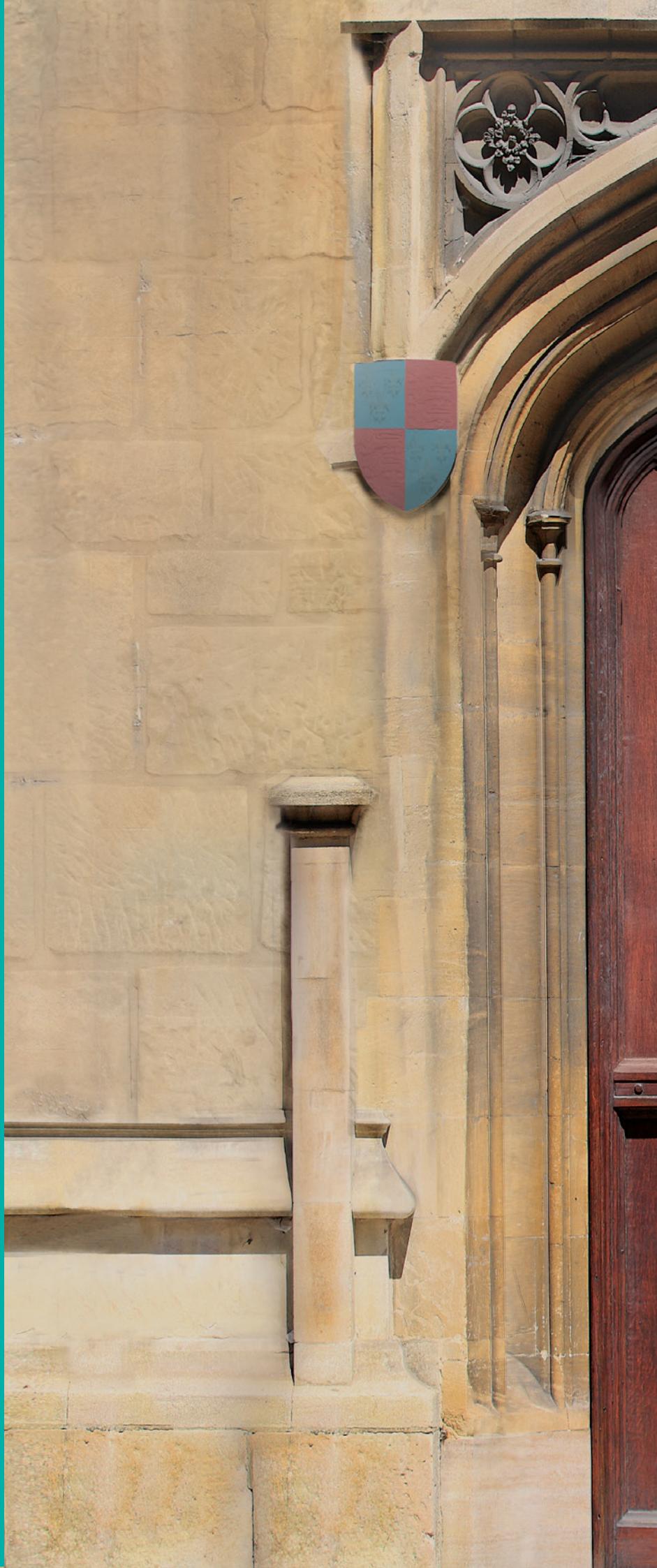




# Audit Reform

**The impact on the role  
and responsibilities of  
audit committees**

Audit Committee Institute



# Introduction

Audit Reform has taken a step closer to reality with the final Ethical Standard and amended law due to be published by The Department for Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) in late spring. With the implementation date fast approaching, we now have more clarity around audit tendering, mandatory firm rotation, the prohibition of many non-audit services and the non-audit services cap.

The role of the audit committee, however, has received little attention amid the important deliberations around the merits of audit firm rotation and the impact of non-audit services on auditor independence and objectivity. Nevertheless, the audit committee has a key role to play if the audit reforms are to be a success; and the new regulations include some new requirements that are difficult to navigate and in some cases will significantly impact the way audit committees of Public Interest Entities (PEI) operate in practice.

For UK listed companies, the reforms are being introduced via changes to Company Law<sup>1</sup> and the Financial Conduct Authority's (FCA's) *Disclosure and Transparency Rules* (DTR 7.1). UK companies with a Premium listing will also have to state the extent of their compliance with the '*UK Corporate Governance Code*'<sup>2</sup> (and be expected to apply the associated FRC '*Guidance on Audit Committees*'<sup>3</sup> ). As is already the case, compliance with the relevant provisions of the '*UK Corporate Governance Code*' would constitute compliance with the DTR 7.1. Audit reforms for FTSE350 companies with financial years beginning on or after 1 January 2015 were also introduced by the recent Competition and Markets Authority (CMA) Order<sup>4</sup>.

Credit institutions (banks and building societies) and insurance undertakings - including unlisted entities - will also be subject to the Prudential Regulatory Authority (PRA) rules. Those that are listed will be subject to both the PRA rules and, where relevant, the other rules and codes noted above. Other than the composition of the audit committee (see Chapter 1), in all material aspects, the requirements are the same as those for UK listed companies.

This booklet looks at the impact of the new regulations across the following areas:

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## A UK incorporated entity is a PIE if it either:

- issues transferable securities that are admitted to trading on a regulated market in the EU;
- is a credit institution (a bank or building society, though not a credit union)\*;
- is an insurance undertaking\*.

\* Credit institutions and insurance undertakings are PIs regardless of whether or not they have listed securities.

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Each chapter starts with the relevant provision (or proposed provision) of the '*UK Corporate Governance Code*'. The requirements of the CMA Order, the proposed Companies Act changes (which reference the specific tendering provisions incorporated in the EU Regulation<sup>5</sup>), the proposed FRC '*Guidance on Audit Committees*' and the relevant DTR and PRA rules are included within the text where appropriate.

The importance of understanding the impact of these changes on the role of the audit committee should not be underestimated - not least because the expectations of the investment community are high.

It should also be noted that the new regulations introduce both an assessment regime which requires the FRC to regularly monitor developments in the market for providing statutory audit services including *inter alia* the performance of audit committees (EU Regulation Article 27); and sanctions that could potentially ban an audit committee member from being a director of a PIE for up to three years (EU Directive<sup>6</sup> Article 30a).

Further guidance on audit tendering, mandatory firm rotation and the prohibition of certain non-audit services can be found [here](#).

For those companies looking for broader insights into the role and responsibilities of the audit committee (for example, because they are an unlisted credit institution or insurance undertaking required to form an audit committee for the first time), the [ACI Audit Committee Handbook](#) sets out the principles underlying the audit committee's role and provides non-prescriptive guidance to help audit committees gain a better understanding of the processes and practices that help create effective audit committees.

