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# *ecoDa – PwC Guidance for audit committees*



*June 2016*



## *Preface*

EU Audit legislation, adopted in 2014 introduces more detailed requirements regarding the statutory audit of ‘Public Interest Entities’ (PIEs). The aim of the legislation is to reinforce the quality of the audit and independence of the statutory auditor or audit firm and to restore investor confidence in financial information. This will be achieved in part by fostering more open competition within the audit market and by ensuring that audit committees take their responsibilities in the selection of an audit firm very seriously.

Given that the functions assigned to the audit committee have been extended in various ways, the European Confederation of Directors’ Associations (ecoDa) in cooperation with PwC has decided to help audit committee members understand the main changes by providing a description of aspects of the new legislation affecting audit committees, in comparison with the 2006 Directive. Many companies have yet to assess the full implications of this reform and are still in the process of getting ready to adapt to these changes although the legislation will be applicable from 17 June 2016.

The new EU regulatory framework contains a number of Member State options; for each of these aspects, flexibility is left to the Member States to opt for lighter or stricter rules. Flexibility in governance matters is a good policy, however, it remains important that the final national implementing laws result in a coherent framework that enhances audit quality and leaves audit committees in a situation where they can properly perform their new duties.

Audit committees have an important role to play in robust corporate governance. Their role in appointing the auditor, and overseeing management and the auditor, underpins the integrity of financial reporting. Putting audit committees at the heart of audit quality acknowledges their value and conveys the important work that audit committees perform. ecoDa recommends independence of the audit committee’s members and not only of the chairman. Audit Committees should be able to confront the board when a problem occurs. In fact, in most jurisdictions, it is common practice to appoint a separate person to be the chair of audit committee, distinct from the board’s chair, to ensure this level of independence.

This being said, Audit Committees should not be seen as separate bodies from the boards. Audit Committees’ members are appointed by the board whereas the board is appointed by the shareholders. Therefore, ecoDa believes that the critical evaluation of the composition and performance of the audit committee should remain the sole responsibility of the board, and calls on competent authorities in the EU to assess the performance of audit committees within the limits of monitoring audit market quality and competition, and not beyond.

In addition to making this informative document available, ecoDa and PwC will be happy to engage with audit committee members to assist in a smooth implementation of the new requirements.

PwC values the opportunity to work with ecoDa in developing this guide. It will take time for all to become familiar with the EU audit legislation and for best practice to emerge; the guide is designed to help audit committees understand the practical implications and offer some examples of good practice. Consistent interpretation of the legislation across the EU member states would limit the regulatory burden and administrative costs on business, especially through the transition period.

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### ***Notification:***

This guide has to be perceived as a technical note which does not reflect ecoDa’s opinion regarding the audit reform. ecoDa is of the opinion that audit committees have performed well over the past years and that the audit reform might add complexity to their work.

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# A Guide

## Structure of this guide

The guide covers the following dimensions:

Governance	Appointment	Independence	Reporting	Oversight
Primary requirements (rights and duties) of boards and board committees	Role of boards and board committees in the selection and appointment of the entity's auditor	Monitoring the independence of the auditor including its provision of non-audit services (NAS) by boards and board committees	New level of comprehensive auditor reporting and an additional report to the AC	Oversight and potential sanctions of boards and board committees by new requirement

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**Note:** Wherever we use the term board we refer either to the supervisory board in a 2-tier system or the board in a 1-tier board system; if reference is made to the management (board) we use the term management.

PIEs, according to Article 2 of the Directive are defined as:

- Entities governed by the law of a member state whose **transferable securities** are admitted to trading on a **regulated market of any EU member state**.
- **Credit institutions** which are defined as an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.
- **Insurance undertakings** which are essentially any undertaking carrying on regulated insurance business including life, general, reinsurance and permanent health.

- **Entities designated by member states** as PIEs, for instance undertakings that are of significant public relevance because of the nature of their business, their size or number of employees.

*There is no ‘one size fits all’ approach to corporate governance in EU member states*

In many jurisdictions, corporate governance consists of hard law and soft law such as corporate governance codes.

It is important to recognise that there is a wide variety of corporate governance codes and frameworks across EU member states, and that implementation of the EU audit legislation should take into account the various models that exist. We would also stress the need for alignment and consistency in the way member states implement the legislation, in particular the many member state options.

It should be noted that audit committees are an advisory committee to the board in many member states.

## Introduction

This guide focuses on the Corporate Governance implications of EU Audit legislation, adopted in 2014, and is addressed to boards and audit committees of public interest entities (PIEs) in the EU. The provisions of the legislation will apply from the first financial year starting on or after 17 June 2016.

The EU legislation comprises a Directive which applies to all statutory audits of annual financial statements, and a Regulation which only applies to the statutory audit of PIEs.

According to the EC press release<sup>1</sup> at the time of adoption, the legislation aims to improve audit quality and to restore investor confidence in financial information, by:

- Reinforcing the independence of the statutory auditor
- Contributing to a more dynamic audit market in the EU
- Reinforcing the role and competences of the audit committee (AC)

## Summary table

Status*	Key-Requirement	Responsibility		
		Auditor	AC	Other
<b>Governance – rights and duties of audit committee (Article 39 Directive)</b>				
<b>NEW</b>	The AC <b>as a whole</b> shall have competence relevant to the sector in which the audited entity is operating		✓	
<b>NEW</b>	A <b>majority</b> of members <b>need to be independent</b> of the audited entity		✓	
<b>Amended</b>	<b>ACs are required to inform the administrative or supervisory body</b> of the audited entity of the <b>outcome of the statutory audit</b> and explain its contribution to the integrity of the financial statements		✓	
<b>Amended</b>	ACs are required to <b>monitor the financial reporting process</b> and submit recommendations to ensure its integrity		✓	
<b>Amended</b>	ACs are required to <b>monitor the effectiveness of the undertaking's internal quality control and risk management systems</b> and, where applicable, its internal audit, regarding the financial reporting of the audited entity, without breaching its independence		✓	

