

Policy Statement | PS16/16

Implementing audit committee requirements under the revised Statutory Audit Directive

May 2016



BANK OF ENGLAND
PRUDENTIAL REGULATION
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This policy statement provides feedback to responses to the Consultation Paper (CP) 34/15 'Implementing audit committee requirements under the revised Statutory Audit Directive' and sets out in the appendices the final rules to implement the PRA's policy in this regard.

Contents

1	Overview	5
2	Approach to implementation	7
3	Policy for forming audit committees	10
	Appendices	15

1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback to responses to CP34/15 'Implementing audit committee requirements under the revised Statutory Audit Directive'.¹ It also sets out the final rules in Appendix 1 implementing the audit committee requirements of article 39 of the Statutory Audit Directive² (the Directive) as amended by Directive 2014/56/EU (Amending Directive)³ for PRA-regulated firms.

1.2 This PS is relevant to CRD credit institutions, UK Solvency II insurance and reinsurance firms (for the purposes of this PS, 'Solvency II insurers'), the Society of Lloyd's and managing agents and PRA-designated investment firms.

1.3 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to have regard to any representations made to the proposals in a consultation, to publish an account, in general terms, of those representations and its response to them, and to publish details of any significant differences in the rules as made. Respondents were broadly supportive of the proposals in CP34/15. The PRA has, however, made the following changes to its proposals in light of the consultation responses:

- The smallest firms are invited to apply for a waiver or modification of the rules, having regard to the Directive minimum requirements. Refer to Proportionality in Chapter 2.
- The PRA has introduced transitional arrangements for a period of two years. Refer to Transitional measures in Chapter 2.
- The PRA has amended the independence of membership requirements for significant subsidiaries of parent undertakings in the European Economic Area (EEA) and outside it also (non-EEA). The requirement in the final rules is for a majority of, rather than all, the members of the subsidiary audit committee to be independent, including the chairman, provided that the audit committee of the subsidiary's parent is comprised fully of independent non-executive directors (independent NEDs). Refer to Independence of membership in Chapter 3.

1.4 The PRA has taken the opportunity in this PS to offer clarification as to the intent of the policy in certain other areas without a resultant change to the rules. These include the PRA's approach to independence, clarification of the PRA's expectations regarding competence, aspects of audit committee functions and how the audit committee requirements will operate alongside the Senior Managers Regime (SMR) and Senior Insurance Managers Regime (SIMR).

1.5 The PRA will take forward the proposed requirements, grouped into four distinct themes, in line with CP34/15:

- Scope
 - Audit committees will be required for: CRD credit institutions; Solvency II insurers, the Society of Lloyd's and managing agents and PRA-designated investment firms.

1 PRA Consultation Paper 34/15 'Implementing audit committee requirements under the revised Statutory Audit Directive', September 2015, available at: www.bankofengland.co.uk/pr/Pages/publications/cp/2015/cp3415.aspx

2 Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32006L0043&from=EN>

3 Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0056&from=EN>

- Subsidiaries of EEA parents, where the parent has an audit committee in accordance with article 39 of the Directive, do not need to have an audit committee, unless those subsidiaries are significant. If the non-executive directors (NEDs) of the significant subsidiary are the same as those of the EEA parent, then the significant subsidiary does not need to have an audit committee.
- Structure – the audit committee must be a sub-committee of the board.
- Membership – the audit committee of a significant firm (stand-alone or parent) should consist entirely of independent NEDs. For other firms (lower impact firms, significant subsidiaries of EEA parents that are not exempted from the rules, and significant subsidiaries of non-EEA parents) audit committees must consist entirely of NEDs provided that a majority, including the chairman, are independent NEDs.
- Functions – the audit committee must carry out the responsibilities prescribed by article 39 of the Directive. In addition, the audit committee of a lower impact firm is allowed to be combined with, and carry out the functions of, the risk committee.

