

The future of internal audit in Europe / Tax governance

Introduction

The European Audit Committee Leadership Network is a select group of audit committee chairs from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

The European Audit Committee Leadership Network held its fourth meeting in London on 7 October 2005. Network members attending the meeting considered two topics: the future of internal audit in Europe and tax governance. They also identified other issues they are currently dealing with, including the need to:

- Balance the time spent by audit committees on corporate governance issues with a focus on important business issues
- Manage the demands of competing regulatory regimes
- Provide oversight of corporate governance in businesses in emerging markets
- Deal with the amount of time needed to provide oversight of the implementation of Section 404 of the Sarbanes-Oxley Act (for SEC registrants)

The members of the network participating in the meeting, or in individual discussions beforehand, between them sit on the boards of about 40 large, mid and small cap public companies. Members participating in the meeting were:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Mr Tom McGrath, Global Managing Partner, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young
- Mr Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Sir Ian Prosser, Audit Committee Chair, BP
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Dr Ronaldo Schmitz, Audit Committee Chair, GlaxoSmithKline

Members who were able to participate in individual discussions before the meeting were:

- Sir Anthony Greener, Audit Committee Chair, BT
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi Universal
- Dr Manfred Schneider, Audit Committee Chair, Allianz

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Comments described as being provided before the meeting were drawn from discussions with all the members listed above.

Executive summary

European Audit Committee Leadership Network members attending the meeting on 7 October 2005 considered two topics that are emerging as important ones for the audit committees of Europe's public companies. The first is the future of internal audit in Europe; the second is tax governance. On both issues, companies from different EU Member States and industries find themselves with similar aspirations but different practices.

The future of internal audit in Europe

Audit committees often rely on the work of internal auditors to inform them about what is happening in the company and provide assurance that agreed upon policies and procedures are being implemented on the ground globally. The internal auditors are the arms and legs of the audit committee. Despite this, audit committees often have an arms-length relationship with the internal audit function. The views of network members are summarised below, with detailed discussion on the following pages.

- **Primary mission of the internal audit function** *(Page 4)*

Audit chairs want the internal audit function to provide good quality audits and reports on processes and internal controls, risk management profiles and experienced teams which can be deployed to sensitive areas of the business. Members are concerned with how best to measure the effectiveness of their internal audit functions. They proposed exploring how much risk appetite the company has, how much assurance management and the audit committee wants, and what level of investment is considered appropriate. Often the only metric used is "headcount" but while members find that unsatisfactory, there was no clear alternative.

- **A department of specialists or an opportunity for high-fliers?** *(Page 5)*

Members believe it is the role of senior management to determine whether to use the internal audit function as a training ground for high-fliers to receive general management development, or whether the function should be staffed primarily by auditors and other specialists. The audit committee's role is to ensure there is a steady group of experienced people in the function and that they have confidence in the head of internal audit.

- **Relationship with the audit committee** *(Page 6)*

The precise relationship between the audit committee and the internal audit function is a matter of debate within the network. The options are that the head of internal audit reports directly to the audit committee, or the head reports to management but with a dotted line to the audit committee. However, some members question whether the internal auditor should report to the audit committee at all, since this would involve the committee crossing over the "bright line" into management decisions. While a few members are currently involved in the performance review of the head of internal audit, more would like to be consulted in the future.

- **Coordination or independence: the relationship with the external auditor** *(Page 7)*

Members also differ on the benefits of coordinating the internal and external audit plans. Some members want to see a high degree of coordination, while others believe the objectives of the two are different enough that coordination becomes meaningless.

Tax governance

A company's approach to tax governance, defined as the oversight of tax planning, reporting and risk management, depends on its general approach to tax risk, its relationship with the tax authorities, and the governance codes of the countries in which it operates. Insights from the meeting are highlighted below, with more detailed discussion on the following pages.

- **Tax risk management** (*Page 8*)

Members see transactions and transfer pricing as the two major sources of tax opportunity for companies. However, they believe many large companies have become more cautious about tax planning, as they have become more concerned with reputation risk. Despite the emphasis on internal controls, driven by Section 404 of the Sarbanes-Oxley Act, audit committees are not yet spending much time on tax internal controls – even though they have been one of the largest sources of material weaknesses disclosed by US companies to date.

