

The role and functions of Audit Committee

Accounting and Auditing Standards Community of Practice Workshop

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Session objectives

- » A general overview of an audit committee's main role and its key responsibilities under the Directive 2006/43/EC (amended by Directive 2014/56/EU) on statutory audits of annual accounts and consolidated accounts and Regulation 537/2014 on specific requirements regarding statutory audit of public-interest entities



Lessons learnt from the Global Financial Crisis in 2008

- » **Absence of** the provision of adequate **warning signs** to the board and top management.
- » The more serious **shortfalls in corporate governance** were not related to technology and risk model construction but to the role of individuals, decision-making processes in general and the understanding and interpretation of risk models.
 - » Corporate governance model **did not perform** as it should have.
 - » Assurance functions **failed**.



Background for new audit legislation

- » **The Global Financial Crisis in 2008 triggered a series of regulatory responses** from EU Member States and the need for a consistent supervision of the European financial markets.
- » the European Commission and the Member States wished to arrive at a new revision of the 8th Company Law Directive and, at the same time, **the Audit Market Reform package** appeared in the pipeline.
- » with objective **to reinforce the independence and the quality of the external auditors** in their work in certifying the financial statements.

EU statutory audit reform

- » On 3 April 2014, the European Parliament adopted the revised Directive and a separate Regulation.
- » The Directive 2006/43/EC as amended by Directive 2014/56/EU is applicable for every statutory audit in the EU and
- » The Regulation 537/2014 sets the requirements specifically relating to statutory audits of Public Interest Entities (PIEs).



THE AUDIT MERRY-GO-ROUND, AS IMPROVED BY RECENT REGULATORY INTERVENTION



Requirements for establishing audit committee

- » PIEs should establish an audit committee
- » For some entities (SMEs in the context of the Directive 2003/71/EC) – audit committee role can be performed by the administrative or supervisory body
- » Member states may allow PIEs to have other body performing equivalent functions responsible for audit committee function – the name of the body should be disclosed
- » Some exemptions (e.g. Subsidiary – may not have an audit committee in case it exists at the group level)



Audit Directive - transposition in progress

- » Transposition deadline: 17 June, 2016
- » Full transposition status: 14 member states or 50%
- » **No transposition measures communicated:**
 - » Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Greece, Latvia, Lithuania, Netherlands, Poland, Romania, Slovenia
- » **Partial transposition measures communicated:**
 - » France
- » **Full transposition measures communicated:**
 - » Austria, Denmark, Finland, Germany, Hungary, Ireland, Italy, Luxemburg, Malta, Portugal, Slovakia, Spain, Sweden, United Kingdom
- » No Commission's enforcement action so far.



Audit committee reform

- » Building well-functioning audit committees is still work in progress in many EU Member States
- » Significant potential to contribute to audit quality
- » Overall objective: improving an effective two-way communication of the audit committee
 - » with management and the internal audit function
 - » with the auditor

The role of the Audit Committee

- » The audit committee has a particular role, acting independent of executive management to ensure that the interests of the shareholders are properly protected in relation to risk management, internal control and financial reporting.





Responsibilities of the audit committee

- » Monitoring the work of the external auditor
 - » Responsible for auditor selection
 - » Central role in reviewing and monitoring auditor independence
 - » Approval of the non-audit services
- » Monitoring the financial reporting process and propose recommendations
- » Overseeing organizational matters, namely the internal control and risk management systems

Responsibility for auditor selection

- » Key words: selection process, auditor appointment, transparency, criteria
 - » Structured tender process followed by reasoned recommendation to the administrative or supervisory body (or directly to shareholders)
 - » The audit committee involvement will ensure: 'Fit for purpose' selection criteria
 - » Auditor independence towards management
- » **The auditor selection responsibility and procedure are now defined by legal requirements**
 - » Directive–Article 39.6(f) and Regulation–Article 16





Reviewing and monitoring auditor independence

- » A central role in overseeing the independence of the auditor
 - » Key words: independence, monitor, conflicts of interest
- » **The 2006/43/EC Directive assigns monitoring of auditor independence to the audit committee. The 2014 amendment adds further clarity and new criteria:**
 - » More specific criteria to assess possible conflicts of interest and threats to auditor independence
 - » Level of dependency towards a specific client (15%)
 - » Employment of former auditors by the audited entity
 - » Specific requirements re provision of non-audit services
 - » Directive–Article 39.6(e) and Regulation– Article 6.2

