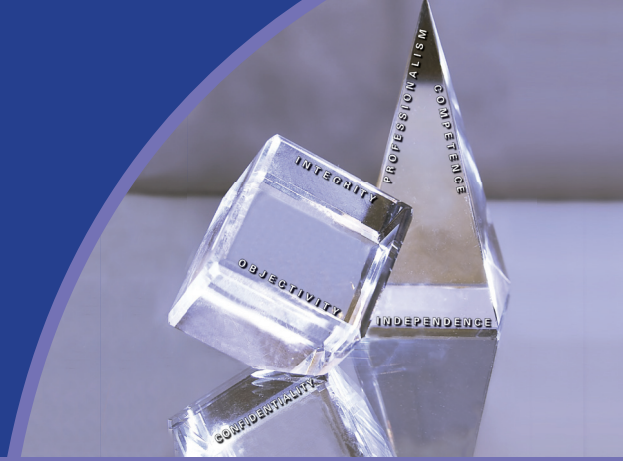


Highlights

Standing for trust and integrity

March 2013



Company Law and Corporate Governance

Highlights on FEE Initiatives on how to Improve the Functioning of Audit Committees Further

Following the publication of a Discussion Paper¹ on this topic, FEE organised a **high level Roundtable on 5 February 2013** to discuss the functioning of audit committees and the potential for further improvement within Europe. The event brought together nearly 100 participants, including European policymakers, audit committee members, investors, professional accountants, auditors and regulators.

Though there are differences in the functioning of audit committees across Europe, there is a consensus that the role of audit committees is now well established. All participants agreed that audit committees should have a strong voice. From the discussions that took place during the Roundtable, three key messages can be highlighted:

- The diversity of members' skills and expertise is instrumental to the efficiency of audit committees.
- The audit committee has a key role to play in overseeing both internal and external audit functions.
- Building well functioning audit committees is work in progress in many European countries; further guidelines at European level might be helpful.

The **first panel** on composition and competences, moderated by **Professor Andrew Chambers**, Deputy Chair of the FEE Company Law and Corporate Governance Working Party, included:

- ▷ **Nathalie Berger**, European Commission Head of Unit, Audit and Credit Rating Agencies, DG Internal Market and Services;
- ▷ **Roger Marshall**, UK Financial Reporting Council (FRC) Board Member;
- ▷ **Dr Christian Holzherr**, former CFO of Celesio AG and EnBW AG, Audit Committee Chair of Herrenknecht AG, Member of the Supervisory Board of Stuttgart Stock Exchange; and
- ▷ **Carlos Soria**, Chairman of the Audit Committee, La Seda de Barcelona Group and Corporación Químico-Farmacéutica Esteve.

The **second panel** on responsibilities and tasks of audit committees, moderated by **Jörgen Holmquist**, ECGI Chairman, included:

- ▷ **Carol Lambert**, Partner at Deloitte France specialised in corporate governance matters;
- ▷ **Jella Benner-Heinacher**, President of Euroshareholders;
- ▷ **Walter Vogt**, Representative of the German trade union IG Metall; and
- ▷ **Andrew Dougal**, Audit Committee Chair and Non-Executive Director, Carillion and Creston.

Opening and Welcome by FEE President

In opening the debate, **FEE President, André Killesse**, highlighted the need for strong corporate governance in Europe, as well as social and environmental responsibility in order to create long term value in businesses. *"At FEE, we believe that corporate governance is instrumental to help businesses perform better. Better governed enterprises means better performance and a more vibrant European economy, more jobs and opportunities, as well as more tax income to help resolve the debt crisis."*

Opening Keynote Speech

Professor Andrew Chambers, FEE Deputy Chair of the Company Law and Corporate Governance Working Party, presented the FEE Discussion Paper on the Functioning of Audit Committees published by FEE in June 2012. This Discussion Paper includes a survey on the functioning of audit committees in Europe, as well as the FEE Recommendations² in this regard.

SESSION 1: Composition and Competences of audit committees

Opening the first session, **Professor Chambers** outlined the differences between European countries in terms of audit committee composition. He highlighted that the audit committee should be a sub-committee of the board with adequate resources and should be composed of non-executive directors that have an appropriate collective competence to discharge their responsibilities. Better guidance is needed at European level, especially regarding the

appropriateness of competences in terms of diversity and experience.

Independence of its members is equally crucial. However, independence does not mean that the audit committee should be seen in a vacuum. Members should have sufficient knowledge of the internal and external business environment of the company.

¹ The Discussion Paper on the Functioning of Audit Committees can be downloaded at the following link: http://www.fee.be/images/publications/company_law/Discussion_Paper_on_Audit_Committees_120615156201218855.pdf

² FEE Recommendations have been reproduced hereafter.

