Audit Committee Institute
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Audit Committee Quarterly

Issue 02

BELGIUM

Introduction	1
Managing Culture	2
Transfer Pricing: Belgium is catching up	4
How do your views compare with your peers?	5
What Boards need to know about financial statement fraud	6
SOX benefits for non-SEC companies	8
Developments in Belgium	10
IFRS: Your service contracts could be finance leases	12
IFRS: Fair Value Option	14
Amended EU Eighth Directive requires Audit Committee installment	15
Five Basic Principles for Audit Committees	16
Resources	20
ACI Events	24

Introduction

Dear All

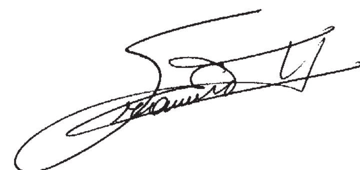
We have received many registrations for the Audit Committee Institute since the first issue of the ACI Quarterly in August of this year. At a time when director responsibility and risk is evolving rapidly, this was an expected – but none-the-less exciting – confirmation of the need for an interactive source of knowledge and competence. We are in direct and regular contact with over 2.500 members of audit committees and boards.

The Audit Committee Institute is focused on bringing corporate governance recommendations to your attention, and as regulations evolve, our goal is to help you implement an effective and learned response to the challenges they represent. The vehicles we use to do this are now well underway. Our Audit Committee Quarterly periodical offers you articles on regulatory and technical matters, features audit committee "hot topics" and includes other content from our extensive resources. ACI Roundtable Sessions and Seminars provide an opportunity for first-hand experience and an exchange with peers.

Since its printing in September, we are especially pleased to offer you – at no charge - the new ACI publication *Shaping the Belgium Audit Committee Agenda*. In addition to such useful tools as templates for an audit committee agenda, a self-evaluation, assessments of external and internal auditors, this publication provides you with specific terms of reference and audit committee basics. These audit committee essentials are up-to-date, incorporating the latest regulatory and legislative changes at the date of printing. Also included is specific guidance for the implementation of the Belgian corporate governance code. We strongly believe you'll find this publication very helpful. Your free hardcopy can be ordered from our ACI Web site at www.audit-committee-institute.be or by using the enclosed registration card.

We are proud to reaffirm our commitment to audit committee and board members to furnish the tools, information and professional development opportunities needed to enhance awareness and ability in implementing effective oversight procedures.

As always, we look forward to hearing from you, and we welcome your feedback.



Theo Erauw
Chairman

Managing culture: The secret ingredient of corporate success

Corporate culture has been described as "the way we do things around here". It's about how an organization's values, attitudes and traditions are reflected in individual and collective behaviors and expectations. An organization's culture determines how others perceive it, how it responds to a crisis, and how it manages growth and change.

Of course, there is no one "right" culture, and each organization must chart its own course. Today, most boards accept they have a role in shaping their organization's culture, and in defining the values and ethical positions that underpin that culture. They recognize it's a "tone at the top" issue. However, many Belgian boards remain uncomfortable with "cultural" issues.

Tangible financial and legal perspectives typically dominate boardroom deliberations. It's easy to view social phenomena such as culture as "soft science", inherently elusive, chaotic and unmanageable. Many directors are reluctant to inject ethical and moral considerations into board debates. Moreover, workplace culture is seen to demand a day-to-day, hands-on involvement that's beyond the capacity of non-executive directors.

Yet it's undeniable that many durably successful enterprises are characterized by strong and distinctive cultures that drive superior business performance. Studies of corporate scandal and failure invariably uncover dysfunctional and toxic cultures that harbor unethical and shareholder destructive behavior. Inappropriate cultural influences in an organization can blindside boards, leaving them vulnerable to unrecognized risks of financial loss, reputation damage and legal sanction.

Recent ACI research suggests boards try to resolve the "culture problem" by relying on formal statements of corporate values and policies to shape their organization's cultural development. That's a good first step; however, statements of good intentions don't automatically translate into appropriate workplace behaviors. It's the unrecognized, undiscussed and unresolved daily decisions and actions that shape the organization's culture, and the ethical and moral dimensions of that culture.

Something more is needed

Just as boards seek to monitor and review critical indicators of corporate financial performance and risk, is it asking too much to suggest they should do the same with organizational culture? Reporting systems such as cultural audits can arm boards with the knowledge and insights to supervise culture, and align it with business strategies and organizational goals. It's an approach that acknowledges that culture can be proactively nurtured, measured and monitored as a living process.

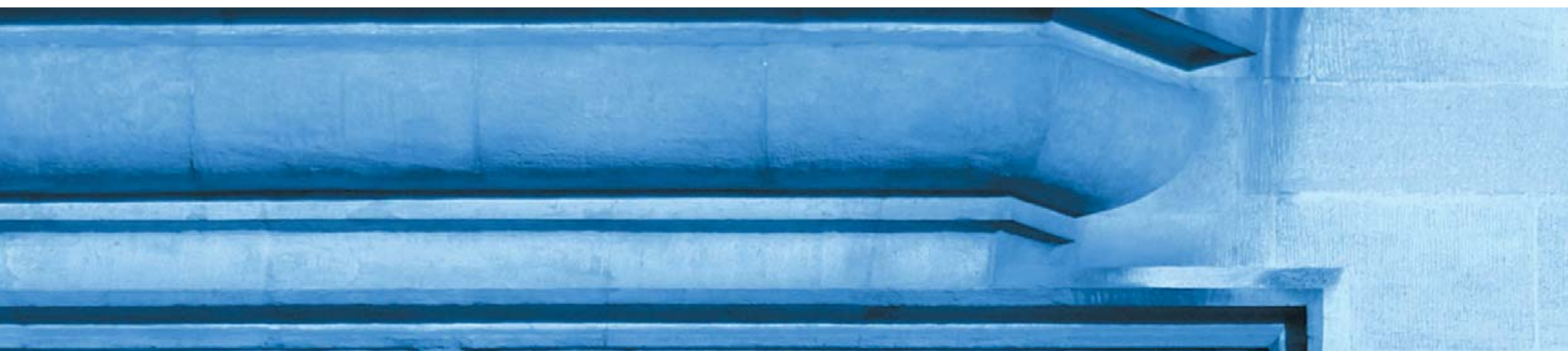
For a start, boards can consider how reward and recognition, recruitment and performance management systems send powerful cultural messages to an organization's people, and indirectly to its customers, suppliers and the community at large. It means removing any doubts and ambiguities about what values and ethical standards are to be protected in pursuing corporate objectives.