1.6 The PRA is required by FSMA to publish a statement on the impact of rules on mutuals where the final rule differs from the draft of the proposed rule.¹ In the PRA's opinion, the impact of the rules as made is not significantly different from the impact of the proposed rules on mutuals. The introduction of a transitional period should delay implementation costs for firms, thereby reducing any potential implementation burden. The impact on mutuals is, though, no different from the impact on other firms.

1 Section 138K of FSMA

2 Approach to implementation

Proportionality

2.1 CP34/15 set out the principle behind the PRA's proposals – an independent audit committee that can probe and challenge executive management and the firm's internal and external auditors contributes to good governance. Such an arrangement will help advance the PRA's statutory objectives to promote the safety and soundness of regulated firms and to ensure that policyholders are appropriately protected.

2.2 The responses to CP34/15 were generally supportive of this principle. Respondents agreed that an effective audit committee is a vital part of a firm's corporate governance framework. However, a number of respondents felt that the PRA's requirements go beyond those necessary to transpose article 39 of the Directive and would be potentially onerous for smaller firms, particularly smaller insurers (including small mutual insurers), to the potential detriment of market entry conditions and competition. Those respondents considered that the PRA should have taken a more proportionate approach to implementation by taking advantage of more of the member state discretions and derogations (collectively referred to as 'options') afforded by the article.

2.3 The PRA considers that the differentiated approach, as proposed in CP34/15, is a proportionate application of its principle. The differentiated approach is achieved by applying the highest standards of governance to significant firms and allowing more flexible arrangements for lower impact firms. The PRA continues to believe that the arrangements allowed for lower impact firms will result in effective audit committees for such firms and will advance the PRA's statutory objectives. Nevertheless, the PRA notes the concerns expressed by smaller firms and agrees with the point made that the benefits of an audit committee may outweigh the costs for some of the smallest firms.

2.4 Small mutual insurers considered that the implementation costs involved in moving from their current arrangements to the PRA's expected arrival point would be disproportionately higher – in many cases new NEDs would have to be recruited – without necessarily providing any additional protection for policyholders. In the interests of proportionality they asked that the PRA reconsider the application of exemptions for the very smallest mutual insurers and particularly for unincorporated firms.

2.5 The PRA has decided to address the above concerns by inviting the smallest firms to apply for a waiver or modification of the rules, having regard to the Directive minimum requirements. As a result such firms may not need to have an audit committee provided that they have a board performing equivalent functions to an audit committee. The PRA will require all other firms to comply with its rules although it recognises the discretionary power available under section 138A of FSMA whereby firms can request waivers or modifications of individual rules to allow for different outcomes on a case-by-case basis where the statutory tests are met.

2.6 Some respondents felt that the PRA's proposals exceed the requirements of the Financial Reporting Council's UK Corporate Governance Code (FRC Code) and that the flexibility of the FRC's 'comply or explain' approach is lost through the PRA's proposals. As noted in CP34/15, the PRA's proposed rules for significant firms – requiring an audit committee to consist entirely of independent NEDs – are consistent with the FRC's Code and the FRC's Guidance on Audit Committees (FRC Guidance), which recommends that Premium listed firms have audit committees made up entirely of independent NEDs. The PRA acknowledges that a rule has more force than a best practice Code based on a 'comply or explain' approach. The PRA notes

that the overall levels of compliance with the FRC Code continue to be high. 57% of the FTSE 350 comply fully and 90% comply with almost all provisions.¹

2.7 Some respondents raised a related concern that the PRA's proposals were disproportionate as regards significant subsidiaries. They noted that some degree of independent oversight is provided by the subsidiary's parent audit committee. Requiring an audit committee of a significant subsidiary to apply the same standard as its parent could present an unjustifiable burden, particularly for those unlisted subsidiaries which would need to recruit additional NEDs. The proposal could potentially increase the complexity of subsidiary governance arrangements. The PRA has responded to the concerns around independence of membership for significant subsidiaries in chapter 3, paragraph 3.17.

