Making a difference: audit committees in Central and Eastern Europe

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Introduction

Are audit committees in Central and Eastern Europe (CEE) making a practical difference when it comes to enhancing the financial reporting and statutory audit process? Audit committees play a pivotal role in helping to ensure the effective stewardship of corporates, enhancing the transparency and integrity of financial reporting. Tasked to help boards discharge their financial and fiduciary responsibilities towards shareholders, they engage with the statutory auditor and the management of the corporate entity.

Their role has been strengthened across the EU during the last decade, initially as a result of the adoption of the 2006 EU Statutory Audit Directive and, more recently, the 2014 EU audit package. The evolution has been particularly marked in CEE, with audit committees often – but not always – set up as a direct consequence of EU membership and the need to comply with the full body of EU law. This ongoing evolution is the focus of this report.

Based on in-depth interviews with audit committee members in seven CEE countries (Bulgaria, Czech Republic, Hungary, Lithuania, Poland, Romania and Slovenia), covering 35 public interest entities (PIEs) active across different sectors including a small number of state-owned enterprises, this report draws out insights on how audit committees are working, how they are having an impact and how they view the future. It provides insights into some of the common challenges still remaining at a time when the role of audit committees is expanding, largely driven by the introduction of new statutory requirements.

This report explores several themes:

- *The workings of audit committees*
  There may not be a one-size-fits-all model for audit committees but there are some shared features, particularly when it comes to the changing skillset and time commitment of committee members. Audit committee engagement with supervisory boards, shareholders and management is evolving. However, issues to do with remuneration and the balance/diversity of audit committees are not yet on the agenda.

- *Areas of individual impact*
  The audit committees on which our respondents sit are having an impact, particularly on supervision of the financial reporting and statutory audit process. However, different approaches remain in evidence when it comes to risk management responsibilities – and only a handful of audit committees are beginning to grapple with broader challenges, including those related to IT and cyber security.

- *The perception of audit committees in CEE*
  Views vary considerably on the effectiveness of audit committees in CEE countries more broadly. There is a shared sense that they are beginning to be less formal and more substantive bodies. But many of our correspondents describe this as being

work in progress, with change driven more often than not by EU law rather than by investor requirements or business needs.

We welcome comments on this report at europe@icaew.com and / or EUPolicyCentre@deloitte.com

1. Performing audit committees: new skills, more communication

Audit committees are at the crossroads between management, statutory auditors and independent boards. Their role in ensuring sound corporate reporting, therefore strengthening trust in business and capital markets, is critical. So it is no surprise that, over the last decade, increasingly detailed requirements and recommendations relating to the form and function of audit committees have been set out at European and national level.

Audit committees reflect the diverse nature of the corporate world and of different corporate governance traditions. They may operate in single-tier or dual-tier board structures. When it comes to composition, frequency of meeting, engagement with the board and management, no one size fits all. This is true of the audit committees in Central and Eastern Europe surveyed here. But there are common themes, particularly in relation to the changing skill and time requirements made of audit committee members.

Audit committee members: new skills required, more time demanded

In line with EU legislation and recommendations, audit committees should normally have at least three members, although entities with smaller boards may have smaller audit committees. In line with such recommendations, the size of the audit committees considered in this report ranges from two to nine members, with the majority composed of three members.

Audit committees should include at least one member with competence in auditing and/or accounting. Collectively, the committee should have a good understanding of the business and industrial sector. The varied background of our respondents – including audit and finance experts as well as representatives from the legal, academic and public sectors – suggests that these requirements are largely being met in the committees surveyed.

It is clear that the skills needed to be an effective audit committee member are changing. Many respondents cite the need for more knowledge and experience in financial reporting, audit and risk management – in addition to industry-specific expertise. This raises questions about how the best skills mix can be determined and evaluated, particularly if not linked to a relevant qualification.

