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TECHNICAL GUIDE 3/2017 ON AUDIT COMMITTEES AT PUBLIC-INTEREST ENTITIES

1. INTRODUCTION

On June 27, 2017 the Spanish Securities Market Commission (“CNMV”) approved a Technical Guide (the “Technical Guide” or “the Guide”) on audit committees at public-interest entities (“PIEs”) to provide a number of principles, recommendations and standards for the proper functioning of audit committees.

The recommendation that listed companies should create an audit committee first appeared in Spain’s earliest good corporate governance code, the Olivencia Code, published in 1998. In 2002, that recommendation became a statutory duty for listed companies. And in 2015, the Spanish Audit Law (Ley 22/2015, “LAC”) broadened the duty to have an audit committee to public-interest entities.

Besides listed companies, the term “public-interest entities” also encompasses certain financial institutions subject to supervision and enterprises over a given size threshold (financial institutions or non-financial firms with more than 4,000 employees and a net turnover (revenues) of over €2 billion), as provided in article 3.5 LAC.

2. NATURE AND OBJECTIVES OF THE GUIDE

Spain already has statutory rules on the functioning, composition and duties of audit committees which were enacted in the LAC and the Spanish Companies Law (Ley de Sociedades de Capital, “LSC”). Moreover, the 2015 Good Governance Code of Listed Companies supplemented those rules with recommendations applicable to the audit committee.

However, as the Guide mentions, doubts have come to light about the scope of the committees’ functions and responsibilities and a range of good practices have been identified which ought to be made widely known and place emphasis on the necessary independence of the audit committee.

The Guide may be particularly useful for PIEs, which until the entry into force of the Audit Law were not required to set up an audit committee and therefore lacked the experience that listed companies have had the chance to gain in this area over a number of years now.

The Guide notes that, given the wide diversity of entities to which it is addresses, PIEs must adapt the principles and recommendations to their own specific circumstances and features, having regard to their size, complexity and fields of operation.

3. CONTENTS OF THE GUIDE

The Guide is divided into two parts. The first sets out a set of basic principles that should guide the audit committee, and the second provides standards and good practices to be implemented in the performance of their role.

3.1 Key principles

- (i) **Responsibility.** Independently of the responsibilities of the board of directors, the audit committee has specific responsibilities in connection with its advising, supervision and monitoring duties.

- (ii) **Sceptical stance.** Audit committee members must take a critical and sceptical approach, by properly questioning the data, assessment processes and conclusions that are examined and monitored by it.
- (iii) **Constructive dialog that encourages members to speak freely.** The committee must nurture a climate that gives rise to constructive dialog among members and ensures that members freely take part unaffected by pressure from its members.
- (iv) **Ongoing dialog with the internal audit unit, the statutory auditor and management.** The task of channeling communication will normally be assigned to the chairperson of the audit committee. The presence of managers or other directors must occur only when strictly necessary.
- (v) **Adequate analytical capability (recourse to experts).** The committee must have the power to seek and obtain expert legal advice, legal opinions and reports when it sees fit.

3.2 Performance of its role

On the basis of the principles described above, the Guide unveils a number of standards and good practices which must guide audit committees in their role, and are briefly as follows:

- (i) **Composition.** Diversity is recommended in gender, career experience, skills sector-specific knowledge and geographical origin. And at least one member with a background in IT is encouraged. The criteria and requirements for appointments should be set out in the regulations of the board or of the audit committee. The audit committee members should have appropriate training for the type of entity. It also recommends having in place a welcome program which ensures that all members have a shared awareness of the company's affairs, and members should be updated with a recurring training program.
- (ii) **Functioning.** The audit committee should have a set of rules that are regularly reviewed and published on the entity's website. It must be ensured that the audit committee has adequate, timely and sufficient access to information. It recommends that meetings should be held frequently (at least four a year), and at least on the occasion of each annual or interim financial reporting date. The entity must provide its audit committee with sufficient resources to perform its role, which includes sufficient funds for audit committee members to obtain external advice. The remuneration of its members must be commensurate with the dedication of time required of them, but must never compromise their independence and impartiality.
- (iii) **Oversight of financial and non-financial reporting.** The audit committee must have an adequate awareness and understanding of the system of internal control over financial reporting (ICFR) and must oversee its effectiveness. It must also review, analyze and comment on material financial and non-financing reporting in discussions with company management, the internal audit unit and the statutory auditor -and delimit the audit committee's responsibilities in this connection-. The Guide also underlines the importance of establishing a system for communication to the audit committee of irregularities in all fields, especially those having financial and accounting implications, and recommends that oversight of the whistleblower channel be assigned to the audit committee.
- (iv) **Supervision of risk management and control.** The risk control and management function must be adapted to the organizational structure of the entity. It must be regularly evaluated whether an independent risk management and control area is needed. The audit committee must have a comprehensive overview of the entity's internal control and risk management, although the power to adopt a risks policy rests with the board. The Guide sets out a number of advisable practices for the appropriate performance of this task, notably including encouraging a culture in which risk is a factor that is considered in all the entity's decision-making processes and levels.
- (v) **Supervision of internal audit.** Regular analysis of the internal audit function is recommended. At entities where no distinct audit area exists, the audit committee must annually consider whether such an area should be created. Adoption of an annual plan is included, in the supervision of which the audit committee must check that the plan covers the main elements and risks of the business and address the resources required for its implementation. The supervision of internal audit must be supported by ongoing interaction and an annual plan based on the key risks.

- (vi) **Relations with the statutory auditor.** One of the audit committee's functions is to propose the appointment or reelection of the statutory auditor, and it is responsible for the process of selection. The Guide therefore recommends that the audit committee should specify a selection procedure. The choice of auditor should be made on the basis of proper consideration of the various factors in play, and predominant weight should not be given to quantitative criteria. Moreover, protection should be given to the independence of the statutory auditor, as laid down in the Companies Law. The Guide sets out a number of standards for how to act in that role. It also states that communication between the audit committee and the statutory auditor should be fluid and ongoing, and must not undermine the auditor's independence. A number of practices to secure this aim in their communications are listed, in the course of the review of the audit committee and in the assessment of the auditor.
- (vii) **Other responsibilities.** The audit committee may take on other roles (areas such as supervision of compliance with corporate governance rules, internal codes of conduct and corporate social responsibility policy), and if it does, these roles must be included in its rules and regulations and the committee must increase its size if necessary to have the appropriate number of specialists in additional areas. If it also has a role in relation to related-party transactions, it must gather and analyze the necessary information and be able to request expert reports.
- (viii) **Assessment and monitoring.** The audit committee must assess its own functioning independently. A public disclosure must be made on the extent to which the assessment has given rise to significant changes in the internal organization and procedures of the audit committee. This disclosure must be included in the audit committee's annual activity report. It is recommended that the company publish the report on the occasion of convening the annual shareholders' meeting.
- (ix) **Information to the entity's other bodies and its shareholders.** The Guide finishes by setting out the minimum contents that must be included in the committee's activity report to give shareholders and other stakeholders a better understanding of the committee's activities.

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