

# Audit Committee Northern Ireland

Issue 05

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# Background

Recognising the importance of audit committees, Audit Committee Institute Northern Ireland (ACINI) 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 ACINI 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 ACINI 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 ACINI is now in direct contact with over 500 audit committee members. For more information on the work of the ACINI please click on our Web site: [www.auditcommitteeinstitute.ie/northernireland](http://www.auditcommitteeinstitute.ie/northernireland) or email: [info@acini.ie](mailto:info@acini.ie)



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Welcome





Arthur O'Brien  
Director  
Audit Committee Institute  
Northern Ireland

Welcome to the latest edition of Audit Committee Quarterly Northern Ireland, a publication designed to help keep audit committee members in Northern Ireland abreast of the latest developments in corporate governance, financial reporting and other related matters. For those of you new to Audit Committee Institute Northern Ireland ('ACINI') and this publication in particular, a brief outline of the background to ACINI is set out on the inside cover.

We set out the framework for drivers of Audit Quality finalised by the FRC in February 2008 in **Audit Quality – the FRC Framework** on **page 5**.

John Abbott, Lead Partner for Management Assurance Services in KPMG Europe, discusses **The evolution of risks and controls** on **page 9** explaining that the move from value preservation to value creation is no small step.

John Hansen, Head of KPMG Belfast Restructuring, looks at the issues the board should consider when the company faces a cash crisis in **Companies in Crisis – a whole new ball game** on **page 12**.

**A good auditor helps us ask the right questions** on **page 15** features an interview with Jon Michael Hessels (Board member of Philips Electronics, Heineken and Fortis) on the added value of the external auditor.

In **10 to – do's for audit committees** on **page 19**, we look at those priorities that are likely to be on the audit committee agenda this year.

Given the increased focus on data protection following a number of high profile data losses within the last 12 months, **Data Security – does your organisation actively manage it?** – on **page 21** provides guidance for audit committee members on the processes and procedures companies can implement to minimise the risk of such losses.

Also included are our regular updates on selected financial reporting matters on **page 25** along with an update on emerging **international audit matters** on **page 31**.

I hope you will continue to enjoy the ongoing benefits of ACINI. Please contact us at [info@acini.ie](mailto:info@acini.ie) with any comments or suggestions of topics you would like to see covered and do visit our website at [www.auditcommitteeinstitute.ie/northernireland](http://www.auditcommitteeinstitute.ie/northernireland) where you will find many articles of interest, as well as links to our international sites.



# Audit quality – the FRC framework

*The Financial Reporting Council issued 'The Audit Quality Framework' in February of this year. It has been designed to support effective communication between auditors, audit committees, preparers, investors and other stakeholders on audit quality.<sup>1</sup> The document speaks to a key area of audit committees' activities in overseeing the integrity of companies' financial reporting.*

The Combined Code's description of the audit committee role (below) sets out six areas of activity - noticeably, three focus on the company's internal processes for ensuring the integrity of financial reporting, while the remaining three address the contribution made by its external auditor. Will the auditor add to the confidence of investors and other stakeholders? Will they view the audit as having the right quality to give confidence? Is the audit process effective? 'Quality' is elusive, as philosophers from Plato onwards will testify. So too might audit regulators - the International Forum of Independent Audit Regulators met during April in Oslo, where business

included sharing views on audit quality issues. Hence the issue of a document distilling experience on this point from the FRC and its members and contributors to an extensive consultation process is an interesting adjunct to regulatory rules.

The Framework reflects the FRC's view that audit quality is driven by five key groups of factors – set out in the table overleaf. It also clearly indicates that audit committees (and others) need to consider not only an audit firm's actions but also the effect of the company's own governance arrangement and broader 'environmental' factors outside the audit firm's control.

## Audit committees - Combined Code description of role and responsibilities

- monitoring the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- reviewing the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- monitoring and reviewing the effectiveness of the company's internal audit function;
- making recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements; and
- developing and implementing policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

<sup>1</sup> Financial Reporting Council, the Audit Quality Framework, February 2008. Available at [www.frc.org.uk](http://www.frc.org.uk)

Driver	Indicators
The culture within an audit firm	<p>The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:</p> <ul style="list-style-type: none"> <li>■ Creates an environment where achieving high quality is valued, invested in and rewarded.</li> <li>■ Emphasises the importance of ‘doing the right thing’ in the public interest and the effect of doing so on the reputation of both the firm and individual auditors.</li> <li>■ Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise.</li> <li>■ Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality.</li> <li>■ Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgement.</li> <li>■ Ensures robust systems for client acceptance and continuation.</li> <li>■ Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing.</li> <li>■ Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.</li> </ul>
The skills and personal qualities of audit partners and staff	<p>The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> <li>■ Partners and staff understand their clients’ business and adhere to the principles underlying auditing and ethical standards.</li> <li>■ Partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit.</li> <li>■ Staff performing detailed ‘on-site’ audit work have sufficient experience and are appropriately supervised by partners and managers.</li> <li>■ Partners and managers provide junior staff with appropriate ‘mentoring’ and ‘on the job’ training.</li> <li>■ Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.</li> </ul>
The effectiveness of the audit process	<p>An audit process is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> <li>■ The audit methodology and tools applied to the audit are well structured and: <ul style="list-style-type: none"> <li>- encourage partners and managers to be actively involved in audit planning</li> <li>- provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently</li> <li>- require appropriate audit documentation</li> </ul> </li> </ul>

Driver	Indicators
The effectiveness of the audit process (continued)	<ul style="list-style-type: none"> <li>- provide for compliance with auditing standards without inhibiting the exercise of judgement</li> <li>- ensure there is effective review of audit work</li> <li>- audit quality control procedures are effective, understood and applied.</li> <li>■ High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with.</li> <li>■ The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor.</li> <li>■ The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.</li> </ul>
The reliability and usefulness of audit reporting	<p>Audit reporting is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> <li>■ Audit reports are written in a manner that conveys clearly and unambiguously the auditor’s opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations.</li> <li>■ Auditors properly conclude as to the truth and fairness of the financial statements.</li> <li>■ Communications with the audit committee include discussions about: <ul style="list-style-type: none"> <li>- the scope of the audit</li> <li>- the threats to auditor objectivity</li> <li>- the key risks identified and judgements made in reaching the audit opinion</li> <li>- the qualitative aspects of the entity’s accounting and reporting and potential ways of improving financial reporting.</li> </ul> </li> </ul>
Factors outside the control of auditors	<p>Factors outside the control of auditors which are likely to make a positive contribution to audit quality include:</p> <ul style="list-style-type: none"> <li>■ An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process.</li> <li>■ Audit committees that are active, professional and robust in dealing with issues identified during the audit.</li> <li>■ Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements.</li> <li>■ Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period.</li> <li>■ Appropriate agreed arrangements for any limitation of liability.</li> <li>■ An audit regulatory environment that focuses on the drivers of audit quality.</li> </ul>

Each of these drivers and related factors point to matters for consideration by audit committees as they consider auditor appointment, continuance and other related factors and together form a useful agenda for discussion with the audit firm. They point to substantive issues where a mere 'tick box' approach to carrying out procedures will not, in the FRC's view, get up to the mark needed. Indeed the fact that the methodology used by a firm is merely one amongst five drivers is indicative of the

importance of environmental factors and individual responsibility.

Finally, the Framework also strongly suggests that the FRC believes that audit committees (and others) need to consider the effect of their own actions on audit quality – both in relation to individual companies' own governance arrangements and their contribution towards establishing a reporting environment that supports and does not frustrate efforts by auditors to deliver the quality needed. Food for thought.

Details of the International Forum of Independent Audit Regulators can be accessed via IAASA's Web site at <http://www.iaasa.ie/news/index.htm#d1104>

# The evolution of risk and controls

*Historically, value preservation issues have driven the risk and controls agenda. In today's ever-changing risk environment, with so much time and effort being expended on the management of risk, it is not unreasonable that businesses should now start to expect more of a return from this investment.*

Businesses need to move beyond value preservation and prove that all this investment brings more tangible benefits than just compliance with the latest regulation. However, as John Abbott, Lead Partner for Management Assurance Services in KPMG Europe LLP, explains, the move from value preservation to value creation is no small step.

