Governance and Corporate Reporting

World Watch*

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Issue 2 2010

E-espionage
Catch criminals at work

IFRS
Quality not quantity

Market confidence
Is the audit relevant?

Picture of performance
Muddled or coherent?

*connectedthinking

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EDITORIAL

A time to work together

The volcanic eruptions in Iceland are a stark example of how vulnerable our interconnected life styles can be to unforeseen events.

Recent weeks have also reminded us that we are exposed to man-made disasters as well as natural ones. The economic crisis was triggered by events in individual countries but there was no escaping the knock-on effects this had in other countries and, indeed, the entire global economy. It may be playing out differently in each territory, but it is clear that we can no more isolate ourselves from the fallout of the crisis that we can control the volcanic ash clouds travelling which ever way the wind blows from Iceland.

Events in Greece are just one illustration that we are still experiencing the after shocks of the credit crisis, which will continue to reverberate around the world for at least the next decade. What should cause most concern is that in many countries the size of the problem has not been spelt out in the stark way that it has in Greece – pensions reform, significant reductions in public services and increased unemployment.

Just as the disasters impact us all, so we cannot respond effectively to them from within our own national or even regional 'bubbles'. The crisis has taught us to strive for global solutions, even though attempts to coordinate a global response – for example the G-20's joined-up approach to the economic crisis – illustrate the huge challenge of doing this in a way that can be interpreted and implemented appropriately within individual territories.

If there is a silver lining to the crisis, it is the fact that at times of such adversity different factions are motivated to work together to find solutions – it's a time for pragmatism and action. Reducing levels of domestic debt, building economic growth and agreeing on an effective global regulatory framework for the financial system must be the priorities for us all.

David Phillips, senior corporate reporting partner
PricewaterhouseCoopers

Richard Keys, global chief accountant
PricewaterhouseCoopers

Governance

OECD

Stick to principles

The OECD's Steering Group on Corporate Governance has issued new guidance to help rectify the weaknesses in corporate governance that contributed to the financial crisis.

While accepting the conclusions of previous reports that widespread weaknesses in areas such as remuneration, risk management, board practices and the exercise of shareholder rights all played a role, it nevertheless believes the OECD Principles of Corporate Governance do not need to be revised. The group argues that the need is rather to encourage the implementation of existing international and national standards, including the OECD principles.

The Group's latest report – *Corporate governance and the financial crisis: Conclusions and emerging good practices to enhance implementation of the principles* – focuses on five areas:

Codes and standards

The report does not accept the need for greater regulation in corporate governance. Rather it calls for regular reviews of existing supervisory, regulatory and enforcement authorities and the promotion of 'forward-looking' capabilities.

Executive remuneration

The report reinforces the conclusion that it is a board responsibility to establish a compensation structure and performance metrics that are in line with the strategic goals of the company. But it notes that managers have had too much influence over the setting of performance-based remuneration and that the link between actual performance and pay has often been weak. It calls for greater transparency and more explicit governance, particularly of compensation consultants, with remuneration policies submitted for shareholder approval.

Risk management

In the light of the widespread failure of risk management, the report calls for the management of risk on an enterprise-wide basis, and the establishment of independent risk functions reporting directly to the board. Risk management and risk assessments should be appropriately disclosed and corporate governance standard setters should be encouraged to bring risk management into their codes. Risk management should actively consider the risks relating to remuneration and incentive systems.

Board practices

The steering group acknowledges that there is no 'silver bullet' to address poor board performance and says that regulation alone will not achieve it. However, it encourages shareholder nomination, separation of chairman and CEO roles, and independent assessment of board competence and objectivity.

Shareholder rights

The report notes that while shareholder interests and those of management were 'aligned' during the bull market this was not sustainable and led to short-term behaviours, with shareholders being reactive and unwilling to challenge boards. Greater attention needs to be paid to avoid conflicts of interest in advising institutional investors and encouraging voting participation.

The report and its predecessor – *The financial crisis: Key findings and main messages* – can be found at www.oecd.org/daf/corporateaffairs

INTERNATIONAL CORPORATE GOVERNANCE NETWORK

New global guidelines for NED pay

The International Corporate Governance Network (ICGN) has called for NED pay to consist solely of a cash retainer and equity-based remuneration, without other perks. The call is backed by new global guidelines for NED remuneration, which respond to shareholder calls for strengthened accountability and transparency of NED pay.

Commenting on the new guidelines, the ICGN chairman Christianna Wood said: 'As the shareholders' representatives, non-executive directors are elected by the owners of the company and must have a strong alignment of interest with the owners in the form of meaningful equity ownership while serving on the board. Directors have a conflict of interest in that they set their own pay and as a result need to provide the utmost transparency and clearly state the board's philosophy behind the director remuneration programme.'

The cornerstone of non-executive director remuneration should be alignment of interest between shareholders and NEDs. The guidelines suggest that NED remuneration should contain an ownership requirement or an incentive to build a prescribed shareholding. However, it suggests prohibiting the use of hedging or other arrangements that mitigate the risk or benefit of share ownership to the NED.

Key aspects of the guidelines are as follows:

- Alignment of NED interests with the long-term owners
- Performance-based remuneration is not appropriate for NEDs
- Remuneration made up of a cash retainer and equity (without options)
- Clear disclosure should include the NED remuneration philosophy
- Equity should be vested immediately but subject to holding periods
- Companies should establish ownership guidelines for NEDs
- NEDs should not be eligible for retirement benefits

The guidelines are intended to be relevant around the world, irrespective of legislative background or listing rules, although local rules and structures may lead to different approaches. In some markets, the ICGN will also seek to change legislation, regulation or guidance where this is considered to improve governance. In many respects, however, the guidelines are consistent with existing good practice in countries such as Australia and with the European Commission's recommendations on directors' pay.

EIRIS REPORT

Investors must act to counter corruption

Investors need to engage with companies to counter the risks arising from bribery and corruption, according to research on 625 global companies from EIRIS (Experts in Responsible Investment Solutions). The report found that while levels of exposure and response to the threat of bribery varied widely across companies, sectors and regions, reporting of how companies were handling the risk was poor.

The threat of bribery was found to be widespread, with only 16% of nearly 200 companies in the FTSE All World Developed Index having a low exposure to bribery. Over half had 'some' exposure, while a third were at a 'high' level of exposure. Companies are on the whole more responsive to the threat of bribery the higher their exposure, but even in the high risk category only 46% of companies were judged to have reached even the intermediate position of having at least some policies, systems and reporting in place to address bribery, though not adequate ones. Even those companies that have introduced counter measures were reluctant to disclose them – only 0.3% of high risk companies were judged to have good reporting on anti-corruption policy and its implementation.

Corporate performance in dealing with bribery varied significantly by sector and country. The mining sector, for example, had the most 'good' performers, which the report attributes to the heightened awareness through issues that have arisen in that sector and stakeholder pressure. National regulation has also had an impact – compulsory legislation in Italy, for example, is seen as the main reason that 92% of high-risk companies there achieved 'intermediate' performance in addressing corruption. And in the US, legislation such as Sarbanes-Oxley has had an influence.

A comparative lack of anti-bribery action in countries in Asia (with the exception of Japan) is reflected in 49% of companies there not producing evidence of taking steps to counter corruption.