- **Role of the board and the audit committee** (*Page 9*)

For many companies in Europe, tax governance – or tax risk management – is a new item on the board agenda added in the last five years or so. Board level discussion of tax is mostly focused on litigation or a specific problem that has to be resolved. However, some companies have a regular, annual review, led by the CFO and tax director. Audit committees, if they discuss tax risk at all, do so in the context of general risk management.

- **External advice and the role of external auditor** (*Page 10*)

As part of the annual audit, the external audit firm will seek to understand the company's risk appetite, tax governance and planning processes. External auditors can also provide routine tax planning in most EU Member States. Members are certainly looking to their external auditors as a source of advice on tax matters. Members also have access to other independent advice if they require it and several have used tax attorneys for specialist advice.

The future of internal audit in Europe

The Institute of Internal Auditors (IIA), the global professional body for all internal audit executives, defines internal auditing as: “an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”.¹

How widespread are such internal audit functions? For European companies listed on the New York Stock Exchange (NYSE), the rules are clear: “Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control”.²

¹ The Institute of Internal Auditors: “What is Internal Auditing?” available for review at http://www.theiia.org/index.cfm?doc_id=4238

² New York Stock Exchange: “Final NYSE Corporate Governance Rules”, page 13, approved by the SEC on 4 November, 2003. Available for review at <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>

Article 39 of the EU 8th Directive on Statutory Audit states that the audit committee should take on responsibility to “monitor the effectiveness of the company’s internal control, internal audit where applicable, and risk management systems”.³ However, according to the European Confederation of Institutes of Internal Auditing (ECIIA), there is little legislation in Europe governing internal auditing and the profession is essentially self-regulated. Consequently, there are a wide variety of practices across EU Member States and across different industries (with the banking sector perhaps the most advanced).⁴

Primary mission of the internal audit function

The ECIIA set out its view on the scope of the internal audit function: “The scope of internal auditing covers all of an organisation’s activities, without regard for internal boundaries or geographical restrictions. Their work is based on the risk assessment. It encompasses the adequacy and effectiveness of governance, risk management and internal control processes in identifying and responding to the risks facing the organisation”.⁵

Audit chairs want the internal audit function to provide:

- **Good quality audits and reports on processes and internal controls**
- **Risk management profiles**
- **Experienced teams who can be deployed to sensitive areas of the business**

As an example, one member said: “*We consider internal audit as a sharp, effective instrument with shifting emphasis to provide assurance, given the complexity of critical systems globally. To maximise value it needs to be aligned with the programme that the audit committee sets itself and be part of the dialogue between the audit committee and management*”. Members have less interest in using the internal audit function as an internal consultancy for general business process improvement.

Members who sit on the board of SEC registrant companies are aware that there may be an impact on the primary mission of internal audit because of the need to focus on the implementation of Section 404 of the Sarbanes–Oxley Act. In our December 2004 meeting, members who chair the audit committee of SEC registrant companies said: “Section 404 compliance efforts are mostly being led by controllers with much of the work undertaken in the business units themselves. In [some] companies, a specialised compliance function or project team has been created to lead these efforts”.⁶

Commenting at this meeting, one member declared: “*Section 404 has impacted internal audit in the US; less so in Europe*”. He said he knew of one US company that had reduced the internal audit function’s involvement in Section 404 from 50% of their time in the first year to 10% in the second year, focused on testing and on assurance of the effectiveness of the compliance process.

Another member reported before the meeting that two-thirds of the internal audit team and their programme in his European SEC registrant company were now focused on implementation of Section

³ Proposal for a Directive of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC, Commission of the European Communities, Brussels, 16 March, 2004.

⁴ For further discussion of this point in the US context see Audit Committee Leadership Network in North America: “The internal auditor’s perspective”, *InSights*, 6 July, 2004, page 2. Full text available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Jul04_Insights4.pdf

⁵ European Confederation of Institutes of Internal Auditing: “Internal auditing in Europe”, February 2005, page 27.

⁶ European Audit Committee Leadership Network: “Section 404: Challenges facing European SEC registrants”, *ViewPoints*, 25 January, 2005, page 7. Full text available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Jan05_View.pdf

404: *“It is the major priority for this year and next”*. They have increased resources in the function by about 20% and are looking at internal controls beyond financial reporting.

