

Accounting judgements,
estimates, and restatements
Implications for audit
committee oversight

Contents

	Page
Introduction	1
Key findings and insights	2
Recent financial restatement trends	3
Earnings management: 'The numbers game'	5
Financial reporting integrity and the role of the audit committee	8
The Directors' report: the growing importance of transparency	13
Audit committee oversight of investigations	16
Conclusion	19





As guardians of shareholder interests, audit committees play a pivotal role in helping to ensure ... [that] management present a fair and accurate picture of the company's financials

Introduction



There are powerful, and often competing, pressures affecting financial reporting today: the increasing complexity of accounting standards, management's drive to 'make its numbers,' and the demand by investors and regulators for integrity and transparency in financial statements.

Financial transactions and accounting issues appear to have reached an unprecedented level of complexity, with continuing questions about 'materiality' and interpretations and areas of grey as prevalent as black-and-white rules and calculations. Such complexities notwithstanding, a growing intolerance for accounting errors and 'earnings management' – the practice of inappropriately modifying accounting policies, judgements, or estimates to paint a rosier picture of the company's financial condition – has put a premium on 'getting the numbers right.'

As guardians of shareholder interests, audit committees play a pivotal role in helping to ensure that the significant accounting policies, judgements, and estimates applied by management present a fair and accurate picture of the company's financials. Effective oversight requires, among other things, understanding key financial reporting processes, getting the right information on a timely basis, posing incisive questions to management and auditors, and setting clear expectations for transparency and quality.

Key findings and insights

In February 2007 the UK Audit Committee Institute (ACI) carried out a survey amongst its members about the general nature of their work. In addition to questions about the composition of audit committees and meetings we asked a number of questions about the challenges and issues that audit committees face in respect of their financial reporting oversight responsibilities. The key findings and insights are set out below:

- A majority of participants said they were “very satisfied” (55 percent) or “somewhat satisfied” (40 percent) that the company’s financial disclosures, including the business review, present a clear and accurate picture of the company’s finances. Three percent indicated that their disclosures “need improvement.”
- Nearly 91 percent of participants said management at the company is “not likely” to inappropriately modify accounting judgements and estimates; yet, 31 percent believe that management at other companies is “somewhat likely” to do so. Three percent of participants said management at the company is “very likely” to inappropriately modify judgements and estimates.
- Ninety seven percent of participants said their audit committees are “somewhat actively engaged” (29 percent) or “very actively engaged” (68 percent) in discussing and understanding management’s significant accounting policies, judgements, and estimates. This contrasts significantly with a survey conducted by the Audit Committee Institute in the US in December 2005¹ where 14 percent said their audit committees are not actively engaged.
- Seventy percent were “very satisfied” with the external auditor’s communications regarding its consideration of the company’s significant accounting policies, judgements, and estimates, with 26 percent “somewhat satisfied” and just four percent “not satisfied.”
- Participants believe the greatest pressures on management to inappropriately modify accounting judgements and estimates stem from analysts’ earnings estimates and forecasts (22 percent), incentive remuneration targets (22 percent), and unrealistic plans and budgets (18 percent). However, 30 percent of participants believe that management feels no pressure.
- Forty three percent of participants said they are “very satisfied” that the audit committee has a formal plan in place that will be effective when investigating internal misconduct or financial reporting complaints. Thirty nine percent are “somewhat satisfied,” nine percent said they do not have a formal plan in place and do not expect to establish one.

These findings suggest that many audit committees are actively engaged in discussing and understanding management’s significant accounting policies, judgements and estimates. However, a significant minority believe that management, albeit at other companies, are subject to external and internal pressures that might lead them to inappropriately modify results.

¹ Accounting Judgements, Estimates, and Restatements: Implications for Audit Committee Oversight, Audit Committee Roundtable Highlights - Fall 2005, KPMG International, 2006

Recent financial restatement trends

In 2004, 414 restatements were filed by public companies in the United States – nearly double the number filed in 2000² – with 61 percent involving annual audited financial statements. Approximately 15 percent of restatements filed with the SEC in 2004 were filed by companies that had reported erroneous financial information – and, as a result, had restated – on more than one occasion since 1997; and, for the fifth consecutive year, 40 percent of the restatements included errors recurring over at least three annual periods – potentially pointing to flawed accounting policies and practices or errors occurring over multiple years³.

While UK data on accounting restatements is difficult to compile, evidence from the US suggests that the number of restatements filed by public companies is on the rise.

The five categories of issues reported in the US that accounted for nearly 60 percent of the restatements filed in 2004 are⁴:

- Revenue recognition
- Equity (including stock option accounting)
- Reserves, accruals, and contingencies
- Capitalisation or expense of assets
- Inventory.

In late 2006 and early 2007 several British companies have made announcements regarding the misstatements of their reported sales and profits, and the FRRP remains vigilant in monitoring compliance with company law and applicable accounting standards.

Isoft shares fall on accounting fears⁵, FT.com, 20 July 2006

Shares in Isoft tumbled in early London trading on Friday after the struggling healthcare software group's new auditors warned it ... of possible accounting irregularities.

