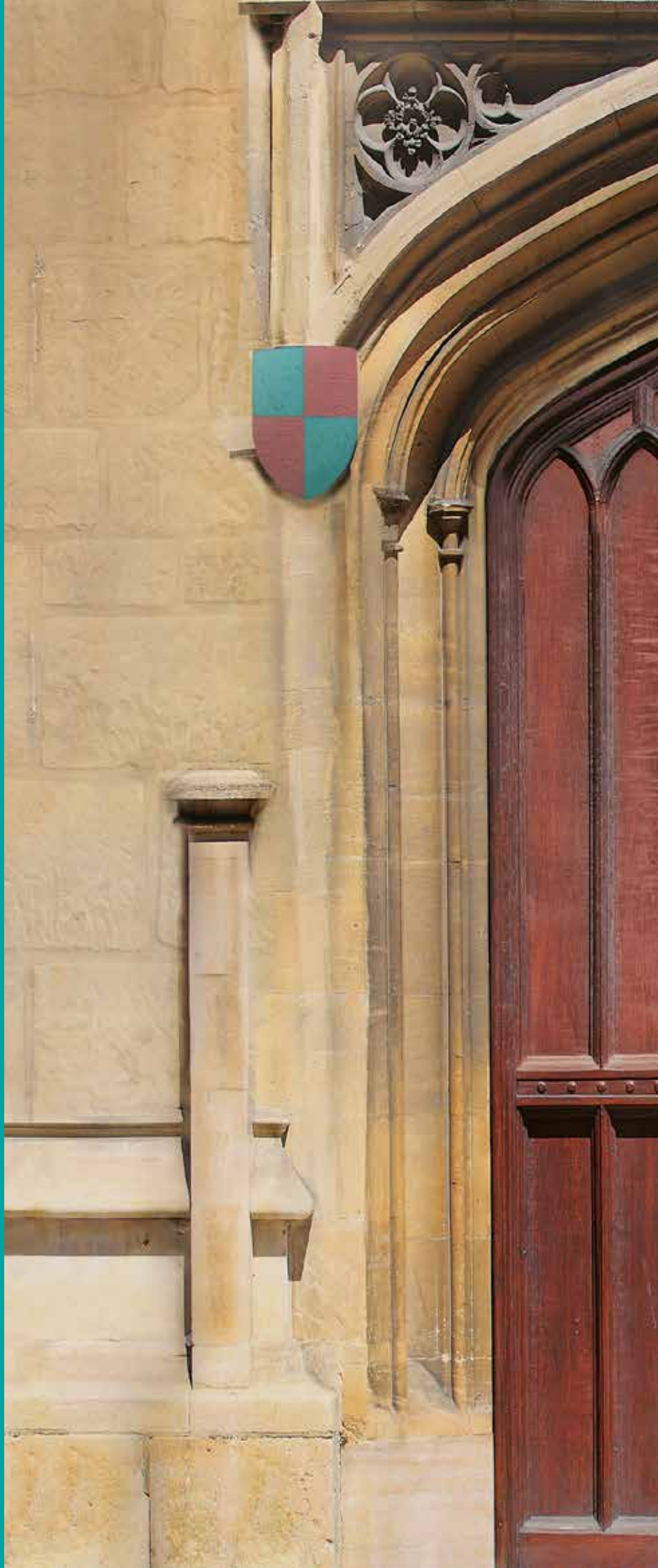
KPMG

EU audit reform

The impact on the role and responsibilities of audit committees

Audit Committee Institute



Introduction

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

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

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

01 Composition

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

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

'Competence in accounting and auditing'

'Competence in accounting and auditing' is already a reflection of the requirement in the EU Directive. It even went further, leaving the 'or' option out.

It is not specified what 'competence in accounting and auditing' entails, however, it can be assumed that that it need to be such that the audit committee is able to fulfil its role effectively. This is generally achieved by having directors on the audit committee that have a professional experience as CFO or equivalent or that have a qualification from a professional accountancy/auditing body.

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

Does the audit committee have at least one member with competence in accounting and auditing?

