

The future of the audit committee in Europe

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 second meeting in Paris on 15 April 2005. Members explored the challenges audit committee chairs face as they consider diverse national laws, regulations and pending European Union (EU) legislation including the 8th Directive on Statutory Audit. During the discussion, members considered the following questions:

- **What role does the audit committee play in public companies across Europe?**
- **What likely impact will EU directives have on the audit committee?**
- **What are the implications for relationships with the internal and external auditors?**

Network members also identified other related issues they are currently dealing with, including:

- IFRS comparability across countries and industries and convergence with US GAAP
- (For SEC registrants) Implementation of Sarbanes-Oxley Section 404 including the quest to define internal controls while generating value and controlling costs
- Improving audit committee effectiveness

The members of the network participating in the meeting sit on the boards of about 25 large, mid and small cap public companies. They 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, AABS, Ernst & Young
- Mr Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Sir Ian Prosser, Audit Committee Chair, BP
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi Universal
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom

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 during meetings are not attributed to individuals or corporations.

Executive summary

Recently, the main concern for network members has been conversion to International Financial Reporting Standards and, for SEC registrants, the internal controls requirements of Section 404 of the Sarbanes-Oxley Act. However, in the coming months, audit committee attention will turn to the EU's proposed 8th Directive on Statutory Audit. The directive addresses a number of broader corporate governance issues, including the role of the audit committee, and is one of a number of directives that together are likely to reinforce recent trends towards convergence of corporate governance standards across the European Union.

The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages.

- **Audit committees: increased influence, workload and compensation** *(Page 3)*

Corporate governance practices differ throughout Europe and contrast with those followed in the US. However, most network members believe that individual European countries are beginning to resemble each other in the rules and regulations they adopt.

Members also believe the audit committee will become more influential over time due, in part, to its role in working with the external auditors on how IFRS is to be applied and the consequential impact on industry-wide accounting standards. Along with increased influence, members also have an increased workload – attending far more meetings than in previous years. Members are concerned that they will find it harder to recruit active operational executives due to the increased committee workload.

- **Likely impact of the proposed 8th Directive on Statutory Audit** *(Page 4)*

Members believe the emerging trend towards European convergence on corporate governance standards is likely to be reinforced by the passage of the proposed 8th Directive on Statutory Audit. The draft directive requires the audit committee to take on greater responsibility for risk management, internal controls and the internal audit function. However, audit committees will respond differently depending on how closely their own national laws and regulations currently reflect the intentions of the proposed directive.

Members report a wide range of responsibilities and practices in all three areas. Compliance with the directive may therefore drive further convergence. However, few network member companies have submitted comments on the directive and little discussion has taken place in audit committees so far. Members felt their companies could take a more active role in commenting on European legislation.

The proposed 8th Directive makes the audit committee responsible for assisting in the nomination process for auditor selection and subsequent appointment at the general meeting. Members are concerned at tensions emerging in their relationships with their external auditors over interpretation of IFRS and, for SEC registrants, fees on Section 404 implementation. Members are also concerned about the vulnerability of the Big Four accounting firms. Network members also firmly reject mandatory audit firm rotation.

Audit committees: increased influence, workload and compensation

Corporate governance practices differ throughout Europe and contrast with those followed in the US. Some European countries have only introduced legislation and recommendations to establish audit committees within the last three or so years. European countries take a principles-based approach to corporate governance: guidelines are proposed and companies must either “comply or explain”. The US system is rules-based and demands compliance with detailed regulations. One member lamented: *“The difference between US listed and EU-only listed companies is that SEC registrants have double the work – typically 400 pages of pre-reading [for an audit committee meeting] versus 200 pages”.*

As another member noted, the mosaic of European governance practice puts European standard setters at a disadvantage in discussions with the US: *“In the US there is one comprehensive system – one law. In Europe, we talk about what is imposed through the EU but we don’t have one set of legal rules because of our different history and traditions. EU [regulation] will be principles-based and lack definition because they can’t override individual legal systems. This is a weakness in dealing with the US system that has magnitude and force”.*

Role of the audit committee

The composition and roles of boards and committees vary across Europe due to national laws, cultures and traditions. The role of the audit committee also varies by country. However, one audit chair commented that: *“Differences in audit committees [also] come from what the audit committee chair wants to do, whether you are an SEC registrant and how centralised the company is”.*

The proposed 8th Directive on Statutory Audit states that the audit committee should:¹

- monitor the financial reporting process
- monitor the effectiveness of the company’s internal control, internal audit (where applicable) and risk management systems
- oversee the statutory audit of the annual and consolidated accounts
- review and monitor the independence of the audit firm and, in particular, the provision of additional services
- select an audit firm for appointment by the administrative body or supervisory board²

One member outlined his committee’s role as: *“the accounts, approval of all financial information – [including] communiqués of the company – and risk management. We are close to the optimal workload for an audit committee”.*

Another member observed the increasing influence of the audit committee: *“IFRS has grey areas which require choice and the audit committee can have a view [that will] impact the company and the industry, now and in the future. The choices we have made in interpreting IFRS – through our auditors – have become the industry standard. That is a big responsibility”.*

¹ 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.