'Irregularities' to hit McAlpine profits⁶, Financial Times, 26 February 2007

Alfred McAlpine ..[has] discovered 'material accounting irregularities' at one of its subsidiaries that would slash annual profits ... The UK-based support services company said an internal investigation at the end of last week uncovered 'systematic misrepresentation of production volumes and sales by senior managers at its slate subsidiary.

Whether a restatement is attributed to the increasing complexity of accounting standards, accounting errors, or earnings management, the markets, users, regulators, and auditors of financial statements today are much more exacting – and far less forgiving – when it comes to 'getting the numbers right.'

² Huron Consulting Group, 2004 Annual Review of Financial Reporting Matters, 25 March 2005

³ Ibid

⁴ Ibid

⁵ Isoft shares fall on accounting fears, Philip Stafford, FT.com site, 20 July 2006.

⁶ 'Irregularities' to hit McAlpine profits, by Toby Shelley, Financial Times, 26 February 2007



When the ACI in the US asked their members informally to what they attributed the increase in restatements, many cited the complexity of accounting issues as the primary reason, with errors and earnings management being contributing factors. Others pointed to an increased focus on technical accounting 'accuracy' by auditors and regulators in the current increasingly 'rules-based' environment as another underlying pressure.

Clearly, the growing sophistication of financial transactions and business relationships has produced complex accounting procedures to revenue recognition methods and numerous treatment alternatives under GAAP. On a global level, where finance organisations are often decentralised, the risk of accounting discrepancies can multiply exponentially; accounting errors (or abuses) by a single person, business unit, or country can significantly undermine the integrity of a company's financial statements.

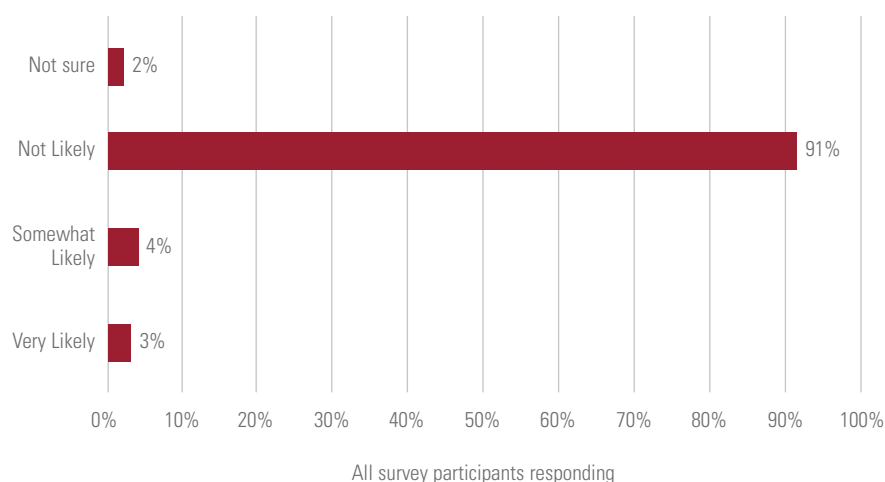
Earnings management: 'The numbers game'

As Ira Millstein, a senior partner at Weil, Gotshal & Manges LLP, noted, "There will always be a temptation to manage earnings inappropriately because meeting projections and 'guidance' suits everyone, from executives whose compensation may be based on earnings driven performance measures to holders of options and Wall Street analysts."⁷ Ensuring the integrity of financial statements in this earnings-driven environment requires that audit committees understand the pressures affecting management and management's choice of accounting policies, judgements, and estimates, as well as the warning signs of 'earnings management.'

Earnings management practices – by which "reported earnings reflect the desires of management rather than the underlying financial performance of the company"⁸ – can typically obscure a company's true financial picture. From misuse of materiality and revenue recognition principles to errant stock provisioning such devices are designed to favourably influence earnings outcomes.

Earnings management has attracted regulatory attention since the 1990's and the environment surrounding financial reporting in the UK has been substantially strengthened during this period. However, as the APB's paper on *Aggressive Earnings Management*⁹ points out "the consequential improvements in quality and reliability of financial reporting may be undermined by the increasing commercial pressures on those responsible for preparing financial statements." It is important therefore that the corporate governance reforms that occurred during the same period have resulted in a renewed focus on the audit committee's role and responsibility in overseeing accounting practices – and earnings management risks.

In your opinion, how likely is management to inappropriately modify accounting judgements and estimates at your company?



