

Throwing the baby out with the bath water? : A critical appraisal of the Companies (Auditing and Accounting) Act 2003

By Carol Fitzgerald and Leonard Durac

Introduction

The Companies (Auditing and Accounting) Act 2003 represents the Irish legislature's most significant company law initiative of a generation. Introduced in the wake of a series of both domestic and international accounting scandals, it is, in many ways, the domestic equivalent of the US Sarbanes-Oxley legislation, which was rushed through as a response to the Enron and WorldCom debacles.¹

Introducing the proposals before the Dáil, the Minister of State for Enterprise, Mr Michael Ahern, described the legislation as "a road map to ensure the highest commercial standards."² Whether this proves to be true, however, will only become apparent over time.

The Act is without precedent in its imposition of a number of crucial new duties on many Irish companies and their directors personally, related to their financial statements, their compliance with laws and their relations with auditors.³

However, in keeping with many similar laws, that have either been passed or are being prepared for enactment in other jurisdictions, the Act has been roundly criticised during the legislative process for what were perceived to be excessively rigorous and harsh governance and compliance provisions as part of a newly inflexible regulatory regime.

Legislators were placed in the invidious position of trying to introduce sufficient reforms to placate angry investors and restore a modicum of trust to the auditing and

¹ For a thought-provoking analysis of the Sarbanes-Oxley legislation, see James Tackett, 'Sarbanes-Oxley and audit failure'. (2004) Vol. 19, No. 3, Managerial Auditing Journal, pp. 340-350

² See Marie O'Halloran, 'Minister praises law to regulate auditors', *Irish Times*, 17 October 2003

³ See 'Regulators get tough on Irish accountants', May 2003, Vol. 131, Issue 1317, Accountancy, p. 14

accounting professions, whilst not making Ireland an unattractive corporate location in the process, with an overly-rigorous, and therefore costly and time-consuming regulatory regime. Successfully achieving so precarious a balance will represent a stern test for the Act, and it is by no means certain to prevail in this respect.

Governance provisions introduced in the 2003 Act

The principal provisions of the Act in relation to corporate governance and compliance are:

The establishment of the Irish Auditing and Accounting Supervisory Authority (IAASA)

Section 5(1) establishes the Irish Auditing and Accountancy Supervisory Authority (IAASA). Effectively a new Irish audit/accounting regulatory authority, the IAASA is entrusted, under Section 8(1), with responsibility for supervising the regulation of accountants by the profession.

Section 8(1)(b) is unambiguous in its statement of the principal goal of the legislation;

“ ... to promote adherence to high professional standards in the auditing and accountancy profession”

Section 6 stipulates that the board of the IAASA is to consist of 14 directors, of which only four may be members of prescribed accountancy bodies. The remainder are to be drawn from ministerial appointments and certain specific bodies including the Director of Corporate Enforcement, IBEC, ICTU and the Revenue Commissioners. Some commentators argue that herein lies a fundamental flaw; with accountants inadequately represented on the IAASA's governing board, “ ... it is difficult to see how the board will be able to carry out. . . key functions,” said the President of the Institute of Certified Public Accountants, Mr. Alan Farrelly. “I fail to see how the

board or a committee of its members will have the expertise to deal with reviewing whether the accounts of companies comply with the companies acts."⁴

Carroll notes that the establishment of the IAASA watchdog effectively 'marks the end of self-regulation of the accountancy profession in Ireland.'⁵ In many ways, the passing of self-regulation has not been widely lamented. Senator Joe O'Toole, a member of IAASA's provisional governing body, has publicly stated his belief in the necessity of changing "the culture of the country to one of compliance within the tax regime. Our shared objective must be that there would be trust and confidence in the view of the auditor and that the auditor is accepted and trusted as the guardian of probity. I firmly believe that this legislation will protect the profession from damage by non-compliant members."⁶

