european corporate governance institute

ecgi

Audit Committees of Public Interest Entities in Europe

Law Working Paper N° 276/2014
December 2014

Christoph Van der Elst
Tilburg University, Gent University and ECGI

© Christoph Van der Elst 2014. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-276-2014

european corporate governance institute

ECGI Working Paper Series in Law

Audit Committees of Public Interest Entities in Europe

Working Paper N°. 276/2014
December 2014

Christoph Van der Elst

© Christoph Van der Elst 2014. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

In 2014 the European Union reformed the regulatory framework of statutory audits in Directive 2014/56/EC and Regulation (EU) Nr. 537/2014. Part of the new legislation addresses the composition and responsibilities of the audit committee of public-interest entities. This contribution studies the innovations for audit committees. It is shown that many new requirements are very detailed and will force audit committees to develop new procedures. We fear that some of these new requirements are too prescriptive and will not necessarily reach the goal of better audits.

Keywords: audit committee, corporate governance, monitoring, auditor, independence

JEL Classifications: K20, M42, M48, G38

Christoph Van der Elst*
Professor of Business Law and Economics
Tilburg University, Law School
PO Box 90153
5000 LE Tilburg, the Netherlands
phone: +31 13-466-3536, fax: +31 13-466-2182
e-mail: c.vdrelst@tilburguniversity.edu

*Corresponding Author

Audit Committees of Public Interest Entities in Europe

Christoph Van der Elst*

Abstract: In 2014 the European Union reformed the regulatory framework of statutory audits in Directive 2014/56/EC and Regulation (EU) Nr. 537/2014. Part of the new legislation addresses the composition and responsibilities of the audit committee of public-interest entities. This contribution studies the innovations for audit committees. It is shown that many new requirements are very detailed and will force audit committees to develop new procedures. We fear that some of these new requirements are too prescriptive and will not necessarily reach the goal of better audits.

Keywords: audit committee, corporate governance, monitoring, auditor, independence

JEL Classification: K20, M42, M48, G38,

* Professor of Business Law and Economics, Tilburg University and Gent University (c.vdrelst@tilburguniversity.edu).

Audit Committees of Public Interest Entities in Europe

1. Introduction

Audit committees are a key instrument for developing a sound corporate governance system in a company. In its communication of May 2003 the European Commission stated that the audit committee has an important role in the monitoring of the internal and external audit function[1]. The European Commission embodied this role in a Recommendation in 2005. As a non-executive subcommittee of the board, the audit committee had to monitor the integrity of the financial information, review the internal control and risk management process, ensure the effectiveness of the internal audit function as well as the external audit process, make recommendations to the (supervisory) board for the election of the external auditor, and monitor the latter's independence and objectivity, in particular by reviewing the extent and nature of non-audit services[2]. The European Commission could rely on the American Sarbanes-Oxley Act of 2002 (SOX) for developing the role and composition of the audit committee.[3] This important piece of federal US legislation was issued to restore the confidence in the American capital market after the collapse of Enron, Worldcom and others. According to this Act the audit committee must appoint the auditor and monitor his work, must establish procedures for addressing complaints related to internal audit and control[4] and must approve certain non- audit services[5]. The external auditor reports the audit committee about different issues related to his work and the accounting policies of the company.[6] The audit committee must be composed with independent directors and comprise at least one financial expert[7].

---

[1] European Commission, *Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move*, COM (2003) 284, Brussels, 21 May 2003, p. 15.

[2] Annex 1 - Committees of the (supervisory) board, section 4.2. Role of the audit committee in Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, *OJ L* nr. 52 of 25 February 2005, p. 51.

[3] Officially 'Public Company Accounting Reform and Investor Protection Act of 2002'. See for an analysis, J. Martella, M. Paul, T. Philipp and R. James, "Audit Committee Requirements for Foreign Companies Listed in the United States", *European Company Law* 2004, p. 62.

[4] Section 301 SOX.

[5] Section 201 and 202 SOX.

[6] Section 204 SOX.

[7] Section 301 and 407 SOX. If no financial expert is part of the committee, the reasons therefor must be disclosed.

The major difference between the American and European approach at that time was the kind of regulation: mandatory in the US, best practice guidance in Europe. In this journal, Erik Mouthaan addressed the state of the art of audit committees in nine European Member States as well as of the European recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board[8]. His research focused on the position of audit committees in the national corporate governance codes which were of a "comply" or "explain" nature. He found that the corporate governance audit committee requirements show a high degree of communality but emphasize "disclosure", "explanations" and "guidance" instead of detailed mandatory regulations.