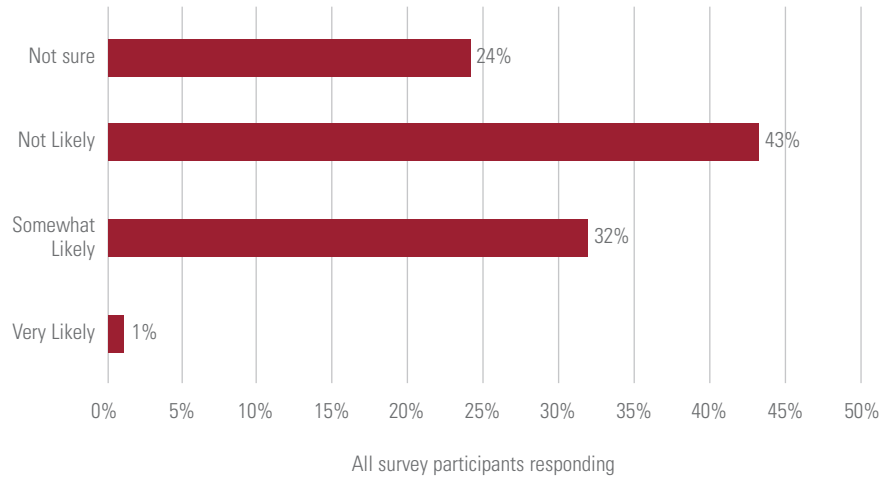
Source: Audit Committee Institute (UK) 2007

⁷ Financial Times, 27 May 2005

⁸ Quoted from 'The Numbers Game' speech by former SEC Chairman Arthur Levitt, delivered at New York University Center for Law and Business, 28 September 1998

⁹ Aggressive Earnings Management, Auditing Practices Board, 2001

In your opinion, how likely is management to inappropriately modify accounting judgements and estimates at other companies?



Source: Audit Committee Institute (UK) 2007

Perhaps one of the most fundamental risks related to earnings management is a 'not at my company' mentality, which can result in complacency, inattention, and missed signs of earnings management activities.

Management may not start out with the intent of managing earnings inappropriately; in response to internal and external pressures, however, management may gradually move from legitimate motives to areas of grey, to illegitimate practices. Identifying and preventing this movement toward inappropriately managed earnings – often referred to as the 'earnings creep' – can depend on the diligence, vigilance, and probing questions of the audit committee.

Common Earnings Management Techniques

Typical earnings management techniques include:

- Creative acquisition accounting
(to influence valuation)
- Misuse of materiality
(to downplay the implications of accounting decisions)
- Revenue recognition
(to accelerate or delay revenue results)
- Deferring costs
(to increase profitability)
- Valuation of work in progress
- Stock provisioning
(to influence stock valuation)

Dealing with earnings management

To fulfil its financial reporting oversight responsibilities properly, the audit committee should clearly understand the variety of earnings management opportunities that exist. It should appreciate the differences between earnings managed in the ordinary course of business and earnings fraudulently managed in an attempt to deceive the financial community.

The committee should not only carefully scrutinise the unrecorded audit adjustments and obtain from management an understanding as to why such items arose - but also discuss significant resolved issues with the external auditor in order to gain some insight into the degree of management bias reflected in the accounts. In these circumstances, the audit committee plays a key role in helping to ensure that the company reports quality earnings.

Incentives and pressures from both within the company and outside it can encourage inappropriate earnings management activities. The audit committee should be vigilant as to the possibility of earnings management and be alert to warning signs that it is occurring. The audit committee should obtain a thorough understanding of the company's processes to make or modify accounting policies, estimates and judgements so those processes can be assessed.

In the next section we consider the audit committee's role in dealing with earnings management and the integrity of financial reporting.



Financial reporting integrity and the role of the audit committee

Potential Red Flags

Certain accounting practices, business activities, and financial performance outcomes, such as the following, can serve as red-flag indicators of possible earnings management activities, potentially warranting further scrutiny by the audit committee:¹⁰

- Complex business arrangements not well understood and appearing to serve little practical purpose
- Financial results that seem “too good to be true” or significantly better than those of competitors—without substantive differences in operations
- Apparent inconsistencies between the facts underlying the financial statements, president’s letter, and MD&A
- A consistently close or exact match between reported results and planned results—for example, results that always are exactly on budget or managers who always achieve 100 percent of bonus opportunities
- A pattern of shipping most of the month’s or quarter’s sales in the last week or on the last day
- Unusual balance sheet changes or changes in trends or important financial statement relationships—for example, receivables growing faster than revenue or accounts payable that are consistently delayed

Under the Combined Code the audit committee is responsible for monitoring the integrity of the financial statements and reviewing the company’s internal financial controls; this includes oversight of the significant accounting policies, judgements, and estimates that management uses in developing the company’s financial statements.

Under ISA (UK and Ireland) 260 *Communication of audit matters with those charged with governance* the external auditor should consider audit matters of interest that arise from the audit of financial statements and communicate them with those charged with governance on a timely basis. Such matters would ordinarily include the selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity’s financial statements. Discussions may include the appropriateness of accounting estimates and judgements, for example, in relation to provisions, including the consistency of assumptions and degree of prudence reflected in the recorded amounts.

To effectively assess the significant accounting policies, judgements, and estimates selected by management, the audit committee should have a sufficient understanding of:

- The processes used by management to make and modify significant accounting decisions, particularly when they materially impact the financial statements
- The pressures that may encourage management to engage in earnings management, particularly compensation-related incentives
- The various earnings management ‘opportunities’ and potential GAAP ‘loopholes’
- ‘Red flags’ that may indicate earnings management activities.

