Issue 11

Audit Committee Quarterly

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Audit Committee Institute Ireland

Sponsored by KPMG

Background

Recognising the importance of audit committees, Audit Committee Institute Ireland (ACI) has been established to serve audit committee members and help them to adapt to their changing role.

Historically, audit committees have largely been left on their own to keep pace with rapidly changing information related to governance, audit issues, accounting and financial reporting. Supported by KPMG, the ACI provides knowledge to audit committee members and a resource to which they can turn at any time for information or to share knowledge.

Our primary objective is to communicate with audit committee members and enhance their awareness and ability to implement effective audit committee processes.

The ACI aims to serve as a useful, informative resource for audit committee members in such key areas as:

- audit committee governance, technical and regulatory issues;
- sounding board for enhancing audit committees' processes and policies;
- surveys of trends and concerns.

The ACI is now in direct contact with over 1,000 audit committee members. For more information on the work of the ACI please click on our Web site:

www.auditcommitteeinstitute.ie or e-mail: *info@auditcommitteeinstitute.ie*

Welcome

Welcome to the latest edition of *Audit Committee Quarterly* Ireland, a publication designed to help keep audit committee members abreast of developments in corporate governance and related matters. For those of you new to Audit Committee Institute (ACI) and this publication in particular, a brief outline of the background to ACI is set out opposite.

The **ODCE guidance on audit committees** was issued just before Christmas. Commentary and evaluation of the guidance is included on **page 2**.

Given the current intense focus on public company financial reporting, **Confronting earnings management** on **page 8** provides guidance for audit committee members as investors and regulators demand better transparency.

The Financial Reporting Review Panel in the UK has issued its first report outlining the preliminary findings of its review of IFRS implementation by listed companies. **IFRS implementation findings** on **page 10** highlights a number of issues of relevance to UK and Irish companies planning the preparation of their second IFRS annual accounts.

Also included are our regular round ups of regulatory developments locally on **page 5** and internationally on **pages 12 and 14** together with an update of selected financial reporting matters on **page 18**.

I hope you will continue to enjoy the ongoing benefits of ACI. Please contact us at *info@auditcommitteeinstitute.ie* with any comments or suggestions of topics you would like to see covered and do visit our website at *www.auditcommitteeinstitute.ie* for further information on ACI.

Kevin O'Donovan
Chairman
Audit Committee Institute Ireland

ODCE guidance on audit committees

The Office of the Director of Corporate Enforcement (ODCE) Paper on audit committee responsibilities, issued just before Christmas, raised expectations of an interesting read, judging by the range of comments and suggestions prompted by the consultation draft issued earlier in 2006. In this article Shelagh McAlpine, Director, KPMG, evaluates and comments on the Paper.

The Director of Corporate Enforcement, Mr Paul Appleby (Director) has chosen to leave comments on broader issues to the Minister, making the focus of the guidance – issued as Decision Notice D/2006/1 – primarily a rehearsal of the 2003 Act's requirements couched in more straightforward language than tends to be used for legislation, with little added comment. This is not without value, as anything that helps to make the law better understood is beneficial – but is perhaps also a lost opportunity, in terms of developing thinking and a thoughtful application of best practice in audit committee work to the Irish environment.

The Director also chose to publish before commencement of the relevant section of the 2003 Act, with an accompanying recommendation to the Minister that the requirements be brought into effect from summer 2007 – albeit with a clear acknowledgement in his letter to the Minister, available on the ODCE website, that many commentators had suggested a longer period for reflection, particularly in light of the need to assess the impact of the finalised 8th Directive's provisions.

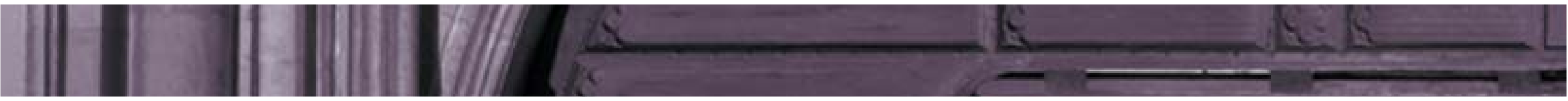
The Director's decision to refer broader comments to the Minister rather than attempt to deal with their implications directly could also be taken to imply that there are underlying differences in approach that cannot be reconciled by giving interpretational guidance. Certainly, despite its merits, the guidance does not provide direction on two key points, highlighted below.

What practical arrangements and day-to-day operations will meet the Act's requirements in a manner that enhances business and governance in a cost efficient manner?

Analysing the extent to which pre-existing arrangements may or may not meet the 2003 Act's provisions is crucial. Many companies have provisions in place to meet the principles of the *Combined Code on Corporate Governance* – not just listed companies, who are required by the Listing Rules to apply the Code but others who have chosen to adopt similar practice or are within scope of the Department of Finance's *Code of Governance*, which draws on the Combined Code. Such an assessment is of particular importance as the wording of the Act's provisions suggests an underlying logic that is not compatible with the Code, as the next issue illustrates.

Does Ireland's implementation of the 8th Directive mean that we need to reconsider the 2003 Act's provisions?

The Act and the Directive take rather different approaches in setting out their requirements – immediately noticeable is that the Directive sets Audit Committee obligations at a rather higher level, giving only four duties compared with the Act's more detailed fourteen. Of itself, that is not a difficulty, though the wisdom of having detailed



prescriptive requirements in primary legislation can be queried. However, there are other differences that merit attention, as set out below.

What type of entity needs an audit committee?

The 8th Directive's provisions have a clear focus on public interest. Those entities that are of public interest are those it determines as needing audit committees, with some allowance for member states to apply judgment in determining how to apply this concept in particular cases.

The 2003 Act on the other hand focuses directly on public limited companies and larger private companies limited by shares. This could be seen as a sub-set of "public interest" entities – but is it? Is a private company owned and run by its shareholder/directors within the 8th Directive provisions simply because it is successful? Is an organisation that is established as a company limited by guarantee automatically not of public interest?

Who should be a member of an audit committee?

The Directive gives member states a choice between non-executive members of the board or other members appointed by the company's members in general meeting. It goes on to require that there must be at least one member who is:

- independent;
- competent in accounting and/or auditing.