The IAASA is also conferred with oversight-rights related to the accounts of all Irish public limited companies, all Irish 'large' private companies limited by shares and certain other forms of undertaking which are 'large' including some unlimited companies, and certain of each of their subsidiary undertakings

Directors' Compliance and Responsibility Statements

In what represents the most controversial of the innovations introduced by the Act, the directors of all Irish public limited companies, and all Irish 'large' private companies limited by shares, will be obliged regularly to prepare, update and publish detailed statements regarding the company's compliance with certain relevant laws

Specifically, the Act amends the Companies Act 1990, by introducing new sections 205E and 205F. The new Section 205E(3) stipulates that;

⁴ See Edward Power, 'Accountants criticise new watchdog over lack of clarity', Irish Times, 11 April 2003

⁵ For a fascinating discussion of self-regulation of the profession, see *Comment*; Peter Carroll, Irish Times, June 18 2004

⁶ See Edward Power, 'Accountants criticise new watchdog over lack of clarity', Irish Times, 11 April 2003

‘The directors of a company to which this section applies shall ... prepare or cause to be prepared a director’s compliance statement containing the following information concerning the company:

- (a) its policies respecting compliance with its relevant obligations;
- (b) its internal financial and other procedures for securing compliance with its relevant obligations;
- (c) its arrangements for implementing and reviewing the effectiveness of the policies and procedures referred to in paragraphs (a) and (b)’

Effectively, the directors are obliged in these statements to describe the company’s policies and “internal financial and other procedures” for securing compliance with those relevant laws and its arrangements for implementing and reviewing the continuing effectiveness of those policies and procedures; and further to acknowledge their personal responsibility for such compliance, to confirm whether or not such policies and procedures exist, to confirm whether they so reviewed continuing effectiveness during the relevant financial year, and to state whether they personally used ‘all reasonable endeavours’ to secure the company’s compliance with those relevant laws in the relevant financial year [Section 205E(6)(a)]

These provisions do not, by virtue of Section 205E(9), apply to private companies limited by shares that had gross assets of less than €7,618,428, and turnover of less than €15,236,856, in the relevant financial year; nor do they apply to limited companies, or to private companies limited by guarantee.

The Director of Corporate Enforcement, Mr Paul Appleby, explains that Section 205E(9) will apply to between 2,000 and 3,000 companies in the State (those with an annual turnover of more than €15,236,856) – ‘approximately 2 per cent of the companies on the companies register.’

Mr Appleby stated that the ‘Oireachtas had decided that the threshold should be set at that level to establish a balance between setting governance standards for company

directors while not imposing a burden on directors of small and medium-sized companies'.⁷

Section 205F obliges the company's auditors to conduct an annual review, and to issue an annual fairness opinion, with respect to the directors' compliance statements, a significant strengthening of the compliance regime that operated until now.

These particular provisions were the subject of fierce criticism during the legislative process. In the Seanad, Mr Feargal Quinn declared that he was 'horrified' at the implications of the Bill, and stated that certain of the stipulations contained therein would make the State uncompetitive in the crucial area of foreign direct investment.⁸

Mr Quinn thought it unwise that, given the need for Ireland to 'compete with many other countries for such investment, we had now come up with a regulatory regime that was tougher than any other in the world'.⁹

The obligation on directors of a company to prepare a statement of the company's policies respecting compliance with its obligations under company and tax law would, Mr Quinn felt, '... have a material impact on the company's financial statement.'

Mr Quinn also advised that the introduction of directors' compliance statements was potentially off-putting for would-be investors, and that national competitors would emphasize the rather draconian implications of the Act; 'The Scots would be delighted with this ... legislation, because they would make sure that every multinational thinking of investing here would know about the need to get signatures to compliance statements saying: "You are guilty unless you prove yourself innocent every year."',¹⁰

⁷ See Colm Keena, 'Draft published on new director obligations', Irish Times, 23 July 2004

⁸ See Jimmy Walsh, 'Quinn voices 'horror' a auditing Bill', Irish Times, 17 April 2003

⁹ Ibid.

