

Dialogue on audit policy

On 7–8 April 2016, members of the European Audit Committee Leadership Network (EACLN) met in London for their 25th stand-alone meeting. One session was a dialogue with audit regulators and policymakers in the European Union (EU), including the following:

- Alain Deckers, head of the Audit and Credit Rating Agencies unit of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union at the European Commission
- Paul George, executive director of the UK Financial Reporting Council (FRC)
- Tim Volkmann, secretary general of the German Auditor Oversight Commission (AOC)

For biographies of the guests, see Appendix 1, on page 9. For a full list of participants, see Appendix 2, on page 10.

Executive summary

In conversations before, during and after the meeting, guests and members touched on various aspects of the following topics:¹

- **Implementing the EU audit legislation** (*page 2*)

EACLN members and guests discussed the challenges of implementing the EU audit legislation of 2014, including mandatory rotation, which is particularly difficult because national variations in engagement periods may force companies to bring in a different auditor. At the same time, members as well as guests acknowledged that tendering the audit is yielding fresh perspectives and innovation, even if the incumbent firm retains the audit. Regarding the requirement in Article 27 that audit regulators report on audit committee performance, Mr Deckers dispelled fears of excessive scrutiny and intervention by noting that the initial focus is simply to understand how audit committees work.

- **Evaluating audit committee performance** (*page 5*)

Audit chairs discussed some of the approaches they themselves have taken in trying to measure and improve their performance. They described their processes for self-evaluation and their efforts to reach out to the external auditor for feedback on how they compare, as clients, to other companies. They also mentioned using outside consultants, who can also provide insights gleaned from their interactions with multiple companies and audit committees. In pre-meeting conversations, members and guests touched on several high-level practices of well-performing audit committees.

- **Cooperation between audit committees and audit regulators and policy-makers** (*page 6*)

The guests and EACLN members agreed that cooperation is fruitful given the convergence of interests among them. They discussed how audit regulators can share the results of their audit firm inspections with audit committees, describing some of the challenges and early successes in this area. While regulation of audit committees should be minimal, the participants suggested, audit regulators can provide guidance on best practices, as the FRC has already done. Both the guests and audit chairs look forward to continuing their dialogue.

¹ *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 are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

For a list of discussion questions for audit committees, see Appendix 3, on page 11.

Implementing the EU audit legislation

Audit oversight in Europe has evolved substantially over the last decade, owing to efforts at both the European and national levels. The focus has typically been on the audit of so-called public-interest entities (PIEs), a category that includes companies with shares or securities admitted to trading on a regulated market in the EU. Over the years, the EU has enacted increasingly significant legislation on the audit of PIEs, exerting more and more control over auditing and the systems for oversight.

In April 2014, the EU adopted two major pieces of audit legislation: a directive that amended the 2006 Eighth Directive on Statutory Audit and a regulation that took EU policy on audit to new levels. A new framework for audit and its oversight was established, which included such elements as mandatory audit firm rotation, significant restrictions on non-audit services and a variety of other requirements. Mr Deckers noted, *“The genesis and negotiation of the new audit framework took place in the aftermath of the financial crisis. There were specific concerns, especially in the financial sector, regarding the lack of warning signs and alarm bells. It caused us to look at auditor independence and professional skepticism.”*

The institutional framework of EU audit regulation

In terms of implementation, regulatory oversight of audit in the EU is still carried out at the national level by authorities in the member states. In fact, EU legislation requires each member state to establish a single “competent authority” tasked with this oversight. Many member states had established such authorities after the accounting scandals of 2000. Their responsibilities include registration and inspection of audit firms, standards setting and education and coordination with other regulators. Some regulators also have broader responsibilities for securities markets oversight, which partly explains why the annual expenditures of the UK’s FRC (approximately \$40 million), for example, are significantly higher than those of the German AOC (approximately \$7.1 million).²