For the control of the financial statements, the European Commission wanted to provide in harmonised statutory audit requirements and it worked towards a directive that would address this issue. It resulted in Directive 2006/43/EC[9] in which the most important parts address the position and activities of the statutory auditor. Auditors must be approved and registered in a public register. The auditors will be submitted to public oversight which must be independent of the industry. The national public oversight system is mutually recognized to be able to meet and cope with international business requirements.

Additionally, the Directive 2006/43/EC contains one part which is directed towards the public-interest entities. These entities include the large listed entities, credit institutions and insurance undertakings[10]. Those entities are required to establish an audit committee at the level of the administrative organ or supervisory board, composed with at least one member being independent and familiar with auditing and/or accounting. The committee has specific duties vis-à-vis internal control, risk management, and the selection procedure of the auditor.[11]

[8] E.Mouthaan, The Audit Committee from a European Perspective, *European Company Law* 2007, p. 10-18.
[9] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/ 660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, *OJ L* nr. 157 9 June 2006, p. 87.
[10] Member States may also designate other entities as public interest entities.
[11] See for a short analysis of article 41 with references to the functioning of audit committees in other countries C. De Groot, *Corporate Governance as a Limited Legal Concept*, Alphen aan den Rijn, Kluwer Law International, 2009, p. 70-72.

Shortly after the publication of the aforementioned Directive 2006/43/EC, the debate was started whether the regulatory framework need further improvements, in particular after the start of the financial crisis. European Commissioner Barnier opined that the regulatory framework was inadequate for appropriately addressing the financial crisis[12]. The European Commission studied the different issues at stake and reported in its Green Paper of 2010 that the audit committee should be regularly in dialogue with the external auditor as well as with the internal auditor.[13] The Commission was of the opinion that this regular dialogue "*would ensure that there are no loopholes in the total coverage of compliance, risk monitoring as well as the substantive verification of assets, liabilities, revenues and expenses*". Later, the Federation of European Accountants (FEE) identified a number of shortcomings in the functioning of audit committees and recommended a further harmonisation of the composition, competences and responsibilities of audit committees and optimization of the relationship between the auditor and the audit committee[14].

The role and duties of the audit committee can be found in the new Directive 2014/56/EC[15] which modifies the existing Directive 2006/43/EC significantly. Furthermore, the audit committee has been granted additional powers in the new Regulation (EU) Nr. 537/2014[16]. Before the enactment of the Directive 2014/56/EC and the Regulation (EU) Nr. 537/2014 the European regulatory framework for audit committees, outside the financial industry, consisted only of article 41 of Directive 2006/43/EC and the aforementioned European Recommendation of 15 February 2005. Especially Regulation (EU) Nr. 537/2014 broadens the work and responsibilities of

[12] G. Griksas and M. Butler, "The European Commission consults on how the European audit market can be improved", *EU Audit Policy*, August 2010, p. 2, http://ec.europa.eu/internal_market/auditing/docs/info-letter/2010_10_en.pdf (last accessed 8 November 2014).

[13] European Commission, *Green Paper – Audit Policy: Lessons from the crisis*, 13 October 2010, COM(2010) 561 final, p.8.

[14] FEE, *The Functioning of Audit Committees*, Discussion paper, Brussel, June 2012, 52 p., http://www.fee.be/images/Discussion_Paper_on_Audit_Committees_120615.pdf (last accessed 7 November 2014).

[15] Article 1, 32) Directive 2014/56/EC of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, *OJ L* nr. 158, 27 May 2014, p. 196–226. The Directive modifies Directive 2006/43/EC and exists of only 2 articles. However for the sake of clarity we refer hereafter to the articles in the modified Directive 2006/43/EC.

[16] Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC *OJ L* nr. 158, 27 May 2014, p. 77–112.

the audit committee of public-interest entities, introduces new procedural requirements for audit committees and provides in a new external supervision of the performance of an audit committee.

The remainder of this contribution is divided in five sections. First the scope of the new directive is briefly assessed. Section three outlines the requirements related to the composition of the audit committee. In Section four the responsibilities of the audit committee are studied. Section five addresses the monitoring of the audit committee. Section six contains some concluding remarks.