Significance of a firm

2.8 Some respondents welcomed the PRA's differentiation between significant and lower impact firms and agreed that the significance of a firm is an appropriate threshold for the purposes of applying the PRA's rules proportionately. However, a few noted that the term 'significant' does not provide clarity for firms in terms of which entities would be subject to particular rules and asked the PRA to define the term more clearly.

2.9 As explained in the PRA's approach to supervision documents² the PRA assesses the significance of a firm to the stability of the UK financial system and in respect of insurers, also to their capacity to cause disruption to the interests of policyholders, by assigning firms with 'categories' of impact. The term 'significant', as referred to in the PRA's rules on audit committees, is based on the two highest potential impact categories. Lower impact firms represent firms that are not significant, as referred to in the PRA rules. As explained in the PRA's approach to supervision documents, firms are told to which category they have been assigned.

Independence

2.10 There was a general view that the PRA's approach to independence was restrictive and that the stated indicators in CP34/15 would prevent certain NEDs from being considered independent. Some respondents felt that NEDs who had served on the board for more than nine years should be able to be classed as independent if they satisfy other criteria and provide balanced views in their audit committee roles. The view of the respondents was that it should remain with the firm to decide which members are considered to be independent, as is currently done under the FRC's Code.

2.11 The PRA had not intended the list of indicators in CP34/15 to be read as requiring all factors to be 'passed' to allow a NED to be judged independent. Rather, in laying out in CP34/15 certain considerations which may compromise independence – mirroring those in the FRC Code – the PRA's aim was to create a level playing field of guidance for all firms, particularly those which are unlisted and may not have looked to the FRC Code for best practice. The PRA has noted the concerns raised and re-emphasises that the rules require certain audit committee members to be independent. It is then for the board to determine whether a director is independent. The PRA notes that other authorities have published guidance regarding independence.

1 The FRC's annual review of developments in Corporate Governance and Stewardship for 2015 as reported in January 2016: www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/January/Quality-of-corporate-governance-in-the-UK-remains.aspx

2 Both the 'PRA approach to banking supervision' and the 'PRA approach to insurance supervision' are available at: www.bankofengland.co.uk/prs/Pages/supervision/approach/default.aspx

Transitional measures

2.12 In CP34/15 the PRA invited firms to comment on whether transition was expected to be challenging. Nearly half of the respondents supported the introduction of provisional measures, generally on the grounds of needing sufficient time to find suitably qualified independent NEDs from what they consider a limited pool. The concerns came largely from smaller firms. Feedback also highlighted that some larger firms, particularly those that are unlisted, may not already meet the independence requirements as set out in CP34/15.

2.13 The PRA acknowledges those challenges, and in response to the feedback received has decided to introduce a transitional period of two years. The timetable for implementing the rules for significant and lower impact firms has been amended. Whilst the final policy temporarily delays the implementation of requirements that the PRA considers will achieve a high standard of governance, the PRA wishes to ensure that firms have sufficient time to source high quality NEDs, increasing the overall long-term effectiveness of their audit committees.

2.14 Those firms that are also in scope of the FCA audit committee rules will be required to comply with the FCA rules during the transitional period, as well as thereafter.

2.15 The transitional arrangements are included as part of the rule instrument in Appendix 1. The transitional arrangements are also summarised in Appendix 2.

Application date

2.16 Subject to the provisions during transition, the policy applies to financial years commencing on or after 17 June 2016. Considering this application date, a firm with a financial year beginning on 1 July would be expected, where relevant, to have its audit committee in place and constituted in accordance with the PRA's rules by around October of that financial year – the point at which it is expected that the external auditors may be meeting with the audit committee as part of their audit planning cycle for that financial year.

3 Policy for forming audit committees

Scope

PRA-designated investment firms

3.1 In CP34/15 the PRA proposed to extend its rules transposing article 39 of the Directive to PRA-designated investment firms, whether listed or not. As a matter of clarification the PRA does not require PRA-designated investment firms (that are not public interest entities as defined in the Directive) to apply the articles of the Audit Regulation¹ or articles other than article 39 of the Directive for the purposes of complying with the PRA rules on audit committees.