Approval of non-audit services

- » Reviewing and monitoring the appropriateness of the provision of non-audit services
 - » Key words: non-audit services, approval, independence, guidance
- » **In overseeing the auditor independence, the audit committee should review and monitor the statutory auditor's provision of non-audit services**
 - » Directive – Article 39.6 (e) and Regulation – Article 5



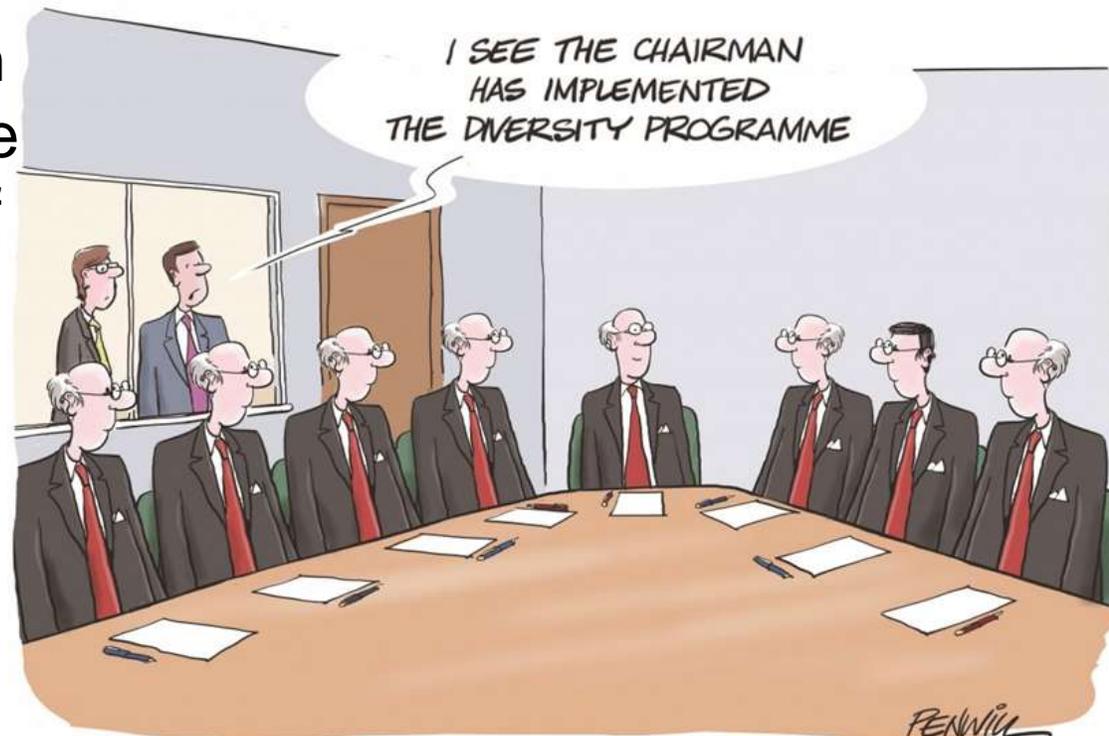


Internal communication and other responsibilities

- » Internal communication and other responsibilities of the audit committee
 - » Key words: communication, financial reporting, integrity, audit, internal quality control, effectiveness
- » **In addition to communication of the outcome of the audit and the audit committee's role in this process, monitoring the financial reporting and statutory audit processes, the audit committee is also expected to monitor the effectiveness of the internal control and the risk management systems of the audited entity**
 - » Directive – Article 39.6 (a-d)
- » **The auditor has to report to the audit committee on key matters arising from the statutory audit, including material weaknesses in internal control in relation to the financial reporting process**
(International Standards on Auditing).

Establishing the Audit Committee

- » The board is responsible for establishing an audit committee and/or a risk committee and defining the roles in a charter of terms of reference
- » The board should ensure that composition of the committee reflects a gender balance in order to benefit from a wider diversity of ideas and opinions and avoid group thinking phenomenon.