> *Audit committee members now need to have a financial background AND expertise in the relevant industry (Lithuania)*
>
> *The skills needed are changing, yes. More knowledge about control, audit and risk management is required of audit committee members (Romania)*
>
> *Although each audit committee member has a particular specialisation, in recent years there has been a greater need for knowledge of more areas including IT, corporate governance and regulatory requirements (Bulgaria)*
>
> *Industry knowledge is very important: it increases the committee's competence. We're on the right track (Czech Republic)*

There is a tension between having too many financial reporting specialists and the audit committee's ability to take a broad perspective on issues falling within its remit. Audit committee members need to deal with a constantly changing regulatory, economic and IT environment. This calls for a diverse group of members with different skills and experiences – not just accounting and auditing experts. As pointed out by a number of respondents, it is also vital that audit committee members have good soft skills, an independent outlook and a willingness to challenge.

> *More communication and persuading skills – more soft skills – are needed (Slovenia)*
>
> *Audit committee members need to be independent and have a global outlook on performance (Hungary)*

Changing skill requirements of audit committee members have been accompanied, in almost all cases, by a significant increase in their time commitment. The frequency of meetings differs considerably across audit committees, with some respondents attending committee meetings on a monthly basis, others only on an annual basis. Yet the majority of respondents judge that audit committee membership requires at least 50% more of their time than it did several years ago. For some, the time commitment has grown by over 100%. On average, our respondents attend meetings every other month with most describing a very high rate of attendance. In some cases, the audit committee meetings are accompanied by additional, informal gatherings.

> *We met five times in 2013, seven times in 2014 and by September 2016 we'd already met 13 times (Romania)*
>
> *We have regular preparatory meetings before the formal audit committee meeting to go through the agenda points thoroughly and a bit less officially to get a proper feel for the material (Slovenia)*

The number of meetings per se is not a reliable indicator of whether sufficient time is allocated to enable the audit committee to fulfil its core functions. Nonetheless, most of our respondents are clear that they are spending more time preparing for meetings and in meetings. This may reflect the increased responsibilities of audit committees as well as changing business needs and a challenging external economic context. It also responds to the enhanced role that audit committees are playing in ensuring good governance. The move noted by many towards more in-depth, substantive and challenging discussions has had – and is likely to continue to have – an impact on the time demanded of audit committee members. In one isolated case, however, it was noted that the increased skills and experience of audit committee members have led to greater efficiency and reduced demands on members' time.

> *The number of meetings has not changed, but the duration has (Lithuania)*
>
> *We are looking at issues which were not on the agenda 10 years ago (Romania)*
>
> *It takes more and more time to prepare for audit committee meetings; we are reviewing topics in more depth than in the past (Slovenia)*
>
> *We're moving away from just taking technical positions towards having more challenging, constructive discussions (Hungary)*

Engaging with management

Audit committees do not operate in isolation. The changing regulatory framework has brought with it new and growing responsibilities for audit committees to make recommendations to boards, helping them to make considered decisions when it comes to the financial reporting process, the statutory audit and the effectiveness of internal quality control and risk management systems.

Audit committees need to maintain their objectivity and independence while engaging with management. According to best practice, directors (and other officers and/or experts) other than audit committee members should be entitled to attend meetings upon invitation. In practice, our respondents describe a mixed picture. In some entities, members of the board or management attend all meetings whereas in others, they are only called upon to attend when specific agenda items are being discussed.

By and large, chairs, CEOs, CFOs, heads of internal audit and internal control are more frequent participants. Other attendees may include the external auditor and/or officers with responsibility for compliance, risk management or legal matters.

> *The CFO and head of financial control attend each quarter to review the interim financial statements and the annual financial statements. The head of internal audit attends to report on the implementation of the internal audit plan for the year as well as the annual assessment of the internal audit department. The head of regulatory control attends two to three times per year to report on the department's activities, the results of inspections by the regulatory authorities and to discuss approval of new policies. The external auditor also attends two to three times per year to discuss the terms of engagement, the external audit plan and the results of the audit and the management letter. Other heads of department attend depending on need and on the nature of the issues arising (Bulgaria)*

Audit committees are also normally entitled to meet with any relevant person from within the corporate entity – including without any other executive member of the board present. Indeed, most respondents indicate that their audit committees do engage regularly with different parts of the entity, although there are exceptions. How and when this interaction occurs also varies. Given the remit of the audit committee, it is not surprising that communication is primarily with the finance and internal audit functions. Other compliance departments, including internal control and legal teams, may also be added to the list. More often than not, contact tends to happen during the audit committee meeting and depends on the specific agenda.