<sup>1</sup> EC press release of May 2014: [http://europa.eu/rapid/press-release\\_MEMO-14-427\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-14-427_en.htm?locale=en)

Status*	Key-Requirement	Responsibility		
		Auditor	AC	Other
Amended	ACs are required to monitor the statutory audit of the annual and consolidated financial statements, taking into account any findings or conclusions by the competent authority		✓	
Amended	ACs are required to review and monitor the independence of the audit firm, and the appropriateness for the provision of permissible non-audit services		✓	
<b>Appointment – selection and appointment of the auditor (Article 16 Regulation)</b>				
Amended	The <b>AC should submit a recommendation to the board for the appointment of an audit firm</b> . It is responsible for the selection procedure. In its recommendation, the audit committee shall state that its recommendation is free from influence by a third party		✓	
NEW	The audited entity is free to select any audit firm to submit proposals, provided that: <ul style="list-style-type: none"> <li>• audit firms with <b>less than 15% market share are not excluded</b> (a list will be drawn up annually by the competent authority),</li> <li>• the tender documents <b>contain transparent and non-discriminatory selection criteria</b>, and</li> <li>• <b>legally required quality standards are included</b> in the tender documents (either EU or national law)</li> </ul>		✓	
NEW	The <b>audited entity is free to determine the selection procedure</b> and to conduct direct negotiations with interested tenderers in the course of the procedure		✓	
NEW	The AC has to validate the audited entity's report on the conclusions of the selection procedure, taking into account <b>national findings or conclusions of inspection reports</b> (if published by competent authority)		✓	
NEW	The audited entity needs to be able to <b>demonstrate</b> , upon request, to the competent authority <b>that the selection procedure was conducted in a fair manner</b>		✓	
NEW	The <b>Board's proposal to the AGM should include the recommendation of the AC</b> ; if it differs from the AC recommendation, the proposal must justify the reasons why.		✓	
NEW	<b>Contractual clauses limiting the choice of the AGM are null and void</b> ; the audited entity must inform the competent authority of any attempts to influence the decision of the AGM.		✓	
<b>Independence of the auditor (Articles 5 and 6 Regulation, Articles 22, 22a, 22b and 24a and b Directive)</b>				
NEW	Auditor to <b>discuss with AC the threats to independence</b> and applicable safeguards	✓	✓	



Status*	Key-Requirement	Responsibility		
		Auditor	AC	Other
Amended	<b>Reviewing and monitoring the independence of the statutory auditor</b> , including the additional annual report from the auditor and discussion with the auditor of key issues and mitigation actions (article 39 Directive)		✓	
NEW	<b>Pre-approving permissible non-audit services (NAS) for the provision of services</b> to the PIE itself, its parent and controlled undertakings in the EU, after having properly assessed the threats to independence and the safeguards applied. ACs will be able to give approvals to certain types of service in advance (article 5.4)		✓	
NEW	<b>Development of an appropriate policy regarding the provision of tax services</b> relating to preparation of tax forms, identification of public subsidies and tax incentives, support regarding tax inspections by tax authorities, calculation of direct and indirect tax and deferred tax, tax advice <b>or valuation services</b> (article 5.4)		✓	
NEW	Statutory auditor shall <b>assess and document the integrity of the members of the supervisory, administrative and management board</b> (article 6)	✓		
Same	Statutory auditor to <b>confirm annually in writing that the audit</b> (by firm, its partners, senior managers and managers) <b>is conducted independently</b> from the audited entity (article 6)	✓		
Same	Statutory auditor to <b>discuss with the AC threats to their independence</b> and applicable safeguards to mitigate those threats in general (article 6)	✓	✓	
<b>Reporting – auditor reporting and additional report to the audit committee (Article 11 Regulation)</b>				
NEW	<b>Additional report to the AC</b> by the auditor	✓		
NEW	<b>Overseeing the statutory auditor’s compliance with additional reporting requirements</b> in the Audit Report and the report to the AC		✓	
<b>Oversight – oversight and potential sanctions (Article 27 Regulation and Articles 30 following Directive)</b>				
NEW	In case of <b>breaches of provisions of the Directive or Regulation a temporary prohibition</b> , of up to three years' duration, banning a member of a board or board committee (Article 30a Directive)		✓	✓
NEW	<b>National competent authorities and the European Competition Network will monitor</b> developments in the audit market and draw up a report every three years; <b>the performance of ACs</b> is one of the areas to be assessed (others include market concentration levels, including in certain sectors, and the risks arising from high incidence of audit quality deficiencies) (Article 27 Regulation)			✓

# 1. Governance of audit committees

Even though the corporate governance requirements relating to boards and board committees are in the Directive, they only apply to PIEs (see Article 39.1 Directive). Of course, there may be entities that do not meet the criteria of the PIE definition but that might follow the requirements voluntarily (e.g. in order to have access to capital).

The AC can be either a stand-alone committee or a committee of the administrative body or supervisory body of the audited entity. However, the functions assigned to the AC may be performed by the administrative or supervisory body (i.e. the board) as a whole.

The table below outlines the requirements of EU ACs in relation to their composition and their members' individual competencies, comparing them with requirements of the previous Directive 2006/43/EC.