² In many European countries, the shareholder meeting appoints the audit firm that has been pre-selected by the audit committee.

Increased compensation for an increased workload

Audit chairs in Europe, particularly in companies and countries with established audit committees, have seen an increased workload with far more meetings scheduled than in previous years. The increased workload on audit committee members is also affecting director compensation. Members report that many companies that did not pay extra compensation for audit committee membership a few years ago are now doing so. One member pointed out: *“More and more directors are paid extra for audit committee work and compensation increases year after year”*. Another member added: *“The audit committee chair should be paid more because the work is so much greater”*.

A trend towards convergence

Most network members believe countries are beginning to resemble each other much more in the corporate governance codes, rules and regulations they adopt. One member commented: *“Convergence is already under way in Europe. Ninety percent of the content and standards in the individual codes is the same. Benchmarking [between companies] will lead to further convergence”*.

Some members also believe there will be convergence between the US and Europe on accounting standards. One member observed: *“Ultimately, we will go to IFRS as a global standard”*. However, other members were more sceptical about the willingness of the US to accept convergence and one member quipped: *“The US will go metric inch by inch”*.

Likely impact of the proposed 8th Directive on Statutory Audit

Members believe the trend towards European convergence on governance standards is likely to be reinforced by the passage of the proposed 8th Directive on Statutory Audit. The 8th Directive is expected to have its first reading in the European Parliament in September 2005. Following formal adoption, the 25 member countries will begin implementation from 1 January 2006 and must complete implementation within two years. Few network member companies have commented on the directive and little discussion has taken place in audit committees so far. One member suggested: *“We should see to it that our corporations are active [in commenting]”*.

Members discussed the main themes of the original text of the directive, and the main points illustrated in over 200 proposed amendments, in order to anticipate the consequences for audit committees. They focused on five areas, each of which is discussed in more detail below:

- Audit committee composition
- Responsibility for risk management at the enterprise level
- Responsibility for internal controls
- Relationship with the internal auditor
- Relationship with the external auditor

Audit committee composition

As proposed, the 8th Directive requires listed companies to have an audit committee, composed mainly of independent directors. The directive requires audit committees to have at least one member who is both independent and competent in the field of accounting or auditing. This fits the current experience of network members. One member said: *“Generally the board chooses audit committee members with finance, accounting and legal experience”*.

However, members are concerned about finding active operational executives to join the audit committee. They felt that such committee members bring much broader experience to the committee's work, particularly around risk management issues. However, the increased committee workload is deterring potential candidates. One member described how his company *"...had issues finding people when we rejuvenated the audit committee"*. Another noted: *"If you want operating CEOs, there is a strategic issue in how you plan the committee's time"*.

Another audit chair talked about the need to identify new candidates for the board and audit committee, saying: *"We want competent people in the audit committee. If [the work] takes a lot of time, and it does, we need to identify younger people who can join and play a role in the future"*.

Responsibility for risk management at the enterprise level

The 8th Directive proposes that members of the audit committee take on greater responsibility for risk management. Audit committees will need to monitor the effectiveness of their company's risk management systems. Members currently report a wide range of responsibilities and practices in the area of risk management at the enterprise level.

In most companies risk is both a board and an audit committee topic. However, some audit committees currently have no responsibility for oversight of risk management. One member stated: *"The board can contribute on risks, can help management identify other risks and provide a holistic view. The audit committee could help but it is still a board matter"*. Another member revealed that in one company: *"Risk is dealt with very well at management level but there is very little responsibility taken at board level for risk"*.

For those companies where the audit committee does play a role, there are wide differences in practice:

- **Oversight of the risk management process.** Audit committees with some risk responsibility also tend to oversee the process of risk management. One member outlined the role: *"The audit committee monitors the risk management process but it is a line duty to manage risk. The audit committee sees to it that there are stringent processes and reporting systems in place and that a good communication process exists"*. Another member summarised his approach: *"The audit committee ensures management understands risk and that they are managing it"*.
- **Oversight of financial risk only.** Where the audit committee has some responsibility for risk management, the emphasis for some audit committees is on financial, rather than non-financial, risks. As one member commented: *"The 8th Directive mandates that the audit committee oversee the process of risk management, but they might only look at financial risk versus more broad risk areas on an enterprise-wide risk management basis"*.
- **Oversight of all material risks.** Other audit committees are involved in all types of risk facing the company but tend to focus their time on the most material ones: *"Our audit committee has a broader role to follow certain risks – whether financial or not. It's always financial in the end! We have price tags for every risk – strategic, regulatory, operations and financial. These are defined in the annual report for shareholders and the audit committee takes an active role in that"*.
- **Shared responsibility for risk among board committees.** Some companies have other standing committees of the board, for example risk or ethics committees that cover non-financial risks: *"It starts with risk mapping. Every business unit puts its risks through the audit committee"*

on an annual basis. The chairmen of [various] committees meet to decide which risks are discussed [in which committee] from a common map”.