Coordination of audit oversight across the EU will take place as of 17 June 2016 in a new body created by the 2014 legislation, called the Committee of European Auditor Oversight Bodies (CEAOB), which is composed of one member from each member state’s competent authority. This body is substantially similar to a previous body except that it is chaired by the member states rather than the European Commission.³ The duties of the CEAOB include facilitating the exchange of information and expertise among the competent authorities, providing expert advice to the European Commission, and assisting in other ways with the implementation of the 2014 legislation. The CEAOB may adopt non-binding guidelines and opinions.⁴

At the time of the EACLN meeting, EU member states were scrambling to implement the new legislation, and less than a handful had completed the process despite the impending June deadline. Mr Deckers noted that the implementation is proving to be a complex undertaking, partly because the legislation contains

² Financial Reporting Council, *Annual Report and Accounts 2014/15* (London: Financial Reporting Council, 2015), page 26; communication from Tim Volkman.

³ 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 (2014) OJ L158/77, art 30.

⁴ *Ibid.*

various options that give member states latitude in how they implement it. *“The European Commission has been trying to ensure that the rules are implemented across the EU in as consistent a way as possible. National options add a twist of complexity. We would prefer uniform implementation. Many countries are still working on it,”* he said.

Challenges of implementing mandatory rotation

Mandatory audit firm rotation is one of the most important new requirements in the legislation, and meeting this requirement is emerging as one of the most significant challenges for companies, in part because the national options – on both the engagement period and the definition of a PIE – may subject subsidiaries considered to be PIEs in certain jurisdictions to different requirements than the overall group. Mr Deckers explained, *“Each country can have different standards. For example, there is the possibility that each country can extend or shorten the maximum audit engagement period. There is a standard of 10 years, but with options to extend it in various ways, such as through tender or joint audit, for example. Also, there is the possibility to shorten it. This potentially complicates an audit at the group level for a public company. Different parts of the group could be changing auditors at different speeds.”*

An EACLN member confirmed that using different auditors is a problem, adding that the restrictions on non-audit services exacerbate it because the auditor of a PIE may be restricted from providing those services to EU-based parents or subsidiaries of that PIE: *“Using different firms creates a massive problem in a widespread, global company, especially if you look at audit rotation and the fact that the auditor can’t provide other services up and down the group. It’s a monstrous dilemma. It’s easy to see all the major audit firms being prevented from doing certain work for the company. Rotation should be the same, country by country.”*

An EY partner participating in the meeting added that rotation with varying engagement periods can make it difficult to support audit quality and effectiveness: *“The unintended consequence is that a significant proportion of the group would be audited by other firms. I think that has audit quality and consistency concerns. In some cases, part of a group could be audited twice. There are huge logistical challenges, plus cost burdens.”*

The partner also cast doubt on the argument that rotation is necessary to prevent excessive familiarity between management and the auditor: *“This is not always the case. The reality is that we haven’t focused on the fact that management rotates. At one company, there were two chairmen, three CEOs, two CFOs, and two audit chairs in my five-year tenure as the auditor. Sometimes, the auditor is the only consistency that is there and we are the corporate memory.”*

Mr Deckers was sympathetic to these concerns: *“I’m interested to hear from you about how much of a problem this is for your companies. Is it common to have more than one firm involved in the audit? There are ways to make these things work. Does the regulation create specific problems that we need to find practical solutions to or, if not, require us to look at the rules and consider changing them?”* Mr Volkmann added that fragmentation of standards is also a challenge for regulators, who will have to coordinate their efforts.