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<sup>1</sup>SI 2016/\*\*\*\* The Statutory Auditors and Third Country Auditors Regulations 2016

<sup>2</sup>Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees Annex 3: Revised UK Corporate Governance Code – Section C.3, FRC, September 2015

<sup>3</sup>Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees Annex 4: Revised Guidance on Audit Committees, FRC, September 2015

<sup>4</sup>The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014

<sup>5</sup>Regulation (EU) No 537/2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC

<sup>6</sup>Directive 2014/56/EU 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

# 01

## Composition

The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. **The audit committee as a whole shall have competence relevant to the sector in which the company operates.**

### **C.3.1 UK Corporate Governance Code (proposed revision emboldened)**

#### **Sector experience**

While most would agree that audit committee members should have a range of skills, experience and personal attributes pertinent to the business in which the company operates; the Code and EU legislation have hitherto been silent other than references to financial experience and competence in accounting and/or audit.

Arguably in response to some of the practices highlighted in the aftermath of the financial crisis, the EU legislative text and the proposed revisions to the Code now partly address the wider skill set relevant to audit committee membership by specifically requiring that the audit committee as a whole shall have competence relevant to the sector in which the company operates.

It is important to stress that the requirement is for competence 'relevant' to the sector in which the company operates and not competence 'in' the sector in which the company operates. Also, it is reasonable to assume that 'the audit committee as a whole' is synonymous with 'the majority of audit committee members'.

Boards and audit committees should satisfy themselves that audit committee members have an appropriate level of expertise and specifically experience relevant to the sector in which the company operates. It is reasonable to expect that such considerations become an important part of both the annual audit committee assessment exercise and board succession planning. When making appointments to the audit committee the board should consider the overall knowledge and experience of the committee in order to achieve sectoral competence.

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**Does the audit committee, as a whole, have competence relevant to the sector in which the company operates?**

The board should satisfy itself that at least one member of the committee has recent and relevant financial expertise.

The need for a degree of financial literacy among the other members will vary according to the nature of the company, but experience of corporate financial matters will normally be required. The availability of appropriate financial expertise will be particularly important where the company's activities involve specialised financial activities.

Further information on the composition of audit committees and the attributes of an effective audit committee chair is discussed more fully in the [ACI Audit Committee Handbook](#).

Compliance with the FRC's '*Guidance on Audit Committees*' requires that the section of the annual report describing the work of the audit committee in discharging its responsibilities includes "how the audit committee composition requirements have been met".

### Standard and unlisted entities

Standard listed entities will not necessarily fall within the Scope of the 'UK Corporate Governance Code'. Nevertheless, the DTR 7.1 sets out similar provisions relating to the composition of audit committees except that only a majority of the members must be independent (not all of them). The chairman of the committee must also be independent.

Capital Requirements Directive (CRD) credit institutions (banks and building societies), insurance undertakings that are subject to Solvency II, the Society of Lloyd's and managing agents, and UK designated investment firms – regardless of whether or not they are listed – will also fall within the scope of the PRA rules. These rules set out that:

- Significant firms: The audit committee must consist entirely of independent non-executive directors
- Lower impact firms: The audit committee must consist entirely of non-executive directors, with a majority being independent non-executive directors, provided that the chairman is also independent

It should be noted that the proposed changes to the PRA Rulebook will require some entities (for example, some unlisted credit institutions and insurance undertakings) to form an audit committee for the first time. The proposed requirements were set out in PRA Consultation Paper CP34/15: Implementing audit committee requirements under the revised Statutory Audit Directive and are reproduced in Appendix 3.

Broader insights into the role and responsibilities of the audit committee are set out in the [ACI Audit Committee Handbook](#).

# 02

## Auditor selection

The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors.

### C.3.7 UK Corporate Governance Code

Making the recommendation to the board on the appointment, reappointment and removal of the statutory auditor has for many years been a fundamental audit committee responsibility. Nevertheless, the recent audit reforms introduce legally binding requirements in relation to audit tendering and rotation (see Fig 1) that for most audit committees will represent a significant change to their role. Specifically, the draft Statutory Instrument *The Statutory Auditors and Third Country Auditors Regulations 2016* proposes that:

- For each financial year, the audit committee must make a recommendation to the board – for it to put to the shareholders for their approval in general meeting – in relation to the appointment or re-appointment of the auditor. [s485A(2)(a) / s489A(2)(a)]
- The audit committee must state in its recommendation that recommendation is free from influence by a third party and does not result from a contractual term restricting the choice of auditor. [s485A(5) / s489A(5)]
- When proposing the auditor for appointment, the board must include in the proposal the recommendation made by the audit committee in connection with the appointment and, if the board's proposal does not accord with that recommendation, the reasons for not following the recommendation. [s485A(2)(b) / s489A(2)(b)]
- The audit committee shall be responsible for the auditor selection procedure and, unless the company qualifies as a small or medium-sized company or is a company with reduced market capitalisation, must: [s485A(4) / s489A(4)]
  - ensure 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;

- ensure that tender documents are prepared that allow the invited auditors to understand the business of the audited entity and the type of audit that is to be carried out;
- ensure that the tender documents contain transparent and non-discriminatory selection criteria that shall be used to evaluate the proposals made by the auditor;
- ensure that the audit proposals are evaluated in accordance with the predefined selection criteria and that a report on the conclusions of the selection procedure is prepared and validated by the audit committee. Consideration should be given to any findings or conclusions of any inspection report on the potential auditors;
- identify in its recommendation its first and second choice candidates for appointment and give reasons for its choices; and
- ensure that the company is able to demonstrate to the competent authorities, upon request, that the selection procedure was conducted in a fair manner.

In addition to the Companies Act requirements, for FTSE350 companies, the CMA Order requires that only the audit committee, acting collectively or through its chairman, is permitted:

- to negotiate and agree the statutory audit fee and the scope of the statutory audit;
- to initiate and supervise a competitive tender process;
- to make recommendations to the board of directors as to the auditor appointment pursuant to a competitive tender process; and
- to influence the appointment of the audit engagement partner.

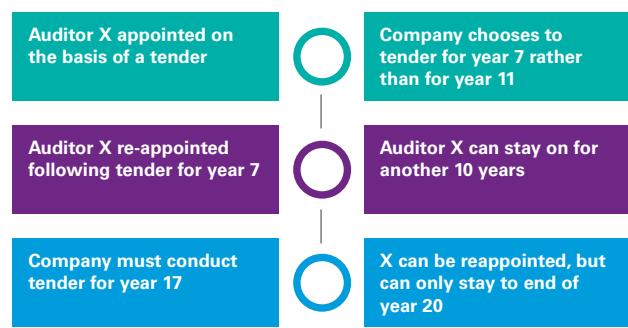
The proposed amendments to the FRC's '*Guidance on Audit Committees*' mirrors the CMA Order by clarifying that "the audit committee should have primary responsibility for the appointment of the auditor" and that "this includes negotiating the fee and scope of the audit, initiating a tender process, influencing the appointment of an engagement partner and making formal recommendations to the board on the appointment, reappointment and removal of the external auditors". The proposed Guidance also states that the audit committee should be responsible for the selection procedure and it should oversee the selection process, and ensure that all tendering firms have such access to information and individuals as is necessary during the duration of the tendering process.