Regardless of internal audit’s role in the company, audit committees are concerned with how best to measure the effectiveness of their internal audit functions. The key questions they suggest the audit committee should ask are:

- **How much risk appetite has the company?**
- **How much assurance do the board and management want?**
- **What resource investment is the company willing to make?**⁷

One member commented: *“Do you maximise value by keeping costs down? How do you balance the cost of internal audit – where 20% of the cost deals with 80% of the problems but the rest [of these problems] could bankrupt you?”* Another member agreed: *“We don’t look at the cost of internal audit but at the scope of their work programme and the quality of the people. Cost is discussed only in terms of the headcount”*.⁸ However, a third member pointed out that a focus on headcount means: *“you might not get the maximum bang... The value depends on what those ‘heads’ are doing”*.

A department of specialists or an opportunity for high-fliers?

Members recommend that senior management determine whether to use the internal audit function as a training ground for high-fliers to receive general management development, or whether the function should be staffed primarily by auditors and other specialists.

- **The management development model** focuses on young high-flying professionals who will stay in the function for three or four years and then return to a line management role within an operating unit. This is often described in the US as the “GE model” because of the General Electric Company’s extensive application of this practice. In Europe, Nestlé follows a similar approach. Supporting the model, one member said: *“It is [also in] the French tradition to use young high-fliers. You start in internal audit control functions as a first step in your career. Good quality staff members are very active – it is important for them to succeed in their first mission”*.
- **The specialist model** is based on the idea that, although inexperienced auditors can be trained to perform assurance functions, many companies prefer to recruit staff with a previous background in public accounting, auditing or information technology. These specialists are often perceived as too narrowly focused for companies to groom them to assume leadership roles in non-financial functions, such as operations, sales or marketing. *“We still look for experienced people, not young people who will stir up questions and extra work – that can be good or bad. We would rather have them in the control area.”*

One member said: *“In Sweden, internal audit was often a graveyard [of the finance organisation] or it was outsourced. The trend is shifting and outsourced capacity is being insourced, so the challenge is to lose the graveyard mentality”*. Another member suggested: *“The [GE] gold standard would not be a good fit everywhere. It is very ambitious and, perhaps, too rigid. You can strive to come close to it*

⁷ See for instance the IIA’s Practice Advisory (PA) 1311-2, “Establishing Measures to Support Reviews of Internal Audit Activity Performance”, CAE Bulletin, 29 September 2005.

⁸ Across the European Audit Committee Leadership Network, the headcount of the group internal audit function ranges from 24–160 people.

and most companies are trying to do that by combining brilliant graduates with those who have multiple years of experience. You need a team approach”.

Whichever approach is adopted by the company, members believe the audit committee should not decide the composition of, or numbers in, the internal audit function, which is management’s responsibility. However, they are adamant that the audit committee should:

- **Ensure there is a steady group of experienced people in the function**

Management has to contend with a competitive employment market for internal auditors and, as one member said before the meeting: *“Most internal audit units are struggling to keep personnel resources intact”.* During the meeting, members also focused on the internal market for good talent and one member cautioned: *“There is an appetite for internal auditors to move into the business and we have to apply brute force to stop them being raided by the rest of the business. We had to increase the number of years they have to stay in the function from two to four”.*

One potential solution to the emerging talent shortage would be to outsource some or all of the internal audit function’s work. Typically, companies use outsourcing to provide additional specialist support in complex, technical areas such as derivatives, information technology and tax. However, one member said, in discussion before the meeting, that outsourcing would diminish the function’s ability to provide management development opportunities for high-fliers. In the meeting, one audit chair said: *“We would not outsource except for a special project or a skill. I believe in people who have some experience of the company, rather than outsourcing”.*

- **Have confidence in the person who will run the function.**

One member set out the qualities he looks for in the head of internal audit. He wants someone who will understand the business, keep the audit committee informed and stand up to the CEO. Another member recommended before the meeting that the head of internal audit should be a senior business person with a *“very successful career in line management ... who knows where the bodies are buried”.*

Relationship with the audit committee

The ECIA recommends: *“To guarantee the independence of the internal audit activity, the chief audit executive should report functionally to a body such as the audit committee and administratively at the level of the CEO of the organisation”.*⁹ For European companies listed on NYSE, the listing requirements include a specific reference to internal audit: *“The audit committee must have a written charter that addresses the committee’s purpose – which, at minimum, must be to assist board oversight of ... the performance of the company’s internal audit function...”*¹⁰

One member suggested: *“The audit committee is nothing without the assistance of external and internal auditors. Without them we don’t have the means to carry out our responsibilities and know what is happening. Direct links between external audit, internal audit and the audit committee are a key factor in governance”.* The precise nature of these “direct links” is matter of debate within the network.

