The functioning of Audit Committees

Discussion Paper

June 2012

Comments to be submitted by 28 September 2012
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Company Law and Corporate Governance Working Party
About FEE

FEE (Fédération des Experts comptables Européens - Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all 27 EU Member States.

In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 700,000 professional accountants working in different capacities in public practice, small and larger firms, business, public sector and education, who all contribute to a more efficient, transparent, and sustainable European economy.
1. EXECUTIVE SUMMARY

A strong and competent audit committee is part of the overall sound corporate governance system in a company. The corporate governance system is in place to ensure the quality of the financial information provided by the company as well as the risk management systems of the company. Furthermore, it contributes to minimising financial, operational and compliance risks within the company as a whole, as set out in the Statutory Audit Directive.

The requirements related to audit committees according to the Statutory Audit Directive have set out some common ground for audit committees and their functioning. Over the last couple of years, audit committees have found their place in the general governance structures of European public interest entities. Experience within audit committees is building up and areas for improvements are materialising.

In some European Member States, audit committees are a new concept introduced following the transposition of the Statutory Audit Directive, whilst in other countries audit committees have been in place for years. With the knowledge of the functioning of audit committees in Europe gathered during the implementation phase, and in the recent years, some potential to strengthen even more the role of audit committees is being identified.

With external audit being another part of the governance of companies, FEE believes that strong audit committees are essential for the quality of financial information provided by companies. Audit committees cooperate with the auditors through their monitoring responsibilities and an effective cooperation between the two parties is beneficial not only for the auditor and the audit committee, but also for the company as a whole. This allows the useful information accumulated by the audit committee regarding the risks for the company as a whole to be exchanged with the external auditor. Such an exchange is useful for the auditor throughout the audit engagement.

The functioning of audit committees in general can be improved. Improvements relate in particular to clarification of the competences and the responsibilities of the audit committee and to the reporting to and from the audit committee. These improvements would be beneficial to companies, having in mind that the main purpose of audit committees is to ensure the quality of financial reporting, overall internal control and risk management.

With the aim of analysing the functioning of audit committees in Europe, FEE has gathered details about national experiences with audit committees across Europe. This has led to the identification of areas of potential improvements for the functioning of audit committees.

Currently, the functioning of audit committees is based on different legislative traditions in various countries, as in some countries the role of audit committees has historically been taken care of by other bodies such as the supervisory boards or the board of directors. In other countries, the governance of companies has given due consideration to the role of a committee with responsibilities related to the financial reporting of the company which has developed over time.

This had led to differences in corporate governance structures as well as in the functioning of audit committees across Europe. Some of these differences are likely to remain, even if initiatives are introduced to further harmonise the functioning of audit committees at European level. Although this may be the case, FEE believes that a more harmonised approach to audit committees is achievable, as further set out in the FEE Recommendations below.
The European Commission, in 2010 and late 2011, has taken initiatives to strengthen corporate governance for companies in Europe as well as to reform auditing within Europe. Specific proposals aim at amending the Statutory Audit Directive as well as introducing more detailed requirements for audits of public interest entities through a regulation. Strengthening the role of the audit committee is part of this initiative, among other proposed measures from the European Commission, where audit committees are to have a greater involvement in the appointment of the auditor.

The European Commission proposes to regulate audit committees through a regulation, a measure which would lead to the highest level of harmonisation possible in European Union (EU) legislation. However, since audit committees are just one part of the overall corporate governance system of a company, the need for flexibility regarding the set-up of audit committees remains in order to accommodate for the different company law systems and corporate governance models that will continue to exist within the European Union.

1.1. The contents of the Discussion Paper

In the context of the implementation of the Statutory Audit Directive regarding audit committees, along with the new proposals from the European Commission, the Discussion Paper contributes to the current debate regarding improvements to corporate governance for companies as well as to the discussions on audit policy in general. Therefore, the Discussion Paper is aimed at policymakers as well as auditors and audit committees, and debates topics regarding:

1. Establishment of audit committees.
2. Composition, including the independence, competence and compensation of the members of audit committees.
3. Responsibilities and tasks, including terms of reference for the audit committee and reporting responsibilities.
4. Reporting to and from the audit committee.

The Discussion Paper is based on a compilation of national experience in the various FEE Member countries. The various issues debated in this paper are illustrated by summaries of the national transpositions of EU provisions, and by practical experience through the relationship between auditors and companies in various European countries.

1.2. The current functioning of audit committees

In general, the current functioning of audit committees can be summarised as follows:

- The functioning of audit committees differs across Europe. The information gathered shows significant variety in the way audit committees are set up and function in various European countries.

- The differences should be seen in the context of the different corporate governance models that exist across Europe. The reasons should be found partly in the different historical and cultural traditions and partly in the experience gathered over the different number of years that audit committees have existed in the different countries.

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1 Background regarding the Survey carried out among FEE Member countries is set out in Appendix 2
The differences between the various countries in Europe are mainly identified in relation to:

- The extent of exceptions applied to establish an audit committee.
- Whether the minimum number of members of the audit committee is specified or not. Additionally, the number of independent members of the audit committee differs from one country to another.
- Whether the chair of the board can be chair of the audit committee or not.
- Whether remuneration policies for members of the audit committee are developed.
- To what extent the auditor attends meetings of the audit committee.

Some of the differences are likely to remain, since they are based on different corporate governance models in general. Furthermore, some flexibility regarding audit committees is needed in order for companies to design the corporate governance system they find appropriate.

Despite some of the apparent differences between countries, the functioning of audit committees in general can be improved. Inspiration regarding improvements may be found in examples from various European countries, as well as through strengthening the common European legal provisions on the matter.

1.3. FEE Recommendations for improvements of audit committees

Based on the information gathered from FEE Member Bodies regarding their national provisions and current practical functioning of audit committees, and in light of the recent EC proposals on audits of public interest entities - which FEE generally welcomes as far as they relate to audit committees - FEE recommends the following initiatives, contributing to a strengthened role for audit committees:

Regarding the composition, the independence and the competence of audit committee members:

1. FEE recommends that it is further clarified that the audit committee acts as a subcommittee of the board.

2. FEE recommends that all members of the audit committee are non-executive directors regardless of whether the member is appointed by the board or by the shareholders. This would implicitly entail that management or even the CFO of the company is not to be a member of the audit committee, neither to chair the audit committee.

3. FEE supports the EC proposals to require that the majority of the members of the audit committee to be independent as well as requiring that the chair of the audit committee is independent.

4. FEE recommends that the collective competence of the audit committee should reflect the appropriate skills needed to carry out the work in a responsible manner. This would reflect the collective responsibility that the audit committee has and would be an appropriate principles-based approach, which also gives due consideration to the complexity of the company as a whole. This also impacts the decision on what the appropriate number of members in the audit committee should be.

5. FEE recommends that more guidance is provided as to what is understood as “competence”. Such guidance could for instance indicate that a university degree in economy or finance, a professional qualification from a relevant professional organisation or significant professional and practical experience in accounting and/or auditing qualify as “competence” for an audit committee member.
6. FEE recommends that the audit committee is sufficiently diverse in its membership based on the principle of “the best person for the job”. In this approach, due care should be given to the competences, qualifications and the collective responsibilities of the audit committee, whether or not this entails more differences in gender, background, age, ethnicity, etc.

Regarding responsibilities of the audit committee:

7. FEE recommends that the responsibility of the audit committee vis-à-vis the board and other board committees is clarified. This should include guidance on delegation of decision-making power and coordination between board committees and in relation to obtaining additional advice on specific matters from external parties, such as from the external auditor.

8. FEE supports the EC proposal to reinforce the audit committee’s evaluation of internal control, internal audit and risk management functions, and recommends that the practical discharge is further specified, especially in relation to the evaluation of the efficiency and effectiveness of internal control and risk management. Such clarification should include references to review of judgements of key or critical accounting policies and estimates. This will also enforce the tools available for the audit committee, including making the clear link between internal control, internal audit and risk management.

9. FEE recommends that the audit committee carries out regular assessments of:

   a. The cooperation between the external auditor and the audit committee. This assessment should be based on criteria developed by the audit committee that can support an efficient tender process.

   b. Self-assessment of its own work and functioning. The self-assessment should preferably include an assessment of possible improvements regarding the relationship with the board and other board committees.

   The audit committee should have sufficient resources at its disposal to carry out such assessments.

10. FEE recommends that the appointment of the auditor is done in a principles based manner that is easily applicable by companies. This will facilitate the selection process led by the audit committee to be efficient and will limit the company’s costs incurred for the appointment of the external auditor as much as possible.

Regarding reporting to and from the audit committee

11. FEE believes that enhanced communication between the auditor and the audit committee will be beneficial to both parties in the discharge of their respective duties. With due consideration to its content, the newly proposed Additional Internal Report which is to be submitted to the audit committee by the statutory auditor and is to contain comments regarding the results of the statutory audit, is an appropriate initiative.
12. FEE recommends that management and the internal audit function ensure that information they provide to the audit committee is timely, concise and of a level of quality that leads to a free and open discussion of all relevant topics.

13. FEE recommends a more transparent audit committee. The transparency should concern matters that are not confidential and will not be harmful for the company and should be under the ultimate responsibility of the board. This increased transparency could be in relation to the assessments made in advising the board, and could especially be on:

a. The work of the audit committee carried out in the current year, especially in relation to the significant issues that arose during the course of the statutory audit.

b. Judgements and conclusions of the audit committee in relation to key or critical accounting policies and estimates.

c. The decisions made and action plan for the coming year(s).

d. The non-audit services either provided or to be provided, following involvement of the audit committee, by the statutory auditor as well as by other auditors to further highlight the need for independence of management regarding such decisions.

e. The audit appointment process, in particular the rationale for selection of a new audit firm or the renewal of an incumbent audit firm’s term.

f. The work of the audit committee, judgements and conclusions made in relation to the monitoring of the company’s internal control, internal audit and risk management system also aimed at shareholders.

