

EU audit reform: how audit committees can prepare for performance monitoring

The European Union (EU) audit reform requires the EU competent authorities (which include audit oversight bodies, securities market regulators and competition authorities, to name a few) to monitor the performance of audit committees of public interest entities (PIEs) and disclose the results of their assessments in three-yearly reports, starting from 2016.¹

At present, there is very little detail around how the competent authorities will assess the performance of audit committees. Nevertheless, a representative from the European Commission told a meeting of the European Audit Committee Leadership Network (EACLN) in April 2016 that the initial focus is simply to understand how audit committees work.² Audit oversight bodies want to understand how tendering is being carried out, which criteria are being used to select auditors and how rotation is affecting audit quality.

From discussions with a number of audit regulators, it is clear that audit oversight bodies want to make stronger connections with audit committees, because they see them as key players in driving audit quality.

Actions to improve performance

In this article, we explore how audit committees can improve their general performance while making certain their organizations comply with the requirements under the EU audit reform. Principally, they should do the following:

Manage the audit tender process by following the rules in their jurisdiction

Since the time frames and requirements for auditor rotation vary by jurisdiction, audit committees must understand the specific rules that apply to their PIE and its different subsidiaries.

Follow a fair and transparent process when selecting a new auditor

The selection procedure must not restrict tendering from audit firms with a low market share (firms that received less than 15% of their total audit fees from PIEs in the entity's Member State in the previous calendar year).³ Also, the tender documents

should set out the transparent and nondiscriminatory selection criteria that the entity will use when evaluating the proposals of different audit firms.

Since a major objective of the new legislation is to improve audit quality, the audit committee is expected to consider the conclusions of audit firm inspection reports during the selection process.⁴ It should also provide a written summary of the selection process, outlining its rationale for choosing a new audit firm or renewing the engagement with the incumbent firm.⁵

Monitor the auditor's independence

The independent auditors of PIEs are now subject to a 70% maximum cap on non-audit fees⁶ (on the basis of a three-year rolling average, with the first average fee being calculated in 2019-20). They are also prohibited from providing account preparation, structuring, valuation, legal, payroll and certain tax services to the PIEs they audit as well as any parent or controlled undertakings of the PIE anywhere in the EU.

So audit committees will need to make strategic decisions about which non-audit services they wish to receive, and when, from the audit firms in the different jurisdictions in which they either have a PIE or a parent or controlled undertaking of a PIE anywhere in the EU. As they must preapprove spend on permissible non-audit services, they will need to strengthen their worldwide policies and procedures for approving non-audit services. They will also need to establish a monitoring process so that the 70% cap is not breached.

Determine whether the audit committee is composed of the people with the right skills

Under the legislation, the audit committee as a whole should have competence relevant to the sector in which the PIE operates. Furthermore, all members of the audit committee must be non-executive directors, with the majority also being independent. So audit committees will need to assess how many of their members would be viewed as independent by the audit oversight body in their jurisdiction. If a committee includes former partners from their incumbent auditor, these partners may be caught by "cooling off" rules and would therefore not be considered independent.

Some audit committees could find the independence requirements challenging given that they must also have at least one member who has competence in accounting or auditing. PIEs in financial services, in particular, could face greater competition to secure the services of suitably qualified audit committee members, since the legislation requires unlisted banks, insurers and certain investment firms to have audit committees for the first time. In future, audit committees will need to focus closely both on their own succession planning and that of the board more broadly. They will want to rotate members on and off the committee in such a way that diversity, independence, objectivity and a fresh perspective are brought to the financial reporting process.

Review the quality of the audit

The importance of audit quality is repeatedly emphasized in the EU legislation. So audit committees should actively engage with their entity's auditor to find out what it is doing to improve the quality of the audit – whether that entails using new technology, applying new methods or bringing in specialist technical expertise to focus on certain aspects of the engagement.

Conduct a self-assessment

Regular self-assessment is a good way for audit committees to evaluate their effectiveness and identify areas for improvement in line with their terms of reference. A self-assessment should cover the committee's performance with regard to monitoring the integrity of the financial statements, reviewing internal financial controls, assessing the effectiveness of the internal audit function and managing the relationship with the independent auditor. It should also examine whether the committee meets the requirements for independence, sector knowledge and accounting or auditing expertise under the legislation. The value of the self-assessment will be enhanced if the audit committee seeks feedback from the entity's management team and independent auditor as well as from external consultants with expertise of assessing audit committees.

Collaboration with regulators

Audit committees should collaborate with regulators to understand what is expected of them and their PIE under the new legislation. They can:

- ▶ Ask regulators for the results of their audit firm inspections
- ▶ Find out from regulators whether their entity should make additional disclosures
- ▶ Ask regulators for guidance on good audit committee practices
- ▶ Produce audit committee reports that summarize the activities they have undertaken
- ▶ Work with regulators and other audit committees to share leading practices

Questions for the audit committee to consider

- ▶ Is the audit committee familiar with the auditor rotation requirements in its jurisdiction?
- ▶ Does the audit committee have processes in place to monitor how much its PIE and its subsidiaries spend on non-audit services provided by its independent auditor?
- ▶ Does the audit committee need to undertake a self-assessment to review its effectiveness and check whether it complies with the new rules on independence, sector competence, and accounting and auditing expertise?
- ▶ Has the audit committee reviewed the audit inspection report for its independent auditor and raised any findings that caused concern?
- ▶ Does the audit committee have an open dialogue with the audit oversight body in its jurisdiction? If not, how could it start one?

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Endnotes

- 1 [“New EU regulatory framework on audit,” Article 27\(1\)\(c\) and 27\(2\) of the Regulation 537/2014](#)
- 2 [ViewPoints: Dialogue on audit policy, Tapestry Networks, 13 May 2016](#)
- 3 [“New EU regulatory framework on statutory audit,” Article 16 \(3\)\(a\) of the Regulation 537/2014](#)
- 4 [Ibid. Article 16 \(3\) \(e\) of the Regulation 537/2014](#)
- 5 [Ibid. Article 16 \(3\) \(e\) of the Regulation 537/2014](#)
- 6 [Ibid. Article 4 \(4\) \(2\) of the Regulation 537/2014](#)