¹⁰ Ibid.

The requirement to produce compliance statements would also result in increased costs, believed Mr Quinn, who felt that it would be necessary for directors to 'hire consultants who were expert in intricate laws'.¹¹

David Devlin, President of the European Federation of Accountants, writing in the *Irish Banking Review* prior to the enactment of the legislation, accepted that the Irish Government was by no means alone in taking steps to strengthen controls and restore confidence, but nevertheless maintained that key elements of the Irish Bill (as it then was) went significantly further than recent EU or US proposals.

Devlin forecast that requirement for directors' to issue an annual compliance statement "may well lead foreign investors and others wishing to conduct business in Ireland to consider whether they would be better advised to avoid this responsibility by choosing to conduct their business through a company incorporated in Northern Ireland or elsewhere."¹²

Regrettably, Devlin's calls for a substantive review of the proposals "to see if they meet our requirements..... in line with the best global standards, while not imposing excessive costs or responsibilities which go further than seem necessary by reference to international norms,"¹³ were not heeded, and the Bill became law in predominantly the same form, save for the addition certain minor, cosmetic tweaks.

The introduction of perhaps the world's most rigorous regulatory regime might not necessarily prove a panacea for the Irish corporate world's many ills, as Professor Niamh Brennan of UCD's Department of Accountancy confirms. Professor Brennan defines accounting as "an art, not a science", and asserts that "the precise numbers and amounts in profit and loss accounts and balance sheets suggest a precision that does not exist.....The reality is that financial reports are the product of multiple subjective judgements by company directors."¹⁴

¹¹ Ibid.

¹² See David Devlin, 'Accounting in Crisis: The Accountant's Perspective', Summer 2003, Irish Banking Review, pp. 18-28

¹³ Ibid.

¹⁴ See Professor Niamh Brennan, 'Accounting in Crisis: A Story of Auditing, Accounting, Corporate Governance and Market Failures', Summer 2003, Irish Banking Review pp. 2-18

Professor Brennan's belief, that "individuals who wish to defraud or manipulate the system will always find a way to do so, notwithstanding even the best regulation,"¹⁵ confirms that the strictures of the Companies (Auditing and Accounting) Act 2003 did not necessarily meet with the unanimous approval of experts in the field, and hints at the potentially counter-productive effects of the legislation in the months and years ahead.

Accounting Standards and Policies

The Act adds a new Section 205A to the Companies Act 1990, and this effectively imposes an obligation on all Irish companies to state in their annual accounts (and where relevant, in their group accounts) whether 'applicable accounting standards' issued by prescribed bodies, have been adopted.

By the same token, Section 205A(2)(b) requires every relevant undertaking to ensure;

'that any material departure from applicable accounting standards, the effect of the departure and the reasons for it are noted in the annual accounts and, where relevant, in the group accounts.'

Furthermore, Section 205C of the Companies Act 1990 (as inserted by the 2003 Act) requires all Irish companies, in their annual accounts, to disclose all of the accounting policies applied in their preparation.

Section 205C(3) also confirms that;

'The accounting policies that a relevant undertaking is required to disclose under this section include, but are not limited to, those relating to the depreciation and diminution in the value of its assets.'

¹⁵ Ibid.

Audit Committees established

In a very close echo of the US Sarbanes-Oxley Act, the directors of all Irish public limited companies (excluding certain plcs which are not the ultimate parent of their corporate groups) are required, under the Act, to ‘establish and adequately resource a committee of directors, to be known as the audit committee’. [Section 205B(2) Companies Act 1990 (as inserted by Companies (Auditing and Accounting Act) 2003]¹⁶

The Audit Committee is vested with extremely wide-ranging duties in Section 205B(2) related to the annual accounts, audit and financial management.

