

Mandatory audit committees for public interest entities

The European Communities (Statutory Audits) (Directive 2006/43) Regulations 2010 (“the Regulations”) were signed into law on 20 May 2010¹. These Regulations give effect to Directive 2006/43/EC. The Regulations introduce the concept of a **Public Interest Entity (PIE)**. From 20 November 2010 a PIE must establish an audit committee.

Are you a PIE?²

Generally, a PIE includes:

- companies with securities admitted to trading on a regulated market of any member state within the European Economic Area (EEA);
- credit institutions; and
- insurance undertakings.

The mandatory audit committee

The committee must consist of at least two independent directors, one of whom must have competence in accounting and audit.

The Regulations outline that the directors must have terms of appointment which indicate they are being appointed in a non executive capacity and possess the requisite degree of independence to be able to contribute effectively to the committee’s functions.

Independence is defined such that it excludes those directors who have:

- a position of employment in the PIE;
- a material business relationship directly with the PIE;
- or occupies the position of partner, shareholder, director or senior employee of a body that has such a relationship with the PIE.

The parties listed above will also be excluded if they have occupied such a position in the three years prior to their appointment to the committee. Some entities may have to consider appointing additional directors to meet the requirements of the Regulations.

Role and function of the mandatory audit committee

- monitoring of the financial reporting process;
- monitoring the effectiveness of the entity’s systems of internal control, internal audit and risk management;
- monitoring of the statutory audit of the annual and consolidated accounts;
- monitoring and review of the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity;
- when a mandatory audit committee has been established it will have responsibility for recommending the appointment of a statutory auditor or audit firm to the board of directors; and
- the statutory auditor or firm will report to the audit committee of the PIE. In

¹ <http://www.irishstatutebook.ie/2010/en/si/0220.html>

² Further guidance on the precise limitations of a PIE can be found in the interpretation section of the statutory instrument

particular the statutory auditor shall report on key matters arising from the statutory audit of the entity. They shall also report on material weaknesses in internal control in relation to the financial reporting process.

General exceptions³

- a subsidiary undertaking, where the requirements of the undertaking are complied with by its parent undertaking, so as to ensure that any statutory audit of the subsidiary comes within the purview of the parent company audit committee;
- most UCITS and non UCITS;
- an entity that has, as its sole business, the issuing of asset-backed securities. It should be noted that for this exemption to apply the entity must set out the reasons why it is availing of the exemption **and** why it considers that the establishment of an audit committee would be inappropriate. The explanation must be published in its annual report, annual return or other periodic statement released by the entity; and
- certain credit institutions as set out in the Regulations.

Further developments

The exercise of any power or carrying out of any duty by the audit committee in respect of the accounts of the PIE will apply to those financial years beginning on or after the establishment of the mandatory audit committee.

There is no definition of competence within the Regulations though compliance will be a matter for the board. The board of directors retains ultimate responsibility for the actions of the PIE regardless of the fact that an audit committee has been put in place. Existing corporate governance practice should be reviewed to ensure that the board and committee operate effectively.

Listed companies will see a significant overlap between the Regulations and their obligations under the listing rules. They should be aware that the Regulations operate in addition to the listing rules. In particular, the listing rules make provision for compliance on the basis of a “comply or explain” approach. The Regulations operate on a strict compliance basis.

Credit institutions should also be aware that the Central Bank’s Code on Corporate Governance for Credit Institutions and Insurance Undertakings published on the 8 November 2010⁴ sets forth obligations that do not provide for any exceptions along the lines of those in the Regulations. Accordingly, the burden placed on those institutions is likely to be significantly higher. While they may not be required to form an audit committee under the Regulations they will need to do so to comply with the regulatory requirements of the Central Bank.

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³ S.I. 220/2010 Part 9 S.91 ss. 9. This section should be reviewed in detail to ensure that the relevant entity falls within the remit of the exceptions set out therein

⁴ <http://www.financialregulator.ie/consultation-papers/Documents/CP41%20-%20Corporate%20Governance%20Requirements/Corporate%20Governance%20Code%20for%20Credit%20Institutions%20and%20Insurance%20Undertakings.pdf>