Benefits of tendering

Despite the drawbacks of rotation, both guests and members acknowledged that tendering the audit can bring clear benefits. Mr George reflected on the experience in the UK, where tendering every 10 years was

introduced before the EU adopted its new requirements: *“With the benefit of hindsight, I see it has provided an opportunity for audit firms to compete on audit quality. I believe there wasn’t any great incentive for firms to innovate. It has led to innovation.”*

EACLN members confirmed this view. One member said, *“We just went through an audit tendering, and I have to admit, I saw a lot more creativity and innovation from the audit firms than before. Every time, the firms that tendered were really focused on what we needed, thinking about how they could bring value to us as the audit committee.”* Another member said, *“I led the tendering process at two companies, and I was struck by the new ideas, the innovation – the fresh look that a new firm can bring to a company.”*

Implementing article 27

As part of a requirement to monitor and report on audit markets, article 27 of the 2014 regulation says that audit regulators must assess “the performance of audit committees” and draw up a report for the CEAOB, the European Securities and Markets Authority, the European Commission and a few other bodies.⁵ The brief article provides no detail on what the reports should contain, stipulating only that the first report is due on 17 June 2016.

How will audit regulators assess audit committee performance? In a pre-meeting conversation, an EACLN member pointed out that in some jurisdictions, required public company disclosures should be helpful: *“The audit committee reports have to be pretty long ... The regulators do have public documents to look at.”* If reporting requirements are minimal, however, regulators will have less to work with: *“It will be very difficult for them. Other than interviewing audit committees, I’m not sure what they will do.”* At the meeting, a member was concerned that *“reporting on audit committee effectiveness could be interpreted differently in every jurisdiction.”*

Mr George noted that the FRC has *“considered audit committee performance for a number of years. Not individual committees, but the role of audit committees more generally.”* Mr Volkmann expressed more concern: *“It will be a challenge because we currently have no responsibility or experience in this area. We are starting from scratch. There is hardly anything we can report in 2016. We can report on the number of audit committees established and our outreach to them, but we have no insight into the performance of audit committees and no insight on the interaction between auditors and audit committees. The problem with the new legislation is that the report was asked for on the first day of it coming into effect.”*

Mr Deckers observed that the German situation is more typical than that of the UK, but he sought to reassure the audit chairs about the rationale behind article 27: *“At the EU level, we have to take things very gradually. There is a lot of misunderstanding and unnecessary fear about audit committee performance in article 27. We’ve tried to explain that this is not legalistic or formalistic. From our point of view, it is to understand how audit committees are dealing with challenges regarding the implementation of the new requirements, including how tendering is carried out [and] the criteria for auditor selection. We would like to understand the way audit committees deal with this challenge and how it impacts audit quality.”*

⁵ 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 (2014) OJ L158/77, art 27.

Evaluating audit committee performance

The discussion of reporting on audit committee performance led to a conversation about how audit committees assess their own performance. EACLN members described several approaches:

- **Self-evaluation.** A member described an annual process in which the audit committee conducts its own evaluation as part of the overall board self-evaluation: *“We address both technical issues and the quality and transparency of our discussions with the external auditor, the CFO and internal audit. We go through a lengthy questionnaire. We use that to create findings, asking the audit committee how we can improve as a committee. It is a complete process within the audit committee. Colleagues on the board also comment on the quality of the report of the audit committee chair to the board, so the audit committee chair can fulfil their responsibilities.”*

Another member said that self-evaluation was an ongoing process, framed by the audit committee’s terms of reference: *“I do it as a continuous evaluation. When I report back to the board, I do one slide for every item in the terms of reference. I list what we did, why we did it, what the outcome was. I set out what the audit committee recommends in terms of action. For us, the key is ensuring that the rest of the board can understand what we do as an audit committee. It’s not a year-end evaluation.”*

- **Feedback from the external auditor.** Members also turn to the external auditor. One member said, *“I seek feedback from the external auditor on what they think about us. I find that audit firms are happy to give it to me. It’s a really useful conversation.”* Other members mentioned auditor feedback on the company as a whole, including management: *“We go to the external auditor to ask them how good a client we are to them. After sharing that with management, I try to have a private meeting with management to get a better look at the trouble spots within the company.”*