With these improvements, FEE believes that audit committees have great potential to improve the quality of financial reporting by companies.
1.4. Questions to respondents

FEE invites comments on any parts of the Discussion Paper on The Functioning of Audit Committees, and in particular on the matters below:

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

Q2. Do you have any comments on the FEE Recommendations on the composition of the audit committee, especially on the:
   a. Composition of audit committees in general?
   b. Whether all members of the audit committee should be members of the board?
   c. Whether appointment of audit committee members should be restricted to be performed by the shareholders or by the board?
   d. Whether appointment of audit committee members by the board or by the shareholders should be decided at national level by each EU Member State or by the individual company?

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

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

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

Q6. Do you have any comments on the FEE Recommendations on responsibilities of audit committees, especially on:
   a. Whether audit committees should have additional responsibilities in relation to assessing the appropriateness of the company’s internal control systems, risk management systems and the application of financial reporting frameworks?
   b. Should audit committees more closely monitor day-to-day operations of the company, such as in relation to early warning monitoring (regarding going concern of the company)?
   c. The frequency of tenders for appointment of the statutory auditor?
Q7. Do you have any comments on the FEE Recommendations on reporting to and from the audit committee, especially on:

a. The desirable level of transparency about the work done by audit committees?

b. Whether reporting of audit committees (under the responsibility of the board) should focus on historical information related to the financial statements or should also address forward-looking and prospective information about the entity?

c. Suggestions on which kind of information that would enhance the quality of the cooperation between audit committees and the auditor?

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

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

Comments regarding the Discussion Paper can be submitted to FEE at secretariat@fee.be by 28 September 2012.

Unless otherwise stated, responses will be regarded as being on the public record. Respondents should indicate specifically when their responses should be treated as confidential.

Comments received will be analysed and used by FEE as a basis for decisions on FEE’s next steps.
2. **Audit Committees**

Based on practical experience across Europe with their set-up and implementation of common requirements in the 2006 Statutory Audit Directive\(^2\), audit committees have now found their place in the general governance structures of European public interest entities. Experience with audit committees is building up and areas for improvements are materialising. In some European Member States, audit committees are a new concept introduced following the transposition of the Statutory Audit Directive, whilst in other countries audit committees have been in place for years. With the knowledge about the functioning of audit committees in Europe gathered during the implementation phase and in the recent years, some potential to strengthen the role of audit committees even more is being identified.

With the external audit being another part of the governance of companies, FEE believes that strong audit committees are essential for the quality of financial information provided by companies. With the aim of analysing the functioning of audit committees in Europe, FEE has gathered details about the national experiences with audit committees across Europe which has led to the identification of areas for potential improvements in the functioning of audit committees\(^3\).

The European Commission has also noted the potential for strengthening audit committees in their monitoring of the quality of financial information provided by European public interest entities. In this regard, the European Commission published in late 2011 proposals to reform statutory auditing, including strengthening the role of audit committees\(^4\). The EC proposals are aimed at audits of public interest entities, and are currently being debated by policy makers in the European Parliament and the Council of Ministers. As far as audit committees are concerned, the European Commission highlights that improvements can be introduced in European legislation to reinforce the independence and capacity of audit committees.

The overall aim of audit committees is to ensure the quality of financial reporting and risk management of the company. The presence of an audit committee also contributes to minimising financial, operational and compliance risks within the company as a whole. Through their monitoring of in particular risks and internal control within the company, audit committees use their competences to ensure that the financial reporting of companies is of quality. This will be of clear benefit to the users of this information.

The current functioning of audit committees is based on different practices in various countries due to the history and tradition of corporate governance and the functioning of governing bodies in the companies. In some countries the role of audit committees has historically been taken care of by other bodies in the company, such as the supervisory boards or the board of directors. In other countries, the role of audit committees has been developed, over a long period of time, as part of the development of overall governance of companies. The Statutory Audit Directive sets out some common principles for audit committees and their functioning, which provide guidance for the establishment and implementation of such committees across the EU Member States.

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\(^3\) Further details on the FEE Survey among its members can be found in Appendix 2

Some national corporate governance codes have, for several years, recommended audit committees as best practice for certain legal entities such as listed companies. The amendment to the Fourth Company Law Directive in 2006 required that public interest companies include a reference to the corporate governance code applied or explain any deviations from the code made in accordance with national law.

An audit committee is set up as a committee under the board and act upon delegation under the responsibility of the board. It has a supervisory role based on the information they receive from other parties within the entity such as instructions from the board, reports and communication from the management, internal audit and information from the external statutory auditor. In general, audit committees do not perform controls themselves but rely on the work and the information received from others.

Another important part of corporate governance for companies is the external audit. Improvements to corporate governance in general should give due consideration to how the audit of the entity interacts with the other elements of the governance of the entity. Good corporate governance highlights the importance of non-executive directors, their structures and their relationship with the board(s), including board committees such as the audit committee. It also focuses on internal controls, internal audit, external audit and disclosures about corporate governance, and in particular, the fundamental relationship and obligations between boards, auditors and shareholders.

It is under the responsibility of the shareholders or the board, as applicable, to set up an effective, independent and competent audit committee. Auditors can provide advice on the functioning of the audit committee, while still maintaining their independence. Auditors have a clear interest in audit committees that are well functioning and engage in high quality information exchange between the audit committee and the auditor. This will be of benefit to both parties.

Frequent and effective dialogue between those charged with governance, including the supervisory board and the audit committee, and the internal audit on one side and external auditors on the other side, is essential in the wider context of good corporate governance and in the direct cooperation between the parties involved in public interest entities. Communication through an open and direct dialogue based on two way communication will contribute to this ultimate goal. Improvements could be made at regulatory level as well as in the application of already existing requirements and guidelines in order to enhance the quality of the cooperation between the two parties.

Improvements could facilitate a more consistent approach on how audit committees discharge their duties in the various EU Member States. More consistency across the EU Member States could also facilitate the presence of non-national members in audit committees, as well as strengthening their functioning and communication. A clarification of the responsibility of audit committees vis-à-vis the board, and specifying in more detail what the monitoring responsibilities of the audit committee entail in practice could be relevant. Additionally, the dialogue should be strengthened and formalised in order to further aid the establishment and effective functioning of the governing bodies.

The structure, the activity and current common practice for audit committees should be seen in light of the different corporate governance models within Europe. The differences between the various models are often related to the geography, the culture and traditions of the different countries, such as in relation to:

- The prominence of institutional investors and major shareholders are greater in some countries than in others.
The existence of one-tier or two-tier boards (such as in Germany) and common practice for appointment of members, including independence of the members impact the functioning of the governing bodies within a company.

Involvement in the corporate governance system as a whole and practice for responsibilities of audit committees have been developed over 20 years in the UK, with the issuance of the first corporate governance code in 1992. In other countries, audit committees are new and have only been in place for a few years and therefore, are currently building up experience about the functioning and interrelation with the board and other board committees in practice.

The following issues are therefore addressed in the paper:

1. Establishment of audit committees.
2. Composition, including the independence, competence and compensation of the members of audit committees.
3. Responsibilities and tasks of the audit committee, including terms of reference for the audit committee and reporting responsibilities.
4. Reporting to and from the audit committee.

**Legal basis for audit committees**

The set up and functioning of audit committees are based on mainly three sources:

- The Statutory Audit Directive.
- The Commission Recommendation on “The role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board” issued in February 2005, also referred to in preamble 24 of the Statutory Audit Directive.
- The national corporate governance codes.

The requirements on audit committees in the Statutory Audit Directive have set out some common ground for audit committees and their functioning. The Directive requires that audit committees and an effective internal control system help to minimise financial, operational and compliance risks, and enhance the quality of financial reporting. Member States were to transpose these requirements in the Statutory Audit Directive before 29 June 2008.

The recommendation explains that the key responsibilities of the board are to ensure that the financial reports and other related information disseminated by the company present an accurate and complete picture of the company’s position, and to monitor the procedures established for the evaluation and management of risks. In this context, most corporate governance codes assign to the audit committee an essential role in assisting the board to fulfil these duties.

The recommendation contains more detailed guidance on the following:

- The board should have three standing subcommittees: a nomination committee, a remuneration committee and an audit committee.

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The role of the board committees, including the audit committee (responsibilities and tasks of the board committees).

The organisation of the committees (terms of reference, number of members, meetings).

Guidance in relation to the members of the committees (appointment and removal of members, qualifications, commitment and independence).

The European Commission evaluated the implementation of this recommendation in 2007\(^6\). The analysis showed that Member States comply to a large extent with the recommendations, but some weaknesses remain, for instance by not recommending a strong presence of independent members in the audit committee.

National corporate governance codes implement the European provisions. They are often more detailed than the European provisions, and, to a great extent, are dependent on the tradition and the national corporate governance system. National corporate governance codes are in many cases based on the international guidelines “OECD Principles for Corporate Governance\(^7\)”.

Since corporate governance in general is one of the areas recently identified as needing some review, some countries have updated national provisions to reflect the lessons learned from the crisis.

The FEE Survey showed that seven countries\(^8\) indicate that changes to corporate governance requirements or recommendations have been made recently following the financial crisis. The countries indicate that the changes were not necessarily introduced in light of the crisis, but the crisis could be one of the causes of the changes made. The changes made by these countries are focused on the following areas:

- Recommending a board approval of a framework for internal control and risk management or requiring disclosures on internal control systems regarding the financial reporting process with involvement of the auditor.
- More disclosures related to the functioning of the audit committee.
- More detailed guidance on the composition of the audit committee and the competence of the members.
- More detailed guidance on independence of the members.
- Recommendations on remuneration of board members.

**Some definitions**

The Statutory Audit Directive and other related documents contain some definitions that are relevant for this paper, such as:

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\(^6\) [http://ec.europa.eu/internal_market/company/docs/independence/sec20071022_en.pdf](http://ec.europa.eu/internal_market/company/docs/independence/sec20071022_en.pdf)


\(^8\) Belgium, Denmark, Finland, Germany, the Netherlands, Spain, UK
Public interest entities

According to the Directive, “public interest entities” are entities that are:

“…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 […] Directive[s]. 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;”.