For years, corporates have thought of risk in purely defensive terms. The challenge was always seen as mitigating – or even

eliminating – risk in an effort to preserve the value of the company. After all, risk is a bad thing is it not? If possible, we'd eliminate the slightest hint of risk in everything we do, wouldn't we?

Well, possibly – but that will never happen.

Instead, some companies have come to realise that a little bit of risk equates to opportunity and have accepted that heightened risk - so long as it is well managed - may be a way of sneaking a competitive advantage over their competitors. Accordingly, more forward-thinking companies now think of risk in offensive terms, rather than defensive terms. They are in the

minority still but they are now thinking about creating value, not just preserving it.

Arguably, there have never been more risks to a business than there are in the current marketplace. Technology, entering new markets, changing consumer habits, new products, dealing with the emerging economies; these are all aspects of business which carry far greater risks than they used to thanks to the effects of globalisation and a more demanding end-user.

*Once you know how much capacity you have to take on further risk, you can then actively pursue the commercial opportunities which your less proactive competitors may be shying away from.*

With so many potential risks out there, it is no surprise that companies have, on the whole, become highly competent in monitoring these risks. From there, with so much risk information to hand, you would be forgiven for thinking that it is one quick, easy step to start

dissecting that information with a view to finding something which could give rise to a competitive advantage.

Sadly, this is not the case. Most companies' default position on risk is to try to avoid it. By all means, they'll be aware of unavoidable risks, they'll monitor them and report on them – but embracing more risk proves a

step too far for many. Instead, they prefer to shy away.

In this changing risk environment, companies need to be able to assess – and quantify - how much risk they are exposed to.

Risk can be quantified in terms of the potential losses to a business which would occur if the worst case scenario relating to a specific risk became a reality. This sort of economic analysis would reveal whether a company could take a hit from every single risk facing it – and yet still emerge, able to keep on trading, on the other side.

Once you know how much capacity you have to take on further risk, you can then actively pursue the commercial opportunities which your less proactive competitors may be shying away from.

We have to accept that there has probably never been a time when corporates have been more sensitive about risk and its implications than they are now. In these post-credit crunch days, there is a burning desire to be completely aware of all the potential risks which could suddenly transform into a wolf at the door.

A recent KPMG survey, *The Evolution of Risk & Controls*, showed that the single most influential factor behind the development of risk and controls within a business was an increased focus on the topic by senior management and the Board. If they're scared of – or unnerved by – risk, then you can't really blame

*If they adopt an appropriate approach to risk management, business leaders can ensure that it makes a significant contribution to value creating activities*

them. The spotlight on risk has never shone more brightly.

However, there is no real correlation between the state of a company's Enterprise Risk Management (ERM) framework and the chances of that company

going bust. The quantification analysis of risk mentioned previously would be a better indication of the likelihood of a company getting into trouble. The ERM framework is merely a mechanism for ensuring that risk is efficiently and effectively monitored across a large organisation. A company could have the most incredible ERM set up but could still ultimately be undone by some rather ill-judged, overly risky decisions made at the highest level.

Such is the intense focus on risk that we're seeing private equity houses ordering complete risk reviews on all the businesses within their portfolios; something which didn't seem so important when the purchases were made a few years ago. Current market conditions have now acted as a catalyst.

The events of the past few months have thrown into sharp focus the increasing power of the ratings agencies in this area. The threat of a company's credit rating being adjusted downwards as a result of perceived failings in its risk frameworks hangs like a sword of Damocles over companies around the world.

This brings us back to a topic which other recent KPMG reports have touched upon; the role of the internal auditor. For too long now, there has been a disconnect between risk and control management teams and a company's internal auditors. The latter can assure the Board that all the risk and control processes are in place and working properly – but who ever decided that they were the right processes in the first place? Are they even monitoring the right risks?

If companies are to turn their management of risk into a more forward-looking, value-creating process, then the internal auditors are key. They need to throw off the shackles of the backward-looking, compliance-driven function which they have performed in recent years and

take a greater role in advising the Board on the company's overall risk profile.

As long as this disconnect exists between internal audit and risk and controls management, then there is a very real problem, right at the heart of company management.

If they adopt an appropriate approach to risk management, business leaders

can ensure that it makes a significant contribution to value creating activities such as finance transformation, merger and acquisition activity, post-merger integration, strategic sourcing and operational improvement – which will make recent investments into risk and control worthwhile.



# Companies in crisis – a whole new ball game

*When a company becomes distressed, the board's responsibility shifts distinctly from shareholders to creditors, writes John Hansen, Head of KPMG Restructuring in Belfast. Faced with the choice of trying to save the business or go into insolvency, both executive and non-executive directors must show an appropriate duty of care to key stakeholders or risk personal liability.*

For most directors, dealing with a troubled business is a once in a lifetime experience for which they are unlikely to be fully prepared. With the company fast running out of cash, they must balance the demands of stakeholders such as shareholders, customers, secured and unsecured creditors, employees, pension trustees and last but not least, the regulators. In such times, executives often turn to the audit committee for guidance, as the body is the custodian of good governance, ensuring that the Board is reporting and behaving correctly.

The Companies and Insolvency Orders are clear that when a business is in cash trouble the directors' responsibility or 'duty of care' is primarily to the creditors rather than the shareholders. The board must ask itself whether the company has a reasonable chance of avoiding insolvency and if not, must do all it can to minimise losses to creditors. One major decision is whether to continue trading; once a business enters insolvency its overall value plummets so by staying in business it can hopefully give existing creditors a better deal. However, directors must also be aware that such a move can prejudice the interests of any new creditors and could potentially expose them to the risks of wrongful trading.

This is the dilemma facing many businesses undergoing a cash crisis. The key decision is whether to carry on trading, despite the directors having concluded that insolvency can not be avoided, as it felt that this course of action could generate better returns for the wider body of existing creditors.

Another legal obligation is to treat all creditors equitably so that no classes or individual creditors are in any way preferred over another.

## **Coping with a new reality**

Directors – both executive and non-executive – will find that their obligations increase substantially when the business is trying to restructure. They have a key role to play and need to take part in meetings with key advisors and possibly regulators. Board meetings also become far more frequent – in some cases increasing to several times a week. This can be a big commitment, especially for non-executives.

The restructuring process itself involves a whole new set of tasks such as creating and implementing a turnaround plan; filling critical leadership positions (and removing unwanted managers); disposing of assets' managing working capital; laying off excess staff and retaining key personnel; managing communications with stakeholders such as creditors and employees, all



*If a board suspects that it might be facing solvency issues, one of the first actions it must take is to secure ongoing specialist advice.*

of whom may be extremely nervous.

The level of workload can take its toll, with directors spreading themselves too thinly and unable to focus on the day-to-day business. Indeed, it is not uncommon for senior management to get caught up in the drama of crisis management and almost completely ignore their day jobs. In such situations the organisation can benefit greatly from the help of turnaround specialists. These professionals can put an action plan into place swiftly and take the kind of tough decisions that may be beyond the incumbent management team, which is often too emotionally committed to existing strategies.

If a Board suspects that it might be facing solvency issues, one of the first actions it must take is to secure ongoing specialist advice (insolvency and/or legal advice), as it could potentially face a challenge from disgruntled stakeholders, or from a Liquidator or Receiver. It is usual in such circumstances for the Board to ask certain advisors to attend Board meetings. Directors are not only risking personal liability for any new credit taken on (should the company continue trading), they also run the risk of disqualification from being a director. In any insolvency procedure there is an obligation on the office holder to assess the actions or inactions of the Directors with a view to concluding on their behaviour. It is important therefore that the decision to cease trading is taken as quickly as possible as the liquidator will always have to file his views as to the conduct of the directors leading up to insolvency and in particular, whether there is any evidence that the directors traded while insolvent. These issues could lead to circumstances where the directors could be disqualified or restricted

from acting as directors in the future.

Resigning is not a viable option. If a company becomes insolvent, a Liquidator will look at the conduct of directors for up to three years prior to the actual date of insolvency.

### **Spotting the warning signs**

With so much to do – and a significant personal responsibility – directors will want to be fully prepared for any cash crisis. Regrettably many fail to read these warning signs, as they are either too wrapped up in day-to-day management or over-optimistic about their ability to stop the rot. Executive management particularly is unlikely to recognise the scale of the issues, and the non-executives can play a crucial role in getting a board to recognise the severity of a rapidly deteriorating situation.