Sector experience

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

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

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

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

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

02 Auditor selection

Making the recommendation to the board on the appointment, reappointment and removal of the statutory auditor has for many years been a fundamental audit committee responsibility. Nevertheless, the recent audit reforms introduce legally binding requirements in relation to audit tendering and rotation (see Fig 1) that for most audit committees will represent a significant change to their role.

– The audit committee must state in its recommendation that recommendation is free from influence by a third party and does not result from a contractual term restricting the choice of auditor.

– When proposing the auditor for appointment, the board must include in the proposal the recommendation made by the audit committee in connection with the appointment and, if the board's proposal does not accord with that recommendation, the reasons for not following the recommendation.

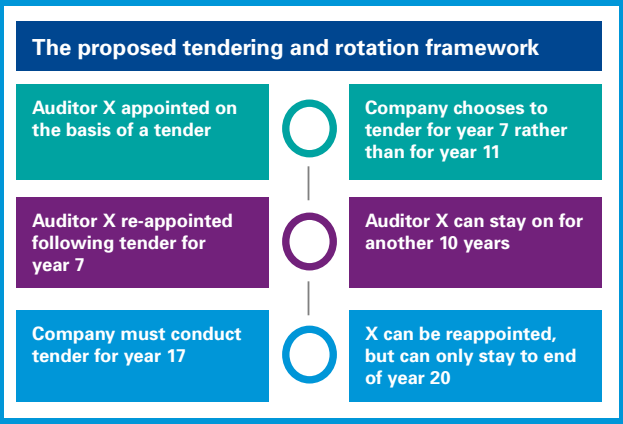
– The audit committee shall be responsible for the auditor selection procedure and, unless the company qualifies as a small or medium-sized company or is a company with reduced market capitalisation, must:

  - ensure that the tender process does not in any way preclude the participation in the selection procedure of firms which received less than 15% of the total audit fees from public-interest entities in the Member State concerned in the previous calendar year;

  - ensure that tender documents are prepared that allow the invited auditors to understand the business of the audited entity and the type of audit that is to be carried out;

Fig 1: Audit tendering and rotation

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



The new regulations are applicable from 17 June 2016. Proposed transitional arrangements are as follows:

When the start of the first financial year of the audit engagement is:

- On or before 16 June 1994 (i.e., 20 or more years tenure at measurement date): a PIE cannot renew or enter into an audit engagement with the auditor in relation to a financial year beginning on or after 17 June 2020

-Between 17 June 1994 and 16 June 2003 (i.e., more than 11 but less than 20 years tenure at measurement date): a PIE cannot renew or enter into an audit engagement with the auditor in relation to the financial year beginning on or after 17 June 2023

-Between 17 June 2003 and 16 June 2006 (i.e., more than 8 but less than 11 years tenure at measurement date): PIEs will need to conduct a tender and reappoint the existing auditors or appoint new auditors so that the new audit engagement takes effect in relation to the next financial year beginning after 16 June 2016.

For audits commencing 17 June 2006 onwards, when an audit engagement reaches a duration of 10 years since first appointed, the auditor could not be reappointed.

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

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

For audit tenders carried out in accordance with the new legislation, audit committees must ensure that "the tender process does not in any way preclude the participation in the selection procedure of firms which received less than 15% of the total audit fees from PIEs in the previous calendar year". This generally means that the tender process should not preclude the participation of non-Big 4 firms. This is entirely consistent with the objective to increase 'auditor choice' – one of the overarching aims of the audit reforms.