Bribery exposes companies to the risk of 'fines, reputational damage, restricted access to markets and difficulties in raising capital,' according to EIRIS. The report therefore recommends that investors take action in four key areas:

- Engage with companies on transparency and reporting of anti-bribery initiatives
- Integrate anti-bribery responses into investment processes
- Reward good performances and highlight areas of concern
- Identify examples of best practice

EIRIS also calls on investors to press for the implementation of the UN Global Compact, which includes measures to combat corruption and bribery.

www.eiris.org

Smart IT

Many company management teams find that their internal controls fail to live up to expectations, but they sometimes struggle to see how to evolve them. Research by PwC in Switzerland considers business views and looks for consensus on the best approaches.

PwC's white paper, *Making sense of internal control*, summarises the findings from round table sessions with internal control officers. Asked about their key objectives, internal control officers at Swiss quoted companies commonly cited the need to:

- Drive down the cost of control
- Increase the tangible added value of internal control for the business
- Gain senior management support to make further investments

The research identified the following as common elements in successful company approaches to developing 'smarter' internal controls:

- Create a vision of how to improve the added value of internal controls
- Rethink roles and responsibilities to align ownership and accountability
- Be smart about the way technology is used to manage and support internal control

Smarter use of technology starts by automating control functionality in existing information systems, according to the report. The next step is to consider the use of tools to manage automated controls. The paper sets out a number of vendors and solutions and gives guidance on how to select and implement them.

For a copy of the white paper, contact sonja.jau@ch.pwc.com.

New Companies Bill set to shake up governance

A draft Companies Bill is being considered by India's Parliament and is expected to become law in late 2010 or early 2011. The bill will provide much needed modernisation of the 1956 Companies Act. It will improve corporate governance, simplify procedures, and impose stiffer penalties for violations.

India's company law has long been seen as in need of modernisation. Reform has broad-based agreement, but legislative processes and global developments have held up the drafting and passing of the new bill. Review and consultation began in 2003 but was not completed until 2008. However, there is a renewed impetus and the government's desire to further raise India's business profile means the bill is expected to pass within the next year.

The bill will streamline substantive elements of company law, de-linking it from procedural aspects and eliminating dysfunctional and old sections. Procedures will be simplified, from incorporation to liquidation. Approvals for mergers and acquisitions will become easier, and issues connected with insolvency will incorporate best practices from the UN Commission on International Trade Law.

Board structure

The activities of company boards will be more closely regulated. The CEO, CFO and company secretary will be defined as 'key managerial personnel', and committees for audit, remuneration and stakeholder grievances will be given statutory recognition. Timelines will be designated for board meetings, one third of directors must be independent, and at least one independent director must be present at board meetings. The changes are based on internationally accepted good practice, but the key will be to make boards and independent directors function more effectively and transparently.

Transparency and penalties

The Ministry of Corporate Affairs has issued a roadmap for financial reporting by Indian entities using accounting standards converged with International Financial Reporting Standards. These will be applicable for financial years beginning after 1 April, 2011, and will be phased in for certain companies.

Company disclosure will also be enhanced by legal requirements for annual reports to include information on board meetings, attendance and remuneration. The annual report will need to include additional disclosures for items such as inter-company loans and related-party transactions. It will be mandatory to include consolidated financial statements for subsidiaries.

Insider trading will be made a punishable offence, liable to imprisonment and/or financial penalties. Offences will be tried by a special court – the National Company Law Tribunal – to transfer cases away from the High Courts and speed up the trial process.

Auditors will have to comply with a new set of standards and will only be able to provide limited additional services to audit clients. There will be tougher rules for disqualifying auditors, including disqualification for owning securities issued by a company (or its subsidiaries) that they audit.

Timeline

2003	Revision of 1956 Companies Act initiated
2005	Review Committee reports findings, followed by period of consultation
2008	Companies Bill 2008 put before parliament, but not passed before 2009 elections
2009	Bill reintroduced to parliament and referred to Parliamentary Standing Committee
2010/ 2011	Companies Bill expected to be passed into law

ISACA

New guidance for monitoring internal controls

The ISACA – the international body for IT governance – is seeking comment on proposed guidance for monitoring internal controls and IT. Recognising that boards are now looking beyond financial reporting risks, the guide advocates the monitoring of operational and compliance risks.

The exposure draft, *Monitoring of internal controls and IT: A primer for business executives, managers and auditors on how to advance best practices*, provides guidance and tools to help companies use information technology to support and sustain the monitoring of internal controls. It supplements the 2009 guidance on monitoring of internal controls from COSO, the international organisation working for more ethical and effective business operations.

ISACA believes that internal controls monitoring for operational and compliance risks, as well as financial reporting risks, is necessary for management to ensure effective governance of the company. However, it recognises that getting this right is one of the greatest challenges facing governance, risk and compliance professionals.

'Done properly, effective IT-enabled monitoring can benefit senior management, including those with governance responsibilities, the audit committee, and the board,' said Joe Nocera, IT risk management partner at PwC in the US. 'This guidance provides practical advice for companies looking to use a risk-based approach to efficiently monitor IT controls.'

The ISACA was previously known as the Information Systems Audit and Control Association, but now only uses the acronym.

www.isaca.org

JAPAN

A clear view of executive pay

The Financial Services Agency (FSA) of Japan has enacted changes that require listed companies to make expansive disclosures about executive compensation in financial statements starting from March this year.

The revisions mean that companies will need to make disclosures about executives receiving 100 million yen or more, including a breakdown of total salary, bonuses, stock options and retirement benefits, along with the names of executives affected. Previously, disclosure of this information was voluntary.

The Cabinet Office Ordinance on Disclosure of Corporate Affairs has been updated to bring the requirements into law. The revised ordinance also requires greater disclosure about companies' corporate governance systems, cross-shareholdings (details of the top 30 stocks held on a market value basis), and the voting results of shareholder resolutions.

The increased disclosures have been introduced by the FSA to bring requirements in line with executive pay disclosures in many Western countries and in the belief that giving shareholders greater access to company information improves governance.

EXECUTIVE COMPENSATION

The rise of the clawback

Many companies are changing their compensation plans to better align pay with long-term performance. One approach companies have been considering is greater use of clawback provisions, which allow companies to reclaim previously awarded compensation if circumstances later indicate the compensation might not have been truly earned.

Some clawback features are already part of compensation arrangements – indeed, Sarbanes-Oxley called for clawbacks of CEO and CFO compensation in the case of restatements. Many companies also have 'non-compete' clawbacks, which require an employee to return some compensation if he or she leaves to work for a competitor.

Companies in the US and elsewhere, however, are developing contracts with new clawback provisions to address issues such as: conduct that is detrimental to the company; actions that result in financial harm; or not achieving expected profits.

These new provisions are intended to help companies better align compensation and risk. However, PwC partner Catherine Bromilow points out that there are a number of challenges in implementing clawbacks. It may be difficult, for example, to determine whether they have been triggered or even who triggered them.

There are also challenges with linking clawbacks to performance-based measures – will they be based on the individual's performance, the business unit's or the subsidiary's? And how easy will that be to track? There may be accounting considerations with the new clawbacks too – for example, they could alter when compensation expense is recognised. Finally, enacting a clawback may result in litigation.