The company is likely to be suffering from a weak operating cash flow, with previous recovery plans failing to deliver. Moreover, with continually falling expectations, directors find themselves having to manage communications from the board to the external world. Under such conditions it does not take too long for such symptoms to become serious problems. The role of the non-executives can be made much more difficult if the information from the executives is being “managed” so that the symptoms are being disguised internally.

Once management has faced up to its challenges, only swift, decisive action can turn the business around and, as mentioned, the organisation may well benefit from additional resources. By taking appropriate steps and getting sound advice, the Board will give itself the best opportunity of preserving value for creditors and avoid making decisions that could have personal repercussions for individual directors.



# A good auditor helps us to ask the right questions

By Jan Klaassen, Chairman of ACI Netherlands

What is the added value of the external auditor? That depends to whom you ask the question. For the audit committee, he is a partner in supervising management and addressing risks. Jan Michiel Hessels, a multiple audit committee member, talks to Jan Klaassen, Chairman of the ACI in the Netherlands, about ways the external auditor can improve his net worth to the audit committee. The committee wants to see an auditor who is of course knowledgeable, but who is also really independent of management and who can and will go on asking questions if necessary. In addition to that, Hessels has several other points on his wish list. "The external auditor could be more proactive".

The primary role of the external auditor appears to be clear and simple: to express an opinion on whether an entity's financial statements are free of material misstatements. But the role of the external auditor does not end there. He is an advisor, a sounding board, a provider of services, a confidant, and he can be an ally or an opponent. The expectations of the [supervisory] board towards the auditor differ from those of management. The first is looking for a partner independent of management, the other for a partner who helps them to stay in control.

Jan Michiel Hessels, former CEO of Vendex KBB, now sitting on the supervisory boards and audit committees of several prominent multinational companies, including

Fortis, Heineken, Philips and NYSE Euronext, recognises the split in roles and responsibilities of the external auditor. "On the one hand, audit committees have seen their workload increase in recent years, after the accounting scandals that led to new regulations and expectations. They want to see an auditor who is of course knowledgeable, but who is also really independent of management and who can and will go on asking unpleasant questions if necessary." Management, on the other hand, has an important say in who is being appointed as external auditor by the shareholders' meeting. "They have to work together and management does not want a watchdog, but a partner who makes sure that the financial statements are correct and who helps them to stay in control."

## Close communication

Hessels believes that good communication is the single most important factor in the relationship between the external auditor and the company he works for. "The world has become more complex, riskier and faster, which increases the risk of miscommunication. For example, after the introduction of Sarbanes-Oxley many companies hired audit firms to implement the necessary controls. This has often been a cumbersome and time consuming process. And costly as well. I know that in some cases fingers have been pointed to and fro; 'couldn't this have been more efficient?' I think this has a lot to do with the communication."

The second example Hessels cites is also from the United States. "If your US subsidiary has trouble with the approval of its annual accounts in the consolidated statements, then the local auditor may also be at risk.

At the same time, he is your partner and you expect him to provide a solution as quickly as possible. The question is whether your local auditor is prepared to also run some risk in his judgement. If he decides to be very formal and waits until you come up with the complete solution and only then will see if it's okay, it will cost the company a lot of time and money."

His conclusion: "the external auditor has to have excellent communicative and empathic skills in order to handle the different interests of management and audit committee as well as his own, and exercise good judgement."

Hessels says he sees no problem in management being closely involved in the selection process of a new external auditor. "They have to work together on a continuous basis so they'd better get along well. At the same time, we have to be sure that the auditor is truly independent and will keep a straight back." He compares the situation with the remuneration process, where top management has an interest in selecting the remuneration consultant who will advise a good remuneration package. "The board must always be

assured that they do not become too close. This is even more relevant with the external auditor because there is more at stake."

The external auditor has to have excellent communicative and empathic skills in order to handle the different interests of management and audit committee as well as his own, and exercise good judgement.

### Critical role

According to Hessels, management and the audit committee, acting in their respective responsibilities, must both be able to rely on the external auditor. The test-case of which is, of course, when there are problems. "Our role as an audit committee is to be critical, which makes no difference whether it's a one-tier or a two-tier board. I really like to have the time to discuss the quarterly results, the claims and the risks. We do not always have that time in the full board, because people like to talk about strategy and the next acquisition. In the audit committee, we go more in-depth. But the audit committee relies to some extent on the external auditor; he really has to know it all. So when we as audit committee members talk with management, we look at the CFO and at the controller but also at the auditor and his body language. Is he comfortable when we ask critical questions, or is he turning in his chair?"



### Thick reports

Hessels cannot suppress a smile when asked if the external auditor's opinion is always sufficiently clear. "Well, at any rate the reports are getting thicker every year! They include long lists of subjects that have received the auditor's attention. Not just the main issues, but everything. Of course this is partly because life has become more complex. But they also want to have things laid on the table lest they be accused of having overlooked something. On balance, I wonder if this is very useful. It leads to longer audit committee meetings, that's for sure!" Hessels also thinks that management is not very pleased with this development. "They don't like the audit committee discussing topics that are not real issues."

Far more important than the exhaustiveness of the auditor's reports, Hessels finds the question whether the external auditor is proactive. "To what extent does he anticipate possible conflicts or problems? I would like an external auditor to also direct our attention to developments that might impact the business. For financial institutions like Fortis, a long period of low interest rates, low inflation and low volatility has come to an end. How will such macroeconomic turning points affect the cost of capital, discount rates, impairments, or the cash value of pensions? The external auditor can play a very valuable role there."

It helps if the auditor understands the business model of his clients, Hessels believes. But he points out that many of these developments are general in nature. "Look at Heineken, where we see the prices of raw materials such as barley and hops rise steeply. Spotting such trends and their impact timely can be very useful." He regards this as an opportunity, although the auditor must be careful not to become involved in risk management, which is the task of the managers. "But he

can demonstrate his involvement and score. It also makes his work much more interesting!"

### Lack of information

Annual financial reports are often criticised for their lack of readily useful information for investors and other stakeholders. Does Hessels think the external auditor should make a judgement about the quality of the annual report as a source of such information? "To my knowledge, audit committees do not check the actual annual report against predefined information and transparency criteria. The risk paragraph is indeed often a long formal laundry list, without any hierarchy. It could be useful to state the risks in order of potential impact. Management may have the tendency to recoil from such explicitness, but the external auditor and the audit committee could certainly play a role there."

Beside the aspect of transparency ("a much-abused term", Hessels thinks) there is the hard requirement of disclosure. "These requirements come to us by law and agreed standards. Apart from that, the level of information is determined by management. But the audit committee, with help from the external auditor, has the task of making sure that things are being disclosed as required. If there is a weakness in some business unit that is likely to become a real problem, then it should be mentioned in the annual report." Hessels thinks that the external auditor should not limit himself strictly to what is required of him by law. "It is a professional, if you wish moral, obligation of the external auditor to address such matters and to start a discussion with the controller and if necessary with the CFO."

### Fraud detection

What the audit committee can expect from the external auditor regarding fraud detection is quite another

matter. On the one hand, Hessels believes the auditor could sometimes do more, on the other hand he recognises that fraud is, by its very nature, very hard to detect without specific investigation. But he can cite some examples where the external auditor could have been more proactive. "When your multinational company is active in a country that is notorious for fraud and corruption and where serious fraud cases come up every year, I find it very strange that the external auditor is always quiet as a mouse. The audit firm often has a local office, so it should be familiar with the local culture and with fraud methods. I would think they could take a more proactive role in helping their client preventing fraud where possible."

Closer to home, Hessels gives an example of property investment fraud which had been going on for years before it was detected. He wonders whether the external auditor could not also have spotted that the recorded revenues were far lower than the market value of the assets.

Although Hessels believes that audit firms could be more proactive when it comes to fraud prevention, he thinks that the external auditor in general lives up to the expectations company management and supervisory boards have of him. "After the scandals that happened around 2000, it was especially the general public and the media who pointed the finger at the auditors and said they had been asleep. But I don't believe many companies felt that way. Having said that, I think that good checks and balances, supported by solid internal and external control systems, are more necessary than ever before. After all, the financial incentives have become so big that more and more people are prepared to cross legal and moral boundaries. More discipline and controls are

needed because the risks have increased. I don't think we need more strict accounting regulation, however. When things go wrong, the cause is almost never a lack of regulation."