A model audit committee

- » Background, composition and expertise of audit committee members
 - » Key words: collective sector and accounting and/or auditing competence, non-executive members
- » Independence of audit committee members
 - » Key words: independence, principle-based approach
- » The specific role of the audit committee chair
 - » Key words: chairmanship, independence
- » **Communicative chair, composed by only non-executives and independent (at least 50%) members in character and judgement, include members with competences in the sector and at least one in accounting and/or auditing**
 - » Directive–Articles 22.a and 39.1

Assessment of the audit committee

- » Regular assessment of performance
 - » Key words: assessment, audit committee performance, sanctions
- » **The Regulation requires that competent national authorities and the European Commission Network (ECN) assess the performance of the audit committee.**
 - » Article 27
- » **The Directive allows for competent authorities to impose sanctions in case of breaches.**
 - » Article 30



Case: ENRC fiasco



Eurasian Natural Resources Corporation plc:

- 2006 - 2013
 - a Kazakhstan/Central African-focused mining company
 - concentrated ownership - oligarchs and government
 - more than 66,000 employees in Kazakhstan
- LSE listing between 2007 and 2013
 - free float was below the usual 25% threshold
 - £1.4bn raised
 - valued £13bn in 2007 and below £3bn in 2013
 - the former UK's blue-chip FTSE 100 index
 - Board of directors: 14 members (7 INEDs)



Case: ENRC fiasco



- ENRC listing saga a debacle of corporate governance: Miner's problems stemmed not just from the oligarchs' roles
- ENRC fiasco shows governance failure: The ENRC fiasco highlights the UK's governance shortfalls

Forbes

- 'Financial Crisis Was Not Caused By Lack Of Rules': A Call To Rethink U.K.'s Corporate Governance

The Telegraph

- The London market only needs transparent and ethical companies

Case: ENRC fiasco

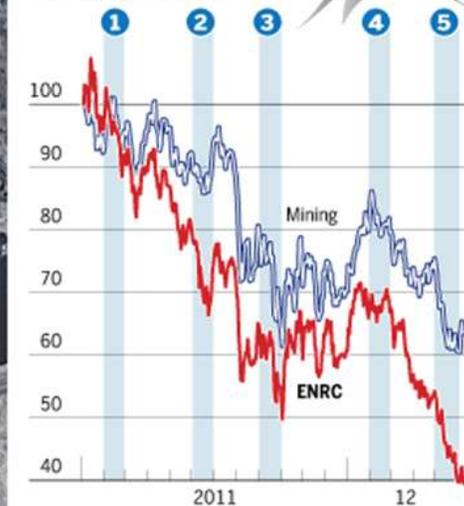
- » disagreements involving the board and management;
- » tensions between shareholders and INEDs
- » turnover of INEDs
- » public accusations of poor corporate governance;
- » “related party transactions”
- » allegations of bribery, fraud and corruption, including criminal investigation into the company’s dealings by the Serious Fraud Office.....

A downward spiral



ENRC

Share price and FTSE index rebased

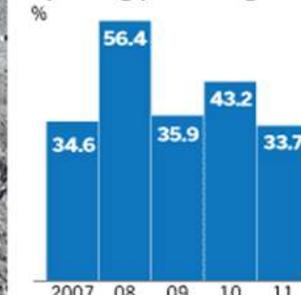


Source: FT

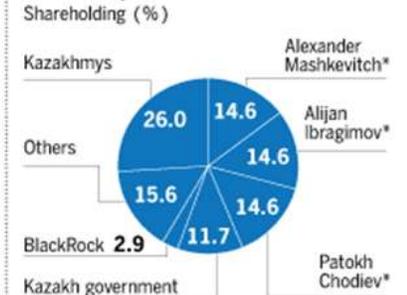
Boardroom changes

- 1 Feb 2011**
Chief executive Felix Vulis resigns for 'personal reasons' but stays on in an acting capacity
- 2 Jun 2011**
Independent directors Ken Olisa and Sir Richard Sykes ejected from the board by ENRC's founders and the Kazakh government
- 3 Sep 2011**
Felix Vulis reinstated as chief executive
- 4 Feb 2012**
Mehmet Dalman appointed as chairman
- 5 May 2012**
Richard Burrows and Mohsen Khalil appointed as independent directors

Operating profit margin



Ownership



Sources: Thomson Reuters Datastream; company

* ENRC's founders Photo: ENFC



Case: ENRC fiasco

- » A 2011 independent report into the workings of ENRC's board, drawn up by corporate governance experts ICSA and seen by Reuters, criticised the chairman's ineffective leadership of the group's audit committee.
- » The independent report, which gave ENRC's board its lowest ever rating, said "serious concerns were voiced about the approach and the manner of the chairman" adding "meetings are said to go on too long, there are questions about personal relationships with the auditors and there are said to be tensions among the audit committee members".

