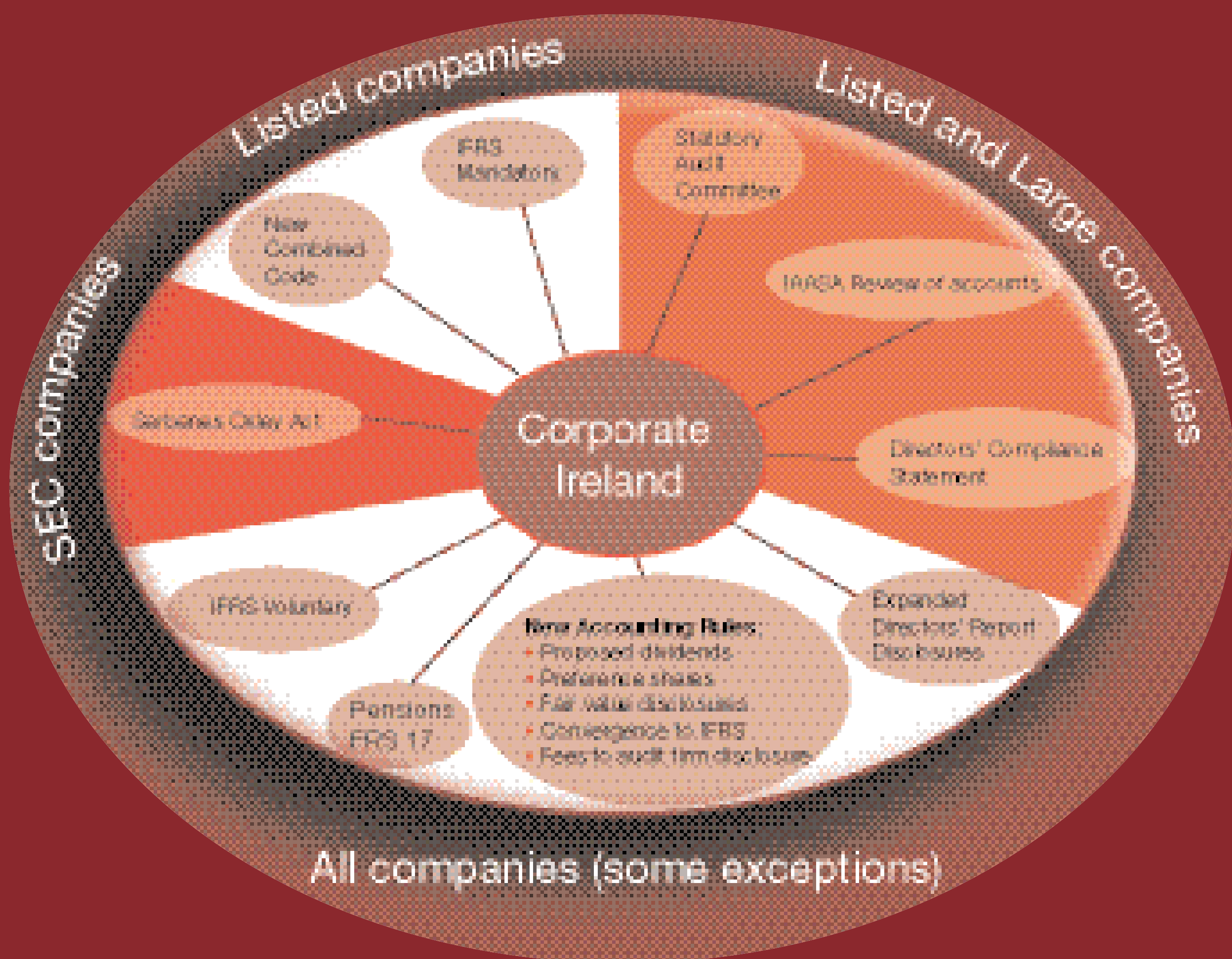
Accounting and Company Law

challenges facing Corporate Ireland

April 2005



The European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005 ('the Regulations') were signed into Irish law by the Minister for Enterprise, Trade and Employment on 24 February 2005. The Regulations implement both the EU Regulation on the use of IFRS in Europe, and the EU Modernisation Directive on the preparation of accounts and directors' reports.

In this briefing we draw attention to aspects of the Regulations. We also take this opportunity to discuss the wider landscape of accounting and company law challenges facing Corporate Ireland. These include the effects of EU directives on Irish companies, as well as changes in Irish company law, accounting rules and corporate governance requirements.