This is a clear extrapolation of the public interest concept into ensuring that the audit committee is placed to comment on and challenge the executive's approach.

In contrast, the 2003 Act indicates that the audit committee must consist of two or more directors, other than the chairman of the board, provided that they have not been employees of the company or one of its subsidiaries in the last three years. The appointment is entirely within the control of the executive – members are to be such as the board sees fit.

The Act makes no mention of independence and has no requirement for accounting or auditing competence. These two qualities are essential if audit committees are to have any value.

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It also appears that the Act may bar non-director members being co-opted to the committee, which would mark a significant change in practice for part of the Irish business community. This too needs some reassessment.

What should an audit committee do?

Leaving aside any issues raised by the Act's greater level of detail, there are also differences in the way it and the Directive describe the committee's responsibilities.

The Directive speaks in terms of "monitoring" and "reviewing", stating the committee is to:

- monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- monitor the statutory audit of the annual and consolidated accounts;
- review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

It also prefaces the requirements by stating that the provisions are without prejudice to the duties of the board as a whole.

The 2003 Act also speaks of "reviewing" but then goes on to require the audit committee to "determine" various matters, for example:

- to determine, in advance of the board doing so, whether the financial statements give a true and fair view and comply with the Companies Act's provisions and then to recommend to the board whether to approve them;
- to determine whether compliance statements are fair and reasonable – wording that must also change to be aligned to amended provisions resulting from the Company Law Reform Group's review of compliance statements;
- to determine whether proper books of accounts have been kept.

The list, though long, does not include any provision equivalent to the Directive's requirement that committees monitor the effectiveness of risk management and internal control – though listed companies and others operating in accordance with the Combined Code will already do so.

The Act couches its duties in terms of the audit committee having a primary responsibility in each area and there is no equivalent to the Directive's "without prejudice" provision. This brings the risk that audit committees will be encouraged to act in a manner that dilutes responsibility of the board as a whole for governance and financial reporting. The ironic – and no doubt unintended – effect of the 2003 Act could then be a narrowing of oversight of governance and financial reporting issues to a sub-set of the board with no real independence.

There are other areas of the Act and the Directive that could be considered: but these three may help to illustrate the need for careful analysis of how we can best implement the 8th Directive before asking companies to take action to meet new legal requirements. It is an area that would benefit from the Company Law Review Group's attention during 2007.

Shelagh McAlpine is a Director in KPMG's Professional Standards department.

The ODCE paper is available online at
http://www.odce.ie/en/media_decision_notices_article.aspx?article=86101051-7690-4c78-b797-f10479e22d07

Stop press

APB issues revised guidance on commencement of extended duty of auditors to report to the Director of Corporate Enforcement in Ireland

The Auditing Practices Board (APB) published Bulletin 2007/2 *The Duty of Auditors in the Republic of Ireland to Report to the Director of Corporate Enforcement* on 2 March 2007.

Bulletin 2007/2 was developed in consultation with the Director and CCAB-I and revises guidance for auditors on their statutory duty to report indictable offences under company law first set out in Bulletin 2002/1 (issued in 2002) for:

- changes to section 194 of the Companies Act, 1990 introducing an additional obligation on auditors to provide, if requested by the Director of Corporate Enforcement, further information relating to reports made to him and taking effect from 1 March 2007. The revised legislation also contains exemptions in relation to privileged information, and;
- experience since the duty to report indictable offences under company law was introduced in 2001.

Copies of the Bulletin may be downloaded from the Publications section of the APB website at:
http://www.frc.org.uk/images/uploaded/documents/APB%20Bulletin%202007-2.pdf

Local regulatory update

The Investment Funds, Companies and Miscellaneous Provisions Act 2006

The *Investment Funds, Companies and Miscellaneous Provisions Act 2006* (the 2006 Act) was signed into law on 24 December 2006. The 2006 Act does not affect the form of the financial reporting framework established by its namesake in 2005 but makes a number of important amendments.

Key elements of the 2006 Act are:

- provisions providing new vehicles for collective investment schemes, permitting private companies to offer debt securities to "qualifying individuals", as defined in the Prospectus Directive. The Financial Regulator has also issued a Consultation Paper *Authorisation of Qualifying Investor Schemes – amendments to the application process* (CP26);
- provisions extending the limits for audit exemption to turnover of €7.3 million and balance sheet total of €3.65 million, replacing the previous figures of €1.5 million and approximately €1.9 million respectively. The new thresholds took effect on 24 December when the Bill was signed into law and apply to financial years in progress which have more than two months to run after the date of signature of the Bill and to other financial years commencing after the date of the Bill's signature. Other criteria for audit exemption continue to apply;
- clarification that it is no longer necessary to obtain consent from auditors for inclusion in prospectuses of their previously published reports on financial statements.

In addition, please refer to our UK matters section on page 14 for details in relation to the UK Companies Act 2006.

New proposals for representations to auditors arising from the international Clarity Project

Audit committees' discussions with auditors in future could be significantly affected by proposals in a recently issued exposure draft of International Standard on Auditing (ISA) 580 *Written Representations*, which has been revised and redrafted as part of the International Auditing and Assurance Standards Board (IAASB)'s Clarity Project.

This exposure draft represents a significant revision of the current ISA and, in particular, requires the auditor to obtain "general written representations" concerning the premises upon which an audit is conducted. These include:

- acknowledgement from boards of their responsibilities for preparing and presenting the financial statements in accordance with the applicable financial reporting framework and confirmation of whether the board believes the financial statements are prepared in accordance with that framework, together with a number of specific representations on key issues to be addressed;
- acknowledgement of boards' responsibility for designing, implementing and maintaining internal controls relevant to preparing and presenting financial statements that are free from material misstatement and confirmation that the directors believe that the internal controls they have maintained are adequate for that purpose;
- confirmation of the completeness of information made available to the auditor.

…written representation… [confirming] that the directors believe that the internal controls they have maintained are adequate...

The APB would welcome comments on the exposure drafts from auditors and other interested parties by 30 March 2007, before it prepares its responses to the IAASB.

If the representations are not given, the proposed ISA leads to the conclusion that the auditor will not have obtained sufficient appropriate audit evidence and that the possible effects on the financial statements are so pervasive that the auditor shall disclaim an opinion.