2014 Directive (2014/56/EC)	New requirement?
At least one member of AC shall have competence in accounting and/or auditing	Same wording as in 2006/43/EC*
AC members 'as a whole' shall have competence relevant to the sector in which the entity is operating	New requirement
Majority of the members of the AC shall be independent of the entity (in case all members of the AC are members of the supervisory board Art. 39.5 of the Directive allows for an exemption of this independence requirement)	In 2006/43/EC at least the member with competence in accounting and/or auditing was to be independent

\* Note: the 2014 Directive is not explicit that this member has to be independent (see below)

## Sector competence

The legislation introduces the concept that the members of the AC "as a whole" have competence relevant to the sector of the entity. Using the term "as a whole" suggests that it is **not necessary for all members of the AC to have competence relevant to the sector of the entity**. Many ACs prefer to include members from other industries to have a broad and diverse set of knowledge, skills and experiences on the board. This is also feasible under the new requirements. Furthermore, in some industries it could be difficult to find a large number of experts to be on the board without appointing representatives of relevant competitors. However, some ACs will need to find further sector experts to achieve sufficient competence and/or to hold regular training sessions to meet the new requirements.

## Independence

While in the past "only" the member with competence in accounting and/or auditing needed to be independent, now the majority of the AC is required to be independent, including the chairman.

The EU Audit legislation states that the majority of the members need to be independent of the "audited entity". Although there is no direct reference to the EU Recommendation (2005/162/EC), defining independence of directors, we can assume that this Recommendation applies, meaning that on top of the obligation that all members of the audit committee should be non-executive (in line with Directive 2006/43/EC), the majority of them should have no interests or relationships with the company that can limit their independence while also being independent from its major shareholders. As it is a Recommendation, it will depend on the Member

States' legislation whether this is a mandatory rule or only a recommendation where flexibility is possible on the basis of a comply or explain approach.

In countries that have no legally binding definition of 'independent directors' a first suggestion could be to assess independence as outlined in the FEE Briefing paper 'The impact of the audit reform on audit committees in Europe' (page 11) which lists the following criteria:

- is independent in character and judgement
- has no business or other relationships with the company's management
- has no material business relationship with the company directly, or as a partner, shareholder, director or employee of a body that has such a relationship with the company
- has, where applicable, completed an appropriate 'cooling-off' period in the case of an individual who used to serve as a member of the management board, as employee of the company, as external auditor, etc.
- is not involved in any other conflicting directorship or don't have other significant link(s) with other directors through involvement in other companies or bodies.

Annex II of the European Commission's recommendation (2005/162/EC) can also be helpful in determining the audit committee's independence. This definition goes further than the FEE approach by including criteria for independence towards controlling shareholders:

- not to be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years
- not to be an employee of the company or an associated company, and not having been in such a position for the previous three years, except when the non-executive or supervisory director does not belong to senior management and has been elected to the board in the context of a system of workers' representation recognised by law and providing for adequate protection against abusive dismissal and other forms of unfair treatment
- not to receive, or have received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director. Such additional remuneration covers in particular any participation in a share option or any other performance related pay scheme; it does not cover the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent in any way on continued service)
- not to be or to represent in any way the controlling shareholder(s) (control being determined by reference to the cases mentioned in Article 1(1) of Council Directive 83/349/EEC (1))
- 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
- not to be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director, and not to have other significant links with executive directors of the company through involvement in other companies or bodies
- 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)
- not to be a close family member of an executive or managing director, or of persons in the situations referred to in points (a) to (h).

**Note:** if these rules should be applied within a group context, it is common practice for group executives to sit on subsidiary audit committees together with independent members.

Finally, member states may require the chairman of the AC to be elected annually by the AGM.



*Adjust criteria for the appointment of new AC Members (independence and sector competence), taking into account the member state option on independence of AC Members.*

*By which date should audit committee members comply with the independence requirements?*

The European Commission published a Q&A in May 2016, stating that the new rules on the composition and the competences of audit committees will apply to the financial year starting on or after 17 June 2016. It is up to each audit committee to assess whether specific changes are required to its composition so that its members and the committee as a whole will be in line with the requirements of the new rules.

**Note:** Certain member states, including the German legislator, have specifically allowed that where members of the AC or the equivalent body were elected before 17 June 2016, they can serve until the end of their mandate.



*Ensure that the corporate governance statement reflects updated appointment criteria and that the entity complies with the new requirements.*

The integrity of the members of the supervisory, administrative and management board will be assessed and documented by the auditor (Article 6 of the Regulation). As highlighted in the preface, ecoDa is very critical on this point and considers it an invalid control mechanism, recognising that it is a requirement of auditing standards, and ISQC<sup>12</sup> in particular, that the auditor has to assess the integrity of the board for acceptance and continuance decisions. In ecoDa's view **it remains essential that the assessment of the board is the duty and role of shareholders and of the nomination committees**, including the assessment of the integrity of board members.

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<sup>2</sup> par. 26c and A19, A20 and A23 of ISQC 1, see <http://www.ifac.org/system/files/downloads/a007-2010-iaasb-handbook-isqc-1.pdf>

## 2. Appointment of the auditor

### Mandatory firm rotation

Article 17 of the Regulation requires that all PIEs in the EU must rotate their auditor after a maximum period of 10 years, with a member state option to extend this period once for a further ten years on the basis of a tender or 14 years in the case of a joint audit. If the member state option has been enabled, the extension is only possible upon a recommendation of the AC and approval of the board's proposal by the AGM (Article 17.5 of the Regulation).