2. Scope

Directive 2006/43/EC launched a new scope in European law. Before the enactment of this Directive the scope of a directive was on companies whose securities are admitted to trading on a regulated market or on specific industries, like insurance or banking. Directive 2006/43/EC required the establishment of an audit committee in all public-interest entities. These entities comprise all listed entities[17], credit institutions and insurance undertakings as well as other entities that the Member States designated as public-interest entities. Directive 2014/56/EC did not modify the scope but updated it. As a consequence the option that Directive 2006/43/EC offered to Member States resulted in a wide diversity of entities being considered as public-interest entities. In some Member States pension funds, UCITS, state owned entities, government agencies, asset management companies and electronic money institutions as well as some other entities like social security institutions or venture capital funds are envisaged as public interest entities[18]. It is estimated that close to 30.000 entities are considered of public-interest. A small country like Ireland has around 2000 public-interest entities, a large country like Germany around 1600. In Spain the number of public-interest entities is even around 8000 and Slovenia counts only 70 public-interest entities.[19]

[17] Or, more precise, entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC.
[18] For an overview of the scope in each country see FEE, *Definition of Public-Interest Entities (PIE) in Europe*, October 2014, p. 11-16, http://www.fee.be/images/publications/auditing/PIE_definition_survey_outcome_141015.pdf.
[19] *Ibid.*, p. 7-8.

Directive 2014/56/EC authorizes the Member States to exempt certain types of public-interest entities to establish an audit committee. The Directive 2014/56/EC differentiates between the exemption to establish an audit committee if the functions of the committee are performed by the (supervisory) board and an overall exemption of both the establishment and the responsibilities of the committee. The exemption of the establishment of the committee can also be provided to companies with an organ that performs equivalent functions to an audit committee[20].

The first exemption can conditionally be granted to small and medium sized companies and companies with a market capitalisation of less than €100 million[21]. The Directive 2014/56/EC emphasizes the importance of the audit committee being composed of non-executive and independent directors.[22] Therefore the Directive conditions of companies that provide the (supervisory) board with the functions of the audit committee not to have an executive chairman, whilst the board is performing the functions of the audit committee.

Second, Member States can provide in a full exemption for both establishing an audit committee and for providing its tasks, to subsidiaries, if at group level the audit committee requirements are fulfilled, to UCITS, to issuers of asset backed securities and to unlisted credit institutions that only issued debt securities with a total amount of less than €100 million.[23] For issuers of asset backed securities it is required to publicly disclose the reasons why they consider an audit committee is not "appropriate".

3. Composition of the audit committee

Directive 2006/43/EC required an audit committee to be composed of at least two members.[24] The members must be non-executive directors of which one member must be independent and one of the independent board members must be competent in

[20] Article 39, §4 Directive 2014/56/EC.
[21] Article 39, §2 Directive 2014/56/EC.
[22] See for an analysis of the composition of the audit committee, section 3.
[23] Article 39, §3 Directive 2014/56/EC.
[24] The Directive uses the term "members".

accounting and/or auditing[25]. The Directive 2006/43/EC left it to the Member States to determine how an independent director can prove his required competence.

Furthermore, the Directive 2006/43/EC stated that the audit committee had to be established either as a subcommittee of the (supervisory) board or its functions must be performed by an organ of the public-interest entity. This requirement is for certain types of public-interest entities difficult to comply with. As an example we refer to the (listed) partnership limited by shares[26] in Belgium which are governed by a business manager. The latter manager is most of the time a public limited liability company but it does not comply with the conditions of independence and plurality. Practically, these companies established an audit committee at the level of the corporate organ of the business manager, but legally it is not an organ *of* the public-interest entity. Directive 2014/56/EC rephrased this requirement but did not modify it.

Directive 2014/56/EC strengthened the composition requirements but built in more flexibility regarding the competence of one of the members. The audit committee as a subcommittee of the (supervisory) board should consist of several non-executive directors and the majority of the members must be independent. The former directive required only one member to be independent. Neither Directive 2006/43/EC nor Directive 2014/56/EC specify any kind of independence prerequisites. Recital 24 of Directive 2014/56/EC refers to the European Commission Recommendation of 15 February 2005 regarding the establishment of and the functioning of the audit committee but it does not explicitly cites the Recommendation vis-à-vis the composition or independence requirements. Hence, it can be argued that the Member States national rules regarding independence prerequisites can be applied. The Directive 2014/56/EC even allows Member States to exempt audit committees from all independence requirements when all members are directors of the company[27].

Directive 2006/43/EC ordered that at least one independent board member is competent in accounting and/or auditing. Directive 2014/56/EC disentangled independence from competence in accounting/auditing. It is sufficient if one member

[25] Article 41, §1 Directive 2006/43/EC.
[26] "commanditaire vennootschap".
[27] Article 39, §5 Directive 2014/56/EC.

has the required expertise in accounting and/or auditing, whether this member is independent or not.