Audit committees that are involved in risk management typically start with a risk mapping process to identify and assess all the significant risks in the company. One member described the process: *“We look at and discuss all risks. Usually we are doing that on the basis of risk mapping. The map is produced internally and [covers] 40 categories in three pages. Management reports on this and the audit committee oversees the risk management process and regularly discusses individual risks where the risk ... can have a major impact on the financial situation. The role is not to manage the risk directly although we can advise on it. You need a confident, transparent and cooperative approach from management, auditors and the audit committee to do this”.*

Once the corporation has a comprehensive view of risk, it is important to classify those risks and determine their relative priority. Most network members in Europe, like their counterparts in the US, are being provided with straightforward rating systems – for instance, many are using a “traffic-lights” system to indicate the degree of risk facing the corporation.³ One member said: *“The audit committee wants to focus on red/yellow issues on a prioritised and quantified map”.*

One issue facing audit committees is what risks should be included in the initial mapping process. Some members *“are approaching risk broadly including reputation risk”*, but this concern is not necessarily reflected by management. One member commented: *“On image risk, the board is very sensitive and management is not. Operational decisions can be taken by subsidiaries that are good for the subsidiary but not for the entity”.*

Responsibility for internal controls

Under the proposed 8th Directive, one of the duties of the audit committee will be to monitor the effectiveness of the company’s internal control systems over financial reporting. The audit committee’s role will be purely supervisory; company management will keep overall responsibility for the control environment. However, there are no clear boundaries for the internal control responsibilities of management, the audit committee and the full board. For SEC registrants, Section 404 of the Sarbanes-Oxley Act requires detailed external reporting by both management and the auditor on the effectiveness of internal controls. In contrast, the 8th Directive proposes auditors report privately to audit committees on any material weaknesses in internal controls.

The PCAOB requirements (Auditing Standard 2) are based on the US Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework. There is no equivalent European standard for reporting on internal controls over financial reporting and many European companies have rejected the COSO framework. Whereas audit chairs in the US have complained about the lack of specificity in the definition of “material weakness” and “significant deficiency”, there are no such commonly agreed definitions in Europe.

³ For further information on risk management practices in North America, see Audit Committee Leadership Network in North America, “Enterprise Risk Management and the audit committee”, *ViewPoints*, 22 December 2003. Full document available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Dec03_View3.pdf

Members are divided on whether the EU should provide more definition on internal control reporting:

- **No further definition required.** One member said: *“Do we need regulation, processes and procedures for internal controls – formal public regulation – or do we prefer pragmatic, professional recommendations? Do we need guidelines for European internal controls?”*. Another member responded: *“The [country] code doesn’t define internal controls and I wouldn’t want it to. The courts will ultimately decide the definition”*.
- **Further definition would be helpful.** In contrast, another member commented: *“We need more frameworks like COSO. If that doesn’t work, get another. We also need a definition of material weakness”*.

However, there are still parts of Europe where any internal control reporting will remain controversial. For instance one member suggested: *“The culture in [my country] is not to reveal errors and weaknesses, so internal control reporting will be an issue”*.

Some large SEC registrants are considering early adoption of Section 404, despite the SEC decision to delay implementation by twelve months. Members who are implementing Section 404 are looking for benefits from the process. One member said: *“As a board member I feel a bigger responsibility than just to comply. We have two years after the US to see if we can get benefit and see if some of the formality is taken out”*. Members felt that companies with good internal controls and risk management processes will see their cost of capital lowered. However, they also believe that the trend towards greater regulation will cause private equity to grow at the expense of capital markets.

Relationship with the internal auditor

The 8th Directive proposes that the audit committee take on responsibility for monitoring the internal audit function. This will affect network members to differing degrees, as members report different approaches to working with internal auditors:

- **The audit committee oversees the internal audit function.** One member said: *“Internal audit is not ‘management side’; it should be ‘audit committee side’. If it is considered as part of the audit committee and board, there is less risk that they lose objectivity vis-à-vis management. The audit committee must be able to request specific missions for internal audit without permission of the CEO or CFO”*.
- **Internal audit has a ‘dotted line’ to the audit committee:** Another member commented: *“Internal audit has to report to line management but needs a strong line [of communication] to the audit committee”*.
- **Internal audit reports to management only:** One member said: *“Management sets the internal audit plan. They have information and knowledge to do the plan”*. Members also differed on which executive the internal auditor should report to. One member mused: *“It depends on the charter of the function. If it is financially oriented it [should report] to the CFO; if risk management oriented [it should report to] the CEO or risk manager”*. However, another audit chair argued strongly that the function has *“to be under the CEO not the CFO, as it has to control what the CFO is doing – in accounting, financial reporting and risk management”*.