For example, the Audit Committee is given no fewer than sixteen competencies under the Act. Essentially, it is charged with responsibility for;

- (a) reviewing, before they are presented to the board of directors for approval, the company’s annual accounts/group accounts
- (b) determining whether the accounts give a true and fair view of the state of affairs of the company, and of the profit or loss of the company
- (c) determining whether the group accounts give a true and fair view of the state of affairs of the group, and of the profit or loss of that group
- (d) recommending to the board of directors whether of not to approval the annual accounts/group accounts
- (e) determining, at least annually, whether the company has kept proper books of account
- (f) reviewing the directors’ statement of compliance under Sections 205E(5) and (6)
- (g) determining whether the compliance statement complies with the legislative requirements, and is ‘fair and reasonable and is based on due and careful enquiry’

¹⁶ For a fuller analysis, see Zabihollah Rezaee, Kingsley O Olibe and George Minmier, ‘*Improving corporate governance: the role of audit committee disclosures*’, (2003) Vol. 18, No. 6 Managerial Auditing Journal, pp. 530-537

- (h) recommending to the board of directors whether to approve the compliance statement
- (i) advising the board of directors as to the recommendation of the company's auditor
- (j) monitoring the performance and quality of the auditor's work and independence from the company
- (k) obtaining up-to-date information from the auditor such that the committee can monitor the company's relationship with the auditor
- (l) recommending whether or not to award non-audit work contracts to the auditor/an affiliate
- (m) satisfying itself that the arrangements made/resources available for internal audits are suitable
- (n) reporting on its own activities for the year, including reference to the discharge of its responsibilities
- (o) performing any additional functions prescribed by legislation
- (p) performing any other functions relating to the company's audit and financial management that are delegated to it by the board of directors

The key function of audit committees, advises David Devlin, President of FEEE, the European Federation of Accountants, is 'in providing high-quality financial information for investors.'¹⁷ Nevertheless, the necessity of vesting audit committees with such a comprehensive array of powers is not immediately obvious. Mr Devlin describes these requirements as "radical", and confirm that "Ireland will be out of step in requiring every company incorporated as a plc to have its own audit committee, even if it is a wholly-owned subsidiary of another parent company. The EU plan is not to legislate on this matter, beyond requiring listing companies only to include in their annual reports a statement on key elements of their corporate governance. This is a far lighter EU approach to the regulation of corporate governance than is proposed here."¹⁸

The directors of large private companies limited by shares and certain other forms of undertaking including certain unlimited companies will be required either to establish

¹⁷ See David Devlin, *Comment*, Irish Times, 30 May 2003;

¹⁸ Ibid.

a committee operating on the same basis or explain in their annual report why they have decided not to do so.¹⁹

These provisions do not, however, apply to ‘small’ private companies limited by shares, defined in Section 205B(1)(a) of the Companies Act 1990 (as inserted by the 2003 Act) as undertakings that, in both the most recent financial year of the company and the immediately preceding financial year, and together with their subsidiary undertakings, possessed gross assets of less than €25,000,000, or if the company’s turnover was less than €50,000,000 for the year. Equally, these particular provisions do not apply to certain unlimited companies, or to private companies limited by guarantee.

Section 205B(6) sets out detailed rules regarding eligibility for Audit-Committee membership, the most significant of which are that the committee should consist of not fewer than 2 members,²⁰ and that a director qualifies for appointment to the audit committee unless s/he is, or was during the 3 years preceding appointment to the committee an employee of the company concerned, or of a subsidiary, or if s/he is currently the chairperson of the board of directors.²¹

Auditors’ independence under the 2003 Act

A new Section 205D of the Companies Act 1990 (inserted by the 2003 Act) requires all Irish companies annually to disclose details of the remuneration paid to their auditors and their affiliates. Specifically, Section 205D(3) requires the giving of sub-totals for audit work, audit-related work and non-audit work, and particulars of the nature of any non-audit work