> *There is no interaction with any of the company's departments (Lithuania)*

> *The only communication is with the finance department (Lithuania)*

> *The financial and audit units attend every meeting (Poland)*

> *The head of internal audit reports on the performance of the audit plan during each audit committee meeting. The head of regulatory compliance reports each quarter – as does the head of financial reporting who provides information on the achieved business results and on the preparation of the financial statements (Bulgaria)*

The level of interaction during audit committee meetings is not necessarily to everyone's satisfaction. At least one respondent welcomed the greater flexibility to make contact across one entity compared to the more limited level of engagement in a second separate entity. Engagement with management and the corporate entity more broadly also depends on how proactive audit committee members are in seeking such interaction. Across the audit committees surveyed there is no uniform practice and some describe a broad level of interaction with senior managers, not just limited to formal committee meetings.

> *We have regular presentations by different parts of the organisation, as well as meetings on specific topics with relevant parts of the organisation (Slovenia)*

> *Tomorrow, the audit committee chair is meeting the chief internal auditor to go through the first plan for next year's internal audit (Slovenia)*

Communicating with shareholders

Different types of ownership and different corporate structures will lead to different forms of interaction with shareholders. The level of engagement between the audit committees surveyed and the entities' shareholders ranges from frequent and regular to limited and sporadic. Some say that they do not interact with shareholders. In publicly-traded firms with a large number of shareholders, communications tend to centre on the publication of the annual report and the participation of the audit committee chair to answer questions at the annual general meeting.

> *The annual report secures the relationship between the audit committee and shareholders (Romania)*

> *Our engagement is limited to the annual report and the attendance of the audit committee chair at the AGM (Bulgaria)*

As a number of respondents point out, there are sometimes more direct and frequent interaction with a limited number of shareholders. This generally takes place via the board. In a handful of cases, the interaction may even take place in the audit committee, if the main shareholder (or representative) is also an audit committee member.

> *The majority shareholder is a member of the supervisory board. There is no other contact with shareholders (Poland)*

> *Three out of four representatives on the audit committee come from the foreign owner (Slovenia)*

> *The CEO is the main shareholder. He joins the audit committee meetings (Lithuania)*

> *The chair of the audit committee is a member of the supervisory board and represents the state as owner of the company. Other than that, contact with the main shareholder is limited (Lithuania)*

A sole shareholder situation, however, may raise issues related to the independence of the audit committee. This may be of particular concern if key responsibilities, such as those related to the corporate reporting process, the appointment of the statutory auditor or the procurement of non-audit services, are driven by the sole shareholder.

Most respondents judge that their committee has an appropriate level of shareholder engagement. This sentiment is expressed by respondents who describe very limited (if any) interaction with the entity's shareholders as well as by those who have more direct and regular contact. While this would appear to be an area where there is clear room for improvement, only a small number of respondents considered that dialogue could be more frequent and communication could be more direct.

The audit committee meets the shareholders once a year. This is sufficient (Lithuania)

Our engagement is too limited in my opinion (Slovenia)

I would like to strengthen the level of engagement with shareholders in the future (Hungary)

Communication, ideally, should be a two-way street. Shareholders, who not only receive information but also engage in substantive discussion, can help enhance the effectiveness of the audit committee. On this point, our respondents describe only limited interest – if any. Yet, audit committees will struggle to make a difference working in isolation. Audit committees can act more effectively where the broader corporate environment is functioning properly.

In one case, an audit committee member was replaced due to differences of opinion with the executive management – there was no reaction by the shareholders (Bulgaria)

Assessing performance

It is good corporate governance practice for the competence and effectiveness of all board committees to be evaluated on an annual basis. The European Commission recommended back in 2005 that audit committees should report what they are doing and what they have achieved to the board, at least twice a year. Evaluations of the work of audit committees are only likely to increase given the legislative changes introduced by the 2014 EU Audit Regulation that specifically mandate competent authorities to assess and report on the performance of audit committees of PIEs – a point specifically raised only by one respondent.

This is an issue requiring attention in CEE member states. More than half say that audit committee performance is not currently being reviewed. Even where performance is assessed, it is often an informal exercise, for instance limited to audit committee members giving each other feedback. Others point to the commentary provided on a quarterly, half-yearly or annual basis to the board and via the audit committee's annual report and annual general meeting to shareholders. For financial services entities, such information is also increasingly shared with the relevant oversight bodies.