### Opportunity

Hessels sees an opportunity for the audit profession in helping companies to extract more benefit from their compliance efforts. "Companies have to spend a lot of time and money to comply with laws and regulations such as Sarbanes-Oxley. In the process, they acquire a wealth of operational and systems knowledge that could be put to use and even create value. Not only from the viewpoint of risk management, but by incorporating this knowledge into the company's operating procedures. A maybe extreme example is private equity investors, who monitor their sales and profit figures almost on a daily basis. Few public companies do that. The external auditors could help their clients to use compliance information and control systems better."

### Jan Michiel Hessels

- Former CEO of Vendex KBB and Deli Universal
- Chairman of the board of NYSE Euronext Inc
- Supervisory board member and audit committee chairman of Philips Electronics NV
- Supervisory board member and audit committee member of Heineken NV
- Vice chairman of the board and chairman risk and capital committee of Fortis NV
- International advisory board member of Blackstone Group
- Supervisory board chairman of Johnson SC Europlant NV

#### Wish list of Jan Michiel Hessels

- ... direct the attention to developments that might impact the business
- ... anticipate possible conflicts or problems
- ... address matters and start a discussion with the controller or the CFO
- ... take a more proactive role in helping clients prevent fraud
- ... help clients to use compliance information productively

# 10 to-do's for audit committees

*When considering their agendas, audit committees should ...*

## **1 Be a catalyst for improving risk management and oversight**

Risk management, and the role of the audit committee and board in its oversight, continues to be at the top of the agenda, particularly for companies potentially affected by the subprime credit crisis. Given the importance of risk management to the company's financial reporting and disclosure processes, the audit committee can be a catalyst in identifying important gaps in the company's risk management arrangements, and in helping to ensure coordination of the oversight activities of the full board and its standing committees.

## **2 Closely monitor management's processes for ensuring adequate disclosure**

The global credit problem is likely to result in greater focus on the adequacy of company disclosures. Management use different means to supervise the company's disclosure processes and ensure the adequacy of its disclosures – a disclosure committee is one such means. Audit committees need to monitor these supervisory mechanisms including, if one exists, the activities of the disclosure committee, making sure that the communications and reports are adequate. Consider face-to-face meetings with responsible individuals and the chairman of the disclosure committee if appropriate.

## **3 Be up-to-speed on fair value, IFRS, and other key financial reporting judgements and developments**

From fair value accounting, to the convergence of IFRS and US GAAP, to critical accounting policies, judgements, and estimates, an ongoing challenge for audit committees will be to understand the implications of important financial reporting developments affecting the company. Given the scope and complexity of this area, consider asking management to cover one key financial reporting matter or development (including key assumptions and estimates) in detail at each audit committee meeting. Ask the external auditor how the item is audited.

## **4 Make sure the CFO and the finance team have what they need to succeed**

With many CFOs playing a leadership role in strategy, risk, IT, M&A, and compliance – and pressures from various stakeholders increasing – the job has become even more demanding. Audit committee support of the CFO and the finance team has become more critical particularly in the areas of: succession planning; evaluations for the CFO and senior finance staff; and the adequacy of the CFO's resources. Audit committees can also provide important support to the CFO by helping to maintain the focus on the long term financial performance of the company as well as the objectivity of financial disclosures.



**5 Ensure there's a shared vision for internal audit**

For many audit committees, it's a real question mark: How involved should internal audit be in risk management and operational audits – while, at the same time, maintaining the requisite focus on internal controls and financial audits? What internal audit should be working on, and whether it has adequate resources and skill sets for the job – particularly given today's tight talent pool – are important areas of focus for the audit committee. Also, reinforce the independence of the internal auditor, and its accountability to the audit committee.

**6 Encourage (expect) frequent, informal communications with the audit engagement partner**

Many audit committee chairs now meet with the engagement partner prior to each committee meeting – or even more frequently – to consider the items that should be the focus of the committee's agenda and to stay abreast of developments. Ask to receive important information on a real-time basis and expect the engagement partner to call to your attention areas of concern before they become major problems. These informal communications are critical to establishing a solid working relationship with the auditor and they can pave the way for more effective formal communications at committee and board meetings.

**7 Be prepared for a crisis**

The media coverage of stock option abuses, the subprime lending crisis, and various allegations of financial accounting irregularities highlights the importance of having a formal plan in place before a crisis occurs – including the ability to implement a credible, independent investigation on a timely basis. When a crisis occurs, the stakes are high, the company's reputation may be on the line and time is of the essence; it is not the time to develop a crisis management plan.

**8 Make sure the full board is aware of the audit committee's activities and needs**

The audit committee's communication with the full board is one of the critical foundations for effective oversight. Given the central role the audit committee plays in the oversight of financial reporting, disclosures, internal controls, risk management and compliance, its communication with the full board is essential. From effective board oversight of risk, to proactively identifying emerging issues, to enabling all directors to understand the factors affecting financial reporting and to have confidence in signing-off on the financial statements.

**9 Assess the tone at the top and throughout the organisation**

Promote a culture of compliance and a commitment to financial reporting integrity throughout the organisation. Consider the adequacy of the processes and vehicles (such as employee surveys) for monitoring the culture throughout the organisation and ensure that the activities of senior management set a clear, unambiguous, and consistent tone in this regard.

**10 Take a hard look at the audit committee's performance**

Effective self-assessments are not easy but they are essential. For a number of audit committees the annual self-assessment process has not been particularly productive and there is work to be done to ensure that the process accomplishes its objectives. Buy-in of all committee members is essential. Engaging the necessary resources and expertise to develop a self-assessment process that works for the audit committee and ensuring that actions are followed up are critical to the success of the self assessment process.



# Data security – does your organisation actively manage it?

By Bernard O'Hara,  
Director Business  
Performance and  
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In the past, occasional stories in the tabloid press of MI5 agents leaving laptops with 'state secrets' in the back of a London taxi may have barely raised an eyebrow, but a number of recent highly publicised instances of mass data loss by organisations in both the public and private sector have brought the issue of data security to the forefront of the public mind. Indeed, the then Finance Minister Peter Robinson announced a full scale review of data protection systems within the Northern Ireland Civil Service in November 2007 which remains ongoing. As a result, the review of data security procedures will be a key issue for the consideration of audit committees going forward.

While many of us may have been aware of the existence of successive Data Protection Acts, introducing the broad requirement for organisations to manage customer data carefully and to use it only for the purposes agreed with the consumer, such high profile data management failures have sharply focused the mind of management towards the need to ensure robust data management and security processes are in place.

Data security failures can be costly both in terms of remedial actions (for example searching for lost data and

communicating with those affected, as seen in the recent loss of CD disks by HM Revenue and Customs), and in terms of reputational loss in the affected organisations. It is thus essential for Audit Committee members to ensure that they are familiar with the principles of sound data management and security to enable them to challenge the processes and controls their organisations have in place to mitigate these risks.

## Principles of sound data security

The Non-Executive director, in their role of holding Executive Management to account, have an opportunity to strongly influence the effectiveness of data security within their organisation. This will be particularly relevant where significant volumes of customer data are

*Data security failures can be costly both in terms of remedial actions... and in terms of reputational loss in the affected organisations.*

maintained, such as in Utility Companies, Banks, Government Departments and Government Agencies – however all companies and public sector organisations should be aware both of the principles of sound data

management, and of their legal obligations under the Data Protection Act.

While strong IT security is an essential ingredient in this process, responsibility for data security does not rest solely with the IT manager –



it extends across all areas of operational management. The Non-Executive, regardless of their personal IT proficiency, may find the following principles useful in challenging Executive Managers on the effectiveness (and pro-activity) of their data management arrangements.

- *Consider whether data security should be included on your corporate risk register*

Best practice for IT dependent organisations would involve identification and management of IT specific risks through an IT Risk Register – and data security is always a key base-line risk in such organisations which requires a corporate level view. Of course, data protection extends beyond IT systems (every Human Resources department will be acutely aware of the need for data privacy) and consequently should be considered as a corporate level risk for all organisations – to be rebutted by senior management in the event that strong data management processes and controls are in place to mitigate risk of loss or misappropriation.

