

**SUBMISSION OF THE LAW SOCIETY OF IRELAND
TO THE DEPARTMENT OF ENTERPRISE, TRADE AND
EMPLOYMENT ON THE COMPANIES (AUDITING AND
ACCOUNTING) BILL 2003**

For further information please contact:

**Sylvia McNeece
The Secretary,
Business Law Committee
Law Society of Ireland
Blackhall Place
Dublin 7**

Telephone: 01 672 4802

Fax: 01 672 4803

E-Mail: s.mcneece@lawsociety.ie

COMPANIES (AUDITING AND ACCOUNTING) BILL 2003

and in particular

PROPOSAL FOR DIRECTORS' COMPLIANCE STATEMENTS

SUBMISSION

OF THE BUSINESS LAW COMMITTEE
OF THE LAW SOCIETY OF IRELAND

28TH May 2003

Background

The World Competitiveness Analysis¹ published this month by the IMD highlighted in its summary three key issues which have a bearing on legislation affecting enterprise:

“III Europe battles with deficits and the ability to reform governments. **Overregulation and complexity hamper its growth.** Joining members perform better.”

“The competitiveness of Europe is plagued by overregulation and complexity. A recent IMF study has suggested that deregulation could add 10% to the European GDP in the medium term. The cost of doing business is a fundamental part of competitiveness. It is not only calculated in monetary terms (compensation levels, taxation, etc.) but it is also related to the complexity of doing business, the rigidity of structures, the fragmentation of decision-making and a lack of flexibility in changing direction. Cost is certainly part of the competitiveness problem of Europe. However, the ability to simplify structures and to increase transparency in policies is also a major challenge, which has to be tackled. The 15 countries of the European Union are only expected to grow by 1 % in 2003.”

“XI **Confidence in business leaders is at an all-time low. Trust in numbers and people has been destroyed. Legislation on accounting, auditing, and corporate governance will step in.**

“- Accounting standards must be updated to face a new reality...
- The rights and obligations of auditing companies should be better defined
- The structure and role of corporate boards should be reinforced
- The financial sector should eliminate conflicts of interest....

“The multiplication of restricting rules, public or private, may however lead to a “whistle-blowing culture”. The Sarbanes Oxley Act, although responding to

¹ **The World Competitiveness Landscape in 2003** by Stéphane Garelli, Director of the World Competitiveness Project and Professor at IMD Business School and University of Lausanne, published by the International Institute for Management Development (**IMD**) on May 14th 2003.

a legitimate concern in public opinion, will also have some unexpected consequences. Requesting CEOs and CFOs to certify corporate data will lead to very conservative statements. “Sandbagging” will prevail, that is building reserves in enterprises rather than declaring profits. In a period of time when, on the contrary, buoyant perspectives would be welcomed by the market, fewer and fewer CEOs will risk being outspoken and bullish about their expected results.”

“XII Competitiveness key words for 2003: back to fundamentals, simple, solid, no-nonsense, adaptive, transparent, and honest.

“In 2003, the competitiveness landscape is characterized by two fundamental principles:

- Nations should concentrate once again on sound infrastructure.....
- Companies should rediscover the virtues of transparent and ethical behaviour inside the nation in which they operate. No enterprise can be successful, and consequently no nation can be competitive, if public opinion is distrustful of the business community.

It is in this context that the Law Society’s Business Law Committee (“the BLC”) has considered the proposed Companies (Auditing and Accounting) Bill 2003 (“the Bill”).

Main points of the Bill

The BLC’s analysis of the Bill is that its main aims are:

- 1 to regulate the regulators of the accountancy and auditing profession, by the establishment of the Irish Auditing and Accounting Supervisory Authority;
- 2 to procure more transparency in accounts as to payments made to audit firms and their related entities;
- 3 to improve the governance of companies by requiring audit committees;
- 4 to require directors of Irish-incorporated companies formed under the Companies Acts to subscribe to periodic compliance statements in connection with compliance with a wide body of law;
- 5 to require auditors to opine on these directors’ compliance statements.

Summary of BLC Submission

- 1 We support the establishment of the Irish Auditing and Accounting Supervisory Authority.
- 2 We support transparency in accounts as to payments made to audit firms and their related entities.
- 3 We are supportive of the policy of companies having audit committees, but have a number of points with regard to the application of the proposed law.
- 4 We are strongly opposed to the proposal, as at present formulated, to require compliance statements of directors of Irish-incorporated companies formed under the Companies Acts, law which will not apply to non-Irish-incorporated companies operating in Ireland (as well as Irish-incorporated corporations that are not companies such as co-operatives).
- 5 In view of our submission on 4 on compliance statements, the question of the requirement of auditors to opine on these directors compliance statements automatically follows.