By virtue of Section 205D(6), where the remuneration for non-audit work is greater than the remuneration paid for audit and audit-related work, officers’ statements will be required in the annual report related to the independence of the auditors, and the

¹⁹ Section 205B(4)(a) Companies Act 1990 [as inserted by Companies (Auditing and Accounting) Act 2003]

²⁰ Section 205B(6)(a) Companies Act 1990 [as inserted by Companies (Auditing and Accounting) Act 2003]

²¹ Section 205B(7)(a) and (b) Companies Act 1990 [as inserted by Companies (Auditing and Accounting) Act 2003]

reasons for their engagement on the non-audit work. This is a significant move, and one which signals a virtual end to the cosy auditor-client relationship that it now perceived to have exacerbated the problems identified during recent high-profile cases of fraud and financial misappropriation.

Conclusion

The provisions of the Companies (Auditing and Accounting) Act 2003 represent a seismic shift in the relationship between many Irish companies (both public and private) and the audit process, and will surely cause company directors fundamentally to re-examine their approach to compliance and governance.

Although the Act introduces many much needed reforms, and significantly strengthens the regime of accountability within the financial sector, it can nevertheless be criticised for its essentially reactionary character.

Notably prescriptive in its approach, it is regrettable that the Act should over-regulate to the extent that it does, even if many of its general company-law provisions tend to amplify or extend (as opposed to effecting fundamental alterations of) existing statutory or common-law duties. It is also true that, in some respects, the Act stops well short of the approach taken in other jurisdictions: for example, the Act does not absolutely prohibit the use of audit firms for any forms of non-audit work, in stark contrast to the US Sarbanes-Oxley Act, and contents itself merely with requiring that the use of audit firms for such work be open and transparent, and communicated to the shareholders through the medium of the annual report.

Eircom director, Mr Padraic O'Connor, has publicly voiced the belief that the new law is a 'disproportionate' response to the tax and corporate law scandals that gave rise to it, and maintains "there will be a continuous onus on directors to prove and declare that their companies are innocent."²²

²² See Barry O'Halloran, 'Compliance Law may apply from January', Irish Times, 8 September 2004

The suspicion remains that, whatever its merits, the legislation may prove to "constitute an avoidable bureaucracy that will solely benefit professions and civil servants, while costing businesses time, money and effort".²³

Labour's spokesman, Mr Brendan Howlin, echoed the views of many observers²⁴ when, whilst acknowledging the need for the profession to have "rigid, enforceable and transparent standards", it would be preferable if this could be achieved without incurring the cost of overly cumbersome regulation which would impact on the nature, type and volume of business in the State, and without impeding the "migration of new business into Ireland".²⁵

These concerns notwithstanding, the Act, it must not be forgotten, represents the law of the land, and, with the legislative process largely complete, Irish companies would be best served trying to accumulate the resources that will be necessary to comply with the Act, without underestimating the potential costs in terms of time and money.

Although it may be possible, over time, to recover the trust of investors, lost amidst recent scandals, it is also quite possible that the measures adopted within the legislation may prove detrimental in the long term, by removing incentives for foreign companies to locate in Ireland and by creating the perception that the Emerald Isle is no longer necessarily a fruitful staging post in which to conduct business. If such a perception does indeed take hold, it might lead one to reflect that, perhaps, the regulation has been achieved at the expense of the industry.

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²³ During the legislative process, Fine Gael's spokesman on Enterprise, Trade and Employment, Mr Phil Hogan, described the legislation as such; See Marie O'Halloran, 'Minister praises law to regulate auditors', Irish Times, 17 October 2003

²⁴ See 'Irish accountants attack government over audit rules', March 2004, Vol. 133, Issue 1327, Accountancy. 14

²⁵ See Marie O'Halloran, 'Minister praises law to regulate auditors', Irish Times, 17 October 2003