- *Ensure that your organisation has strong IT policies and data security procedures in place and that these are clearly communicated to staff – these should include use and transmittal of data*

A strong IT general control environment is the foundation of ensuring that data is managed securely – as key data sets are often stored on, manipulated and analysed by IT based systems – databases in particular. Policies should cover IT security, backup arrangements, system changes, physical security of key hardware and use of key systems such as email and internet access and should be backed up by detailed procedures – which should be

automated insofar as possible.

- *Ensure that appropriate access controls to key data systems are in place*

Data management policies must be supported by detailed procedures covering network and application access. Management should implement both automated and manual controls. A balance of preventative controls (such as password protection linked to access rights relevant to job functions), as well as detective controls (such as monitoring of failed login reports), should be put in place.

- *Ensure that your organisation has processes in place to ensure regular and secure backup of key applications, and customer data sets in particular*

Backup procedures for key applications which manage key data sets are a key ingredient in ensuring effective control and play a key role in wider Business Continuity processes within almost every organisation. The ability to retrieve data in the event of system failure or data corruption may be key in ensuring that your organisation can continue to function in the event of a major incident. The physical security of system backups, (including storage and access arrangements) must not be overlooked – nor should transportation arrangements to the secure site. Some recent scandals have arisen as a result of complacency when data sets have been outside of their secure systems (which are protected by complex automated controls) – basic mistakes have been made, such as the failure to encrypt data placed on portable storage media.

- *Ensure that appropriate safeguards are in place to ensure that downloads of customer data are tightly controlled and are only*

*processed where absolutely necessary*

Downloads of large volumes of data have become increasingly common in the workplace. Most members of staff will have a personal computer at home and may become blasé about handling data in work – and the widespread ownership of portable storage media (such as memory sticks) has only exacerbated the problem. Auditors too, are increasingly dependent on downloading large data sets from clients.

Management should always challenge whether a system download is absolutely necessary and, where the answer is ‘yes’ – appropriate encryption and access controls should be put in place over the downloaded data.

■ *Safe disposal of hardware, including cleansing of customer data*

The recent sale of a second hand computer on E-bay containing thousands of customer banking details highlights the risks associated with the disposal of IT hardware. Many companies donate used hardware to charity or community groups, and this is a very real benefit for recipients – but care should be taken to ensure that all data is removed prior to sale / donation. This may incur a financial cost for data cleansing (which may need to be carried out by a specialist third party ) but sight should not be lost of the wider benefits relating to corporate social responsibility where such assets may gain a second life.

■ *Develop and enforce policies on access of customer accounts by friends and family*

Policies on access of customer accounts by friends and family should be put in place where data sets relate to customer data – such as call centres, banks or

utility companies (water / electricity / gas). Staff members should be barred from accessing accounts of family or friends in such instances – particularly where there is a risk of fraud e.g. where payments are involved.

Compliance with such policies can be difficult to monitor or enforce and consequently strong policies on such access, coupled with strong deterrents (such as the threat of disciplinary action) and periodic ‘spot checks’ on customer accounts are key.

■ *Ensure that Senior Management are familiar with the main requirements of the Data Protection Act and that a Data Protection Officer is in place*

As noted earlier, there are a number of specific legal obligations arising directly from the Data Protection Act which should be incorporated into the Corporate Data Management policies and procedures – these include:

- Data may only be used for the purpose for which it was collected.
- Data shall be obtained only for one or more specified and lawful purposes, and shall not be further processed in any manner incompatible with that purpose or those purposes.
- Data shall be adequate, relevant and not excessive in relation to the purpose or purposes for which they are processed.
- Data shall be accurate and, where necessary, kept up to date.
- Data must not be disclosed to other parties without the consent of the individual it relates to
- Personal information may be kept for no longer than is necessary
- Entities holding personal information are required to have adequate technical and organisational security measures in place

- Personal information may not be transmitted outside the European Economic Area (EEA) unless the individual whom it is about has consented or adequate protection is in place, for example by the use of a prescribed form of contract to govern the transmission of the data.

Responsibility should be assigned to a Data Protection Officer to ensure that these are clearly communicated to staff and that appropriate compliance measures are in place.

The key principles set out above should assist you, as a Non-Executive, to hold Executive Management to account on this key issue. Active consideration and management of data security is of the utmost importance - the costs associated with breaches of data security, in both financial and reputational terms, are much too great to ignore – don't let your organisation be on the front pages for the wrong reasons!





# Financial reporting update

Key developments discussed in Quarterly 14	Title of article	Effective date
ASB issues a Discussion Paper on the reporting of pensions	The financial reporting of pensions	Discussion paper
Amendments to IAS 32 and IAS 1	Amendments to IAS 32 and IAS 1 – Puttable Financial Instruments and Obligations Arising on Liquidation	Financial years beginning on or after 1 January 2009
IASB issues a Discussion Paper on proposed amendments to IAS 19	Preliminary views on amendments to IAS 19 Employee Benefits	Discussion paper
IASB issues a Discussion Paper on reducing complexity in reporting financial instruments	Reducing Complexity in Reporting Financial Instruments	Discussion paper

## The financial reporting of pensions

In January 2008, the Accounting Standards Board (ASB) issued a Discussion Paper *The Financial Reporting of Pensions* which proposes significant changes to the way pension fund assets and liabilities are measured and presented. Issued under the auspices of the European Financial Reporting Advisory Group (EFRAG), the paper does not propose near-term changes to FRS 17: its intention is to generate debate in this area and influence the International Accounting Standards Board's (IASB) long-term project with the Financial Accounting Standards Board (FASB) regarding IAS 19 pension accounting.

The Discussion Paper proposes a reconsideration of pension accounting

from first principles, including the following areas:

- How pension obligations should be measured, expressing the view that pension scheme liabilities should be discounted using a risk-free rate rather than a high-quality (AA) corporate bond rate. The effect of using a risk-free rate would be to increase pension liabilities. However, the paper also addresses the treatment of future salary increases, suggesting (although mixed views are expressed) that they should not be taken into account when measuring pension scheme liabilities owing to the employer's discretion in making salary increases.

This would reduce pension liabilities, thus mitigating the effect of using a lower discount rate (the actual effect would have to be assessed on a scheme by scheme basis). The debate about future salary increases is related to a proposed focus on the employer's current obligations, which would mean taking into account only benefits it is currently committed to pay.

- Changing the way pension scheme assets and liabilities are presented. The proposals include applying normal consolidation rules to pension scheme assets and liabilities, which would have the effect of presenting scheme assets and liabilities 'gross' in some cases.

- Arguing that the corridor approach in IAS 19 should be abolished (this approach is not permitted under FRS 17) and that actuarial gains and losses should be recognised in the profit and loss account.

The Discussion Paper includes a chapter considering pension schemes' accounts and makes the controversial proposal that they should fall into line with normal accounting principles and include obligation to pay benefits in the future.

The ASB is requesting comment on the Discussion Paper by 14 July 2008, after which it will consider what revisions should be made and submit its final report to the IASB and FASB.

The Discussion Paper and a brief summary can be found at [www.frc.org.uk/asb/technical/projects/project0065.html](http://www.frc.org.uk/asb/technical/projects/project0065.html)

### Amendments to IAS 32 and IAS 1 – Puttable Financial Instruments and Obligations Arising on Liquidation

In February, the International Accounting Standards Board (IASB) published amendments to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial Statements*. (Consequential amendments to IFRS 7 *Financial Instruments: Disclosures*, IAS 39 *Financial Instruments Recognition and Measurement*, and IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* were also issued.)

The Accounting Standards Board (ASB) in March issued an exposure draft of an amendment to its equivalent Financial Reporting Standard (FRS) 25 (IAS 32) *Financial Instruments: Presentation*.

#### Background

The amendments introduce an exemption to the principle otherwise applied in IAS 32 for the classification of instruments as equity; the amendments allow certain instruments that would normally be

classified as liabilities to be classified as equity, if and only if, they meet certain conditions.

#### Amendments to IAS 32

The amendments provide exemptions for two categories of instruments issued by an entity. They are:

- a puttable financial instrument; or
- an instrument, or component of instruments, that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

The amendments define a puttable instrument as "...a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder."