### Fig 1: Audit tendering and rotation

The latest proposals from the Department for Business Innovation and Skills (BIS) and the Financial Reporting Council (FRC) will require PIEs to put their audit out to tender at least every ten years and that they must change their auditor at least every twenty years.

The maximum duration of an engagement, for which an auditor can be appointed and reappointed annually before a tender process is required, will be ten successive accounting years. However, a PIE will be permitted to extend the maximum duration of an audit engagement by ten years on the basis of one or more tender processes for any accounting year up to and including that following the conclusion of the ten year maximum duration. But, if the auditor has been reappointed following one or more tender processes, the maximum duration of a continuous audit engagement will be twenty years.

#### The proposed tendering and rotation framework



The new regulations are applicable from 17 June 2016. Details of the proposed transitional arrangements can be found [here](#).

## Ensuring the tender process does not preclude the participation of certain firms

For audit tenders carried out in accordance with the new legislation, audit committees must ensure 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 PIs in the previous calendar year”. In a UK context, this means that the tender process should not preclude the participation of non-Big 4 firms. This is entirely consistent with the objective to increase ‘auditor choice’ – one of the overarching aims of the audit reforms.

It is not clear how this requirement will operate in practice. Does it simply mean that the selection criteria can not specify a Big 4 firm or that the audit committee should maintain an open mind when considering which firms should be asked to participate in the tender? Or does it mean that all firms (potentially thousands of firms that have neither the scale nor appetite to tender) should have the opportunity to participate in the tender process should they wish to do so? It is reasonable to conclude that any non-Big 4 firm not invited to tender might consider themselves precluded from participation in the selection procedure – though that might not be the regulators intention. In any event, while the requirement for non-discriminatory selection criteria (see below) might preclude a prerequisite for a Big 4 firm, for some global organisations criteria around scale, global coverage, expertise, etc may legitimately rule out the participation of many firms.

In the absence of any further guidance, perhaps the safest course of action is to put advance notice of any tendering plans into the public domain either through disclosure in the annual report (see below), disclosure on the company website or via the RNS.

Clauses restricting the choice of audit firms are prohibited elsewhere in the legislation.

As an aside, audit committee’s should mindful that, in the run up to an audit tender, awarding non-audit services to potential audit firms might preclude their ability to tender if such work cannot be completed, or otherwise cured, before the new auditor needs to be independent (see chapter 3).

## Ensuring tender documents allow the invited firms to understand the business

The audit committee is responsible for ensuring tender documents are prepared that allow the invited auditors to understand the business of the audited entity and the type of audit that is to be carried out.

Each invited auditor will have different experiences and existing relationships with the company so it is important to create as level a playing field as possible by providing sufficient information to ensure a fair selection process.

The following information would normally be considered necessary to provide invited auditors with an appropriate understanding of the business:

- Mission statement and corporate strategy
- Organisation chart, showing the key individuals, responsibilities and reporting lines
- Organisation structure, e.g. business processes, business units, functional, including key locations
- List of subsidiaries and associates, including those subject to audit
- Details of any specific independence restrictions that arise from (say) secondary listings or specific regulated activities

## How will the audit committee demonstrate that non-Big 4 firms have not been precluded from the selection procedure?

## Would a third party consider the tender documents to include all the information necessary for a fair selection process?

- Names of all directors and senior management
- Locations and operations, domestically and overseas
- Cultural information
- Most recent financial statements for all key group companies (last two years)
- Group structure chart
- Year-end / reporting / consolidation process and timetable
- Internal Audit scope and plan
- Internal Audit department structure, responsibilities and reporting lines
- IT systems in operation
- Current tax arrangements / suppliers
- Current tax status

The formal invitation to tender should also include certain procedural matters – most importantly transparent and non-discriminatory selection criteria (see below). Consider:

- The scope of the services being tendered
- The period of the appointment
- The process and timetable
- Areas to include in the proposal document
- Transparent and non-discriminatory selection criteria
- Document delivery information – number of copies required, format and delivery details. It is useful to include a page limit
- Likely format, content and timing for any presentation phase
- Any ground rules for the proposal, for example, all communication must be copied to the project manager
- Information regarding access to your personnel and site visits
- Contact information for the key contact

### Transparent and non-discriminatory selection criteria

The audit committee is responsible for ensuring that the tender documents (see above) contain transparent and non-discriminatory selection criteria that shall be used to evaluate the audit proposals.

Having identified the criteria that are important to the organisation, consider prioritising them according to importance and weighting them with a number score. Consider what is important to the different internal and external stakeholders (including the shareholders) when weighting the criteria. Whatever process is adopted, the criteria should take into account both the tangible (eg, expertise, geographical coverage, etc) and the intangible (eg, cultural fit, rapport and interpersonal skills).

The legislative text states clearly that the audit committee must ensure that the “audited entity shall evaluate the proposals... in accordance with the selection criteria pre-defined in the tender documents”. *Prima facia* this would appear to remove any latitude for changing the selection criteria once the process has started. Selecting the right selection criteria, in conjunction with all relevant stakeholders, before the process begins, and articulating them in the ‘right’ way, is therefore essential – and arguably the most difficult part of the selection process.

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**What selection criteria are most appropriate to the company's circumstances?**

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**Will they be as appropriate at the end of the process as they were at the beginning?**

Notwithstanding the above, as the process progresses, invited auditors may raise issues that merit revisiting their performance against certain of the pre-defined selection criteria. Equally some pre-defined criteria may alter or become redundant as the group's circumstances change (eg, the withdrawal from a geographic market or business sector). Some flexibility in this regard would – if handled transparently – be reasonable as ultimately it will ensure a fair process that leads to a better informed choice of audit firms.

Similarly, providing firms with feedback across the process will allow them to finesse their proposition. For example, if a proposed team member is not a 'good fit', consider providing feedback and allow the invited auditor the opportunity to change that team member and provide their best possible audit proposition.

The Regulations also set out that in considering the audit proposals the audit committee should consider "any findings or conclusions of any inspection report on the potential auditors". It is reasonable to assume that this would include both firm-wide reports and any relevant reports on individual audit engagements. Due consideration should be given to reports by the FRC's Audit Quality Review Teams (AQRTs) and any relevant reports by overseas regulators.

### **A report on the selection procedure**

A written report providing the conclusions of the selection procedure is a now a legislative requirement. The report is to be prepared by the audited entity (presumably management or those responsible for managing the audit proposal on a day-to-day basis) and validated by the audit committee. It should include the rationale for the selection of the auditor or reappointment of the incumbent auditor.

Also, the audit committee must ensure that the company is able to demonstrate to the competent authorities, upon request, that the selection procedure was conducted in a fair manner. The written report on the selection procedure will be a key document should such circumstances arise.

Other than providing the audit committee with a clear rationale to support their choice of two audit firms and documenting the decision making process (and in providing evidence to the competent authority (FRC) if called upon to do so) it is not clear what other purpose the report is required or intended to fulfil. Clearly the intention is that it should not be publically available, however, some companies have put summaries of their audit selection procedure into the public domain and these have generally been well received.

