

Audit Committee Institute

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Audit Committee Quarterly

www.auditcommitteeinstitute.ie

Issue **13**

Local regulatory update

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Background

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

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

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

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

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

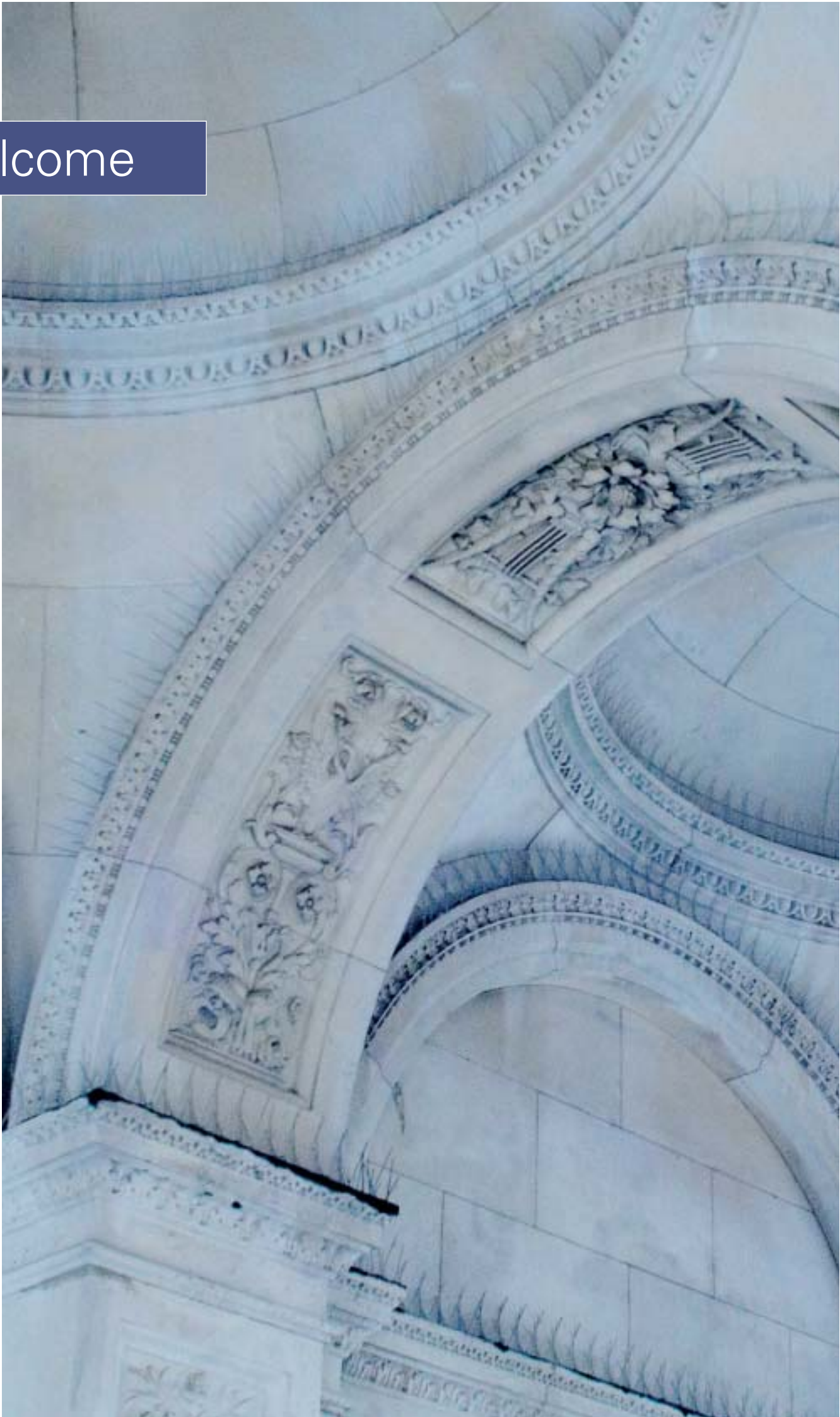
The ACI is now in direct contact with over 1,000 ACI members. For more information on the work of the ACI, please click on our Web site at www.auditcommitteeinstitute.ie or e-mail at info@auditcommitteeinstitute.ie



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Welcome





Kevin O'Donovan
Chairman
**Audit Committee Institute
Ireland**

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

A round up of **local regulatory developments** since our last edition is included on **page 4**.

Principles or rules in the quest for a global reporting language on **page 6** takes a brief look at the future development of IFRS and it's convergence with US GAAP.

What gets measured gets managed – a new approach to assessing board performance on **page 9** discusses a new approach to the measurement and assessment of board performance.

In light of the current economic climate, we propose some **Key questions for audit committees** to consider on **page 12**.

Also included is our regular round up of regulatory developments locally (**page 14**) and internationally (**page 16**) together with an update of selected financial reporting matters (**page 24**).

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

Local regulatory update

There has been little change in regulatory requirements affecting Irish business and audit committees outside developments in financial reporting driven by the continual update of IFRS and the welcome recognition by the SEC of IFRS-based financial statements.

As business for 2008 gets underway, we can look forward to seeing a number of developments in legislation – in particular company law, taking forward the Heads of the Consolidated Companies Bill developed by the Company Law Review Group and incorporating provisions of the 8th Directive. The Financial Reporting Council has also been active in considering a number of issues affecting financial reporting and governance of listed companies in the UK and Ireland. But first, boards and audit committees will be focussing on issues in reporting 2007 results in an environment that is considerably more challenging than has been seen for some time.

Boards and audit committees will be focussing on issues... in an environment that is considerably more challenging than has been seen for some time

Activity by the Director of Corporate Enforcement to monitor and encourage adherence to the requirements of current company law continues and the Director's Report for 2007 has recently been issued. The Report shows – outside the area of property management companies, where the Director proposes to issue a "Governance Handbook" - improving levels of compliance. This is matched by a 28% drop in the number of cases on hand following "whistle blowing" reports to the Director by auditors and others. New reports by auditors in 2007 show a drop of 32%. The Report is available on the ODCE Web site at www.odce.ie.

Outside company law, key developments to note on the regulatory front include legislation affecting charities – for the first time in Ireland – and an update of anti-money laundering requirements resulting from implementation of the 3rd Money Laundering Directive.

Charities Bill

November 2007 saw the completion of the first stage of a Charities Bill which will establish a significant new

Regulatory Authority together with a body of rules relating to the way charities are established, raise funds and account for their use. Though it will directly affect only the not-for-profit sector, the Bill will be of interest to businesses and boards who already

support – or are considering supporting – charitable and philanthropic organisations.

Included in the proposed legislation is a definition of charitable purposes. For an organisation to be given recognition as a charity in future, its trustees will need to be able to demonstrate that its activities meet the relevant criteria, set out in the Bill as:

- prevention or relief of poverty or economic hardship;
- advancement of education;
- advancement of religion; or
- other aims that are of benefit to the community.



Charities Bill

Purposes that benefit the community

- advancement of community welfare
- advancement of community development
- promotion of civic responsibility
- promotion of health
- advancement of conflict resolution
- promotion of religious or racial harmony
- protection of the environment
- prevent or relief of suffering of animals
- advancement of arts, culture, heritage or sciences
- integration in society of those who are disadvantaged

The last point is an open-ended category but the Bill also sets out a number of purposes that are specifically recognised as being “of benefit to the community” – see Table A.