The amendments state that even though a puttable instrument contains an obligation for the entity to deliver cash or another financial asset, it can be classified as an equity instrument, if and only if, it meets a number of specific conditions which are set out in paragraphs 16A to 16B of the revised Standard. In summary, the Standard requires the instrument must have the following features in order to be classified as equity:

- it entitles the holder to a pro rata share of the entity's net assets upon liquidation;
- the instrument is in the class of instruments that is subordinate to all other classes of instruments; and
- all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.

This is not a complete list of the requirements for achieving equity classification of puttable instruments and the specific paragraphs in IAS 32 should be referred to when analysing any instrument under the revised Standard.

#### Reclassification

The amendments specify that an entity should classify a financial instrument that meets the requirements in the amendments as equity from the date when the financial instrument has all the

features and meets all the conditions required. The amendments further specify that an instrument should be reclassified from the date when it ceases to have all the features or meets all of the conditions.

In particular, the amendments explain that when an instrument is reclassified from equity to financial liability then the latter should be measured at the instrument's fair value at the date of reclassification. Any difference between the carrying value of the equity instrument and the fair value of the financial liability at the date of reclassification is recognised in equity.

If the instrument is reclassified from financial liability to equity then the equity instrument should be measured at the carrying value of the financial liability at the date of reclassification.

#### Effective date

The amendments outlined above are effective for annual periods beginning on or after 1 January 2009, however early adoption is permitted.

The scope exemption relating to the classification of instruments is applicable only when accounting for the instruments under IAS 1, IAS 32, IAS 39 and IFRS 7. Consequently, the scope exemption should not be applied when accounting for instruments under other IFRSs, e.g., under IFRS 2 *Share Based Payments*.

Further information on the amendments can be found at

[www.iasb.org/News/Press+Releases/IASB+issues+amendments+to+improve+the+financial+reporting+of+particular+financial+instruments.htm](http://www.iasb.org/News/Press+Releases/IASB+issues+amendments+to+improve+the+financial+reporting+of+particular+financial+instruments.htm)

#### Preliminary views on amendments to IAS 19 Employee Benefits

In March, the International Accounting Standards Board (IASB) published a Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* (DP).

Key changes proposed in the DP as compared to the existing

requirements of IAS 19 include:

- requiring changes in the value of plan assets and post-employment benefit obligation to be recognised when they occur, which therefore would remove the optional 'corridor' deferral method for

recognition of actuarial gains and losses;

- replacing the current distinction between defined benefit plan and defined contribution accounting with two categories of promises with different accounting:
  - defined benefit promises; and
  - contribution-based promises.
- presenting actuarial gains and losses in the statement of comprehensive income, which has been introduced by the revised version of IAS 1 *Presentation of Financial Statements*; and
- changing the unit of account from being based on a promise, which could result in a single plan having multiple elements requiring different accounting.

The IASB's project on post-employment benefits is divided into a short-term and long-term phase. This DP is the first milestone in the short-term phase, which will result in a revised employee benefits standard envisaged for issue in 2011. Thereafter the IASB will work together with the U.S. Financial Accounting Standards Board (FASB), to develop a converged standard, which is the ultimate objective of this project.

The DP addresses the following issues:

#### **Introduction of a new type of benefit promise**

In the DP, the Board proposes eliminating the definition of 'defined contribution plans' under IAS 19. A new type of benefit promise would be introduced, the 'contribution-based promise'. The category of contribution-based promises would include promises with a promised return, commonly described as cash-balance plans; however, a promised return feature is not required. 'Defined benefit plans' would be re-named 'defined benefit promises' and would include any post-employment

benefit promise that is not a contribution-based promise.

#### **Accounting for defined benefit promises, including their presentation**

The DP proposes requiring all changes in the value of plan assets and defined benefit obligation to be recognised in the period in which they occur. The DP also proposes that unvested past service costs should be recognised in the period of the plan amendment. The DP illustrates three approaches for recognising changes in the defined benefit obligation and the value of plan assets:

- all changes in profit or loss;
- service costs, including adjustments made as a result of changes in assumptions to service costs other than those arising from changes in the discount rate, in profit or loss and all other costs in other comprehensive income; or
- all costs in profit or loss except for re-measurements arising from changes in financial assumptions, which would be recognised in other comprehensive income.

Note that the approach of recognition of all actuarial gains and losses directly in equity currently permitted by IAS 19 will no longer be allowed.

#### **Accounting for contribution-based promises**

The DP proposes that both vested and unvested contribution-based promises be recognised as a liability. Liabilities arising from contribution-based promises, i.e., unpaid contribution amounts and promised returns, if any, would be measured at fair value, and that fair value would reflect the entity's own credit risk. While all changes in the fair value of the liability or of any plan assets would be recognised in profit or loss, the portions related to service costs and to other value changes would be disaggregated.

### Accounting for 'higher of' options

If a promise provides an option for the employee of the higher of a defined benefit promise and a contribution-based promise, then the 'host' defined benefit promise would be accounted for as if it were a stand-alone defined benefit obligation. The DP proposes that any additional

potential obligation arising from the 'higher of' option be recognised separately at fair value; however this fair value is determined assuming that the benefit promise does not change.

The IASB has invited comments on any aspect of the Discussion Paper by 26 September 2008.

Further information on the Discussion Paper can be found at [www.iasb.org/News/Press+Releases/IASB+opens+discussion+on+proposals+to+increase+transparency+in+the+accounting+for+post-employment+be.htm](http://www.iasb.org/News/Press+Releases/IASB+opens+discussion+on+proposals+to+increase+transparency+in+the+accounting+for+post-employment+be.htm)

### Reducing complexity in reporting financial instruments

In March, the International Accounting Standards Board (IASB) published Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (DP).

#### Background

The project on reducing complexity in reporting financial instruments is a joint convergence project between the IASB and the U.S. Financial Accounting Standards Boards (FASB).

The overall objective of the project is to develop less complex principle-based standards on the accounting for financial instruments. The purpose of the Discussion Paper is to gather information that will assist the IASB, and also the FASB, in moving forward with this objective.

#### Complexity in accounting for financial instruments

The DP acknowledges that the main complexities in accounting for financial instruments arise from the multiple methods used to measure them and the associate rules. Currently, the appropriate measurement method depends on:

- the applicable standard;
- the categorisation of the financial instrument under IAS 39 *Financial Instruments: Recognition and Measurement*; and

- whether hedge accounting has been applied.

#### Long-term solution to improving and reducing complexity of accounting for financial instruments

The DP suggests that a long-term solution to the objective of this joint project is to have all financial instruments measured at fair value that are within the scope of the financial instruments standard. This single measurement method for all such financial instruments would:

- significantly reduce the complexity in reporting financial instruments;
- make reported information easier to understand; and
- improve the comparability of reported information between entities between periods.

In addition, fair value measurement would result in the following current IAS 39 requirements no longer being required:

- the need to classify financial instruments into the categories of fair value through profit or loss, available for sale, held-to-maturity and loans and receivables;
- accounting for the transfers between such categories; and
- the identification and quantification of impairments.

### Intermediate approaches to improving and reducing the complexity of accounting for financial instruments

The DP recognises that a single measurement method would not resolve all of the current problems and notes that it would not be possible to achieve the long-term solution of measuring all financial instruments at fair value until the following issues have been resolved:

- how to present the effects of changes in fair value in earnings;
- what disclosures are required for financial instruments; and
- the definition of financial instruments in the scope of the standards for financial instruments.

As a result, the DP discusses three intermediate approaches to address the complexity of measuring financial instruments.

#### Amending the current measurement requirements

This approach would involve reducing the number of categories of financial instruments (which are previously mentioned above) and/or simplifying or eliminating some of the current requirements or restrictions, e.g., the tainting rules for the held-to-maturity category or the fair value option.

### Replacing the existing measurement requirements

This approach would involve replacing the existing measurement requirements with a fair value measurement principle, which would make fair value through profit or loss the default category. An exemption would be to measure some financial instruments at amortised cost. This approach would be similar to the accounting treatment proposed in the IASB Exposure Draft of an IFRS for Small and Medium Sized Entities.

#### Simplifying hedge accounting requirements

This approach would involve simplifying hedge accounting requirements by:

- eliminating (or potentially replacing) one or more of the existing hedge accounting models, e.g., replacing the current models with a less complex fair value hedging model; or
- maintaining and simplifying the current hedge accounting models, e.g., changing the requirements for assessing effectiveness, hedging of portions and partial term hedges.