'Developing compensation arrangements that meet the needs of the company, the employee, and other stakeholders is a sensitive and complicated matter,' said Ms Bromilow. 'Clawbacks can help reinforce the pay/performance link, but companies may not want to rely on them exclusively.'

PORTUGAL

Awaiting an alternative

An attempt to provide Portuguese companies with a new governance code, as an approved alternative option to recommendations from the securities regulator, has failed.

The initiative was led by the Portuguese Corporate Governance Institute (IPCG), with participation from senior people such as António Borges, former dean of INSEAD and current chairman of the European Corporate Governance Institute. However, on the eve of the code's publication, a number of leading companies pointedly withdrew their support.

This means that companies listed on the Portuguese (Euronext) stock exchange will be obliged to adopt the corporate governance code published by the Portuguese Securities Commission (CMVM) updated in January this year, as no 'equivalent' code had been approved.

The CMVM's recommendations go significantly beyond existing requirements and are considered particularly challenging in terms of reporting on directors' remuneration. For example, companies must reveal (on a 'comply or explain' basis) the individual remuneration of directors in their corporate governance report. The details of various components making up their remuneration packages must also be included.

'Clearly, we welcome initiatives to improve governance practices in Portugal,' said PwC partner Ricardo Pinheiro. 'However, it is important that the leading players are meaningfully involved in any new initiative and we would strongly recommend that they look to established international good practice to determine the appropriate framework. It is important for all concerned that an alternative code is developed.'

Its recommendations on the services provided by auditors and their rotation also goes further, in some respects, than the OECD's international guidelines and other territory codes regarded as 'good practice'.

BAHRAIN

New code raises the bar

The Bahrain Ministry of Industry and Commerce (MOIC) has issued a corporate governance code based on nine core corporate governance principles, operating under a 'comply or explain' framework.

The Corporate Governance Code of the Kingdom of Bahrain was developed by the ministry working with the Central Bank of Bahrain (CBB) and a national corporate governance committee. The committee was made up of representatives from government agencies, academics, the banking and accounting sectors and the business community – they sought advice on international best practice in drafting the code.

The code's recommendations are considered the minimum standards companies should apply. It supplements corporate governance practices laid down in local company law, and companies are expected to follow the guidelines in both. However, the code should be followed where its requirements are more stringent. For example, the code recommends that the chairman and CEO should not be the same person, and that at least 50% of the board should be non-executive directors. If a company elects not to follow the code there should be a good reason why not, and that reason should be disclosed.

'While the new code draws on all the key elements of the OECD code, this framework is designed to make those charged with governance accountable for their roles in their respective companies,' commented PwC partner Madhukar Shenoy. 'Bahrain's regulators are renowned for their efforts to keep pace with international standards and leading practices, and this development represents an important step forward in improving the local business environment.'

The code will initially apply to all operating joint stock companies incorporated under the Bahrain Commercial Companies Law, from 1 January 2011. Other companies are expected to follow the principles as far as applicable. Responsibility for monitoring compliance with the code will fall to many parties, including: the board, shareholders, the ministry, the central bank, the exchange, the courts and professionals such as auditors and lawyers.

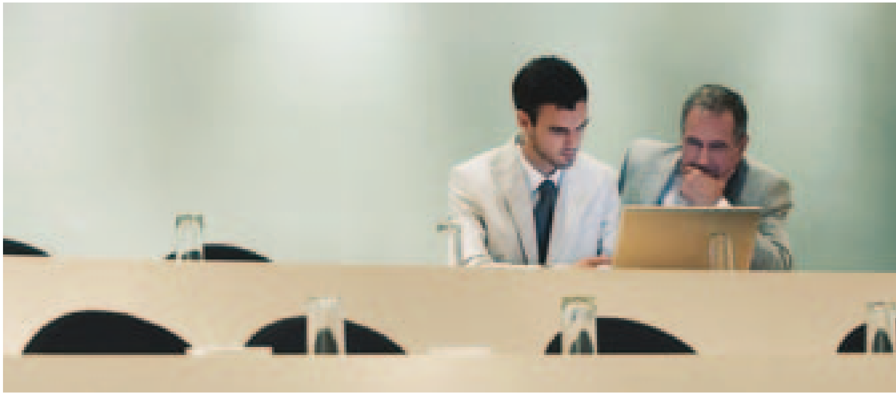
Nine governance principles

1. The company to be headed by an effective, collegial and informed board
2. The directors and officers to have full loyalty to the company
3. The board to have rigorous controls for financial audit, internal control and compliance with law
4. Rigorous procedures for appointment, training and evaluation of the board
5. Fair and responsible remuneration of directors and officers
6. The board to establish a clear and efficient management structure
7. The board to communicate with shareholders and encourage their participation
8. Company to disclose its corporate governance
9. Companies that refer to themselves as 'Islamic' must follow the principles of Islamic Shari'a

www.moic.gov.bh/Bahraincg

SWEDEN

Model for tomorrow's governance?



Countries should look to Sweden in their attempts to improve corporate governance and engage shareholders more actively in the governance process, according to a new report.

The report, *Tomorrow's Corporate Governance*, by think tank Tomorrow's Company and investors Cevian Capital, argues that the Swedish governance system has successfully encouraged greater participation in the governance of companies by shareholders, which has had a positive impact.

In Sweden, a company board is primarily formed of non-executives with the company's CEO frequently, but not always, participating as an additional member. The Swedish board holds the operational responsibilities of a unitary board and is accountable to shareholders. Non-executive board members are appointed by a nomination committee, which has significantly greater powers than their counterparts in other countries, such as the UK. The Swedish nomination committee is composed of four or five of the largest shareholders of the company, together with a non-executive chair of the board.

As well as appointing board members, the committee also recommends the structure and amount of remuneration for each director, a decision which is then confirmed or rejected by shareholders at the AGM.

The Swedish system has been criticised in the past on the grounds that governance is more often than not controlled by four or five family shareholders, but the report points out that as share turnover has increased in Sweden in recent years it has become far more likely that pension funds, mutual funds and international investors will play a significant role in the nominations committee.

The report also points out that the attitude to company ownership is different in Sweden. 'The shareholders' meeting stands at the peak of a governance hierarchy,' it says. 'Boards are subordinate to the AGM and the company's executive management is subordinate to the board.'

The report argues that the experience in Sweden suggests that active shareholder engagement in the nomination process has increased confidence in the board function. The system has also stimulated shareholders to become more engaged in the companies in which they invest, and the nominations committee process has created a forum that encourages investors to think about pursuing the interests of all shareholders.

Even so, the report acknowledges that the Swedish system is not without its difficulties, mainly because the skills needed to be a good nominations committee member mean that many international shareholders decline to participate.

The report argues that shareholder representation on nomination committees could work elsewhere and recommends experimentation with elements of the Swedish system, for example by first inviting major shareholders to nominate representatives to serve on their nominating committees. It adds that the US SEC's recent proposed changes to the conduct of board elections to permit shareholder proxy access are another effective channel for shareholder participation.

'If stewardship is to take a leap forward, it needs to be part of some formal process in which major shareholders engage with companies and start to work in a more proactive way,' the report concluded. 'The choice is not between a shareholder-led nomination committee and no change. It is between this solution and other stewardship solutions.'