Other key aspects of the proposed legislation include:

- prevention or relief of poverty or economic hardship;
- new requirements for the preparation and audit of charities’ accounts;
- obligations on charity trustees to submit annual reports to the new Authority; and
- new rules relating to fund-raising.

More information on the Bill can be obtained from the Department of Community, Rural and Gaeltacht Affairs at www.pobail.ie/en/CharitiesRegulation/KeyMilestonesLatest

3rd Money Laundering Directive

Legislation transposing the 3rd Money Laundering Directive has been issued in draft form. The Directive introduces a number of changes in the overall direction of anti-money laundering legislation.

First, the Directive requires boards of financial institutions and other entities currently regarded as “designated bodies” to put in place adequate policies and procedures to assess and respond to the risk of money laundering activity. These include new requirements relating to customer due diligence, reporting and record keeping, risk assessment and management and internal controls.

The Directive requires boards... to put in place adequate policies and procedures to assess and respond to the risk of money laundering activity

Additionally, the Directive’s emphasis on a risk based approach will require a reassessment of existing procedures. The Directive allows a graduated approach to identifying customers – introducing the broader term “customer due diligence” to describe the process of obtaining reasonable evidence of a customer’s true identity and the nature of its business and expected transactions – but also requires a more “risk-responsive” approach, including:

- identification of beneficial owners;
- specific requirements relating to “politically exposed persons”;
- on-going monitoring of customers and their activities sufficient for the business to assess money laundering risks that may be present and determine an appropriate approach to their management.

The Consultative Committee of Accounting Bodies-Ireland has been actively assessing the impact of the Directive and working with other designated bodies with a view to guidance being available on a timely basis to support implementation of the new legislation – though clearly much will depend on the actual form of legislation presented to the Oireachtas by the Departments of Finance and Justice, who are jointly involved in its development of the legislation.

Transposing legislation was brought into effect in the United Kingdom from 15 December 2007. Guidance has been issued by the UK Joint Money Laundering Steering Group and is available from www.jmlsg.org.uk/bba/jsp/polopoly.jsp;jsessionid=aYa1hN1Ntql5?d=749



Table A

Principles or rules in the quest for a global reporting language

Based on the developments in IFRS to date, there appears to be an expectation amongst many that as the standards converge with US GAAP there will be some movement towards a more rules-based approach.

There is a widespread sense of encouragement at what is perceived to be a positive stance being taken by the SEC in the US, with the recent decision by the SEC to eliminate the requirement for a reconciliation, and the real prospect that US companies will be allowed to choose to report under IFRS themselves. This prospect brings with it the problem that the US system is founded on a mass of complex rules created by a more legalistic culture, and ultimately to create one global financial reporting language, will mean a shift further towards the rules-based approach of the current US standards.

For some, IFRS has already meant that the old principles of UK and Irish GAAP have become less centrally enshrined. It is clear that complexity and details are still at the root of worries about IFRS. The concept of “substance over form” used to be embedded but there is nothing in IFRS to replace this concept. Ruaidhri Gibbons, head of audit at KPMG in Ireland, said a drift towards a rules-based approach had already started and that the financial reporting community globally needs to “find a way of stripping back...complexity, and of ensuring that sound accounting principles are allowed to drive reporting, without the need for dense disclosure notes or a narrow rules-driven approach.”

Sir David Tweedie, chairman of the International Accounting Standards Board (IASB), says that we are at a “tipping point”. “I hope the principles-based approach will gain

the upper hand,” he said. “Certainly that’s what we are intending to try. If we lose it now then we will be rules-based.”

Robert Herz of the US Financial Accounting Standards Board (FASB) said he preferred the term “outcome-based” to “principles-based” and added “In the US we are setting principles in the standards and beginning to use bold-facing. And on all the major areas we are working on now we are working with the IASB so hopefully they will be more principles-based.”

“It is down to all of the stakeholders”, says Mary Tokar, head of the IFRS Group at KPMG. “It is down to the standard-setters and the regulators. As auditors, it is a question of how much we say we want principles and then ask for rules”. This worry extends right across the corporate process.

There is not enough genuine desire for a principles-based approach outside of the UK and Ireland. There is a view that companies don’t like principles and that they approach the regulator asking for more rules, and as a result the pressure will grow to make IFRS more comprehensive. The consequence of companies being held accountable will be a tendency towards rules-based standards gaining the upper hand.

Some movement is widely seen as inevitable. According to Ruaidhri Gibbons, “the US rules-based approach may move a little bit and we will also move a bit. I’d like to



think we will end up with more judgment...I fear we will move closer to a rules-based approach but hopefully not very far."

John Hegarty of the World Bank observed that "there is a need for regulators to be firm but also to hold back to allow judgments to be applied. We would need to be very clear as to who gets to make the final judgment... I don't think we have finalised enough of these details on an operational basis yet."

Narrative reporting is strongly endorsed, as a vital and increasingly important component of financial reporting. According to analysts, it is important that management give their view of the world outside accounting constraints.

Looking to the future, many believe that stability and simplification should

it is important that management give their view of the world outside accounting constraints

be the first priorities for standard-setters. However, there are other issues to be considered, such as the IASB's Conceptual Framework and this needs to be put in place in the short to medium term.

For Sir David Tweedie, the main priority is to "hand back accounting to the practitioners. We need to get the standards to reflect what people feel intuitively and we need them to be in simple language...We need to cut through the garbage and provide the raw facts."

Ruaidhri Gibbons said that preparers and auditors need to be able to "exercise judgment and integrity" and added "I am confident about what can be achieved – provided a focus is retained on serving the needs of the users of financial accounts."

This article is based on commentary published in the UK's *ACI Quarterly* publication in September 2007.





What gets measured gets managed – a new approach to assessing board performance

Richard LeBlanc, a commentator and researcher on corporate governance, and Mark Jones, Partner, KPMG in Australia discuss a new approach to the measurement and assessment of board performance.

Many evaluations of corporate board performance rely heavily on the structural characteristics. Yet experienced company directors and shrewd observers of the corporate scene know that structural elements are a necessary but not sufficient condition for board effectiveness.

They appreciate that information on structural condition tells us a limited amount about how boards actually work and how they make informed decisions. They understand that the structure of a board is

an imperfect indicator of how well it undertakes its primary responsibility - to create and preserve shareholder value. Thus some boards that

exhibit all the structural indicators of good governance can fail, while others that might be seen to be deficient by structural measures of good governance, manage to perform exceptionally well over long periods.

Conventional structural measures of corporate governance are limited in much the same way that traditional financial reporting is limited. Financial data which underpins the valuation of public companies tells only part of the story. The "value" of non-financial factors will also affect an organisation's ongoing performance, and will be built into its market valuation. Likewise, there are elusive intangible or 'soft' elements of board

performance that are difficult to measure, but will certainly affect the quality and effectiveness of an organisation's governance performance. And if these elements do not get measured, there is a good chance that any potential for improvement will not get managed.

So how should boards go about measuring the quality of their own performance - beyond the structural aspects - and how might this process be managed to ensure that the board is performing adequately?

how should boards go about measuring the quality of their own performance...

Many boards and board advisers have begun to look for better and tougher ways of measuring and managing board

effectiveness. In doing so, boards are considering what their own "effectiveness" means and looks like.