Policy perspective from the European Commission

Nathalie Berger, European Commission Head of Unit, Audit and Credit Rating Agencies, emphasised the fact that the audit committee plays a central role in the European corporate governance model. Audit committees need to be strengthened in order to better protect the interests of shareholders and investors. Furthermore, independence is a key feature of a strong audit committee. The competences of the members should be well balanced between accounting and auditing specialists as well as sectoral and business experts.

The responsibilities of the audit committee should include the appointment of the external auditors, an effective dialogue with the external auditors during the different phases of the statutory audit and strong monitoring powers over financial reporting, effectiveness of internal control, internal audit and risk management.

National Regulator point of view

Roger Marshall, FRC Board Member, discussed the FRC's views on the composition of audit committees. He agreed that the majority of members should be independent (in the UK most audit committees are entirely independent) and that there should be at least one member with recent and relevant financial experience.

However, given the need for diversity on an audit committee, he questioned the proposal in the draft Audit Regulation for a member with auditing competence and one with accounting or auditing competence. Such a proposal would be particularly challenging in small growing public companies with only a few non-executive directors and needs for commercial as well as financial skills. Diversity of competences is key: in order to understand the company's business model and risk profile, as well as the wider economic environment.

The view of a Preparer of Financial Statements

Dr Christian Holzherr, former CFO of Celesio AG and EnBW AG, highlighted the advantages of interaction of executive management with the audit committee from the perspective of the Chief Financial Officer of a company.

As audit committees are relatively small in size and normally show more preparedness to invest time and focus on their dedicated tasks related to financial information, there is a potential for more direct and regular interaction between supervisory board members (forming the audit committee) and the

Chief Financial Officer, as well as with other executives. It is not only to oversee them, but also to discuss with them and advise them to achieve the best possible outcome.

This role of the audit committee is very important and necessary in times where the supervisory board is principally unable, because of the vastness of all its responsibilities, to address finance subject matters in a similar intense way.

It is from this point of view regrettable that, in some countries, as for example in Germany, there is a tendency to restrict the possibility of delegating responsibilities to audit or other subcommittees of the supervisory board. This threatens the future development of these subcommittees and may even lead to diminishing entrepreneurial behaviour due to risk-aversion.

Perspective of an Audit Committee Chairman

Carlos Soria, Chairman of the Audit Committee, La Seda de Barcelona Group and Corporación Químico-Farmacéutica Esteve, introduced his remarks by pointing out that there is no such thing as a 'flavour of Southern Europe' in relation to audit committees. Their functioning as far as the profile, skills and size of membership, as well as relationships with other stakeholders within the company, are not materially different from the rest of Europe. This is the case even though the practice of having audit committees did start quite recently, at least in Spain, as compared to other European countries.

A well functioning audit committee should focus on a number of responsibilities, in particular:

- Supervising the integrity of the financial statements and financial information;
- Reviewing the functioning of the internal control and risk management systems;
- Safeguarding the independence and efficiency of the external audit;
- Supervising and setting-up a "whistle-blowing" mechanism;
- Maintaining close relationships with the internal audit function of the company, including involvement in their selection, appointment, remuneration and guarding of their independence; and
- Making proposals in relation to the selection and appointment of the external auditor, with a clear preference for one single auditor for a large multinational group of companies.

It is strategic to enhance transparency of the audit committee workings, as well as its effectiveness by performing self assessment.

SESSION 2: Responsibilities and tasks of audit committees

Jörgen Holmquist, ECGI Chairman, opened the second session by welcoming FEE's timely initiative. In the aftermath of the financial crisis, the audit committee has a role to play in restoring confidence in the marketplace. Strong audit committees are essential for the quality of financial information provided by companies. Audit committees cooperate with auditors through their monitoring responsibilities. An effective cooperation between these parties is beneficial, not only for the auditor and the audit committee, but also for the company as a whole.

Auditor's view

Carol Lambert, Partner, Deloitte France, specialised in Corporate Governance matters, emphasised that, for listed companies, the concept

of audit committees is well established as a principle, and it is no longer a debate within Europe. They exist and work, but the success of an audit committee is not fully guaranteed by its mere existence. Indeed, areas of special attention have to be taken into account, for instance its composition is crucial. Besides, its members should be well informed and well trained. Moreover, they should interact with the company's executives to properly form their own independent opinion.