The report can be found at www.forceforgood.com

SWEDEN

Governance code revised

The Swedish Corporate Governance Board has announced changes to the country's Corporate Governance Code following a comprehensive review. The revised code introduces new rules on director remuneration and independence, as well as changes to the guidelines surrounding audit committees. The changes reflect recent EC recommendations on directors' remuneration, as well as changes to Swedish legislation necessary to implement EU Company Directives. The new rules came into force on 1 February 2010.

The revised code can be seen at www.corporategovernanceboard.se

UK & HONG KONG

Female board representation stalls

The number of women on FTSE 100 boards remained static in 2009, amid a mixed picture for the progress of women in boardrooms.

According to Cranfield School of Management's *Female FTSE Board Report 2009* a total of 131 (12.2%) of FTSE 100 board members are now female, although there was a decline in the number of companies with female executive directors or multiple women directors.

The top two ranking companies in the survey – Alliance Trust and Burberry – were newcomers to the FTSE 100, and there was also an increase in the proportion of new female FSTE board appointees from 10.7% to 14.7%. Of the 23 new female appointees, 14 had not previously held FTSE directorships and all of these newcomers to the FTSE were also foreign nationals.

One in four FTSE 100 companies still have exclusively male boards and the report contrasts Britain's progress with that of Norway, where 100% of the top

100 companies now have female directors, who represent 30.9% of the total board population. Although this follows the introduction of legally binding quotas backed by tough sanctions, the report notes that women also hold 27% of directorships on the boards of unregulated Norwegian companies. In Spain the Equality Law of 2007, which is not mandatory but recommends a 'balanced presence' on boards, has succeeded in boosting the numbers of female directors by nearly 30%.

Hong Kong

Cranfield has for the first time begun to study the composition of boards on the Hang Sen Index, where 8.9% of board directors are women. The leading performer is the China Construction Bank Corporation, with five female directors out of a total of 17. In second place is Bank of China Ltd, a fifth of whose directors are female. While the Hang Sen can now boast one female CEO and one female chair, a third of companies have no female board members at all.

However, 12.7% of all new board appointments in 2009 were female. The female directors who were interviewed were optimistic that the number of women on boards would grow significantly over the next five years (between 9% and 20%) – all except one preferred this to be driven by education rather than quotas.

INTERNAL AUDIT

Teams well placed on strategic risk advice

With the worldwide economic crisis making strategic risk management a key issue for business leaders, a new survey suggests that internal audit teams have the right company-wide visibility and mandate to serve as strategic risk advisers to boards. However, they need to redefine the way they work to ensure they provide stakeholders with the information and support they require.

PwC 2010 State of the internal audit profession survey polled more than 2,000 executives from 55 countries. The resulting report asserts that companies must do better at monitoring and managing the risks that matter. It says: 'In 2010's business environment, company leaders must understand the events and shortcomings that drive risk, the effects risk may have on their organisation's strategies and objectives, and the capabilities required to manage and mitigate the key risks.' It also concludes that, to remain relevant and meet stakeholder demands, internal audit must evolve to an enhanced 'Internal Audit 2.0' state that provides business leaders with actionable business risk intelligence.

The study identifies three key areas on which internal audit departments need to focus: critical risks and issues; aligning internal audit's value proposition with its stakeholders' expectations; and matching the staffing model with that value proposition. However, these are also the three areas where internal audit leaders believe they have the most room to improve.

The study finds some discrepancy between respondents' views and PwC's experience. For example, 65% of respondents said they provided boards with an assessment of key enterprise risks – a result not consistently borne out by observations in the field. While risk assessments are being used to drive internal audit plans, from PwC's perspective they frequently do not provide the type of insights into key strategic risks that boards are looking for.

Action on strategic risk

Internal audit must take a more radical approach to change than it has in the past, and rethink and redefine the way it works, to meet stakeholder demands. The survey outlines several important steps that internal audit can take:

- Start with a plan
- Rethink risk assessment practices
- Fill the skills and capabilities gap
- Align with other assurance functions
- Focus on obtaining return on investment (RoI) from technology

The report is available from www.pwc.com/us/en/internal-audit

ECONOMIC CRIME SURVEY

Economic pressures drive fraud increase

Individuals under pressure to deliver positive results despite the economic downturn could increase the risk of fraud within organisations, a recent survey suggests. Senior executives need to understand this increased risk and ensure their organisations have robust risk assessment procedures in place.

Nearly one in three organisations around the world (30%) reported being the victims of economic crime during the past 12 months, according to the fifth *PwC Global Economic Crime Survey*. Of those, 43% said the incidences of fraud in their organisation had increased during the period. Asset misappropriation or theft was most pervasive (cited by 67% of those reporting economic crime), followed by financial statement fraud (38%) and bribery and corruption (27%).

Among 40% of respondents who foresaw a greater risk of fraud in the current economic environment, 68% attributed this to increased incentives or pressures, particularly due to financial targets being more difficult to achieve. The report therefore advises organisations to be realistic when setting targets, and more prepared to adjust them downwards during an economic downturn.

Some participants identifying a greater risk of fraud attributed this to increased opportunities (18%). Of these, 62% believed the main contributing factor to be staff reductions resulting in fewer resources deployed on internal controls.

The survey highlights that fraud risk assessments are essential for identifying potential threats and weaknesses in controls that create opportunities for fraud. It found a correlation between frauds reported and the frequency of fraud risk assessments performed – organisations that carry out more frequent assessments report more fraud. However, the report concludes that companies cannot rely on fraud controls alone to detect and deter economic crime. Companies need to build loyalty to the organisation and give employees the confidence to do the right thing. Senior executives need to take an active interest in fraud risks and demonstrate the highest ethical behaviour themselves to set an appropriate 'tone from the top'. They also need to put in place clear sanctions for those who commit fraud, regardless of their position in the company.

The web-based survey, conducted in conjunction with the INSEAD business school, involved over 3,000 senior representatives of organisations in 54 countries.

Fraud risk assessment – What areas should it cover?

- Identify potential internal fraud risks
- Assess the likelihood of occurrence and significance of the identified fraud risks
- Evaluate which people and departments are most likely to commit fraud and identify the methods they are likely to use
- Identify and map existing preventative and detective controls to the relevant fraud risks
- Evaluate whether relevant controls and processes are effectively designed to address the identified fraud risks
- Identify and evaluate residual fraud risks resulting from ineffective or non-existent controls
- Respond to residual fraud risks

www.pwc.com/gx/en/economic-crime-survey

UK GOOD PRACTICE

Guidance on corporate governance statements

Corporate governance: Best practice reporting **was published in January by PricewaterhouseCoopers to help those with responsibility for drafting or reviewing corporate governance statements. PwC's 5th compendium provides good practice examples of governance reporting from the annual reports of FTSE 350 companies.**

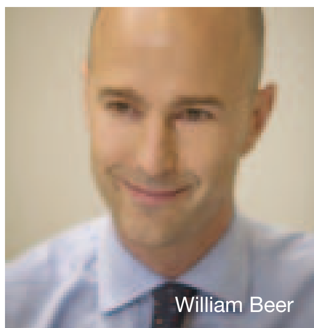
It includes a summary of the current technical requirements and guidance, together with comments on the key topics discussed during the Walker and UK Financial Reporting Council reviews of governance. A section on remuneration-related disclosures has also been added this year.