Other Clarity Project drafts

The Clarity Project was a highly significant element of IAASB's work throughout 2006 and will continue to be so in 2007. Its aim is to improve the quality of International Standards on Auditing (ISAs) by:

- setting an overall objective for each ISA;
- clarifying obligations by using the word "shall" for all requirements intended to apply to every audit to which the ISA is relevant;
- eliminating ambiguity about the status of material intended to be guidance rather than requirements;
- improving the overall readability and understandability of the ISAs.

In addition to the proposed "clarity" version of ISA 580, the IAASB also recently issued five exposure drafts of ISAs redrafted in accordance with its Clarity Project drafting conventions:

- ISA 230 (Redrafted), *Audit Documentation;*
- ISA 540 (Revised and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures;*
- ISA 560 (Redrafted), *Subsequent Events;*
- ISA 610 (Redrafted), *The Auditor's Consideration of the Internal Audit Function;*
- ISA 720 (Redrafted), *Reading Other Information in Documents Containing Audited Financial Statements.*

With the release of these drafts, "clarity" versions of approximately half the total of 33 ISAs have now been released for comment.

The APB staff have prepared versions of the clarity exposure drafts, together with covering papers and comparisons with existing ISAs to assist assessment of the effect for auditors in Ireland and the UK. This material is available in the Publications (IAASB Clarity Documentation) section of the APB's Web site: *www.apb.org.uk*

The IAASB's comment periods for the exposure drafts of ISA 580 (Revised and Redrafted) and ISA 540 (Revised and Redrafted) end on 30 April 2007. The APB would welcome comments on the exposure drafts from auditors and other interested parties by 30 March 2007, before it prepares its responses to the IAASB.

The IAASB's comment periods for the other exposure drafts referred to above, which redraft current ISAs using the Clarity Project drafting conventions, end on 31 March 2007.

Promoting audit quality – the Financial Reporting Council seeks views

Quality can be an elusive concept – seeking to define and then support quality in the context of a dynamic process such as audit is no exception. A Discussion Paper issued by the Financial Reporting Council (FRC) grapples with these issues and seeks opinions on whether, within the existing legal and regulatory framework, all appropriate steps are being taken to maintain and enhance the quality of audits and, if not, seeks views on what more could or should be done.

The Discussion Paper – which has been developed in the context of the financial reporting framework in both Ireland and the UK – includes a comprehensive summary of the current environment in which audits are conducted and then sets out a description of the key drivers that the FRC believes are central to achieving a high quality audit of listed companies and then considers whether there are "threats" which weaken the effective operation of those drivers.

Views are sought from stakeholders and others with an interest in the audit – with comments invited by 31 March 2007. Thereafter the FRC has indicated that it envisages holding meetings at which the suggestions that emerge can be discussed and will formally consult on any proposals that it intends to take forward – and that should the comments reveal a consensus for change or action that is outside the FRC's powers, it will raise those matters with those responsible.

Copies of the Discussion Paper are available at *http://www.apb.org.uk/publications/pubs.cfm*

Audit Quality Forum calls for audits to be more open

Audit reports, as the main channel of communication between auditors and shareholders, are too boilerplate and standardised, says the Audit Quality Forum (AQF) in a paper, *Fundamentals - Auditor Reporting*.

The audit report is a signed document expressing the truth and fairness of a company's financial statements, which goes to the heart of discussions around transparency and confidence in the independent audit.

The AQF working group on auditor reporting was tasked with considering whether the wording of the audit report satisfies shareholders' expectations.

To achieve this, the group considered the information that shareholders wish to see within the audit report, why they require this information and whether the current audit report meets their needs.

The paper recommends that the audit report should, within a clearly defined framework and in line with applicable European Commission (EC) requirements, include the following:

- an opinion paragraph adopting as soon as practicable the wording and structure of Section 495(3) of the *Companies Act 2006* in its three distinct parts. Clearly, the wording of audit reports will have to comply with the law from the effective date of the *Companies Act 2006* regardless of whether there is early adoption;
- a positive statement that adequate accounting records have been kept;
- a positive statement that there are no matters that auditors wish to draw attention to by way of emphasis under Section 235(2A)(b) of the *Companies Act 1985* or Section 495(4)(b) of the *Companies Act 2006*;
- improving the readability of audit reports by moving the opinion to the front and much of the standardised boilerplate text to the back or into an appendix.

Richard Reid, chair of the AQF working group on Audit Reports said:

"On one hand, investors would like to understand more about the key issues and discussions that take place during the course of the audit. On the other hand, auditors are constrained by case law and clauses around confidentiality, legislation and auditing standards. But at the crux of all of this was also the impact on business.

"The question we have therefore tried to address is how to maintain a balance so that shareholders are able to get the information that they would like without compromising auditors' duties around confidentiality, but without all of this creating an unnecessary burden on those that have to prepare the information, the companies."

The paper also proposes a review of the following areas:

- to meet the investors' requirements for more company-specific information (of key subjective areas), a review needs to be carried out of the current disclosures within the annual accounts, and information to be provided under future new requirements, to assess the extent to which disclosures being made in practice, go all or part of the way to meeting the wishes of investors for further information;
- the Combined Code recommendations for audit committee disclosures could be reviewed and amended such that audit committees would be expected to include more specific information through their report to shareholders, including identifying key issues and significant accounting and reporting matters discussed with auditors as a result of the audit.

This review would also need to consider the auditors' reporting role in relation to these disclosures. In the meantime, the working group encourages audit committees to do this as a matter of course and would like to see this evolving as best practice.

All the recommendations will also need to be considered in the context of the EC's appetite for a single common audit report in Europe.

The working group recommends that the Department of Trade and Industry (DTI), the Financial Reporting Council (FRC) and other UK stakeholders encourage the International Auditing and Assurance Standards Board (IAASB), the EC and other bodies that operate at European level to consider the recommendations above, especially in discussions around the development of ISA 700 *The Independent Auditor's Report on General Purpose Financial Statements*.

In the longer term, these recommendations would need to be considered in the context of the requirements of the 8th Directive.

Confronting earnings management

Rarely has there been such intense focus on public company financial reporting as exists today. There is increasing evidence of investors and regulators demanding more and better transparency.

