

## Audit Committees – Dillon Eustace

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## Audit Committees

### 1. Background

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 (the “Directive”) is due to be transposed into Irish Law on 29 June, 2008 and provides the rationale for revisiting and amending, if necessary, some of the provisions of Section 42 of the Companies (Auditing and Accounting) Act, 2003 (the “2003 Act”).

Section 42 of the 2003 Act provides for the establishment and responsibilities of audit committees by those types of Irish Companies and other undertakings specified in Section 42 and thereby acknowledging the important function of audit committees in the overall corporate governance process. International best practice requires that certain companies should establish and adequately resource an audit committee to monitor the financial integrity of the financial statements and any formal announcements in relation to the company’s financial performance. While it is recognised that all directors have a duty to act in the best interests of the company, the audit committee has a particular role acting independently from the board of directors (the “board”), to ensure that the best interests of shareholders are properly protected by scrutinising the financial and other information made available to the board and in enhancing the quality of financial reporting generally.

The terms of reference for Irish audit committees will be shaped first and foremost by the provisions of Article 41 of the Directive as recently confirmed by the Department of Enterprise, Trade and Employment and partly by the specific duties introduced by Section 42 of the 2003 Act, when commenced. It is important to note that the Directive is a minimum harmonisation directive and therefore allows Member States flexibility to impose more stringent or other requirements if deemed appropriate.

In general, the Directive’s provisions relating to audit committees are consistent with those in the 2003 Act but with some notable differences specifically in relation to audit committee compositional requirements which are described below (See also the Table contained in Appendix 2 which provides a concise guide to the primary requirements contained in the 2003 Act and the Directive respectively and relevant national and international guidance on audit committee best practice).

Furthermore, the Directive is more principles based and less prescriptive in its approach to setting audit committee requirements with many of its provisions based on the “Combined Code on Corporate Governance”<sup>1</sup> (the “Combined Code”) principles which are also contained in other good corporate governance codes such as the Department of Finance’s “Code of Practice on the Governance of State Bodies”<sup>2</sup>.

Within this proposed new legal framework, the terms adopted by each audit committee need to take into account the requirements of the individual company, and will vary according to the size, complexity and risk profile of the company. However it is vital that the board and management of

<sup>1</sup> Financial Reporting Council, (2006).

<sup>2</sup> Department of Finance, (2001). This publication and the Combined Code are endorsed by the Office of the Director of Corporate Enforcement in its Decision Notice D/2006/1 “ODCE Guidance on Audit Committees” (2006) (the “ODCE Guidance”).

the company are fully committed to building and maintaining an effective audit committee and to working with the committee to ensure it meets its objectives.

The following is an outline of the requirements of Section 42 of the 2003 Act and the relevant Directive provisions in respect of audit committee terms of reference and requirements.

## 2. Audit Committees

### The 2003 Act

Section 42 of the 2003 Act requires that all Irish-registered public limited companies (“PLCs”), whether listed or not, establish and adequately resource an audit committee. An exception is made for PLCs wholly owned by another Irish PLC and additional types of PLCs may be exempted by the Minister in due course as provided for under Section 48(1)(j) of Part 4 (Regulations and Miscellaneous Matters) of the 2003 Act.<sup>3</sup>

Private companies limited by shares exceeding a €25 million balance sheet total and a €50 million turnover threshold in both of the last two financial years also fall within ambit of Section 42 of the 2003 Act as do ‘relevant undertakings’, which are defined as :

- large Irish-registered unlimited companies/partnerships subject to certain qualifying conditions, including the above balance-sheet total and turnover criteria; or
- large Irish-registered unlimited holding companies/partnerships and all of their subsidiaries subject to the same qualifying conditions.

Qualifying private companies and relevant undertakings must either establish an audit committee with all or some of the defined responsibilities, or can decide not to do so. If they decide not to establish an audit committee they must give the reasons for such decision in their annual directors’ report. Furthermore the report must state if the audit committee has only some of the specified responsibilities as provided for in Section 42 (2) of the 2003 Act (see Appendix 1 which sets out a full list of these responsibilities ).

### The Directive – Public Interest Entities

The Directive provides that entities which are of ‘public interest’ are required to have an audit committee with specified functions. Article 2.13 of the Directive defines ‘public interest entities’ as including (a) entities which have issued transferable securities admitted to trading on a regulated market governed by a Member State<sup>4</sup>, (b) credit institutions<sup>5</sup> (i.e. banks and building societies) and (c) insurance undertakings<sup>6</sup>.