The determination of public interest entities may vary from one EU Member State to another depending on how the definition has been implemented at national level, but includes as a minimum listed entities, financial institutions and insurance undertakings. For the purpose of this paper, the references made to “public interest entities” are based on the national understanding of the term.

The European Commission proposes a wider definition of public interest entities, as in particular, more financial institutions are to be covered due to the evolution in the financial sector in recent years. This entails that in the definition of public interest entities, it is proposed to cover also investment firms, payment institutions, undertakings for collective investments in transferable securities (UCITS), electronic money institutions and alternative investment funds.

Statutory auditor and audit firm

The terms “statutory auditor” and “audit firm” are defined as follows in the Statutory Audit Directive:

- “statutory auditor” means a natural person who is approved in accordance with this Directive by the competent authorities of a Member State to carry out statutory audits;
- “audit firm” means a legal person or any other entity, regardless of its legal form, that is approved in accordance with this Directive by the competent authorities of a Member State to carry out statutory audits.

Board

The meaning of “board” (or “board of directors” in some countries) may differ at national level, depending on which of the two main types of board structures is used: the unitary board of directors system or the two-tier board system with a management board and a supervisory board that may have different responsibilities.

A unitary board is comprised of executive and non-executive directors. In a two-tier system, the term “board” distinguishes between the management board, whose members have executive responsibilities, and the (supervisory) board, responsible for the monitoring and supervision of the company’s management. Within the two-tier system, the responsibilities of the board could in some countries include responsibilities for the strategic direction of the company (and assume certain management decisions). For the purpose of this paper, “board” covers both understandings, i.e. both under a unitary one tier system and under a two-tier system.
The relationship between the board and the audit committee in both systems can be displayed as follows:

As displayed above, the audit committee acts as a subcommittee of the board (supervisory board) in both systems.

The relationship between the board(s) and management differs compared to the relationship between the audit committee and management.

Since the audit committee is a subcommittee of the (supervisory) board, the audit committee acts under their responsibility and delegation for certain issues of the board.

The relationship between the audit committee and management relates more to the day-to-day work and consists, to a great extent, of the provision of information from management to the audit committee for the support of the committee’s monitoring responsibilities. Furthermore, management attends regularly the meetings of the audit committee, also in order to provide information requested by the audit committee.

2.1. Establishment of audit committees

Current provisions

National requirements on corporate governance and audit committees are based on national company law requirements, which again are based on a mix of European and other requirements or recommendations, such as the Statutory Audit Directive, the EC Recommendation on Independent Directors in listed companies and various corporate governance guidelines.
Article 41 of the Statutory Audit Directive requires public interest companies to establish an audit committee. Member States may, under certain conditions, exempt some public interest entities from establishing an audit committee or allow the board to perform the tasks of the audit committee. This is explained further down in this section.

Findings of the FEE Survey

The FEE Survey showed that a few countries have introduced some additional or clarifying requirements in the national transposition compared to the text of the Directive as follows:

- **Belgium** has specified, when implementing the Statutory Audit Directive, that the competences of the audit committee in the selection process of the statutory auditor is without prejudice to the veto right by the workers’ council (that includes other stakeholders than the employer's representatives or directors, i.e. employees’ representatives) and, where applicable, the competence of the President of the Tribunal of Commerce.

- **France** does not explicitly require the establishment of an audit committee, but uses the expression “comité spécialisé”.

- **Germany** has no general requirement to establish a supervisory board which has had an impact when transposing the requirements related to audit committees as follows:
  
  - In case a public interest entity has established a supervisory board (either on a mandatory or on a voluntary basis), the supervisory board can set up an audit committee.
  - If a public interest entity has not established a supervisory or administrative board with one independent member that has competence in accounting or auditing, it must establish an audit committee.

- **Italy** has transposed the requirement in the Statutory Audit Directive regarding audit committees to function as the company’s internal control body as follows:
  
  - For listed entities adopting the so-called “traditional” governance system, comprised of a board of directors and a collegio sindacale (nearly all companies in Italy):
    - Italian law requires all companies to have a Collegio Sindacale. The Collegio Sindacale is an independent supervisory board, which is charged by law with supervising the compliance with laws and the company’s statutes of all actions undertaken by directors and management. The supervisory board is appointed by the general assembly of shareholders and at least one member must be a registered auditor (in most cases all three are registered auditors);
    - Additionally, an audit committee (“Comitato controllo e rischi”) is required for listed companies and is also recommended by a national corporate governance code (“Codice di Autodisciplina”) approved by an independent corporate governance committee sponsored by the Italian Stock Exchange. The corporate governance code recommends that the members of this audit committee are drawn from the members of the board and appointed by the board itself.
For non-listed entities adopting the so-called “traditional” governance system, comprised of a board of directors and a collegio sindacale including all (non-listed) public interest entities and all limited liability companies above the thresholds for statutory audit:

- A Collegio Sindacale is required by law as an independent supervisory board, which is charged by law with controlling the conformity to law and to the company’s statutes of all actions undertaken by directors and management. The three members of the supervisory board are elected by the general assembly of shareholders and at least one member must be a registered auditor (in most cases all three are registered auditors).

- The very few, listed or non-listed, companies that have a dualistic or monistic governance system have a supervisory board (appointed by the general assembly of shareholders) or a committee (appointed by the board).

- The UK has an established best practice to establish an audit committee in the corporate governance code.

Some countries (Cyprus, Denmark, Greece, the Netherlands and the UK) have specific and additional requirements for audit committees in financial institutions.

As is apparent from the description above, European countries have chosen different combinations of legislative measures to implement audit committees and corporate governance in general in their jurisdiction.

The implementation is based on traditions, common practice, and in relation to the approach to company law in general in a particular country. Audit committees function as a subcommittee of the board in any of the overall corporate governance systems. The audit committee, in practice, advises the board on financial reporting matters and can have decision-making power on matters that are delegated from the board.
As noted in figure 2 above, there are different approaches with regard to whether the board can take up the responsibility of an audit committee, as this can be done in 13 out of 20 countries.

Six countries\(^9\) have not exempted any company to have an audit committee, whilst fifteen countries have introduced exemptions. The exemptions introduced are for example related to:

- Audit committee only required for listed entities (on a regulated market).
- SME entities.
- Insurance undertakings, banks, collective investment undertakings, companies issuing asset backed securities, investment funds, etc.

In addition, some exceptions are in place in some of these countries:

- In two countries (Latvia and Norway), an exception for smaller listed entities is in place. Companies below a certain threshold (SME threshold) are exempted from establishing an audit committee.
- In France, the board does not have to comply with independence and competence requirements if they take up the role of the audit committee, whilst it is the opposite in Norway, where the same provisions apply to the board if they perform the role of audit committee.
- Poland has established an exception stating that the role of the audit committee can only be taken up by the board if the board consists of no more than 5 members.
- In France and Hungary, the task of audit committees can be taken up by any other board or committee and is not restricted to the board itself.
- In Spain, savings banks can appoint an alternative committee.

Under certain circumstances as described in the Directive, Member States may exempt certain public interest entities from the obligation to have an audit committee. These exemptions apply to, for instance, subsidiary undertakings, collective investment undertakings and certain small and medium-sized public interest entities\(^10\).

For other entities than public interest companies, requirements to have an audit committee are applied in five countries\(^11\); for entities such as:

- The Federal Administration and the National Bank, or
- A liquidation organisation and large non for profit sector companies, or
- Public corporations/public sector bodies/companies of substantial public interest, including all financial institutions.

However, the scope of companies depends largely on the definition of public interest entities, which, as mentioned, varies from one Member State to another.

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\(^9\) Greece, Hungary, Italy, Portugal, Romania, UK
\(^10\) Article 41 paragraphs 1 and 6 set out the exemptions in more detail. Especially with regard to small and medium-sized entities article 41 paragraph 1 states that Member States for certain small and medium-sized public interest entities “… 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.” The companies are to be public interest entities which according to their last annual or consolidated accounts meet two of the three thresholds:
- Net turnover: 50 mio. euros
- Balance sheet total: 43 mio. euros
- Number of employees: 250
\(^11\) Belgium, Cyprus, Greece, Ireland, UK
The FEE analysis showed that almost all countries comply with the EC Recommendation on independent non-executive directors. Austria, Germany and Norway are the only three countries where the EC Recommendation has not been implemented at national level. Although the preparatory work of the Norwegian law implementing the Statutory Audit Directive refers to the EC Recommendation. Additionally, a reference in the Norwegian legislation is made to independence of the audit committee members, which then entails an indirect implementation of the recommendations related to independence.

Other countries highlight the independence requirements as stemming from the recommendation without highlighting that the EC Recommendation as a whole has been implemented at national level.

European Commission proposals

The European Commission proposes to regulate audit committees through a regulation, a measure which would lead to the highest level of harmonisation possible in European legislation.

However, since audit committees are just one part of the overall corporate governance system, there may be challenges in reaching a truly harmonised approach with regard to audit committees, despite the legal measure used at European level. The reason is that the need for flexibility regarding the set-up of audit committees remains in order to accommodate for the different company law systems and corporate governance models that will continue to exist even after implementation of the EC proposed Regulation on audit of public interest entities and audit committees as proposed.

2.2. Composition

Current provisions

Article 41 paragraph 1 of the Statutory Audit Directive requires that the composition of the audit committee is as follows:

“... 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. ....”

The composition of an audit committee includes requirements in relation to the appointment of the members. The Directive contains a number of exemptions to these general requirements dealing with the composition of the audit committee.

The EC Recommendation on independent non-executive directors provides further guidance on the internal organisation of the audit committee and the work in general, which are issues related to the appointment of the chair of the audit committee, the relationship between the audit committee and the board, as far as the reporting responsibilities and documentation for the conclusions made by the audit committee are concerned, and the relationship between the auditor and the board.

Furthermore, the EC Recommendation encourages a rotation of board members by noting that non-executive directors should be appointed for specified terms at maximum intervals with a view to enable both the necessary development of experience, and sufficiently frequent reconfirmation of their position.
Appointment of audit committee members

Current provisions

The Statutory Audit Directive entails that members of the audit committee can be appointed by the board or by the shareholders. In general, the EC Recommendation states that board committees, including the audit committee, work under the delegation of the board, it states in the preamble that “…the (supervisory) board should therefore determine the desired composition of the audit committee …”.