The aforementioned easing of one requirement comes with a new obligation. The audit committee must make sure that it has "*competence relevant to the sector in which the audited entity is operating*"[28]. This collective competence requires companies to identify the sectors in which operational activities are developed. A useful tool is the industry classification benchmark that is applied by many stock exchanges which differentiates between 41 sectors[29]. The Directive 2014/56/EC does not identify the kind of competence – operational, strategic, financial, or other - that the audit committee must establish. Therefore we argue that the competence must relate to all the tasks that the audit committee must perform[30]. However, we are of the opinion that the Directive should not only have related the competence to the industry of the audited entity but also to its subsidiaries and related entities, especially when the latter are making use of the exemption provided in article 39, §3 of the Directive 2014/56/EC and the audit committee operates for the group.

A last innovation of Directive 2014/56/EC regarding the composition of the audit committee relates to the chairman of the committee. The chairman must be independent of the audited entity.[31] We already addressed the absence of any kind of definition of *independence*. However, the Directive only requires the chairman to be independent *of the audited entity*. Furthermore, the Member States can opt to exempt the members from the independence requirement when all the members of the audit committee are selected from the (supervisory) board of the entity.[32]

Next, the chairman must be appointed among the members of the committee or by the supervisory board of the entity. The Directive does not seem to allow that the board appoints the chairman in a one-tier board structure. The Directive explicitly provides this power to the committee itself or to the supervisory board. It is unclear why in a one-tier board, the chairman will have to be appointed by the members of the audit committee themselves, and in a two-tier board, the members of the supervisory board can appoint the chairman of the audit committee.

[28] Article 39, §1, al. 3 Directive 2014/56/EC.
[29] For more information see http://www.icbenchmark.com/ (last accessed 8 November 2014).
[30] For an analysis of the duties and responsibilities of the audit committee, see section 4.
[31] Article 39, §1, al. 4 Directive 2014/56/EC.
[32] Article 39, §5 Directive 2014/56/EC.

Member States can also opt to have the chairman of the audit committee elected annually by the general meeting of shareholders. Only in the latter case, the procedure for election must be applied annually, which might be burdensome when the board and the audit committee members are elected multi-annually.

4. The responsibilities of the audit committee

4.1. Modernisation of the existing responsibilities

Directive 2006/43/EC provided the audit committee with five specific responsibilities, of which four are monitoring duties: the monitoring of the financial reporting process, the monitoring of the effectiveness of the internal control and risk management system including, if applicable, the internal audit, the monitoring of the statutory audit of both the annual and the consolidated accounts, and the monitoring of the independence of the statutory auditor or audit firm, especially when the auditor provides non audit services to the audited entity[33]. The fifth responsibility related to the recommendation upon which the proposal for the appointment of the statutory auditor is based[34]. The auditor must inform the audit committee when key matters arise from the audit, especially when the auditor discovers material weaknesses in the internal control in relation to the financial reporting process of the audited entity.[35]

Directive 2014/56/EC and Regulation (EU) Nr. 537/2014 expand the responsibilities of the audit committee. The four monitoring duties of the committee are retained but the Directive 2014/56/EC fine-tunes and/or rephrases each of these tasks:

- The monitoring of the financial reporting process is retained but it is broadened to include recommendations ensuring the integrity of that process.
- The second task related to the monitoring of the effectiveness of the internal quality control and risk management systems including the internal audit if applicable, regarding the financial reporting, has been modified.

[33] Article 41, §2 Directive 2006/43/EC.
[34] Article 41, §3 Directive 2006/43/EC.
[35] Article 41, §4 Directive 2006/43/EC.

As of now, the audit committee must monitor the effectiveness of the internal *quality* control system. It raises the question whether the addition of "quality" limits the scope, as in Directive 2006/43/EC the overall "*internal control*" was envisaged, or further broadens the committee's monitoring duties as the monitoring of *the risk management systems* is not modified in Directive 2014/56/EC. Internal control can be embedded in an entity, based on frameworks like COSO or Turnbull but these frameworks do not address quality controls. The International Organization for Standardization distinguishes between risk management (ISO 31000) and internal quality control (ISO 9000). However, in the Directive 2014/56/EC any further reference to internal quality controls of the audited entity is lacking. This type of controls is only developed for the audit firm[36]. We are of the opinion that the Directive 2014/56/EC does not want to modify the existing monitoring of the effectiveness of the internal control process but it is advisable that the Directive either clarifies or modifies the wording.

The monitoring of the effectiveness is in Directive 2014/56/EC limited to the financial reporting. We support this limitation. In 2006 the monitoring of the effectiveness of internal control was an unlimited responsibility and hence had to include all different objectives: strategic, operational, compliance and reporting. This was virtually impossible. The limitation in the Directive 2014/56/EC brings the effectiveness control more in line with that of the American Sarbanes-Oxley Act.