Boards can usefully ask other questions on matters that have a strong cultural and ethical dimension.

- Are the organization's stated values and ethical positions consistent with its actual policies and behaviors?
- What precautionary steps does the board take when approving policies that impact on ethical behavior, e.g., reward and recognition policies, overseas investment strategies, organizational re-engineering initiatives?
- Are the cultural and ethical issues an integral part of board reviews of CEO and senior executive performance?
- Is the organization's industry particularly susceptible to particular conflicts of interest and other practices? What measures are in place to monitor and manage these matters?
- Does the Board regularly commission a review of the organization's culture and behaviors by an independent reviewer?
- Is guardianship of the organization's values and ethics clearly articulated and treated as a key CEO accountability?

While boards can not exercise control over the external environment that affects the company, they can provide vision and leadership, and in the absence of a universal ethical code, publicly set the ethical tone for their enterprises.

By demanding explicit commitments to ethical accountability, boards create the necessary counterweight to the pursuit of individual gain or aggrandizement within the organization. Taking decisive action ensures that leadership capability moves beyond good intentions into tangible action to bring forth the ideal environment in which successful business can flourish.



Transfer Pricing: Belgium is catching up

Transfer pricing has not only become a major tax planning opportunity for multi-nationals in recent years, when remodeling business structures, but has also become the most important area in corporate income tax for tax authorities to raise adjustments and increase tax revenues

Multinationals must, on the one hand, convince tax authorities that their change in business models and related transfer pricing policies are for genuine commercial reasons, and not solely to avoid taxes. At the same time, they must satisfy shareholders expectations, as investigating low-tax jurisdictions for business locations can be seen as a responsibility of the Board.

In many of the countries surrounding Belgium, such as the UK, France, Germany and the Netherlands, transfer pricing legislation has been introduced, and specialized transfer pricing teams within the tax departments conduct focused transfer pricing audits to safeguard their tax revenue streams.

As a consequence, tax authorities have created a large transfer pricing compliance burden for European multinationals, as the latter attempt to avoid tax penalties, limit the personal liability of directors, reduce the time and costs associated with local transfer pricing audits and mutual agreement and Arbitration procedures, and avoid economic double taxation.

Recently, the Belgian government has recognized the importance of transfer pricing in today's international economic environment, and has decided to set-up a specific national team of tax inspectors, who will solely deal with transfer pricing audits of those Belgian and foreign multinationals with important activities in Belgium (such as regional European head office, important production facilities, etc.).

On the plus side, the Belgian government has re-organized its transfer ruling practices in the beginning of 2005, with an objective for more constructive and open-minded thinking. The government recognized that a well-functioning and flexible tax ruling system is an important tax differentiator for multi-nationals, when deciding among EU countries. The efforts at European level to harmonize taxes between countries by abolishing favorable tax regimes have made up-front certainty in transfer pricing policy an important taxpayer priority, as it avoids the excessive time spent during transfer pricing audits.

There is no question that Belgium is catching up with Europe concerning transfer pricing matters. Therefore, Boards should set their business structure and related transfer pricing strategy in such a way that it optimizes tax efficiency and limits the cost of being compliant, either pro-actively through transfer pricing rulings (APAs), or by defending sound transfer pricing documentation during future transfer pricing audits.

How do your views compare with your peers?

The Audit Committee Institute, established internationally in 1999, has had the opportunity to question its member directors on several hot topics. For your convenience, we have summarized below the responses of your colleagues in the U.S. and the UK. You will agree that it would be interesting to have European results as well. Therefore, ACI is gathering quick polls all over Europe, and you can participate. **Please access our electronic survey on our ACI web site** (www.audit-committee-institute.be). Your voting will only take a few minutes of your time.

	U.S.	UK
1. Which of the following best describes the role of the CEO in audit committee meetings?		
a) Only attends when invited by the Chair of the audit committee for a specific agenda item	31.1%	23.7%
b) Formally attends most/all audit committee meetings and plays an active role during the course of the meeting	38.8%	35.6%
c) Attends most/all audit committee meetings as an observer only	25.7%	27.1%
d) Generally does not attend audit committee meetings	9.4%	13.6%
2. How confident are you that management has the appropriate skill and experience to address financial reporting and accounting issues related to increasingly complex business processes and transactions?		
a) Very confident	37.0%	49.2%
b) Somewhat confident	51.9%	45.7%
c) Not confident	11.1%	5.1%
d) Not sure	-	-
3. Do you believe that the losses incurred in some of the high profile financial reporting scandals of the last few years could have been avoided or reduced if the financial reporting and audit processes of the company had been overseen by an audit committee deemed to be "effective" by today's standards?		
a) Yes	66.7%	64.4%
b) No	33.3%	35.6%
4. How important is the quality of the pre-meeting information (i.e., audit committee papers) to enhancing the effectiveness of the audit committee meeting?		
a) Very important	76.9%	89.8%
b) Important	15.4%	10.2%
c) Somewhat important	3.1%	-
d) Not important	4.6%	-
5. What electronic communication tools are regularly used by management, if any, to provide the audit committee with its pre-meeting materials?		
a) E-mail	57.8%	55.6%
b) Computer disk, memory stick or similar, sent through the mail	3.1%	4.8%
c) Information provided through the company's intranet	6.3%	1.6%
d) No pre-meeting materials in electronic format	32.8%	38.0%
6. On average, during audit committee meetings, how much time do audit committee members spend discussing issues or asking questions (as opposed to listening to information being presented)?		
a) Less than 10% of the time is spent discussing issues or asking questions	2.0%	-
b) Between 10 and 25%	43.1%	30.5%
c) Between 25 and 50%	27.5%	30.5%
d) Between 50 and 75%	23.5%	32.2%
e) Between 75 and 90%	3.9%	6.8%
f) More than 90% of the time is spent discussing issues or asking questions	-	-
7. Who in your opinion has the most influence over the appointment and remuneration of the independent auditor?		
a) CEO	20.8%	6.9%
b) Finance director	54.2%	43.1%
c) Audit committee	20.8%	48.3%
d) Internal audit	4.2%	-
e) Other	-	1.7%