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<sup>3</sup> Section 49 of the 2003 Act provides that any regulation exempting classes of companies or undertaking as provided for under Section 48(1) (j) *cannot be effective* unless (a) a draft of the proposed regulation has been laid before the Houses of the Oireachtas, and (b) a resolution approving the draft has been passed by each House. (emphasis added)

<sup>4</sup> Within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC of the markets in financial instruments (as amended).

<sup>5</sup> Credit institutions as defined by Article 4(1) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast).

<sup>6</sup> Insurance undertakings as defined by Article 2(1) of Directive 1991/674/EC on the annual and consolidated accounts of certain types of companies and insurance undertakings.

### **SME Exemption**

Article 41.1 enables Member States to make a specific but limited exception for public interest entities that are small or medium sized companies from some of the requirements under Article 41 on the composition of audit committees i.e. those entities which meet the criteria of Article 2(1), point (f) of Directive 2003/71/EC<sup>7</sup> :

“small and medium-sized enterprises [...] 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 €43,000,000 and an annual net turnover not exceeding €50, 000, 000”

### **Other Exemptions**

A wider exemption is permitted under Article 41.5 of the Directive which enables Member States to choose not to apply the compositional requirements for audit committees specified in Article 41.1 to 41.3 (outlined below), to entities which already have an established body performing equivalent functions as specified in the Directive and any other functions specified in current national provisions.

Furthermore the Directive permits Member States to exempt certain classes of public interest entity from the obligation in Article 41.1 to have an audit committee. These entities are (a) securitisation vehicles<sup>8</sup>, subject to a ‘comply or explain’ regime; (b) certain supervised collective investment undertakings which spread risk and do not seek control of issuers<sup>9</sup>; (c) certain credit institutions not listed on an EU regulated market which have only issued debt securities totalling below €100 million and have not issued a prospectus<sup>10</sup>.

### **3. Audit Committee Composition**

Section 42 (6) of the 2003 Act provides that the audit committee must consist of two or more directors, other than the chairperson of the board, provided that they have not been employees of the company/undertaking or one of its subsidiaries in the preceding three years. The appointment of audit committee members is entirely within the remit of the board concerned and members are to be such as the board deems appropriate.

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<sup>7</sup> Directive 2003/71/EC of the European Parliament and of the Council of Europe on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

<sup>8</sup> Within the meaning of Article 1 of the Seventh Council Directive 89/349/EEC concerning consolidated accounts of companies with limited liability.

<sup>9</sup> As defined by Article 1(2) of Directive 85/611/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

<sup>10</sup> As defined by Article 2(5) of Commission Regulation 809/2004/EC implementing Directive 2003/71/EC as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements (the “Prospectus Directive”).

However these requirements do not apply where only one director of the board meets all of the preceding criteria and that director may form a single member audit committee or hold the casting vote on a two member audit committee<sup>11</sup>.

Where none of the current directors meet the specified criteria, the board may appoint an external suitably qualified person, to serve on the audit committee<sup>12</sup>. Section 42 of the 2003 Act states that failure to establish an audit committee if required is an offence.

In contrast Articles 41.1 and 41.3 of the Directive set out specific and concise compositional requirements for audit committees. Member States are given a choice between non-executive members of the board or other members appointed by the company's members in a general meeting. In addition, at least one member of the audit committee must be independent<sup>13</sup> and have competence in accounting and/or auditing. These provisions are consistent with current best practice with respect to audit committee composition as provided for in the Combined Code and other publications<sup>14</sup>.

Section 42 of the 2003 Act is silent on the requirement for any audit committee member to be independent and there is no express requirement for accounting or auditing competence. However, the ODCE Guidance recommends that at least one member of the audit committee should have significant, recent and relevant financial experience<sup>15</sup>.

These two compositional requirements contained in the Directive i.e. independence and competence in accounting and/or auditing are of paramount importance if audit committees are to add any value to the management of the companies within which they operate. In particular independence of audit committee members is important to enable its members to comment on and indeed, where necessary, challenge the board's approach to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.