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

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

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

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

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

Ensuring tender documents allow the invited firms to understand the business

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

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

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

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

- Mission statement and corporate strategy
- Organisation chart, showing the key individuals, responsibilities and reporting lines
- Organisation structure, e.g. business processes, business units, functional, including key locations
- List of subsidiaries and associates, including those subject to audit
- Details of any specific independence restrictions that arise from (say) secondary listings or specific regulated activities
- Names of all directors and senior management
- Locations and operations, domestically and overseas
- Cultural information
- Most recent financial statements for all key group companies (last two years)
- Group structure chart
- Year-end / reporting / consolidation process and timetable
- Internal Audit scope and plan
- Internal Audit department structure, responsibilities and reporting lines
- IT systems in operation
- Current tax arrangements / suppliers
- Current tax status

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

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

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

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

Transparent and non-discriminatory selection criteria

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

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

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

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

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

The Regulations also set out that in considering the audit proposals the audit committee should consider "any findings or conclusions of any inspection report on the potential auditors". It is reasonable to assume that this would include both firm wide reports and any relevant reports on individual audit engagements.

A report on the selection procedure

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

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

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

Would a third party consider the rationale to be reasonable?

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

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

Where such documents are put in the public in the public domain, they provide an opportunity to discuss any peculiarities or sensitives attached to the audit tender process in more detail than might be discussed in the annual report. Such issues might include, for example, the steps taken to secure (and demonstrate) independence where an audit committee member is a former partner of one of the firms being asked to tender.

Recommending at least two choices for the audit engagement

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

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

Ideally, selection from among three to five audit firms should allow a non-discriminatory selection procedure while at the same time carrying out an efficient and cost effective process.

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

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

03 Auditor independence and non-audit services

Independence and objectivity

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

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

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

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

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

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

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

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

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

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

Former employees of the external auditor

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

Some principal types of threats to the integrity, objectivity and independence are:

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

Non-audit services

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

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

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

Audit Committees should be responsible for approving non-audit services in order to ensure that the provision of such services does not impair the external auditor's independence or objectivity. In the context of non-audit services that are not prohibited by law, the audit committee should apply judgement concerning the provision of such services, including assessing:

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

Non-audit services

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendices

Appendix a: EU Regulation No 537/2014

Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC

Article 16: Appointment of statutory auditors or audit firms 489A.

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

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

   In its recommendation, the audit committee shall state that its recommendation is free from influence by a third party and that no clause of the kind referred to in paragraph 6 has been imposed upon it.
3. Unless it concerns the renewal of an audit engagement in accordance with Article 17(1) and 17(2), the recommendation of the audit committee referred to in paragraph 2 of this Article shall be prepared following a selection procedure organised by the audited entity respecting the following criteria:

   a. the audited entity shall be free to invite any statutory auditors or audit firms to submit proposals for the provision of the statutory audit service on the condition that Article 17(3) is respected and that the organisation of the tender process does not in any way preclude the participation in the selection procedure of firms which received less than 15 % of the total audit fees from public-interest entities in the Member State concerned in the previous calendar year;

b. the audited entity shall prepare tender documents for the attention of the invited statutory auditors or audit firms. Those tender documents shall allow them to understand the business of the audited entity and the type of statutory audit that is to be carried out. The tender documents shall contain transparent and non-discriminatory selection criteria that shall be used by the audited entity to evaluate the proposals made by statutory auditors or audit firms;

c. the audited entity shall be free to determine the selection procedure and may conduct direct negotiations with interested tenderers in the course of the procedure;

d. where, in accordance with Union or national law, the competent authorities referred to in Article 20 require statutory auditors and audit firms to comply with certain quality standards, those standards shall be included in the tender documents;

e. the audited entity shall evaluate the proposals made by the statutory auditors or the audit firms in accordance with the selection criteria predefined in the tender documents. The audited entity shall prepare a report on the conclusions of the selection procedure, which shall be validated by the audit committee. The audited entity and the audit committee shall take into consideration any findings or conclusions of any inspection report on the applicant statutory auditor or audit firm referred to in Article 26(8) and published by the competent authority pursuant to point (d) of Article 28;

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

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

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

4. Public-interest entities which meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC shall not be required to apply the selection procedure referred to in paragraph 3.

5. The proposal to the general meeting of shareholders or members of the audited entity for the appointment of statutory auditors or audit firms shall include the recommendation and preference referred to in paragraph 2 made by the audit committee or the body performing equivalent functions.

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

6. ...