PwC governance director Margaret Cassidy said: 'The question of whether the UK governance code is fit for purpose was at the heart of the governance debate following the economic crisis. However, we believe that it is the culture, the tone at the top and the personal behaviours of directors that most influence the direction of companies. Good disclosures of the kind included in our compendium can provide a valuable insight into companies' governance arrangements.'

www.corporatereporting.com

E-espionage – criminals at work

Every minute of every day, a growing number of sophisticated cyber-criminals seek to gain access to company data. **William Beer** explains why e-espionage should be on every board's agenda


William Beer

In the past, the security and integrity of company data tended to be regarded as a matter for the IT function. However, the increasing threat and the rising impact of possible breaches mean the prevention and detection of e-espionage has been elevated to the board's agenda. Companies that have yet to make this a board issue are putting the future of their organisations at risk.

You only have to look at the high profile cases that reach the public domain to see that the threat is not just to the company's business reputation, it is to its very existence. As one large international company said in its SEC 10-K filing report: 'We regularly face attempts by others to gain unauthorised access through the internet to our information technology systems…The theft and/or unauthorised use or publication of our trade secrets and other confidential business information as a result of such an incident could adversely affect our competitive position and reduce marketplace acceptance of our products.'

Investors and other stakeholders are increasingly demanding evidence in investor presentations and annual reports that management is taking the threat of e-espionage seriously and that it is taking action to minimise the likelihood of attack by cyber criminals.

To gauge the company's readiness and ability to manage the risk of e-espionage, boards should ask themselves:

- Is the threat of e-espionage on the corporate risk register, and/or discussed in the annual report?
- How many security incidents occurred in the last year, and what was the nature of those incidents?
- Are information systems and their exposure being monitored on a 24/7 basis?
- Is there a security strategy and governance approach that is aligned to the business strategy?

PwC recently conducted research into information security among more than 7,000 CEOs, CFOs, CIOs, CSOs, vice presidents and directors of IT and information security from 119 countries. The study found that more than three out of 10 respondents worldwide cannot answer basic questions about the risks to their company's most sensitive information and a worrying number admitted they have no idea how many security incidents have occurred.

Know your enemy

If your business does not know the number, nature and source of breaches it is impossible to create an effective strategy to address them, or to build a business case for investment in security.

In the past, cyber crime was commonly blamed on employees (both current and past) and hackers. PwC's research found that in today's world it is less likely to be attributed to these groups and more frequently believed to be the work of 'unknown' parties.

It is often hard to establish where attacks come from. E-espionage detection and prevention is an arms race where the cyber-criminals have access to much of the best brainpower and technology, and are always pushing ahead. These criminals are smart, well-funded and adept at covering their tracks. They are not just after 'custodial data' such as customer information either. A recent report by the analyst firm Forrester found that proprietary knowledge and company secrets are twice as valuable as custodial data.

Fighting the threat

In PwC's view, the threat of e-espionage should be one of the top issues addressed by today's boards. There are several concrete steps that companies can take today to meet this challenge and mitigate the risks. These include:

- **Conduct a risk assessment**
  Establish the size, number, nature and source of the attacks to date, gauge the current vulnerabilities, and assess the resulting impact on your business.
- **Formulate a security strategy and appropriate budget**
  Without a carefully-considered security strategy in place, your business risks spending its time and resources on fire-fighting as problems emerge.
- **Align your security strategy with the business strategy**
  When formulated and implemented properly, the security strategy can become a business enabler by building trust among stakeholders, and supporting sustainable growth at lower risk.
- **Employ a broad range of tools**
  Once the strategy is in place, tools can be used to mitigate risks, refine the strategy and stay ahead of the cyber-criminals. There is a wealth of anti-espionage technology to explore.

However it is worth remembering that your people are your first line of defence. With their full support, as part of a balanced programme of protective measures, you will be well placed to mitigate the information risks facing your organisation.

William Beer is a director in the OneSecurity team at PricewaterhouseCoopers in the UK.

Financial Reporting

JAPAN

Companies taking action on IFRS

Most large listed companies and many mid-size listed companies in Japan have already started to prepare for IFRS, even though the regulator is not expected to decide whether to make IFRS mandatory for all public companies until 2012. The deadline for compliance is unlikely to be before 2015 or 2016.

There are good reasons, it appears, for thinking ahead. Japanese management teams want enough lead time to plan, implement and embed the expected changes. Many are also taking the opportunity to combine IFRS implementation with other organisation-wide initiatives, such as improving the effectiveness of their group finance function.

The move to adopt IFRS has looked inevitable since the Tokyo Agreement in 2007, which accelerated work by the Accounting Standards Board Japan (ASBJ) and the International Accounting Standards Board (IASB) to converge Japanese GAAP and IFRS. Many major differences between the two GAAPs have already been eliminated, and further differences are expected to be removed by June 2011.

In December last year, the Japanese Financial Services Agency (FSA) gave another clear signal of the direction of travel when it allowed Japanese listed companies meeting certain criteria to prepare IFRS consolidated financial statements from 31 March this year (see *World Watch* issue 1 2010). Companies using this option, however, must provide full parallel disclosure of Japanese GAAP in the first year, and explanatory notes of significant differences thereafter.

Principles versus rules

Early preparation by companies is also a response to the dramatic cultural shift that IFRS represents – from 'rules-based' to 'principles-based' accounting. Successful implementation will depend on substantial prior experience of IFRS and use of judgement.

In its report, *Opinion on the application of IFRS in Japan*, the Business Accounting Council (advisory body to the FSA) highlighted this issue and the importance of training to help companies and other stakeholders tackle the challenges involved. A committee has been set up tasked with developing and implementing an education and training system to build IFRS knowledge.

Current practices

Japanese business is already aware of the risks of underestimating the practical impact of the move to IFRS, which arise from trade practices, the law and the tax system as well as different accounting. There is no difference, for example, in the depreciation periods for property, plant and equipment under IFRS and Japanese GAAP – both require 'useful economic lives'. However, it is current practice in Japan to depreciate assets over periods prescribed by tax legislation.

The IFRS Council has been established to identify the significant issues and develop strategies to address them. The council is made up of key Japanese accounting and business groups, including the ASBJ and its oversight foundation, the Japanese Institute of CPAs, the Tokyo Stock Exchange and the Japan Business Federation (Nippon Keidanren).

Multi-GAAP to single GAAP?

A significant challenge for companies adopting IFRS will be moving foreign subsidiaries towards a single unified set of group accounting policies, a challenge accentuated by the traditionally decentralised management structure of Japanese companies. In addition, it is common for foreign subsidiaries to use different reporting systems from their parent or fellow subsidiaries, so the system and process changes (as well as the accounting policy changes) will often differ for each subsidiary.

'Some companies are planning to address some of the root causes of this challenge by linking their IFRS conversion with wider organisational change,' said Hitoshi Kiuchi, PwC partner in Japan. 'For example, some companies are considering implementation of a single financial system across all their group companies alongside their convergence to IFRS'.

