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# AUDIT COMMITTEES' APPOINTMENTS OF STATUTORY AUDITORS (ON THE EXAMPLE OF WARSAW-LISTED BANKS) – REGULATORY REQUIREMENTS VERSUS EFFECTIVE PROTECTION OF THE PUBLIC INTEREST

## **Abstract**

This paper looks at the procedure for appointing statutory auditors in the context of the role of the audit committee – a new quasi-corporate body of listed companies. The committee was established as one of the elements that were to ensure the transparency of listed companies, particularly as regards balance sheet issues. Therefore, it is meant to be a guarantor of the public interest, ensuring complete correctness of the financial reporting process, which comprises, among other things, the need to appoint an independent and objective external auditor. The authors investigate whether statutory auditor appointment procedures in a group of banks listed on the Warsaw Stock Exchange meet the regulatory requirements and also – even more importantly – whether they really satisfy the demand for the protection of a specific public interest.

**Keywords:** audit committee, statutory auditor, public banking companies, appointment of a statutory auditor.

## 1. Audit Committees as New, Quasi-corporate Bodies

In 2006, the European Union adopted Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts<sup>1</sup>, which made audit committees mandatory for entities whose activity is particularly important to the public interest. Often described as PIES (public-interest entities)<sup>2</sup>, they are exemplified by such undertakings as banks and insurance companies. Designed to play a key role in contributing to high-quality statutory audit at these entities, the audit committees are bodies that act as part of an effective internal control system to minimise financial, operational and compliance risks.

The following issues addressed by audit committees are particularly important to the security of business turnover: monitoring financial reporting, performing reviews, ensuring the independence of the statutory auditor (particularly in respect of additional services they provide) and making recommendations on the appointment of the statutory auditor.

One of the tasks set before audit committees involves cooperation with external auditors. Their role in this regard consists in supervising cooperation between a company's governing bodies and the external auditor and ensuring the independence of the latter. While it may be true that external auditors should respect the principle of independence and strive to ensure it themselves, self-regulation proved insufficient and it was seen fit to introduce audit committees.

The independence of the statutory auditor can be assessed based on the tasks it performs for the public-interest entity in question. This means scrutiny of the auditor's annual statement of independence from the audited entity and oversight of the annual report on the subject and scope of any additional services the auditor performs for it. The statutory auditor is also obliged to discuss with the audit committee the threats to their independence and the safeguards applied to mitigate them<sup>3</sup>.

<sup>1</sup> 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, OJ L 157, 8 June 2006, p. 87 and subsequent pages.

<sup>2</sup> The concept of public interest entities was introduced in the Directive not only in connection with the idea of establishing audit committees for them. Article 40 of the Directive sets out specific obligations of audit firms carrying out audits of public interest entities. These primarily involve information.

<sup>3</sup> Statutory auditors are required to document threats to independence in the audit documentation.

The audit committee is charged with monitoring events as they occur and is expected to identify a range of threats to the professional integrity of a statutory auditor or auditing firm. These can be understood in five broad categories, beginning with self-interest threat, where a financial or other interest can have a negative effect on the firm or person conducting the audit. There is then the risk presented by self-review: has the professional concerned properly reviewed earlier work that he or another member of his company has done and that the current audit is based on? Where a statutory auditor or audit firm identifies too closely with the position of a public-interest entity, so that their professional integrity is put in doubt, we are confronted with advocacy threat. The threat of familiarity, meanwhile, occurs when there is a long and close relationship with a public-interest entity, which carries the risk that the auditing firm or professional concerned will be over sympathetic to their work or too willing to tolerate their errors or shortcomings. Finally, there is the threat of intimidation where a professional firm or individual is deterred from acting objectively when put under real or perceived pressure (Handbook 2012, sections 100.12 and 200).

Regardless of the information obtained from audit firms, the audit committee should exercise oversight of the statutory auditor or audit firm in relation to ownership structure, the latest quality inspection<sup>4</sup> and the statement concerning the audit firm's independence practices, which also confirms that an internal review of independence compliance has been conducted<sup>5</sup>.