Findings of FEE Survey

As displayed in Figure 3 above, a majority of the countries require or recommend that the members of the audit committee should be appointed by the board. In addition to this, some countries have specific additional requirements in relation to the appointment of the audit committee members, such as in relation to:

- In three countries\(^\text{12}\), whether the members have been appointed by the board or by the shareholders, it is explicitly required that the members of the audit committee have to be members of the board.
- In France, it is explicitly required that the shareholders are not to appoint members of the audit committee.
- The specific requirements regarding the audit committee in Germany as described in section 2.1 above, are also applicable here, as in the case of a public interest entity that has not established a supervisory or administrative board with one independent member that has competence in accounting or auditing, that entity must establish an audit committee whose members are appointed by the shareholders.

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\(^{12}\) France, Portugal, Sweden. In all these countries, the audit committee members must be non-executive board members
- For Italy, the general rule calls for a Collegio Sindacale to be appointed by the general assembly of shareholders. Reference is made to section 2.1 above for a description of the appointment of an audit committee in Italy.

- In the UK, audit committee members are appointed by the board from amongst the independent directors. Members of the board are usually appointed by the shareholders. Though they may be appointed as members of the board, and thus become eligible to sit on board committees, their appointment is subject to confirmation by the shareholders at the next general meeting of the company.

Normally, if an audit committee member does not fulfil the assigned duties, the member can be removed by the board. Only in the countries where the audit committee is appointed by the shareholders at the annual general meeting, the board cannot remove the member from the audit committee without approval by the shareholders.

The audit committee should ensure sufficient diversity in its board and its board committees based on the overall principle of “the best person for the job”. In this approach, due care should be given to the competences, qualifications and the collective responsibilities of the audit committee, whether or not this entails more differences in gender, background, age, ethnicity, etc. When appointing members, it is important to recruit from a sufficiently large and diversified pool of candidates. A diversity policy describing these principles is bound to result in companies having more focus on diversity in general.

**European Commission proposals**

Even though the general principle regarding appointment (appointment of the audit committee and its members being done by the board or by the shareholders) remains the same, the EC proposals for audits of public interest entities will alter the current approach of having each EU Member State decide this. The proposed Regulation will entail that the body that appoints the audit committee and its members is to be decided by the entity itself and not by the EU Member State based on national legislation. Although it will provide more flexibility for each company with regard to appointment of audit committee members, this change will lead to less harmonisation at national level. This is not preferable, as the aim of strengthening the role of audit committees would benefit from a common approach in each Member State.

**Number of audit committee members**

**Current provisions**

The number of audit committee members is not specified in the Statutory Audit Directive. The EC Recommendation on non-executive directors stipulates that board committees are composed of at least three members, with an exception of at least two members in case of small boards.
Findings of FEE Survey

Minimum number of audit committee members

Figure 4: Minimum number of audit committee members

In 12 countries, the minimum number of audit committee members is specified (minimum 3), as displayed in figure 4 above. A few details and exceptions are introduced in relation to the minimum number of members of an audit committee. These are for instance:

- Audit committees in Austria are required to include an employee representative (1/3 of the audit committee members).
- Although not specified, it is common practice in Germany that a “committee” consists of more than one member, and also often more than two.
- An exception for smaller listed companies (i.e. those outside the FTSE 350 index) is introduced in the UK. Such companies can have audit committees with only 2 members.

A majority of the countries have specific provisions regarding the chair of the audit committee. Figure 5 displays the different approaches.
More than half of the countries have specific requirements regarding the chair of the audit committee. In most of these countries, the chair of the board cannot act as chair of the audit committee. In Cyprus and Norway, the chair of the board can only act as chair of the audit committee, if he or she is a non-executive director.

European Commission proposals

The proposed EC Regulation for audit of public interest entities explicitly requires that the audit committee is to be composed of non-executive board members and/or members appointed by the general meeting of shareholders\textsuperscript{13}. It is currently up to the Member State to decide how audit committees should be composed, as per article 41 of the Statutory Audit Directive above.

The EC proposals would strengthen the composition and independence of the audit committee and would lead to an even more objective monitoring by the audit committee, which would further contribute to strengthening the role of the audit committee, although the wording of the proposed Article 31 could be clarified. This clarification would ensure that all members of the audit committee are non-executive directors, regardless of whether the member is appointed by the board or by the shareholders. This would implicitly entail that management or even the CFO of the company is not to be a member of or to chair the audit committee.

\subsection{Independence of audit committee members}

\subsubsection*{Current provisions}

The Statutory Audit Directive requires that at least one member shall be independent. Furthermore, the Directive refers to the EC Recommendation on non-executive directors for more detailed guidance on how audit committees should be established and function.

\textsuperscript{13} Proposed EC Regulation for audit of public interest entities, article 31
The EC Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the board\textsuperscript{14} contains more specific criteria for independence of members of the audit committee by stating that independence means “… free of any business, family, or other relationship, with the company, its controlling shareholder or management of either, that creates a conflict of interest such as to impair his judgement”. Furthermore, the EC Recommendation states that at least a majority of the audit committee members should be independent.

In addition, the EC Recommendation sets out that 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 at national level for assessment of the independence of directors, the director cannot be considered independent owing to the specific circumstances of the person or the company, and the converse also applies. The assessment of the profile of independent directors should be based on due consideration of at least the following:

a. Not to be an executive or managing director of the company or an associated company for the previous five years or not to be an employee of the company or an associated company for the previous three years (unless the audit committee member is an employee representative). This also includes receipt of significant additional remuneration (such as share options) apart from a fee received as non-executive or supervisory director and compensation under a retirement plan.

b. Not to be or to represent the controlling shareholder(s).

c. Not to have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee as well as not to be a close family member of an executive or managing director.

d. Not to be, or have been within the last three years, partner or employee of the present or former external auditor of the company or an associated company.

e. Not to have served on the board as a non-executive or supervisory director for more than three terms (or, alternatively, more than 12 years where national law provides for normal terms of a very small length).

Findings of FEE Survey

In seven countries\textsuperscript{15}, the independence requirements for audit committee members are the same or similar to those of the EC Recommendation. Another fourteen countries\textsuperscript{16} have a majority of independent audit committee members or some of the criteria stated above from the EC Recommendation included in national laws or recommendations. Only Hungary and Slovenia have no specific provisions on independence.

Denmark has one exception in relation to cooling off period for former employees as the Danish cooling off period is set to 5 years instead of the recommended 3 years according to the recommendation.


\textsuperscript{15} Belgium, Czech Republic, Denmark, France, Norway, Portugal and Sweden

\textsuperscript{16} Cyprus, Finland, Germany, Greece, Ireland, Italy, Latvia, the Netherlands, Poland, Romania, Slovak Republic, Slovenia, Spain, UK
The number of independent members of audit committees is set out in the figure below:

![Number of independent members in audit committees](image)

As is apparent from Figure 6 above, provisions regarding the number of independent members of audit committees vary across Europe with half of the countries being in line with the Statutory Audit Directive stating that one or at least one member of the audit committee should be independent.

A few countries have some additional criteria, such as:

- In Germany and Slovenia, the independent member shall be the member with expertise in accounting and/or auditing. In Austria, both the chair of the audit committee and the member with expertise in accounting and auditing need to be independent.

- In addition to require that all members should be independent, Finland explicitly requires that at least one member should be independent of the significant shareholders.

- In the UK, the chair of the board can be a member, but not a chair of the audit committee in smaller companies, provided that the person was independent at the time of appointment as chair of the board.

Disclosures of the independence for the members of the audit committee are required or recommended by nine countries to be included in the annual report or the corporate governance statement. In Greece, this information should only be disclosed to the regulator.

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17 Austria, Belgium, Cyprus, Finland, France, Italy, the Netherlands, Norway, Spain
It is normally the board that carries out the assessment of whether the audit committee has fulfilled the requirements regarding independence (12 countries\(^{18}\)). In three countries (Greece, Latvia and Portugal), the shareholders perform this task. In Italy, non-compliance with the independence requirement in the internal body (Collegio Sindacale) in the company is required to be declared by the board (or by the shareholders in a one-tier, monistic or dualistic system) within 30 days from the appointment or from its learning of the failure.

**EC proposals**

The EC proposals for a new regulation for audits of public interest entities suggest that a majority of the members of the audit committee should be independent, which is strengthening the current requirement in the Statutory Audit Directive of only one member being independent. Having the majority of the audit committee members independent is, however, in line with the 2005 EC Recommendation on The Role of Non-executive directors in listed companies. As referred to in the EC proposals\(^ {19}\) this EC Recommendation sets out how audit committees should be established and function. Therefore, independence of audit committee members is to be understood as set out in the 2005 EC Recommendation described under “Current provisions” above.

This further underlining in European legislation of the importance of independent audit committee members and independent as a whole would be viewed as a step in the right direction. It would contribute to a more objective and more effective monitoring from the viewpoint of the audit committee whilst also maintaining the presence of knowledge about the company.

Furthermore, the EC proposals for audit of public interest entities suggests that an auditor, after having resigned as statutory auditor or key audit partner of an audit engagement, can only be a member of an audit committee of the audited entity until at least two years have passed since resigning as a statutory auditor or key audit partner from the audit engagement.

This proposal goes further than the current Statutory Audit Directive which does not specify such a time interval for a cooling off period for a statutory auditor becoming a member of the audit committee of a former client. The EC proposal is less stringent than the current 2002 EC Recommendation on auditor’s independence, which recommends that the cooling off period for an auditor in the external audit firm responsible for the audit of the company to take up audit committee mandates is 3 years.

However, the EC proposal could be made less specific as it would be sufficient, for independence reasons, to require such a cooling off period for a period of 12 months before taking up a position as member of the audit committee of an entity that was an audit client of the previous key audit partner, or before being in a position to exert significant influence over the preparation of the client’s accounting records or the financial statements. This approach would be in line with the equivalent international provisions on the matter in the International Ethics Standards Board (IESBA) Code of Ethics.