The IASB has invited comments on the Discussion Paper by 19 September 2008.

Further information on the Discussion Paper can be found at [www.iasb.org/News/Press+Releases/IASB+publishes+a+discussion+paper+as+first+step+towards+reducing+complexity+in+reporting+financial+i.htm](http://www.iasb.org/News/Press+Releases/IASB+publishes+a+discussion+paper+as+first+step+towards+reducing+complexity+in+reporting+financial+i.htm)



# International Audit matters



## UK matters

### Review of the impact of the Combined Code

The consultation gives effect to recommendations from the Market Participants Group (MPG) which was established in October 2006 to provide advice to the Financial Reporting Council on market-led actions to mitigate the risks that could arise in the event of one or more of the Big Four audit firms leaving the market. The Group's final report, containing 15 recommendations to enhance the efficiency of the UK audit market, was published last October.

Four of the MPG's recommendations relate to audit committees – hence the proposals for updating and amending the Guidance on Audit Committees (the Smith Guidance), initially published in 2003 to assist boards of listed companies in implementing relevant sections of the Combined Code on Corporate Governance.

The proposed changes arising from the audit market project include requiring that in fulfilling their

responsibilities under the Code, audit committees should:

- consider audit firm's annual transparency reports, where available;
- assess the risks associated with the possible withdrawal of their external auditor from the market and consider whether any mitigating action is appropriate; and
- explain to shareholders how it reached its recommendation to the board on the appointment, reappointment or removal of the external auditors. This should include information on:
  - any contractual obligations that acted to restrict the audit;
  - committee's choice of external auditors;
  - when the audit was last subject to tender; and
  - when the current group auditor was appointed.

Further information on the review of the Smith Guidance can be found at [www.frc.org.uk/corporate/review\\_smith\\_guidance.cfm](http://www.frc.org.uk/corporate/review_smith_guidance.cfm)



## US matters

### New guidance on estimating useful lives of intangible assets

Companies estimating the useful life of a recognised intangible asset must consider their historical experience in renewing or extending similar arrangements or, in the absence of historical experience, must consider assumptions that market participants would use about renewal or extension as adjusted for in FASB Statement No 142's *Goodwill and Other Intangible Assets* entity-specific factors, according to new FASB Staff Position No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*. Market-participant assumptions considered in these useful-life estimates have to be consistent with FASB Statement No 157's *Fair Value Measurements* concept of the 'highest and best use' of the asset.

The Staff Position's guidance replaces Statement 142's requirement to consider whether the company would incur substantial costs or the intangible asset would be materially modified when renewing it. These factors generally tended to weigh in favour of concluding that the useful lives were not indefinite and that the useful lives were shorter. The premise underlying the Board's revised requirement is that the fair-value measurement together with the disclosures made in accordance with the Staff Position will result in conclusions that are more consistent with the entity's intended use of

renewable intangible assets but with the carrying amount limited by the required impairment analysis.

The Staff Position adds the following disclosures to those already required by Statement 142:

- the accounting policy for costs incurred to renew or extend the term of a recognised intangible asset;
- in the period of acquisition or renewal, the weighted average period prior to the next renewal or extension (both explicit and implicit) by major intangible asset class; and
- for an entity that capitalises renewal or extension costs, the total amount of costs incurred in the period or extend the terms of the recognised intangible assets for each period by major intangible asset class.

The Staff Position is effective for financial statements issued for fiscal years beginning on or after 15 December 2008, and interim periods within those fiscal years. Early adoption is prohibited. The requirements for estimating useful lives must be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements must be applied prospectively to all intangible assets recognised as of the effective date.

This section is adapted from KPMG's Defining Issues, April 2008, No. 08-15 *New Guidance on Estimating Useful Lives of Intangible Assets* available at [www.us.kpmg.com/definingissues](http://www.us.kpmg.com/definingissues)

### FASB moves toward elimination of QSPEs

The FASB tentatively decided to remove the qualifying-special-purpose-entity (QSPE) concept from U.S. GAAP and its exception from consolidation, a step that would dramatically increase the population of variable interest entities that companies must evaluate for

consolidation and change accounting for transfers of financial assets. The step would be accompanied by changes in the accounting model for variable interest entities.

The tentative decision envisions deleting the QSPE concept in paragraph 9(b) of

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and simultaneously removing the QSPE exception from consolidation in FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*. It would also amend Statement 140's other qualifications for sale accounting, changing paragraphs 9(a) to explicitly require preparers assessing legal isolation to consider all involvements with the transferred asset by entities within the consolidated group and 9(c) to prohibit sale accounting if the transferor has imposed a constraint on the transferee. These potential changes are likely to increase the number of transactions that fail Statement 140's requirements for sale accounting. The primary potential

consequences of the tentative decision are that the transferors would have to evaluate whether to consolidate any entity to which the assets are 'sold' if the transferor retains an economic interest in the transferred assets, and that transfers would not be accounted for as sales if the transferor imposes a constraint on the transferee under any circumstances.

The SEC's Office of the Chief Accountant has requested that the FASB complete the project in time for the new requirements to be effective no later than fiscal years beginning after 31 December 2008. The FASB plans to issue an exposure draft before the end of June 2008, with a final Statement effective for periods beginning on or after 15 December 2008.

This section is adapted from KPMG's *Defining Issues*, April 2008, No. 08-14 *FASB Moves Toward Elimination of QSPEs* available at [www.us.kpmg.com/definingissues](http://www.us.kpmg.com/definingissues)

### Separate accounting for the conversion options of many convertible bonds

Issuers of convertible debt that may be settled wholly or partly in cash upon conversion will have to account for the debt and equity components separately, under new FASB Staff Position No. APB 14-1. The requirements for separate accounting must be applied retrospectively to previously issued cash-settleable convertible instruments as well as prospectively to newly issued instruments, negatively affecting both the net income and earnings per share for issuers of the instruments.

The Staff Position applies to any convertible instrument that upon conversion may be settled wholly or partly with cash. This scope is broader than applicability only to the specific instrument that originally drew standard-setting attention, a type of convertible debt instrument that receives less dilutive EPS treatment than many other convertibles and is called 'Instrument C.'

The primary characteristics of Instrument C are that when it is

converted, the issuer must settle the par value of the debt in cash and may settle the conversion spread (the excess conversion value over par) in either cash or stock. The primary characteristics of the other two most common types of convertible debt within the scope of the Staff Position, identified by the names frequently used in practice to designate them, are as follows:

- Instrument B: The issuer at the time of conversion may settle the entire obligation either in stock or cash equivalent to the conversion value.
- Instrument X: The Issuer at the time of conversion may settle the entire obligation in any combination of stock or cash equivalent at the conversion value.

The FASB concluded that the new guidance was necessary because current requirements do not capture the value of the conversion feature at

issuance as a borrowing cost (i.e., it does not increase interest expense), and its full possible dilutive effect is not included in the denominator of earnings-per-share calculations. The Staff Position is intended to remedy those concerns by requiring cash-settleable convertibles to be

separated into their debt and equity components at issuance.

The new model for cash-settleable convertible instruments is effective for financial statements issued for fiscal years beginning after 15 December 2008.

This section is adapted from KPMG's Defining Issues, May 2008, No. 08-17 *New Accounting for Many Convertible Bonds* available at [www.us.kpmg.com/definingissues](http://www.us.kpmg.com/definingissues)

### Proposed disclosures about postretirement benefit plan assets

Employers of public and non-public entities would have to disclose more information about assets held in postretirement benefit plans, including concentrations of risk, fair-value measurements by major category of plan assets, and the fair-value techniques and inputs used to measure plan assets, under proposed FASB Staff Position No. FAS 132(R)a *Employers' Disclosures about Postretirement Benefit Plan Assets*. The proposal would also require non-

public entities to disclose net periodic pension cost.

The new requirements would amend FASB Statement 132R, *Employers' Disclosures about Pensions and Other Postretirement Benefits*.

The Staff Position would be effective for fiscal years ending after 15 December 2008. Early application would be prohibited. Comments on the proposal were due by 2 May 2008.