The financial statements of public-interest entities, which contain high-quality information, are of particular importance to stakeholders in the capital market. For this reason, Directive 2006/43/EC draws attention to the powers of the audit committee to monitor the effectiveness of public-interest entities' internal-control systems and financial-reporting.

Monitoring financial reporting involves examining an entity's internal regulations to check that the tasks and responsibilities of the organisational units involved in the preparation and review of financial statements have been completed correctly and in full. The audit committee should

<sup>4</sup> Quality control of statutory auditors or audit firms operating in Poland is exercised by the National Supervision Commission, which is a body of the National Chamber of Statutory Auditors. Its tasks include inspecting the audit documentation concerning completed financial audits, including checking compliance with the requirements of independence (Article 26, clause 2, of the Act of 7 May 2009 on Statutory Auditors and their Self-Government Body, Entities Licensed to Audit Financial Statements, and Public Oversight, *Journal of Laws* 2009, No. 77, item 649).

<sup>5</sup> For more information, see Article 40, clause 1, of Directive 2006/43/EC, which sets out the information required for a report ensuring an audit firm's transparency.

continuously monitor an entity's situation based on reports of individual areas of activity. It is thus possible to assess how far the targets, tasks and strategy adopted in financial and accounting plans and other internal documents have been accomplished. Scheduled and random internal audits and ex-post audits to ensure that audit recommendations have been acted upon are also significant. An independent statutory auditor or audit firm, whose selection is also an important matter, should review the appropriateness of the information set out in the financial statements to ensure that the assets, financial standing, financial result, and other items in the financial statement have been presented fairly.

## **2. Appointing a Statutory Auditor and an Audit Committee**

One of the most “measurable” tasks of an audit committee is to make recommendations on the appointment of an external auditor to perform a statutory audit (Article 41, clause 3, of the Directive). As one would expect given its prime position in the title, it is this matter that the paper considers in greatest depth.

Unfortunately, the wording of the provision mentioned above is defective: “In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee”. The clause suggests that the role of these bodies is to submit a proposal concerning the statutory auditor to the general meeting. However, because it is in fact common practice for a statutory auditor to be appointed by the supervisory body and not the general meeting, this is not necessarily the case. Does the wording of the provisions of the Directive make the appointment of a statutory auditor an exclusive power of the general meeting pursuant to EU law? This hypothesis is perhaps too far-reaching. But it is not impossible. If, however, a more moderate interpretation is applied, one would have to assume that Article 41, clause 3, of the Directive applies only to a situation where the appointment of a statutory auditor falls within the competence of the general meeting and thus does not include a situation where the choice is made by a body other than the general meeting. This interpretation is, however, wrong from the teleological point of view. The essence of the provision discussed is in fact to indicate the necessary power of the audit committee to make a recommendation for the appointment of the statutory auditor – regardless of which body ultimately makes a decision on its appointment. This is perhaps the only standard that does not require

interpretation<sup>6</sup>. It is not clear, however, whether the proposal of the corporate body recommending the appointment of a statutory auditor to the decision-making body is meant to be consistent with the committee's recommendation. Furthermore, is the body making the appointment bound by the recommendation or not? We may risk a negative reply in the second case to the effect that the body deciding the appointment is not bound by the committee recommendation because this would represent too great a restriction of its powers. It would be very difficult to draw the opposite conclusion while there is no clear statement that the audit committee has the power to appoint a statutory auditor, which is what would be meant were its appointment recommendations to be binding. However, the body making the appointment should be obliged to explain its decision where it is different from that of the audit committee. It would appear to be the case, then, that the committee recommendation would have to be made public for the proposed solution to be effective (Okolski & Wajda 2008, p. 234)<sup>7</sup>. Otherwise, the powers of the audit committee to recommend a statutory auditor are somewhat unclear. This is a key problem in the implementation of the Directive into national laws: where EU legislation is vague, it is the national legislator at the level of national law that is forced to correct the errors.