Insurers

3.2 The scope of the audit committee requirements includes insurance undertakings. As outlined in CP34/15, in light of the transition to the Solvency II regime on 1 January 2016, for the purposes of the Directive, public interest entities include insurance undertakings that are in scope of the Solvency II Directive (2009/138/EC), including ‘the association of underwriters known as Lloyds’ (ie the Lloyd’s market). As a means of achieving the implementation of the article 39 requirements, CP34/15 proposed that the audit committee requirements apply to the Lloyd’s market at the level of the Society of Lloyd’s and at managing agent level in respect of the syndicates for which they are responsible. Having considered the feedback, the PRA’s approach to apply requirements of article 39 on the Society and managing agents remains appropriate and is consistent with its policy and approach to applying the requirements of the Solvency II Directive to Lloyds. As a matter of clarification, the application to the Society of Lloyd’s is for the audit committee to, among other functions, monitor the audit of the financial statements of the Society and the aggregate accounts, in the context of the respective audit scopes.

Subsidiaries

3.3 Whilst respondents were generally supportive of the PRA’s approach not to require lower impact subsidiaries of EEA parents to establish an audit committee, some respondents felt that the exemption should be extended to significant subsidiaries on the same terms. Their view was that requiring a significant subsidiary to have an audit committee would result in duplication and inefficiencies within the group corporate governance framework, particularly when certain functions were more usually and effectively dealt with by the audit committee of the parent. Some respondents also felt that restricting the exemption to significant subsidiaries which have the same NEDs on their board as that of their EEA parent, was not workable in practice and unnecessarily rigid.

3.4 The PRA continues to be of the view that requiring significant subsidiaries that do not have the same NEDs on their board as that of their EEA parent to have their own audit committees is proportionate; such firms have high potential impact to the stability of the UK financial system and/or in the case of insurers, significant capacity to cause disruption to the interests of a substantial number of policyholders. An audit committee supports the subsidiary board’s capability of taking decisions independently where required to meet its own legal and governance responsibilities.

3.5 The PRA does, however, acknowledge the views expressed around duplicating functions at both subsidiary and parent levels. The PRA understands that an audit committee of a

¹ 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: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN>

subsidiary, in deciding how to fulfil its responsibilities under the PRA rules, may rely for certain functions on the audit committee of its parent provided that it is confident that the audit committee of the parent has performed the functions as prescribed in article 39 of the Directive.

3.6 As regards the exemption for significant subsidiaries with boards that have the same NEDs as the board of their EEA parent, the PRA had sought to recognise that the same individuals would be covering audit committee matters relating to both the subsidiary and the parent, and thus aimed for a proportionate outcome. The PRA did not intend for firms to reorganise their boards in ways they would not otherwise do.

Structure

3.7 Having considered the feedback, the PRA considers its proposal, to structure an audit committee as a sub-committee of the board, and not permit the board or another body to fulfil the functions of an audit committee, remains appropriate.

Membership

3.8 Respondents were in general supportive of the PRA's membership requirements. However, some respondents did not agree with the PRA's proposal to restrict membership of an audit committee to NEDs only. They considered that firms should be allowed flexibility in determining the membership of their committees.

3.9 Having considered the feedback, the PRA maintains that the members of an audit committee should be separate from day-to-day decision-making, to be in a position to effectively challenge executive management. The PRA notes, however, that firms are able to determine which individuals within the group structure are competent and capable, and to appoint them as NEDs onto the firm's board to be eligible for membership of the audit committee.

3.10 Some respondents felt that the PRA should clarify its expectations relative to 'competence relevant to the sector' and 'competence in accounting and/or auditing' (both terms used in article 39 of the Directive and replicated in the PRA rules), and relative to training and induction of audit committee members.

3.11 The PRA considers that it is the responsibility of the board to ensure that members of the audit committee have an appropriate range of experience, knowledge, professional qualifications and skills, which meet the requirements of the PRA's rules.