Audit committee members need to understand the pressures on management to meet the earnings expectations of analysts, investors or senior management. They also need to be alert to red flags that executives may be engaging in earnings management techniques to help make the numbers. The audit committee should help to ensure that management has a long-term focus and is not unduly focused on short-term reported results.

What can be done?

There are many actions that can mitigate the risk of inappropriate earnings management techniques being used by a company.

Tone at the top

The tone at the top of any organisation should demand that management focuses on quality financial reporting and on long-term financial performance. The commitment to report quality earnings should extend to all levels in the company and should be a key element in the controls system, especially those controls surrounding the financial reporting process. The audit committee can assess the tone at the top through its periodic meetings with senior management and in discussions with the internal and external auditors. These meetings can be augmented with other meetings involving other management and line personnel to evaluate whether the tone at the top relating to quality financial reporting has filtered down throughout the company. The audit committee should be alert to numerous top-side entries or last minute adjustments necessary to close the books as these may be indicators of earnings management processes.

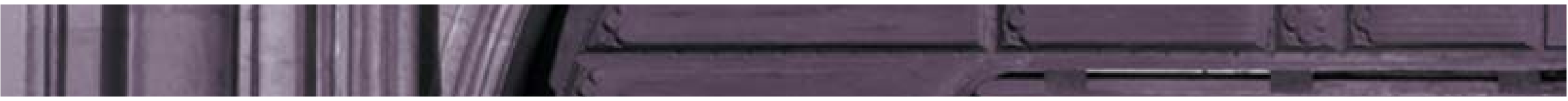
Management may have been put into the position of having both the incentive and opportunity to manage earnings.

Executive remuneration

The audit committee needs to examine and understand the executive (and perhaps non-executive) remuneration plans.

The audit committee should understand those elements of the remuneration plan, including cash bonuses and share options, which are based on attaining financial targets. Such targets represent potential pressures on senior executives to manage earnings (for example if goals are based on company or divisional earnings, profit margins, revenues, efficiencies or earnings per share amounts). This pressure can all too often lead to biased, aggressive and sometimes inappropriate financial reporting considerations. Management may have been put into the position of having both the incentive and opportunity to manage earnings. This problem can become even more troublesome if goals and targets are based on short-term outcomes as opposed to being based on long-term results.

In addition, the audit committee should inquire into the status of previously issued share options, both vested and unvested, since there may be pressure to increase the company's share price to make these options more valuable to employees and management.



Trends in estimates

The audit committee should have a solid understanding of the company's critical accounting policies and estimates. The audit committee should hold regular, in-depth discussions with management about the significant estimating processes used and the data and assumptions inherent in those estimates, particularly for those that are highly judgmental, for example the valuation of long-term work in progress. Estimates that are generated by quantitative models may require special scrutiny. The audit committee should understand management's process for helping to ensure the accuracy and validity of such models and be comfortable that management's process is robust and based on realistic assumptions, which are regularly updated.

The quality of the processes and systems and the reliability of the data underlying management's estimates should be challenged. At least on an annual basis, the audit committee should obtain from management a retrospective analysis as to how the historical estimates have compared with actual results. Such an analysis of the 'run off' of estimates should consider issues such as:

- how the value of the initial estimate has changed over time?
- what additional estimates have been provided for in the intervening periods?
- what were the actual amounts realised?
- what events caused the actual results to be different from the estimated amounts?

This may flag areas where reserves are being established or drawn down inappropriately.

Materiality

The concept of materiality plays a vital role in the financial reporting process. Insignificant misstatements that result from the normal course of business (rather than from an intentional scheme to manage earnings) are generally not of significant concern unless they are indicative of weaknesses in internal control over financial reporting.

However, intentional errors and misstatements made by management on the basis they are not material should be challenged by the audit committee. In addition, misstatements created with the principal intent of managing earnings (e.g., creating unsupported accrued revenue to offset against known misstatements) also should not be acceptable. Where misstatements offset one another, each misstatement and its materiality should be considered both separately and in aggregate.

Dealing with earnings management

To fulfil its financial reporting oversight responsibilities properly, the audit committee needs to have a good understanding of the variety of earnings management opportunities that exist. This requires an appreciation of the differences between earnings managed in the ordinary course of business and earnings fraudulently managed in an attempt to deceive the financial community.

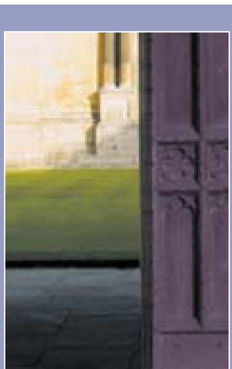
It is important not only to carefully scrutinise the unrecorded audit adjustments but also to obtain from management an understanding as to why such items arose. In these circumstances, the audit committee has a key role to play in helping to ensure that the company reports quality earnings.

There are incentives and pressures both from within the company and from outside the company to engage in inappropriate earnings management activities. The audit committee should be vigilant as to the possibility of earnings management and be alert to the warning signs that it is occurring. The audit committee should obtain a thorough understanding of the company's processes to make or modify accounting policies, estimates and judgments so that those processes can be assessed. The audit committee should also assess the role that compensation and bonus plans, which are tied to performance, can have on earnings management, and clearly understand their consequences. It should be remembered that the pattern of earnings is rarely smooth, and financial reporting should not mask that reality.

This piece is adapted from an *Audit Committee Insights* feature by Michael Meagher, ACI Canada published in June 2006. To subscribe to *Audit Committee Insights* click on ***www.kpmginsights.com***

IFRS implementation findings

The Financial Reporting Review Panel (FRRP) in the UK has issued its first report outlining the preliminary findings of its review of IFRS implementation by listed companies. Its review continues but it has identified a number of issues which it believes should be drawn to the attention of companies planning the preparation of their second IFRS annual accounts. While the observations relate to the UK accounts which were received, they apply equally to Irish companies reporting under IFRS.