Where such documents are put in the public domain, they provide an opportunity to discuss any peculiarities or sensitivities attached to the audit tender process in more detail than might be discussed in the annual report. Such issues might include, for example, the steps taken to secure (and demonstrate) independence where an audit committee member is a former partner of one of the firms being asked to tender. [Note: a number of audit committee chairs who were until recently partners of tendering firms have excluded themselves from the tender process other than providing comments on the initial design of the tender process].

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**Does the report provide a clear rationale to support the choice of two audit firms and the committee's preference for one?**

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**Would a third party consider the rationale to be reasonable?**

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**Would the report help demonstrate to the competent authority that the selection procedure was conducted in a fair manner?**

## Recommending at least two choices for the audit engagement

Statute now requires that the audit committee recommends two potential audit firms – a first and second choice candidate – together with the reasons for its choices.

Notwithstanding the challenge facing many large multinational companies in finding more than two appropriate audit firms willing and able to tender, the question arises as to whether an audit committee can reasonably recommend two potential audit firms from a field of only two invited to be part of the tender process?

Ideally, selection from among three to five audit firms – as recommended in the 2013 FRC best practice note 'Audit Tenders' – should allow a non-discriminatory selection procedure while at the same time carrying out an efficient and cost effective process.

However, while not ideal, it might still be possible to conduct a competitive tender process in those cases where the choice of audit firms might, for practical reasons, be restricted to just two firms. However, there is a risk to audit committee members (who may face a temporary ban of up to three years from being a board member of a PIE if found to be in breach of the Regulation) and the process itself if the audit committee is unable to recommend a first and second choice if (say) one firm pulls out of the selection process or subsequently proves to be an unacceptable choice.

Where the choice of audit firms is limited, it is particularly important to establish as early in the process as possible that all firms are willing and able to accept appointment; or alternatively conduct a tender with sufficient lead time to enable any issues to be managed (i.e., tender two years out); or with some flexibility on timing (i.e., tender for year nine with a backstop for year ten).

## Disclosure

The CMA Order became effective for financial years beginning on or after 1 January 2015 and requires companies in the FTSE350 to put their statutory audit services out to tender not less frequently than every 10 years. The Order requires that each FTSE350 company that has not completed a competitive audit tender in the last 5 years should disclose (in the fifth year):

- the financial year in which it proposes to carry out a competitive tender process; and
- the reasons why completing a tender in the year proposed is in the best interests of shareholders

Such information should be included in all subsequent audit committee reports until such time as a competitive tender process is completed.

- Also, where the audit committee considers that the proposed financial year is no longer appropriate for the completion of a competitive tender process, it must provide reasons for the decision in the audit committee report published immediately subsequent to the making of the decision.

Furthermore, compliance with the 'UK Corporate Governance Code' and FRC 'Guidance on Audit Committees' requires that a separate section of the annual report describes the work of the audit committee in discharging its responsibilities, including:

- the approach taken to the appointment or reappointment of the external auditor
- the length of tenure of the current audit firm

## Should the selection procedure include three or more firms if the audit committee ultimately has to recommend two?

## How might any practicalities be overcome where only two appropriate firms are willing and able to tender?

- the current audit partner name, and for how long the partner has held the role
- when a tender was last conducted
- advance notice of any retendering plans

Beyond the required CMA disclosures and those referred to in the 'UK Corporate Governance Code' and FRC 'Guidance on Audit Committees', audit committees might consider disclosing the following information in the last audit committee report before the tender commences:

- the tender timetable
- the accounting period from which the successful audit firm will be expected to start
- whether the incumbent will be invited to tender
- how conflicts with alumni on the audit committee will be managed and mitigated
- activities the audit committee plan to undertake in preparation for the tender

Finally, in addition to a RNS announcing the proposed change in auditor, the audit committee should consider disclosing the following information in the first audit committee report to shareholders after the tender process is completed:

- the firms who participated in the tender process for the tender
- who was involved internally and at what stage of the process
- an explanation as to how any conflicts of interest were managed
- a summary of the tendering process
- a summary of how the invited audit firms were assessed by the audit committee
- an explanation of why the successful firm was chosen, including key areas where they excelled
- a summary of the handover process

# 03

# Auditor independence and non-audit services

The main role and responsibilities of the audit committee should be set out in written terms of reference and should include: [...]

- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements.
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

## C.3.2 UK Corporate Governance Code

### **Independence and objectivity**

The external auditor should remain independent and objective at all times.

The audit committee should, at least annually, assess the independence and objectivity of the external auditor, taking into consideration relevant UK law, regulation, the Ethical Standard and other professional requirements. The audit committee should consider the annual disclosure from the statutory auditor and discuss with the auditor the threats to their independence and the safeguards applied to mitigate those threats.

In making the assessment as to whether such relationships impair, or appear to impair, auditor independence and objectivity, the audit committee should:

- consider all the relationships between the company and the audit firm, including both group companies and the auditor's network firms;
- have regard to the views of the external auditor, management, internal audit and the investor community.

The audit committee should monitor the external audit firm's compliance with the Ethical Standard, the level of fees that the company pays in

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**Did the audit firm report to the audit committee all matters that might reasonably be thought to bear on the audit firm's independence (including any breaches of the Ethical Standard)?**

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**Did the audit firm discuss safeguards in place to detect independence issues?**

proportion to the overall fee income of the firm, or relevant part of it, and other related regulatory requirements. The Audit Committee should pay special attention to instances where the amount of work done for the entity by the auditor may, or may be seen to, impair its independence and objectivity. Compliance with the '70% fee cap' (see later) is relevant here.

On an annual basis, the audit committee should also seek information from the audit firm about their policies and processes for maintaining independence and monitoring compliance with relevant requirements, including those regarding financial independence, business relationships the rotation of audit partners and staff.

#### *Audit partner rotation*

The normal rotation period for the engagement partner and key audit partners is five years, but a degree of flexibility over the timing is possible where, for instance, the audit committee decides that it is necessary to safeguard the quality of the audit. In such circumstances, the audit engagement partner may continue in this position for an additional period of up to two years, so that no longer than seven years in total is spent in this position. The audit committee should disclose this fact and the reasons for it to the shareholders as early as practicable.

#### *Employment of former employees of the external auditor*

The audit committee should agree with the board the company's policy for the employment of former employees of the external auditor, taking into account the Ethical Standard and legal requirements and paying particular attention to the policy regarding former employees of the audit firm who were part of the audit team and moved directly to the company. The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the company, and consider whether in the light of this there has been any impairment, or appearance of impairment, of the auditor's independence and objectivity in respect of the audit and consider the committee's own safeguards around independence in its review of effectiveness.