To support this introspection, we suggest there are three key attributes of board effectiveness that are currently not measured well. We call them the three Cs of board performance.

- **Chair effectiveness.** Measuring the leadership behaviours of the chairman and how that individual conducts board meetings and facilitates board decision making.
- **Competency of directors.** Exploring the competencies that directors need to bring to the boardroom.



- **Chemistry.** Understanding the personal interaction between directors and the group dynamics of the board, including their contribution to effective decision-making.

Of course, any framework for measuring board effectiveness should exhibit certain qualities if it is to be applicable in real-world boardrooms. These qualities constitute our five Cs of board performance assessment.

- 1 **Convenient.** Frameworks should be rigorous, but easy to execute. They should be user friendly, but make negligible impact on directors' workloads.
- 2 **Confidential.** They should encourage candour in a confidential environment.
- 3 **Constructive.** The results of a board assessment should be considered in a proactive manner that discourages finger pointing, but encourages discussion about opportunities for development.
- 4 **Comparative.** Board effectiveness should be assessed against prior periods and against other boards in other organisations.
- 5 **Comprehensive.** A holistic, integrated and detailed assessment of board function and performance.

Based on our own observations and other studies, we believe few board assessments measure the three Cs of board performance effectively using the five Cs of board performance assessment criteria. New holistic approaches by external facilitators can, however, help boards assess more objectively the intangible or "soft" attributes of superior performance.

Any framework for measuring board effectiveness should exhibit certain qualities if it is to be applicable in real-world boardrooms

The external facilitator is typically able to provide a structured, rigorous, comprehensive, yet constructive, board self-assessment process involving a measurable

(through self-assessment surveys and benchmarking) and qualitative (through individual director interviews, Chairman feedback and facilitated boardroom discussion and debrief) evaluation approach that builds on the strengths of and helps manage developmental opportunities for the board.

To give some flavour of such an approach, below provides an insight into the questions boards should usefully ask of themselves in assessing their performance (focusing on the three Cs).

The three Cs of board performance

1. Chair effectiveness

- Does our chairman have an effective personal leadership style? Is he/she courteous, inclusive, sensitive, yet decisive?
- Is our chairman building healthy boardroom dynamics? Is he/she relating well with directors and management, dealing effectively with dissent and working constructively towards consensus?
- Does the chairman oversee an effective decision making process? Does he/she ensure that for crucial decisions alternatives are considered, thorough discussion and analysis is encouraged and different perspectives are brought to bear? Are we satisfied that the best decisions are being made and that these are being subsequently supported by the board?
- Does the chairman ensure the board's workload is properly managed?
- Are our committee chairs properly discharging their responsibilities, marshalling resources and expertise, and providing appropriate reporting and recommendations to the full board?
- Do we choose our board and committee chairs based on appropriate criteria? Are we

properly considering the responsibilities of the position, including the ability, experience and expected performance of the candidate?

- Are our board and committee chairs setting a good example to the board and holding us all to appropriately high standards?

2. Competencies of directors

- In considering the appointment of new directors, does the board consider any gap between its current competencies and those likely to be required in the future?
- Are our processes for recruiting new directors working well? Are we taking account of prospective directors' character, ability, expertise, experience, behaviour and the ability to devote sufficient time to the job? Are candidates' credentials and references checked prior to appointment?
- Do the qualities of our directors as a whole - their ability, expertise, experience and knowledge of the organisation – match the future strategic needs of the organisation?
- Is the ability and experience of board committee members appropriate to the needs of the committees?
- Do our directors exhibit a high level of integrity, including maintaining the confidentiality of board proceedings and appropriately disclosing and managing any conflicts of interest?
- Are directors receiving relevant

education and training, including internal company briefings and site visits, presentations from independent advisers and relevant external courses and conference?

- Is inadequate performance or commitment on the part of individual directors being promptly addressed through peer remediation or intervention by the chairman?

3. Chemistry

- Does our board work constructively as a team through collegial, productive working relationships that foster trust and respect?
- Is the effectiveness of our collective decisions as a board greater than the sum of individual director contributions?
- Do I know as much about the qualities of my fellow directors as I do about those of our CEO?
- Do our board discussions enhance the quality of management decision-making? Do we engage constructively with management to stimulate its thinking and performance?
- Does the board respond appropriately to management, building trust and encouraging openness and candour?
- Does management's involvement in board meetings contribute to the board effectiveness?
- Do the chairs of our board committees maintain positive working relationships with the relevant managers?

This article is written by Dr Richard Leblanc, a commentator and researcher on corporate governance, and Mark Jones, Partner, KPMG in Australia. Dr Leblanc has advised boards and executives from organisations in the US, Canada, the UK, Australia, New Zealand, Europe, Russia and China.

This article first appeared in ACI (Australia)'s Across the board, Issue 12, December 2006.

Key questions for audit committees

As a result of the current liquidity crisis emanating from the sub prime mortgage difficulties in the United States and the consequent challenges to be faced in valuing securities, the Financial Reporting Council have issued a list of questions that should be considered by audit committees when reviewing financial statements. This list is not exhaustive but more intended to stimulate consideration and discussion of the relevant issues

Area of consideration	Part 1 – Key questions of a general nature
Risk management procedures	<p>Are the risk management procedures adequate to identify and evaluate all relevant risks and exposures across the group on a timely basis?</p> <p>To what extent is there a heightened risk of manipulation of reported financial results, or balance sheet presentation? How have these risks been mitigated?</p> <p>Are group and local management competent to identify and address the business and reporting risks including the exposure to third parties adversely affected by the current market turbulence?</p> <p>Does the group finance function have sufficient skill, experience and resources to prepare the annual report in the current circumstances?</p>
Year end planning considerations	<p>Is the audit committee adequately briefed on key issues?</p> <p>Is the group reporting timetable realistic both in terms of meeting investor expectations and ensuring that all issues are properly addressed?</p> <p>Are the accounting policies comprehensive and still appropriate?</p> <p>Is there any evidence that current developments have any implications for information reported in prior periods?</p>
Year end reporting - going concern and funding facilities	<p>How will the board satisfy itself that it is appropriate for the financial statements to be prepared on a going concern basis? How realistic are the assumptions underlying the cash flow forecast?</p> <p>To what extent is there dependence on short-term borrowings or other short term finance? Are there any defaults on covenants? What steps are in place to deal with any funding deficiencies?</p>
Year end reporting – business review	<p>Does the business review present the risks, particularly the financial risks, associated with the group’s activities in a fair way?</p> <p>Is the business review consistent with the rest of the annual report?</p>
Key accounting issues	<p>Has detailed consideration been given to identifying impairments of businesses or other assets impacted by current events?</p> <p>Has due care and diligence been applied in valuing financial and other assets reported at fair value?</p> <p>Has market volatility impacted the effectiveness of hedges subject to hedge accounting?</p> <p>Have appropriate disclosures in relation to financial instruments been made in accordance with relevant accounting standards?</p>