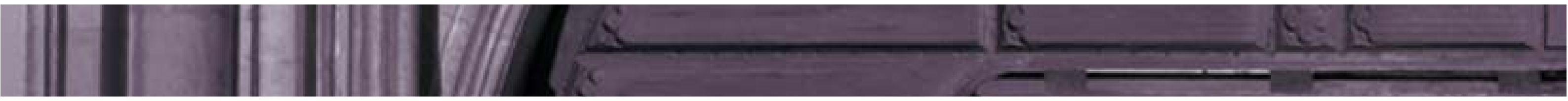


In keeping with the FRRP's earlier activity report, the FRRP reports a good level of compliance with IFRS and recognises the significant amount of work by companies that has gone into the accounts production process. The FRRP identified several key areas for improvement which are discussed in more detail below:

- accounting policies;
- disclosure of judgements and estimates;
- disclosure of reasons for goodwill;
- intangible assets;
- impairment testing;
- related party disclosures;
- new standards and interpretations;
- presentation.

Accounting policy descriptions were found to be a little too generic with companies opting to use wording from the standards, rather than adapting the wording to describe more accurately the issues relevant to the company's individual circumstances. Also old Generally Accepted Accounting Principles (GAAP) terminology was still found, despite this issue being highlighted in their report on interims. For example, revenue recognition policies may need to include a description of the methods applied to determining a transaction's stage of completion. In addition, the FRRP found that some stated accounting policies were irrelevant since there were no accounting transactions falling within their scope, e.g., the inclusion of a policy in respect of hedging when this was not applied in practice. In its report, the FRRP encourages companies to disclose only those accounting policies applied in practice, with information provided being specific to their particular circumstances.

IAS 1 *Presentation of Financial Statements* requires disclosure of the key sources of estimation uncertainty and key assumptions concerning future events that have a significant risk of causing material adjustment in the carrying amounts of assets or liabilities in the subsequent year. It also requires disclosure of the judgements made by management in applying the accounting policies that have the most significant impact on the amounts recognised in the accounts. The FRRP found that practice varied with some companies providing detailed disclosures of their key judgements and estimation uncertainties, whereas others provided only disclosures similar to those required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Others provided "bland" disclosures that bore no relation to the company's particular



disclosures… should always cover specific information relevant to understanding… a company's key sources of estimation uncertainty

circumstances; they should always cover specific information relevant to understanding, in particular, a company's key sources of estimation uncertainty.

The FRRP also reminds preparers that where goodwill is recognised on an acquisition, IFRS 3 requires an explanation of why that goodwill arises and an explanation of any intangible assets that were not recognised, including why their value could not be measured reliably. In addition, IAS 36 *Impairment of Assets* requires goodwill and those intangible assets with indefinite lives to be tested for impairment annually. In particular, paragraph 134 of IAS 36 requires disclosures regarding the method and assumptions used to determine the recoverable amount for a cash-generating unit that contains goodwill or indefinite-lived intangibles, whether or not impairment has been charged. In some cases, the FRRP found that these disclosures were omitted.

IAS 24 *Related Party Disclosures* includes key management within the definition of a related party and requires certain disclosures in respect of transactions with those related parties, including remuneration. The Companies Act continues to require disclosure of directors' remuneration but the remuneration of key management personnel was sometimes overlooked as a related party transaction under IAS 24. In other cases companies stated that their only key management were their directors: the FRRP specifically states that where narrative reports elsewhere in the annual accounts refer to management personnel by name, companies should consider whether their remuneration and other details should be included within the IAS 24 disclosures.

The FRRP also noted that some companies had failed to comply with the requirement under IAS 8 *Accounting Policies* to disclose details of the impact of new standards and interpretations that were issued but not yet effective ("issued" means endorsed for use in Europe). Where the impact is not known or reasonably estimable, this fact should be stated.

As a final point, the FRRP comments on the presentation of the primary statements, in particular the income statement, and the narrative reports. It found that some companies provided additional line items in their income statements, similar to those found under old GAAP such as amortisation or impairment charges. Although IAS 1 allows additional line items, the FRRP states that in its view, these should be included only when they are necessary to explain elements of financial performance. The report also reminds companies that non-GAAP performance measures should be defined and reconciled to GAAP measures and should not be given undue prominence.

The FRRP's preliminary report is available on the Web at
www.frc.org.uk/frrp/press/pub1206.html

EU matters

Auditor liability

During January, the European Commission (EC) issued a consultation paper seeking views on whether there is a need to reform rules on auditors' liability in EU member states – and how this could be achieved.

The consultation follows on from findings in a report commissioned by the EC from London Economics, whose findings indicated that the stability and flexibility of the audit market is affected in a significant manner by the unlimited liability. In particular, the report noted that:

New entrants to the international audit market are unlikely, limiting choice

Currently, this market and that relating to larger domestic companies is highly concentrated and dominated by the Big-4 networks (Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers). Under the current circumstances, middle-tier firms are unlikely to become a major alternative if a Big-4 network fails.

Entire international audit networks are at risk when large claims arise

Unlimited liability applies in an environment where the level of auditor liability insurance available for higher limits has fallen sharply in recent years. The remaining source of funds to face claims may essentially be the income of partners belonging to the same international network. Consequently, large claims could jeopardize the continued operation of an entire network's audit business.

The potential effects could create serious difficulties for companies seeking to appoint auditors

The failure of a network could lead to difficult consequences for the wider economy – a significant reduction in audit firms with the capacity to deal with large company statutory audits has the potential effect of a shortfall in the availability of auditors with the capacity and scale to deal with large, international businesses. Inability to obtain an audit in the context of capital markets and regulatory regimes that require audited information could have a significant impact on the companies affected.

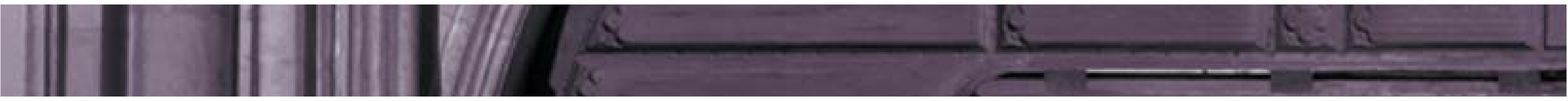
Limitation on auditor liability would reduce this risk

The report's conclusions prompted the Minister to request the Company Law Review Group (CLRG) to examine the question of auditor liability in the context of the existing legal framework in Ireland, as confirmed by the Minister in the course of announcing other developments in the *Investment Funds, Companies and Miscellaneous Provisions Act 2006.*

The EU's consultation paper was issued on 17 January and puts forward four possible solutions:

- the introduction of a fixed monetary cap at European level;
- the introduction of a cap based on the size of the audited company, as measured by its market capitalisation;
- the introduction of a cap based on a multiple of audit fees charged by auditors to their clients;
- the introduction by Member States of the principle of proportionate liability, whereby each party (i.e., auditor and client entity) would be liable only for the portion of any loss that corresponded to the relevant party's degree of responsibility.