#### Mandatory firm rotation: summary of requirements and options

Core requirements	Member state options
a 10-year audit firm rotation for all public interest entities (PIEs) in the EU	i. To extend the period once for up to a maximum further: <ul style="list-style-type: none"> <li>• 10 years if a tender is undertaken</li> <li>• 14 years if joint audit is adopted</li> </ul>
b At the request of the audited entity, the national regulators/supervisory authorities can extend the term once for a further maximum two years, in 'exceptional circumstances'. The definition of this remains unclear but is understood to include mergers or where a tender process has not been concluded.	ii. To adopt a shorter term of rotation

Article 16 of the Regulation lays down requirements for the selection and appointment of the auditor. The audit committee has overall responsibility for the selection procedure.

The new legislation gives clear guidelines for a fair and transparent selection and appointment process of a new auditor. The selection procedure organised by the audited entity must include the following steps:

- The audit committee must submit a recommendation to the administrative or supervisory body which is justified and **contains at least two choices** and the audit committee should express a preference for one of them, giving its reasons. If the board's final proposal differs from the preference of the AC, reasons must be given.
- The audited entity is free to invite any statutory auditors or audit firms to submit proposals for the provision of the statutory audit service on the condition that the tender process does not in any way preclude the participation in the selection procedure of 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 (this list will be drawn up on an annual basis by the competent authority). **It is unclear how the requirement 'not preclude' the participation of smaller audit firms is to be interpreted** but the purpose of this requirement is to ensure that smaller audit firms are not routinely excluded from the tender process. The requirement does not impose a duty on the PIE to approach smaller firms actively but clearly the tender process cannot specifically exclude small and medium sized firms.
- In terms of how a company demonstrates that they have not excluded such firms from the tender process, the audit committee should formally document the various criteria they have considered in deciding which firms to invite to tender. The audited entity and the AC shall take into consideration any findings or conclusions of any inspection report issued by the national competent authority.

## *Impact on multinational groups*

With regard to groups which have subsidiaries in various EU member states, each EU PIE in the group will have to comply with the MFR rules applicable to the member state in which it is based, however there is no requirement for non-PIE entities in the group to rotate their audit firm.

The audit committee of the parent undertaking in the EU is responsible for the selection procedure of the audit firm for the group in the EU. Where subsidiaries of the group which are a PIE in their own right are concerned, we recommend that the audit committee of the subsidiary would also be involved in the selection procedure of the audit firm, in particular if they are based in EU member states with shorter rotation periods than the PIE parent in another member state.



***Do the terms of reference and all relevant meeting agendas of the board and audit committee reflect the new requirements in the selection process of the statutory auditor?***

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***Is sufficient documentation available to demonstrate upon request by the competent authority that the selection procedure was conducted in a fair manner?***

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Furthermore the AC has to state that the recommendation is free from influence by a third party and that no clause restricting the choice of the AGM has been imposed. Any clause or contract restricting the choice by the AGM shall be null and void. The entity shall inform the competent authority directly and without delay of any attempt to impose such a contractual clause or to otherwise improperly influence the decision of the AGM.

Where the audited entity has a nomination committee which has the task of making recommendations on the selection of auditors, member states may allow that nomination committee to perform the functions of the AC that are laid down in Article 16 of the Regulation and require it to submit the recommendation to the general meeting of shareholders or members.

## 3. Independence of the auditor

### *Auditors' independence and prohibited non-audit services*

The Regulation treats all 'services other than statutory audit' as "non-audit services", and includes a list of **prohibited non-audit services** (see Appendix 2) which statutory auditors, audit firms or any members of their networks cannot provide to audited PIE entities in the EU, nor to their EU parent or controlled undertakings. Article 5 does not distinguish in the case of EU parent or controlled undertakings of the audited entity between PIEs and non-PIEs.

Member states can prohibit further services or establish stricter conditions.

If the audited entity has subsidiaries in other member states, these would have to comply with the law of the member state in which they were established (principle of local law).

### *Approval of permissible non-audit services (NAS) by the audit committee*

According to Article 39(6)(e), ACs have to 'review and monitor the independence of the statutory auditors or the audit firms in accordance with Articles 22, 22a, 22b, 24a and 24b of the Directive and Article 6 of the Regulation, and in particular the appropriateness of the provision of non-audit services to the audited entity in accordance with Article 5 of that Regulation'.

Article 6.2 of the Regulation lays down that, before accepting or continuing an engagement for a statutory audit of a PIE, the statutory auditor and audit firm has the duty to **assess and document any threats to their independence** and the safeguards applied to mitigate those threats, and to discuss them with the audit committee.

In addition, Article 5.4 of the Regulation requires **approval from the audit committee of a PIE for the provision of any non-audit services** (NAS) which are not on the prohibited list to the PIE itself, to its parent and to its subsidiaries\* in the EU, after having properly assessed threats to independence and safeguards. The audit committee is also required to issue guidelines regarding the provision of certain tax and valuation services if a member state exercises its option to permit these.

Under the 2006 Directive, audit committees were required to 'review and monitor the independence of the statutory auditor or audit firm and in particular the provision of additional services to the audited entity'. However there was no formal approval requirement.

### *Impact on multinational groups*

As a general principle, approval of permissible NAS is only required by audit committees of entities which are located within the EU and in relation to services that will be provided within the EU.

With regard to groups which have subsidiaries in various EU member states, we recommend that **as a minimum, the audit committee of the ultimate PIE parent undertaking in the EU should approve services to be provided to any entity** (both PIE and non-PIE) in the group, to the extent that these entities are **based in the EU** (taking into the account the cap on non-audit services, where relevant).

Where **services are provided to subsidiaries in the EU**, those services should also be approved by the audit committee of the subsidiary **if the subsidiary is itself a PIE** and is a direct recipient of these services (i.e. the service is being provided directly to the subsidiary).



However, we recommend that **where services of a confidential nature** are concerned, such as an investigation into possible wrongdoings at or due diligence of a subsidiary that may be sold, these services are not required to be approved by the audit committee of the relevant PIE subsidiary.