What Boards need to know about financial statement fraud

Boards are becoming increasingly sensitive to the risk of fraud affecting their respective organizations. But how many of them have considered that they might be signing off on "fraudulent" financial statements?

One of a board's worst nightmares is that it signs off on financial statements that are subsequently shown to have materially misstated the organization's financial position and performance.

If the misstatement is significant, the board is likely to suffer damage to its credibility, not to mention personal vulnerability to legal sanctions and civil liabilities that could ultimately arise from such an event.

Material misstatements can arise from a variety of causes, including simple error. Still, wise boards will be alert to the possibility that their organization's financial statements could be impaired by fraudulent activity.

Much of the recent regulatory change such as the U.S. Sarbanes-Oxley Act has been aimed at improving the integrity and transparency of financial reporting. It is time for boards to reassess the approach to managing the risks of financial statement fraud.

Understanding financial statement fraud

Financial statements can be materially affected by fraudulent behavior in two ways. The first is the undetected misappropriation of assets on the part of one or more individuals. This is theft, pure and simple. Experience shows that, although such actions are eventually detected, the sums at risk may be very large, even to the point of threatening the survival of a business.

The second is financial reporting fraud in which financial statements are manipulated to deceive the users of financial reports, including, in some instances, the board itself. It typically involves the overstatement of assets and/or revenue, the concealment or understatement of liabilities, or the construction of artificial transactions with the sole purpose of disguising the true state of the entity's affairs.

The motivations for financial fraud are varied, but often reflect the desire to meet earnings forecasts, clear executive compensation hurdles linked to profitability or market capitalization, avoid breaching debt covenants tied to financial performance, or cover-up poor management decisions. Obviously such manipulation occurs at the senior management level, and may even reach as high as the CFO and CEO. Some distinguish between the fraudulent manipulation of financial statements and the management of financial results. The former entails a deliberate, unambiguous breach of both the letter and the intent of the applicable Generally Accepted Accounting Principles (GAAP).
The latter involves an aggressive, liberal or imaginative interpretation of the relevant GAAP, but will typically fall short of a total deviation from them. That is, the accounting treatment adopted is at least arguable.

Boards should recognize that the distinction between the two practices is often blurred, and that it can be a relatively small step from managing or massaging the figures to their fraudulent misstatement. The problem will be accentuated when senior management doesn't accept that the manipulation of financial statements can amount to fraud.

> "After all, the history of business failures and scandals is littered with the corpses of unsuspecting boards from whom vital information was withheld or concealed."

What should boards do?

Financial statement fraud is clearly a sensitive area as it's unlikely to occur without the involvement or complicity, or perhaps complacency of elements of senior management.
The board needs to tread carefully while retaining a healthy skepticism about the information it is given.
After all, the history of business failures and scandals is littered with the corpses of unsuspecting boards from whom vital information was withheld or concealed.

A useful starting point is to understand that all frauds – including fraudulent financial reporting and the misappropriation of assets – are the outcome of three factors:

- The existence of incentives and pressures to engage in such activity;
- The opportunity to do it, and
- The 'cultural' influences that allow perpetrators to rationalize their behavior.

The board must deal with the issue on all three fronts.

For example, executive compensation schemes based on unrealistic profit targets provide an incentive for financial statement fraud. Similarly, a board or audit committee that fails to properly understand and scrutinize changes in accounting treatments and policies creates an opportunity for financial reporting fraud.

A cavalier approach to compliance with accounting and other regulatory requirements suggests weak cultural constraints on fraudulent behavior.

Robust controls and risk management systems will help deter and detect fraudulent misstatements, but can be subject to management overrides that negate their effectiveness. Direct reporting to the board by internal audit, can help when unmediated by management, as can appropriate "whistleblower" procedures.

If particular risk factors or areas are identified, the board can consider bringing in external consultants to scrutinize the situation. CEO/CFO formal signoffs on the financial statements, are a further comfort, but only if they are based on rigorous processes and controls. Ultimately, it's a "tone at the top" issue. The board must make the effort to understand the reality behind the figures, and make it clear to senior management that departures from its required standards will not be tolerated.

This said, a board should be alert to the "red flags" that indicate the possibility of financial statement manipulation. They include:

- A CEO who is intimately involved in accounting entries
- "Opinion shopping" among accounting firms, particularly with regard to revenue recognition practices
- Unexplained differences between management accounts and the annual financial statements, including significant "Period 13" adjustments
- Deferred expenses on the balance sheet
- Complex or unusual transactions entered into close to year-end. Particular note should be taken of such transactions involving related parties.

Ultimate responsibility for preventing and detecting fraud remains with the board and senior management. In summary, a robust control environment and sound reward and remuneration structures, underpinned by a corporate culture that sets an appropriate "tone at the top" for ethical behavior, is the board's best defense against financial statement fraud.