The principal types of threats to the integrity, objectivity and independence, as set out in the FRC's Ethical Standard are:

- *Self-interest threat* – arises when the audit firm, its partners, staff or other persons in a position to influence the conduct or outcome of the audit, have financial or other interests which might cause any of them to be reluctant to take actions that would be adverse to the interests of the firm or any individual in a position to influence the conduct or outcome of the audit engagement.
- *self-review threat* – arises where the audit engagement team (or others within the firm) perform non-audit services the results of which are reflected in the amounts included or disclosed in the financial statements of the audited entity.
- *management threat* – arises where the audit firm, its partners or staff, make judgements or take decisions on behalf of the management of the audited entity.
- *advocacy threat* – arises when the firm undertakes work that involves acting as an advocate for the audited entity and supports a position taken by management in an adversarial or promotional context.
- *familiarity (or trust) threat* – arises when the auditor is predisposed to accept, or are insufficiently questioning of, the audited entity's point of view.
- *intimidation threat* – arises when the conduct of the audit firm or a person in a position to influence the conduct or outcome of the engagement is influenced by fear or threats (for example, where the persons conducting the engagement encounter an aggressive or dominating individual).

## Non-audit services

Non-audit services are any services other than statutory audit services

To help ensure that non-audit services do not impair, or appear to impair, the auditor's independence or objectivity, the audit committee should develop and recommend to the board the company's policy in relation to the provision of permitted non-audit services by the auditor, taking into account the Ethical Standard and legal requirements (see box out)

In doing so, the audit committee should have regard to non-audit services provided by the audit firm and any of its network firms to any parents, subsidiaries or material affiliates to the company. The audit committee should keep the policy under review. For international groups, both the prohibited services and the entities to which those restrictions apply, might differ according to local regulations.

The FRC's '*Guidance on Audit Committees*' explicitly states that the audit committee is responsible for approving non-audit services and goes on to set out that its objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In the context of non-audit services that are not prohibited by law, the audit committee should apply judgement concerning the provision of such services, including assessing:

- threats to independence and objectivity resulting from the provision of such services and any safeguards in place to eliminate or reduce these threats to a level where they would not compromise the auditor's integrity and objectivity;
- the nature of the non-audit services;
- whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service;
- the fees incurred, or to be incurred, for non-audit services both for individual services and in aggregate, relative to the audit fee, including special terms and conditions (for example contingent fee arrangements); and
- the criteria which govern the compensation of the individuals performing the audit.

The '*Guidance on Audit Committees*' also sets out that the audit committee should set and apply a formal policy specifying the types of non-audit service for which use of the external auditor is pre-approved; and that such approval should only be in place for matters that are 'clearly trivial'. The implication is that for all non-clearly trivial services, prior approval by the audit committee is required before the auditor can be engaged.

What constitutes 'clearly trivial' will need to be determined by the audit committee after due consideration of both the inherent nature of the 'type' of non-audit service and impact on the financial statements. While a sense of proportion should be applied, the introduction of the term 'clearly trivial' appears to be designed to discourage pre-approval, or at least encourage audit committees to think carefully about whether too many non-audit services have been pre-approved in the past.

The '*Guidance on Audit Committees*' also notes that the audit committee needs to set a policy for how it will assess whether non-audit services have a direct or material effect on the audited financial statements, how it will assess and explain the estimation of the effect on the financial statements and how it has considered the external auditors' independence.

## Non-audit services

For accounting periods commencing on or after 17 June 2016 the prohibited services which auditors or members of their network cannot provide to their PIE audit clients are much more restrictive than existing non-audit services restrictions in the UK. For most companies the most significant impact of these changes is likely to be for tax, corporate finance services and valuations which are largely prohibited. There are derogations (subject to the requirements that services 'have no direct or have a clearly inconsequential effect') for some tax and valuation services.

Furthermore, permitted services provided by the statutory audit firm and its network will be subject to cap of 70% of the average of the audit fees in the last three consecutive financial years for the statutory audit(s) of PIEs and their group entities.

**Do we understand what non-audit services are, and are not, prohibited in various parts of the group?**

**Do we have a coherent policy with respect to non-audit services? Is pre-approval in place only for those permitted services that are 'clearly trivial'?**

**Is the non-audit services policy well understood and appropriately cascaded throughout the group?**

The EU legislation is being implemented differently at Member State level. This has created cross-border differences in the definition of what non-audit services can be provided by the statutory auditor. To ensure both compliance with the various regulations and common best practice, most groups will wish to address this issue at group level. Consequently, when setting the non-audit services policy, the 'group' audit committee will need to factor into its deliberations any non-audit service prohibitions existing in countries in which any group undertakings operate as well as those determined by the FRC.

### Disclosure

Compliance with the 'UK Corporate Governance Code' and proposed FRC 'Guidance on Audit Committees' requires that a separate section of the annual report describes the work of the audit committee in discharging its responsibilities, including:

- if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded

Elsewhere in the 'Guidance on Audit Committees', it states that reporting on the use of non-audit services should include those subject to pre-approval.

The FRC Financial Reporting Lab Report 'Reporting of Audit Committees' goes further in suggesting that the disclosure should include:

- a summary of the non-audit services policy
- the audit committee approval criteria
- a description of non-audit services provided beyond 'generic' categories
- the ratio of non-audit fees to audit fees
- the fees paid for each service listed
- a cross-reference to the financial statements not on audit/non-audit fees

### What is the committee's appetite for the 70% non-audit fee cap and how will external stakeholders view it?

If the auditor carries out significant non-audit services at the moment, which services will and will not be permitted in future?

Is there an alternative supplier for the non-audit services to which the auditor will no longer be able to provide?






Are there any projects or transformational work on the horizon that will potentially require support from the audit firm?





Has the interaction between audit tendering and the provision of non-audit services been properly thought through?

Has consideration been given to the additional 'cooling in' period for work in connection with financial information systems/controls?

# Appendices

1. Proposed changes to the Companies Act 2006
2. Proposed changes to the FRC's Disclosure and Transparency Rules
3. Proposed changes to the PRA Rulebook
4. The CMA Order
5. EU Regulation No 537/2014 regarding statutory audit of public-interest entities
6. EU Directive on statutory audits of annual accounts and consolidated accounts
7. Prohibited (and potentially prohibited) services

## Appendix 1: Proposed changes to the Companies Act 2006

### Companies Act 2006

(Incorporating changes propose by the October 2015 Draft SI 2016/\*\*\*\*  
The Statutory Auditors and Third Country Auditors Regulations 2016  
(October 2015)

S489A sets out provisions relating to the appointment of auditors of public companies that are public interest entities. S485A includes similar provisions relating to the appointment of auditors of private companies that are public interest entities.

