

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

CONSULTATION DOCUMENT

CONSULTATION ON AMENDMENTS TO THE LISTING RULES IMPLEMENTING AUDIT COMMITTEE REQUIREMENTS

[MFSA REF: 07-2016]

28th June 2016

Closing Date: 11th July 2016

Note: The documents circulated by the MFSA for the purpose of consultation are in draft form and consist of proposals. Accordingly, these proposals are not binding and are subject to changes and revisions following representations received from the market participants and other involved persons. It is important that persons involved in the consultation bear these considerations in mind.

Note for Consultation

1. Purpose

With the view of enhancing the degree of public confidence in the annual and consolidated financial statements of “*public interest entities*¹”, Directive 2006/43/EC 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, (“the Statutory Audit Directive”), has been amended by Directive 2014/56/EU of 16 April 2014. The Statutory Audit Directive is a minimum harmonisation measure and Member States may impose more stringent requirements.

Moreover, the special provisions for the statutory audits of public-interest entities set out in the Statutory Audit Directive have been further developed in the new Regulation (EU) No 537/2014 of the European Parliament and of the Council of the European Union of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, (“the Statutory Audit Regulation”).

During April 2016, it was brought to the attention of the MFSA that Directive 2014/56/EU, which amends the Statutory Audit Directive, will be partially transposed in a Draft Bill amending the Accountancy Profession Act (Cap. 281) and the Companies Act (Cap. 386), and that some Articles found in the Statutory Audit Directive, as amended, may require amendments to the Listing Rules dealing with Audit Committees which were introduced in 2008. The transposition deadline for Directive 2014/56/EU was 17th June 2016.

This Consultation Document lays down the proposed amendments to the Listing Rules which are herewith attached as Annex A. The proposed amendments transpose the provisions of Article 39 of the Statutory Audit Directive and certain provisions of the Statutory Audit Regulation. In its proposal, the MFSA also considers the options or derogations found in the said Article 39 and the Statutory Audit Regulation.

Any comments and feedback are to be addressed to the Listing Committee by email on listcomm@mfsa.com.mt. Interested parties are kindly asked to submit any comments in writing by not later than 11th July 2016.

2. Summary of the main changes

The new Article 39 of the Statutory Audit Directive sets out the requirements on audit committee composition and the functions that audit committees shall perform. The following is a summary of the main changes with respect to this committee:

¹ The term “public interest entities” is defined in Article 2 of Directive 2006/43/EC as amended by Directive 2014/56/EU, and includes listed companies.

2.1 Composition and Functions of the Audit Committee

- a. Presently Listing Rule 5.117 provides for the majority of the members to be non-executive and for at least one of the members to be independent. The Audit Committee is now required to be composed **entirely** of non-executive directors, the **majority** of who shall be independent of the Issuer.
- b. The Chairman shall be **independent** from the Issuer, and shall be appointed by the members of the Audit Committee. Presently the Listing Rules require that the Chairman is a non-executive director and does not specify how the Chairman should be appointed.
- c. The Committee members as a whole shall have competence relevant to the sector in which the Issuer is operating. Presently the Listing Rules are silent in this respect although it is expected that listed entities already adopt this principle as part of its corporate governance.

This modified composition aims to ensure that there is the necessary level of independence for the audit committee to carry out its role.

2.1.2 Functions of the Audit Committee

Article 39 (6) provides for a non-exhaustive list of the functions of this Committee. Similar functions were already present under the Listing Rule 5.127, however, this new list of functions updates and extends these functions with special emphasis on the integrity of the financial reporting and the selection of the statutory auditor or audit firm.

3 Member State Options or Derogations from the requirements of Article 39(1) of the Statutory Audit Directive

Article 39 contains a number of Member State discretions and derogations. The MFSA believes that an independent Audit Committee that can probe and challenge management contributes to good governance and is essential especially in the case of local listed companies where the shareholding is typically concentrated in the hands of few investors who are usually also actively involved in the management of the companies. Moreover, experience has shown that locally the Audit Committee has a very important role in vetting and approving related party transactions. For these reasons it is proposed that the options available in Article 39(2), (4) and (5) are not taken.

The MFSA has considered the options in the following manner:

3.1 a. Article 39 (1)

Option - Member States may require that the Chairman of the Committee is elected annually by the general meeting of the shareholders of the audited entity as per the fourth sub-paragraph of this said article.

Consideration – The MFSA does not propose taking any of the options allowing the Audit Committee being made up of members which are not directors of the Issuer (which could allow the committee to be a stand-alone committee or another body or allow for an SME to have the committee’s functions performed by the board). Accordingly this option does not fit well with this proposal since all the members of the Audit Committee are appointed by the board of directors of the Issuer.

b. Article 39(2)

Option - Pursuant to the first sub-paragraph of Article 39(2) of the Statutory Audit Directive, a derogation from the requirements of Article 39(1) may apply in respect of a listed company which is a “small and medium-sized enterprise”² within the meaning of Article 2(1) (f) of Directive 2003/71/EC and which falls under the definition of company with reduced market capitalisation within the meaning of Article 2 (1) (t) of the consolidated version of Directive 2003/71/EC.³

Consideration – The MFSA believes that an independent Audit Committee is vital for the quality of governance of listed companies irrelevant of size.

c. Article 39(3)

Option - Article 39(3) of the Statutory Audit Directive provides that by way of derogation from Article 39(1), Member States may decide that certain public-interest entities which are enlisted under this referred Article are not required to have an audit committee.