Establishment of the Irish Auditing and Accounting Supervisory Authority

The BLC is of the view that Ireland should have and be seen to have regulation which is on a par with any peer jurisdiction. In the context of convergence of accounting standards in coming years, and in order to ensure that Ireland is not left behind in the matter of regulation of auditors, we support the proposal in Part 2 of the Bill.

Transparency in accounts as to payments made to audit firms and their related entities

The BLC supports the proposal to require disclosure of non-audit payments made to affiliated entities contained in section 33 of the Bill. We have two drafting points:

- 1 In the proposed 1963 Act s 182(2)(a)(iv) to be inserted by section 33(c) of the Bill, we propose the insertion after professional services of :

“, or of information, earnings, profits, or exclusive agreements as to client referral, or otherwise”

The purpose of this amendment would be to tighten up the definition of affiliate.

- 2 In the proposed 1963 Act s 182(2)(b) to be inserted by section 33(c) of the Bill, we propose the insertion after subparagraph (iii) a proviso (to affect subparagraphs (i), (ii) and (iii)):

“other than a partnership whose sole business is the acquisition and holding of assets and distribution of profits or gains therefrom.”

The purpose of this amendment is to address the possible application of the provision to payments to stallion syndicates, property partnerships or other similar types of co-ownership of non-related entities.

The Requirement for Audit Committees

In principle, the BLC favours the concept of audit committees, in companies whose size and status requires it. We have two proposed amendments.

- 1 In the proposed 1990 Act s 205B(3) to be inserted by section 40 of the Bill, we propose the following change of wording:

“Subject to subsection (14), the board of directors of each large private company and of each relevant undertaking shall ~~either~~ –

- (a) establish an audit committee that meets the requirements of this section, or
- (b) state in their report under section 158 of the Principal Act the extent to which that they have failed to do so and explain the reasons for the failure not done so, and the reasons therefor, or
- (c) identify in their report under section 158 of the Principal Act a parent undertaking of such company or undertaking which has established an audit committee that meets the requirements of the section.”

The purpose of this amendment is twofold. First it is to remove the word “failure”, which impliedly connotes misbehaviour. The proposed statute appears to permit an opt-out subject to explanation. If that is the ethic underpinning the provision, then the amended wording would be fairer. Indeed subsection (4) refers to companies which “choose” to establish an audit committee. If it is a choice then the language should not speak of “failure”. Secondly, in most groups at present the audit committee would be at parent undertaking level, not at individual group level. The amendment would require a cross reference to the fact of a committee at parent undertaking level.

- 2 Reword the proposed 1990 Act s 205B(7)(c) to be inserted by section 40 of the Bill as follows:

“(c) the directors of the company or undertaking concerned state in their report under section 158 of the Principal Act that paragraphs (a) and (b) apply to such company or undertaking.”

The purpose of the amendment is to render the wording consistent with the intent. The company will be “complying” with the requirement of the section, but in a way that is different from the default. Where there is this difference, which is accommodated by the proposed law, it should not be described as non-compliance.

- 3 The proposed 1990 Act s 205B(11) to be inserted by section 40 of the Bill does not appear to reflect the “choice” available to companies. Should this not refer to public limited companies only?

The Requirement for Directors’ Compliance Statements

The proposed 1990 Act s 205E, to be inserted by section 43 of the Bill, if enacted, will complete a triad of legislation which will create a substantial difference in the form and substance of compliance obligations between Ireland and the UK.

1 Presumption of officers’ default

Section 100 of the Company Law Enforcement Act 2001 has reversed the burden of proof as to when an officer is in default under the Companies Acts.

“ (1) For the purpose of any provision of the Companies Acts which provides that an officer of a company who is in default shall be liable to a fine or penalty, an officer who is in default is any officer who authorises or who, in breach of his duty as such officer, permits, the default mentioned in the provision.

(2) For the purposes of this section, an officer shall be presumed to have permitted a default by the company unless the officer can establish that he took all reasonable steps to prevent it or that, by reason of circumstances beyond his control, was unable to do so.

(3) It is the duty of each director and secretary of a company to ensure that the requirements of the Companies Acts are complied with by the company.