The audit committee of the subsidiary will be able to give advice on the implementation of the member state options in its territory. Of course, groups can require additional approvals as a matter of their internal corporate governance policy.

The audit committee of the parent undertaking in the EU is responsible for obtaining the approval of the audit committee(s) of PIE subsidiaries in the EU, following the audit firm's documented assessment of threats to independence and the safeguards applied to mitigate those threats, and a discussion with the audit committee.

Where the service is provided to a **parent entity located outside the EU**, and where the EU PIE audit client is also intended to be a recipient of the service, the audit committee of the EU PIE(s) will need to approve the services provided to the entities in the EU.

If the PIE subsidiary is audited by audit firm A but the PIE parent is audited by firm B, non-audit services provided by audit firm A to the subsidiary, and if relevant the parent, would need to be approved by the audit committee of the audited entity, i.e. the PIE subsidiary.

There does not seem to be anything preventing audit committees giving approval to certain types of service in advance. Of course, parent entities of groups can decide that audit committees at each level in the group need to assess the threats to independence and safeguards on a case-by-case basis. National regulators may also issue further guidance.

### Examples

The following examples illustrate the application of the principles above. The Directive (Article 39.3) gives member states the option to exempt certain PIEs from the obligation to have an audit committee (see Appendix 1 for more details). In the examples below, this option has not been taken.

Company structure	NAS to whom?	Approval by whom?
French PIE parent – German PIE subsidiary	NAS to French PIE but not to the German subsidiary	AC of the French PIE parent
French non-PIE parent - German PIE subsidiary	NAS to French non-PIE	AC of the German subsidiary has to approve (taking into account the French law). The audit committee of the French parent would not need to approve the services (unless the parent is subject to other jurisdictional requirements, such as the US SEC), though it may nevertheless request that it be consulted as the AC of the parent entity receiving the services.
French PIE parent - German PIE subsidiary	NAS to German subsidiary but not to the French parent	Both the AC of the French parent and of the German subsidiary need to approve, taking into account the German law.
UK bank with PIE subsidiaries in all EU28	NAS to the group	AC of the UK parent and ACs of the subsidiaries in the EU, taking into account the law of the territory in which they are established
UK bank with PIE subsidiaries in all EU28	NAS to the parent only	AC of the parent needs to approve
UK bank with subsidiaries outside the EU	NAS to the whole group	AC of the parent has to approve NAS to the UK bank. The audit firm should assess the threats to its independence and apply safeguards with regard to services provided to entities outside the EU (article 5.5)



Company structure	NAS to whom?	Approval by whom?
US bank with PIE subsidiaries in all EU28	NAS to the whole group	The ACs of the subsidiaries in the EU would each need to approve the services, taking into account the law of the territory in which they are established. Services to the US bank may need pre-approval by the parent AC if subject to US SEC rules.

### *When will the prohibitions apply?*

The non-audit services prohibitions apply from the first financial year starting after 17 June 2016. **An audit firm cannot provide the prohibited services to the audited entity during the period between the beginning of the period audited and the issuing of the audit report.**

There is an additional requirement for one category of NAS, namely “designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or financial information technology systems” whereby such services also cannot be provided in the financial year prior to the period audited.

**Note:** It is not clear from the text what the responsibility of the AC is in regard. However the cooling-in period will need to be considered where a provider of non-audit services is being considered for appointment as auditor and will thus indirectly impact the AC.

### *Requirements with regard to the allowance of certain tax and valuation services*

A member state can allow the provision of certain tax and valuation services (see Appendix 2) by the audit firm, provided that the following requirements are complied with:

- These services have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements
- The estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report from the auditor to the AC referred to in Art. 11 of the Regulation
- The principles of independence laid down in Directive 2006/43 are complied with by the statutory auditor

The AC should actively monitor the requirements above and should issue **guidelines** with regard to these services. It is not specified what form the guidelines should take.



*Where member states allow for the provision of certain tax and valuation services, are guidelines in place with regard to the provision of such services?*



*Update the terms of reference/rules of procedure of the AC regarding the pre-approval process.*



*Do agendas and minutes reflect the activities of the AC in connection with approving the provision of permissible NAS?*

## Fee-cap on permissible NAS

The legislation introduces a cap on the amount of non-audit services that an audit firm can provide to an audited PIE. **The relevant limit is 70% of the average of the statutory audit fees** paid to the statutory auditor for the audit of the PIE, and where applicable, its parent undertaking and its controlled undertakings for the previous and consecutive three years. The permissible NAS are services provided by the audit firm to the audited entity and its parent undertakings and controlled undertakings, whether in the EU or outside of the EU.

All permissible NAS provided by the statutory auditor are included in the calculation, however services that are required by EU law or the law of a member state are excluded, both from the denominator and the numerator (article 4.2).

The calculation of fees would be based on the disclosures made by the PIE in its financial statements, i.e. on an accruals basis (both for audit and non-audit services), as per the statutory requirements (i.e. Article 18 of the Accounting Directive 2013/34/EU or its implementation in the relevant jurisdictions).

In exceptional circumstances (such as IPOs and capital market transactions) the audit firm may ask the competent authority to be exempted from the requirements for a period of maximum two years (provided that the member state has enabled this option).

**Note:** Article 4.2 does not specifically mention the role of the audit committee however in practice the amount of NAS will be subject of discussions between the audit firm and the AC.