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Changes introduced by the Regulations

IFRS

- Irish companies whose shares are listed on a regulated market in the EU must prepare their consolidated accounts in accordance with IFRS for years commencing on or after 1 January 2005.
- Most other Irish companies may choose to prepare their accounts, both individual and consolidated, for years commencing on or after 1 January 2005, either in accordance with IFRS or under existing Irish GAAP. (Charitable and Not-for-Profit companies may not use IFRS.)
- Irish companies with debt, but not shares, listed on a regulated market in the EU must prepare their consolidated accounts in accordance with IFRS for years commencing on or after 1 January 2007.
- The directors of an Irish parent company that prepares group accounts are required to ensure that all the Irish companies in the group prepare their individual accounts using the same accounting framework, i.e. either IFRS or Irish GAAP, with some exceptions:
    - The Regulations provide that where 'there are good reasons', the directors may depart from the general requirement for consistency
    - Where a parent company prepares its consolidated and individual accounts under IFRS, its subsidiary companies may continue to prepare their accounts under Irish GAAP
- Once an Irish company switches to IFRS, there are limited circumstances under which it is permitted to revert to Irish GAAP, including:
    - where an Irish company is acquired by a parent that does not use IFRS
    - where an Irish company or its parent ceases to be listed on a regulated market.

Directors' Report

The Regulations require the Directors' Report of all companies, for years commencing on or after 1 January 2005, to include a fair review of the development and performance of the business of the company or group and of its position, together with a description of the principal risks and uncertainties that it faces. That review must be balanced and comprehensive, consistent with the size and complexity of the business.

Large companies are required to provide, in addition, an analysis of their key performance indicators, both financial and non-financial, to the extent necessary for an understanding of the development, performance and position of the business.

The Directors' Reports of large Irish companies (other than insurance companies) are also affected by the Fair Value Regulations which implement the EU Fair Value Directive and which were published in November 2004. Large companies will be required to disclose their financial risk management objectives and policies in the annual report, together with their hedging policies where hedge accounting is used, and their exposures to price risk, credit risk, liquidity risk and cash flow risk. This information must be provided in relation to their use of financial instruments where it is material for an assessment of the assets, liabilities, financial position and profit or loss of the company or group. The Fair Value Regulations also take effect from 2005.

At EU level, further changes to EU directives are being considered to require enhanced disclosure of off balance sheet arrangements and related party disclosures in order to combat corporate malpractice. Meanwhile, the UK is already in the process of introducing a mandatory OFR (Operating and Financial Review) for listed companies for 2006 and the Accounting Standards Board (ASB) is developing a reporting standard on the content of such an OFR.

Accounting for Dividends and Preference Shares

The Regulations facilitate the application of two of the Accounting Standards Board's recent accounting standards - FRS 21 in relation to accounting for proposed dividends and FRS 25 in relation to how non-equity shares are presented in the accounts. Both of these standards become effective for financial years commencing on or after 1 January 2005.

Proposed dividends are no longer to be accounted for in the profit and loss account or balance sheet. Dividends will be accounted for in the profit and loss account and balance sheet only if they have actually been declared by the directors, or authorised by the shareholders, before the balance sheet date. Proposed dividends, and dividends declared or authorised after the balance sheet date, are to be disclosed in the notes to the accounts.

The Regulations require directors to have regard to the substance of transactions (not just their legal form) in determining how to present them in accordance with generally accepted accounting principles. A major consequence of this is that most non-equity shares, including redeemable preference shares, will be presented as liabilities on the balance sheet.

Fair Value Disclosures and Accounting

The Fair Value Regulations (referred to above) require the notes to the accounts of all companies to disclose the fair values of their derivative financial instruments from 2005, irrespective of whether these fair values have been incorporated in the balance sheet.

The Fair Value Regulations also permit the use of fair value accounting for most financial instruments and prescribe how it is to be applied in practice. The ASB's recent standard FRS 26 deals with the accounting measurement of Financial Instruments and Derivatives. FRS 26 will apply to companies that choose not to switch to IFRS. FRS 26 becomes mandatory for listed companies for years commencing on or after 1 January 2005 and, for companies that prepare their accounts in accordance with the fair value accounting rules of the Fair Value Regulations, for years commencing on or after 1 January 2006. Companies subject to FRS 26 (with some exceptions) will also be required to comply with the detailed disclosure requirements of FRS 25 in respect of their financial instruments.