Directive 2014/56/EC explicitly states that the monitoring of the effectiveness of the aforementioned systems shall not breach the independence requirement of the audit committee. We are of the opinion that the audit committee always must preserve its independence. The additional wording "*without breaching its independence*" for this specific monitoring duty creates confusion vis-à-vis its independence to monitor the other identified duties. Besides, while this paragraph stresses the

[36] See for example article 24, §1, (b) of Directive 2014/56/EC

independence of its activities, the paragraphs on the composition of the audit committee differently approaches the independence requirements.

- Third, the audit committee must monitor the (performance of the) statutory audit of the annual and consolidated financial statements. Contrary to the previous Directive 2006/43/EC, the Directive 2014/56/EC stresses the monitoring *of the performance* of the audit. While performing this duty, the audit committee must take into account the findings and conclusions of the national supervisory authority.

  We believe that his monitoring duty leads to a kind of circular monitoring. The auditor is responsible for the auditing of the financial statements. According to Directive 2013/34/EC the members of the administrative, management and supervisory bodies have collectively the duty for drawing up and publishing the financial statements and annual report[37]. The financial statements must "*give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss*"[38] which is controlled by the auditor, opining that these financial statements indeed give a true and fair view in accordance with the relevant financial reporting framework[39]. Next, the audit committee, which is either a subcommittee of the (supervisory) board or a stand-alone committee of the entity, monitors the work of the external auditor. Performing its monitoring duty, the audit committee will take into account the findings and conclusions of the supervisory agencies of the auditors. Furthermore, the latter agencies will assess the performance of the audit committee.[40] The auditor is auditing the entity, which is, through its audit committee monitoring the controlling auditor, which is controlled by competent agencies that is assessing the performance of the audit committee of the controlled entity!

[37] Article 33 of Directive 2013/34/EC of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC Text with EEA relevance, *OJ L* nr. 182, 29 June 2013, p. 48.
[38] *Ibid.*, article 4 of Directive 2013/34/EC.
[39] Article 28, §2 (c), (i) Directive 2014/56/EC.
[40] Article 27 Regulation (EU) Nr. 537/2014.

- The last retained monitoring duty of the audit committee is the review and the oversight of the independence of the auditor or audit firm. This duty has been refined in Directive 2014/56/EC by explicitly emphasizing that the audit committee must take into account several provisions in the Directive 2014/56/EC and the Regulation (EU) Nr. 537/2014 performing its monitoring duty. Furthermore the committee must monitor whether the provision of non-audit services by the auditor is appropriate[41]. The 'appropriateness' of these services needed not be reviewed in the Directive 2006/43/EC.

The task of the audit committee in the selection process of the auditor is resumed. According to Directive 2006/43/EC the (supervisory) board had to base its proposal for the election of the auditor on a recommendation of the audit committee. The general meeting must elect the auditor[42].

According to the new Directive 2014/56/EC, the audit committee has its proper responsibility, viz. "*for the procedure for the selection of statutory auditor(s) or audit firm(s) and recommend the statutory auditor(s) or the audit firm(s) to be appointed in accordance with Article 16 of Regulation (EU) No 537/2014*"[43]. Before, the responsibility for the selection was vested in the (supervisory) board, this responsibility shifted to the audit committee. Not only article 39, §6 of the Directive 2014/56/EC but also article 16, §3, al. 2 of Regulation (EU) Nr. 537/2014 empowered the audit committee: "*The audit committee shall be responsible for the selection procedure*".

A further analysis of the responsibility of the audit committee for the selection process of the auditor shows some ambiguity. Whereas article 16, §3, al. 2 of Regulation (EU) Nr. 537/2014 makes the audit committee responsible for the selection procedure, article 16, §3 of Regulation (EU) Nr. 537/2014 starts with the requirement that the *audited entity* shall *organise the selection procedure* of which the

[41] See section 4.3.
[42] Article 37 Directive 2006/43/EC, retained by Directive 2014/56/EC.
[43] "*except when Article 16(8) of Regulation (EU) No 537/2014 is applied*". This exception relates to the nomination committee that can, if it is compliant with the requirements of article 16(8) of Regulation (EU) No 537/2014, take over this responsibility of the audit committee.

recommendation of the audit committee forms an important part. We opine that the responsibility of the audit committee is more related to the "monitoring" of the selection procedure, organised by the audited entity. Besides, the Regulation (EU) Nr. 537/2014 requires in article 16, §3, al. 1, c) that the audited entity "*shall be free to determine the selection procedure*". The responsibility of the audit committee should be found in the monitoring that the audited entity organises a selection process and reviewing how the entity is shaping the process in accordance with both the Directive 2014/56/EC and Regulation (EU) Nr. 537/2014. This view can be aligned with the start of article 39, §6 of the Directive 2014/56/EC stating that the duties of the audit committee are *without prejudice to the responsibility* of the members of the (supervisory) board.