Key accounting issues cont'd	<p>Does the group audit plan adequately assess the current risks? Have the auditors allocated sufficient resources including the involvement of experts to the audit?</p> <p>Have the auditors provided any ad hoc services or advice which could compromise their independence and objectivity in light of current market circumstances?</p>
Auditors	<p>Does the group audit plan adequately assess the current risks? Have the auditors allocated sufficient resources including the involvement of experts to the audit?</p> <p>Have the auditors provided any ad hoc services or advice which could compromise their independence and objectivity in light of current market circumstances?</p>
Area of consideration	Part 2 – Key questions of a general nature
Lending and loan losses	<p>Has management prepared a thorough assessment of exposures and risks and what procedures are in place to mitigate those risks?</p> <p>What is the group's loan default experience in recent months and how does this compare with experience prior to the credit market turbulence? Are the procedures and methodologies in place to assess allowances for impairment appropriate? Are resulting impairment allowances appropriate?</p>
Securitisation structures	<p>Has management adequately identified and re-assessed the risk profile of securitisation structures and products?</p> <p>Have all potential exposures and areas of losses been identified and assessed?</p> <p>Has any action been taken either to fund structured investment vehicles (SIVs) or to liquidate them?</p> <p>Has a sufficiently robust process been adopted to identify those SIVs that may need to be brought on balance sheet?</p> <p>Have appropriate disclosures been made in accordance with relevant accounting standards?</p> <p>What further explanations, in addition to those required by standards, may be needed in the annual report to provide transparency in relation to off-balance sheet arrangements?</p> <p>Is there sufficient substantiation of the assumptions underlying any valuation techniques applied and models used?</p>
Fair value and modeling techniques	<p>Is there a robust process in place to ensure that appropriate fair values are obtained?</p> <p>To what extent are models used in pricing and evaluating financial instruments and is any change in methodology explained and justified?</p> <p>Is there sufficient substantiation of the assumptions underlying any valuation techniques applied and models used? How have they been modified to reflect current market turbulence?</p> <p>Are the key assumptions used in valuation models clearly understood? What is the sensitivity and possible range of outcomes to changes in those assumptions?</p> <p>What is revealed by any sensitivity analyses that have been performed?</p>
Liquidity risk	Is there proper analysis and disclosure of the entity's exposure to liquidity risk?
<p>These questions and further information is available on the FRC's Web site at www.frc.org.uk/press/pub1467.html</p>	



EU matters

Equivalence of financial reporting standards

December 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 Commissioner plans to put forward during the first quarter of 2008 a Recommendation to Member States asking them to limit auditor liability. Prudent proportional steps, determined by Member States, are seen as a key factor in encouraging a wider and more competitive audit market.

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 is therefore planned for the first quarter of 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.



Other international matters

UK matters

The Financial Reporting Council and its related bodies were active over the year end, issuing a number of documents relating to governance and financial reporting issues. One of those documents was highlighted earlier in Key Questions for Audit Committees. Others of interest to audit committee members are discussed below, together with an update on the position regarding publication of business reviews under UK company law.

Auditors' reports: a time for change?

Changes in the way that auditors report on financial statements have been the subject of discussion since the Auditing Practices Board (APB) issued its exposure draft of ISA (UK and Ireland) 700 during 2005. This exposure draft followed the International Auditing and Assurance Standards Board's revised ISA 700 and proposed the first set of significant amendments in audit reports since 1993, when the APB issued its first standard relating to auditors' reports (SAS 600). A number of UK commentators expressed significant concerns with the ISA version, however, as a result of which the APB decided to defer introduction of the revised ISA. Those concerns included:

- dissatisfaction with the ISA's indication that "true and fair" and "presents fairly, in all material respects" were equivalent and that only in "extremely rare" circumstances should departure from a specific requirement of the financial reporting framework be appropriate to ensure that financial statements give a true and fair view;

- a desire for a clearer focus on the auditors' duty under company law to form an opinion on the financial statements, rather than to perform an audit in accordance with auditing standards; and
- concern that the wording of management responsibilities did not properly reflect legal obligations of directors.

At the same time, other developments have been taking place - the UK Companies Act 2006 introduces changes in the legal specification of auditors' reporting duties, and discussion of how and what auditors should report has been further prompted by the FRC's paper *Promoting Audit Quality*. Meanwhile at EU level, the Statement Audit Directive provides for adoption of ISAs within the EU, subject to consideration and approval - the result of which, for audit reporting, is as yet uncertain. And IAASB has been further developing its thinking as part of its 'Clarity Project', with revised ISAs dealing both with "clean" and modified auditors' reports now in issue.

Against this backdrop, the APB issued in December the paper *The auditor's report: a time for change?* making a range of suggestions and seeking views on how best to develop current reporting practice. Whilst written in the context of UK developments,

given the similarities in auditor's reporting obligations in Ireland, the APB has indicated that, if major changes are introduced for UK reports as a result of the exercise, it will consult separately on Irish auditors' reports.

Auditor liability agreements

The FRC has published for consultation draft guidance on the use of agreements between companies and their auditors to limit the auditor's liability, as provided for under the Companies Act 2006.

The draft guidance has been produced by a working group chaired by Sir Anthony Colman, previously a Judge of the Commercial Court, and including representatives of companies, investors and the accountancy profession.

The intention of the draft guidance is to:

- explain what is and is not allowed under the 2006 Act;
- set out some of the factors that will be relevant when assessing the case for an agreement;
- explain what matters should be covered in an agreement, and provide specimen clauses for inclusion in agreements; and
- explain the process to be followed for obtaining shareholder approval, and provide specimen wording for inclusion in resolutions and the notice of the general meeting.

Copies of the draft guidance can be obtained from the FRC Web site at: www.frc.org.uk/about/auditorliability.cfm. Consultation runs until 14 March 2008. Subject to the outcome of consultation the intention is to publish the final guidance in the first half of 2008.

Proposed changes to the Combined Code

The FRC has issued for consultation a proposal that would remove the restriction on an individual chairing more than one FTSE 100 company; and, for listed companies outside the FTSE 350, to allow the company chairman to be a member of, but not chair, the audit committee provided he or she was considered independent on appointment.

These proposals follow a review of the impact and implementation of the Combined Code, which found that the Code continues to have a

broadly beneficial impact, and is seen as having contributed to higher overall standards of governance among UK listed companies and to more professional boards; but while there are many positive indicators to suggest that the "comply or explain" approach is working fairly well, there is also some frustration with its day-to-day operation.

Comments are requested by 14 March 2008 and it is expected that if changes result, the revised Code would apply to financial years beginning on or after 29 June 2008.

Copies of the consultation document can be obtained from the FRC Web site at www.frc.org.uk/corporate/2007review.cfm

Choice in the audit market

The final report on the Market Participants Group, appointed to advise the FRC on possible market-led actions to mitigate risks in the UK audit market, was published during the final quarter of 2007.

In its findings, the Group noted that there is concern amongst market participants over the uncertainty and costs that could arise in the event of one or more of the Big Four firms leaving the market. This risk could be mitigated through increased choice of auditors. However a number of current market characteristics, when taken together, reduce the propensity of existing or new non-Big Four firms to make “step change” investments in their capability to audit public interest entities and the propensity

for public interest entities to select non-Big Four firms as auditors.

The Group evaluated a wide range of possible actions to increase choice of auditors. In its evaluation, the Group sought to identify possible actions which would, when combined with others, contribute to increased choice whilst at least maintaining audit quality, at a cost which is proportionate to the likely benefits and at a cost which is lower than any alternatives offering equivalent benefits.

Fifteen recommendations are made (see table) with the Group also noting that there is no one answer nor any “silver bullets” that could rapidly increase choice at a proportionate cost whilst maintaining audit quality.