In Polish law, the right to appoint a statutory auditor is conferred by Article 66, clause 3, of the Accounting Act<sup>8</sup>, which provides that the entity licensed to audit or review financial statements is appointed by the body which approves the entity's financial statements. It also states that the articles of association, agreement or other laws binding on the entity may change this principle. There is no doubt that Article 384 §1 of the Code of Commercial Companies and Partnerships is important for the practical application of this provision. It states that the articles of association may expand the powers of the supervisory board enabling it to approve legal transactions that are expressly defined in the articles of association<sup>9</sup>. What this means, in fact, is that a company's articles of association determine the manner of appointing a statutory auditor. With regard to public interest

<sup>6</sup> *Clara non sunt interpretanda*.

<sup>7</sup> It seems reasonable to apply "comply or explain", which is a principle operating on the stock market in relation to corporate governance rules, to the case under analysis.

<sup>8</sup> Accounting Act of 29 September 1994 (*Journal of Laws* 2013, item 330).

<sup>9</sup> Act of 15 September 2000 – Commercial Partnerships and Companies Code (*Journal of Laws* 2000, No. 94, item 1037, as amended).

entities, however, it is the Act on Statutory Auditors<sup>10</sup>, which implements the relevant sections of Directive 2006/43/EC into the Polish legal system, that should be taken into account.

Polish law regulating issuers of securities admitted to trading on a regulated stock market requires the issuer's competent authority to give notice, in the form of a current report, that an entity licensed to audit financial statements has been appointed to provide, under the terms of a contract, audit, review or other services concerning annual or consolidated accounts<sup>11</sup>.

### **3. Procedure for the Appointment of a Statutory Auditor to Public Banking Companies Listed on the Warsaw Stock Exchange\***

Table 1 provides a summary of the procedure for the appointment of a statutory auditor to public banking companies whose securities are listed on the Warsaw Stock Exchange. There are two important elements: the body appointing a statutory auditor and the existence of related recommendations of the audit committee. The data presented can be evaluated in terms of the procedure's compliance with the law and its effectiveness in protecting the public interest, which is understood to lie in the transparency of public companies and the protection this affords their investors and customers.

The examples demonstrate that the procedure for the appointment of a statutory auditor complies with the law. This does not mean, however, that it is highly efficient in protecting the public interest. In the opinion of the authors, the procedure for the appointment of a statutory auditor should, within the limits of the law, be composed of the following basic steps:

1. Analysis of the appointment of a statutory auditor by the audit committee and its adoption of a resolution recommending the appointment to the supervisory board. The audit committee, if it consists of independent members who have competence in accounting and/or auditing, is the most appropriate authority.

<sup>10</sup> Pursuant to article 86, clause 8, of the Act of 7 May 2009 on Statutory Auditors and their Self-Government Body, Entities Licensed to Audit Financial Statements, and Public Oversight (*Journal of Laws* 2009, No. 77, item 649), the audit committee recommends to the supervisory board or other body overseeing the entity licensed to audit financial statements to perform a financial audit of the entity.

<sup>11</sup> Section 5, clause 1, item 19, of the Regulation of the Minister of Finance of 19 February 2009 Regarding Current and Periodic Information Provided by Issuers of Securities and the Conditions for Recognising as Equivalent the Information Required by the Laws of a Non-Member State (*Journal of Laws* No. 33, item 259, as amended).

\* The data presented in this section are drawn from research done into the 13 WIG-Banks on the Warsaw Stock Exchange (as of May 2013).