We do not assess the committee's performance. But if the shareholders want us to do so, it can be done (Romania)

We don't have special measurements for reviewing performance, but we work very closely with each other on the committee and give each other feedback (Hungary)

Some do describe a more structured assessment process. This may be based on questionnaires, which in one case are provided by the group owner, or on feedback from other quarters, such as internal management and/or the statutory auditor.

The committee provides a self assessment of its annual activity. Feedback is provided by the executive management, the internal auditor and the external auditor. The board and shareholders receive the assessment (Bulgaria)

Given the increasing role of audit committees and the new legislative requirements, it might be expected that audit committees are reflecting on whether they should rely on self assessment, seek feedback from those they interact with or use external advisers to help with the process. The last approach appears to be further down the line: none of the audit committees surveyed are currently using (or planning to use) external expertise to facilitate their performance review.

The situation is similar when it comes to reviewing the quality of the external audit. In this case, the majority of respondents said that their audit committee does evaluate external audit quality. But again, such assessments appear to be generally quite informal and/or based primarily on reports provided by the statutory auditor. For some, this reflects the lack of more formal criteria by which to judge audit quality.

> *External audit quality is assessed but informally. The criteria for a formal assessment are missing (Slovenia)*

2. Making a difference: areas of impact

Audit committees are in place to have an impact on how businesses function. They have key corporate governance responsibilities, playing a central role in helping to ensure the effective stewardship of entities. Core functions of the audit committee, including those relating to oversight of the financial reporting and statutory audit process, are laid down in hard and soft law, as also outlined in the technical annex. How these functions are discharged differs, especially with regards to risk management responsibilities.

It can also be hard to assess if and how audit committees are making a difference in practice. Often this is a reflection of the nature of audit committees, with conversations taking place in private. When questioned, our respondents overwhelmingly (and perhaps unsurprisingly) consider that the audit committees in which they are involved are making a difference, particularly when it comes to core areas of competence. Feedback on whether this is the case more broadly across the region is more nuanced, as explored in section 3.

Is risk management a core function?

While most audit committees surveyed monitor the internal audit and internal control functions, responsibilities for risk management are more fluid. In the majority of the entities considered here, audit and risk responsibilities are not split between different board committees. Some respondents are comfortable with this, noting that a separate risk committee is not required given the perceived overlap between audit and risk management responsibilities. In other cases, the current status is explicitly described as a reflection of the limited development of risk functions within the entity. Of course, the remit and structure of board committees is not static but evolves over time – and at least one respondent noted that consideration is currently being given to setting up a new risk committee alongside the audit committee.

> *The agenda is very close, so there is no need to split audit and risk responsibilities (Czech Republic)*
>
> *Audit and risk responsibilities are related, so should not be split (Lithuania)*

While risk management may be a relatively new discipline for audit committees in CEE, of greater concern are the handful of respondents who note that, irrespective of legislative requirements already in force, the audit committee has no responsibility for risk management and internal control.

> *The audit committee has no responsibility for risk management and internal control. There is no need for such responsibility (Lithuania)*

On the other hand, about a third of our respondents describe a situation where risk responsibilities are shared between board committees, with the audit committee generally having more of an oversight role – as would be expected. In these cases, audit committees tend to focus on assessing the adequacy and efficacy of an entity's risk management functions and processes. It is not always clear what risks are being considered by audit committees – those related to the financial process or broader risks to the corporate entity? Some respondents describe specific responsibilities, for instance active monitoring or evaluation of different types of risk or even determining plans to decrease operational risks. It may be that some audit committee members feel more comfortable in assessing some of the 'number-driven' risks in the financial services sector rather than in other industries.

> *The audit committee is in charge of evaluating the efficiency and effectiveness of the company's risk management system. The risk function is in charge of identifying and managing risks (Romania)*

> *The audit committee shares responsibilities to actively detect operational, financial, internal and external risks in the company. It helps mitigate risk and works with management to put out fires (Poland)*

> *The audit committee monitors risks related to liquidity, capital adequacy, interest rate changes, operations. The risk committee monitors credit risk (Slovenia)*

While a greater separation of risk responsibilities between board committees tends to be seen as good corporate governance practice, it is also often a reflection of the size of an individual entity, with larger corporate structures tending to require more specialised board committees. For financial services entities this also reflects changed legal requirements, as noted by some of our respondents. The separation may be more formal on paper than in practice: in a handful of cases, respondents describe risk responsibilities as being split between audit and risk committees but also observe that the membership of the two committees is very similar.