Mr Kiuchi added that the language barrier is a burden for preparers which makes it difficult for their concerns about IFRS to be effectively communicated in international discussions. He welcomes the progress on an authentic Japanese version of IFRS.

Tax returns get tagged

The UK's inspector and collector of taxes (HMRC) is introducing online filing of company tax returns using inline eXtensible Business Reporting Language (iXBRL) from 31 March 2011.

From that date, each UK statutory company preparing a tax return will need to deliver statutory financial statements to HMRC using an iXBRL format. In short, this means that numbers and text disclosed in the financial statements will need to be accompanied by electronic 'tags' embedded within a readable electronic document. Tags will also need to be included within tax computations. HMRC's initial minimum requirement for financial statements specifies over 2,000 pre-defined tags that must be used wherever appropriate.

The practical challenge is to implement a method to match financial statement disclosures to the pre-defined tags and capture those 'matches' electronically, whilst applying appropriate controls to the process. Some software solutions have already emerged to reduce the time taken to tag and check an individual set of financial statements.

'For groups with many individual statutory companies, iXBRL could be a major undertaking and will require those responsible for tax and accounting to work together in a coordinated way,' explained Jon Rowden, PwC XBRL assurance leader.

Planning for iXBRL

- Appoint the manager responsible for devising an implementation plan
- Consider appointing an iXBRL implementation adviser
- Identify internal stakeholders, turning their perspectives into selection criteria
- Meet and negotiate with relevant solution providers
- Set a budget and timeline

Changes to have an impact on M&A deals

The economic downturn has created opportunities for mergers and acquisitions, with buoyant companies looking for bargains. The financial reporting implications are now a key consideration when formulating merger and acquisition strategies. The revisions of IFRS 3, *Business combinations*, applicable to calendar year companies from 1 January 2010, have made this even more important.

'Acquisition accounting under IFRS 3R may have different and even counter-intuitive effects on earnings and equity when compared with previous IFRS 3,' said Yvonne Kam, partner in PwC's accounting consulting services group in China. 'Management should avoid nasty surprises on transactions that are in the pipeline and, if necessary, make changes to the deal structure.'

To reach the best possible solution for the business, management of an acquisitive entity needs to understand the financial reporting implications. Some of these are considered below.

Recognition of earn-outs

There could be a significant impact on an acquirer's post-acquisition profit or loss. All types of purchase consideration are now measured at fair value on the date the acquirer takes control of a business. Adjustments to earn-outs used to be made against goodwill. Other than measurement period adjustments, IFRS 3 revised requires subsequent changes to be put through the income statement.

Measurement of earn-outs

Appropriate structuring of deals and accurate fair valuation of earn-outs may reduce or eliminate earnings volatility. The more the acquired business exceeds the performance projections underpinning the initial fair value, the greater the charge against the post-acquisition income statement. Equally, poor performance will result in a reduction in the recorded liability and a credit in the income statement. The results could be counter-intuitive. It is therefore essential to measure reliably the fair value of earn-out clauses at the acquisition date.

Classification as liability versus equity instruments

Earn-outs are classified as a liability and initially recognised at fair value if they fail to qualify as an equity instrument under the 'fixed-for-fixed' criteria in IAS 32. Changes in fair value go through the income statement. Earn-outs classified as equity instruments are recognised at fair value and are not subject to re-measurement. This reduces volatility and may be a more palatable alternative for all parties when compared to cash earn-outs. However, payment in shares of the acquirer may result in the transfer of more benefit to the seller than the acquirer had intended.

Earn-outs to employees or vendor-shareholders

Judgement is required in determining whether these earn-outs are part of the business combination or a separate transaction.

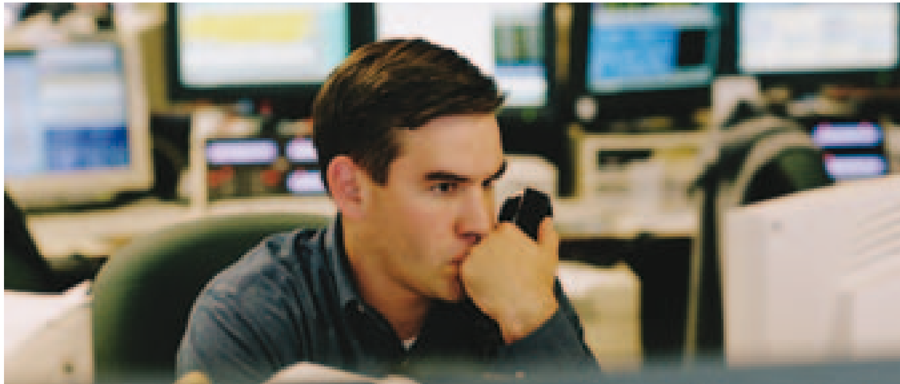
Application challenges

IFRS 3R may have significant effects in the year of, and years following, an acquisition. An accurate estimate of the ability to achieve the performance objectives on which additional payments are based will reduce the amount of subsequent changes and earnings volatility. This area might be a challenge for CFOs and valuers and may result in more equity-settled arrangements or fewer earn-outs altogether.

Deal restructuring

The simplest way to limit volatility is to eliminate cash earn-outs and contingent consideration. However, management will need to consider how the transactions are structured. Equity instruments eliminate volatility but may not be acceptable to the sellers or may represent too high a cost to the acquirer. Management could also ensure that due diligence is thorough and they have a full understanding of the risks before determining if contingent consideration is the right approach.

Defined benefit plans ripe for improvement



The International Accounting Standards Board (IASB) has issued proposals that, if adopted, will make it easier for users of financial statements to understand how companies account for pensions and other post-employment benefits. Management needs to look at the detail, as there could be significant implications for those operating defined benefit plans.

The IASB's exposure draft, *Defined benefit plans*, follows a lengthy and thorough due process. It was developed after considering the views of 150 respondents to an earlier discussion paper, *Preliminary views on amendments to IAS 19*, published in 2008. It is widely acknowledged that pensions accounting has long been ripe for improvement, and the board and staff intend to continue consulting with interested parties during the comment period.

The key proposals in the exposure draft relate to:

- Recognition of actuarial gains and losses
- Recognition of past-service cost
- Measurement of pension expense
- Presentation of pension expense
- Disclosure requirement

'The proposed changes are not as far-reaching as the ideas explained in the 2008 discussion paper, and some key issues are still to be addressed,' said Tony de Bell, partner in PwC's global accounting consulting services group. 'But they will significantly change the recognition and measurement of employee benefit expense and extend the disclosure requirements.'

The proposed changes will affect all entities that apply IAS 19 to defined benefit plans, by:

- Changing the way that information about the benefit obligation is presented in the financial statements
- Increasing the volatility in the post-employment benefit liability and in total comprehensive income for entities that currently use the corridor and spreading option for the recognition of actuarial gains and losses
- Increasing the net pension cost for many funded pension plans
- Changing the line items in which employee benefit costs are reported for some entities

The proposals could significantly change a number of performance indicators, including EBITDA, earnings per share and balance sheet ratios, according to specialists in PwC's accounting consulting services group. Management will need to determine the effect of the proposed changes and how they should be communicated to shareholders and other users of the financial statements.