SOX benefits for non–SEC listed companies

Compliance with Sarbanes-Oxley has, at the very least, pushed many companies to strengthen their accounting controls and the infrastructure needed to support quality financial reporting. It has even spurred many companies to look closely at their business processes, the fountainhead of their raw accounting data, and to consider which controls can help achieve better management of processes and business risks, and which can not. This has helped to streamline processes and internal controls, with the potential benefit of reduced costs in the long run.

Sustainable control and business improvement

Sarbanes-Oxley has put internal controls in the spotlight, and non-SEC listed companies are increasingly looking to implement a Sarbanes-Oxley-type program.

Application of the principles of Sarbanes-Oxley can be a springboard for improvements in controls, processes and business performance, governance and reputation. The transformation journey to improved business performance should start with a greater understanding of the organization's control portfolio. Forthcoming European legislation on controls also strengthens the case for action in this area.

Due to efforts to achieve compliance, SEC companies have more information about their controls in place. By assembling this controls portfolio, leaders of the SEC companies know what controls are performed and by whom – for perhaps the first time. They are beginning to understand how the nature of their controls affect, or are affected by, business performance and, consequently, what changes may be needed to balance this portfolio as the business itself changes.

The efforts of compliance also provide considerable information about an organization's business processes. The documentation and evaluation of controls is heavily guided by the nature of processes managed, their individual significance, and the need to identify potential issues with internal controls over financial reporting. With this information, organizations are beginning to understand how their business processes work, how they interface, and how they can be made more effective and efficient. The insights about the business processes can lead to important business changes. This knowledge provides leaders with a new "lens" through which they can evaluate their business; a new means of considering and managing risks, improving the quality of their initiatives, and driving a return from the Sarbanes-Oxley investment.

Remedial action on core controls can also be used as an opportunity to address the root cause of operational inadequacies, and deal with inconsistencies as a route to business improvement. A move to link disparate areas of the finance function, for example, should improve the speed and accuracy of management information, helping to provide both quantitative and qualitative analysis to support strategic decision making. This data and control-enhanced environment can also make it easier to drive savings by more quickly identifying and then redressing deficiencies in cash management, in licensing and other contractual relationships, in supply and procurement processes, in IT management, and in outsourced relationships. Sarbanes-Oxley requirements enhanced companies' internal control over financial reporting through:

- More timely identification and remediation of weaknesses
- An increased understanding of risks and how you can manage them
- Identification of opportunities for business and risk management improvements that go well beyond financial controls
- Strengthened and streamlined controls – more extensive standardization, consolidation and automation
- Standardized and simplified processes.

Lessons learned from Sarbanes-Oxley compliance activities to date

For many organizations, analyzing the basics has helped to reveal widespread rudimentary financial control issues. Some of the trends identified have included:

- Improper or inadequate segregation of duties
- Inadequately defined or applied policies and procedures
- Weaknesses in the account reconciliation process: untimely, inconsistent and lack of meaningful management review
- Inadequate structuring of the year-end closing process
- A lack of built in controls to new or changing IT programs, lack of system access controls, poor end-user computing controls
- Absence of a fraud risk management strategy and procedures
- A lack of audit trails to support journal entries
- A lack of internal review or monitoring process
- A lack of requisite staff and/or experience in regard to accounting/financial reporting areas and the financial close process.

As a result of these control deficiencies, the entire underlying framework for the organization's financial reporting can be flawed. Therefore, many believe that non-SEC companies should also consider the implementation of an ongoing evaluation processes.

Your response

The overall process in relation to both the financial and operational control arena involves the following:

- Identify key risks, core processes and the core controls that the organization places reliance on through a control environment review
- Identify the elements of a Sarbanes-Oxley program which are likely to add value to the organization's control environment
- Undertake a Sarbanes-Oxley type gap assessment
- Assess the effectiveness of controls in place
- Prepare a practical action plan on remediating control weaknesses and helping to improve the portfolio of existing controls
- Roll out this approach across the business.

SEC companies increasingly drive business value by achieving a balance between risk management and business improvements. The major benefits of Sarbanes-Oxley should encourage non-SEC companies to consider a greater focus on monitoring the internal control environment.

Developments In Belgium

Mandatory publication of price sensitive inside information without delay

The Royal Decree of 24 August 2005, published in the Belgian Official Gazette of 9 September 2005, amends the law of 2 August 2002 relating to the monitoring of financial markets.

In the previous version of this law, it was not required that price sensitive inside information be made public immediately if the company could prove the information was insufficiently fixed or stable.

The Royal Decree amendment to this law now requires public interest entities in Belgium to make an "occasional" publication without delay of any price sensitive inside information. Very limited exceptions to the rule still exist, but in any case, the BFIC needs to be informed of the existence of "inside knowledge".

The full text of the BFIC September 2005 publication can be found on the BFIC web site (www.cbfa.be) by selecting "Listed Companies - Information", selecting Circulars and double-clicking "FMIC2003-02"-September 2005 amended publication (available in Dutch and French).

Banking, Finance and Insurance Commission reports new policy relating to public offers

The European Prospectus Directive comes into effect on 1 July 2005. In anticipation of the complete incorporation of the Directive into Belgian law, requiring modification of several aspects of current Belgian legislation, the BFIC announced on 16 June 2005 that it will adopt, as of 1 July 2005, a new policy for the treatment of files relating to public offers and admissions to trading on a regulated market.

The full text of the BFIC 2005 prospectus directive can be found on the BFIC web site (www.cbfa.be) by selecting "Public Offers - Issues of Securities", selecting "Circulars" and double-clicking "Prospectus Directive".