Furthermore, it is not clear, neither in the current provisions at European level nor in the EC proposals, whether members of the audit committee are all to be members of the board. Alternatively, the board (or the shareholders, as appropriate) can decide to appoint audit committee members that are not board members. Such a solution could be used to highlight the need for independence and objectivity in the audit committee in comparison with the work of the board, but could compromise the overall principle of the audit committee being a subcommittee of the board.

\(^{18}\) Cyprus, Finland, France, Germany, Ireland, Italy, Malta, the Netherlands, Slovenia, Spain, Sweden, UK

\(^{19}\) EC proposals for a Regulation for audits of public interest entities, Recital 23
2.2.2. Competence of audit committee members

Current provisions

The Statutory Audit Directive requires that at least one member of the audit committee shall have competence in accounting and/or auditing.

Furthermore, the EC Recommendation states that the members of the audit committee, should, collectively, have a recent and relevant background in and experience of finance and accounting for listed companies appropriate to the company’s activities.

Findings of FEE Survey

Seven countries have requirements or recommendations in line with the EC Recommendation.

Some countries have added some specific criteria in relation to the requirement on competence, such as:

- A university degree in economy or finance or significant professional experience.
- At least three years of practical experience in the area of accounting, finance or statutory audit.
- A professional qualification from a professional accountancy body or another relevant professional organisation.

The EC Recommendation recommends induction programmes for new members of the audit committee. Seven countries have required or recommended such an initiative. Three countries have more detailed guidance on the context of the training for new members and subsequently for the members to maintain such knowledge.

In four countries, there are requirements or recommendations to disclose information about the competence in accounting and/or auditing. Such disclosures can be included in the corporate governance statement or elsewhere in the annual report, whether separate or not.

It is common that the board (9 countries) performs the assessment on whether the audit committee (member) complies with the competence requirement. In three countries, (Greece, Latvia and Portugal) the shareholders are responsible for making this assessment in the annual general meeting. In Finland, the assessment of whether the audit committee has sufficient competence in accounting and auditing matters is done through a self-assessment. In some countries, specific criteria or additional guidance have been provided on this matter, such as:

- In France, it is common that when documents do not specify whether the competence requirement is complied with, a former managerial position can often be considered as sufficient to have the required level of competence to be a member of the audit committee.

- In Latvia, representatives of the shareholders suggest candidates with the necessary experience whilst the supervisory board may assist in carrying out this assessment.

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20 Belgium, Denmark, Finland, Italy, Norway, Romania, Slovak Republic
21 Cyprus, Denmark, the Netherlands, Romania, Spain, Sweden, UK
22 Cyprus, the Netherlands and the UK
23 Belgium, France, Norway, Spain
24 Cyprus, France, Germany, Ireland, Malta, the Netherlands, Slovenia, Sweden, UK
In Malta, the initial assessment on competence is made by the board based on the individual’s Curriculum Vitae verified through information from individual sources.

European Commission proposals

The EC proposals for audits of public interest entities suggest that at least one member of the audit committee shall have competence in auditing and another member in accounting and/or auditing. This would be a more stringent approach than the current one where only one member shall have competence in accounting and/or auditing.

Although it is clearly appropriate to strengthen the competences of the audit committees, it may in practice be more appropriate for the audit committee as a whole to have the appropriate balance of competences. Other competences, such as competences in risk assessment, business strategy and business models may also be relevant for the audit committee. Audit committees are normally quite small in order for them to be as efficient as possible. This means that a more principles based approach to the composition, in addition to having one member with experience in accounting and/or auditing, would be more appropriate.

2.2.3. Compensation of audit committee members

European Commission proposals

Compensation of audit committee or board members is not addressed in the Statutory Audit Directive or in the EC Recommendation on non-executive directors. Two different EC Recommendations address the issue of remuneration for directors with the most recent one focusing on remuneration for directors in financial companies. In addition, the European Commission has, in the late 2009, issued a draft directive addressing remuneration of directors of financial companies which is based on the recommendation on the same issue. The relevant EC documents are the following:

- EC Recommendation on “Fostering an appropriate regime for the remuneration of directors of listed companies” of 14 December 2004. The European Commission has evaluated the implementation of this recommendation and has issued a report on its findings in 2007.

- EC Recommendation on “Independence of non-executive directors” from 2005, where remuneration is specifically an issue that should be addressed as the board should set up a committee that deals with remuneration for executive or managing directors.

- EC Recommendation on “Remuneration policies in the financial sector” of 30 April 2009.

- Proposal for amendments to the Capital Requirements Directive addressing the supervisory review of remuneration policies.
None of these EC Recommendations, nor the draft directive, address compensation for members of the audit committee, but they deal with remuneration for executive directors and management of the entity. This is presumably due to the fact that most audit committee members are also board members. The recommendations on remuneration are similar in all documents where they recommend that:

- A remuneration policy should be developed and applied for executive directors.
- Shareholders’ vote on such a policy should be solicited.
- The remuneration policy should be disclosed.

Although the principles regarding remuneration are not directly applicable for the audit committee, the principles for remuneration for executive or managing directors could be applied to the audit committee members by analogy.

Findings of FEE Survey

Out of the nine countries that have some or all of the three principles for audit committee members (a remuneration policy, shareholders’ vote on the policy and disclosures), as displayed in figure 7 above, four of them require companies to disclose information related to remuneration of audit committee members.
It varies in practice whether the remuneration policy of the supervisory board and/or its committees is approved by the board (in case of specific settings for the audit committee) or by the shareholders. In Cyprus and Slovenia, for instance, it is the board that approves the remuneration, whilst in Finland, France, Germany, Hungary, the Netherlands, and Sweden, it is the shareholders that approve the remuneration policy at the annual general meeting. Furthermore, there are variations as to the additional guidance that is provided in some countries, such as:

- **Remuneration for the time devoted:**
  - In Cyprus, Greece, France, Malta and Sweden, it is explicitly required or common practice that the remuneration for the work in the audit committee is determined in accordance with the time devoted, such as the number of meetings held. In the UK, the remuneration of non-executive directors should reflect the time commitment and responsibilities of the role.
  - In Germany and the UK, the chairman of the audit committee usually receives additional remuneration, as it is expected that the chair devotes more time compared to the members of the audit committee.
  - In Germany and Hungary, members of audit committees are not allowed to receive remuneration for work done in an audit committee in addition to the remuneration received as members of the board.

- **Variable or fixed amount:**
  - Six countries have some restrictions that do not allow for the compensation of the audit committee members to be based on share based payment or performance related measures.³⁰
  - In two countries, Germany and Italy (in the latter case when voluntary audit committees established in accordance with the national Italian corporate governance code), the compensation can or shall have some performance related element. Compensation of Collegio Sindacale members in Italy is generally not linked to the company’s performance. In Germany, a high level of variable compensation is broadly viewed as potentially conflicting with oversight responsibilities of the audit committee and its members. This is similar to Denmark, where independence requirements for the audit committee members are normally viewed as preventing them from receiving large compensation amounts.
  - In the Netherlands, the remuneration of supervisory board members cannot be dependent on the results of the company.
  - In Greece and Portugal, the audit committee is usually remunerated by a nominal fee for the work in the audit committee.
  - In Malta, members of audit committees cannot have remuneration for this task as their main source of income.

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³⁰ Austria, Finland, France, Norway, Portugal, UK
FEE Recommendations

With the aim of further strengthening the Composition, Independence and Competence of audit committee members, the following could be considered:

1. FEE recommends that it is further clarified that the audit committee acts as a subcommittee of the board.

2. FEE recommends that all members of the audit committee are non-executive directors regardless of whether the member is appointed by the board or by the shareholders. This would implicitly entail that management or even the CFO of the company is not to be a member of the audit committee, neither to chair the audit committee.

3. FEE supports the EC proposals to require that the majority of the members of the audit committee to be independent as well as requiring that the chair of the audit committee is independent.

4. FEE recommends that the collective competence of the audit committee should reflect the appropriate skills needed to carry out the work in a responsible manner. This would reflect the collective responsibility that the audit committee has and would be an appropriate principles-based approach, which also gives due consideration to the complexity of the company as a whole. This also impacts on the decision on what the appropriate number of members in the audit committee should be.

5. FEE recommends that more guidance is provided as to what is understood as “competence”. Such guidance could for instance indicate that a university degree in economy or finance, a professional qualification from a relevant professional organisation or significant professional and practical experience in accounting and/or auditing qualify as “competence” for an audit committee member.

6. FEE recommends that the audit committee is sufficiently diverse in its membership based on the principle of “the best person for the job”. In this approach, due care should be given to the competences, qualifications and the collective responsibilities of the audit committee, whether or not this entails more differences in gender, background, age, ethnicity, etc.

2.3. Responsibilities and tasks of the audit committee

Audit committees are deemed to help minimising financial, operational and compliance risks and enhancing the quality of financial reporting. Following the Statutory Audit Directive, the audit committee shall carry out a number of tasks without prejudice to the responsibility of the members of the management or supervisory bodies.

According to the Statutory Audit Directive the audit committee shall:

- Monitor the financial reporting process, such as reviewing critical accounting policies.
- Monitor the effectiveness of the company’s internal control, internal audit where applicable, and risk management systems.

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31 Preamble (24) of the Statutory Audit Directive
32 Article 41 paragraph 2 of the Statutory Audit Directive
• Monitor the statutory audit of the annual and consolidated accounts.

• Review and monitor the independence of the statutory auditor or audit firm and in particular the provision of additional services to the audited entity.

• Provide a recommendation on the proposal to the administrative or supervisory body to appoint a statutory auditor or audit firm.

In general, the audit committee should apply sufficient professional scepticism when reviewing the information that they receive. In this way, the monitoring responsibilities of audit committee are also preventive, as they may influence the incentives for management not to engage in fraudulent behaviour due to the heightened scrutiny of risk management systems and financial reporting procedures that the audit committee carries out. This offers additional comfort for the investors to rely on the financial information provided by companies.