> *Risk needs to be on the agenda, in a way that it has not been in the past (Czech Republic)*

A positive impact, with some exceptions

Most respondents consider that they are members of audit committees that are making a difference. There is consensus that the audit committees surveyed are having an impact when it comes to core responsibilities relating to financial reporting, internal control, internal audit, risk management, the statutory audit process as well as industry-specific issues. Unsurprisingly, this list closely matches soft and hard law requirements.

> *The committee has an impact. The risks are known and there is adequate oversight on the company's response. Audit results are adequately presented (Romania)*

> *The committee has a disciplining effect on the company. It forces management to control finances and to pause to consider how well the company is doing (Poland)*

Many respondents also provide some additional colour, highlighting how measures recommended by the committee are being implemented operationally. Internal audit units have been upgraded with qualified staff now in place. IFRS reporting has been introduced. Financial statement disclosures have been improved. New budgeting systems introduced.

Internal control functions have been enhanced. Broader organisational structures have been changed. Compliance with legislative and regulatory requirements has been monitored.

> *Our biggest impact has been in the areas of financial reporting and internal audit. We've made specific recommendations to improve the quality of financial statements and have actively contributed to help remove negative findings in the area of internal audit. The committee has also expressed an opinion on issues related to conflicts and has acted as a counterweight in this regard (Bulgaria)*

> *We've made sure that the financial reporting process is well established and that there are adequate controls … Our discussions with the external auditors have also covered their assessment of our internal controls, primarily over financial reporting … We've been discussing the audit plan, the capacity of internal audit as well as the response of management to audit findings (Czech Republic)*

> *Many measures have been taken to improve internal control systems taken as a result of the committee's recommendations, including better formalisation of internal control procedures and rules. We've also made recommendations to improve risk management, for instance by implementing proper documentation to record delivery of leased items, ensuring better monitoring of restructuring cases and improved management of the risk of damage to recovered equipment (Romania)*

> *The audit committee definitely had an impact during the 2011-13 crisis, with regards to operational risk where we had to introduce benchmarks, working with the national banking association (Slovenia)*

Some respondents express more nuanced views, observing, for instance, that while the committee's recommendations are being implemented, it is work in progress. Others point out that even where the general trend is positive, there can be exceptions. And a small minority are downbeat in their assessments, noting the limitations facing the audit committee.

> *I'd give us a 6 on a scale of 1-10. Sometimes I am less satisfied with the speed with which the organisation implements certain measures (such as an integrated risk management system) (Romania)*

> *Audit quality is generally good. But there have been some exceptions where quality was reduced due to a compromise on the company's management side (Bulgaria)*

> *The local audit committee does not have much power to appoint or change the external auditor. This is done by the foreign owner. During the financial crisis, the audit committee was not satisfied with the external auditor due to inconsistent demands with regards to provisions (Slovenia)*

On the agenda

Looking ahead, the audit committees surveyed remain primarily focused on issues falling within their remit: financial reporting, internal audit, internal control and risk management. Although in some cases respondents describe priority shifting to particular items within their overall remit – for instance paying greater attention to particular risks or trying to ensure better organisational alignment.

Only a small number of respondents indicate they are taking a broader look at the regulatory, business and economic environment. Issues such as whistle-blowing arrangements, broader regulatory compliance, greater shareholder engagement and IT security concerns are only on a few agendas.

> *One of our current focus areas is to better align top management with the internal control and internal audit departments (Romania)*

> *We are focusing on unusual transactions, investments, liquidity, solvency issues and equity adequacy (Slovenia)*

> *Current focus areas include avoiding slip-ups (financial risk), supervising the credit committee, assessing the independence of experts and IT security (Poland)*

A similar pattern emerges when respondents look to the future. Certainly, financial reporting, internal control, risk management and, to a lesser extent, internal audit remain topics of concern. Indeed, a number of respondents do not expect any significant changes to future agendas. Others note that audit committees are likely to shift emphasis within their areas of responsibility. For example, in the financial services industry, audit committees may look more closely at how IFRS9 is being implemented.