The audit committee should be comfortable that management has the skills, knowledge, and experience to apply significant accounting policies appropriately; but audit committee oversight should not be based solely on management’s input. The views of the external auditor and internal audit as well as relevant regulatory bodies, industry organisations, and independent experts are essential to help the audit committee achieve a balanced, objective, and contextual picture of the company’s financial statements.

¹⁰ Audit Committees: A practical Guide, Report of the NACD Blue Ribbon Commission, 2004 Edition, Appendix G, National Association of Corporate Directors.

Potential Red Flags (continued)

- Unusual accounting policies, particularly for revenue recognition and cost deferrals – for example, recognising revenue before products have been shipped or deferring items that normally are expensed as incurred
- Accounting principles or practices at variance with industry norms
- Use of reserves to smooth out earnings – for example, large additions to reserves that get reversed in a later period
- Frequent and significant changes in estimates for no apparent reasons, increasing or decreasing reported earnings.

Key Audit Committee Questions

While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must be actively engaged in understanding the company's significant accounting policies, judgements, and estimates.

To this end, the audit committee should be diligent in probing management about the accounting issues it took management and the external auditor the most time to resolve. And while the nature and extent of the questions that the audit committee puts to management will vary depending on the company's circumstances, several fundamental queries can help the audit committee identify significant – if not controversial – issues affecting the quality of the financial disclosures.

In his 2002 annual letter to Berkshire Hathaway shareholders, prominent investor Warren Buffet suggested four fundamental questions that audit committees should consider when assessing the integrity of financial statements¹¹:

- If the auditor were solely responsible for preparation of the company's financial statements, would the statements have been prepared any differently than the manner selected by management? (The audit committee should inquire as to both material and non-material differences. If the auditor would have done anything differently than management, an explanation should be made of management's argument and the auditor's response.)
- If the auditor were an investor, would the auditor have received the information essential to a proper understanding of the company's financial performance during the reporting period?
- Is the company following the same internal audit procedure that would be followed if the auditor were CEO? If not, what are the differences and why? Does the accounting policy appear appropriate based on the substance of the transaction?
- Is the auditor aware of any actions – either accounting or operational – that have had the purpose and effect of moving revenue or expenses from one reporting period to another?

Audit committees also may consider the following questions about management's significant accounting policies, judgements, and estimates:

- What alternative policies and estimates were considered? (What impact would they have had on the financial statements and why were they rejected?)
- Are the accounting principles and estimates used consistent with GAAP? Do they in any way subvert the intent of the guidance?

¹¹ Chairman's Letter to Berkshire Hathaway Shareholders, 2002.

Accounting Areas Typically Affected by Significant Accounting Policies, Judgements, and Estimates

- Revenue recognition
- Restructuring charges
- Impairments of long-lived assets, investments, and goodwill
- Depreciation and amortisation expenses
- Income tax liabilities
- Retirement and post-retirement liabilities
- Pension income and expense
- Environmental liabilities
- Repurchase obligations under repurchase commitments
- Stock-based remuneration
- Insurance loss reserves
- Loan loss reserves
- Inventory reserves and allowance for doubtful accounts

ACI Quick poll

In September 2005 the ACI in the UK carried out research¹² that found that 49 percent of UK audit committee members are ‘very confident’ that company management has the skill and experience to address financial reporting and accounting issues relating to increasingly complex business processes and transactions, as opposed to only 37 percent in the US¹³. Forty six percent of UK respondents describe themselves as a more lukewarm ‘somewhat confident’, and 52 percent in the US. More than one in ten in the US are not confident at all.

- What was the process used to arrive at the accounting judgement or estimate? Does the process take into consideration all material factors that might impact the judgement / estimate?
- What is the likelihood of materially different reported results if different assumptions or conditions were to prevail?
- Were there any major changes to the terms or conditions of the company’s business transactions or relationships with its customers or suppliers?
- On what significant accounting issues did the external auditor consult with its national office?
- How do the company’s accounting practices compare with those of other companies in the industry?

The quality of the processes and systems and the reliability of the data underlying management’s estimates should also be challenged. At least on an annual basis, the audit committee should obtain from management a retrospective analysis as to how the historical estimates compare with actual results. Such an analysis of the ‘run off’ of estimates should consider issues such as:

- How has the value of the initial estimate changed over time?
- What additional estimates have been provided for in the intervening periods?
- What were the actual amounts realised?
- What events caused the actual results to be different from the estimated amounts?

This analysis may flag areas where reserves are being inappropriately established or drawn down.