When the **total fees** received from a public interest entity **are more than 15%** of the total fees received by the auditor (in each of the last three consecutive years for one audit engagement), the auditor has to discuss with the AC the threats to its independence and applicable safeguards (Article 4.3). The audit committee should:

- Consider whether the audit engagement should be subject to an engagement quality review by another audit firm prior to the issuance of the audit report
- Decide whether the auditor may continue to carry out the statutory audit for an additional period, when fees received from the PIE exceed 15%. The additional period may not exceed the duration of two years.

Member states have the option to lay down more stringent requirements.

## Cooling-off period for key audit personnel joining the audited entity

Art. 22a of the Directive outlines the requirements in cases where former statutory auditors of the entity become a part of the management or corporate governance bodies.

Function in the entity	Key audit partner		Employee or other partner
	PIE	Non PIE	PIE or Non PIE
Key management position	2 yrs	1 yr	1 year
Member of audit committee	2 yrs	1 yr	1 year
Non-Executive member of Board	2 yrs	1 yr	1 year

Cooling-off

The cooling-off period mentioned above is the time that has elapsed since he or she was directly involved in the statutory audit engagement team.



*Do the policies of the board and audit committee reflect the responsibility to monitor the history of new key management staff joining the company in relation to previous employment by the incumbent audit firm?*

## 4. Reporting

### *The audit report*

The new audit report required by the EU Audit Legislation is an important change. Previously the auditor's opinion on the financial statements was included in an audit report that was largely standardised. The EU Audit Legislation introduces a new audit report for PIEs that is aimed at providing **increased transparency and insight** on key judgements taken in the audit, as well as additional information on the **independence** of the auditor or audit firm. The new reports will be longer and more bespoke.

The requirements that apply to the statutory audits of PIEs are summarised in the table below. Similar changes are being introduced audit reports in other jurisdictions and in the International Standards on Auditing (ISAs), which a number of EU Member States adopt in their national auditing standards.

#### Summary of new audit report requirements

a	State by whom or by which body the audit firm(s) was (were) appointed	
b	Indicate the date of the appointment and the period of total uninterrupted engagement including previous renewals and reappointments of the audit firm	
c	In support of the audit opinion:	<ul style="list-style-type: none"> <li>Describe the most significant assessed risks of material misstatement, including due to fraud</li> <li>Summarise the auditor's response to those risks</li> <li>Where relevant, provide key observations arising with respect to those risks</li> </ul> <p>Where relevant to the above information, provide a clear reference to the relevant disclosures in the financial statements</p>
d	Explain to what extent the audit was considered capable of detecting irregularities, including fraud	
a	Confirm that the audit opinion is consistent with the additional report to the audit committee	
b	Declare that prohibited non-audit services (NAS) were not provided and that the audit firm(s) remained independent of the audited entity in conducting the audit	
c	Indicate any services, in addition to the statutory audit, provided by the audit firm to the audited entity and its controlled undertaking(s), which were not disclosed in the management report or financial statements	
d	The statutory auditor(s) or audit firm(s) shall also:	<ul style="list-style-type: none"> <li>express an opinion on: <ul style="list-style-type: none"> <li>whether the management report is consistent with the financial statements for the same financial year</li> <li>whether the management report has been prepared in accordance with the applicable legal requirements</li> </ul> </li> <li>State whether, in light of the knowledge and understanding of the undertaking and its environment obtained in the course of the audit, he, she or it has identified material misstatements in the management report, and shall give an indication of the nature of any such misstatements</li> <li>In light of the above, include an opinion and statement, both of which shall be based on the work undertaken in the course of the audit</li> </ul>

There are a few areas worthy of note.

First, the audit report will now include bespoke descriptions of what the auditor viewed as the **most significant risks of material misstatement** in the audit and how the auditor addressed those areas in the audit. This will provide insight into the areas that were of most significance in the audit and where the auditor focussed effort. This is likely to include those areas in the financial statements that involved significant management judgement. This section of the new reports will be tailored to the specific circumstances of the entity and the audit and is the section that will increase the length of the audit report.

Second, auditors will be required under both the Accounting and Audit Directives to provide **two opinions and a statement regarding the management report**. To a large extent, these requirements are aligned with the auditor's responsibilities as part of the financial statement audit in relation to the other information in a company's annual report under auditing standards (e.g., the auditor's responsibilities in accordance with the ISAs). However, the requirement to express an opinion on whether the management report has been prepared in accordance with the applicable requirements goes beyond the ISA requirements and, at a minimum, auditors will need to check if the required disclosures have been included. In some Member States, auditing standard setters may set additional work effort requirements. As there could be different work effort as the basis for the opinion being expressed, it will be important that there is transparency in the audit report about the work effort on which the opinion is based.

Third, auditors will also be required to **report certain factual information** regarding the audit engagement, such as the date of the appointment and the period of total uninterrupted engagement including previous renewals and reappointments. In relation to **independence**, there are required declarations on the auditor's or audit firm's independence, including a declaration regarding not having provided any prohibited NAS. Auditors are also expected to indicate any permitted services, in addition to the statutory audit, which were provided to the audited entity and its controlled undertakings. If those services have been disclosed in the annual report or financial statements, they do not need to be repeated in the auditor's report. Including that disclosure in the PIE's annual report or financial statements would be the best way to make the disclosures because the audit committee can then indicate their approval of them.

### *Additional report to the AC*

The value of statutory audit for the audited entity is particularly enhanced if the communication between the statutory auditor or the audit firm, on the one hand, and the audit committee, on the other hand, is reinforced. The new Audit Regulation, therefore requires statutory auditors of PIEs to **provide a written more detailed report to the audit committee** on the results of the statutory audit. The report is required to be submitted to the audit committee no later than the audit report. Member States may additionally require that the report be submitted to the administrative or supervisory body of the audited entity.