Surprisingly, only a small number of respondents expect that, as part of their risk oversight responsibilities, greater attention will be paid to IT, data and cyber security risks despite the potential impact on core business operations and on corporate reputation. Limited attention to digital matters may reflect the skills and experience of audit committee members – with few likely to be real IT specialists. However, audit committees should be able to raise questions and indicate whether there is a need for proper policies and procedures to be in place.

> *We will perhaps monitor IFRS9 implementation more closely (Slovenia)*

> *The biggest challenge will be to look at IT risk, including data security issues (Hungary)*

Several respondents note that audit committees will be obliged to spend more time dealing with new legal requirements, particularly the changes brought about by the 2014 EU audit package, which substantially expand the audit committee's responsibilities, particularly in relation to the statutory audit process. As discussed in section 4, levels of preparation vary greatly when it comes to dealing with the new legal requirements being placed upon PIE audit committees.

> *We'll need to respond to changes relating to non-audit services and ensuring the auditor's independence – as well dealing with changes to IFRS (Slovenia)*

> *Implementation of the new EU audit rules is on our agenda (Bulgaria)*

> *We need to focus more on the independent measurement of the performance of audit committee members (Hungary)*

3. Audit committees in CEE: gradually becoming bolder

Audit committees across the EU have seen their remit change and expand during the last decade, but perhaps nowhere as much as in CEE where countries have had to comply with the full body of existing EU law as a condition of membership. Nor has EU law stood still. For the majority of respondents, the changes have been significant: matters of substance are increasingly discussed and audit committees are increasingly challenging management. Not all audit committees in the region have evolved at the same pace – and significant challenges remain ahead.

From formality to substance

As audit committees have become more established across CEE during the last decade or so, many of our respondents are clear about the challenges ahead. Nevertheless, there is a clear sense that audit committees in the region are becoming more assertive in fulfilling their statutory obligations. The gaps, however, between the best-in-class and the rest may be persisting.

> *There has been a dramatic change as there were no audit committees 10 years ago (Czech Republic)*
>
> *Audit committees have emerged. They are new entities (Poland)*
>
> *Audit committees have only started to gain importance in the last few years. Before that they were only a formality (Romania)*
>
> *Audit committees in the country have only improved a little. Our audit committee has seen larger improvements (Slovenia)*
>
> *There have been significant changes in the last 10 years. Now the goal is to move away from being a formal entity to providing added value to the board and CEO (Hungary)*

Many respondents mention the shift from a formal, legal role to a more professional, challenging one. In some cases, this is judged to be a result of more independent and skilled audit committee members. Others consider that it is a consequence of changes to the responsibilities of the audit committee or a reflection of external factors, with new issues coming to the fore.

> *With the introduction of more independent members, the focus is beginning to shift to more substantive matters (Czech Republic)*
>
> *The remit and role of audit committees has not changed much in the last decade but the competence of people sitting on the committees has increased (Lithuania)*
>
> *There have been significant changes to the duties of audit committees; they have to analyse matters that were not on the agenda 10 years ago (Romania)*
>
> *People are beginning to understand how audit committees can have an impact. Shareholders are beginning to use the expertise that is available to them within audit committees (Czech Republic)*

Not all respondents are convinced that audit committees more broadly across CEE have changed – or changed enough. Several respondents perceive only limited (or no) developments. Audit committees exist because they are mandated by law: this does not mean that they are having an impact. Two respondents view audit committees as being another bureaucratic requirement placed on businesses and that only large international entities should be obliged to have them. A minority of respondents are also critical about the selection of audit committee members in some entities, feeling that a number of appointments should not be taken seriously. In one case, a clear distinction is drawn between the audit committees of private sector entities (generally good) and those of state-owned entities (filled with well-connected rather than well-qualified individuals).

> *Audit committees are established because the law requires it (Lithuania)*

> *Audit committees are just a burden for companies. Only large international companies should be obliged to have audit committees (Lithuania)*

Drivers for change

With audit committees emerging across much of CEE since EU membership, it is unsurprising that many respondents consider that EU legal requirements have been, and continue to be, the main driver for change. For some this also reflects the limited demand from investors, reflecting the size of local capital markets. Of course, mandating change via legislation can lead to the formal establishment of audit committees in order to remain in line with the law – and indeed, for some this is what has happened. However, two thirds of our respondents are more positive. The EU has driven change where the business or investors have not. The ability of audit committees to oversee the integrity of the financial reporting process may still be work in progress in some jurisdictions but the trend is encouraging.