Emission Rights

The Commissie voor Boekhoudkundige Normen - Commission des Normes Comptables has issued in August 2005 an interpretation on the accounting treatment of Emission Rights (Interpretation 179-1 De boekhoudkundige verwerking van broeikasgasemissierechten - Le traitement comptable des quotas d'émission de gaz à effet de serre)

The Interpretation recommends that emission rights are accounted for in either of two methods:

Using the gross method

Allowances are intangible assets, whether issued by government or purchased. Allowances that are issued for less than fair value shall be measured initially at their fair value. When allowances are issued for less than fair value, the difference between the amount paid and fair value is other operating income, which shall initially be recognized as deferred income in the balance sheet, and subsequently recognized as income on a systematic basis over the compliance period for which the allowances were issued.
As emissions are made, a liability is recognized for the obligation to deliver allowances equal to emissions that have been made. It shall be measured at the value of the allowances received and at fair value for the portion exceeding the allowances received.

Using the net method

According to this method, only a liability is recognized for the portion exceeding the emission rights granted. It is measured at fair value.

You can retrieve the 179-1 CBN interpretation in the “Other Resources” caption of our Web site www.audit-committee-institute.be.

IFRS: Your Service Contracts Could Be Finance Leases

The International Financial Reporting Interpretation's Committee (IFRIC) has recently issued IFRIC 4 Determining whether an Arrangement contains a Lease (2 December 2004). This interpretation contains guidance for determining whether an arrangement is, in substance, a lease or contains a lease, even if the agreement is not in the legal form of a lease. IFRIC 4 does not, as such, establish any new lease accounting requirements, but considerably enlarges the scope of the lease accounting standard IAS 17.

A first practical experience with IFRIC 4 shows that there could be a considerable impact on the balance sheet of companies as from 1 January 2006. Indeed, contracts, which at first view are not leases, may have to be considered as finance leases, i.e., to be recognized on your balance sheet.

Background

IFRIC 4 arises from the increasing number of arrangements that do not take the legal form of a lease, but convey rights to use items for agreed periods of time in return for a payment or series of payments.

Common examples of such arrangements may include, among others:

- Outsourcing arrangements, such as information technology management. Every company that has outsourced certain of its functions – not necessarily limited to IT – may be impacted.
- Take-or-pay contracts, which require purchasers to make specified payments whether or not they take delivery of the contracted products. These especially apply to certain industry sectors such as electricity, gas, chemicals, etc., since these sectors traditionally act as third party providers for other companies, or utilize third party providers for their own purposes, e.g., water, pressurized air, gases, etc.
- Companies entering into (take-or-pay) subcontractor agreements, in which an asset is used. For example: plant or warehouse management.

IFRIC 4 contains guidance whether such arrangements are, or contain, leases that should be accounted for under IAS 17 (leasing). IFRIC 4 however does not apply to leases excluded from the scope of IAS 17.

If an agreement is determined to contain a lease, then IFRIC 4 requires IAS 17 to be applied to classify and account for the lease as either a finance lease or an operating lease following the requirements in IAS 17. Practical experience shows, however, that in case IFRIC 4 is applicable to an arrangement, the “embedded” lease is in most cases a finance lease.

Issue of IFRIC 4

The interpretation addresses the following issues:

- How to determine whether an arrangement is, or contains, a lease as defined by IAS 17
- When the assessment and reassessment of an arrangement should be made
- How to separate lease payments from payments relating to other elements of the arrangement that contains a lease.

When determining whether an arrangement is, or contains, a lease the assessment is based on the substance of the arrangement, considering whether:

- Fulfillment of the arrangement is dependent upon the use of a specific asset, and
- The arrangement conveys the right to use an asset.

The second condition might be especially difficult to assess. IFRIC 4 states that an arrangement grants the purchaser the right to use an asset if it conveys to the purchaser the right to control the use of the underlying asset. This is the case if one of the following conditions is met:

- The purchaser has the ability or right to operate the asset in a manner it determines, while obtaining or controlling more than an insignificant amount of the asset's output.
- The purchaser has the ability or right to control physical access to the asset, while obtaining or controlling more than an insignificant amount of the asset's output.
- Facts and circumstances indicate that it is a remote possibility that another party (or parties) will take more than an insignificant amount of the asset's output produced during the term of the arrangement, and that the price paid by the purchaser for the output is neither a contractually fixed price per unit of output, nor the market price per unit of output at the time of delivery.

Separating payments for the lease from other payments

If an arrangement is or contains a lease, the requirements of IAS 17 should only be applied to the lease element of the arrangement. To this end, payments and other considerations required by the arrangement have to be separated at the inception of the arrangement, or upon a reassessment of the arrangement, into those for the lease and those for other elements based on their relative fair values.

Effective date

IFRIC 4 is effective for annual periods beginning on or after 1 January 2006, with earlier application encouraged. Full retroactive application is not required.

Conclusion

The introduction of IFRIC 4 obliges the management of every company reporting under IFRS to carefully review their contractual arrangements to assess whether they have concluded agreements that contain "embedded" leases which might need specialist involvement. The calculated impact can be of importance from a "lessor" side (where the company acts as a provider of the service some assets might have to be de-recognized) as well as from a "lessee" side (where the company utilizes a third party service provider). The impact will undoubtedly be greater in certain industry sectors than in others, but considering the large scope of IFRIC 4, any company might ultimately be affected.

IFRS: Fair Value Option - Amendment to IAS 39

This Fair Value Option is likely to simplify the application of IAS39 for many entities, once endorsed by the EU. It would bring relief for both accounting mismatches and the burden of separating embedded derivatives.

In response to the concerns of many constituents that the previously unrestricted fair value option through profit and loss could be used inappropriately, the IASB recently published Amendment to *IAS 39 – Fair Value Option*, restricting the use of the fair value option in IAS 39 to situations that meet certain criteria.