⁹ European Confederation of Institutes of Internal Auditing: “Internal auditing in Europe”, February 2005, page 15.

¹⁰ New York Stock Exchange: “Final NYSE Corporate Governance Rules”, page 10, approved by the SEC on 4 November, 2003. Available for review at <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>

Three internal audit reporting options for the audit committee to consider:

- **The head of internal audit reports directly to the audit committee:** *“It is important that the [audit committee as the] audit control function manages all the auditors and consultants... The plan is proposed by internal audit but debated and approved by the audit committee.”*
- **The head of internal audit reports to management but with a dotted line to the audit committee:** *“Internal audit reports to the CEO and sits on the audit committee ... The audit committee chair meets the head of internal audit before each audit committee meeting”. Another member agreed: “They report to the CEO or CFO. The audit committee approves the plan”.*
- **The audit committee has no role in managing the head of internal audit:** One member questioned whether the internal auditor should report to the audit committee, as this would involve the committee in management decisions. Another agreed: *“The audit committee has no active control of the budget or the hiring and firing of the head of internal audit”.*

This concern about crossing the “bright line” into management decisions may be one reason why only a few members currently participate in reviewing the performance or compensation of the head of internal audit, although many would like the audit committee to be consulted by management in the future. Members describe various levels of involvement consistent with three options noted above:

- **Annual assessment of the function and input to bonus decisions:** *“The audit committee has to assess internal audit every year, so there is a structure to discuss the leader’s performance.”*

Members also question whether the internal audit head should participate in equity based compensation programmes. While they concede such programmes are useful to align the internal audit function with shareholder interests over the long-term; it would not necessarily enhance objectivity if the head of internal audit could benefit from ignoring potential internal control problems that could undermine the share price in the short-term.

- **Annual assessment of the function but with no input into bonus decisions:** *“The CEO will ask the audit committee chair’s view on the performance of the head of internal audit.”*
- **Not currently involved at all:** One member commented before the meeting: *“The CFO knows better the qualities to do this job”.* Another said in the meeting: *“I am not consulted now but I will ask to be consulted in the future”.*

Coordination or independence: the relationship with the external auditor

The Institute of Internal Auditors’ performance standard on coordination states: “The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimise duplication of efforts”.¹¹ One member sees a well functioning internal audit group as a *“good complement to the external auditor and a bargaining chip”* in fee negotiations with them.

¹¹Institute of Internal Auditors, *Performance Standard 2050 on Coordination, International Standards for the Professional Practice of Internal Auditing*, (Institute of Internal Auditors, 2004). Available to members at http://www.theiia.org/?doc_id=1617

Members set out two approaches to coordinating the internal and external audit plans:

- **High degree of coordination between the internal and external audit plans.** One member said: *“I don’t see the alternative. A good combination is a plus for the company. Who could be against this?”*. Another commented: *“If you can assure the external auditor that internal audit has checked the [basic] processes, then the external auditor can focus on [higher] risk areas”*.
- **Internal audit function to arrive at its plan independently of the external auditor.** Another member said: *“The objectives could be so different that coordination is meaningless. External audit knows the internal audit plan and vice versa but the activity is different. Internal audit is focused on processes and systems unrelated [to financial reporting]. There is no case for intensive coordination”*.

For SEC registrants, Section 404 is driving more links between internal and external auditors and one member thought that pattern would continue for some time. One reason is that in its recent guidance, the US accounting firm regulator, the Public Company Accounting Oversight Board (PCAOB) confirmed that: “Auditing Standard No. 2 provides the auditor with considerable flexibility to use the work of others”.¹² Many audit chairs believe the greatest source of cost effectiveness for Section 404 implementation will come from external auditors relying more on the work of internal audit.

Tax governance

A company’s approach to tax governance, defined as the oversight of tax planning, reporting and risk management, depends on its general approach to tax risk, its relationship with the tax authorities, and the governance codes of the countries in which it operates.

In formulating its own tax philosophy, the company will determine if it is trying to maximise shareholder value by taking advantage of opportunities to reduce tax or whether the company is more concerned with limiting the reputation risk associated with overly aggressive tax management. One observer noted that US governance models typically focus on the shareholder, while European models recognise a broader group of stakeholders and this might explain differences in attitudes to tax planning.