The requirements are summarised below. Many of the matters required to be included in the audit committee report are already widely communicated in audit committee reports in practice and required to be communicated under auditing standards (e.g., the ISAs). But there are a number of new, or enhanced, disclosures required.

#### **Audit committee report requirements**

The statutory auditor should report on:

a. Their independence, and in addition to identifying any other statutory auditor or audit firm that is not part of the same network involved in the audit and any external experts, confirm that confirmations have been received regarding their independence	<b>More comprehensive disclosure</b>
b. The key audit partner (s) involved in the audit	
c. The nature, frequency and extent of communication with the audit committee (or equivalent), management and/or supervisory board, including dates of meetings	<b>More comprehensive disclosure</b>
d. The scope and timing of the audit	
e. Where more than one audit firm is appointed, the distribution of tasks	<b>New</b>

### Audit committee report requirements

f. Identify audit work performed by third-county auditors other than by members of the same network	New
g. The methodology used, including which categories of the balance sheet have been directly verified and which have been based on system and compliance testing, including an explanation of any substantial variation in the weighting when compared to the previous year, even if carried out by another audit firm	New
h. Quantitative levels of materiality applied to perform the statutory audit for the financial statements as a whole and, if applicable, for particular classes of transactions, account balances or disclosures, and the qualitative factors considered when setting the level of materiality	New
i. The judgments about events or conditions identified during the course of the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty.	Some additional supporting documentation required to be included
j. Any significant deficiencies in the internal financial control system, as well as in the accounting system. For each significant deficiency, the additional report shall state whether or not the deficiency in question has been resolved by the management	
k. Any significant matters involving actual or suspected non-compliance with laws and regulations or articles of association, which were identified during the course of the audit, in so far as they are considered to be relevant in order to enable the audit committee to fulfil its tasks	
l. Report and assess the valuation methods applied to the various items in the financial statements, including any impact of changes of such methods	New
m. Explain the scope of consolidation and the exclusion criteria, and whether the criteria applied are in accordance with the financial reporting framework	New
n. Indicate whether all requested explanations and documents were provided by the audited entity and report any significant difficulties encountered, any significant matters that were discussed or subject to correspondence with management, and any other matters that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.	

Much of the new information is factual, but certain requirements will require consideration to determine the most effective way of presenting it in a way that can facilitate effective dialogue between the audit committee and auditors. For example, the requirement to **describe the methodology used** and the approach taken to audit balance sheet items, including the change in it from previous periods, uses different terminology than auditing standards. The key aim will be to describe it in a way that audit committees can understand the audit approach taken on significant balance sheet items and how audit evidence was obtained (e.g., whether through testing relevant controls or substantive testing, including tests of details or analytical procedures, or a combination thereof).



**Discuss the timing of proposed meetings of the AC with the auditors so that there will be sufficient time to reflect on the matters reported in the auditor's additional report to the audit committee.**

The audit committee can be made available, upon request, to the competent authorities responsible for oversight of statutory auditors. There is also a member state option in place to allow ACs to disclose the additional report to third parties if provided for in national law.



**Allow sufficient time in the AC agenda for effective dialogue with the auditor about the matters disclosed in the auditor's report and in the additional report to the audit committee.**

Member states can lay down additional requirements in relation to the content of the additional report to the AC.

## 5. Oversight

### *Market monitoring (Article 27 of the Regulation)*

The Regulation introduces a new obligation on national competent authorities in the EU, as well as on the European Competition Network (ECN), to monitor developments in the PIE audit market, and in particular:

- The risks arising from high incidence of quality deficiencies, which may lead to the demise of any audit firm
- The market concentration levels, including in specific sectors
- **The performance of audit committees**
- The need to adopt measures to mitigate the risks referred to above.

By 17 June 2016, and at least every three years thereafter, each national competent authority and the ECN, shall draw up a report on developments in the market for providing statutory audit services to public-interest entities and submit it to the CEAOB, ESMA, EBA, EIOPA and the Commission. The ECN consists of the national competition authorities in the EU member states, and is coordinated by the EC's Directorate General for Competition.

The Commission will draw up a joint report on those developments at EU level, however there is no deadline for the EC to issue such a report. The joint report will be shared with the Council, the European Central Bank and the European Systemic Risk Board, as well as, where appropriate, to the European Parliament.

Our understanding is that the performance assessment would be in line with the objective of article 27 of the Regulation, entitled "Monitoring market quality and competition", to ensure that audit committees take into account the impact of their auditor appointment decisions on audit market concentration when rotation of their external auditor is due, and that **appointment decisions are primarily based on audit quality** - price should not be the primary driver for audit committees' choice of an audit firm.

The legislation also introduces the possibility of **imposing sanctions on individual board members** for any breach of the provisions of the legislation. In this context ecoDa wants to stress that this proposal **seems to be in contradiction with the collegial spirit of the board**. In principle board committees have advisory power and no decision power. Since the audit committee is an advisory subcommittee, it is the board which is accountable for the consequences of all board decisions. The board should remain the ultimate responsible body because eliminating this essential characteristic will inevitably disturb its reason for being, i.e. collegial decision-making at the helm of the company.