This section is adapted from KPMG's Defining Issues, April 2008, No. 08-11 *Proposed Disclosures about Postretirement Benefit Plan Assets* available at [www.us.kpmg.com/definingissues](http://www.us.kpmg.com/definingissues)

### New disclosures about derivative instruments and hedging activities

Companies must disclose the fair value of derivative instruments and their gains or losses in tabular format and information about credit-risk-related contingent features in derivative agreements, counterparty credit-risk, and strategies and objectives for using derivative instruments, according to new FASB Statement No. 161 *Disclosures about Derivative Instruments and Hedging Activities*, which amends and expands FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Statement 161 requires companies with derivative instruments to disclose information that should enable financial-statement users to understand how and why a company

uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133, and how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows.

The new requirements apply to derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under Statement 133.

Statement 161 is effective for financial statements issued for fiscal years and interim periods beginning after 15 November 2008. Early application is encouraged.

This section is adapted from KPMG's Defining Issues, March 2008, No. 08-10 *New Disclosure about Derivative Instruments and Hedging Activities* available at [www.us.kpmg.com/definingissues](http://www.us.kpmg.com/definingissues)

## SEC matters

### SEC proposes amendments to foreign issuer reporting requirements

In February, the U.S. Securities and Exchange Commission (SEC) agreed to propose changes to its current filing requirements for foreign private issuers (FPIs). Key aspects of the proposal include:

- accelerating the reporting deadline for annual reports filed on Form 20-F by FPIs from six months to 90 days after the issuer's fiscal year-end for large accelerated filers, and to 120 days after the issuer's fiscal year-end for all other issuers, allowing a two-year transition period;
  - amending Form 20-F to require disclosure in annual reports with respect to:
    - changes in and disagreements with the registrant's certifying accountant;
    - fees, payments and other charges relating to American
- Depository Receipts;
- significant differences in corporate governance practices compared to U.S. registrants; and
  - financial information on completed acquisitions that are significant at the fifty percent or greater level, measured according to Rule 1-02(w) of Regulation S-X.
- revising when reporting foreign issuers are required to assess their eligibility to use the FPI special forms and rules to once a year on the last business day of their second fiscal quarter, rather than on a continuous basis, which is required currently; and
  - amending Form 20-F by eliminating the current requirement that permits certain FPIs to omit segment data from their U.S. GAAP financial statements.



## EU matters

### Equivalence of financial reporting standards

December 2007 saw a development in the EU's consideration of "equivalence" of non-EU financial reporting standards in the context of financial information issued by listed companies with the issue of Commission Regulation (EC) No 1569/2007.

The Regulation sets out conditions under which the Generally Accepted Accounting Principles (GAAP) of a country outside the EU may be considered equivalent to International Financial Reporting Standards and a mechanism for determining equivalence, in order to meet requirements of Article 23(4) of Directive 2004/109/EC (the Transparency Directive).

The key criteria in the Regulation requires that "other" GAAPs should result in financial statements that:

*"enable investors to make a similar assessment of the assets and*

*liabilities, financial positions, profit and losses and prospects of the issue as financial statements drawn up in accordance with IFRS, with the result that investors are likely to make the same decisions about the acquisition, retention or disposal of securities of an issuer."*

Specific commitment is given in the preamble to reaching agreement on equivalence of US, Canadian and Japanese GAAP. The latter has made significant steps towards IFRS recently and the Accounting Standards Board of Japan is actively pursuing a work programme to achieve convergence.

Determinations that a non-EU GAAP meets that requirement will be publicised by the Commission and various conditions are set out to allow for conditional acceptance of a particular GAAP during a period of convergence with IFRS.

### Implementing the 8th Directive

Charlie McCreevy, European Commissioner for Internal Market and Services, has set out an action plan to support implementation of the 8th Directive, also known as the Statutory Audit Directive.

The 8th Company Law Directive was adopted in May 2006 and comes into effect on 29 June this year. The Directive sets out a framework of principles which Member States are to implement into their national legislation – but is also based on the underlying premise that the European Union will continue to focus on some specific policy areas - such as auditor liability, International Standards for Auditing, inspections of audit firms, and relations with non-EU countries – across all member states. In a speech to the EU Legal Affairs Committee, Mr McCreevy outlined key areas of focus and measures to support effective implementation of the Directive. Areas covered in the Commissioner's plan are set out below.

#### Auditor Liability

The European Commission has issued a Recommendation concerning the limitation of auditors' civil liability. Its main purpose is to encourage the growth of alternative audit firms in a competitive market. The Recommendation responds to the increasing trend of litigation and lack of sufficient insurance cover in this sector. It aims to protect European capital markets by ensuring that audit firms remain available to carry out audits on companies listed in the EU. The Recommendation leaves it to Member States to decide on the appropriate method for limiting liability, and introduces a set of key principles to ensure that any limitation is fair for auditors, the audited companies, investors and other stakeholders. This initiative arises from a mandate in the 2006 Directive on Statutory Audit to examine the issue of limitation of financial liability and to present

recommendations to Member States where appropriate.

Internal Market and Services Commissioner Charlie McCreevy said: "After in-depth research and extensive consultation, we have concluded that unlimited liability combined with insufficient insurance cover is no longer tenable. It is a potentially huge problem for our capital markets and for auditors working on an international scale. The current conditions are not only preventing the entry of new players in the international audit market, but are also threatening existing firms. In a context of high concentration and limited choice of audit firms, this situation could lead to damaging consequences for European capital markets."

The Recommendation proposes three examples as possible methods but any other equivalent method might be used. The selected method should best suit the Member State's legal environment.

The Recommendation also introduces key principles to be followed by Member States when they select a limitation method:

- The limitation of liability should not apply in the case of intentional misconduct on the part of the auditor;
- A limitation would be inefficient if it does not also cover third parties;
- Damaged parties have the right to be fairly compensated.

The Recommendation is available at: [http://ec.europa.eu/internal\\_market/auditing/liability/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/liability/index_en.htm)

#### Ownership restrictions

The issue of the way audit firms are structured has been the subject of considerable attention internationally and within individual member states – witness the FRC's consideration of the issue in the UK. An external study

carried out for the Commission suggests that a relaxation of ownership restrictions in the audit profession could help reduce market concentration – though there are also fears that such a step could cause a drop in audit quality and risk to auditor independence. A public consultation on this issue was united by the council following the publication of a discussion paper in May 2008

#### **Audit Quality and Inspections**

The 8th Directive sets out a number of criteria for quality assurance including systems independence from the reviewed auditors and firms. To assist effectiveness and even implementation, issue of an EU Recommendation on the independence of inspections of audit firms who are engaged in the auditing of listed companies is proposed – which the Commissioner indicated will give more responsibilities to the public oversight bodies and limit the role of professional bodies and practitioners in the inspection process.

#### **The Implementation of the Statutory Audit Directive by Member States**

Timely and accurate implementation of the Directive – not merely transposition into local law but without “gold-plating” – is the aim. To support its achievement, a “scoreboard” of the implementation of the 8th Directive will start in Spring 2008 describing where Member States stand, particularly as regards the establishment of an independent public auditor oversight.

#### **International Standards on Auditing (ISAs)**

Under Article 26 of the 8th Directive, the Commission may make ISAs mandatory for the European Union. Mr McCreevy’s speech indicates clear support for working towards that position, but raised questions about timing, for a number of reasons:

- the IAASB is currently part way through its “Clarity Project”, intending to define more clearly which parts of the ISAs should be mandatory standards and which parts are guidance for the auditing profession. The EU is taking an active part in that process – but results will not be seen before the end of 2008. At the same time, some concerns relating to the governance of IAASB and its accountability remain;
- the Commission is also assessing the costs and benefits of applying ISAs across the UK. Two studies, one by the Duisburg-Essen University and the other by Maastricht University, were commissioned towards the end of December, with results expected by early 2009.

We can therefore expect to see continued activity by the Commission during the coming year, but a final decision on the application of ISAs is unlikely before 2009.

#### **Co-operation with Third Countries**

The 8th Directive requires Member States to monitor the quality of the audits of a number of third country companies listed on European markets and audited by their auditors in their home jurisdictions by exercising oversight over those auditors. To allow an orderly approach to this rather thorny and difficult issue, a transitional period is proposed of up to 1 January 2011 – with recognition given to firms who provide appropriate information – and allowing the Commission space to assess the equivalence of third countries which already have public oversight systems in place and will discuss progress with other third countries which show a potential to move towards such a system.

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