> *EU legislation has driven change, but only to the extent that audit committees are now required to fulfil formal obligations. I don't think business or investors are acting as drivers for change (Bulgaria)*

> *The audit committee was established because it was a legal requirement to do so (Lithuania)*

> *EU legislation has had a positive impact. Without it, local legislators would have limited interest and understanding of issues such as corporate governance (Czech Republic)*

> *EU legislation has had a positive impact in terms of increased shareholder safety with regards to the accuracy, reliability and relevance of the disclosures in financial statements (Romania)*

> *Generally, the impact of EU legislation has been positive since they have contributed to better controls on, and supervision of, the statutory audit, and by ensuring shared responsibility in cases of fraud and incorrect reporting (Bulgaria)*

The broader external context has also been important. The last 10 years have been economically turbulent across the EU. Many audit committees have found themselves fulfilling a more important role as businesses have had to deal with a more unstable economic and political environment. Some respondents are clear that business and/or investor needs have been far more significant drivers for change, particularly where group owners have become more demanding. In the case of one respondent, it is the prospect of a new potential strategic partnership that has led to the strengthening of the audit committee. Others deem business needs and/or investors to have had limited impact, if any. Audit committees themselves have also driven change, pushing for a more professional and substantive role.

Change has been driven by the supervisory board (Lithuania)

The audit committee's role has evolved. Our shareholders require analysis and a fair presentation of the organisation's financial operations regardless of the result (Romania)

Business needs have had a limited impact (as have EU requirements) but investors are beginning to take notice (Romania)

Investors only focus on financials which is not enough to drive change (Slovenia)

For many the drivers for change are multiple, a combination of regulatory requirements, business needs and investor requests. Indeed, for audit committees of financial services entities, as the quotation below highlights, regulatory and business demands have been especially significant and specific.

Change has been driven by our regulator, who has joined some board meetings to discuss corporate governance issues. Regulatory changes in the banking sector have influenced the work of the audit committee. Group demands have led to significant changes since 2008. Corporate governance issues used to be at the discretion of the local subsidiary. Now we have a more structured approach across the group, with more emphasis on internal controls and compliance. No deviation from the group rules is allowed – and in some cases these are stricter than those of other banks in the country which can create difficulties (Slovenia)

Work in progress

Individual audit committees may be gaining more profile within individual entities, but their broader profile across different CEE member states still needs bolstering. More than half of our respondents are doubtful that audit committees in their jurisdiction have sufficient profile and impact. The ability of audit committees to take decisions, challenge management and the external auditor is still work in progress. Too often they are perceived as being a nominal body; they need to do more in order to become effective.

Audit committees are not effective enough. It is hard for them to challenge management and the external auditor. There may be some positive exceptions (Bulgaria)

Legislation gives audit committees enough power to have an impact. This is not happening in practice (Lithuania)

New legislation provides a good basis, enabling audit committees to challenge management and the external auditor – but we still have to see how it will work in practice (Czech Republic)

The role of audit committees is underestimated. They are maintained because of the legal requirement to do so. Improvements will come with the results of the work of the committees themselves. The history of audit committees in our country is short (Bulgaria)

Some respondents take a more positive view, again remarking how much more prominent audit committees have become since the introduction of EU legislation. Although again it is repeatedly noted that there is a difference between the rules on paper and the rules applied in practice.

> *I think audit committees in our jurisdiction are quite good and could serve as a model – especially in the banking sector. We've been required to have audit committees by the regulator for a long time. In 2015, the demands became even stricter. In other industries, the state holding for SOEs also started to enforce new rules to improve corporate governance. Things are getting better and better and audit committees have a good profile (Slovenia)*

> *Audit committees are effective, but the trend is towards them providing greater challenge and added value. This should improve further in the future (Hungary)*

Several respondents observe that much depends on how empowered an individual audit committee is. This depends also on the corporate governance structures within individual entities – and consequently varies significantly from organisation to organisation. Some respondents consider that the audit committees with most impact are those within multinational groups. Others, echoing another common theme, perceive the clout and resolve of the audit committee as being largely determined by the committee members themselves.