The last has long been argued by auditors in Ireland and the UK as having the additional benefit of



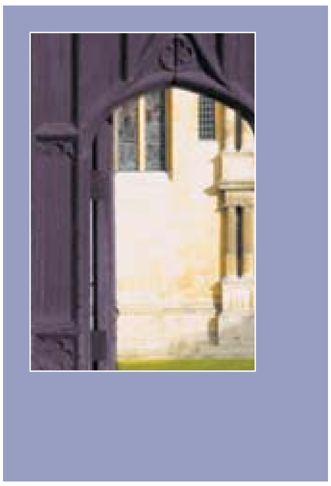
no one solution is likely to provide an answer for all EU states, given the differences that already exist in this area

ensuring that both markets and directors appreciate the extent to which the latter are responsible for the quality of financial information provided by a company. The audit is an important check underpinning that quality – but the most vigilant auditor, in the timeframes that capital markets demand financial information, is vulnerable to collusion or other steps to disguise the true impact of events affecting a company, undermining judgments made on evidence available during the audit.

However, no one solution is likely to provide an answer for all EU states, given the differences that already exist in this area – for example, Germany and a number of other states already have a relatively low cap on the extent of auditor liability, making a move to share a proportion of a larger whole rather less attractive. Meanwhile, in the UK the new Companies Act sets out a framework for greater transparency of arrangements between a company and its auditors, including the potential to allow auditors to contract with companies to limit liability.

Audit committees, with their focus on the integrity of financial reporting by companies, have a significant interest in identifying steps to achieve a balance of risk and reward that encourages high quality audits – the EU proposals would support audit committees in this regard.

Comments have been requested by 15 March 2007 and the Consultation Paper is available on the Europa website. IAASA has also made it available on its site at *http://www.iaasa.eu/news/index.htm*. In doing so, IAASA has not added any specific comments of its own – but with increasing involvement in EU debates and the government's referral of auditor liability to the Company Law Reform Group, committees may like to contribute to the development of views in the Irish business community as well as to respond to the EU's invitation.



Other international matters

UK matters

UK Companies Act 2006

The UK *Companies Act 2006* (Act) was brought into law in November 2006 and whilst earlier amendments to facilitate the introduction of IFRS remain broadly unchanged, the Act marks a significant overhaul of the framework of company law in the UK, following discussion and analysis that commenced with the launch of the Company Law Review in 1998.

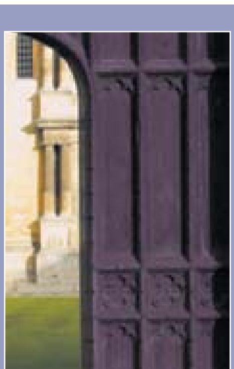
A major question addressed in the course of the Act's development has been that of for whom the company is run. In codifying the case law of directors' duties, the Act provides that the directors are to run the company for the benefit of its members. However, in taking decisions to promote the success of the company for the benefit of members, directors are to take into account, in those decisions, specified corporate social responsibility factors.

The UK 2006 Act also requires, to the extent necessary for an understanding of the development, performance or position of the business, trends and factors that may be relevant to the future and disclosure in the area of specified corporate social responsibility factors. These range from the environment through to – in a late addition during the legislative process – persons with whom the company has essential relationships or arrangements, e.g., potentially the supply chain. In recognition of the more forward-looking nature of this review, a safe harbour and an exemption from disclosure on the grounds of serious prejudice in certain cases are introduced.

Other key elements of the Act include:

- enfranchising beneficial owners – institutional investors are required to allow beneficial owners to have a right to all communications that would otherwise be sent by the company to members (e.g., the annual accounts);
- company administration and communications – provisions aimed at simplifying the process of administration. These include changes relating to filing and also to facilitate the use of electronic communications with shareholders.

The UK 2006 Act's communication provisions came into force in January 2007; consultation on detailed plans for the rest of the Act is expected during February and it is expected that all provisions will be brought into force by October 2008.



ASB publishes review of narrative reporting

The Accounting Standards Board (ASB) has recently published its first review of narrative reporting by UK listed companies, with the aim of keeping the spotlight on narrative reporting and the importance of encouraging continuing improvement in this area.

The review, which also draws on work by other bodies in the field, found that while most companies were good at describing their strategy and current performance, they were weaker on providing forward looking information and identifying their principal risks and how they are managed.

The purpose of this review is to highlight the strengths and weaknesses of current narrative reporting, in the interests of widespread adoption of best practice. The ASB, as part of its role in promoting confidence in corporate reporting, will continue to review progress in the UK and be a leading contributor to any international developments on management commentary.

The report had dual objectives of assessing:

- best practice – the degree to which companies have adopted the recommendations in the ASB's *Reporting Statement on the Operating and Financial Review* (OFR), given that it is the most complete and authoritative source of best practice guidance; and
- compliance – how UK companies are performing in the light of the requirement under the EU Accounts Modernisation Directive for companies to provide a business review in the Directors report in their 2006 Annual report.

Whilst companies are generally complying with the legal requirements, when measured against the best practice recommendations set out in the ASB's Reporting Statement, the following was found:

Areas of good reporting

- companies are generally good at providing descriptions of their business and markets, together with their strategies and objectives, although some improvements could be made in providing information on their external environment;
- all companies within the sample provided satisfactory or better descriptions of the current development and performance of the business;
- there has been an increase in companies reporting environmental, employee and social issues although very few discuss their contractual arrangements and relationships in any depth.

Areas for improvement

- the greatest area of difficulty for companies when producing their narrative reports is the disclosure of forward-looking information. The proposed "safe harbour" provisions in the *Companies Act 2006* may encourage companies to provide greater detail in the future;
- companies need to improve their descriptions of resources available to the entity, in particular intangible items such as brand strength, corporate reputation and natural resources not reflected in the balance sheet;
- companies need to describe more carefully their principal risks and uncertainties, and set out their approach to managing and mitigating those risks, rather than simply providing a list of all their risks and uncertainties (33 risks in one case);
- many companies are providing a good deal of information on measures and indicators, but improvements can be made in identifying their key performance indicators, both financial and non-financial.