(4) In this section ‘default’ includes a refusal or contravention.”

2 Reporting by auditors of possible indictable offences to the Director of Corporate Enforcement

The insertion of 1990 Act s 194(5) by section 74(e) of the Company Law Enforcement Act 2001, which imposes on auditors an obligation to notify the Director of Corporate Enforcement where they “form the opinion that there are reasonable grounds for believing that the company or an officer or agent of it has committed an indictable offence under the Companies Acts.”

3 **The proposed compliance statement**

The proposed compliance statement requires the directors as soon as possible after the commencement of this section of the Bill to prepare a directors' 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).”

The directors' compliance statement (including any revisions) must—

- “(a) be in writing,
- (b) be submitted for approval by the board of directors,
- (c) at least once in every 3 year period following its approval by the board, be reviewed and, if necessary, revised by the directors, and
- (d) be included—
 - (i) in the directors' report or the notes to the company's annual accounts, where the report or those notes are required by the Companies (Amendment) Act 1986 to be annexed to the company's annual return, or
 - (ii) in the notes to the company's accounts, where the company as permitted by section 10(2) of that Act does not annex the directors' report to its annual return.”

The directors in their Report of the Directors (on the accounts) are to include in their report under section 158 of the Principal Act a statement—

- “(a) acknowledging that they are responsible for securing the company's compliance with its relevant obligations,
- (b) confirming that the company has internal financial and other procedures in place that are designed to secure compliance with its relevant obligations, and, if this is not the case, specifying the reasons,
- (c) confirming that the directors have reviewed the effectiveness of the procedures referred to in paragraph (b) during the financial year to which the report relates, and, if this is not the case, specifying the reasons, and
- (d) specifying whether, based on the procedures referred to in paragraph (b) and their review of those procedures, the directors are of the opinion—

- (i) that they used all reasonable endeavours to secure the company's compliance with its relevant obligations in that financial year, and
- (ii) that (except for instances of non-compliance of a minor or otherwise immaterial nature that may have occurred) the company has complied with its relevant obligations in that financial year, and, if they are not of that opinion, specifying the reasons."

"Relevant obligations" is widely defined as meaning the company's obligations under—

- (a) the Companies Acts,
- (b) tax law, and
- (c) "any other enactments that provide a legal framework within which the company operates and that may materially affect the company's financial statements".

'Tax law' means the Customs Acts, the statutes relating to the duties of excise and to the management of those duties, the Tax Acts, the Capital Gains Tax Acts, the Value-Added Tax Act 1972 and the enactments amending or extending the VAT Act, the Capital Acquisitions Tax Act 1976 and the enactments amending or extending the CAT Act, the statutes relating to stamp duty and to the management of that duty and any other laws relating to those taxes.

This definition is so wide that, if enacted, will lead to an adviser-fest and compliance industry which will serve to suck value out of the real economy. Potentially "any other enactments that provide a legal framework within which the company operates and that may materially affect the company's financial statements" can include labour law, health and safety legislation, environmental legislation. In each of those cases, there has been a standard of behaviour imposed on company officers in that legislation. To add a requirement in company law is to render redundant any discussion as to liabilities when those bodies of legislation were introduced.

New legislation and proposed legislation has missed the point

- The BLC is of the opinion that the accumulation of well-intentioned random legislation which is aimed at compliance runs the risk of bringing all such law into disrepute.
- To quote from another company law review in relation to another issue, the law may prove to be

“an occasional embarrassment to the honest without being a serious inconvenience to the unscrupulous².”

- In many if not most of the recent accounting scandals, the disreputable behaviour was a mix of sharp and smart technical compliance with a great body of technical accounting rules, where by a combination of trickery by accountants and bullying by executives in companies, the integrity of accounting information of companies was hopelessly corrupted. If those responsible for the accounting had been required to disregard the technical accounting rule books and instead to provide for true and fair – i.e. honest – accounts, we believe that many of the scandals would not have occurred.
- We believe:
 - that s 100 / 383 should be repealed
 - that reports to the Director of Corporate enforcement should be concentrated on issues of fraud and false accounting, and
 - that there should be no requirement for the compliance statements.

We recognise however, that the political environment would be unresponsive to a submission on this basis.

• **We therefore submit that the focus of the recent and proposed law**

- presumed guilt
- reporting to regulators
- compliance statements

ought to be concentrated on the integrity of financial information, with historical law restored for other purposes.