A well-functioning audit committee is beneficial to the external or statutory auditor as its work should contribute to an enhanced level of audit quality in the way that good quality information provided to the external auditor facilitates high quality internal control and risk management performance and assessment during the audit.

2.3.1. Terms of reference for the audit committee

Current provisions

The EC Recommendation on non-executive directors recommends development of Terms of Reference for the audit committee. The content is not specified in detail in the EC Recommendation but could contain the following elements:

a. Periodic review of the composition of the audit committee.

b. Delegation of the decision-making power addressing tasks and responsibilities.

c. Frequency of meetings.

d. Necessary time and attention to be devoted by members to assure the proper performance of duties.

e. Reporting responsibilities, including the frequency of such reporting:

• To other bodies in the entity.
• To the public.

The EC Recommendation on the role of non-executive and supervisory directors in listed companies also includes a number of relevant principles recommending a yearly self-assessment and evaluation of the board as well as transparency and communication on these matters.

In the continuous improvement of the day-to-day work of the audit committee, a regular self-assessment of the work and functioning of the audit committee as part of the self-assessment of the board is recommended to be carried out.
Findings of FEE Survey

Sixteen countries require or recommend development of terms of reference for audit committees with all or some of the points above.

Experience regarding the functioning of audit committee is building up in many European countries with the implementation of the Statutory Audit Directive that facilitated a significant and tangible step forward regarding audit committees in Europe. Trends or common practice for the implementation and functioning of the required or recommended terms of reference for audit committees can therefore be further analysed when the audit committees will have been through a few more cycles of financial reporting. In general, audit committees should have an open communication among its members and with its counterparts. It should have regular meetings that are aligned with the cycle relevant for the company as a whole.

As an audit committee is set up as a subcommittee of the board, it does not have and it is not common that the audit committee has decision-making power. The audit committee acts as an advisor to the board and assists the board regarding financial and audit matters. There may be some matters of a more operational character where the board has de facto delegated some decision-making power, which is seen for instance in Germany, where it is common that the audit committee has decision-making power with regard to matters such as audit fees, significant audit areas and discussions of quarterly financial statements. In practice, it may be helpful for audit committees to have more guidelines on how to operate with delegation of powers between the board and the audit committee as well as with other board committees.

When assigning responsibilities to the audit committee and its individual members, each member as well as the body appointing the members should ensure that the audit committee members are able to devote sufficient time and the necessary attention to the task, also in times of crisis. This is in line with the 2005 EC Recommendation on the role of non-executive or supervisory directors in listed companies which entails that directors in listed companies are discouraged from accepting too many appointments.

Further details to complement the overarching principle of sufficient time could include:

- Requiring that the expected time commitment is clearly specified in the terms of reference for the audit committee, such as the number of meetings, expected contribution of each of the members, participation in cooperation with other board committees, etc.

- Highlighting considerations related to proportionality, such as size and complexity of the company and the line of business it operates in.

- Setting specific expectations for members’ involvement in general and in times of crisis.

In general, the audit committee bases its work on reporting from others, such as from management. For instance, it is common that the financial reporting process is monitored in relation to the reporting cycle, such as half-yearly and/or annually whilst effectiveness of internal control can be monitored through the work carried out by management or by the internal audit function at continuous meetings throughout the year. Practices may, however, vary significantly from one company to another.

Furthermore, it is common that all members of the audit committee, the chief financial officer, the internal audit function and sometimes the chief executive officer attend the closing meeting with the external auditor for the finalisation of the external audit of the financial statements.

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33 Seen in Cyprus, Germany, Greece, Hungary, Latvia, Malta, Portugal
In some countries (such as in Germany, Greece and Hungary), separate closing meetings between the external auditor and management take place without the attendance of the audit committee. Meetings without attendance of management, i.e. only between the external auditor and the audit committee, also take place.

The topics that are common for debate relate to, for instance:

- Internal control matters, including weaknesses identified by the auditor during the external audit.
- Financial reporting matters, such as significant accounting policies applied and risk related issues.
- Audit related matters, such as unadjusted audit differences and general experiences during the performance of the external audit.
- Assurance and assurance-related services (such as services related to financial reporting) and non-audit services provided by the external auditor.

In general, it is important to reinforce the tools available for the audit committee, including making a clear link between internal control, internal audit and risk management.

**European Commission proposals**

The EC proposals reinforce the scope and tools for the work on evaluation of internal control which is to be carried out by the audit committee. This will also reinforce the internal audit and risk management functions. In addition, the practical discharge of the monitoring responsibilities, especially in relation to evaluation of the effectiveness of internal control of the audit committee could be further specified. It could also be considered to require audit committees to more closely monitor day-to-day operations of the company, such as in relation to early warning monitoring (regarding the going concern of the company).

The self-assessment of the audit committee could be further elaborated and should preferably also include an assessment of possible improvements regarding the relationship with the board and other board committees.

**2.3.2. Responsibilities of the audit committee related to non-audit services**

**Current provisions**

Article 42 of the Statutory Audit Directive requires the statutory auditor to discuss threats to independence with the audit committee as well as the safeguards applied to mitigate those threats.

**Findings of FEE Survey**

Nine countries have specific detailed provisions in this regard that provide more guidance on how the audit committee should act with regard to this reporting on independence of the external auditor. A number of countries provide additional guidance in relation to the independence of the external auditor, for instance:

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34 Austria, Belgium, Finland, France, Germany, the Netherlands, Slovak Republic, Spain, UK

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In a number of countries, a specific reference to the assessment of the non-audit services provided by the statutory auditor is made, although such disclosure may not be mandatory (as in France). This is in addition to the already required disclosure of additional services provided by the auditor in the Statutory Audit Directive. For instance:

- In Cyprus, the audit committee should keep the nature and extent of non-audit services under review, in case they are substantial, seeking to balance the maintenance of objectivity and added value provided.
- In Finland, pre-approval procedures are often established, even if these procedures have been delegated to the internal audit department of the audited entity.
- In the UK, the regulator has issued specific guidance in relation to the audit committee’s responsibilities for non-audit services. The audit committee should seek reassurance that the auditors and their staff have no financial, business, employment or family and other personal relationship with the company which could adversely affect the auditor's independence and objectivity, taking account of relevant ethical standards. The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.
- In Spain, the audit committee is required to annually issue a report with its opinion on the independence of the auditors with specific reference to non-audit services.
- Monitoring responsibilities for the audit committee normally also include monitoring of the effectiveness and the results of the work of internal audit in Finland and the Netherlands or the effectiveness of compliance measures or compliance management systems, like in Germany and the Netherlands.

In case of differing opinions between the statutory auditor and the entity, it is required or recommended in five countries\(^{35}\) that such differing opinions are reported to the board/those charged with governance.

**European Commission proposals**

Specifically in relation to non-audit services, the EC proposals regarding audit of public interest entities entail that the audit committee would have to pre-approve the provision of some non-audit services.

### 2.3.3. Responsibilities regarding appointment of the auditor

**Current provisions**

Article 37 of the Statutory Audit Directive regarding the appointment of statutory auditors or audit firms for all entities requires that:

> “The statutory auditor or audit firm shall be appointed by the general meeting of shareholders or members of the audited entity.”

\(^{35}\) Denmark, Finland, France, Portugal, Spain
Member States may allow alternative systems or modalities for the appointment of the statutory auditor or audit firm, provided that those systems or modalities are designed to ensure the independence of the statutory auditor or audit firm from the executive members of the administrative body or from the managerial body of the audited entity”.

The audit committee is involved with the appointment of the statutory auditor or audit firm as the appointment in a public interest entity should be based on a recommendation made by the audit committee.

Regarding dismissal and resignation of statutory auditors or audit firms, the Statutory Audit Directive requires that they may be dismissed only when there are proper grounds. Divergence of opinions on accounting treatments or audit procedures shall not be proper grounds for dismissal. According to preamble 22 of the Directive the requirements regarding dismissal are protect the independence of the auditor.

Findings of FEE Survey

In all countries, the auditor is appointed by the shareholders, which either is or can be based on a recommendation by either the board or the audit committee.

14 countries have requirements that only allow dismissal of the statutory auditor, if there are proper grounds to do so. In some countries there are in addition explicit requirements stating that the auditor can only resign if it is justified (i.e. for serious personal reasons, not against good audit practice or when reasons for the resignation are provided). In France, the dismissal of an auditor shall be approved only by a court.

In a majority of these countries, reporting of the reason for dismissal or resignation should be done to the authorities.

In five countries\(^{36}\), the audit committee is to be involved with the dismissal of the auditor, for instance by submitting a proposal to the board to do so.

Some additional guidance is provided in some countries as to the criteria for the audit committee to make a recommendation for appointment of the statutory auditor. This guidance consists of:

- Stating that the shareholders must be informed about the external auditor candidate in a timely manner prior to the general meeting.
- Stating that the audit committee shall obtain a statement from the proposed auditing firm stating whether and where applicable, which business, financial, personal or other relationships exist between the external auditor and the entity.
- An example of a proposal for the assignment of an audit engagement duly justifying the choice of candidates.

European Commission proposals

As mentioned above, it is already required that the appointment of the auditor is based on a recommendation made by the audit committee. The EC proposals include a number of initiatives to strengthen the involvement of the audit committee in the selection process and the appointment of the auditor. The measures entail that the audit committee is to be explicitly responsible for the procedure for selection and appointment of the auditor. This includes:

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\(^{36}\) Cyprus, Germany, Ireland, Spain, Sweden
• Organising audit tenders at regular intervals based on the mandatory audit firm rotation; and
• Deciding whether or not to appoint more than one auditor.

The tendering process is only to be initiated in case of appointment of the auditor, and thus not if the company decides to appoint its statutory auditor for a second term.

The EC proposals specify that the recommendation from the audit committee shall contain at least two choices of statutory auditors for the audit engagement and that the audit committee shall express a duly justified preference for one of the auditors proposed. At least one of the proposed candidates shall be an auditor or audit firm that does not receive more than 15% of its audit fees from large public interest entities.