The amended IAS 39 allows an entity to designate a financial asset or financial liability as at fair value through profit or loss in any one of the following situations:

- When the designation results in more relevant information, because either:
  - It eliminates or significantly reduces an "accounting mismatch" arising from measuring assets or liabilities or recognizing gains and losses on such instruments on different bases, or
  - A group of financial assets and/or financial liabilities are managed on a fair value basis, in accordance with a documented risk management or investment strategy, with information being provided to key management personnel on this basis, or
- When a contract contains one or more substantive embedded derivates unless:
  - The embedded derivative does not significantly modify the cash flows of the host contract, or
  - It is clear, with little or no analysis, that IAS 39 would prohibit separation of the embedded derivative.

In practice, the designation in the first situation described above would eliminate the need for hedge accounting for hedges of fair value exposures when there are natural offsets, thereby eliminating the related burden of designating, tracking and analyzing hedge effectiveness. Under the mixed measurement model of IAS 39 (before fair value option), a forward exchange contract must be measured at fair value, with fair value adjustments recognized through profit and loss, whereas the underlying floating rate debt denominated in foreign currency is measured at amortized cost, unless the transaction qualifies for hedge accounting (documentation, effectiveness).

Since the financial liability is a floating rate liability, the fair value of the liability will not depend on fluctuations of market interest rates. However, both instruments are exposed to foreign currency risk, and by recognizing both the forward exchange contract and the debt at fair value through profit and loss by applying the fair value option, the offsetting effects of changes in exchange rates on the fair value of both instruments will be recognized in profit or loss without the need for hedge accounting.

The designation in the second situation described above will bring relief to the burden of separating embedded derivatives from the host contract; in permitted cases it is indeed far simpler to use the option to fair value the entire instrument.

It is not required that the amended fair value option be applied consistently to all similar transactions. However, an instrument may be designated as at fair value through profit or loss on initial recognition, and that designation may not subsequently be revised.

The amendments are effective for annual periods beginning on or after 1 January 2006, with earlier application encouraged. At its meeting on 8 July 2005, the Accounting Regulatory Committee (ARC), which advises the European Commission on the endorsement of individual International Financial Reporting Standards (IFRS) for use in the European Union, agreed unanimously to recommend endorsement of an amended version of IAS 39 relating to the Fair Value Option (FVO) previously carved out. The European Commission intends that the amendment will be endorsed in time for use in December 2005 financial statements.

Amended EU Eighth Directive requires Audit Committee installment

In view of recent developments (globalization, financial scandals, etc.), the European Commission considered it opportune to modernize the Eighth Directive, and to make a more concise and broader European legal framework with clear principles on statutory audits of accounts, professional ethics, independence and objectivity, auditing standards and reporting, quality assurance, investigations and sanctions, etc.

The most important items in the new Eighth Directive, as approved by the European Parliament in October 2005, are:

- Statutory audits must be carried out in accordance with international auditing standards;
- The group auditor bears full responsibility;

Special provisions for public interest entities:

Audit Committee requirement

The requirement to set up an audit committee (or similar body) will strengthen the monitoring of the financial reporting process and the statutory audit, and help to prevent any possible undue influence of the executive management on the financial reporting of the audited entity. To enhance the quality of financial reporting, the statutory auditor or audit firm must communicate to the audit committee on key matters of governance arising from the audit, in particular on any material weaknesses observed in internal controls relating to the financial reporting process.

The function of the audit committee shall be inter alia:

- monitor the financial reporting process;
- monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- monitor the statutory audit of the annual and consolidated accounts;
- review and monitor the independence of the statutory auditor or audit firm and in particular the provision of additional services to the audited entity.

Member States may decide that the provisions on the audit committee installment shall not apply to public interest entities that have a body performing equivalent functions, established and functioning according to provisions in place in the Member State where the entity to be audited is registered. In such a case the entitiy shall disclose which body carries out these functions and how it is composed.

A cooling-off period of two years

The statutory auditor or the key audit partner who carries out the statutory audit on behalf of an audit firm is not allowed to take up a key management position in the audited entity before two years have elapsed from their resignation.

Mandatory audit partner rotation

(Note: not audit firm rotation)

The key audit partner is to rotate within a maximum period of seven years after the date of appointment. The audit partner can be allowed to participate in the audit of the audited entity again after a minimum period of two years.

Annual transparency report

Statutory auditors or audit firms that carry out statutory audits of public interest entities must publish on their web sites, within three months of each financial year, an annual transparency report that includes, among other information, a description of the governance structure of the audit firm, a description of its internal quality control system, and a statement by its administrative or management body on the effectiveness of its functioning (Art. 38).

The full text of the Eight Directive can be found at the Web site of the European Union (http://www.europa.eu.int/comm) under the "Internal Markets" caption by selecting "Financial Reporting" followed by "Auditing" and "Directives and other official Documents".

Five Basic Principles for Audit Committees

During the last decade, the issue of corporate governance and especially the role of the audit committee has been dominated by reactions to a number of crucial events. The collapse of several high-profile multi-nationals, and new perceptions of risk from numerous restatements of financials have resulted in significant shareholder interest in the audit committee, and how it might be improved to minimize similar risks at their companies. These events have also brought about close scrutiny by the media, regulators, legislators, and other groups interested or involved in corporate governance.

In response, directors have been more focused than ever on enhancing both the effectiveness and efficiency of their audit committees, including improving its interaction with management, internal audit, and the external auditors. The maintenance of a dynamic audit committee process is one of their primary concerns.

Much of the current debate and dialogue offers recommendations and best practices for improving the effectiveness of the audit committee in overseeing a company's financial reporting process. While such advice is well intentioned, we urge some caution to audit committees that may be attempting to adopt each and every generic best practice.

It would be wise, at the least, to consider the following Basic Principles for Audit Committees, first developed by the Audit Committee Institute. We believe these principles can provide the foundation for each audit committee to develop and adopt its own best practices.

These audit committee basic principles are incorporated, together with the Code Lippens, in our recent publication *Shaping the Belgium Audit Committee Agenda*. You can order your free copy from our ACI Web site at www.audit-committee-institute.be or by using the enclosed registration card.