The spectrum of the audit committees' role can be seen as:

- Overseeing the auditors' independence;
- Reviewing risks, IT, internal controls and sensitive items such as valuation and impairment, financing liabilities and off-balance sheet transactions, etc.;

- Dealing with emerging issues, e.g. non financial information;
- Coordinating with other committees: strategy, remuneration, governance, CSR, etc.;
- Reporting to the board and control of the delegated tasks;
- Reporting to and dialogue with investors;
- Ensuring the principle of substance over form is consistently and constantly applied.

The view of Investors and Shareholders

Jella Benner-Heinacher, President of Euroshareholders, emphasised the crucial role of audit committees. The board should act as the agent of all shareholders and, in that context, the quality of board and audit committee members is decisive.

Inclusion of at least one financial expert in the audit committee gives to this committee a more instrumental role in the audit process. Therefore, audit committees have a crucial role to play in relation to the statutory auditors. They should set very strict rules in this framework in order to ensure the independence of the auditors, as well as the quality of the audit performed.

Trade Union point of view

Walter Vogt, IG Metall, Germany, argued that trade unions are instrumental in audit committees and other subcommittees of the board to ensure the voice of employees is heard.

Indeed, enterprises have to be seen as social institutions more than fixed interest financial investments with variable labour costs. Trade union representatives are committed to challenging management decisions in order to avoid too much focus on shareholders' value. This focus might result in short term decisions in company policies.

Workers' representatives have therefore to stand up against short term views. Audit committees have to pay also attention to personnel key data, which is often neglected. Workers' representatives do not reject any structural discussion with corporate management, but safeguard the enterprises' long term objectives and their social welfare sustainability. To fulfil their responsibilities and tasks, trade union representatives are constantly trained to best perform their role as audit committee members.

FEE Conclusions

Although a "one size fits all" approach for audit committees is not the way forward across Europe, there is a lot of potential for audit committees to develop further and play an ever more important role within the governance of a company.

With regard to composition and competences, a proper balance has to be struck between independence and diversity of skills – including operational and financial expertise. The audit committee needs to have open dialogue and cooperation with the management of the company, with its internal audit function and with its external auditors: this is crucial to its role and efficiency. Such dialogue and cooperation is performed with the aim of enabling the audit committee to oversee and critically assess the work of these key stakeholders.

Perspective of an Audit Committee Chairman

Andrew Dougal, Audit Committee Chair and Non-Executive Director, Carillion and Creston, noted that, in order for an audit committee to most efficiently support its board, it must seek to fulfil its terms of reference in an effective and timely manner. This requires the audit committee to have:

- Clear and unambiguous terms of reference; in particular, this should include oversight and review of:
 - the preparation of financial statements by management;
 - significant judgements made in the financial statements;
 - design and operation of the risk management process;
 - planning and conduct of internal and external audits;
 - the effectiveness and independence of the internal and external audit processes.
- The right balance of skills and experience within the committee, taking account of the industry sector, the risks the business faces and the advantages of diversity;
- Effective communication channels in place, with regular and effective engagement between meetings e.g. with senior executives, internal and external auditors. In this respect the role of the Chair is vital;
- Access to all necessary information.

Audit committees give comfort to users in relation to the scrutiny of financial information and their oversight of the entity's internal controls over financial reporting. They are seen as another pillar in the "assurance" chain.

In order to enhance transparency and better explain to users their important role, an audit committee should report – informatively, but concisely, and without breaching confidentiality – within the entity's annual report, detailing the main actions, issues, considerations and judgements it dealt with.

Closing Speech

Giacomo Bugna, member of the FEE Board and Chairman of the FEE Company Law and Corporate Governance Working Party, thanked all participants for the fruitful exchange of ideas and experience at a European level. It is timely to provide thought-leadership on the topic of audit committees. He noted that, in this regard, the accountancy profession has a key role to play in the public interest. FEE may consider further work in this area.

Stimulating closer involvement of the audit committee in the selection of the auditor, in guaranteeing the independence of the auditor, and in its appointment is a must. Additionally, greater cooperation throughout the audit engagement, especially the exchange of high quality information between audit committees and the external auditor, will be of great benefit both to the company and to the quality of the external audit.

In the course of the event, speakers and participants expressed considerable support for many of the FEE Recommendations as included in the FEE Discussion Paper on the Functioning of Audit Committees issued in June 2012. Although some FEE Recommendations were not referred to or not discussed in-depth, all suggested improvements and forward-looking ideas, which were brought up during the Roundtable, were consistent with these Recommendations. FEE is looking forward to developing these Recommendations further.

FEE Recommendations³

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 set needed to carry out the work in an effective and 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.

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 of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

³ These Recommendations are the outcome of a European survey on the functioning of audit committees as included in the FEE Discussion Paper published in June 2012.