However, one member said that the willingness to provide feedback varies from firm to firm: *“I’ve had two different experiences as audit committee chair. In one, it was a very open relationship, and I could ask him everything about performance, etcetera. In the other one, I saw an attitude suggesting he was not allowed to talk to me. There was a concern that independence means that they shouldn’t be talking to people in the company. Not all audit firms and audit teams are the same.”*

- **External review.** A few members said an outside consultant could provide a fresh perspective, though not necessarily every year. One member said, *“We also get an external consultant to look at it all, every three years.”* In a pre-meeting conversation, another member said the outside consultant should be sure to use interviews, noting, *“You get more out of discussions than [out of] questionnaires.”* Like the external auditor, an outside consultant can apply knowledge gleaned from interactions with audit committees at different companies.

In pre-meeting conversations, EACLN members pointed out that assessments of the audit committee’s performance are likely to be difficult, even under the best of circumstances, because they may not lend themselves to the application of formal criteria. One member said, *“My first thought is, I would love to know how to measure the performance of my audit committee! There’s no real truth to doing that, except the sense you get sitting in the committee, watching the exchange between the audit committee and management, the auditor, internal audit, etcetera. You need to make it as transparent, honest and thorough as possible. If you are successful, you can say it’s working well. But I don’t see boxes I could check that would make sense.”*

Cooperation between audit committees and audit regulators and policy-makers

Some audit regulators have already been taking a stronger interest in audit committees and their role in audit quality. The FRC is particularly well positioned to involve the audit committee because its mandate includes corporate governance, but audit regulators in Germany, the Netherlands and other countries have said that they are also increasing their dialogue with audit committees.⁶ The AOC's Mr Volkmann said, *"Over the last two or three years, the AOC has become more active in outreach to audit committees. We see them as key players in audit quality."*

Beyond the countries represented around the table, many countries' regulators interact with the audit committee community far less. In a conversation leading up to the April meeting, a member noted that there is considerable variation among regulators in general: *"We will find that the agendas of regulators across Europe are quite different, that they are at different stages."*

Sharing information on inspections

One way in which audit regulators can assist audit committees is by sharing information gathered through inspections of audit firms. In pre-meeting conversations, several members mentioned the value for audit committees of learning about the results of inspections. One member noted that the positive impact of such communications extends to relations with the external auditor: *"It will push the auditor to be open with us, because they will know information is being shared between the audit regulator and the audit committee."*

In the meeting, Mr Volkmann explained how his organization overcame some initial difficulties to find an information-sharing approach that proved effective: *"We can share our inspection results only with the audit firm. But we sit on a treasure of information that we want to share in an ongoing dialogue with the audit committee. In 2013, we started outreach to audit committees in Germany. We sent out aggregate information which was dense and complicated. It was not well received. So we started to do individual outreach to DAX 30 companies. This has had good results. We saw that someone else was focused on the quality of the audit. We could work together on improving audit quality, trying to highlight findings, ask for root-cause analysis. Not to shame and blame."*

Mr George elaborated on the FRC's approach to sharing information: *"Early on, audit committees lobbied the FRC very hard to ask for the information that we have from inspections. We seek to have a dialogue. In some inspections, we speak with the audit chair up front to see where we should focus. Increasingly, we also have a dialogue with the audit chair after our inspection. It's very important; it helps us focus on the right things and also explain why we think some items are important. We have put items in reports that we didn't think were as important but that audit chairs think are very important. The dialogue helps us improve this process. We are obligated to monitor audit quality, and an important part of that is helping get information to audit committees."*

Providing guidance

The EAACN members and guests also noted that audit regulators can provide guidance on good audit committee practices. One member explained the potential benefit, using the example of a specific practice: *"Audit regulators are a focal point for gathering best practices from different companies and firms. I get a lot of cross-fertilization by sitting on different boards; you have a much wider view of what is going on. I ask*

⁶ International Forum of Independent Audit Regulators, *2014 Annual Report & Accounts* (International Forum of Independent Audit Regulators, 2014), pp 31 and 41.

the audit firms for the internal quality reports on the firms themselves. It's part of my input into monitoring the quality of my audit ... It's a really useful role for you to gather these kinds of practices and disseminate them."