The core question inherent in all of the above: *Were any accounting decisions, judgements, or estimates made to achieve a specific earnings outcome?*

¹² The research was carried out during an ACI event: Audit Committee Institute Breakfast Roundtable - Review of the Turnbull Guidance, September 2005

¹³ Management’s Ability to Resolve Complex Accounting Issues, US ACI Quick Poll, 18 April 2005 - 26 May 2005

Earnings Guidance: A Double-Edged Sword

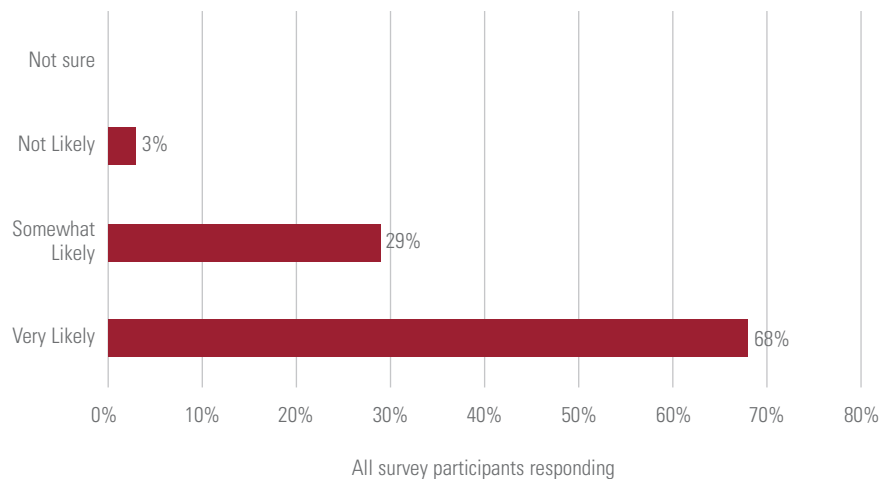
Providing investors and analysts with earnings guidance, while long viewed as necessary to manage marketplace expectations, can put significant pressure on management to achieve its estimates. To reduce such pressures, some companies are backing away from offering any earnings guidance while others are issuing earnings guidance on an annual basis and providing an estimated performance range (as opposed to guidance with to-the-penny estimates).

Materiality

The concept of materiality plays a vital role in the financial reporting process. Insignificant misstatements that result from the normal course of business (rather than from an intentional scheme to manage earnings) are generally not of significant concern unless they are indicative of weaknesses in internal control over financial reporting.

However, intentional errors and misstatements made by management on the basis they are not material should not be accepted by the audit committee. In addition, misstatements created with the principle intent of managing earnings (e.g., creating unsupported accrued revenue to offset against known misstatements) also should not be acceptable. Where misstatements offset one another, each misstatement and its materiality should be considered both separately and in the aggregate.

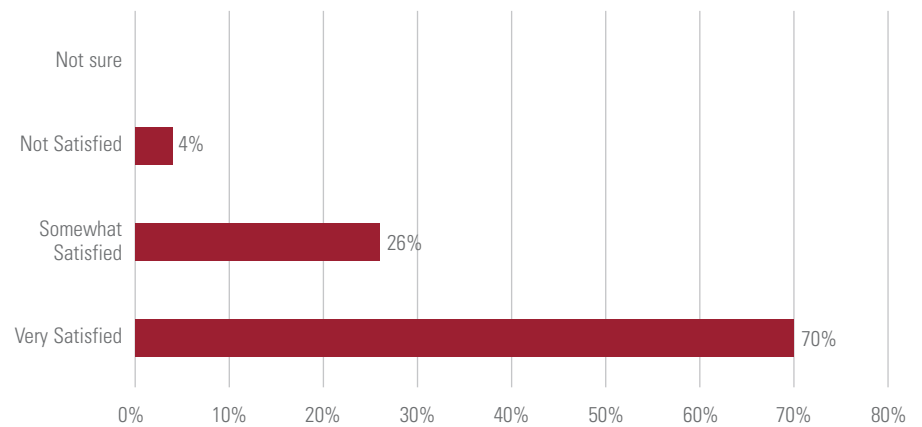
How actively engaged is the audit committee in discussing and understanding the company's critical accounting policies and management's critical accounting judgements and estimates?



Source: Audit Committee Institute (UK) 2007

Ultimately, effective oversight requires the audit committee's *active engagement* with management and auditors in the financial reporting process. Regular, in-depth discussions with management and auditors about the key processes and data used to generate financial statements can help provide the audit committee with a fuller understanding of the numbers and their basis. Broadly, the audit committee should also monitor the 'tone at the top' and encourage management to focus on *quality* financial reporting and long-term financial performance, versus short-term earnings and stock price.

How satisfied are you with the external auditors' communications regarding its consideration of the company's critical accounting policies, judgements and estimates?



All survey participants responding

Source: Audit Committee Institute (UK) 2007



The Directors' report: the growing importance of transparency

Given the complexity and subjectivity of accounting, the numbers alone don't always tell the full story; technical accuracy often does not equate with transparency. As a result investors, regulators and analysts appear to be paying increasing attention to the narrative explanation of the accounting issues and risks underlying the company's financial condition given in the directors' report.

The Financial Reporting Review Panel (FRRP) is responsible for ensuring that the financial information issued by public and large private companies complies with relevant accounting requirements. In its latest activity report¹⁴ the FRRP highlights that the majority of improvements that it recommended to companies related to the "quality and clarity of corporate reporting rather than change underlying accounting treatments" and not due to "systematic weakness".