#### **4. Audit Committee Responsibilities**

Section 42 (2) of the 2003 Act prescribes fourteen duties which every qualifying PLC must discharge as outlined in Appendix 1. Although the duties in the 2003 Act are in general

<sup>11</sup> Furthermore these requirements do not apply where the annual directors' report discloses the reasons for relying on that the exemption and any additional prescribed Ministerial requirements are met.

<sup>12</sup> See the Office for the Director of Corporate Enforcement Decision Notice D/2006/1 "ODCE Guidance on Audit Committees" (2006). This conclusion would appear to meet the requirement in Article 41.1 of the Directive which provide *inter alia* that at least one member of the audit committee shall be independent which is not expressly provided for in the 2003 Act. The compositional requirements contained in the 2003 Act do not encompass all of the requirements expressed in the Directive.

<sup>13</sup> See "Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committee of the (supervisory) board" (2005/162/EC) which includes a general statement pertaining to the independence of directors and the types of relationship judged to impede directors' independence. See the Combined Code which states that one important criterion in order to be considered independent is that a director may not have served on the board for more than 9 years.

<sup>14</sup> Further guidance can be found in the "Guidance on Audit Committees (The Smith Report)", Financial Reporting Council, (2003).

<sup>15</sup> For detailed guidance on current best practice see "Shaping the Irish Audit Committee Agenda", Audit Committee Institute Ireland, (2005); the Combined Code and Code of Practice for the Governance of State Bodies. These publications, endorsed by the ODCE Guidance, discuss the current and emerging issues in relation to audit committees and the former contains in its appendices a number of examples and templates that companies may find useful in ensuring compliance on the establishment of an audit committee.

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consistent with the Directive's requirements, albeit more detailed, there are differences in language and emphasis.

Article 41.2 of the Directive sets out four specific functional requirements for audit committees. These are as follows; the requirement to (a) monitor the financial reporting process; (b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems; (c) monitor the statutory audit of the annual and consolidated accounts; and (d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional non-audit services to the audited entity. These requirements are prefaced in the Directive by stating that the provisions are "without prejudice" to the responsibilities of the members of the board as a whole.

## **5. Audit Committee Terms of Reference**

Section 42 of the 2003 Act provides that the audit committee's terms of reference and any amendments thereto must be prepared, approved and reviewed annually by the board. These terms of reference must be submitted for shareholders' information at the Annual General Meeting. Furthermore the terms of reference must, at a minimum, specify how the audit committee will discharge its responsibilities, as well as providing for a programme of separate and joint meetings with management, the external auditor and the internal auditor of the company or undertaking concerned. The ODCE Guidance recommends that the audit committee should, at least annually, meet the external and internal auditors, without management being present, to discuss issues arising from the audit and to ensure that there are no unresolved issues of concern. International guidance in relation to specific audit committee terms of reference is detailed in Appendix 2.

## **6. Other: Ministerial Regulations?**

Notwithstanding Section 42 of the 2003 Act, the Directive and its provisions will take centre stage once the requisite transposing legislation is available for public commentary. It is anticipated that draft regulations will be reviewed by the Company Law Review Group during the first quarter of 2008. The Directive permits Member States to exempt certain entities (as previously outlined) and the Minister may by regulation exempt certain companies and other classes of undertakings if he is of the opinion that the regulation makes it unnecessary or inappropriate to apply the audit committee requirements to them as provided for in Section 42 of the 2003 Act. However no such regulations have yet been made, although the Minister retains the power to do so, subject to requirements of Section 49 of the 2003 Act previously outlined at footnote 3 above.

The qualifying balance sheet and turnover thresholds for application of the audit committee requirement may also be varied as provided for in Section 48(1) (l) of the 2003 Act although it is not anticipated at this stage that these will be amended<sup>16</sup>.

In addition, the Minister may prescribe additional functions to be discharged by the audit committees and supplementary rules governing the operation of those committees as provided under Section 48(1)(m) of the 2003 Act .i.e. the role/qualification of audit committee members may require amendments in light of the provisions contained in the Directive.

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<sup>16</sup> See ODCE Guidance generally where it states at point 2.10 (pg.15) that there is no indication of any Ministerial intention to vary the qualifying balance sheet and its turnover thresholds as these would be subject to prior consultation with the Irish Auditing and Accounting Supervisory Authority as provided for in Section 48(3) and to Section 49 requirements of the 2003 Act. At the time of writing, there were no further updates in respect of the proposed Ministerial regulations.