The new Regulations also facilitate the introduction of fair value accounting into Irish GAAP in respect of investment properties and biological assets (living plants and animals).

Consolidated Accounts

An Irish parent company, that is itself a subsidiary, need not prepare group accounts provided certain conditions are met. One of the existing conditions is that it must have a parent in the EU that prepares group accounts. The Regulations have relaxed that condition so that, for 2005, the Irish company's parent need not be incorporated in the EU so long as it prepares its group accounts in accordance with either the EU Seventh Directive or in a manner equivalent to the Seventh Directive. The Committee of European Securities Regulators has commenced a project to assess which non-EU accounting frameworks, such as US GAAP, may be regarded as equivalent to the Seventh Directive.

The Regulations have also widened the legal definition of a subsidiary company so that a subsidiary now includes an undertaking which the parent is able to control, whether or not the parent has an investment in that undertaking. This legal amendment facilitates the application of a recent amendment to FRS 2: Accounting for Subsidiary Undertakings.

Challenges posed by the wider regulatory landscape

In addition to the accounting and reporting changes referred to above, some of the other challenges facing Corporate Ireland include:

Corporate Governance and Compliance with Legal Obligations

- Irish and UK listed companies are required to comply with the revised Combined Code of Corporate Governance in Annual Reports for years commencing on or after 1 November 2003. The revised Code has added substantially to the level of transparency and accountability to be applied to the governance of listed companies. In particular, it has introduced specific responsibilities for Audit Committee members. The Irish Companies Act 2003 prescribed additional responsibilities for Audit Committee members, but these are not yet in force.

- The Companies Act 2003 requires most private companies over a certain size (balance sheet total Euro 25m and turnover Euro 50m - company or group), as well as public limited companies, to establish an audit committee. However, it permits the board of such a private company to decide not to establish an audit committee, in which case it must state its reasons for that decision in the Directors' Report. This Section of the Act is not yet in force.

- The Companies Act 2003 also included a requirement for directors of companies above a certain size to make a compliance statement on their policies and procedures for complying with all relevant legal obligations. We welcome the Taoiseach's recent announcement that this provision for a Directors' Compliance Statement has been referred to the Company Law Review Group for consideration, including a cost benefit analysis.

- Many Irish subsidiaries of SEC registered corporations have been carrying out fundamental reviews of their systems of internal control in order to comply with the post-Enron reporting requirements imposed on them by the Sarbanes-Oxley Act. Irish companies registered with the US SEC will also have to report on their internal controls but not until years ending on or after 15 July 2006.

Enforcement

- The Companies Act 2003 provided for the accounts of listed and large Irish companies, and their subsidiaries, to be subject to scrutiny and challenge by the Irish Auditing and Accounting Supervisory Authority. The relevant Sections of the Act establishing IAASA are not yet in force.

Accounting

- Apart from the accounting consequences for those listed companies that are obliged to adopt IFRS, most other companies are faced with the choice of whether, and when, to switch to IFRS. Clearly, many companies will choose not to switch; however, the explicit strategy of the Accounting Standards Board (ASB) is to converge to IFRS over an appropriate period. To this end, the ASB issued an unprecedented number of new accounting standards in 2004, eight in all, which take effect for various classes of companies at different dates. Seven of these new standards substantially replicate the equivalent IFRS standard.

- Companies switching to IFRS, or adopting new accounting policies that change the measurement of their profits, may be affected by the provisions of the Finance Act 2005 on the relationship between accounting profits and taxable profits.

- All companies with defined benefit pension arrangements face the challenge of complying with the full accounting rigours of FRS 17 (or its IFRS equivalent) for 2005. Recent trends in equities, interest rates, salary levels and longevity have all combined to cause difficulties for companies in keeping their pension schemes appropriately funded.
- The Companies Act 2003 provides for accounting disclosure, by all companies, of the amounts paid to their auditors for audit work, audit-related work, and other services. This Section of the Act has not yet commenced.

Concluding Comment

As this briefing illustrates, Irish companies of all sizes are being subjected to increasingly complex rules and regulations. These rules and regulations stem from a variety of sources: EU Directives, Stock Exchange Listing Rules and Irish Companies legislation, as well as the activities of both the UK and International Accounting Standards Boards.

PricewaterhouseCoopers is committed to monitoring each of these developments and to working with our clients to help them adapt to the changing corporate landscape.

For support or information on any of the areas outlined in this briefing please contact your usual PricewaterhouseCoopers Relationship Partner or

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