The ASB reports referred to in this article are available at
http://www.frc.org.uk/asb/press/pub1228.html

US matters

FASB staff issues staff position on accounting for registration payment arrangements

Under a registration payment arrangement, a company may issue equity-based financial instruments (for example, equity shares or warrants) and agree to register the underlying shares with the SEC (or other applicable regulator if shares are to be registered outside the US). Such arrangements may also require that the company maintains an effective registration statement for the resale of shares upon exercise or conversion of the financial instruments. In general, companies must use "best efforts" or "commercially reasonable efforts" to file the registration statement and have it declared effective by the SEC within a specified period of time. A company failing to meet these conditions may have to make payments in cash or other consideration to an investor until such time as the conditions are met.

FSP EITF 00-19-2 *Accounting for Registration Payment Arrangements* provides guidance in accounting for contingent obligations arising under these arrangements and requires that if, at inception, the payment is probable and reasonably estimable, a liability should be separately recognised and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*. The guidance in this FSP is effective immediately for new or modified arrangements and must be applied to existing arrangements for fiscal years beginning after 15 December 2006 through recognition of a cumulative effect adjustment on retained earnings as of the beginning of the year of adoption.

The Position is available at ***http://www.fasb.org/fasb_staff_positions/fsp_eitf00-19-2.pdf***

FASB staff issues staff position on planned major maintenance

FSP AUG AIR-1 *Accounting for Planned Major Maintenance Activities* prohibits companies from accruing as a liability in annual and interim periods the future costs of periodic major overhauls and maintenance of plant and equipment. Other methods of accounting for planned major overhauls and maintenance previously acceptable under US Generally Accepted Accounting Principles (GAAP) will continue to be permitted.

The prohibition against accruing future major maintenance costs will affect companies that currently accrue those costs over several fiscal years and companies that accrue the costs over interim reporting periods within the annual period in which the costs are expected to be incurred. The prohibition applies to entities in all industries for fiscal years beginning after 15 December 2006 and must be applied retrospectively.

The Position is available at ***http://www.fasb.org/fasb_staff_positions/fsp_augair-1.pdf***

Emerging Issues Task Force approves seven consensuses

The Emerging Issues Task Force (EITF) has concluded on the following EITF issues:

- EITF 06-1 *Accounting for Consideration Given by a Service Provider to Manufacturers or Resellers of Equipment Necessary for an End-Customer to Receive a Service from the Service Provider;*
- EITF 06-4 *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements;*
- EITF 06-5 *Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realised in Accordance with FASB Technical Bulletin No. 85-4 Accounting for Purchases of Life Insurance;*
- EITF 06-6 *Debtor's Accounting for a Modification (or Exchange or Convertible Debt Instruments);*
- EITF 06-7 *Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities;*
- EITF 06-8 *Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums;*
- EITF 06-9 *Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee.*

The EITF consensuses are available on the FASB's Web site at
http://www.fasb.org/eitf/agenda.shtml

SEC matters

SEC and PCAOB issue proposed guidance and final rules on Section 404 and internal control over financial reporting

The SEC and PCAOB have recently issued proposed guidance intending to make compliance with the requirements of Section 404 of the Sarbanes-Oxley Act more cost effective. The SEC's proposed interpretive guidance for management describes a top-down, risk-based approach in assessing internal control over financial reporting. An evaluation that complies with this interpretive guidance would be one way to satisfy the rules for management's annual evaluation of internal controls. However, registrants would be allowed to continue to follow their current 404 assessment approach.

Consistent with the SEC's proposed guidance, the proposed PCAOB auditing standards are intended to achieve a more efficient, risk-based and scalable audit approach. The proposed standard would also facilitate the elimination of certain procedures, including the requirement for auditors to evaluate management's assessment process.

The SEC final rule defers the requirement to provide an auditors' report on internal control over financial reporting for foreign private issuers that are accelerated filers (but not for those that are large accelerated filers) until fiscal years ending on or after 15 July 2007.

The final rule is available at ***http://www.sec.gov/rules/final/2006/33-8730a.pdf***

SAB 108: The effect of prior-year errors on current-year materiality evaluations

SEC Staff Accounting Bulletin (SAB) No. 108 *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* addresses how uncorrected errors in previous years should be considered when quantifying errors in current year financial statements. The SAB requires registrants to consider the effect of all carry-over and reversing effects of prior-year misstatements when quantifying errors in current year financial statements. The SAB does not change the SEC staff's previous guidance on evaluating the materiality of errors.

The SAB allows registrants to record the effects of adopting the guidance as a cumulative-effect adjustment to retained earnings. This adjustment must be reported as of the beginning of the first fiscal year ending after 15 November 2006.

SAB 108 is available at ***http://sec.gov/interps/account/sab108.pdf***

SEC adopts new compensation disclosure requirements

The SEC recently adopted changes to the required disclosures about executive and director compensation, related person transactions, director independence and other corporate governance matters, and ownership of securities by officers and directors. Under the requirements, foreign private issuers may continue to follow the compensation disclosure requirements in Form 20-F, but must disclose more detailed information if it is made publicly available for some other reason, such as a home-country requirement (e.g., in the UK, a Directors' Remuneration Report prepared in accordance with Schedule 7A of the *Companies Act 1985*). The rules generally become effective for fiscal years ending on or after 15 December 2006. The potential effect of the new rules on compliance obligations is a legal matter on which companies should consult their securities counsel.