Mr George mentioned the FRC's responsibility for the UK Corporate Governance Code, including its guidance for audit committees. He highlighted the FRC's interest in improving audit committee reporting practices: *"We also talk about the reporting obligations that the code puts on audit committees in particular. We are seeing some very good audit committee reports, focused on what the audit committee has done, how they assess the effectiveness of their audit, audit tender, etcetera. At the request of some audit committees, we review this report and make some suggestions on how it could be improved."*

At the same time, both members and guests made the point that guidance differs greatly from regulation, which members did not view favourably. One member said, *"Sharing practices is perfect, but I don't think we need more in the way of regulation."* Another member agreed, but mentioned the challenge of achieving consistent performance across jurisdictions: *"I agree we don't need regulation. My issue is that not all the countries are at the same level. It would be helpful to bring this discussion to the same level at all countries."* Mr George argued for a balanced approach in nudging audit committees that are lagging to a higher standard: *"You are engaged in these topics – we need to get access to those who are not as engaged. But I also understand the point about guidance. We don't want to issue too much because we fear that people think of our guidance as rules. We think long and hard about it. We want to get that balance right."*

Mr Deckers suggested that the European Commission's objectives were in harmony with these views: *"I can assure you that there is no great clamour in Brussels to bring out new regulations. It's not first on our list of priorities. We're interested in making the new rules work. It's important, across the board, to bring everyone to the same level using the process of supervisory convergence. It's not a proscriptive approach but a chance to draw on best practices and disseminate them."*

A call for more cooperation

EACLN members and guests underscored the common objectives of audit committees, audit policy-makers and audit regulators, and they called for more dialogue between these groups. Mr Volkmann said, *"We share a common objective. In this implementation phase of the new regulation, we should establish an ongoing dialogue with audit committees. Strong coordination and dialogue on what challenges you see will help us have a better focus in our ongoing oversight. Also, it will allow us to identify things that need to be fixed."* Mr Deckers added, *"I have more to learn from you than you can learn from me. I'm interested in your challenges as the new rules kick in."*

An EACLN member offered their perspective on the harmony of interests between audit regulators and audit committees: *"Audit committee chairs take their fiduciary responsibility dead seriously. We know that the financial health of the enterprise is important. We are fiercely independent. We know that we have to be almost like an external observer. We are allies with the regulator, eyes and ears in the boardroom, in the depths of the company. We have almost identical interests."*

Conclusion

The dialogue among the national audit regulators, the policy-maker from the European Commission and the audit committee chairs yielded greater mutual understanding of the perspectives each brings to bear on public company audits and their respective roles in enhancing audit quality. As they discussed the

implementation of the EU audit legislation, they learned about the objectives that they are each pursuing and the challenges they face in areas such as mandatory rotation. The audit chairs also provided insights on how they evaluate their own performance, and the audit regulators described their efforts to assist audit committees using information they gather in the course of audit firm inspections and other activities. The audit chairs and guests agreed that the dialogue should continue. As Mr George observed, “*we support you and you support us.*”

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisors as they endeavour to fulfil their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, management and advisors who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix: Biographies of the guests

Alain Deckers

Mr Deckers has almost 20 years of experience in public service at the European Commission. He has been responsible for policy reviews and policy development in areas including trade in goods, environmental policy, public procurement and financial services regulation. He currently heads a team responsible for policy and regulation of the audit and credit rating sectors.

Mr Deckers earned a Master of Science in Industrial Strategy and Technical Change at the University of Manchester. He is also fluent in Spanish and French.

Paul George

Mr George is the Executive Director of the FRC Corporate Governance and Reporting Division, which is responsible for fostering the conditions for sustainable long-term investment, which is vital so that the market has confidence in the quality of corporate governance and reporting.