Copies of the report are available at www.frc.org.uk/press/pub1419.html

Recommendations on choice in the audit market

1. The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.
2. Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.
3. In developing and implementing policy on auditor liability arrangements, regulators and legislators should seek to promote audit choice, subject to the overriding need to protect audit quality.
4. Regulatory organisations should encourage participation on standard setting bodies and committees by appropriate individuals from different sizes of audit firms.
5. The FRC should continue its efforts to promote understanding of audit quality and the firms and the FRC should promote greater transparency of the capabilities of individual firms.
6. The accounting profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.
7. The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.
8. The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor selection decision.

9. When explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms.
10. Investor groups, corporate representatives, auditors and the FRC should promote good practices for shareholder engagement on auditor appointments and re-appointments.
11. Authorities with responsibility for ethical standards for auditors should consider whether any rules could have a disproportionately adverse impact on auditor choice when compared to the benefits to auditor objectivity and independence.
12. The FRC should review the Independence section of the Smith Guidance to ensure that it is consistent with the relevant ethical standards for auditors.
13. Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.
14. Every firm that audits public interest entities should comply with the provisions of a Combined Code-style best practice corporate governance guide or give a considered explanation.
15. Major public interest entities should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning.

FRC plans for 2008/09

In January, the FRC issued its proposed plans and budget for the next two years, based on its assessment of risk to confidence in corporate reporting and governance and is seeking to engage investors and other interested parties in finalising its proposals.

Four key themes continue to underpin the FRC's proposed work, namely:

- lead public debate on the major issues affecting future confidence in corporate reporting and governance;
- monitor corporate reporting and governance practices in the UK and take enforcement action where appropriate;
- increase participation in the development of high-quality international standards and cooperation with international regulatory organisations; and
- contribute to modifying the UK regulatory regime to take account of changes in EU and UK legislation.

Major projects that the FRC indicates it will undertake include:

- monitoring the implementation of the recommendations made by the Market Participants' Group on choice in the audit market. The FRC's audit choice project has stimulated discussion in the UK and internationally about critical issues associated with the audit market. The FRC has set out a detailed plan for monitoring progress in the implementation of the recommendations of the Audit Choice Market Participants' Group;
- reviewing the complexity and relevance of current reporting requirements. The project will consider whether corporate reporting requirements are contributing to the increasing complexity of corporate reports without making them more useful or understandable. The scope of the project will include requirements relating to financial statements, accompanying management commentary and other reports;

- implementing the provisions of the EU Directive on Statutory Audit relevant to foreign auditors. The project will implement the relevant procedures which will enable the UK to comply with the Directive. The implementation of these provisions will be heavily influenced by decisions made by the EU; and
- finalising the conceptual framework for actuarial standards.

Following the consultation being undertaken in 2007/08, a principles-based conceptual framework will be issued that will contribute to the relevance, transparency of assumptions, completeness and comprehensibility of actuarial information and advice.

Copies of the Plan are available at www.apb.org.uk/press/pub1482.html

Enhanced business review

The new “business review” requirements have been made effective for financial periods beginning on or after 1 October 2007.

The new requirements introduce:

- more forward-looking disclosure regarding the trends and factors likely to affect the future development, performance and position of the business;
- disclosure about environmental matters, employees and social and community issues as well as policies and the effectiveness of any such policies in relation to these matters. If any of this information has not been given, a statement must be made to this effect; and
- disclosure about persons with whom there are contractual or other arrangements which are essential to the business (the so-called “supply chain” disclosure requirements) but subject to limited exemption from disclosure where that disclosure would be both seriously prejudicial to that person and contrary to the public interest (we expect such cases to be extremely rare in practice).

There remains a general exemption from disclosure for any impending matters or matters in the course of negotiations where disclosure would be seriously prejudicial to the interests of the company.

It should be noted that the directors’ report, and thus the business review, is within the remit of the FRRP for accounting periods beginning on or after 1 April 2006.

It is also worth noting that section 463 of the 2006 Act (the so-called “safe harbour” provision) became effective in relation to directors’ reports sent to members on or after 20 January 2007. This sets out the basis of directors’ liability to the company in relation to statements in the directors’ report (and also in the directors’ remuneration report and any summary financial statement derived from the directors’ report or directors’ remuneration report). The aim is to exclude the courts from developing a common law approach to directors’ liability in relation to these reports. A director will be liable in relation only to statements that have proved untrue or misleading, on a “knowingly or recklessly” basis, or if the director knew that an omission was a dishonest concealment.



US matters

New accounting for business combinations and non-controlling interests

New Statements 141R and 160 require most identifiable assets, liabilities, non-controlling interests, and goodwill acquired in a business combination to be recorded at "full fair value" and require non-controlling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with non-controlling interest holders. The new Statements are the U.S. GAAP outcome of a joint project with the IASB. Both Statements are effective for periods beginning on or after 15 December 2008 and earlier adoption is prohibited.

Statement 141R will be applied to business combinations occurring

after the effective date. Statement 160 will be applied prospectively to all non-controlling interests, including any that arose before that date.

On 10 January 2008, the IASB also issued its standards with substantially converged conclusions. The primary differences between the FASB and IASB standards relate to measuring non-controlling interests and recognising contingencies. The two sets of standards use the same language except for areas where they reached different conclusions. The IASB revised standards, IFRS 3 (2008) and IAS 27 (2008), will be effective for periods beginning on or after 1 July 2009 with early adoption permitted.

This section is adapted from KPMG's Defining Issues, December 2007, No. 07-40 *New Accounting for Business Combinations and Non-controlling Interests* available at www.us.kpmg.com/definingissues

Partial deferral of Statement 157's effective date

The FASB has agreed to a one-year deferral of FASB Statement No. 157's, *Fair Value Measurements*, requirements for non-financial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. The proposed deferral would not apply to any financial assets or liabilities or non-financial assets and liabilities measured at fair value on a recurring basis.

Companies would be required to apply Statement 157 to non-financial assets and liabilities that qualified for the deferral for fiscal years beginning after 15 November 2008 (1 January

2009 for calendar-year companies). However, companies will be permitted to adopt Statement 157 for all fair value measurements for fiscal years beginning after 15 November 2007.

The FASB also intends to clarify disclosure requirements about the fair-value measurements of pension plan assets by plan sponsors, and will develop additional guidance on how Statement 157 applies to measurements of liabilities. The immediate result of these decisions will be three proposed FASB Staff Positions.

This section is adapted from KPMG's Defining Issues, November 2007, No. 07-35 *Partial Deferral of Statement 157's Effective Date* available at www.us.kpmg.com/definingissues

SEC matters

SEC eliminates U.S. GAAP reconciliation for foreign private issuers using IFRS

The SEC will allow foreign private issuers to file financial statements using IFRS as published by the IASB without a reconciliation to U.S. GAAP. The permission will be available beginning with financial statements for years ending after 15 November 2007.

The final rule will provide relief from the reconciliation only to those foreign private issuers that prepare their financial statements in accordance with IFRS as issued by the IASB. The financial statements must contain an explicit, unqualified statement of compliance with that version of IFRS, and the auditor's report must refer to IASB-issued IFRS. An entity could satisfy this requirement by asserting that the financial statements comply with both IASB-issued IFRS and a jurisdictional version of IFRS (e.g., IFRS as adopted by Australia).