Table 1. Procedure for the Appointment of a Statutory Auditor to Banks whose Shares are Listed on the Warsaw Stock Exchange

Bank	Body appointing a statutory auditor	Note on a recommendation of the Audit Committee concerning the appointment of a statutory auditor in financial statements or in other information published by the bank	Source of information
Alior Bank SA	Supervisory Board	No information on the recommendation of the Audit Committee	www.aliorbank.pl
Bank Millennium SA	Supervisory Board	Recommendation of the Audit Committee	www.bankmillennium.pl
BOS SA	Supervisory Board	On the basis of a motion of the Bank's Management Board resulting from a tendering procedure; in addition, a recommendation of the Audit Committee	www.bosbank.pl
BPH SA	Supervisory Board	Recommendation of the Audit Committee	www.bph.pl
BRE SA	General Meeting	Opinion of the Audit Committee	www.brebank.pl
Getin Holding SA	Supervisory Board	No information on the recommendation of the Audit Committee	www.gnb.pl
Getin Noble Bank SA	Supervisory Board	No information on the recommendation of the Audit Committee	www.getin.pl
Bank Handlowy SA	Supervisory Board	Opinion of the Audit Committee following a recommendation of the Management Board at the request of Chief Financial Officer	www.citihandlowy.pl
ING Bank Śląski SA	Supervisory Board	Recommendation of the Audit Committee	www.ing.pl
Pekao SA	General Meeting	Recommendation of the Supervisory Board	www.pekao.com.pl
Pekao BP SA	Supervisory Board	Recommendation of the Audit Committee	www.pkobp.pl
Unicredit SPA	General Meeting	Proposal of the Board of Statutory Auditors	www.unicreditgroup.eu
Nova Kreditna Banka Maribor DD	General Meeting	Opinion of the Supervisory Board	www.nkbm.si

Source: authors' own study based on information provided by the banks comprising the WIG-Banks on the Warsaw Stock Exchange.

2. The adoption of a relevant resolution by the supervisory board which, if its appointment is contrary to the recommendation of the audit committee, should be justified and communicated to the public. The supervisory board may not be bound by the recommendation of the audit committee. If that were the case, then the adoption of that resolution by the supervisory board would be pointless. The supervisory board must therefore be offered an opportunity to make a different choice. If that is the case, the public must be given an explanation. It is best, of course, for the decision to be made by a supervisory board composed of a maximum number of so-called independent board members, who have no relationship to the company or to its shareholders.

It is the authors' opinion that the following should be avoided in the procedure for the appointment of a statutory auditor:

1. Members of the management board and key executives who are not on the management board (in particular, chief financial officers) should not have any influence on the appointment. This is because the adoption of such a solution could violate the auditor's principles of objectivity and independence. Since the management board runs a company's affairs and the statutory auditor inspects them to some extent, it would seem absurd, or at least inappropriate, to adopt the principle that the audited entity selects the auditor. This would contradict the meaning and purpose of inspection. In other words, the management board should not at any stage (even a very technical one) participate in the selection of a statutory auditor.

2. A statutory auditor should not be appointed by the general meeting either. Due to their dispersed shareholding structure, public companies' general meetings are usually very large. The decisions at these gatherings are thus made by a majority shareholder (shareholders). Would the public interest be sufficiently protected if the appointment were made only by the majority shareholder or shareholders? In practice, the majority shareholder appoints the management board and thus indirectly (but effectively) manages the company. This could lead to the violation of the interests (at least the information-related interests) of minority shareholders. Appointment of a statutory auditor by general meeting could be especially dangerous where a public banking company is a subsidiary of another banking company.

It may be noted that 5 of the 13 banks we investigated take the influence of management board members or key executives representing the majority shareholder into consideration when appointing a statutory auditor or audit firm. Of the sample analysed, 3 banks provided no information on the recommendation of the audit committee on the appointment of



a statutory auditor or audit firm. At Alior Bank SA, the functions of the audit committee were performed by a five-person supervisory board chaired by a person representing the interests of the majority shareholder<sup>12</sup>. In the case of Getin Holding SA and Getin Noble Bank SA, the same person, the chairman of the supervisory board, holds more than 50% of shares (directly and indirectly) in the share capital of both banks, as well as more than 50% of the votes at these banks' general meetings<sup>13</sup>. The percentage of banks that take the influence of management board members or key executives representing the majority shareholder into consideration when appointing a statutory auditor or audit firm is presented in Fig. 1.