### Appointment of auditors of public company: additional requirements for public interest entities

#### 489A.

1. This section applies to the appointment (other than an appointment under section 489(3) or section 490) of an auditor or auditors of a public company which is also a public interest entity.
2. Before an appointment to which this section applies is made
  - a. the audit committee of the company must make a recommendation to the directors in connection with the appointment, and
  - b. the directors must propose an auditor or auditors for appointment, including the following information in the proposal

- i. the recommendation made by the audit committee in connection with the appointment, and
  - ii. if the directors' proposal does not accord with that recommendation, the reasons for not following the recommendation.
3. If the directors' proposal does not accord with the recommendation made by the audit committee, the auditor or auditors proposed for appointment must be chosen by carrying out a selection procedure in accordance with Article 16(3) of the Audit Regulation.
4. The audit committee must
  - a. prepare its recommendation by carrying out a selection procedure in accordance with Article 16(3) of the Audit Regulation, unless
    - i. the company qualifies as a small company under section 382 or 383 of this Act;
    - ii. the company qualifies as a medium-sized company under section 465 or 466 of this Act;
    - iii. the company is a company with reduced market capitalisation within the meaning in Article 2(1)(t) of Directive 2003/71/EC.
  - b. identify its first and second choice candidates for appointment in the recommendation, and
  - c. give reasons for its choices under paragraph (b),
5. The audit committee must state in the recommendation that
  - a. the recommendation is free from influence by a third party, and
  - b. the recommendation does not result from a contractual term of the kind mentioned in regulation 8 of the Statutory Auditors and Third Country Auditors Regulations 2016(2) being imposed on the company.
6. Subsection (4) does not apply
  - a. if a selection procedure in accordance with Article 16(3) of the Audit Regulation has been carried out in respect of the appointment of the auditor or auditors in relation to one or more of the preceding nine financial years, and
  - b. if the auditor or auditors appointed by the company were appointed for the previous financial year.

## Appendix 2: Proposed changes to the FRC's Disclosure and Transparency Rules

### DTR 7.1 Audit committees

(Incorporating the changes proposed by CP15/28: Quarterly Consultation Paper No. 10)

Except as set out below, DTR 7.1 applies to an issuer whose transferable securities are admitted to trading and which is required to appoint a statutory auditor. DTR 7.1 does not apply to:

- any issuer which is a subsidiary undertaking of a parent undertaking where the parent undertaking is subject to (a) DTR 7.1, or to requirements implementing Article 41 article 39 of the Audit Directive in any other EEA State; and (b) articles 11(1), 11(2) and 16(5) of the Audit Regulation;
- any issuer the sole business of which is to act as the issuer of asset-backed securities provided the entity makes a statement available to the public setting out the reasons for which it considers it is not appropriate to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee;
- a credit institution whose shares are not admitted to trading and which has, in a continuous or repeated manner, issued only debt securities which are admitted to trading provided that (a) the total nominal amount of all such debt securities remains below 100,000,000 Euros; and (b) the credit institution has not been subject to a requirement to publish a prospectus in accordance with section 85 of the Act; and
- any issuer which is a UCITS or an AIF.

### Audit committees and their functions

#### 7.1.1 R

An issuer must have a body or bodies responsible for performing the functions set out in DTR 7.1.3R.

#### 7.1.1 A RA

1. A majority of the members of the relevant body must be independent.
2. At least one member of the relevant body must have competence in accounting or auditing, or both.
3. The members of the relevant body as a whole must have competence relevant to the sector in which the issuer is operating.

**[Note:** article 39(1) of the *Audit Directive*]

#### 7.1.2 G

The requirements for independence and competence in accounting and/or auditing may be satisfied by the same members or by different members of the relevant body.

## 7.1.2 R

The chairman of the relevant body must be:

1. independent; and
2. appointed by the members of the relevant body or by the administrative or supervisory body of the issuer.

**[Note:** article 39(1) of the *Audit Directive*]

## 7.1.3 R

An issuer must ensure that, as a minimum, the relevant body must:

1. monitor the financial reporting process and submit recommendations or proposals to ensure its integrity;
2. monitor the effectiveness of the issuer's internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the issuer, without breaching its independence;
3. monitor the statutory audit of the annual and consolidated financial statements, in particular, its performance, taking into account any findings and conclusions by the competent authority under article 26(6) of the *Audit Regulation*;
4. review and monitor the independence of the statutory auditor in accordance with articles 22, 22a, 22b, 24a and 24b of the *Audit Directive* and article 6 of the *Audit Regulation*, and in particular the appropriateness of the provision of non-audit services to the issuer in accordance with article 5 of the *Audit Regulation*;
5. inform the administrative or supervisory body of the issuer of the outcome of the statutory audit and explain how the statutory audit contributed to the integrity of financial reporting and what the role of the relevant body was in that process;
6. except when article 16(8) of the *Audit Regulation* is applied, be responsible for the procedure for the selection of *statutory auditor(s)* and recommend the *statutory auditor(s)* to be appointed in accordance with article 16 of the *Audit Regulation*.

**[Note:** article 39(6) of the *Audit Directive*]

## 7.1.5 R

The issuer must make a statement available to the public disclosing which body carries out the functions required by DTR 7.1.3 R and how it is composed.

**[Note:** article 39(4) (part) of the *Audit Directive*]

## 7.1.6 G

An issuer may include the statement required by DTR 7.1.5 R in any statement it is required to make under DTR 7.2 (Corporate governance statements).

## 7.1.7 G

In the FCA's view, compliance with provisions A.1.2, C.3.1, C.3.2, C.3.3 and C.3.83 of the *UK Corporate Governance Code* will result in compliance with DTR 7.1.1 R to DTR 7.1.5 R.

## Appendix 3: Proposed changes to the PRA Rulebook

### PRA Rulebook: CRR Firms and Solvency II Firms: Audit Committee instrument

(Incorporating the changes proposed by CP15/28: Quarterly Consultation Paper No. 10)

The PRA's proposals apply to Capital Requirements Directive (CRD) credit institutions (banks and building societies), insurance undertakings that are subject to Solvency II, the Society of Lloyd's and managing agents, and UK designated investment firms, regardless of whether or not they are listed.

#### 1. Application and definitions

1.1 Unless otherwise stated, this Part applies to:

1. a *CRR firm*;
2. a *UK Solvency II firm*;
3. in accordance with Insurance General Application 3, the Society, as modified by 3; and
4. in accordance with Insurance General Application 3, managing agents, as modified by 3.

1.2 This part does not apply to a *firm* which is a *subsidiary undertaking* of a *parent undertaking* where the parent undertaking complies at group level with Chapter 2 or with requirements implementing Article 39 of the *statutory audit directive* in any other EEA state and with Articles 11(1), 11(2) and 16(5) of the *statutory audit regulation*, provided that:

1. the *firm* is not significant; or
2. if the *firm* is significant, its *governing body* is composed of the same *non-executive directors* as the *governing body* of that *parent undertaking*.

**[Note:** Art. 39(3)(a) (part) of the Statutory Audit Directive]

1.3 ...

#### 2. Audit committee

2.1 Subject to 2.3, a *firm* must have an *audit committee* which meets the criteria set out in 2.2 and which is responsible for performing the functions set out in 2.4.