Source: <http://www.reuters.com/article/enrc-board-idUSL6N0DA4MN20130423>



Case: Lessons learnt

The ENRC fiasco demonstrates, among other things:

- » Key role that audit committee should have played in protection of shareholders interests
- » Importance of audit and corporate governance reforms
- » Challenges and complexity of corporate governance issues in companies with concentrated ownership (private and SOEs)

“It is simply not correct for a company to say that because they have ticked certain boxes, they show good governance”

*Mr. Kenneth Olisa,
former independent
non-executive director of ENRC*



Ask yourself...

- » Are the EU requirements significantly different from the legislation in your country?
- » What is different or common?
- » Does legislation in your country requires establishment of an audit committee?
- » What types of companies in your country should establish an audit committee?
- » What are the requirements towards the composition of the audit committees?
- » Does legislation in your country determine the applicable rotation and tendering requirements?



Questions

- » Thank you for your attention!
- » Any questions?



Recommended further readings

- » European Commission: Audit Market and Regulation
<http://ec.europa.eu/finance/auditing/>
- » 2016 FEE paper The impact of the audit reform on audit committees in Europe
http://www.fee.be/images/publications/company_law/160115_Impact_of_audit_reform_on_audit_committee.pdf
- » 2012 FEE paper The functioning of Audit Committees, available on:
http://www.fee.be/images/Discussion_Paper_on_Audit_Committees_120615.pdf.
- » 2014 FERMA / ECIIA paper Guidance for Boards and Audit & Risk Committees Audit and Risk Committees News from EU Legislation and Best Practices http://www.eciia.eu/wp-content/uploads/2014/10/ECCIA_FERMA_Brochure_v8_HD1.pdf

Appendix:

Article 39.6 of the Directive states that the audit committee shall:

- a. **inform** the administrative or supervisory body of the audited entity of the outcome of the statutory audit and **explain** the role of the audit committee in that process;
- b. **monitor** the financial reporting process and **submit recommendations** or proposals to ensure its integrity;
- c. **monitor** the effectiveness of the undertaking's internal quality control, risk management systems and internal audit (where applicable), regarding the financial reporting of the audited entity, without breaching its independence;
- d. **monitor** the performance of audits – taking into account the findings and conclusions of the audit reviews carried out by the competent authorities;
- e. **review** and **monitor** the independence of the statutory auditors; and
- f. be **responsible** for the **procedure** for the selection of the statutory auditor.

Appendix: Specific activities required of a PIE's audit committee set out by the Regulation

Activities	Key provisions affecting audit committee oversight of PIE statutory audits
Monitoring the level of audit fees	Monitor the percentage of fees received from a PIE by the statutory auditor – including oversight by the audit committee of the operation of the 70% fee cap for permitted non-audit services (Article 4).
Assessment of compliance	Oversee the process by which the statutory auditor assesses the provision of permitted services, ensuring that the following requirements are complied with: a. they have no direct or have immaterial effect, separately or in the aggregate, on the audited financial statements; b. the estimation of the effect on the audited financial statements is comprehensively documented and explained; and c. the process complies with the principles of independence (Article 5.3).
Pre-approval of permitted non-audit services	Assess the threats to independence and the safeguards that the statutory auditor will apply to mitigate these threats, before approving permitted services. All permitted services require approval from the audit committee following this assessment (Article 5.4).

Appendix: Specific activities required of a PIE's audit committee set out by the Regulation (continued)

Issuing guidelines and policy	Issue guidelines and appropriate policy in relation to services that may be permitted subject to Member State derogation in relation to certain tax services and valuation services, provided that they are immaterial, comprehensively documented and independent – i.e. in line with the requirements of Article 5.3 above (Article 5.4).
Appointment of statutory auditors	Assess and recommend potential statutory auditors. The audit committee is responsible for the procedure and recommendation for the selection of the statutory auditors. The recommendation should consist of two choices for the audit engagement and the justified preference for one of them (Article 16.2).
Extension of audit tenure	Recommend extension of audit tenure only if appropriate. The maximum initial period (of up to 10 years) may be extended (for Member States that opt to permit extension) only if the audit committee recommends at the general meeting of shareholders that the engagement be renewed, and the proposal is approved (Article 17).
Monitoring auditor independence	Monitor auditor independence. The statutory auditor should confirm its independence annually to the audit committee of the audited entity and discuss any threat to its independence as well as the safeguards applied to mitigate those threats (Article 6.2).

Source: KPMG 2014, EU AUDIT REFORM – WHAT YOU NEED TO KNOW

<https://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/EU-Audit-Reform-fact-sheet-audit-committee-role.pdf>