FRRP has also conducted a review of interim accounts prepared under IFRS. In its report¹⁵ the FRRP comments that "IFRS accounts are often said to be too long and too complicated. The Panel has found that there is a tendency to use 'boiler-plate' descriptions for disclosure of accounting policies whether or not the matters described actually apply to the company concerned. More focused and thoughtful treatment would reduce length and increase understanding of the complexities which are inevitable in sophisticated commercial operations".

One of the keys to cutting through the complicated nature of financial reporting today is to provide clear and understandable explanations around the numbers and the nature of the business.

The Enhanced Business Review

The Enhanced Business Review¹⁶ is designed to increase the investor's understanding of the financial statements. It should include, amongst other things:

- a fair review of the business of the company; and
- a description of the principal risks and uncertainties facing the company.

It is worth noting that although the enhanced business review is effective for years beginning on or after 1 April 2005 the FRRP will not be including the business review in its review of financial statements until the following year (i.e., for financial years beginning on or after 1 April 2006).

¹⁴ Activity Report, Financial Reporting Review Panel, 5 October 2006 (Press notice 97)

¹⁵ Preliminary report, IFRS Implementation, Financial Reporting Review Report, 4 December 2006 (Press notice 98)

¹⁶ For further detail on the Business Review please see: <http://www.kpmg.co.uk/services/ras/br/>

The Transparency Directive

The Transparency Directive¹⁷, which is effective for years commencing on or after 20 January 2007, will place further narrative disclosure requirements on companies operating on a UK regulated market - in particular those relating to half yearly and interim reports.

Both the Business review and Transparency Directive regulations require companies to explain and describe in further detail and with more regularity the issues surrounding the business.

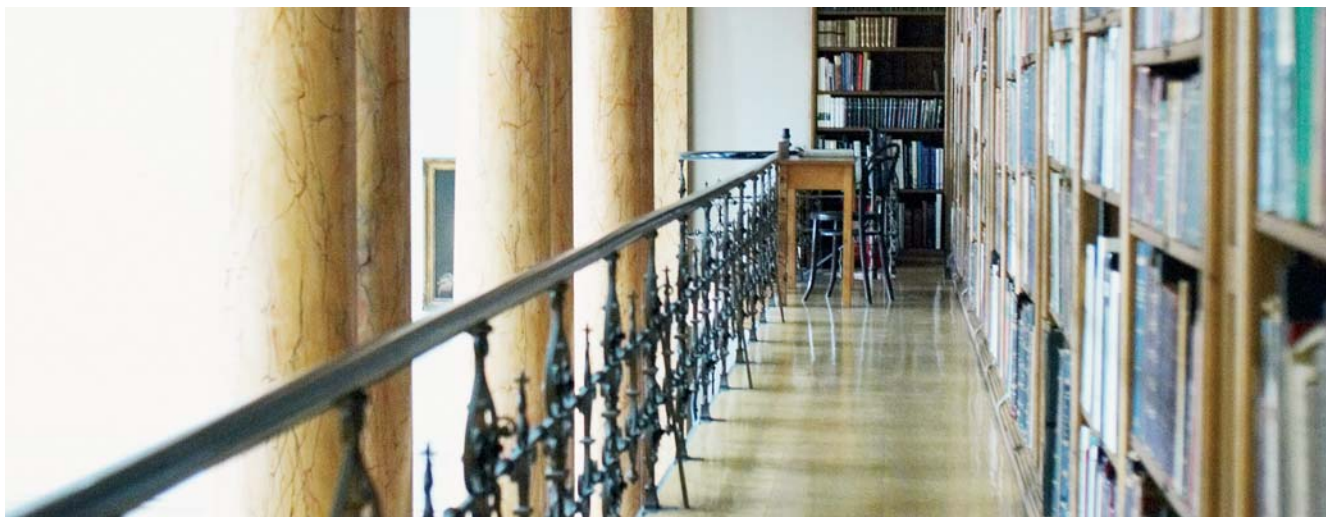
The role of the audit committee

Working with management and auditors the audit committee can help ensure that the business review and other narrative disclosures provide a clear, accurate, and understandable explanation of the significant accounting issues and risks underlying the company's financial condition.