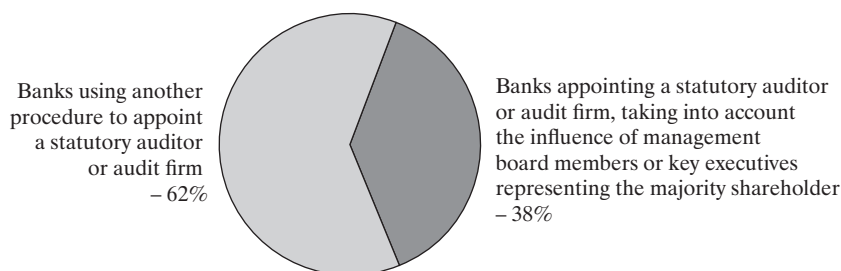


Fig. 1. Structure of the Method for Appointing a Statutory Auditor or Audit Firm by Banks Listed on the Warsaw Stock Exchange, Taking into Account the Influence of Management Board Members or Key Executives Representing the Majority Shareholder

Source: authors' own study.

Further analysis revealed that in the case of 4 banks, Unicredit SPA, NKBM DD, BRE SA and Pekao SA, whose securities are listed on the Warsaw Stock Exchange, it was the general meeting that appointed a statutory auditor. The percentage of competent authorities who make decisions on the appointment of a statutory auditor or audit firm at banks listed on the Warsaw Stock Exchange is shown in Fig. 2.

If the information presented in Fig. 3 is analysed from the perspective of both solutions, it turns out that a high proportion (69%) of the listed banking companies studied do not ensure adequate protection of the public interest.

<sup>12</sup> Based on the Management Board Report on the business operations of Alior Bank SA for 2012 and information published at [www.aliorbank.pl](http://www.aliorbank.pl).

<sup>13</sup> Based on the report on the business operations of Getin Holding SA for 2012, the report on the business operations of Getin Noble Bank SA for 2012, and information published at [www.getin.pl](http://www.getin.pl) and [www.gnb.pl](http://www.gnb.pl).

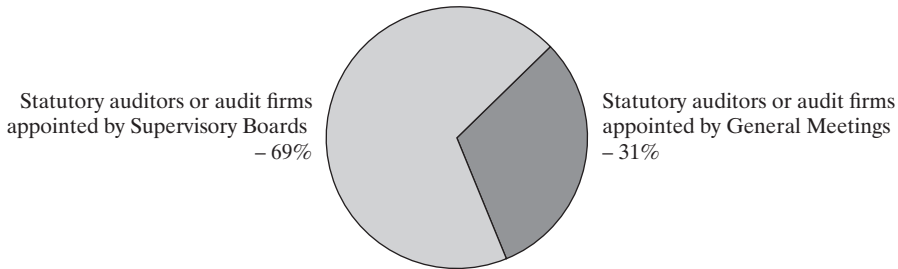


Fig. 2. Structure of the Method for Appointing a Statutory Auditor or Audit Firm by Banks Listed on the Warsaw Stock Exchange, Taking into Account the Competent Authorities Making the Appointment

Source: authors' own study.

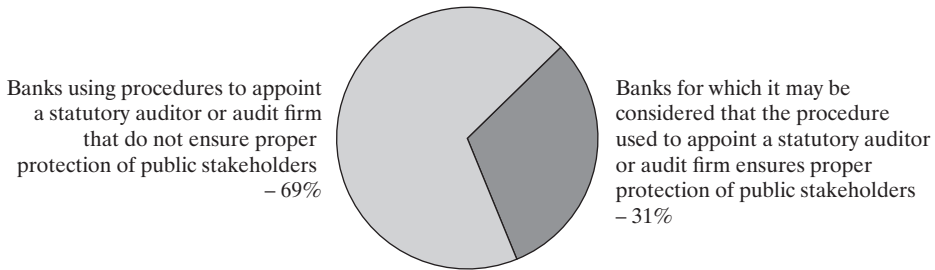


Fig. 3. Structure of the Method for Appointing a Statutory Auditor or Audit Firm by Banks Listed on the Warsaw Stock Exchange, Taking into Account the Level of Protection of Public Stakeholders

Source: authors' own study.