² Article 2(1)(f) of Directive 2003/71/EC provides that: “*“small and medium-sized enterprises” means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43 000 000 and an annual net turnover not exceeding EUR 50 000 000.*”

³ Article 2 (1) (t) of consolidated version of Directive 2003/71/C provides that: “*‘company with reduced market capitalisation’ means a company listed on a regulated market that had an average market capitalisation of less than EUR 100 000 000 on the basis of end-year quotes for the previous three calendar years.*”

Consideration – The MFSA considers the exemptions listed in Article 39(3) as sensible and is of the opinion that allowing such exemptions will not compromise the effectiveness of Audit Committee in listed companies as a whole. Accordingly the MFSA proposes to keep the exemptions in the Listing Rules. The only amendments to the Listing Rules in this respect will be to update references to EU Directives to reflect changes in such Directives.

d. Article 39 (4)

Option – This Article provides that Member States may require to allow listed companies not to have an audit committee provided that it has a body or bodies performing equivalent functions to an audit committee. In such a case the entity shall disclose which body carries out those functions and how the body is composed.

Consideration – The MFSA believes that an independent Audit Committee is vital for the quality of governance of listed companies as explained above and its importance cannot be undermined or replaced.

e. Article 39 (5)

Option – This Article provides that where all members of the Audit Committee are members of the administrative or supervisory body of the Issuer, 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.

Consideration - The MFSA considers that the independence requirement enhances the effectiveness of the Audit Committee and therefore does not agree with the exemption.

4 Member State Options or Derogations from the requirements imposed on Audit Committee when selecting the auditor in terms of the Statutory Audit Regulation

The Statutory Audit Directive is supplemented by the Statutory Audit Regulation. Although the Statutory Audit Regulation does not require transposition into national law, entities (including listed companies) are nonetheless required to comply with the Articles contained therein, as applicable. This Regulation contains specific requirements regarding the statutory audit of public-interest entities. It is important that, in so far as the requirements relating to the audit committee are concerned, Issuers refer to and comply with the provisions of this Regulation, in particular with Article 16 and 17 of Title III of the said Regulation relating to the appointment of statutory or audit firm by public-interest entities.

Article 16 of the Regulation provides for the role of the audit committee with regards to the appointment of statutory auditors or audit firms. Sub-paragraph 2 in fact provides that the audit committee shall submit a recommendation to the board of directors of the Issuer for the appointment of statutory auditors or audit firms. This recommendation shall be justified and shall contain at least two choices for the audit engagement. The audit committee shall express a duly justified preference for one of them and shall also state that its recommendation is free from influence by a third party and that no clause restricting the choice of the statutory auditors or audit firms has been imposed upon it. The recommendation of the audit committee shall be prepared following a selection procedure set by the Issuer respecting certain criteria including a tendering process. This selection procedure is detailed in the Regulation.

Issuers which meet the criteria set out in points (f) and (t) of Article 2(1) of Directive 2003/71/EC are not required to apply the selection procedure. (refer to details in section 3.1(b) above)

The proposal to the general meeting of shareholders of the Issuer for the appointment of statutory auditors or audit firms shall include the recommendation and preference referred to above made by the audit committee. If the proposal made by the directors 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 outlined above.

Article 17 requires certain obligations on Issuers with regards the duration of the audit engagements. Issuers shall appoint a statutory auditor or an audit firm for an initial engagement of at least one year and a maximum duration of 10 years. In certain circumstances the Issuer may, on an exceptional basis, request that the competent authority grant an extension to re-appoint the statutory auditor or the audit firm for a further engagement.

It is also to be noted that Article 41 of the Statutory Audit Regulation sets out transitional provisions which apply in relation to Articles 16(3) and 17 of the said Regulation, as applicable.

The Regulation also contains a number of Member State discretions and derogations. The MFSA has considered the options relating the requirements imposed on Audit Committee in the following manner:

a. Article 11(1)

Option – This Article states that Member States may allow the audit committee to disclose the additional report prepared in terms of Article 11 of the Statutory Audit Regulation to such third parties as are provided for in their national law.

Consideration – It is proposed that the Listing Rules are amended to allow the Audit Committee to disclose the additional report to third parties in order to execute its functions in line with the terms of reference.

b. Article 11(2)

Option – This Article allows Member States to lay down additional requirements in relation to the content of the additional report to the audit committee.

Consideration – The MFSA is not taking this option at this stage as it has not yet identified additional requirements which may add value to this report.

c. Article 16(8)

Option - Where the Issuer has a nomination committee in which shareholders have a considerable influence and which has the task of making recommendations on the selecting of auditors, Member States may allow that nomination committee to perform the functions of the audit committee that are laid down in this Article and require it to submit the recommendation referred to in paragraph 2 to the general meeting of shareholders.

Consideration – The MFSA suggests that this function should rest with the audit committee and therefore does not intend taking up this option.

**Communications Unit
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