Additionally, the audit committee shall explicitly state that no contractual clauses have been imposed upon it in making the recommendation. It should also ensure that the tender documents contain transparent and non-discriminatory selection criteria that shall be used by the audited entity to evaluate the proposals made by candidate audit firms. This should lead to the use of criteria for the selection of the auditor that are not just cost-driven, but are based on an informed assessment of the quality of the audit services to be provided.

The proposals for tendering of the audit of public interest entities at regular intervals entail tendering at least every 6 years, depending on the duration of the maximum two terms that the same auditor can be appointed. The selection procedure, including the enhanced involvement of the audit committee follows the figure below:

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37 Proposed EC Regulation for audits of public interest entities, articles 32 and 33
The proposed enhanced involvement of the audit committee in the selection and appointment procedure would clearly strengthen the appointment process being sufficiently independent of management. The tender process should be as efficient and cost-effective as possible for the company. In this context, it is appropriate that a tender process is initiated only upon appointment of a new auditor and thus not in case the board, based on a recommendation from the audit committee, decides to appoint the statutory auditor for a second term. The audit committee should carry out regular assessments of the functioning of the auditor as well as of the cooperation between the external auditor and the audit committee. This would be useful as this would make the audit committee being prepared for any upcoming tender and selection process of a new auditor (or in case of a decision to renew the term of the existing statutory auditor).

With the valid objective of enhancing choice in the audit market, the European Commission proposes that companies, being public interest entities, should be required to appoint a new audit firm every 6 years as a general principle. However, the solution proposed by the Commission is unlikely to stimulate a more vibrant audit market and can also have undesirable effects.

The real impact of mandatory rotation of audit firms on market structure remains unknown. Based on the limited experience available, many consider that it would increase (not reduce) concentration.

The model proposed by the European Commission for rotation of audit firms is supplemented with the option to appoint more than one statutory auditor. When a company decides to have more than one auditor, it would be allowed to rotate the auditor(s) with longer intervals. The proposed model can be illustrated as follows:

**Mandatory audit firm rotation**

![Diagram of mandatory audit firm rotation](image)

*Figure 9: Mandatory audit firm rotation, based on the EC proposed Regulation for audits of public interest entities, article 33*

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38 Proposed EC Regulation for audits of public interest entities, article 33
There is little doubt that imposing rotation every 6 years might be counterproductive. Companies may very well face practical difficulties in complying with the numerous thresholds that are included in the model (2 terms, term minimum 2 years, 6 consecutive years of joint audit, rotation of audit firms at different intervals in case of joint audit as encouraged in the EC proposals, combination between two terms, maximum 6 years and key audit partner rotation every 7 years, etc.). Furthermore, it is not clear under which conditions the additional third term would be granted, as the “exceptional circumstances” are not explained in detail.

The model proposed for mandatory audit firm rotation will severely restrict the auditors’ knowledge of the entity being audited and potentially reduce the quality and value of the audit. Similarly, it is likely to cause unnecessary disruption and therefore increase risks and cost.

FEE Recommendations

With the aim of further strengthening the responsibilities of audit committee, the following could be considered:

7. FEE recommends that the responsibility of the audit committee vis-à-vis the board and other board committees is clarified. This should include guidance on delegation of decision-making power and coordination between board committees, and in relation to obtaining additional advice on specific matters from external parties, such as from the external auditor.

8. FEE supports the EC proposal to reinforce the audit committee’s evaluation of internal control, internal audit and risk management functions and recommends that the practical discharge is further specified, especially in relation to the evaluation of the efficiency and effectiveness of internal control and risk management. Such clarification should include references to review of judgements of key or critical accounting policies and estimates. This will also enforce the tools available for the audit committee, including making the clear link between internal control, internal audit and risk management.

9. FEE recommends that the audit committee carries out regular assessments of:

   a. The cooperation between the external auditor and the audit committee. This assessment should be based on criteria developed by the audit committee that can support an efficient tender process.

   b. Self-assessment of its own work and functioning. The self-assessment should preferably include an assessment of possible improvements regarding the relationship with the board and other board committees.

   The audit committee should have sufficient resources at its disposal to carry out such assessments.

10. FEE recommends that the appointment of the auditor is done in a principles based manner that is easily applicable for companies. This will facilitate the selection process led by the audit committee to be efficient and will limit the company’s costs incurred for the appointment of the external auditor as much as possible.
2.4. Reporting to and from the Audit committee

The audit committee plays a pivotal role in facilitating communication within the company and between the company and the external auditor. The starting point for enhanced internal communication could be the strengthening of audit committees and clarifying their roles and responsibilities vis-à-vis other parts of the governance structure of the entity. In most EU Member States, external auditors of public interest entities report information to those charged with governance that is not considered appropriate to be included in the (public) audit report, but considered sufficiently important to be submitted as part of the (private) reporting by the external auditor to those charged with governance.

The Statutory Audit Directive does not set out any reporting responsibilities of the audit committee. According to the EC Recommendation on the role of non-executive or supervisory directors, the audit committee should report to the board on its activities at least once every six months, at the time the yearly and half-yearly financial statements are approved. The EC Recommendation also sets out that the committees of the board should have their mandate described in the “Terms of Reference” that should be made public at least once a year.

As part of those charged with governance within an entity, the audit committee is charged with some responsibilities related to reporting. In this context, it is important to maintain the key principle that it is the responsibility of management and those charged with governance of an entity to provide the information on an entity that is required by users.

For the company as a whole, there are various user groups of company information and the information provided to them should be tailored to the user-group in question which can be displayed as follows:

- The company itself, its board of directors and any board committees, including the audit committee: Internal reporting on relevant management information in accordance with internal corporate governance codes and other agreed procedures for internal reporting, long-form audit reports and other reporting from the auditor to the company.
- Regulators: Regulatory reporting based on international, European or national requirements, such as Basel II requirements for financial institutions or Solvency II requirements for insurance companies as well as information based on recommendations and national law requirements.
- Users, investors, public: Financial statements, the audit opinion, analysts’ briefings, investor relations’ presentations, etc.

The audit committee is to be involved in the relevant stages of reporting to and from the company as a whole as part of its monitoring and oversight role.

The work of the audit committee and communication about it is of great use to investors and other external stakeholders of the company. More transparency about the work carried out by the audit committee would further facilitate the assessment of the efficiency of the audit committee and contribute to the appreciation for the quality of the financial information provided by the company.

The external auditor has subsequently a separate role to provide assurance on the information provided by the company.
The relationship between all involved parties in an efficient two-way communication can be displayed as set out in the figure below.

**Three party two-way communication**

![Diagram of three party two-way communication](image)

*Figure 10: Three party two-way communication*

### 2.4.1. From the audit committee

**Current provisions**

The EC Recommendation states that the audit committee should report to the (supervisory) board on its activities at least once every six months, at the time the yearly and half-yearly statements are approved. As the audit committee is established as a subcommittee of the board, it has not specific explicit reporting responsibilities to shareholders or users externally, besides recommending that the chairman of the audit committee should be able to communicate directly with shareholders. The Statutory Audit Directive does not include any reporting responsibilities for the audit committee.

The EC Recommendation on non-executive directors includes some provisions regarding reporting irregularities (whistle blowing) for the audit committee. This is done by recommending that the audit committee should review the process for the possibility for employees to report alleged significant irregularities in the company, such as through complaints or through anonymous submissions. The audit committee should ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

**Findings of FEE Survey**

In practice, a variety of means and methods of communication can be identified. Most common are written and oral reports (Finland, France, Greece, Italy, Latvia, Norway, Poland, Portugal), including attendance in board meetings (Cyprus, Italy, Norway), although minutes of the meetings are not always prepared (France), but minutes of all meetings in other countries (such as Malta, the Netherlands and Norway) are very common.
In some countries, the communication is quite formalised and specified, such as in Germany where the audit committee has to report on its activities to the supervisory board in writing but also orally in the next supervisory board meeting subsequent to an audit committee meeting. In Spain, there is direct personal communication between the two chairs and at least one formal meeting per financial year takes place.

In other countries (such as in Ireland), communication takes place, but is not specified in recommendations or guidance, but the frequency and content reflect the particular circumstances of the company.

Nine countries have general provisions related to whistle blowing in laws or recommendations in line of “...those charged with governance should decide whether to establish procedures that facilitates adequate and confident reporting of serious or suspected wrongdoings....”

Two countries (Belgium and Sweden) highlight a legal requirement for the external auditor to report certain kinds of suspected crimes to report to the prosecutor. In Belgium the auditor cannot inform the company in question about such reporting.

Four countries have specific provisions regarding reporting irregularities either from employees to the audit committee or the board and/or from the audit committee to the board or to the shareholders. In Cyprus, there are specific requirements for financial institutions regarding whistle-blowing.

In most cases, there are no specific references to the follow-up from the audit committee or the board, respectively, on reported irregularities.

In practice, some audit committees report to the public in the annual reports of the company, for instance noting the composition and responsibilities of the audit committees, the tasks and topics assigned to the committee. Some audit committees also refer to the issues debated for the current year as well as to remuneration information. Such information is normally most useful for the users, especially when it explains the activities of the audit committee in the current year in a way that is entity-specific and valid for the year in question.

European Commission proposals

The EC proposals on audits of public interest entities do not include any new requirements regarding reporting from the audit committee to the board or subsequently to the public.

2.4.2. Between the audit committee and the external auditor

Communication between those charged with governance and the external auditor already today takes place on a regular basis and in a formalised way. In some countries the dialogue is more formalised than in others and is for instance done in a special long form report whilst in other countries the information is usually included in other documents submitted by the external auditor to those charged with governance. This can be in management letters and presentations to the audit committee based on the responsibilities each of these parties has to fulfil within the financial reporting system.

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39 Denmark, Finland, France, Ireland, the Netherlands, Portugal, Romania, Spain, UK
40 Cyprus, France, Italy, Norway
Current provisions

The statutory auditor is responsible for reporting to the audit committee according to the Statutory Audit Directive as follows\(^\text{41}\):

“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.”

The International Standards on Auditing (ISAs) include requirements and more details guidance on the communication between the external auditors and those charged with governance in ISA 260 and ISA 265\(^\text{42}\), including the board and the audit committee. ISA 610\(^\text{43}\), recently revised, includes some specific requirements and guidance on the relationship between the external and internal auditor.