Foreign private issuers based in the EU that are unable to assert compliance with IASB-issued IFRS only because of the "EU carve out" for IAS 39 will be permitted to reconcile those financial statements to IFRS as issued by the IASB. This accommodation will be available only for the next two years. All other foreign private issuers that are unable to assert compliance with IASB-issued IFRS, including those using a jurisdictional version of IFRS, will continue to be required to reconcile their financial statements to U.S. GAAP.

The SEC's decision to accept IFRS financial statements from foreign private issuers without a reconciliation to U.S. GAAP may be another step on the road toward allowing or requiring use of IFRS by domestic issuers. A more immediate

effect will be on whether the financial statements of U.S. companies that either are acquired by or are significant investees of a foreign private issuer are presented in the foreign private issuer's filings. This comes about because foreign private issuers will have to apply certain SEC-required tests on an IFRS basis. The test of significance of an acquired subsidiary (Rule 3-05) or equity investee (Rule 3-09) will be computed using IFRS financial information. As a consequence, a U.S. company that is acquired by a foreign private issuer or is an investee of a foreign private issuer will have to measure its assets and income using IFRS in order for the foreign private issuer to determine whether the U.S. company's financial statements are required to be presented.

A domestic issuer that acquires a foreign entity or that has a significant foreign investee will continue to be required to include the acquiree/investee's financial statements in its filings pursuant to the significance tests of Rule 3-05/3-09 determined on a U.S. GAAP basis. However, if the acquiree/investee prepares its financial statements in accordance with IFRS, the 3-05 or 3-09 financial statements will no longer need to be reconciled to U.S. GAAP.

The elimination of the U.S. GAAP reconciliation requirement for foreign private issuers using IFRS does not change the applicability of other filing requirements – for example, the requirement that the financial statements be audited in accordance with PCAOB standards. The SEC staff will continue to review and comment on the IFRS financial statements included in SEC filings.

The descriptive and summary statements in this article are not intended to be a substitute for the text of any of the cited documents or any other applicable or potential accounting literature or SEC regulations. When complying with GAAP or filing requirements, companies should consult the text of the applicable documents that set out requirements, consider their particular circumstances and consult their accounting and legal advisers.

This section is adapted from KPMG's Defining Issues, November 2007, No. 07-36 *SEC Eliminates US GAAP Reconciliation for Foreign Private Issuers Using IFRS* available at www.us.kpmg.com/definingissues

SEC guidance on loan commitments recorded at fair value through earnings

Fair-value measurements of derivative or other written loan commitments that are recorded through earnings should include the future cash flows related to the loan's servicing rights, according to a new Staff Accounting Bulletin 109, *Written Loan Commitments Recorded at Fair Value Through Earnings*, which also requires that internally developed intangible assets should be excluded from the measurements.

SAB 109 supersedes SAB 105, *Application of Accounting Principles to Loan Commitments*, which applied only to derivative loan commitments that are accounted for at fair value through earnings. The new guidance applies not only to measurements of

derivative loan commitments but also to other written loan commitments that are accounted for at fair value through earnings under FASB Statement No. 159's, *The Fair Value Option for Financial Assets and Financial Liabilities*, fair-value election.

Financial statements filed with the SEC before applying the guidance in SAB 109 should include the disclosures required by Staff Accounting Bulletin 74. The staff's views on incorporating expected net future cash flows related to loan servicing activities in the fair value measurement should be applied prospectively to derivative loan commitments issued or modified in fiscal quarters beginning after 15 December 2007.

This section is adapted from KPMG's Defining Issues, November 2007, No. 07-33 *SEC Staff Guidance on Loan Commitments Recorded at Fair Value Through Earnings* available at www.us.kpmg.com/definingissues

PCAOB issues guidance on auditing internal control in smaller public companies

In October the Public Company Accounting Oversight Board published for public comment staff guidance on auditing internal control over financial reporting in smaller public companies.

The guidance, *An Audit of Internal Control That Is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*, explains how auditors can apply the Board's internal control auditing standard, Auditing Standard No. 5, to audits of smaller, less complex public companies.

When it adopted Auditing Standard No. 5 in May, the Board committed to provide additional guidance on applying the standard to audits of smaller public companies. Auditing

Standard No. 5 provides direction to auditors on scaling the audit based on the company's size and complexity.

This guidance demonstrates how auditors can apply the principles described in the standard and provides examples of approaches to particular auditing issues that might arise in audits of smaller, less complex companies.

Topics discussed in the staff guidance include: entity-level controls, risk of management override, segregation of duties and alternative controls, information technology controls, financial reporting competencies and testing controls with less formal documentation.



Financial reporting update

Key developments discussed in Quarterly 13	Title of article	Effective date
The FRRP publishes a report on its activity during the year ended 31 March 2007	FRRP Activity	Report
TECH 2/07, issued by the ICAEW and ICAS, provides extensive guidance on the effect of IFRSs on distributable profits	Distributable profits	Immediate
Amended standard IFRS 2 Share-based Payment (2008)	Share-based payments	Periods beginning on or after 1 January 2009
Amended IFRS 3 Business Combinations (revised) and amended standard IAS 27 Consolidated and Separate Financial Statements (2008)	Business combinations	Periods beginning on or after 1 July 2009
Exposure Draft of Proposed Improvements to International Financial Reporting Standards	IASB's annual improvement proposals	Comments were due by 11 January 2008. Revised standards expected to apply for periods beginning on or after 1 January 2009

FRRP activity

The SEC will allow foreign private issuers to file financial statements using IFRS as published by the IASB without a reconciliation to U.S. GAAP. The permission will be available beginning with financial statements for years ending after 15 November 2007.

Statistics

In 2006/07, the Panel reviewed 311 sets of accounts (2005/06: 284) and wrote letters to 135 companies (2005/06: 82) asking for further information about areas of possible non-compliance with the accounting requirements of the Companies Act 1985 or the Listing Rules.

Key messages from activity report

The report highlights improvements and corrections identified by the Panel in the course of their reviews and sets out a number of key messages to companies.

The Panel wrote letters to more than 43 percent of the companies whose accounts it reviewed (of the accounts it reviewed, 45% were FTSE 350 companies and 57% were other listed companies). It explained the high level of activity in relation to listed company accounts as a focussed attempt to challenge seemingly questionable IFRS accounting treatments and disclosures which appeared inadequate before they became established practice.

The areas of reporting to which the Panel drew attention in its preliminary report in December 2006 on first-time adoption of IFRS continue to feature in this report, namely:

- accounting policies should be thoughtful and tailored;
- non-boiler-plate disclosure of judgments and estimates;
- the disclosure of the effect of new standards and interpretations;
- factors giving rise to goodwill;
- goodwill impairment testing details;
- related party disclosures;

- additional lines in the income statement should be justifiable; and
- non-GAAP measures – these should not be misleading or given undue prominence, and should be reconciled.

The Panel noted that the IAS 1 requirement to disclose significant estimates and judgments attracted more Panel questions and comment than any other aspect of IFRS or, indeed, any other standard.

We strongly encourage companies to consider and, if necessary, upgrade the disclosures in their accounts in light of the FRRP's report, as it is likely that these areas will come under further scrutiny in the future.