If audit committees are to provide meaningful protection for investors, they must be in a position to challenge executive management and draw sufficient attention to dubious practices – even in apparently successful companies.

One

Recognize that the dynamics of each company, board, and audit committee are unique - one size does not fit all.

The organization and operational approach followed by any audit committee should take into account the unique aspects of the organizational and governance structures of the company that the committee serves.

In addition, the delegation of responsibilities to an audit committee by the board of directors must be explicit, and responsive to the needs and culture of the company and the board as a whole.

The basic responsibilities of an audit committee are to oversee the financial reporting process of the company as implemented and maintained by management. This includes the risks and controls relating to that process, and the internal and external auditors' roles and responsibilities within the financial reporting process. The audit committee should avoid both overload and the temptation to immerse itself in too much detail, otherwise the committee may lose sight of its key objectives or perform its duties superficially.

Once delegated, the ongoing support of the board for the activities of the audit committee, including appropriate management interaction, is critical.

Two

The board must ensure the audit committee comprises the “right” individuals to provide independent and objective oversight.

If audit committees are to provide meaningful protection for investors, they must be in a position to challenge executive management and draw sufficient attention to dubious practices even in apparently successful companies. To do this, audit committee members must be diligent, truly independent and knowledgeable. Audit committee members must be prepared to invest the time necessary to understand why critical accounting policies were chosen, how they were applied, and why the end result fairly presents their company's actual status. In essence, this means that they need to understand their businesses and the substance of complex transactions, and ensure that the financial statements fairly reflect their understanding.

It is imperative that all audit committee members are able, both in theory and in practice, to express views to the board that are different to those of the CEO, and be confident that, provided this is done in a considered way, they will not suffer any consequences. Even where audit committees comprise vigorously independent non-executive directors, they will prove ineffective unless they have both access to, and an understanding of, all the relevant information.

In an age of “smoke and mirrors”, where both financial transactions and accounting standards are becoming increasingly complex, it is no longer possible for audit committee members to operate effectively with only a passing knowledge of finance. They must have expertise, or access to expertise, that goes beyond familiarity with financial statements. They must be able to understand the rules and, perhaps more importantly, the principles that underpin the preparation of financial statements.

Three

The board and audit committee must continually assess whether, and assert that, the "tone at the top" embodies insistence on integrity and accuracy in financial reporting. The company must have the right "tone at the top", and the audit committee, as a check and balance on management, is the guardian of the company's financial reporting integrity. The highest standards of objectivity, integrity and judgment can't be the exception – they must be the rule. Each audit committee member should ask three tough questions:

- If we were responsible for the preparation of the company's financial statements, would we have prepared them differently than in the manner selected by management?

- If we were investors, would we have received the information essential to a proper understanding of the company's financial performance?

- Is the company following the same internal audit procedures that would be followed if we were the CEO? If not, what are the differences and why?

Four

The audit committee must demand, and continually reinforce the accountability of the external auditor to both the board and audit committee as representatives of shareholders.

The external auditor's accountability to the board and the audit committee, as representatives of the shareholders, must be more than words in the audit committee's terms of reference. The audit committee, external auditor, and senior management must all acknowledge this reporting relationship and their "allegiance" thereto by their actions and deeds.

Five

Audit committees must implement a process that supports their understanding and monitoring of the:

- Specific role of the audit committee in relation to the roles of the other participants in the financial reporting process
- Critical financial reporting risks (and other risks where considered appropriate)
- Effectiveness of financial reporting controls (and other controls where considered appropriate)
- Independence, accountability and effectiveness of the external auditor
- Transparency of financial reporting.

The audit committee process provides a framework for coordinating the activities of, and information provided by, the participants in the financial reporting process that support the audit committee's understanding, and monitoring, of the "key risks and controls". A strong audit committee process allows a company, including its shareholders, to benefit from the collective insight and experience of each member of the committee.

Management, internal audit, the independent external auditor, and the audit committee all have a critical role to play in providing responsible disclosure and active oversight of the financial reporting process. The audit committee must not only understand the specific and unique role that each participant plays, but also hold these participants accountable to the board and the audit committee.

When a company establishes an audit committee and the board delegates oversight of the financial reporting process to it, implicit in that delegation decision is that the audit committee is thereby assigned oversight responsibility for financial reporting risks (including fraud risks) and controls relating to those risks. Therefore, the audit committee must have an understanding of both the significant risks relating to financial reporting reliability and the controls that the company has established to address those risks. Sometimes the board may feel it appropriate to further delegate to the audit committee oversight of the process for identifying, evaluating and managing other (non-financial) risks.

With a well-defined process based on an understanding of the specific roles of management, the internal auditor and the external auditor, the audit committee will have established the framework within which to exercise effective oversight – to listen, ask, assess, and challenge.

Resources

2005 Corporate Governance Reporting of listed companies in Belgium

Do companies comply with the Code Lippens recommendations?
What has actually been disclosed of management remuneration?

In December 2004 the Belgian Corporate Governance Commission issued a new Belgian Code. The *Code Lippens* recommends listed entities to inform the shareholders and investors of their corporate governance practices at their 2005 general meeting, although companies only have to report their compliance from 2006 onwards.

The working paper of Christoph Van der Elst, professor at the Financial Law Institute, analyzed the information disclosed in the annual reports, the agendas of 2005 general meetings, and the companies' Web sites. It focused on the actual disclosure reported on corporate governance, on the operations of the board of directors and its committees, and on the disclosure of remunerations to the board, the non-executive directors, top management and the CEO.

It is interesting to see that most of the companies already comply with the majority of the recommendations of the new Code. However, it remains clearly an open question whether companies will disclose detailed information of management's remuneration.

The working paper can be downloaded from the Web site of the Financial Law Institute http://www.law.ugent.be/fli/ . Once at the site, select "Working Paper Series", scroll down to find, and double click "WP 2005-03".