Defined benefit plans is open for comment until 6 September 2010. The exposure draft can be downloaded from www.iasb.org

Investors get more say in standard setting

The investor community has received a welcome boost for its initiatives to raise the level of investor involvement in the standard-setting activities of the International Accounting Standards Board (IASB).

The IASB and the trustees of its oversight body, the International Accounting Standards Committee (IASC) Foundation, have launched a programme that will give investors more influence over the development of financial reporting standards. The programme includes:

- Investor alerts published by two board members with an investor background. Called investor perspectives, these give interested investors and analysts a timely mechanism to make comments on financial reporting matters.
- A new area of the IASB website, dedicated to investor resources. This will include an archive of material that will benefit investors, including the investor alerts.
- Dedicated plans to seek investor input for each project on the board's agenda. The drive to focus on investors as part of the project communication plans will involve, for example, asking investors for their views on proposals for the impairment of financial assets through an online questionnaire.

These initiatives can be seen to add weight to the standard setters' claim that it recognises investors as a target audience for financial information.

'The development of this programme demonstrates the IASB's commitment to involving investors in their standard-setting activities,' said Alison Thomas, PwC director of corporate reporting. 'The board recognises that the investment professionals' day-to-day experiences can bring a critical perspective to the standard-setting process.'

Investors can find more information at http://go.iasb.org/investors

Capitalising on the financial crisis

Dealing with the crisis – including its impact on funding, liquidity management, commodity price volatility and financial counterparty risk – has provided the sternest possible test for treasury teams. Yet, it has also brought the work of treasury to the forefront of the boardroom agenda.

Despite the huge pressures faced by treasurers during the economic crisis, most saw this as their greatest opportunity to push their issues to the top of the corporate agenda. A recent PwC global survey of treasurers found that nearly 80% of participants believe they now have the board's attention, and more than 70% have seen their reputation for adding value increase throughout the business.

Those surveyed generally agree that the main focus going forward will be on risk management. The real issue is not faults in what treasury is doing, but risk from what it is not doing, possibly as a result of understanding.

'Partnering with business' was listed as a key area for adding value (closely behind cash management). Boards and treasurers now recognise that integrating treasury with the business is vital to understanding and managing the organisation's financial risk dynamics.

However, if businesses want their treasury departments to be in a position to implement best practice before the next crisis looms, they will need to 'grasp the nettle', according to the report. This will often mean organising additional resources, integrating systems and taking a more collaborative and commercially-minded approach.

The *PwC global treasury survey 2010* surveyed 585 individuals from 26 countries across five continents. These respondents represented 330 multinational companies covering all sectors and with turnovers ranging from less than €1 billion to over €10 billion.

Contact kristof.de.smedte@pwc.be for a copy of the survey.

Recommendations for disclosures in periodic reports

The International Organisation of Securities Regulators (IOSCO) has issued *Principles for periodic disclosure by listed entities*, making disclosure recommendations targeted at entities whose securities are listed or admitted to trading on a regulated market in which retail investors participate.

The aim of the disclosure principles is to provide securities regulators with a framework for building or reviewing their periodic disclosure regimes. Fundamental to the principles is the view that information contained in periodic reports should enable investors to compare different companies' performance and enable them to make meaningful comparisons. Although the report gives particular focus to disclosures that could be provided in the annual and interim reports, it also covers the timeliness of disclosures, disclosure criteria and storage of information.

IOSCO has long advocated reporting of high quality disclosure information, having published earlier guidance such as the *International Equity Disclosure Standards* (1998) and *International Debt Disclosure Principles* (2007) related to public offerings and initial securities listings, and the *Principles for Ongoing Disclosure* (2002) that highlighted the importance of ongoing disclosure.

The latest recommendations were issued in February 2010, following a review of responses to an IOSCO consultation report. Some respondents wanted to see the recommendations cover a wider remit, such as disclosures on: environment, social and governance issues; fraud (based on a liability threshold); and compensation disclosure. The technical committee considered the concerns raised and incorporated those that fell within the scope of the project.

The principles are not binding. Rather, they allow jurisdictions to flex the principles to suit their regulatory environment and supplement them with more detailed disclosures where appropriate for their markets. Many of the principles contain examples to illustrate how different approaches may be used to reach the same disclosure objective.

The principles

- Periodic reports should contain relevant information
- Those responsible for financial statements should be clearly identified, and should state that the financial information is fairly presented
- The issuer's internal control over financial reporting should be assessed or reviewed
- Information should be available to the public on a timely basis
- Periodic reports should be filed with the relevant regulator
- The information should be fairly presented, not misleading and without material omissions
- Equal access to disclosure of material information should be provided to all investors
- Material periodic information should be made available promptly to all relevant markets

www.iosco.org

'Le CRUF' is set up in France

Senior investment professionals in France established a new chapter of the Corporate Reporting Users' Forum (CRUF) in May this year. The move follows the inaugural meeting, in December 2009, of another new chapter in Tokyo, Japan.

The CRUF is an informal network of investors and analysts, set up to contribute to the corporate reporting debate by giving the investor perspective on proposed accounting standards, particularly those of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board. It has grown rapidly since its inception in 2005 with chapters in the US, the UK, Germany, Australia and now in France and Japan as well.

'We are delighted to see such active participation by investment professionals in the reporting debate,' said Philippe Kubisa, PwC partner in France. 'Such input is vital if we are to ensure that the information produced by management meets the needs of the company's shareholders.'

In recent months, the CRUF has provided its views on the proposed changes to accounting for financial instruments and provisions as well as the constitutional review of the IASB. Its website also includes presentations that CRUF members have given to corporate executives on the usefulness of reporting today.

www.cruf.com

GLOBAL ACCOUNTING ALLIANCE

Tackling complexity in financial reporting

A series of roundtable discussions with key accounting figures around the world has raised the issue of how regulators, standard setters and preparers can tackle the problem of the growing complexity of financial reporting.

The events in London, New York and Beijing were organised by the Global Accounting Alliance (GAA) as a follow-up to its 2008 research report, *Getting to the heart of the issue: Can financial reporting be made simpler and more useful?* (see *World Watch* Issue 1, 2009, p13). That report raised a simple question: if everyone supports principles-based accounting, why can we not move towards it? Participants in the roundtables included IASB chairman Sir David Tweedie, FASB chairman Bob Herz, Wayne Carnall, chief accountant at the SEC's corporate finance division and Ian Wright, director of corporate reporting at the UK's Financial Reporting Council.

The GAA's report on the roundtable discussion reveals 'overwhelming agreement' that the use of principles-based standards applied through the exercising of judgement would stand accountants, auditors, preparers and users in much better stead. 'The problem arises from what people perceive as a principles-based system and the exercise of those principles,' adds the report. 'One man's principle turned out to be another man's rule.'

The roundtable participants suggested that part of the difficulty was that for preparers, compliance was their main objective and a regime that emphasises principles over rules does not help them achieve it. Others argued against the view that principles-based judgements would lead to greater uncertainty in financial reporting. Wayne Carnall pointed out that there had been very few instances where the SEC had ordered companies to restate their financial statements because of a difference in view around areas of professional judgement.