Relationship with the external auditor

The proposed 8th Directive gives the audit committee responsibility for assisting in the nomination process for auditor selection and subsequent appointment at the general meeting. At a recent meeting of the Audit Committee Leadership Network in North America, audit chairs noted: “there is a fair degree of tension in the relationships among audit committees, management, auditors, and regulators”.⁴ That tension is also developing in Europe, with one member stating there are “two new tensions in the relationship: [the audit firms’] interpretations of both IFRS and Sarbanes-Oxley; and fees for Section 404 work”.

The North American edition of *ViewPoints* also reported on the tensions from the accounting firms’ perspective: “The problem was outlined by one accounting firm leader: ‘There is a lot of second-guessing in the system. The level of stress is at its highest in over 30 years. The National Office people become very conservative, and they second-guess the engagement team, so they [in turn] second-guess the client beyond the natural scepticism we are trained in, and the whole system becomes dysfunctional’”.⁵ This trend is also apparent in Europe and one member revealed that “small day-to-day issues in [my country] have become legal issues in the US as local partners have taken issues to the US national office and the firm’s lawyers have become involved”.

Members are also concerned about the vulnerability of the Big Four accounting firms. Members believe that “with four firms it is a healthier, more competitive environment” and that “a Big Three will be a disaster”. The problem is particularly acute in France because each public company needs two audit firms to conduct a joint audit, so there is already less choice for non-audit services.

Members discussed a scenario in which one of the firms is linked to another accounting scandal and a hostile media could drive their clients and their people to defect from the firm – sealing its fate and that of the profession as it stands today. They proposed that if one of the audit firms were threatened by such an event: “the major clients of the firm should go to the regulators to ask what they will do and how we can help”. Another audit chair said: “We have a conversation every year on ‘what if’ scenarios. The risk profile of the auditor is important”.

However, on a more positive note, European members also discussed the major change in the relationship between the board of directors and the external auditors. Members say that auditors are now “actors in the corporate governance process”. One member said: “In ten years on the board of one company, I never heard the voice of one of two external auditors who attended. Now they are regarded as a board partner and they are consulted and involved”.

The proposed 8th Directive gives each EU member country discretion over whether to require audit firm rotation every seven years or audit partner rotation every five years. This recommendation goes further than the Sarbanes-Oxley Act, which requires mandatory rotation only of the audit partner every five years. All the countries represented by network members currently require audit partner rotation, but none require audit firm rotation.

⁴ Audit Committee Leadership Network in North America, “The future of the accounting profession”, *ViewPoints*, 22 April 2005, 2. Full document available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Apr05_View9.pdf

⁵ Ibid, 6.

In Italy, where audit firm rotation has been required for over 30 years, a recent study found that rotating auditors “yields no benefits and is counterproductive overall”.⁶ One member pointed out that: “If you tell someone he’s going to die, it will impair his behaviour”. According to the study by the SDA Bocconi Institute in Milan, audit firms were more likely to be cautioned by the stock market regulator in their first year with a company than in any other year. Despite the evidence of damage caused to companies’ market value and to audit quality, the Italian Parliament is expected to tighten the requirement for auditor rotation this year to two three-year terms, followed by a three-year cooling off period together with three-year partner rotation.

Network members firmly reject mandatory audit firm rotation. One member stated: “We should fight like blazes against mandatory rotation of audit firms”. He observed that it was often management that, in pursuit of cost reduction in audit fees, proposed audit firm rotation. Audit chairs, on the other hand, believe it is more important to control audit partner rotation: “I am happy to change people at the top and get a partner who fits our culture. Every seven years is about right. We can always change the partner and fire the auditor if we want to”.

Conclusion

The audit committee, as an institution, has a bright future and an important role to play in the European corporate governance arena. Most public companies across Europe will have established audit committees through national company law, EU directive or simple best practice benchmarking. As these audit committees gain experience in building their relationships with management, internal and external auditors and the regulatory authorities, they will also gain influence. Over time, audit committees across Europe are likely to experience a convergence of roles and responsibilities. This is also likely to mean a future filled with an increased workload, greater responsibility and, perhaps, greater liability for the audit committee chair and members.

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.

The views expressed in this document represent those of the European Audit Committee Leadership Network, a select group of audit committee chairs from Europe’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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⁶ Maurizio Dallochio, Dean of SDA Bocconi School of Management, *Financial Times*, “Heed the Italian experience”, 10 February 2005.