-sized entities are not required to have an audit committee if the functions normally assigned to the audit committee are carried out by the board/supervisory body as a whole and the body is not chaired by an executive chairman when carrying out audit committee business.
- **Body performing equivalent functions** - Public interest entities are not required to have an audit committee where they have a 'body performing equivalent functions to an audit committee' that is established and functioning in accordance with national law. In such a case the company must disclose which body carries out the audit functions and how it is composed.
- **Certain other entities** - Subject to various technical definitions. Member States may exempt certain other entities - certain subsidiaries, collective investment undertakings and credit institutions - from the obligation to have an audit committee.

Notwithstanding the existence of the exemptions, many organisations might voluntarily choose to create an audit committee as part of their governance framework to help ensure strong and effective processes - relating to independence, internal control, risk management, compliance, ethics, and financial disclosures - are in place.

Appendix 1: EU 8th Company Law Directive

DIRECTIVE 2006/43/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/ 660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC

Article 41 Audit Committees

1. Each public-interest entity shall have an audit committee. The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing.

In public-interest entities which meet the criteria of Article 2(1), point (f) of Directive 2003/71/EC (1), Member States may permit the functions assigned to the audit committee to be performed by the administrative or supervisory body as a whole, provided at least that when the chairman of such a body is an executive member, he or she is not the chairman of the audit committee.

2. Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia*:
 - (a) monitor the financial reporting process;
 - (b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
 - (c) monitor the statutory audit of the annual and consolidated accounts;
 - (d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.
3. In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee.
4. The statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.
5. Member States may allow or decide that the provisions laid down in paragraphs 1 to 4 shall not apply to any public interest entity that has a body performing equivalent functions to an audit committee, established and functioning according to provisions in place in the Member State in which the entity to be audited is registered. In such a case the entity shall disclose which body carries out these functions and how it is composed.
6. Member States may exempt from the obligation to have an audit committee:
 - (a) any public-interest entity which is a subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC if the entity complies with the requirements in paragraphs 1 to 4 of this Article at group level;

- (b) any public-interest entity which is a collective investment undertaking as defined in Article 1(2) of Directive 85/611/EEC. Member States may also exempt public-interest entities the sole object of which is the collective investment of capital provided by the public, which operate on the principle of risk spreading and which do not seek to take legal or management control over any of the issuers of its underlying investments, provided that those collective investment undertakings are authorised and subject to supervision by competent authorities and that they have a depositary exercising functions equivalent to those under Directive 85/611/EEC;
- (c) any public-interest entity the sole business of which is to act as issuer of asset-backed securities as defined in Article 2(5) of Commission Regulation (EC) No 809/2004 (2). In such instances, the Member State shall require the entity to explain to the public the reasons for which it considers it not appropriate to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee;
- (d) any credit institution within the meaning of Article 1(1) of Directive 2000/12/EC whose shares are not admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and which has, in a continuous or repeated manner, issued only debt securities, provided that the total nominal amount of all such debt securities remains below EUR 100,000,000 and that it has not published a prospectus under Directive 2003/71/EC.

Appendix 2: Exemptions within the EU 8th Company Law Directive

The Statutory Audit Directive contains a number of exemptions from the requirement for a public interest entity to have an audit committee. Individual member states have adopted these exemptions to a greater or lesser extent.

Small and medium-sized companies

In public-interest entities which meet the criteria of Article 2(1), point (f) of Directive 2003/71/EC (1), Member States may permit the functions assigned to the audit committee to be performed by the administrative or supervisory body as a whole, provided at least that when the chairman of such a body is an executive member, he or she is not the chairman of the audit committee.

Article 41(1) 8th Company Law Directive of the European Union

Public interest entities that qualify as small or medium-sized entities (as defined by Article 2(1)(f) of Directive 2003/71/EC (1) - the so-called 'Prospectus Directive') are not required to have an audit committee if the functions normally assigned to the audit committee are carried out by the board/supervisory body as a whole and the body is not chaired by an executive chairman when carrying out audit committee business.

Such an exemption is pragmatic insofar as smaller entities are likely to have smaller boards/supervisory bodies and an appropriately constituted audit committee (see chapter 1) may well include most if not all of the board/supervisory body members. Furthermore, it should be remembered that audit committees are advisory committees and should in any event carry out their duties for and on behalf of the board as a whole.

Article 2(1)(f) defines small and medium-sized entities as:

"... companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43,000,000 and an annual net turnover not exceeding EUR 50,000,000."

If the chairman of the board/supervisory body is an executive member and the entity wishes to take advantage of the exemption; the chairman must hand over the chairmanship while the board/supervisory body is discharging its audit committee duties. It would appear to be the intention of the Directive that whilst carrying out the audit committee functions, the board/supervisory body should be chaired by an independent director.

The practical difficulties of this should not be underestimated as tensions may well arise between the chairman of the board/supervisory body and the independent member chairing the board/supervisory body during any audit committee business. Very strong independent member(s) are required if any unwelcome influence of a domineering board/supervisory body chairman is to be resisted. Board harmony is key to ensuring such arrangements work in practice.

Notwithstanding the above, local codes and regulations may contain recommendations or have requirements that render the partial exemption for small and medium-sized entities redundant;

compliance with the UK Corporate Governance Code, for example, would require that all (applicable) companies have an audit committee comprised solely of independent non-executive directors (albeit only two in the case of smaller companies).

Body performing equivalent functions

Member States may allow or decide that the provisions laid down in paragraphs 1 to 4 shall not apply to any public interest entity that has a body performing equivalent functions to an audit committee, established and functioning according to provisions in place in the Member State in which the entity to be audited is registered. In such a case the entity shall disclose which body carries out these functions and how it is composed.

Article 41(5) 8th Company Law Directive of the European Union

The directive allows Member States to disapply the functional requirements of paragraphs (1) to (4) of Article 41 for those companies that have a 'body performing equivalent functions to an audit committee' that is established and functioning in accordance with national law. In such a case the company must disclose which body carries out the audit functions and how it is composed.

It appears that this 'exemption' was designed to allow companies that have long standing alternative oversight arrangements to continue with their existing practices. One such example would be Italy where the traditional corporate structure is unique in the oversight role it assigns to the 'board of statutory auditors' – an independent 'external' body charged with monitoring the performance of board of directors, compliance with the law and the adequacy of internal control. The board of statutory auditors also has responsibility for monitoring the statutory audit firm.

Subsidiaries, collective investment undertakings and credit institutions

Member States may exempt from the obligation to have an audit committee:

- (a) any public-interest entity which is a subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC if the entity complies with the requirements in paragraphs 1 to 4 of this Article at group level;
- (b) any public-interest entity which is a collective investment undertaking as defined in Article 1(2) of Directive 85/611/EEC. Member States may also exempt public-interest entities the sole object of which is the collective investment of capital provided by the public, which operate on the principle of risk spreading and which do not seek to take legal or management control over any of the issuers of its underlying investments, provided that those collective investment undertakings are authorised and subject to supervision by competent authorities and that they have a depositary exercising functions equivalent to those under Directive 85/611/EEC;
- (c) any public-interest entity the sole business of which is to act as issuer of asset-backed securities as defined in Article 2(5) of Commission Regulation (EC) No 809/2004 (2). In such instances, the Member State shall require the entity to explain to the public the reasons for which it considers it not appropriate to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee;
- (d) any credit institution within the meaning of Article 1(1) of Directive 2000/12/EC whose shares are not admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and which has, in a continuous or repeated manner, issued only debt securities, provided that the total nominal amount of all such debt securities remains below EUR 100,000,000 and that it has not published a prospectus under Directive 2003/71/EC.

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