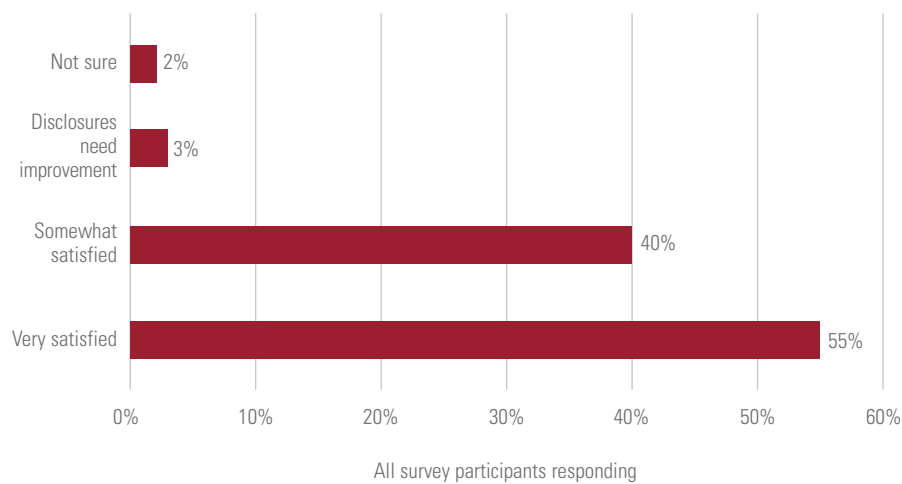
In addition to asking incisive questions about management's choice of accounting policies and judgements and estimates (see *Financial reporting integrity and the role of the audit committee*, page 8), the audit committee should:

- Insist on having sufficient time to review the financial statements and disclosures, including earnings releases and other information released publicly
- Consider the consistency of assertions in the directors' report and the financial statements
- Ask to be informed about FRRP and other regulatory communications received by the company (the FRRP noted in its Activity Report that replies to the Panel's letters of enquiry continued to be generally well considered, and that many had been reviewed by the company's audit committees)
- Consider the clarity of the narrative reporting (Is it written concisely, in plain English, and in a way that most investors can understand?)
- Consider the appropriateness of assumptions as well as the 'economics' of significant accounting decisions and their materiality.

¹⁷ For further detail on the Transparency Directive, its disclosure requirements and its implementation please visit the FSA Web site: www.fsa.gov.uk



How satisfied are you that the company reporting, including the Business Review, present a clear and accurate picture of a company's financial condition and the results of its operations?



Source: Audit Committee Institute (UK) 2007

Audit committee oversight of investigations

Given the significant legal, financial, and reputational risks that financial disclosure errors or abuses can have on a public company, audit committees should (1) consider the key processes and policies required to determine when to undertake an internal investigation and (2) ensure the investigation is sufficient in scope, objective, and thorough.

Who would participate in the investigation? What disclosures would be required – or advisable? Who would lead the investigation? How would an independent legal counsel or outside expert be selected? To what extent should the investigation be documented? These and other essential aspects of an internal investigation should be part of a robust action plan, which can be invaluable in guiding the investigation to a timely, credible, and conclusive result – particularly when faced with time pressures.



Independent investigations may be required when:

- A company is required to restate its accounts either by prior adjustments or revised accounts
- Fraudulent activity or other misconduct is alleged
- A regulatory inquiry has been launched.

When the board or audit committee determines that an independent investigation is required, the following factors can be essential to establishing the credibility of the investigation:

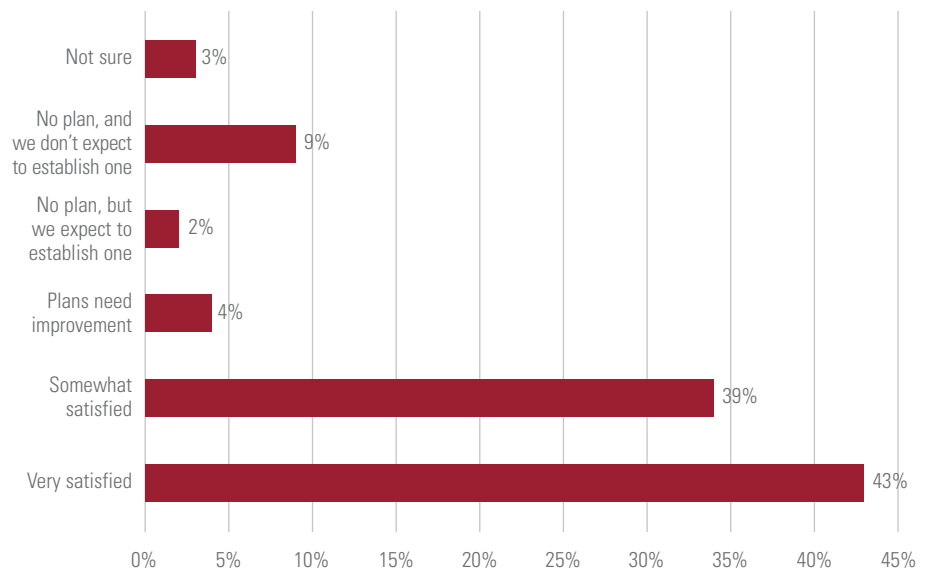
- Conducting the investigation in an objective and timely manner
- Employing outside experts—such as legal counsel and forensic accounting professionals – who are truly independent and appropriately qualified (such experts can help define the scope of the investigation and help ensure immediate preservation of electronic and other evidence)
- Considering external auditor involvement, including what communications and updates may be appropriate (the external auditor may conduct its own parallel or ‘shadow’ investigation)
- Managing the flow of information among the appropriate parties at the appropriate points in the investigation while ensuring that the information is not shared with individuals who may be implicated (and thereby tainting the investigation)
- Making timely and accurate disclosures to regulators and others, as appropriate or required

- Documenting key processes, findings, and remedial actions taken (as recommended by legal counsel)
- Investigating the matter until the audit committee is fully satisfied that all relevant issues have been addressed

Audit committees also should be regularly apprised of the legal and regulatory issues that arise during an investigation, including financial reporting deadlines, and necessary disclosures. While it is important that investigations be pursued to their full and satisfactory conclusion, audit committees should be cognisant of any debt covenants that could trigger legal action as a result of missed filing deadlines.