The rule is available at ***http://www.sec.gov/rules/final/2006/33-8732.pdf***

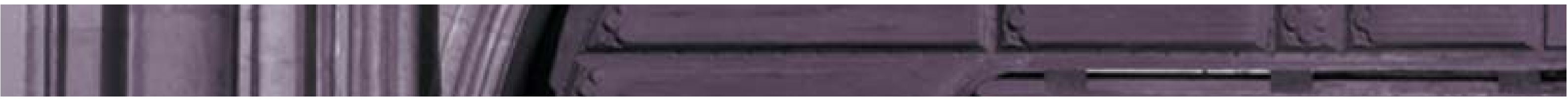
Key developments since Quarterly 10	Title of article	Effective date
UITF 43 *The Interpretation of Equivalence for the Purposes of Section 228A of the Companies Act 1985*	UITF 43 and interpretation of equivalence	Accounting periods beginning on or after 1 January 2005
IAS 36 *Impairment of Assets*	IAS 36 and goodwill impairment	Currently effective

UITF 43 and interpretation of equivalence

The Urgent Issues Task Force (UITF) has issued UITF Abstract 43 "The Interpretation of Equivalence for the Purposes of Section 228A of the Companies Act 1985". The equivalent legislation in the Republic of Ireland is Regulation 9A of the European Communities (Companies: Group Accounts) Regulations 1992 ("Group Accounts Regulations") which provides an exemption from preparing consolidated accounts for intermediate parent undertakings whose parent entity is not established under the law of a European Economic Area (EEA) State, subject to certain conditions. The Abstract has effect for accounting periods beginning on or after 1 January 2005.

In order to qualify for the exemption, the company must either be a wholly-owned subsidiary or the parent must hold more than 50% of the shares and no request to prepare group accounts must have been received from minority interests within six months of the previous financial year end. Exemption is also conditional upon compliance with all of the following conditions:

- the relevant company and all of its subsidiary undertakings (as defined in Regulation 4 of the Group Accounts Regulations and Financial Reporting Standard (FRS) 2) are included in the consolidated accounts for a larger group drawn up to the same date or to an earlier date in the same financial year;
- the larger group's accounts and, where appropriate, the annual report (the equivalent of the UK directors' report) are drawn up in accordance with the relevant EU directives, or in a manner so equivalent;
- the consolidated accounts are audited;
- the company discloses in its individual accounts that it is exempt from preparing group accounts and states the name of its higher parent in whose consolidated accounts it is included and the place of its incorporation (if outside EEA);
- the company delivers to the Registrar a copy of the group accounts together with the annual report (where appropriate) and audit report.



The Abstract addresses whether a higher parent's consolidated accounts are drawn up in a manner equivalent to the directives. Whilst the Abstract notes that EU-adopted International Financial Reporting Standards (IFRS), IFRS and national Generally Accepted Accounting Principles (GAAPs) in EEA States are directives-equivalent, beyond that it does not provide a definitive list of GAAPs considered equivalent. It does however state that, in other cases, equivalence of a set of accounts does not require compliance with every provision of the directives, but only with the basic requirements thereof.

It specifically considers US, Canadian and Japanese GAAPs and states that, subject to three points, they "normally" lead to equivalent accounts. The Abstract does not provide an exhaustive list of potential areas of non-equivalence.

This exemption was introduced into the *Group Accounts Regulations, European Communities (Credit Institutions: Accounts) Regulations 1992* and *European Communities (Insurance Undertakings: Accounts) Regulations 1996* which are applicable to limited companies. There are concerns as to whether it is therefore appropriate for unlimited companies to apply this exemption also. As such, to the extent that directors of an unlimited company are proposing to avail of this exemption, consultation with their legal advisors and auditors is recommended.

The Abstract is available at ***www.frc.org.uk/asb/uitf/pub1181.html***

IAS 36 and goodwill impairment

IAS 36 "Impairment of Assets" requires cash generating units (CGUs) that contain goodwill to be tested for impairment annually and whenever there is any indication of impairment. The standard requires extensive disclosures of the estimates and assumptions used in the calculation of the CGUs' recoverable amounts for the purposes of the impairment test. However, in order to reduce the financial burden of carrying out annual impairment tests, the standard allows the recoverable amount calculated for a CGU in prior periods to be used in the current period, subject to certain conditions being met.

The most recent detailed calculation of the recoverable amount of a CGU to which goodwill has been allocated may be brought forward from a preceding period and used in the current period provided that:

- the assets and liabilities of the CGU have not changed significantly since the most recent calculation of recoverable amount;
- that recoverable amount calculation exceeded the carrying amount of the CGU by a substantial margin;
- the likelihood (based on an analysis of events and circumstances occurring since the last calculation of recoverable amount) that a current calculation of recoverable amount would fall below the current carrying amount of the CGU is remote.

In the event that a company preparing accounts under IFRS as adopted by the EU meets all these criteria, the disclosures of its estimates and assumptions used in calculating the recoverable amount will be based on the recoverable amount from the prior period, i.e., an entity will simply repeat disclosures reported in its prior year accounts.

Events

The latest breakfast seminar hosted by the Audit Committee Institute took place on 24 January 2007 at The Berkeley Court Hotel in Dublin. Speaking at this well attended event were Paul Appleby, Director of Corporate Enforcement, and John Barry, Director of Corporate Broking from Coyle Hamilton Willis.

The seminar covered:

ODCE Guidance for Audit Committees

Mr. Paul Appleby provided an outline of the new legal provisions relating to audit committees in Irish company law following the recent publication of his Office's Guidance on Audit Committees.

His presentation included key aspects of these legal provisions, their impact, potential exemptions under consideration and likely commencement date.

Directors' indemnity insurance

Mr. John Barry provided an outline on key considerations for directors in managing the risk of personal financial exposure for audit committee members following the results of a recent survey showing 78% of respondents were concerned about this potential risk.

His presentation included an overview of Directors' and Officers' liability cover, standard exclusions and key areas to be aware of.

Pictured at the last ACI seminar from left to right:
Paul Appleby, Kevin O'Donovan (ACI Chairman) and John Barry

If you wish to receive a training certificate in relation to attendance at an ACI seminar, please email us at ***info@auditcommitteeinstitute.ie*** or phone us at +353 1 410 1160.

More information on ACI events is available on our Web site:
www.auditcommitteeinstitute.ie/events.htm

Let us know what you think

We are always grateful for feedback regarding topics for breakfast seminars, roundtables and *Audit Committee Quarterly*. Let us know what you would like covered by phoning us at +353 (1) 410 1160 or emailing us at: *info@auditcommitteeinstitute.ie.*

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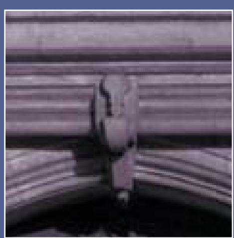

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