The selection process criteria are provided in article 16, §3 of Regulation (EU) Nr. 537/2014. A detailed assessment of these criteria goes beyond the analysis of the new rules for audit committees. However, the criteria demonstrate the policy of the European Commission supporting smaller audit firms. Audit firms "*which received less than 15 % of the total audit fees from public-interest entities in the Member State concerned in the previous calendar year"*[44] shall not be precluded in a selection procedure. The criteria need not to be applied in case of a renewal of the election of the auditor within the maximum term before an external rotation of the auditor is required in accordance with article 17 of Regulation (EU) No 537/2014. Smaller public-interest entities[45] are also exempted of the specificities of the selection procedure of Article 16, §3 of Regulation (EU) No 537/2014. However the audit committee of these smaller entities must adhere to the other provisions of article 16 of the Regulation (offer two choices, be free of any influence, etc.).

Since Directive 2006/43/EC, the audit committee must provide in a recommendation for the appointment of the auditor. The new European legislation further specifies how this recommendation should be developed. The recommendation must provide in at least two choices and the audit committee must express its motivation for one the

[44] Article 16, §3 (a) of Regulation (EU) No 537/2014.
[45] Public-interest entities that meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC.

retained auditors[46]. The recommendation shall also state that the audit committee was under no circumstances influenced by *a third party*[47]. Next, it is forbidden for the audited entity to provide any kind of clause in a contract that restricts "*the choice by the general meeting of shareholders or members […] to certain categories or lists of statutory auditors or audit firms, as regards the appointment of a particular statutory auditor or audit firm to carry out the statutory audit of that entity*"[48]. In case any such clause is provided in a contract, it shall be null and void.

The Regulation (EU) No 537/2014 forbids the influence of any third party. This Regulation does not define who third parties are[49]. We are of the opinion that third parties are those parties that have no relationship with the audited entity and are *located* outside the audited entity. Indeed, in some countries other parties are involved in the selection process of the auditor. Under Belgian law the employees council has the right to recommend the auditor to the general meeting, based upon a proposal of the board which is, if an audit committee is established, proposed by that committee[50]. In the Belgian law, the auditor has been provided with specific duties vis-à-vis the employees council, and hence it is considered of relevance that the council is involved in the selection process of the auditor. Whereas the employees council will recommend the selection of the auditor after the audit committee has performed its duties in that perspective, it cannot be excluded that the employees council is signalling its preferences. Although this signalling should not necessarily be identified as undue influence[51], we are of the opinion that the employees council should not be considered as a third party.

The problem of undue influence might arise when an audit committee is operating in a subsidiary that has not (yet) been derogated from this requirement according to article 39, §3, (a) of Directive 2014/56/EC. For instance, after an acquisition, the parent

[46] Article 16, §2 , al. 2 of Regulation (EU) No 537/2014.
[47] Article 16, §2 , al. 3 of Regulation (EU) No 537/2014.
[48] Article 16, §6 of Regulation (EU) No 537/2014.
[49] Also in other European legislations "third parties" are not identified. This is for instance also the case in the Environmental Liability Directive 2004/35/EC (see for an analysis, *The study evaluating the status quo and the legal implications of third party liability for the European security industry*, L. Bergkamp, M. Faure, M. Hinteregger and N. Philipsen (eds.), Maastricht, October 2013, p. 23, http://ec.europa.eu/enterprise/policies/security/files/final-report-tpl-11-10-2013_en.pdf)
[50] Article 156 Belgian Companies Code.
[51] An assessment of the meaning of influence is outside the scope of this contribution.

company of that subsidiary could, for reasons of efficiency, support the selection of the group auditor.

Next, the audit committee must state that there is no clause in any kind of contract between the audited entity and a third party restricting the choice by the general meeting to certain categories or lists of statutory auditors or audit firms. As an example we can refer to a loan agreement in which the credit institution requires the audited entity to elect an auditor of the list that the credit institution provides. This clause in the loan agreement will be null and void. The Regulation (EU) No 537/2014 forbids two types of clauses: clauses that limit the choice to a certain category or clauses that limit the choice to a predefined list of auditors. We are of the opinion that both kinds of clauses *de facto* excludes any kind of restriction. However, the restriction is only forbidden if it is provided in a contract. Hence when restrictions follow from other requirements, like the specific lists that exists for certain types of industries, like the banks, to elect an auditor, it is not forbidden.

Any improper influence of the decision of the general meeting of shareholders or any attempt to impose a forbidden contract clause must be reported to the supervision authorities[52]. Surprisingly, (any attempt of) influencing the recommendation of the audit committee must not be reported.