3.12 The PRA's Prescribed Responsibilities, as set out in Allocation of Responsibilities 4¹ and Insurance – Allocation of Responsibilities 3² require PRA-regulated firms to make a NED in scope of the SMR and SIMR, commonly the Chairman, responsible for:

- the firm's performance of its obligations under Fitness and Propriety in respect of its notified NEDs, which may include members of specialised board committees such as the audit committee; and
- leading the development and monitoring effective implementation of policies and procedures for the induction, training and professional development of all members of the firm's governing body.

1 <http://www.prarulebook.co.uk/rulebook/Content/Part/212514/17-05-2016>

2 <http://www.prarulebook.co.uk/rulebook/Content/Part/212599/17-05-2016>

3.13 The rules in Fitness and Propriety state that when deciding whether a person is fit and proper, a firm must be satisfied that the person has appropriate qualifications, training, competence and personal characteristics needed to perform his or her function effectively and in accordance with any relevant requirements, and to enable sound and prudent management of the firm.

3.14 Moreover, supervisory statements SS28/15 'Strengthening individual accountability in banking'¹ and SS35/15 'Strengthening individual accountability in insurance'² elaborate on the PRA's expectations of how firms and chairmen should assess the fitness and propriety of those NEDs who are not in scope of the SMR and SIMR.

3.15 Two respondents noted that the PRA made no reference to how the audit committee requirements, and particularly the requirements for audit committee chairs, will operate alongside the SMR and SIMR. One respondent specifically asked if members of audit committees who have already been approved would have a reasonable expectation of 'grandfathering' rights.

3.16 As a matter of clarification, the chair of the audit committee requires pre-approval by the PRA, with FCA consent, under the SMR and SIMR. Other members of the audit committee will only require pre-approval if they perform certain designated non-executive senior management functions such as chairman of the board, or chair of the nomination, risk or remuneration committee. Where a firm already has an audit committee, the chairs of these committees will in most, if not all cases, have been approved as a NED under the former Approved Persons Regime (APR). Where this is the case, these chairs were eligible to be grandfathered into the SMR and SIMR without a further re-assessment by the PRA or the FCA (the deadline to submit relevant grandfathering documentation was 8 February 2016).

Independence of membership

3.17 As noted in paragraph 2.7 above, some respondents raised concerns over the burden being imposed on significant subsidiaries, which are not exempted from the rules, by requiring them to have audit committees composed solely of independent NEDs. The respondents noted that it could in some cases be desirable to allow representatives of the parent or wider group to be members of a significant subsidiary's audit committee, as they can bring relevant skills, experience and perspective which add to, rather than lessen, the effectiveness of the audit committee.

3.18 The PRA considered the feedback and in recognition of the relationship between subsidiaries and their parents, has decided to amend the independence requirements for an audit committee of a significant subsidiary. Under the final rules, an audit committee of a significant subsidiary (which is not exempted from the rules) of an EEA or non-EEA parent must consist entirely of NEDs provided that it has at least a majority of independent NEDs and that the audit committee of the subsidiary's parent is fully comprised of independent NEDs. This achieves a more proportionate outcome for significant subsidiaries. The PRA encourages those significant subsidiaries that already have audit committees comprised solely of independent NEDs to continue to follow this practice.

1 PRA Supervisory Statement 28/15 'Strengthening individual accountability in banking', January 2016, available at: www.bankofengland.co.uk/pr/Pages/publications/ss/2016/ss2815update.aspx

2 PRA Supervisory Statement 35/15 'Strengthening individual accountability in insurance', August 2015, available at: www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss3515.aspx

3.19 Under the SMR and SIMR, the PRA defines the Chair of the Audit Committee function (Senior Management Function 11¹ and Senior Insurance Management Function 11²) as having responsibility for overseeing the performance of the committee responsible for the oversight of the internal audit system. This oversight includes, but is not limited to, ensuring that no member of the committee exercises undue influence over it so as to undermine its independence, and ensuring that the overall independent balance of the audit committee is satisfactory. Just as the PRA expects the overall independent balance of a subsidiary board to be satisfactory,³ it expects the audit committee of a significant subsidiary to have an effective independent balance.