> *Audit committees are visible and have authority in entities that have implemented the necessary requirements in relation to their organisation and operation, the appropriate corporate governance principles. In other entities, they are formal if not non-existent (Romania)*

> *We need greater awareness of audit committees in the country. They would have greater authority if their activities were regulated by law not just on the basis of recommendations. Generally, audit committees are a nominal body. Few organisations have a strong and effective audit committee – and those that do tend to be multinationals (Lithuania)*

> *It is still very much a rubber-stamping exercise and not taken as seriously as it should be. Ensuring the committees' effectiveness is an uphill battle, very much dependent on the ambition and skills of individual audit committee members (Romania)*

And there is the odd exception, with one or two stating that it would be better if responsibility for many of the issues under the audit committee's remit lay with the external auditor.

The challenges ahead: a regional perspective

Asked to consider the main challenges faced by audit committees in the region, many of the issues flagged by respondents are similar to those on their minds when it comes to the work of the audit committees on which they sit. Respondents want to see audit committees improve further, becoming more professional and independent. Yet finding a balance between independence, professional competence and industry knowledge in a rapidly changing business world is a critical challenge for others. A handful of respondents consider that this requires the development of more standardised procedures for audit committees. A small number also highlight the growing challenge of finding the right people – and remunerating and training them appropriately.

We need to increase awareness within boards and executive management of the importance of an effective audit committee (Romania)

The biggest challenge will be to develop a normal role for audit committees – I expect this will be a continuous process (Bulgaria)

We need to develop a GAAP for audit committees (Czech Republic)

The biggest challenge will be to find people with right skill set (Lithuania)

Is it possible for independent members to understand the business and industry if they are not in day-to-day contact with the entity? How can audit committee members ensure they receive the appropriate information outside of quarterly meetings? (Czech Republic)

Audit committees may need to pay more attention to ensuring that the appropriate internal audit, internal control and risk management functions and processes are in place, in line with both legal requirements and best practice in the industry. Implementation of the 2014 EU audit package will be challenging for many. Changing business practices, including privatisation and/or the arrival of more foreign investors, in addition to new financial reporting standards and non-stop IT and digital transformation will further challenge audit committees in the region. Some will be more prepared than others to deal with such changes.

Greater public supervision of audit committees will make the work of the committees less effective, particularly as the oversight body lacks the resources to fulfil this task. This will mean more formalities to be completed by the audit committee – and is against the spirit of independence of audit committees (Bulgaria)

Knowledge and implementation of EU legislation in the activity of audit committees will be a challenge (Romania)

The biggest challenges will relate to how financial services organisations in the country will react to privatisation and the arrival of foreign banks, or new investors. Will the new players change the game? (Slovenia)

The biggest challenges will be those relating to the IT environment and IT risks (Hungary)

About the research

A total of 30 respondents participated in the research, drawn from seven EU member states in Central and Eastern Europe (Bulgaria, Czech Republic, Hungary, Lithuania, Poland, Romania and Slovenia). As such, this report is not designed to provide a detailed analysis of the role of audit committee members in CEE countries. Rather, our research seeks to draw out insights to help understand the practical ways in which audit committees are having an impact and what is on their agenda – as well as sharing informed opinions on the state of audit committees in individual countries.

All respondents are members of one or more audit committees, covering 38 public interest entities across a range of different sectors, including financial services, energy, agriculture and manufacturing. The corporate structure of the entities also varied, from locally listed entities to privately owned ones, to entities that are part of multinational groups or where the state is the majority shareholder.

Interviews were carried out by local Deloitte partners in person or by telephone. A number provided input online. All interviews were undertaken on the basis of an interview discussion guide agreed by ICAEW and Deloitte. Fieldwork was undertaken between May and December 2016 on a confidential basis. Most interviews lasted between 30 and 45 minutes. ICAEW and Deloitte jointly analysed the responses. To protect respondents' anonymity, we have deliberately not identified respondents (or entities) throughout the report.

Deloitte corporate governance experts in CEE also provided input for the annex to this report on audit committee structure, composition, powers and duties under local law.