**[Note:** Art. 39(1) (part) of the Statutory Audit Directive]

2.2 The criteria referred to in 2.1 are:

1. the *audit committee* must be a committee of the *governing body* of the *firm*;
2. the *audit committee* must be composed only of *non-executive directors*;
3. at least one member of the *audit committee* must have competence in accounting and/or auditing;
4. the members of the *audit committee* as a whole must have competence relevant to the sector in which the *firm* is operating;

5. subject to (6), a majority of the members of the *audit committee* must be independent of the *firm*;
6. all members of the *audit committee* of a firm that is significant must be independent of the *firm*; and
7. the chairman of the *audit committee* must be appointed by its members and must be independent of the *firm*.

**[Note:** Art. 39(1) (part) of the *Statutory Audit Directive*]

2.3 A *firm* may combine its *audit committee* with its risk committee (if applicable) provided that:

1. the *firm* is not significant; and
2. the members of the combined committee have the knowledge, skills and expertise required for the exercise of the functions of the risk committee and the *audit committee*.

**[Note:** Art. 76(3) CRD]

2.4 A *firm* must ensure that its *audit committee* performs at least the following functions:

1. informs the *governing body* of the firm of the outcome of the statutory audit and explains how the statutory audit contributed to the integrity of financial reporting and what the role of the *audit committee* was in that process;
2. monitors the financial reporting process and submits recommendations or proposals to ensure its integrity;
3. monitors the effectiveness of the *firm*'s internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the *firm*, without breaching its independence;
4. monitors the statutory audit of the annual and consolidated financial statements, in particular, its performance, taking into account any findings and conclusions of the [competent authority]<sup>1</sup> pursuant to Article 26(6) of the *Statutory Audit Regulation*;
5. reviews and monitors the independence of the statutory auditor or the audit firm in accordance with [UK Implementation of articles 22, 22a, 22b, 24a and 24b of the *Statutory Audit Directive*] and Article 6 of the *Statutory Audit Regulation*, and in particular the suitability of the provision of non-audit services to the *firm* in accordance with Article 5 of the *Statutory Audit Regulation*;
6. is responsible for the procedure for the selection of the statutory auditor or audit firm and recommends the statutory auditor or the audit firm to be appointed in accordance with Article 16 of the *Statutory Audit Regulation* except when Article 16(8) of the *Statutory Audit Regulation* is applied.

**[Note:** Art. 39(6) of the *Statutory Audit Directive*]

### **3 Lloyd's**

3.1 This Part applies to the *Society* and *managing agents* separately.

3.2 For the purposes of complying with 2, a *managing agent* must establish an audit committee which meets the criteria set out in 2.2 and which is responsible for performing the functions set out in 2.4 in respect of:

1. each *syndicate* it manages; and
2. any *syndicate* in respect of which it was the last *managing agent* to manage during the preceding year and which has no *managing agent* on 31 December where *syndicate statutory accounts* are required to be prepared.

3.3 For the purpose of:

1. 2, as applied to the *Society*, references to "governing body" are to be interpreted as references to the Council.
2. 2.4, as applied to *managing agents*,
  - a. references to "statutory audit" and "statutory audit of the annual and consolidated financial statements" are to be interpreted as references to the audit of the *syndicate statutory accounts* in accordance with the requirements of the Insurance Accounts Directive (Lloyd's Syndicate and Aggregate Accounts) Regulations 2008 (SI 2008/1950); and
  - b. references to "statutory auditor" or "audit firm" are to be interpreted as a reference to the statutory auditor or audit firm responsible for the audit of the *syndicate statutory accounts* referred to in 3.3(2)(a);
3. 2.4(3), as applied to *managing agents*, the reference to "the financial reporting of the *firm*" is to be interpreted as a reference to the financial reporting in respect of each *syndicate* referred to in 3.2 for which the *managing agent* is responsible; and
4. 2.4(4), as applied to the *Society*, the reference to the "consolidated financial statements" is to be interpreted as a reference to the *syndicate aggregate accounts*.

## Appendix 4: The CMA Order

### The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014

The provisions of this Order apply to a Company from the date on which it enters the FTSE 100 or FTSE 250 index until the date on which it ceases to be a FTSE 350 Company.

#### 5. Audit Committee responsibilities – further provisions

- 5.1 Only the Audit Committee, acting collectively or through its chairman, and for and on behalf of the board of directors, is permitted:
  - a. to the extent permissible by law and regulations, to negotiate and agree the Statutory Audit fee and the scope of the Statutory Audit;
  - b. to initiate and supervise a Competitive Tender Process;
  - c. to make recommendations to the board of directors as to the Auditor Appointment pursuant to the Competitive Tender Process;
  - d. to influence the appointment of the Audit Engagement Partner; and
  - e. subject to Article 5.2 and to the extent permitted by law and regulations, to authorise an Incumbent Auditor or an Auditor appointed to replace an Incumbent Auditor to provide any Non-Audit Services to the FTSE 350 Company or the Group of which that FTSE 350 Company is a part, prior to the commencement of those Non-Audit Services.
- 5.2 The Audit Committee may specify a policy for the pre-approval of permitted Non-Audit Services including setting materiality thresholds based on the value of the proposed Non-Audit Service engagements.
- 5.3 The Audit Committee may consult such persons as it deems appropriate in the performance of the obligations in Articles 3.1(b), 4.1, 5.1 and 5.2.

## Appendix 5: EU Regulation No 537/2014

### 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

#### Article 16: Appointment of statutory auditors or audit firms

1. ...
2. The audit committee shall submit a recommendation to the administrative or supervisory body of the audited entity for the appointment of statutory auditors or audit firms.

Unless it concerns the renewal of an audit engagement in accordance with Article 17(1) and 17(2), the recommendation shall be justified and contain at least two choices for the audit engagement and the audit committee shall express a duly justified preference for one of them.

In its recommendation, the audit committee shall state that its recommendation is free from influence by a third party and that no clause of the kind referred to in paragraph 6 has been imposed upon it.

3. Unless it concerns the renewal of an audit engagement in accordance with Article 17(1) and 17(2), the recommendation of the audit committee referred to in paragraph 2 of this Article shall be prepared following a selection procedure organised by the audited entity respecting the following criteria:
  - a. the audited entity shall be free to invite any statutory auditors or audit firms to submit proposals for the provision of the statutory audit service on the condition that Article 17(3) is respected and that the organisation of 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;
  - b. the audited entity shall prepare tender documents for the attention of the invited statutory auditors or audit firms. Those tender documents shall allow them to understand the business of the audited entity and the type of statutory audit that is to be carried out. The tender documents shall contain transparent and non-discriminatory selection criteria that shall be used by the audited entity to evaluate the proposals made by statutory auditors or audit firms;
  - c. the audited entity shall be free to determine the selection procedure and may conduct direct negotiations with interested tenderers in the course of the procedure;
  - d. where, in accordance with Union or national law, the competent authorities referred to in Article 20 require statutory auditors and audit firms to comply with certain quality standards, those standards shall be included in the tender documents;
  - e. the audited entity shall evaluate the proposals made by the statutory auditors or the audit firms in accordance with the selection criteria predefined in the tender documents. The audited entity shall prepare a report on the conclusions of the selection procedure, which shall be validated by the audit committee. The audited entity and the audit committee shall take into consideration any findings or conclusions

of any inspection report on the applicant statutory auditor or audit firm referred to in Article 26(8) and published by the competent authority pursuant to point (d) of Article 28;

- f. the audited entity shall be able to demonstrate, upon request, to the competent authority referred to in Article 20 that the selection procedure was conducted in a fair manner.

