

# European Policy<sup>1</sup> – Director Elections – Audit Committee Independence

## Background and Overview

Across Europe, a number of recent high-profile corporate failures and accounting scandals have occurred at large, widely-held public companies. These incidents have raised questions about the efficacy of the financial statements and the need for improved audit quality and boardroom oversight.

Audit committees play a decisive role in contributing to a high-quality statutory audit. The 2014 European audit directive (2014/56/EU) requires that “a majority of the members of the audit committee shall be independent of the audited entity. The chairman of the audit committee shall be appointed by its members or by the supervisory body of the audited entity, and shall be independent of the audited entity”. Those requirements have been progressively transposed in most local European regulations or codes and can be considered as a common standard.

## Key Changes Under Consideration

Under current ISS European Voting Guidelines, the policy requiring majority independent audit committees is applicable to Belgium, the Netherlands and Switzerland, but not to other countries covered. The proposed policy update would extend the current ISS European Voting Guidelines on majority audit committee independence to all countries in Continental Europe covered under the European Voting Guidelines. In addition, the proposed update would strengthen the policy by requiring the chairman of the audit committee to be independent.

A negative ISS recommendation would be applied to:

- The (re)election of any non-independent members of the audit committee if it would lead to a non-independent majority on that committee.

In order to take local specificities into account, and similarly to the policy on board independence, the 50 percent threshold would be assessed with the exclusion of non-shareholder elected members (employee representatives for example) and employee shareholder representatives where relevant. In that case, a second threshold of one-third independence of all audit committee members would also be applied; and

- The (re)election of a non-independent chairman of the audit committee.

This policy will only apply to widely-held companies.

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<sup>1</sup> ISS' European Policy applies to companies incorporated in the following territories: Austria, Belgium, Bulgaria, Croatia, the Czech Republic, Cyprus, Denmark, Estonia, the Faroe Islands, Finland, France, Germany, Greece, Greenland, Hungary, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, Romania, Spain, Slovakia, Slovenia, Sweden, and Switzerland.

## Intent and Impact

The proposed policy update would align the European Voting Guidelines with an increasingly shared standard and establish a common approach in Continental Europe. It will also be aligned with investor views on this topic of growing concern, as highlighted in ISS' 2018 Governance Principles survey and the discussions held during policy roundtable discussions with institutional investors in Europe and UK.

A vast majority of widely-held companies in Continental Europe already maintain a majority independent audit committee with an independent chairman as these standards have been incorporated in most local corporate governance codes.

For the minority of companies that have not adopted those standards, the potential impact of this proposed policy update on ISS' negative vote recommendations on audit committee members will be relatively limited notably due to practical constraints in its implementation. These constraints include the limited frequency of renewal of audit committee members, insufficient information to determine the future composition of the audit committee, election mechanisms that make it difficult to target the issue.

## Request for Comment

While we will appreciate any comments on this topic, ISS specifically seeks feedback on the following:

- Would your organization consider a non-majority independent audit committee to be of sufficient concern to warrant votes against non-independent members of the audit committee?
- Would your organization consider a non-independent chairman of the audit committee to be of sufficient concern to warrant a vote against the non-independent chairman of the audit committee?
- What counterbalancing mechanisms or exceptions, if any, would your organization consider sufficient to make the presence of a non-independent chairman of the audit committee acceptable?
- The future composition of an audit committee can often not be determined in cases where current committee members step down at an AGM and potential new committee members have not been disclosed by the company. Would your organization consider audit committee independence in such cases? If yes, please explain how you would evaluate audit committee independence.