Key messages from follow-up report on pensions disclosures

The Panel carried out a follow-up review on IFRS pension disclosures in the accounts of the same 20 companies whose IFRS pension disclosures it reviewed in 2006. The report included the following findings:

- considerable improvement in disclosures about mortality assumptions and in the provision of sensitivity analysis;
- no discernible improvement in information about assets held within the funds, nor about how expected returns have been calculated;
- limited improvement in disclosures about maturity of funds; and
- minor omissions made in 2005 were almost always repeated in 2006.

Extension of the scope of the FRRP's review to directors' reports, including the enhanced business review

The FRRP has started to review the directors' reports of public and large private companies, as well as their accounts. This brings the business review within the Panel's scope for the

first time. The change applies to reports for accounting periods commencing on or after 1 April 2006.

The Panel has published the criteria to be applied in its review of directors' reports. In its consideration of business reviews, the Panel will take account of a number of factors, including whether:

- the directors' report contains an explicit cross-reference where the requirements of the review are met elsewhere in the report and accounts;
- the information in the business review is consistent with all other information included in the report and accounts;
- the information in the business review is consistent with that disclosed in the company's other announcements;
- the business review is balanced and comprehensive in the sense that it deals even-handedly with the positive and negative aspects of the development, performance and position of the business;
- the discussion of the risks and uncertainties facing the company identifies and describes the principal ones; and
- the business review includes appropriate key performance indicators.

The activity report, follow-up review of pension disclosures and the notice of scope extension are available at www.frc.org.uk/frp/press/pub1402.html

Distributable profits

TECH 2/07 *Distributable profit: Implications of recent accounting changes*, issued by the ICAEW and ICAS, provides extensive guidance on the effect of EU-adopted IFRSs and more recent standards issued by NASB on distributable profits.

Though set in the context of UK law, given the similarity of company law in Ireland and the UK, the guidance is also helpful in answering Irish companies distributable profits. The main points, drawn from the guidance, are discussed below.

Fair value accounting

Under the 2003 guidance, fair value gains on marked to market financial instruments were treated as realised only in limited circumstances. However, the introduction of adopted IFRSs has resulted in many more assets and liabilities being measured at fair value – in particular, financial instruments. The new guidance addresses this issue by providing that fair value gains under IAS 39 FRS 26 *Financial Instruments: Recognition*

and *Measurement* are realised to the extent that they are "readily convertible to cash", regardless of whether those gains are reported in the income statement/profit and loss account or taken directly to equity.

"Readily convertible to cash" means, broadly speaking, that an asset can be immediately cashed-in, and three conditions must be met:

- a value can be determined at which a transaction could occur without negotiation or marketing;
- observable market data are available to determine the value; and
- the company can actually dispose of or close out the position without curtailing its business or accepting adverse terms.

Further guidance is given on investment properties and unquoted investments. Investment property revaluations, which under adopted IFRSs are recognised in the income statement, are unrealised in almost all

circumstances because the period for marketing/negotiation disqualifies such properties from being readily convertible to cash. Similar considerations also apply to unquoted equity investments.

Although the new guidance permits fair value gains to be treated as realised in many more circumstances than has hitherto been the case, it advises directors to consider their fiduciary duties when making a distribution. In particular, directors should consider whether it is prudent to distribute profits arising from either an asset that is subject to volatility, or gains arising from assets and liabilities that are economic hedges but where one is accounted for at fair value and the other is not. Consideration should be given to the immediate cash flow implications of a distribution and the continuing ability of the company to pay its debts as they fall due.

With respect to fair value losses, the new guidance confirms that these will be realised where profits arising on the re-measurement of the same asset or liability would be treated as realised profits under the guidance. Thus, fair value losses are generally realised. However, there are certain circumstances where fair value losses would not be realised. A common example is the loss which reverses a previous unrealised gain on, say, an investment property or unlisted investment.

Hedge accounting

Where fair value hedging is undertaken, the movements in both the hedged item and the hedging instrument will be taken to the income statement. In many cases, both legs will be realised by reference to the guidance and no further consideration is required. However, where one leg is unrealised, a more detailed examination is required. Where a net loss arises, this loss will generally be treated as realised.

For example, if a fair value hedge results in a realised loss of 100 on the hedging instrument and an unrealised gain of 90 on the hedged item, the net loss of 10 that arises from the hedge ineffectiveness is treated as a realised loss. Owing to the hedging relationship, the unrealised gain on the hedged item is offset against the realised loss on the hedging instrument – i.e., the 90 unrealised gain cancels out 90 of the realised loss. Where a net gain arises, a similar exercise should be undertaken to determine if the net gain gives rise to a realised profit or unrealised profit.

When cash flow hedging takes place, the effective portion of the hedging instrument – either a gain or loss – is recognised in equity and recycled to the income statement or balance sheet at a later date. Those gains and losses taken to equity under cash flow hedging are treated as unrealised until they are recycled.

Issues arising from IAS 32 and FRS 25

IAS 32 (FRS 25) *Financial Instruments: Presentation* often requires that financial instruments are presented on a basis that is different from their legal form – e.g., many preference shares are presented as debt rather than equity. However, at law such instruments are still shares, resulting in some important issues with respect to determining realised profits.

For example, IAS 32 requires the distributions and capital repayments on many preference shares to be presented as interest payable. Nevertheless, the legal status remains unchanged and, as a result, the advanced recognition of such amounts (say, by accruing interest for accounting purposes) does not lead to a consumption of distributable profits. Rather, distributable profits are consumed when the distribution is paid or declared, or the capital repayment is effected. However, the

position of public companies is further complicated by the application of section 264 (the net assets test), which requires that a distribution must not reduce net assets below share capital and un-distributable reserves. As a result, the accrued finance charge will cause a

restriction in distributable reserves because net assets are reduced but share capital and un-distributable reserves are unaffected.

Tech 2/07 is available at www.icaew.com/index.cfm?route=151003

Share based payments

The original definition of vesting conditions in IFRS 2 (2004) described them as “including” service conditions and performance conditions. However, it was unclear how “other” conditions related to share-based payment arrangements (i.e., that are neither service nor performance conditions) should be treated. Examples of such conditions include the requirement for an employee to contribute to an employee share purchase plan (ESPP), or for an employee to hold shares of an entity for a specified period in order to be eligible to participate in a share-based payment grant.

This amendment to IFRS 2:

- clarifies the definition of vesting conditions;
- introduces the concept of “non-vesting conditions”;
- requires non-vesting conditions to be reflected in grant date fair value; and
- provides the accounting treatment for non-vesting conditions and cancellations.

It also provides additional guidance, including a flowchart to assist in evaluating whether a condition is a non-vesting or a vesting condition, and in the case of the latter, whether it is a service or a performance condition.

Vesting Conditions

The definition of vesting conditions has been amended in IFRS 2 (2008) to clarify that vesting conditions are:

- conditions that determine whether the entity receives the services that entitle the counterparty to a share-based payment; and
- limited to service conditions and performance conditions.

The treatments of service and performance conditions in accounting for share-based payment arrangements remains unchanged in IFRS 2 (2008).

The amended definition of vesting conditions defines performance conditions as those conditions that require both:

- the counterparty to complete a specified period of service; and
- specified performance targets to be met.

Consistent with IFRS 2 (2004) performance conditions may be either market or non-market performance conditions.