Appendix 2: EU Directive

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

Article 39: Audit committee

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

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

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

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

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

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

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

   a. any public-interest entity which is a subsidiary undertaking within the meaning of point 10 of Article 2 of Directive 2013/34/EU if that entity fulfils the requirements set out in paragraphs 1, 2 and 5 of this Article, Article 11(1), Article 11(2) and Article 16(5) of Regulation (EU) No 537/2014 at group level;

b. any public-interest entity which is an UCITS as defined in Article 1(2) of Directive 2009/65/EC of the European Parliament and of the Council (1) or an alternative investment fund (AIF) as defined in Article 4(1)(a) of Directive 2011/61/EU of the European Parliament and of the Council (2);

c. any public-interest entity the sole business of which is to act as an issuer of asset backed securities as defined in point 5 of Article 2 of Commission Regulation (EC) No 809/2004 (3);

d. any credit institution within the meaning of point 1 of Article 3(1) of Directive 2013/36/EU whose shares are not admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and which has, in a continuous or repeated manner, issued only debt securities admitted to trading in a regulated market, provided that the total nominal amount of all such debt securities remains below EUR 100 000 000 and that it has not published a prospectus under Directive 2003/71/EC.

The public-interest entities referred to in point (c) shall explain to the public the reasons why they consider that it is not appropriate for them to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee.

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

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

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

a. inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and explain how the statutory audit contributed to the integrity of financial reporting and what the role of the audit committee was in that process;

b. monitor the financial reporting process and submit recommendations or proposals to ensure its integrity;

c. monitor the effectiveness of the undertaking's internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the audited entity, without breaching its independence;

d. monitor the statutory audit of the annual and consolidated financial statements, in particular, its performance, taking into account any findings and conclusions by the competent authority pursuant to Article 26(6) of Regulation (EU) No 537/2014;

e. review and monitor the independence of the statutory auditors or the audit firms in accordance with Articles 22, 22a, 22b, 24a and 24b of this Directive and Article 6 of Regulation (EU) No 537/2014, and in particular the appropriateness of the provision of non-audit services to the audited entity in accordance with Article 5 of that Regulation;

f. be responsible for the procedure for the selection of statutory auditor(s) or audit firm(s) and recommend the statutory auditor(s) or the audit firm(s) to be appointed in accordance with Article 16 of Regulation (EU) No 537/2014 except when Article 16(8) of Regulation (EU) No 537/2014 is applied. Appendix 3: Prohibited (and potentially prohibited) services

Prohibited services

1. Tax services:
   g. preparation of tax forms*
   h. payroll tax
   i. customs duties
   j. identification of public subsidies and tax incentives unless support from the audit firm in respect of such services is required by law*
   k. support regarding tax inspections by tax authorities unless support from the statutory auditor or audit firm in respect of such inspections is required by law*
   l. calculation of direct and indirect tax and deferred tax*
   m. provision of tax advice*
2. Services that involve playing a part in the management or decision-making of the audited entity
3. Bookkeeping and preparing accounting records and financial statements
4. Payroll services
5. Designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems
6. Valuation services, including valuations performed in connection with actuarial services or litigation support services*
7. Legal services, with respect to:
   – the provision of general counsel,
   – negotiating on behalf of the audit entity
   – acting in an advocacy role in the resolution of litigation;

8. Services related to the audit entity's internal audit function
9. Services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity
10. Promoting, dealing in, or underwriting shares in the audited entity.
11. Human resources services with respect to:
    a. management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:
        i. searching for or seeking out candidates for such positions; or
        ii. undertaking reference checks of candidates for such positions.
    b. structuring the organisation design
    c. cost control.

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

Potentially permitted services

a. A number of prohibited services (as identified by asterisks above) may still be provided, subject to audit committee approval and after an assessment of threats, if the following requirements are complied with:
b. no direct or clearly inconsequential effect, separately or in aggregate, on financial statements;
c. estimation of the effect on the financials is comprehensively documented and explained in the additional report to the audit committee;
d. in line with the principles of independence; and
e. the audit firm would not place significant reliance for the purpose of the audit on the work performed by the audit firm in performing these services.

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