In its deliberations, the company will face scrutiny from regulators, legislators, tax authorities, interest groups and shareholders, aided and abetted by the media. One member commented: *“There is a lot of prudent tax planning that is not being done due to [reputation] risk”*.

Tax risk management

Once the company has agreed its tax philosophy and strategies, tax risk management will deal with the risks associated with the particular approach:

- **A conservative tax approach requires focus on compliance and tax internal controls**
- **A tax minimisation approach will require the risk management process to focus on relationships with the tax authorities and reputation issues**

Members see transactions and transfer pricing as the two major sources of tax opportunity for companies. However, as one member observed, as tax authorities have become more aggressive, many

¹² Public Company Accounting Oversight Board: “Policy Statement Regarding Implementation Of Auditing Standard No. 2, *An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*”, PCAOB Release No. 2005-009, May 16, 2005, 9-10. Complete document available at http://www.oversightsystems.com/pdfs/PCAOB_PolicyStatement05162005.pdf

large companies have become more cautious about tax planning: *“Most companies would not enter into artificial tax schemes, although they will reorganise internally to minimise tax. They are worried about reputation risk”*.

Even those companies using enterprise risk management frameworks do not always have a particular focus on tax risk. According to a 2004 survey by Ernst & Young, half of all tax directors globally play no role in the company’s risk management processes.¹³ Tax risk management will also affect the way the tax function is measured. The Ernst & Young survey also showed: *“Risk is cited more frequently than cash impact, effective tax rate, or even timeliness of compliance”*.¹⁴

Tax has been one of the top causes of material weaknesses and restatements under the Sarbanes-Oxley Act’s Section 404. The risk involved is that these internal controls over income taxes in particular could materially impact the balance sheet. This is certainly an issue in situations where, in the words of one member, *“the audit committee just assumes the calculations are right”*.

A survey by Factiva and *Compliance Week* showed that 20% of reported material weaknesses in the first five months of 2005 were tax-related. According to an Ernst & Young survey in June 2005, 32% of responding companies required significant remediation of controls related to taxes before they could comply with Section 404.¹⁵

Typical tax internal control weaknesses disclosed in the US include:

- Problems with documentation of tax calculations and the valuation of tax assets
- Lack of links to the business plan
- Too many error-prone manual processes
- Tax contingencies and reserves not well documented or over-accrued
- Faulty analysis of effective tax rates
- Lack of documented controls in international operations

According to one tax expert interviewed before the meeting, the internal audit function in most companies has not spent much time understanding tax: *“It is a black box where the tax function is mostly left to their own devices”*. In an individual discussion, one member agreed saying: *“The tax department is not used to this level of review; although there were no issues found, it was a change for tax to be thinking about internal controls”*.

Role of the board and the audit committee

Members say their companies have a range of practices for holding tax discussions at board level:

- **An annual discussion is part of the board agenda:** *“On our board there was no talk about tax for many years. Then we began to request the tax director and CFO talk to the audit committee annually about the tax position. It is on the [board] agenda but there is no review of controls over the tax mechanism.”*

¹³ Ernst & Young: “Tax Risk Management. The Evolving Role of Tax Directors”, 2004, page 9.

¹⁴ Ibid, page 5.

¹⁵ Jim Kunitz, Ernst & Young Thought Center Webcast: “Navigating the Perfect Storm. Tax and 404+1”, 12 August, 2005. Available at <http://webcast.ey.com/thoughtcenter/interfaces/ey2/pages/description.asp?pid=80&source=tc&sid=1126965003328>

- **Tax is only discussed in relation to litigation or other risks:** *“We are informed more and more by management and the external auditor about tax litigation and tax risk in the framework of the analysis of enterprise risk. The question is becoming more important for two reasons. First, the treatment of different taxes under US GAAP and IFRS can be a major accounting issue. Second, several companies we are looking at have... transactions in tax havens. We review this every year.”*
- **Tax is discussed when a specific problem arises:** *“We could spend all our time on tax issues. How do you isolate which [ones] to look at until there is a problem.”*
- **Tax may not be discussed at all in board meetings:** In some European countries, companies prefer not to discuss tax at a board level to prevent any loss of confidentiality due either to co-determination or to avoid providing a paper trail for the tax authorities.

In considering the best way to present tax issues to the board one audit chair recommended: *“When you have a complex issue it is prudent to have an expert give a presentation to the board but... it needs to be complemented by the CFO giving the context and framework for the discussion”*.