Non-vesting Conditions and Cancellations

The amendment to IFRS 2 (2008) introduces the term “non-vesting conditions”, which are conditions other than service or performance conditions. Unlike service and performance conditions, non-vesting

conditions do not determine whether the entity receives the services that entitle the counterparty to the share-based payment.

There are three types of non-vesting conditions:

- non-vesting conditions that the entity can choose to meet;
- non-vesting conditions that the counterparty can choose to meet; and
- non-vesting conditions that neither the entity nor the counterparty can choose to meet.

The requirement for employees to make monthly contributions to an ESPP is an example of a non-vesting condition that the counterparty can choose to meet, whereas the continuation of a share-based payment plan by the entity is an example of a non-vesting condition that the entity can choose to meet. An example of a non-vesting condition that neither the entity nor the counterparty can choose to meet is a commodity index that is unrelated to the entity's share price.

Accounting for Non-vesting Conditions and Cancellations

Under the amendment:

- non-vesting conditions are reflected in measuring the grant date fair value of the awards; and
- there is no "true-up" for differences between expected and actual outcomes due to failure to meet non-vesting conditions.

Therefore, if all vesting conditions that are not market conditions are met, then the entity will recognise

the grant date fair value of the share-based payment as compensation cost.

However, a failure to meet non-vesting conditions may impact the timing of recognition (see below).

Failure to Meet Non-vesting Conditions that either the Entity or the Counterparty can Choose to Meet

Failure to meet a non-vesting condition that is within the control of the entity or the counterparty is treated as a cancellation. Under cancellation accounting:

- the amount of the compensation cost that otherwise would be recognised over the remainder of the vesting period is recognised immediately upon cancellation (accelerated vesting), normally in profit or loss; and
- if the share-based payment arrangement includes a liability component, then the liability element is re-measured to fair value at the date of cancellation prior to its settlement.

The Board concluded that a cancellation by the counterparty should be treated in the same manner as a cancellation by the entity, as the Board believes that these events are indistinguishable.

When neither the entity nor the counterparty can choose whether to meet a non-vesting condition, there is no change to the accounting if the non-vesting condition is not satisfied. The entity continues to recognise the full compensation cost over the remaining vesting period.

ASB is also consulting on an amendment to FRS 20, based on the revised IFRS 2. For more details, see www.frc.org.uk/asb/press/pub1487.html

Business combinations

IFRS 3 (2008) is the outcome of the second phase of the IASB's and the U.S. Financial Accounting Standards Board's (FASB) business combinations project, which was conducted as a joint project of the Boards. The first phase of the project resulted in the issue of IFRS 3 (2004) and the U.S. standard SFAS 141 *Business Combinations* (2001). The second phase of the project reconsidered the application of acquisition accounting for business combinations.

The amendments to IAS 27 (2008) reflect changes to the accounting for non-controlling (minority) interest and deal primarily with the accounting for changes in ownership interests in subsidiaries after control is obtained, the accounting for the loss of control of subsidiaries, and the allocation of profit or loss to controlling and non-controlling interests in a subsidiary.

The main changes introduced by the revised standards are as follows:

IFRS 3:

- the scope of IFRS 3 (2008) has been extended to include business combinations involving only mutual entities and to business combinations achieved by contract alone;
- the definition of a business combination has been revised to focus on control;
- the definition of a business has been amended to clarify that it can include an integrated set of activities and assets that are not currently being operated as a business, as long as the set is capable of being operated as a business;
- all items of consideration transferred by the acquirer are measured and recognised at fair value at the acquisition date, including contingent consideration;
- the acquirer can elect to measure any non-controlling interest at fair value at the acquisition date, or at its proportionate interest in the fair

value of the identifiable assets and liabilities of the acquiree, on a transaction-by-transaction basis;

- transaction costs incurred by the acquirer in connection with the business combination do not form part of the business combination transaction. As such, they are expensed as incurred, unless they relate to the issuing of debt or equity securities, in which case they are accounted for under the financial instruments standards; and
- new disclosures are required.

IAS 27:

- when an acquisition is achieved in successive share purchases (step acquisition), the identifiable assets and liabilities of the acquiree are recognised at fair value when control is obtained and a gain or loss is recognised in profit or loss for the difference between the fair value of the previously held equity interest in the acquiree and its carrying amount. Any amount relating to previously held equity interests in the acquiree that was recognised directly in other comprehensive income (e.g., the investment was classified as available-for-sale) is reclassified and included in the calculation of the gain or loss recognised in profit or loss;
- acquisitions of additional non-controlling equity interests after the business combination are accounted for as equity transactions;
- disposals of equity interests while retaining control are accounted for as equity transactions;
- transactions resulting in a loss of control result in a gain or loss being recognised in profit or loss. The gain or loss includes a re-measurement to fair value of any retained equity interest in the investee; and
- new disclosures are required.

Further information is available at www.iasb.org/News/Press+Releases/IASB+completes+the+second+phase+of+the+business+combinations+project.htm

IASB's annual improvement proposals

The International Accounting Standards Board (IASB) issued during October an Exposure Draft (ED) covering changes to a range of existing standards. The ED is the result of the IASB's first annual improvements project, which has included the IASB accumulating throughout the year what it believes will be non-urgent, minor improvements to IFRSs. The ED provides these proposed improvements on a collective basis. The final Annual Improvement Standard is expected to be published in April 2008 and will be effective for annual periods beginning on or after 1 January 2009. Early adoption would be permitted provided that all of the annual improvements contained in the final Annual Improvement Standard and IAS 1 *Presentation of Financial Statements* (as revised in 2007) are applied in the same period.

Proposed amendments to IFRSs contained in the ED include a wide range of factors, most notably, a change to IAS 1.

IAS 1 Presentation of Financial Statements

- the ED proposes additional IAS 1 disclosure requirements for entities that refer to IFRSs in describing the basis on which their financial statements are prepared, but that are not able to make an explicit and unreserved statement of compliance with IFRSs. Such an entity would disclose how its financial statements would have differed if prepared in full compliance with IFRSs;
- amending IAS 1 so that the potential conversion of a liability into equity does not affect the classification of such liability as current or non-current; instead, liquidity and solvency factors (e.g., the timing of any cash settlement) would be the key determinants for classification;
- removing the potential implication currently in IAS 1 that financial liabilities that are classified as held for trading in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* must be presented as current liabilities.

Further information is available at <http://www.iasb.org/Current+Projects/IASB+Projects/Annual+Improvements/Annual+Improvements+Process.htm>



Useful references

The Institute of Chartered Accountants in Scotland have recently issued its second edition of their publication *Appraising Your Auditors – A Guide to the Assessment and Appointment of Auditors*.

This practical guide addresses highly discussed issues such as auditor independence and objectivity and the role of the audit committee. Easy to use flow chart diagrams and guidance questions provide audit committees with practical support and direction to help them carry out their duties and assistance in evaluating audit issues.

The full publication is available on the ICAS Web site at
www.icas.org.uk/Site/CMS/Download/app_aud_2007.pdf

Stop press

Audit Quality Framework

Following extensive consultation on its publication, *Promoting Audit Quality*, issued in November 2006, the FRC published the *Audit Quality Framework* in early February. The Framework is intended to be complementary to existing regulations and guidelines and assist audit committees and others in evaluating external audit.

Further details and copies of the Framework are available at
www.frc.org.uk/about/promotingauditquality.cfm

Let us know what you think

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

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Produced by KPMG's Creative Services

Publication Date: February 2008