Mr George joined the FRC in 2004 as the director of the Professional Oversight Board. He was chair of the International Forum of Independent Audit Regulators from April 2011 to April 2013 and executive director of the FRC Conduct Division from April 2012 to March 2016.

He holds a degree in Accountancy and Financial Analysis from Warwick University, qualified as a Chartered Accountant with KPMG in 1985 and was made a partner in 1995. In addition to being responsible for the audits of many major public interest entities, he managed one of KPMG's significant consulting businesses and was on their UK Consulting management committee. Following KPMG and prior to joining the FRC in 2004, Mr George was a main board director of a UK publicly quoted company specializing in helping multinational companies improve their operational efficiency and the effectiveness of their finance functions.

Tim Volkmann

Mr Volkmann has been Secretary-General of the German Auditor Oversight Commission since its inauguration in 2005. From 1999 to 2005 he worked for the German Chamber of Public Accountants as head of European and International Affairs. From 2002 to 2010 he served as technical advisor to several members, including public members, of the International Ethics Standards Board for Accountants.

Since 2011 he has been chairman of the Inspection Workshop Working Group of the International Forum of Independent Audit Regulators, which organizes annual workshops for inspection staff.

Mr Volkmann earned a master's degree in law in 1996, qualified for judgeship in 1998 and has held a license as attorney-at-law since 1999.

Appendix 2: List of participants

Members participating in all or parts of the meeting sit on the boards of about 40 public companies:
Mr. Aldo Cardoso, Audit Committee Chair, ENGIE
Ms. Carolyn Dittmeier, Chairman Statutory Audit Committee, Generali
Mr. Ángel Durández, Audit Committee Chair, Mediaset España
Dr. Byron Grote, Audit Committee Chair, Tesco, Akzo Nobel and Anglo American
Ms. Liz Hewitt, Audit Committee Chair, Novo Nordisk
Mr. Phil A. Hodgkinson, Executive Director, BT (alumnus)
Mr. Lou Hughes, Audit Committee Chair, ABB
Ms. Shonaid Jemmett-Page, Audit Committee Chair, GKN
Mr. Nasser Munjee, Audit Committee Chair, Tata Motors
Mr. Pierre Rodocanachi, Vice-Chair and Audit Committee Member, Vivendi
Ms. Guylaine Saucier, Audit Committee Chair, Wendel
Mr. Jack Tai, Audit Committee Chair, Royal Philips Electronics
Mr. Jacques Theurillat, Audit Committee Chair, CNH
Ms. Martine Verluyten, Audit Committee Chair, STMicroelectronics and Thomas Cook
EY was represented in all or parts of the meeting by:
Mr. Hywel Ball, EY United Kingdom and Ireland Managing Partner - Assurance
Mr. Jean-Yves Jégourel, EY EMEIA Assurance Leader
Mr. Felice Persico, EY Global Vice Chair - Assurance
Dr. Allister Wilson, Assurance Partner, Ernst & Young LLP.

Appendix 3: Discussion questions for audit committees

- ? What is your view of the effectiveness of EU audit policy and audit oversight? What would you like the audit regulators to know?
- ? How much interaction have you had with the audit regulator in your jurisdiction?
- ? What kinds of assessments of audit committees have worked well in your experience? How does your board evaluate the work of the audit committee?
- ? What advice would you give audit regulators on how to assess audit committee performance? How can they best gather information and analyze it? What should audit committees disclose about their performance?
- ? What are key good practices by the audit committee, especially as it evaluates audit quality and oversees auditor selection?
- ? Has your audit committee discussed the impact of audit tendering and rotation on audit quality, and the role of audit committees in managing this impact?
- ? What kind of assistance from audit regulators would help the audit committee meet its responsibilities?
- ? What could audit regulators do more generally to improve audit quality and promote a healthy market for audit services?