3.20 As also noted in paragraph 2.2 concerns were raised that the PRA's proposals were potentially onerous for smaller firms, particularly smaller insurers (including small mutual insurers). To meet the majority independence requirements, lower impact firms would potentially have to look to remove a number of NEDs in order for independent NEDs to be in the majority, which respondents felt was likely to weaken the membership and compromise the quality of governance arrangements.

3.21 Considering that the concerns were mainly raised by the smallest firms in scope of the requirements, the PRA is content that inviting the smallest firms to apply for a waiver or modification of the rules, as outlined in paragraph 2.5, adequately addresses the feedback.

Functions

3.22 Concerns raised around duplicating functions at subsidiary and parent were discussed in paragraph 3.3 and addressed in paragraph 3.5. In terms of other feedback, respondents generally supported the PRA's approach to audit committee functions through a direct transposition of the requirements of article 39 of the Directive. Only one respondent had specific comments on the clarity of the functions and was of the view that there should be sufficient flexibility in the requirement to monitor internal quality control and risk management systems to enable this responsibility to be shared with a separate board risk committee, as is allowed under the FRC Guidance.

3.23 The PRA notes that the function of monitoring the effectiveness of risk management systems is in relation to financial reporting and is a function required by article 39 of the Directive. The function more naturally falls under the remit of the audit committee and the PRA maintains its view that the rules as drafted are in line with the Directive minimum requirements.

3.24 A few respondents also commented that significant insurers should not be prevented from combining their audit and risk committees. The PRA's approach to allow lower-impact firms to combine audit and risk committees follows the approach of Article 76(3) of the Capital Requirements Directive for credit institutions. The PRA does not propose to have different requirements across banking and insurance as the overall principle of achieving independent challenge and high quality of governance is the same for both sectors.

1 <http://www.prarulebook.co.uk/rulebook/Content/Chapter/212479/17-05-2016>

2 <http://www.prarulebook.co.uk/rulebook/Content/Chapter/302670/17-05-2016>

3 PRA Supervisory statement 5/16 'Corporate governance: board responsibilities', March 2016, available at: www.bankofengland.co.uk/prarulebook/Pages/publications/ss/2016/ss516.aspx.

3.25 Smaller firms welcomed the option to combine an audit committee with a risk committee but felt that this would only be practical if the relevant structure and membership requirements were also more flexible. They would also have welcomed the extension to a combination of other functions. The PRA does not consider that combining an audit committee with functions other than risk is desirable or in line with its principle and considers that an audit committee should remain focussed on its core responsibilities.

Appendices

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- 1 **PRA RULEBOOK: CRR FIRMS AND SOLVENCY II FIRMS: AUDIT COMMITTEE INSTRUMENT 2016, available at:
www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps1616.aspx**

 - 2 **Summary table of transitional arrangements**

Appendix 2 - Summary table of transitional arrangements

	Significant firms (that are not subsidiaries)	Lower-impact firms and subsidiaries of non-EEA parents	Subsidiaries of EEA parents
Structure	The audit committee must be a sub-committee of the board and separate from other committees of the board	Where there is no audit committee the board may perform equivalent functions to the audit committee	Exempt from the requirement to have an audit committee, provided that the subsidiary has a parent entity in the EEA that is subject to the audit committee requirements of article 39 for that entity at group level.
Membership	The audit committee must consist of a majority of independent NEDs, including the chairman	Whether or not there is an audit committee, there are no membership requirements	
Functions	The audit committee shall, among other responsibilities: <ul style="list-style-type: none"> • report on aspects of the statutory audit to the board; • monitor the financial reporting process; • monitor the effectiveness of the firm's internal quality control and risk management systems and, where applicable, its internal audit; • monitor the statutory audit; • review and monitor the independence of the statutory auditors; • be responsible for the procedure for the selection of statutory auditor(s) 		