The study covered only 13 banks listed on the Warsaw Stock Exchange. It is important to note that two of them were not established in Poland and were operating based on Italian and Slovenian law respectively. The results of the study support the argument that the EU legislator has not achieved its objectives, that is, to harmonise EU law and to improve the security of trade, which is shown here especially in the principle of protecting the public interest on the capital market. Of the banks analysed, only 31% applied procedures which, from a substantive, and not only formal, point of view, may be considered appropriate in the context of protecting stakeholders and the market. It is worth noting that none of the foreign banks were included in this group. The thesis advanced here could be tested further by researching a larger sample of listed companies drawn from both the Warsaw Stock Exchange and from other regulated markets in the European Union.

#### 4. Conclusions

In the context of what has been achieved in practice and of the recommendation issued by the European Commission in 2005, a prescriptive description of the powers of the audit committee must be somewhat surprising. Both the operating reports and the recommendation are surprising in that they regulate the areas of operation of the audit committees in detail and establish formal and organisational frameworks for their operation. In this context, the wording of the Directive appears even more inappropriate: determining the powers of the audit committee by specifying four items at a high level of generality should not be considered suitable to regulate the tasks performed by these bodies. Moreover, the fragmentary description of the formal and organisational framework, which is limited to specifying the entities able to appoint members of the committee and their qualifications, is defective. Having once decided to introduce binding regulations for audit committees, the EU legislator should have done so in a proper and comprehensive manner informed by both its own experience (recommendation of the European Commission) and by practice<sup>14</sup>. If, however, it was unable to settle these issues correctly, it should have drafted an order to establish audit committees at public-interest entities and left the issues of appointing committees and their manner of operation to practice.

The correct assessment is that the current prescriptive status, which raises fundamental doubts given the harmonisation purpose of EU law, is inappropriate. The example of public banking companies listed on the Warsaw Stock Exchange clearly demonstrates that the extremely general wording of the Directive's provisions, which was repeated by the Polish legislator, has resulted in practices that are far from appropriate. It would appear, since the general legal regulation is used to circumvent its own fundamental objectives, that there are strong grounds for change in the form of a regulation that will prevent such evasion.

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<sup>14</sup> The powers of the audit functions that result from practical experience are described extensively in Helin and Wisłowski (2009, pp. 79–92).

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## Abstract

### **Procedura powołania audytora zewnętrznego przez komitet ds. audytu (na przykładzie banków notowanych na giełdzie warszawskiej) – wymogi prawne a efektywna ochrona interesu publicznego**

W artykule analizowana jest procedura powoływania audytora zewnętrznego w kontekście roli komitetu ds. audytu – nowego quasi-organu korporacyjnego spółek publicznych. Komitet został ustanowiony jako jeden z elementów mających zapewnić przejrzystość spółek publicznych, szczególnie w zakresie sprawozdań finansowych. Oznacza to, że jest on gwarantem interesu publicznego, zapewniającym pełną poprawność procesu sprawozdawczości finansowej, która uwarunkowana jest odpowiednią procedurą powołania niezależnego i obiektywnego audytora zewnętrznego. Autorzy badają, czy procedura powołania audytora zewnętrznego w grupie banków notowanych na Giełdzie Papierów Wartościowych w Warszawie spełnia wymagania regulacyjne oraz, co jest istotniejsze, czy w rzeczywistości spełniane są wymogi ochrony szczególnego interesu prawnego.

**Słowa kluczowe:** komitet ds. audytu, audytor zewnętrzny, publiczne spółki bankowe, powołanie audytora zewnętrznego.