Notional Interest Deduction

Maybe it's not too late for some tax-saving action!

Many companies in Belgium are currently busy increasing their capital, often by means of a contribution in kind, to take advantage of the so-called Notional Interest Deduction tax benefit.

Designed to replace a previous benefit, the "Coordination centre regime", the newly introduced "notional interest deduction" is a general measure, available to all Belgian companies (and branches of foreign companies), granting a tax exemption of about 3.5 percent of total equity.

Its practical impact has been calculated as effectively leading to a final corporate income tax burden of about 27 percent, and potentially a zero percent burden for certain equity-funded types of entities.

To learn more about the timing, the planning opportunities and restructuring requirements, follow the link to http://www.kpmg.be, scroll down to find the "Belgian Newsletter", double-click the link to former editions and browse to the June 2005 special edition on notional interest.

New IAASB Standard focuses on improving audit documentation

If it's not promptly and neatly on file, it has not been performed!

At its meeting in September 2005, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) approved a revised International Standard on Auditing (ISA) 230, *Audit Documentation*.

To establish the level and completeness of documentation, the standard requires that the auditor prepare audit documentation sufficient to allow an experienced auditor, who has had no previous connection with the audit, to understand the audit work performed, the audit evidence obtained, the significant matters arising during the audit, and the conclusions reached.

The standard also requires the auditor to prepare documentation promptly, and to close the files within a reasonable time. It also severely limits the amendments that can be made to a closed file to certain exceptional circumstances. There are new documentation requirements for those very rare occasions when an auditor finds it necessary to depart from the requirement of a standard to achieve the objective of the audit.

The standard is effective for audits of financial periods beginning on or after 15 June 2006.

The standard may be downloaded at no charge from the IFAC online bookstore at http://www.ifac.org/store. Browse to "Auditing, Assurance and Related Services", scroll down to find, and double click "International Standard on Auditing 230 (revised), *Audit Documentation*".

The Future of the Board: Information will help it sink or swim

But, for the large majority of board members, only a very small part of the information they receive seems relevant to their board work.

"Knowledge is power" goes the old Roman saying, and this still rings true today, particularly in the corporate world. Around the globe, the effects of past corporate scandals have left their mark in the form of new legislation, with a greater onus on the company's board of directors to provide sound governance systems. The "right" information at the "right" time is crucial for a board to be effective. But are company boards equipped to succeed in their new, more powerful role?

IMD Professor Ulrich Steger - Director of the Building High Performance Boards program and Research Associates Jochen Brellochs and Wolfgang Amann set about finding out.

You can retrieve their results in the "Other Resources" caption of our Web site www.audit-committee-institute.be.

Covering Yourself on the Audit Committee

When it comes to documenting board meetings, less is more, right? Before Sarbanes-Oxley, many held this view. These days, however, meaningful record-keeping must be a top priority for boards looking to fulfill their duties and shield themselves from potential litigation.

With greater power associated to Audit Committees comes indeed increased responsibility. Documentation does more than provide a record of an audit committee's work. The very act of recording brings much-needed discipline to the oversight process, helping to ensure that the committee fulfills its duties. In the event of fraud allegations, documentation can rebuff plaintiffs' claims that the audit committee was partly to blame. It can also pick up where fading memories leave.

You can read about the background, methods and consequences of keeping minutes by going to the "Archives" section of www.boardmember.com, scrolling down and double-clicking on the September/October 2005 issue to find and double-click the article entitled "A View From the Bar: Covering Yourself on the Audit Committee".

What Triggers Financial Re-statements?

Poor documentation of transactions, the wrong accounting treatment, lack of transparency, weak internal controls, and – in rare instances – fraud can cause damage on corporate and personal reputations.

The number of financial re-statements increased significantly in the past five years – a period that includes major accounting scandals. But the story runs deeper than the familiar tales of incompetence and fraud.

Accounting complexity has gone up while finance has undergone a gradual transformation into a more strategic function during the past decade, and while cost-cutting has also altered the function's face.

The audit committee should partially take over. Its goals are to prevent financial reporting errors, to find out why any errors occurred and to oversee correction of the financial statements.

The complete article on the subject can be found in the October 2005 issue of *Business Finance Magazine,* available on http://www.businessfinancemag.com.

ACI Events

Roundtable Series

ACI facilitates interactive audit committee roundtables twice each year. The Belgium Autumn 2005 Audit Committee Roundtable series are organized over lunch:

• Tuesday 29 November 2005
Guest speaker : Mr. Luc Van Nevel, Chairman BoD Picanol & Pinguin, Chairman AC LSG

• Monday 5 December 2005
Guest speaker : Baron Hugo Van Damme, Chairman BoD Roularta & Kinepolis

The next Roundtable series will be held in spring 2006.

Each Roundtable features a guest speaker, and provides for a limited number of professionals an exchange of views and insights on topics of interest to members of boards and audit committees.

The ACI roundtable sessions can provide you with additional knowledge (focus on topics), enhanced competence (sharing of best practices) and personalized assistance (individual contacts with your peers) you will find helpful in your increasingly responsible oversight role.

Seminars

The professional development of board members is of increased importance and focus as corporate governance evolves.

The ACI seminars are designed to update members of boards and audit committees on current best practice, along with recent developments in accounting, company law, corporate governance and other regulatory matters. The material will be focused and presented at a high level, adapted to the particular needs of members of boards and audit committees. Registration is free of charge.

For more information on the ACI events, or to register, please visit our Web site www.audit-committee-institute.be, or contact us via
Email: info@auditcommitteeinstitute.be.

About us

The Belgian Audit Committee Institute (ACI) was established with the purpose of providing members of audit committees and other board members with the knowledge required to carry out their responsibilities. ACI follows developments in the field of governance, audit issues, accounting, and financial reporting, both in Belgium and internationally.

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