Approaching accounting investigations in a proactive manner can offer important advantages. An internal corporate investigation can allow the company to ‘take control’ of a potentially negative situation and effectively manage the flow of information and the pace and direction of the investigation. A well-managed internal corporate investigation also may result in a shorter and less disruptive regulatory inquiry.

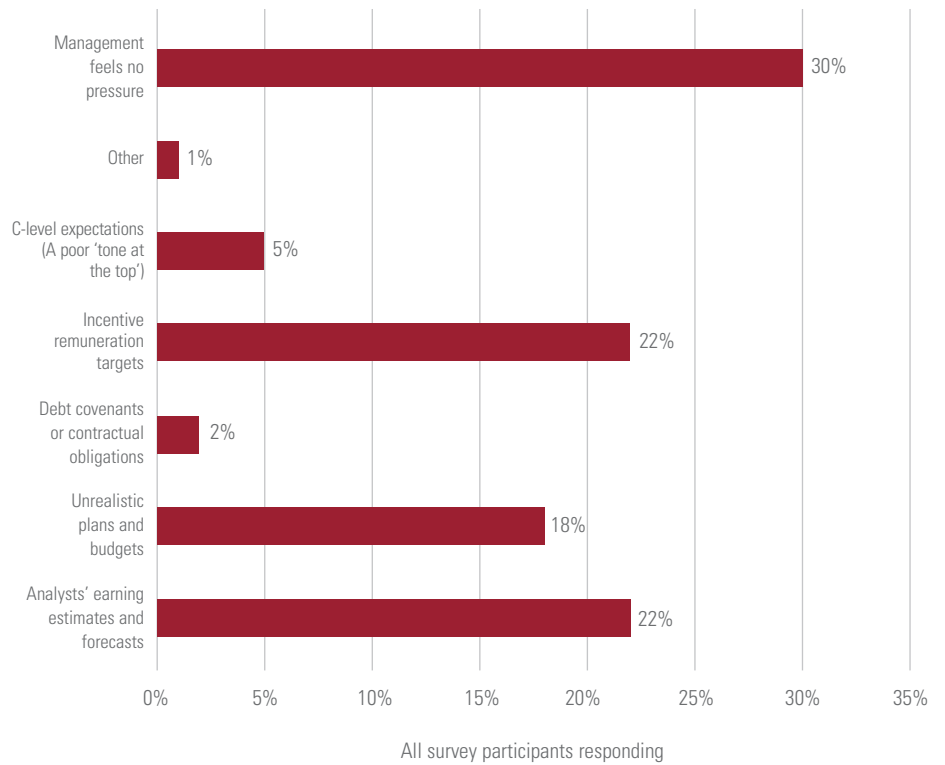
How satisfied are you that the audit committee has an effective plan in place for the investigation of internal misconduct or financial reporting complaints should they arise?



All survey participants responding

Source: Audit Committee Institute (UK) 2007

Which of the following poses the greatest pressure for management to inappropriately modify accounting judgements and estimates?



Source: Audit Committee Institute (UK) 2007



Conclusion

The expectation of shareholders and regulators for quality, accuracy, and transparency in financial disclosures demands that an audit committee be effective in its oversight of the company's financial statements. To this end, the audit committee will need to understand and effectively monitor:

- The significant accounting policies, judgements, and estimates used by management to develop the company's financial statements
- The basis for management's selection of significant accounting policies, judgements, and estimates (including potential outcomes had alternative accounting policies been applied)
- The external auditor's assessment of the accounting policies selected by management (and any related concerns or issues raised with management)
- The pressures on management that can lead to 'earnings management' (and ways to reduce such incentives)
- Common 'red flags' pointing to potential earnings management activities
- The processes, policies, and practices required to carry out an effective internal investigation related to the company's financial reporting.

In addition, by taking sufficient time to discuss significant accounting issues with management and auditors, encouraging the right tone at the top, and setting clear expectations with regard to financial reporting quality and long-term performance, audit committees can effectively exercise their oversight responsibilities and help ensure the integrity of – and confidence in the company's financial statements and disclosures.

Staying Current on Accounting Issues

To stay abreast of important accounting developments, audit committees should leverage the knowledge and resources of management and external and internal auditors.

In addition, various regulatory bodies offer valuable updates and insights into accounting issues, including:

International Accounting Standards Board (IASB) at www.iasb.org

Financial Reporting (FRC) at www.frc.org.uk

The Institute of Chartered Accountants in England and Wales (ICAEW) at www.icaew.co.uk

ACI's Quarterly publication at www.kpmg.co.uk/aci

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