### *Sanctions*

Article 30a of the Directive requires member states to provide that the following sanctions can be imposed in cases of breaches of provisions of the Directive or Regulation:

- a temporary prohibition (of maximum three years), banning a member of an audit firm or an administrative or management body of a PIE from exercising functions in PIEs
- imposition of administrative pecuniary sanctions on natural and legal persons



***Is sufficient documentation available to produce proof of the activities of the AC in connection with the frequent assessment of the AC?***



***Is the potential liability of individual members of the AC reflected in the director's and officer's insurance?***

*The report has been reviewed by ecoDa's policy committee and its chair (Lutgart Van den Berghe) as well as by ecoDa's board*



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# *Appendices*

# Appendix 1

## Member state option to exempt the following PIEs from the obligation to set up an AC (Article 39.3 of Directive)

A 'subsidiary undertaking' meaning:

An undertaking controlled by a parent undertaking, including any subsidiary undertaking of an ultimate parent undertaking, provided that, at group level, the following conditions are fulfilled:

- The group, presumably the (ultimate) parent, has an AC;
- In cases where the member state has decided to assign the functions of the AC to the administrative or supervisory body as a whole, the chairman, if an executive member, does not act as a chairman of the body when it is performing the functions of the AC;
- The AC independence requirements are respected, unless member states have exempted the AC from those requirements where all members of the AC are members of the administrative or supervisory body of the audited entity;
- The auditor carrying out the statutory audit submits an additional report to the AC explaining the results of the statutory audit; this report must include the elements listed in Article 11(2) of Regulation 537/2014; and,
- The proposal to the shareholders for the appointment of the statutory auditor includes the recommendations and preference made by the AC

**Note:** it is our understanding that the AC must be an AC of an EU entity. This follows (albeit implicitly) from the references in Article 39(3)(a) of the new Audit Directive. The wording of Articles 39(1), (2) and (5) of the new Audit Directive and of Articles 11(1) and (2) of the Audit Regulation, to which Article 39(3)(a) of the new Audit Directive makes reference, all give member states a certain amount of discretion as to how the ACs of the PIEs within their respective territories are to be governed. This suggests that the concept of "AC" within the meaning of the EU audit legislation only covers ACs of EU entities, since member states would not ordinarily have jurisdiction to exercise this discretion over ACs of third-country entities.

An Undertaking for Collective Investment in Transferable Securities (UCITS), meaning an undertaking:

- With the sole object of collective investment in transferable securities or in other liquid financial assets of capital raised from the public and which operates on the principle of risk-spreading; and
- With units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.

An Alternative Investment Fund (AIF), meaning collective investment undertakings, including investment compartments thereof, which:

- Raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and
- Do not require authorisation as a UCITS under Article 5 of Directive 2009/65/EC.

Where the sole business is to act as an issuer of asset backed securities, meaning securities which:

- Represent an interest in assets, including any rights intended to assure servicing, or the receipt or timeliness of receipts by holders of assets of amounts payable thereunder; or
- Are secured by assets and the terms of which provide for payments which relate to payments or reasonable projections of payments calculated by reference to identified or identifiable assets

**Member state option to exempt the following PIEs from the obligation to set up an AC (Article 39.3 of Directive)**

Any credit institution (meaning an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account):	<ul style="list-style-type: none"><li>• Whose shares are not admitted to trading on a regulated market<sup>3</sup> of any member state; and</li><li>• Which has, in a continuous or repeated manner, issued only debt securities admitted to trading in a regulated market, provided that the total nominal amount of all such debt securities remains below €100,000,000; and</li><li>• Which has not published a prospectus under Directive 2003/71/EC (relating to the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a member state).</li></ul>
Member state exemption	<ul style="list-style-type: none"><li>• Provided there is a body or bodies performing equivalent functions to an AC, established and functioning in accordance with provisions in place in the member state in which the entity to be audited is registered.</li></ul>

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<sup>3</sup> The list of specific exchanges is published by the European Securities and Markets Authority (ESMA). The list is up-dated periodically and is available at:

[http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks\\_id=23&language=0&pageName=REGULATED\\_MARKETS\\_Display&subsection\\_id=0](http://mifiddatabase.esma.europa.eu/Index.aspx?sectionlinks_id=23&language=0&pageName=REGULATED_MARKETS_Display&subsection_id=0)

# Appendix 2

## List of the prohibited non-audit services (Article 5 of the Regulation)

a. Tax and tax compliance services:	i. Preparation of tax forms	Member states can allow the provision of tax services relating to i), iv), v), vi) and vii) as long as:	<ul style="list-style-type: none"> <li>• They have no direct or have immaterial effect on the audited financial statements.</li> <li>• The effect on the financial statement is documented in the additional report to the audit committee; and</li> <li>• Principles of independence are complied with.</li> <li>• Audit committee to set guidelines with regard to provision of such services</li> </ul>	
	ii. Payroll tax			
	iii. Customs duties			
	iv. Identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law			
	v. Support regarding tax inspections by tax authorities unless support from the statutory auditor in respect of such inspections is required by law			
	vi. Calculation of direct and indirect tax and deferred tax			Note: Tax services relating to payroll tax and customs duties are not included in the member state option and are therefore never permitted
	vii. Provision of tax advice			
b. Services that involve playing any part in the management or decision-making of the audited entity.				
c. Bookkeeping and preparing accounting records and financial statements				
d. Payroll services				
e. Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems;				
f. Valuation services, including valuations performed in connection with actuarial services or litigation support services (subject to a member state option, as in point a)				
g. Legal services with respect to:	<ul style="list-style-type: none"> <li>• The provision of general counsel</li> <li>• Negotiating on behalf of the audit client</li> <li>• Acting in an advocacy role in the resolution of litigation</li> </ul>			
h. Services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity				
i. Promoting, dealing in, or under-writing shares in the audited entity				
j. Services related to the audit client's internal audit function				
k. Human resources services relating to:	<ul style="list-style-type: none"> <li>• Management in a position to exert significant influence over the preparation of the accounting records or financial statements subject to statutory audit, where such services for such positions involve: <ul style="list-style-type: none"> <li>• structuring of the organisation</li> <li>• cost control</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• searching for or seeking out candidates</li> <li>• undertaking reference checks on candidates</li> </ul>		



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