According to the Ernst & Young survey of tax directors cited earlier: “[Only 46% of] respondents have a channel of communication to their audit committee, despite the larger number who said their decisions must meet that group’s scrutiny (59%)”.¹⁶ Most members report their audit committee receives a report on tax at least annually, usually from the CFO.

There is a wide divergence of practice across Europe with the two ends of the spectrum perhaps best represented by Germany and the UK:

- **Members in Germany state that the audit committee typically does not discuss tax, except sometimes as part of a broader risk report.** However, one German member commented before the meeting: *“We need convergence on common standards between the US and Europe, so the audit committee will need to do this, even though in Germany tax litigation almost never happens”*.
- **Members representing UK-based companies say that audit committees are becoming more involved in discussions on tax risk and want to debate options with management.** Members said the tax director usually joins the CFO for tax discussions at least once a year. One UK member remarked before the meeting: *“In the past we have been more concerned with the tax numbers, such as the rate and the reserves, but increasingly we are concentrating on tax planning and on ways the company manages the audit of tax and the controls on tax risk”*.

Members also mentioned discussions prompted by SEC challenges on tax provisions and requirement for more precision on reserves.¹⁷ One member commented: *“The audit committee may need an item-by-item review of tax provisions [in the future]”*.

External advice and the role of external auditor

As part of the annual audit, the external audit firm will seek to understand the company’s risk appetite, tax governance and planning processes. If there are tax minimisation programmes in place, they have to

¹⁶ Ernst & Young: “Tax Risk Management. The Evolving Role of Tax Directors”, 2004, page 11.

¹⁷ See also Financial Accounting Standards Board, “Accounting for Uncertain Tax Positions—an interpretation of FASB Statement No. 109”, (Proposed Interpretation), July 14, 2005. Available at <http://www.fasb.org/draft>

understand them and assess the level of reserves on the books. However, one member said they had never read any remarks or questions on tax in their firm's audit report.

External auditors can also provide routine tax planning in most EU Member States. The 8th Directive reinforces a principles-based approach to auditor independence. However, depending on how countries choose to interpret this, implementation at local level could still lead to complete prohibitions on the provision of certain types of non-audit services. The directive is less rigid than the Sarbanes-Oxley Act and introduces the concept of a materiality threshold for such services. In July 2005, the Public Company Accounting Oversight Board further clarified the rules concerning auditor independence, tax services and contingent fees in the US.

The SEC amended its rules in 2003 to require companies to disclose the fees paid to the external auditor for financial statement audit fees, specific IT services, tax services, and other non-audit services.¹⁸ These requirements are echoed in the 8th Directive, Article 38, which calls for a transparency report setting out, among other items: "financial information showing the importance of the audit firm such as the total turnover divided into fees from the statutory audit of annual and consolidated accounts, and fees charged for other assurance services, tax advisory services and other non-audit services".¹⁹

Audit chairs in the US report that pressure from the investor community, prompted by the transparency required by the SEC, has pushed many companies to reduce non-audit fees as a proportion of audit fees. In the European network's April meeting several members predicted, in the words of one audit chair: "*Non audit services will increase once the current pressure is off because it is quicker and cheaper to use your audit firm*". Before the October meeting, one member reported his external auditor does a lot of the work on tax as they know the business and that concern about non-audit services is: "*nonsense. The external auditor is bound to be involved as they have the knowledge, so why keep them out of it? Bringing in someone else will cost you more. This is knee-jerk rules-based stuff, not common sense*".

Those members whose audit committees discuss tax matters also have access to other independent advice if they require it and several members have used tax attorneys for specialist advice.

Conclusion

The diversity of Europe is reflected in audit committees' approaches to fundamental items on their agenda, such as the role and future of the internal audit function, as well as to newer topics such as the importance of tax risk as a focus for the audit committee and the board. However, diversity also creates opportunities for change. Tradition and national culture are no longer seen as adequate reasons in themselves to continue with current practices.

It is clear from members of the European Audit Committee Leadership Network that the aspirations of audit committee chairs are converging: they want to see boards and audit committees have a clear view on these important topics, discuss them with management and agree the appropriate role for each party in the corporate governance process.

¹⁸ Securities and Exchange Commission, Release No. 33-8183 (SEC 2003c)

¹⁹ Proposal for a Directive of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC, Commission of the European Communities, Brussels, 16 March, 2004.

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, advisers and auditors who become systematically engaged in this dialogue, the more value will be created for all.

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