The audit committee shall be responsible for the selection procedure referred to in the first subparagraph.

For the purposes of point (a) of the first subparagraph, the competent authority referred to in Article 20(1) shall make public a list of the statutory auditors and the audit firms concerned which shall be updated on an annual basis. The competent authority shall use the information provided by statutory auditors and audit firms pursuant to Article 14 to make the relevant calculations.

4. Public-interest entities which meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC shall not be required to apply the selection procedure referred to in paragraph 3.
5. The proposal to the general meeting of shareholders or members of the audited entity for the appointment of statutory auditors or audit firms shall include the recommendation and preference referred to in paragraph 2 made by the audit committee or the body performing equivalent functions.

If the proposal departs from the preference of the audit committee, the proposal shall justify the reasons for not following the recommendation of the audit committee. However, the statutory auditor or audit firm recommended by the administrative or supervisory body must have participated in the selection procedure described in paragraph 3. This subparagraph shall not apply where the audit committee's functions are performed by the administrative or supervisory body.

6. ...

## Appendix 6: EU Directive

### 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

#### Article 39: Audit committee

1. Member States shall ensure that each public-interest entity has an audit committee. The audit committee shall be either a stand-alone committee or a committee of the administrative body or supervisory body of the audited entity. It shall be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity or, for entities without shareholders, by an equivalent body.

At least one member of the audit committee shall have competence in accounting and/or auditing.

The committee members as a whole shall have competence relevant to the sector in which the audited entity is operating.

A majority of the members of the audit committee shall be independent of the audited entity. The chairman of the audit committee shall be appointed by its members or by the supervisory body of the audited entity, and shall be independent of the audited entity. Member States may require the chairman of the audit committee to be elected annually by the general meeting of shareholders of the audited entity.

2. By way of derogation from paragraph 1, Member States may decide that in the case of public-interest entities which meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC of the European Parliament and of the Council ( 1 ), the functions assigned to the audit committee may be performed by the administrative or supervisory body as a whole, provided that where the chairman of such a body is an executive member, he or she shall not act as chairman whilst such body is performing the functions of the audit committee.

Where an audit committee forms part of the administrative body or of the supervisory body of the audited entity in accordance with paragraph 1, Member States may permit or require the administrative body or the supervisory body, as appropriate, to perform the functions of the audit committee for the purpose of the obligations set out in this Directive and in Regulation (EU) No 537/2014.

3. By way of derogation from paragraph 1, Member States may decide that the following public-interest entities are not required to have an audit committee:

- a. any public-interest entity which is a subsidiary undertaking within the meaning of point 10 of Article 2 of Directive 2013/34/EU if that entity fulfils the requirements set out in paragraphs 1, 2 and 5 of this Article, Article 11(1), Article 11(2) and Article 16(5) of Regulation (EU) No 537/2014 at group level;
- b. any public-interest entity which is an UCITS as defined in Article 1(2) of Directive 2009/65/EC of the European Parliament and of the Council ( 1 ) or an alternative investment fund (AIF) as defined in Article 4(1)(a) of Directive 2011/61/EU of the European Parliament and of the Council ( 2 );

- c. any public-interest entity the sole business of which is to act as an issuer of asset backed securities as defined in point 5 of Article 2 of Commission Regulation (EC) No 809/2004 ( 3 );
- d. any credit institution within the meaning of point 1 of Article 3(1) of Directive 2013/36/EU whose shares are not admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and which has, in a continuous or repeated manner, issued only debt securities admitted to trading in a regulated market, provided that the total nominal amount of all such debt securities remains below EUR 100 000 000 and that it has not published a prospectus under Directive 2003/71/EC.
- e. the public-interest entities referred to in point (c) shall explain to the public the reasons why they consider that it is not appropriate for them to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee.

4. By way of derogation from paragraph 1, Member States may require or allow a public-interest entity not to have an audit committee provided that it has a body or bodies performing equivalent functions to an audit committee, established and functioning in accordance with provisions in place in the Member State in which the entity to be audited is registered. In such a case the entity shall disclose which body carries out those functions and how that body is composed.

5. Where all members of the audit committee are members of the administrative or supervisory body of the audited entity, the Member State may provide that the audit committee is to be exempt from the independence requirements laid down in the fourth subparagraph of paragraph 1.

6. Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia*:

- a. inform the administrative or supervisory body of the audited entity of the outcome of the statutory 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;
- 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 and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the audited entity, without breaching its independence;
- d. monitor the statutory audit of the annual and consolidated financial statements, in particular, its performance, taking into account any findings and conclusions by the competent authority pursuant to Article 26(6) of Regulation (EU) No 537/2014;
- e. review and monitor the independence of the statutory auditors or the audit firms in accordance with Articles 22, 22a, 22b, 24a and 24b of this Directive and Article 6 of Regulation (EU) No 537/2014, and in particular the appropriateness of the provision of non-audit services to the audited entity in accordance with Article 5 of that Regulation;
- f. be responsible 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 except when Article 16(8) of Regulation (EU) No 537/2014 is applied.

## Appendix 7: Prohibited (and potentially prohibited) services

### Prohibited services

- a. Tax services:
  - i. preparation of tax forms\*
  - ii. payroll tax
  - iii. customs duties
  - iv. identification of public subsidies and tax incentives unless support from 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 or audit firm in respect of such inspections is required by law\*
  - vi. calculation of direct and indirect tax and deferred tax\*
  - vii. provision of tax advice\*
- b. Services that involve playing a 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\*
- g. Legal services, with respect to:
  - i. the provision of general counsel,
  - ii. negotiating on behalf of the audit entity
  - iii. acting in an advocacy role in the resolution of litigation;
- h. Services related to the audit entity's internal audit function
- i. 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
- j. Promoting, dealing in, or underwriting shares in the audited entity.
- k. Human resources services with respect to:
  - i. management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:
    - i. searching for or seeking out candidates for such positions; or
    - ii. undertaking reference checks of candidates for such positions.
    - iii. structuring the organisation design
  - iv. cost control.

The services in point e are prohibited in the financial year prior to the year subject to audit (the 'cooling in' period).

### Potentially permitted services

A number of prohibited services (as identified by asterisks above) may still be provided, subject to audit committee approval and after an assessment of threats, if the following requirements are complied with:

- a. no direct or clearly inconsequential effect, separately or in aggregate, on financial statements;
- b. estimation of the effect on the financials is comprehensively documented and explained in the additional report to the audit committee;
- c. in line with the principles of independence; and
- d. the audit firm would not place significant reliance for the purpose of the audit on the work performed by the audit firm in performing these services.



## Contact us

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