- In the competitiveness report at the head of this submission, we deliberately included the final conclusion of the IMD – the requirement for transparency and ethics. Where one begins writing ethical rule books, the sense of ethics is lost and it becomes a cat-and-mouse environment of technical compliance with those rules. The underlying ethics are forgotten.
- Therefore, if the compliance statement is to remain we submit that it ought to be limited in scope to the following obligation:

a statement in the report of the directors under section 158 of the Principal Act that the directors have satisfied themselves as to the accuracy in all material respects, and / or

² Jenkins Committee Report 1963 para 176

internal structures within the company which will take all reasonable steps to procure such accuracy, in all material respects, of:

- (a) the information in the annual accounts;
- (b) financial information returned to the revenue commissioners for the purposes of corporation tax and value added tax;
- (c) information furnished by the company to any regulator for the purpose of the issue of a regulatory licence to conduct the particular business of the company.

- We submit that section 100 / 383 be redrafted to read as follows:

(1) For the purpose of any provision of the Companies Acts which provides that an officer of a company who is in default shall be liable to a fine or penalty, an officer who is in default is any officer who authorises or who, in breach of his duty as such officer, permits, the default mentioned in the provision.

(2) For the purposes of this section:

(a) in the case of the obligations of the company as to the preparation of accounts and the keeping of books of account under the Companies Acts, an officer shall be presumed to have permitted a default by the company unless the officer can establish that he took all reasonable steps to prevent it or that, by reason of circumstances beyond his control, was unable to do so; and

(b) in any other case, an officer who is in default means any officer of the company who knowingly and willfully authorizes or permits the default.

(3) It is the duty of each director and secretary of a company to ensure that the requirements of the Companies Acts as to the preparation of accounts and keeping of books of account are complied with by the company.

(4) In this section 'default' includes a refusal or contravention.

- We submit that section 194(5) of the 1990 Act be redrafted to read as follows:

''Where, in the course of, and by virtue of, their carrying out an audit of the accounts of the company, information comes into the possession of the auditors of a company that leads them to form the opinion that there are reasonable grounds for believing that:

(a) the company is in breach of the provisions of the Companies Acts as to the preparation of accounts and keeping of books of account; or

(b) the company or an officer or agent of it has committed an offence involving fraud under the Companies Acts;

the auditors shall, forthwith after having formed it, notify that opinion to the Director and provide the Director with details of the grounds on which they have formed that opinion.

Auditors' duties as to Directors' Compliance Statements

In view of our submission as to the nature of the compliance statement, we would envisage no requirement for extra legislation for auditors.

Other issues

Investment funds

- 1** We submit that the entire Bill be disapplied from any entities which are authorised or regulated by the Central Bank of Ireland under the UCITS Regulations or Part 13 of the 1990 Act.

Revision of accounts

- 2** In section 26 of the Bill we submit that subsection (9) be split into two paragraphs, with the following inserted as paragraph (b)

“A director who votes against the approval of the accounts and, in writing, notifies the other directors and the auditors of his or her disapproval of the accounts shall be deemed to have taken all reasonable steps to prevent their being approved.”

The purpose of this amendment is clarity.

- 3** In section 26 of the Bill we submit that a new subsection (16) should be inserted.

“Where, before a notice is given by the Supervisory Authority under subsection (3), the directors of a relevant undertaking revise the annual accounts of that undertaking to which that subsection refers, then, those revised accounts shall be deemed to be the accounts to which that subsection refers.

The purpose of this amendment is to permit revision of the annual accounts by the directors without the need for formal notice and the consequent potential imposition of costs by the Supervisory Authority.

Conclusion

The competitiveness report highlighted three needs for European economies which are relevant in the context of the discussion of the new law:

- the avoidance of overregulation and complexity
- the requirement for restoration of confidence and trust
- a return to fundamentals, simplicity, solidity, transparency, and honesty

The enactment of legislation must not constitute an empty gesture which floods the regulators with a meaningless blizzard of technical non-compliance. There must be a concentration on what matters rather than on the generality. To take a parallel example – in road traffic legislation, there is a concentration on preventing speeding and driving by intoxicated persons. By that focus, the law has won more respect, as well as saving many lives. If instead there were an even concentration on trifling offences, a broken indicator might be equated with dangerous driving.

The law grants limited liability to companies. In return the State expects honest accounting and fair dealing. The law should concentrate on this.