We will provide further updates in respect of any future developments in relation to Audit Committees arising out of the transposition of the Directive or the commencement of Section 42 of the 2003 Act as the case may be.

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## Appendix 1

### Section 42 of the Companies (Auditing and Accounting) Act, 2003

- (2) Subject to subsection (16), the board of directors of a public limited company (whether listed or unlisted) shall establish and adequately resource a committee of directors, to be known as the audit committee, with the following responsibilities:
- (a) reviewing, before they are presented to the board of directors for approval –
    - (i) the company's annual accounts, and
    - (ii) if the company is a parent undertaking the group accounts of the group of undertakings of which the company is the parent undertaking;
  - (b) determining whether the annual accounts are reviewed comply with section 205(A)2 and whether, in the committee's opinion they give at the end of the financial year a true and fair view of –
    - (i) the state of affairs of the company, and
    - (ii) the profit or loss of the company, even if by virtue of section 3(2) of the Companies (Amendment) Act 1986, section 3(2) of the Companies (Amendment) Act 1986, section 3(1) of that Act does not apply to the company's profit and loss account;
  - (c) determining whether the group accounts so reviewed comply with section 205A(2) and whether, in the committee's opinion, they give at the end of the financial year a true and fair view of –
    - (i) the state of affairs of the group of undertakings of which the company is the parent undertaking, and
    - (ii) the profit or loss of that group;
  - (d) recommending to the board of directors whether or not to approve the annual accounts and group accounts so reviewed;
  - (e) determining, at least annually, whether in the committee's opinion, the company has kept proper books of account in accordance with section 202;
  - (f) reviewing, before its approval by the board of directors, the statement required to be made under section 205E(5) and (6);
  - (g) determining whether, in the committee's opinion, the statement so reviewed –
    - (i) complies with section 205E(5) and (6), and
    - (ii) is fair and reasonable and is based on due and careful enquiry;
  - (h) recommending to the board of directors whether or not to approve a statement reviewed under paragraph (f);

- (i) advising the board of directors as to the recommendation to be made by the board to the shareholders concerning the appointment of the company's auditor;
- (j) monitoring the performance and quality of the auditor's work and the auditor's independence from the company;
- (k) obtaining from the auditor up to date information to enable the committee to monitor the company's relationship with the auditor, including, but not limited to, information relating to the auditor's affiliates;
- (l) recommending whether or not to award contracts to the auditor or an affiliate of the auditor for non-audit work;
- (m) satisfying itself that the arrangements made and the resources available for internal audits are in the committee's opinion suitable;
- (n) reporting, as part of the report under section 158 of the Principal Act, on the committee's activities for the year, including, but not limited to, the discharge of its responsibilities under paragraph (j);
- (o) performing any additional functions prescribed by regulation under *section 48(1)(m) of the Act of 2003*;
- (p) performing any other functions relating to the company's audit and financial management that are delegated to it by the board of directors.

**Appendix 2: Audit Committee requirements - A comparison of the Section 42 of the 2003 Act and Article 41 of the Directive.**

<b>Requirement</b>	<b>Section 42 of the 2003 Act</b>	<b>ODCE Guidance</b>	<b>Article 41 of the Directive</b>	<b>UK Combined Code</b>
<b>Composition</b>	At least two members.	At least two members	Non-executive members of the board or other members appointed by the company's members in general meeting.	At least three members or in the case of smaller companies, two members.
<b>Competence</b>	No express requirement for accounting and/or auditing competence.	At least one member should have significant, recent and relevant financial experience.	At least one member should be competent in accounting and/or auditing.	At least one member should have recent and relevant financial experience.
<b>Independence of Members</b>	No express requirement.	No express requirement.	At least one member should be independent.	All members should be independent non-executive directors.
<b>Frequency of Meetings</b>	No specific provision.	Recommended no fewer than three meetings annually.	No specific provision.	Recommended no fewer than three meetings annually.
<b>Remuneration of AC Members</b>	Not stipulated.	Recommended.	Not stipulated.	Recommended.
<b>Resources</b>	Adequately resourced.	Adequately resourced.	Adequately resourced.	Provision of sufficient resources.

### **Appendix 3 Bibliography**

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