ISA 260 underlines the need for an effective two-way communication between the external auditor and those charged with governance when an audit is performed. The matters that the auditor should communicate according to the ISAs in question are generally:

- The scope of the auditor’s responsibilities in relation to the financial statements audit.
- Planned scope and timing of the audit.
- Significant findings from the audit.
- Matters related to auditor independence.
- Significant deficiencies in internal control identified by the auditor during the audit.

Findings of FEE Survey

Fourteen countries have more detailed guidance in relation to this requirement with references to previous or current versions of ISA 260 and ISA 265 or to equivalent national standards. This guidance is incorporated in national provisions either as a direct reference in the law to these two auditing standards through either including the main principles of the standards in the law or via a requirement to apply ISAs in general at national level.

One country (Denmark) has a specific legal requirement to include information about key weaknesses in the audit and regarding threats to independence in a long form report that is submitted to those charged with governance.

Five countries\(^\text{44}\) have additional guidance in relation to the auditors’ communication on threats to independence, for instance with reference to the IESBA Code of Ethics or other equivalent guidance on independence.

\(^{41}\) Article 41 paragraph 4 of the Statutory Audit Directive

\(^{42}\) ISA 260 Communication with Those Charged with Governance and ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance

\(^{43}\) ISA 610 on Using the Work of Internal Auditors

\(^{44}\) Denmark, Finland, Germany, Ireland, Sweden
In practice, the auditor attends the meetings of the audit committee, although it is due to different reasons as set out in the figure below:

As apparent from figure 11, in some countries the external auditor attends all audit committee meetings to foster the communication between them and in other countries the external auditor attends the meetings when the audit committee finds it relevant to have the auditor present.

In most countries, the external auditor communicates within the audited entity with both the audit committee and the board\(^{45}\) and in a minority of the countries\(^{46}\) with mainly with the audit committee and only with the board in specific circumstances, such as once a year in connection with the audit of the annual financial statements.

The information that is normally received by the audit committee and/or board is in the form of written reports, presentations and attendance at meetings.

The communication includes normally the external auditor’s views on financial reporting matters, observations regarding the financial statements and/or deficiencies in internal control as well as audit related matters, such as the audit plan for the year. In Germany for instance, the audit committee receives a copy of the management letter upon request, although this letter from the auditor to the management is not normally shared with the board.

Fifteen countries have whistle-blowing provisions for the auditor\(^{47}\), either with reference to ISA 240\(^{48}\) on fraud or directly stating the provisions in the law. These provisions can also include reporting to regulators and/or in relation to criminal investigations as well as communication of irregularities with those charged with governance and/or the audit committee.

In general, it is essential that there is a regular communication between the external auditor and the audit committee throughout the financial year in addition to the discussions held in relation to the annual statutory audit of the financial statements. Such regular dialogue facilitates the efficiency of the work of the external auditor as well as the audit committee.

\(^{45}\) Cyprus, Finland, Germany, Hungary, Italy, Malta, Norway, Poland, Portugal, Slovak Republic, Sweden

\(^{46}\) France, Greece, the Netherlands, Spain

\(^{47}\) Whistle blowing provisions in this context is seen as reporting irregularities:
   a) From the auditor to those charged with governance (entity’s management, board(s) or audit committee)
   b) In particular cases, from the auditor to the audit committee only

\(^{48}\) ISA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements
European Commission proposals

The EC proposes that the auditor submits an additional internal report regarding the results of the statutory audit to the audit committee. This report will supplement the already published audit report. The internal report is proposed to include more detailed information about the audit to the benefit of the audit committee and its monitoring responsibilities.

The internal report is an appropriate initiative that will strengthen the communication between the statutory auditor and the audit committee in addition to the current requirement, that is maintained in the EC proposals, to have the auditor report on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to financial reporting.

The new internal report underlines that some information is relevant for the (private) reporting to the audit committee in addition to what the statutory auditor reports to the public in the audit report, for instance in relation to further references to going concern assessments carried out by the statutory auditor.

2.4.3. To the audit committee from other sources than the external auditor

Reporting responsibilities may have been established between the board and the audit committee through the terms of reference and internal corporate governance codes. The information delivered to the audit committee is normally submitted by management, the internal audit function or by the board.

It is important that the information provided to the audit committee is:

- Timely, concise and of a level of quality that leads to developing appropriate knowledge and understanding of the business.

- Potentially based on guidance from the audit committee to management and other departments in the company as to the type of reports and level of detail of information provided that is of most use to the committee. For instance, this could be in relation to the level of detail needed in the various reports which may be tailored to the audit committee as a whole and to its individual members that possess various competences.

- Leading to a free and open discussion of all topics that are relevant for review by the audit committee.

This will facilitate the efficiency of the monitoring of the quality of the financial reporting carried out by the audit committee.
FEE Recommendations

With the aim of further strengthening the reporting to and from the audit committee, the following could be considered:

11. FEE believes that enhanced communication between the auditor and the audit committee will be beneficial to both parties in the discharge of their respective duties. With due consideration to its content, the newly proposed Additional Internal Report which is to be submitted to the audit committee by the statutory auditor and is to contain comments regarding the results of the statutory audit, is an appropriate initiative.

12. FEE recommends that management and the internal audit function ensures that information they provide to the audit committee is timely, concise and of a level of quality that leads to a free and open discussion of all relevant topics.

13. FEE recommends a more transparent audit committee. The transparency should concern matters that are not confidential or will not be harmful for the company and should be under the ultimate responsibility of the board. This increased transparency could be in relation to the assessments made in advising the board, and could especially be on:

   a. The work of the audit committee carried out in the current year, especially in relation to the significant issues that arose during the course of the statutory audit.

   b. Judgements and conclusions of the audit committee in relation to key or critical accounting policies and estimates.

   c. The decisions made and action plan for the coming year(s).

   d. The non-audit services either provided or to be provided, following involvement of the audit committee, by the statutory auditor as well as by other auditors to further highlight the need for independence of management regarding such decisions.

   e. The audit appointment process, in particular the rationale for selection of a new audit firm or the renewal of an incumbent audit firm's term.

   f. The work of the audit committee, judgements and conclusions made in relation to the monitoring of the company’s internal control, internal audit and risk management system also aimed at shareholders.
Appendix 1 – Text of relevant articles from European legislation, including the Statutory Audit Directive

This appendix contains the text of articles 37, 38, 41 and 42 of the Statutory Audit Directive as well as links to relevant European legislative texts.

Article 37

Appointment of statutory auditors or audit firms

1. The statutory auditor or audit firm shall be appointed by the general meeting of shareholders or members of the audited entity.

2. Member States may allow alternative systems or modalities for the appointment of the statutory auditor or audit firm, provided that those systems or modalities are designed to ensure the independence of the statutory auditor or audit firm from the executive members of the administrative body or from the managerial body of the audited entity.

Article 38

Dismissal and resignation of statutory auditors or audit firms

1. Member States shall ensure that statutory auditors or audit firms may be dismissed only where there are proper grounds. Divergence of opinions on accounting treatments or audit procedures shall not be proper grounds for dismissal.

2. Member States shall ensure that the audited entity and the statutory auditor or audit firm inform the authority or authorities responsible for public oversight concerning the dismissal or resignation of the statutory auditor or audit firm during the term of appointment and give an adequate explanation of the reasons therefore.

Article 41

Audit committee

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 depository 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.

Article 42

Independence

1. In addition to the provisions laid down in Articles 22 and 24, Member States shall ensure that statutory auditors or audit firms that carry out the statutory audit of a public interest entity:

(a) confirm annually in writing to the audit committee their independence from the audited public interest entity;
(b) disclose annually to the audit committee any additional services provided to the audited entity; and
(c) discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats as documented by them pursuant to Article 22(3).

2. Member States shall ensure that the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment and is/are allowed to participate in the audit of the audited entity again after a period of at least two years.

3. The statutory auditor or the key audit partner who carries out a statutory audit on behalf of an audit firm shall not be allowed to take up a key management position in the audited entity before a period of at least two years has elapsed since he or she resigned as a statutory auditor or key audit partner from the audit engagement.

The European Commission proposals to reform the audit market published in November 2011 can be found here: http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf

Appendix 2 – Methodology and list of respondents

The information included in the Discussion Paper is based on a Survey carried out among FEE Member Bodies during 2010 and 2011. A full list of FEE Member Bodies is available on the FEE website\(^{51}\). The total number of potential countries to respond was at the time 32 which included the 27 EU Member States, Iceland, Israel, Monaco, Norway and Switzerland\(^{52}\).

Responses to the FEE Survey on audit committees were received from the following 25 countries:

- Austria
- Belgium
- Cyprus
- Czech Republic
- Denmark
- Finland
- France
- Germany
- Greece
- Hungary
- Ireland
- Italy
- Latvia
- Malta
- Netherlands
- Norway
- Poland
- Portugal
- Romania
- Slovenia
- Slovak Republic
- Spain
- Sweden
- UK
- Switzerland noted that Swiss listed companies follow either the “Swiss Corporate Governance Code” or the “Swiss Code of Best Practice for Corporate Governance” although the Statutory Audit Directive is not implemented, as Switzerland is not an EU Member State.

The questionnaire focused on the following two parts:

- Part 1 relates to issues that refer to the transposition of the Statutory Audit Directive and the EC Recommendation into national law, recommendations, corporate governance codes, etc.
- Part 2 refers to issues that are related to the functioning of audit committees in practice. In case this information is not readily available to a FEE Member Body, the FEE Member Body is kindly requested to find out more from practitioners involved with audit committees at national level and respond to the questions accordingly.

Not all countries responded to all questions included in the questionnaire. Thus, the summary of responses included in the Discussion Paper can include less than 25 countries, issue per issue.

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\(^{51}\) List of FEE Member Bodies [http://www.fee.be/aboutfee/memberbodies/default.asp](http://www.fee.be/aboutfee/memberbodies/default.asp)

\(^{52}\) Since the Survey was conducted, the audit profession of Croatia became a FEE Member Body