4.2. The new responsibility

Next to the aforementioned resumed monitoring duties, Directive 2014/56/EC starts in article 39, §6, (a) with a new responsibility for audit committees. The audit committee must inform the (supervisory) board of the results of the audit and "*explain how the statutory audit contributed to the integrity of financial reporting and what the role of the audit committee was in that process*". While we presume that it follows from good practices that the external auditor regularly discusses the financial reporting policies and processes (including the integrity issues) with at least the chief financial officer (and or other members of the board), the relationship with the audit

[52] Article 16, §6 , al. 2 of Regulation (EU) No 537/2014.

committee is formalised through the reporting requirement of the latter to the (supervisory) board. When the different actors perform their duties responsibly, we are of the opinion that most information should already be available to the (supervisory) board. However we deem that article 39, §6, (a) in fine is not fully clear with respect to the process that is indicated. The Directive refers to "*that*" process. Does the directive 2014/56/EC refers to the role of the audit committee in the statutory audit process as performed by the auditor or to the role in the internal reporting process with, in particular, the integrity of this reporting? Demonstrating in *concrete* and *verifiable* grounds that the statutory audit contributed to the integrity as well as how the audit committee performed its role therein, is not always obvious.

4.3. Particularities

Some of the responsibilities of the audit committee in article 39, §6 of Directive 2014/56/EC are further elaborated in the Regulation (EU) No 537/2014. In particular the monitoring of the independence of the auditor is specifically addressed in the latter regulation.

Article 4 of the Regulation (EU) No 537/2014 compels the audit committee to discuss with the statutory auditor the threats to the latter's independence and the safeguards applied to mitigate these threats when, during three consecutive financial years, the total fees that the statutory auditor received from the public-interest entity exceeded 15 per cent of the total fees of that statutory auditor. The latter must inform the audit committee that this threshold has been exceeded. The limitation is also applicable on the group level of the audited entity. The Regulation materialises the principles which were already developed by the European Commission in its Recommendation of 16 may 2002 which stated that the statutory auditors' independence is impeded when "*the total (audit and non-audit) fees that an Audit Firm, or a Network receives or will receive from one Audit Client and its Affiliates make up an unduly high percentage of*

the total revenues in each year over a five-year period"[53]. That Recommendation did not identify what was considered an unduly percentage.

The audit committee must consider whether an engagement quality control review is necessary before the issuance of the audit report when the aforementioned threshold has been crossed. We presume that in light of the tight timelines during which the statutory audit control of the financial statements must take place, this quality control review is practically impossible. Most likely the statutory auditor and, if need be together with the audit committee of the audited entity, will search for alternative solutions avoiding the crossing of the 15 per cent threshold in the third consecutive year.

In the unlikely situation that the crossing of the threshold continues, the audit committee must decide "*on the basis of objective grounds whether the statutory auditor […] may continue to carry out the statutory audit for an additional period which shall not, in any case, exceed two years*."

Second, the audit committee has a specific role when the statutory auditor provides the audited entity non-audit services. Since many years it is debated if and to what extent rendering non-audit services to an audited entity impedes the independence of the auditor[54]. In its Recommendation of 16 May 2002 the European Commission was of the opinion that drawing up a comprehensive list of non-audit services that compromises the independence of the auditor is impossible but that six services, if unaccompanied by certain protective instruments, would impede the independence of the auditor[55]. Directive 2006/43/EC did not provide in any list of non-audit services

[53] Commission Recommendation of 16 May 2002 Statutory Auditors' Independence in the EU: A Set of Fundamental Principles, *OJ L* nr. 191 of 19 July 2002, Article 8.2. (2) Relationship between total fees and total revenue.

[54] Already in 2000 the Securities and Exchange Commission issued a rule that prohibited the rendering of certain non-audit services like bookkeeping, financial information systems design and implementation, appraisal or valuation services and fairness opinions, actuarial services, internal audit services, etc., to the audited entity (SEC, *Final Rule: Revision of the Commission's Auditor Independence Requirements, Revision of the Commission's Auditor Independence Requirements*, Effective Date 5 February 2001, http://www.sec.gov/rules/final/33-7919.htm#P139_57710 last accessed 8 November 2014). This Rule required audit committees to monitor the work of the auditor. In its comment on the Rule the SEC stated that the debate on the endangering of the independence of the auditor when he is delivering non-audit services already started in 1957 (see note 69 of the rule). In 2002 many requirements of this Rule were overruled by the Sarbanes-Oxley Act.

[55] Preparing accounting records and financial statements, design and implementation of financial information technology systems, valuation services, participation in the audit client's internal audit, acting for the audit client in the resolution of litigation, recruiting senior management.

that had to be considered as impeding the independence of the auditor. In the recitals of that directive some examples could be found but for the remainder the directive referred to the Member States to ensure that the provision of non-audit services does not compromise the auditor's independence[56]. From now on, the Regulation (EU) No 537/2014 forbids "*any member of the network to which the statutory auditor or the audit firm belongs*" to provide non-audit services of a list of eleven services, including the six non-audit services of the Recommendation of 16 May 2002, but also tax services. Member States can derogate from a number of these services if their legislation provides in appropriate safeguarding measures[57]. We can remark that the European Parliament and the Council could provide in a comprehensive list, which the European Commission could not draw.

For the other non-audit services the network of the auditor is allowed to provide to the group of the audited entity, the audit committee must approve these services. It is only allowed to do so if it has properly assessed the threats to the auditor's independence and the safeguards the auditor applied. In the Member States where non-audit services that are on the European forbidden list are allowed if appropriate measures are provided, the audit committee shall "*issue guidelines with regard to the services*".

Third, the auditor must report extensively to the audit committee. Every year, the auditor must confirm his independence[58] and discuss the threats to the independence and the safeguarding measures in place[59]. Next, the auditor must every year provide the audit committee with an additional report consisting of sixteen items related to the work of the auditor, including the independence declaration, the scope of the audit, the timing, the communication with audit committee, etc.[60]

5. Monitoring of the audit committee

An innovation of the European legal framework of the statutory auditor is the external monitoring of the audit committee. According to article 27 of the Regulation (EU) No

[56] See article 22 Directive 2006/43/EC.
[57] See thereto article 5, §3 of Regulation (EU) No 537/2014.
[58] As well as the independence of the audit firm and partners, senior managers and managers, conducting the statutory audit.
[59] Article 6, §2 of Regulation (EU) No 537/2014.
[60] Article 11 of Regulation (EU) No 537/2014.

537/2014, the national supervisory agency or the European Competition Network (ECN) shall assess the performance of the audit committee. These monitoring activities raise specific questions with respect to the position of the committee as a subcommittee of a corporate organ of a company: can or must the supervisory agency point the audit committee at deficiencies, does the agency need to inform the (supervisory) board, must the agency take further action when mistakes were made, etc. These questions are not addressed but should be taken into account with due care.

6. Concluding remarks

This first analysis of the new European legal framework of audit committees of public-interest entities shows that the role and importance of this committee is considered to be pivotal. The requirements to monitor the work and independence of the auditor should not be underestimated. The audit committee, the (supervisory) board, the audited entity as well as the auditor have to develop procedures to act in accordance with the new Directive 2014/56/EC and the Regulation (EU) No 537/2014. "Compliance" will be key.

We have some doubts whether all the new measures are all equally advantageous for reaching the goal of an effective statutory audit. We are of the opinion that the mutual monitoring duties of the audit committee and the statutory auditor over the statutory audit overlap in its current configuration. Further, the responsibilities of the audit committee as a "advisory" subcommittee of the (supervisory) board which remains the ultimate responsible corporate organ is stretched to the extreme. Third, the selection procedure for the statutory auditor is excessively restrictive: the audit committee, the board, the general meeting, in some countries the employees council, all must have their say in a very prescriptive manner, which will raise the costs significantly. Fourth, we fear that some of the policy elements of the new audit framework, like better audits in a more competitive market, will not reach their goal. The heavily regulated audit market with low margins, significant liability risks and high insurance premiums could become unattractive and peripheral to some audit firms which might refocus their strategic investments in more lucrative other (non-audit) services. We hope that future developments prove us wrong.

european corporate governance institute

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI produces and disseminates high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It draws on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

www.ecgi.org

european corporate governance institute

ECGI Working Paper Series in Law

Editorial Board

Editor — Luca Enriques, Allen & Overy Professor of Corporate Law, Faculty of Law, Jesus College, University of Oxford

Consulting Editors — Theodor Baums, Director of the Institute for Law and Finance, Johann Wolfgang Goethe University, Frankfurt am Main

Paul Davies, Emeritus Fellow, formerly Allen & Overy Professor of Corporate Law, Faculty of Law, Jesus College, University of Oxford

Henry Hansmann, Oscar M. Ruebhausen Professor of Law, Yale Law School

Klaus Hopt, Emeritus Professor, Max-Planck Institut für Ausländisches und Internationales Privatrecht

Roberta Romano, Sterling Professor of Law and Director, Yale Law School Center for the Study of Corporate Law, Yale Law School

Editorial Assistants : Pascal Busch, University of Mannheim
Marcel Mager, University of Mannheim
Hakob Astabatsyan, University of Mannheim