The main consensus emerging from the roundtables was that complexity was the underlying problem with financial reporting. There was a feeling that the issue could be resolved but was continually being shelved as a more urgent crisis came along. How the objective of less complexity could be achieved, though, was a different matter.

Some panellists felt that the profession would achieve nothing if it restricted itself to 'chipping away at the edges' of complexity. Instead, it was a question of changing human behaviour. 'There is unavoidable complexity, which is related to the growing complexity of business and the accounting which underpinned it,' concluded the report. 'And there is avoidable complexity, the simple accretion of unnecessary detail. Accepting one while ridding reports and accounts of the other has to be the aim. The continual urge to add more and more refinements and additions to the financial reporting process has to be curtailed.'

The report can be seen at www.globalaccountingalliance.com/financial_reporting_way_forward.html

Support for IFRS spreads

An analysis of IFRS adoption in South American countries shows the majority are either applying, or planning to adopt, IFRS. The following summarises the position in Argentina, Bolivia, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay and Venezuela.

Argentina

IFRS is mandatory for public companies (except banks and other financial institutions) for accounting periods beginning on or after 1 January 2012. Early adoption is permitted for years beginning on or after 1 January 2011.

Bolivia

The Association of Auditors and Accountants of Bolivia (CACB) has for several years been preparing a local framework that has been converged with IFRS, with the support of the International Bank of Development. The CACB in December 2009 issued a draft of the 15 standards to be approved by the government accounting standard setter before their mandatory application. The remaining IFRSs are expected to be issued and approved during 2010.

Brazil

IFRS is mandatory for the consolidated financial statements of listed entities, including banks and insurance companies, from 1 January 2010. However, a number of options permitted under IFRS have been eliminated by local regulators.

Recently, the Brazilian accounting standards setter and the Brazilian Federal Counsel of Accountants signed a memorandum of understanding with the IASB, which aims to increase the level of convergence between IFRS and Brazilian GAAP, including increased participation from these Brazilian bodies in the development of new standards by the IASB.

Chile

IFRS is mandatory for public companies, for accounting periods beginning on or after 1 January 2009. In addition Chilean GAAP has converged with IFRS. Insurance companies are required to present full IFRS financial statements in 2010. Banks are required to do the same, with some exceptions.

Colombia

There is a current government initiative to adopt IFRS in the near term. The Superintendencia de Servicios Públicos Domiciliarios issued several rules that require companies under its supervision to initiate the IFRS adoption process from 2010.

Ecuador

In November 2008, the Superintendencia de Compañias established a calendar for the adoption of IFRS between 2010 and 2012, depending on the type of entity. Those under stock market law will adopt from 2010.

Paraguay

Adoption of IFRS is being analysed. Although originally planning to adopt by 2010, it is more than likely that this will be delayed. Paraguay must adhere to the standards adopted by the other member countries of Mercosur.

Peru

IFRS (or IAS as it was then) were first applied in 1989, as decreed by a resolution issued by the National Accounting Board (NAB). However, Peruvian rules state that the local accounting principles are those endorsed by the NAB, and no standard, interpretation or revisions made by the IASB have been endorsed since 2005. Despite this, plans are in place to obligate public companies to comply with IFRS by 2011.

Uraguay

Local accounting decrees issued in 1991 and 2004 required Uruguayan GAAP to converge with IASs. However, significant differences between the accounting frameworks remained. Another decree in July 2007 declared that the IFRSs internationally in force at July 2007 were mandatory for the accounting periods beginning on or after 1 January 2009. The first reporting date under full IFRS is still to be established.

Venezuela

IFRS is applied for all ‘big' companies for annual periods ending on or after 31 December 2008. The IFRSs applied locally are those endorsed by the local accountancy body (FCCPV). However the current endorsed version does not include the improvements and amendments made by the IASB after 2008. IAS 21 and IAS 29 also differ slightly from the standards issued by the IASB.

GERMANY

Act brings sweeping changes to financial reporting

A new German Financial Standard Reform Act (BilMoG) represents the most comprehensive revision of statutory accounting principles for 20 years – it affects all companies that prepare German GAAP financial statements. The goal of the new rules is to establish modern, less complex accounting principles as a sustainable alternative to International Financial Reporting Standards.

The change moves German statutory accounting closer to IFRS, which improves the information available to stakeholders and facilitates in several areas an alignment of separate entity financial statements with IFRS group accounting of the parent company.

The use of IFRS in separate entity financial statements is voluntary in Germany, and only allowed for presentation purposes. German commercial law continues to require the application of German GAAP, particularly for profit distribution, tax and statutory presentation and disclosure purposes.

'BilMoG implements numerous substantial changes that can catch overseas subsidiaries with statutory reporting obligations in Germany by surprise,' said Armin Slotta, PwC partner in Germany. He explained that recognition and measurement criteria are quite different and there are several new and changed disclosure requirements. At the same time, companies also have to provide more information in their management commentary and implement new corporate governance rules.

'These requirements have a far-reaching impact on balance sheet structures, shareholders' equity, corporate earnings and other key performance ratios,' Mr Slotta warned. 'They may also influence covenants, refinancing conditions, and management's ability to distribute dividends.'

The new accounting principles also increase the divergence between financial statements and the computation of taxable income. The exercise of tax valuation options is conditional on a complete and current register of all valuation differences between the balance sheet and the tax computation. This register must show for each item (asset or liability): the day of acquisition or construction, its cost, the reference to the legal source of the tax option, and the depreciation as recorded.

In the area of corporate governance, certain management and supervisory board obligations receive a stronger emphasis and new disclosures provide additional external transparency. Particular emphasis is placed on the obligations of the supervisory board (including requirements of the audit committee) to oversee accounting processes, internal controls, internal risk management and the internal audit function.

The new regulations apply for all financial years from 1 January 2010. The inclusion of certain disclosure notes had already been required for the fiscal year 2009.

KOREA

Countdown to IFRS

Some significant differences between Korean GAAP and IFRS, combined with the cultural adjustment of moving from a rules-based framework to principles-based will be a challenge for Korean financial statement preparers and investors alike.

Korean listed companies are preparing to move to IFRS in 2011. However, some of the differences between Korean GAAP and IFRS could have a significant impact on how financial statements are prepared and perceived.

One of the biggest challenges companies face is the requirement to present consolidated financial statements in place of individual financial statements, and making a call on what should be consolidated and what should not. Unlike Korean GAAP, which is very prescriptive about this, IFRS requires judgement as to who has the control, risk and reward.

Another big difference is the format of the financial statements. Korean GAAP has a standard format that includes operating income. IFRS, again, provides only guidance and requires judgement. Management will have to consider whether operating income should go in the income statement or not.

Regulators and investors will both need to embrace the change from a rules-based framework to principles-based. It's a cultural change for them too. 'We are talking with the investment community to communicate how the financial statements may change and raise awareness of where there may appear to be volatility in the financial statements as a result of the move to IFRS,' said Kyung Ho Lee, a partner in PwC's accounting consulting services group in Korea.

'They may struggle initially with the new format of the financial statements, and understanding how the disappearance of the operating income number from some reports will affect the apparent comparability between entities.'

Some other significant differences between Korean GAAP and IFRS are:

- Classification of debt versus equity – redeemable preference shares move from equity to debt
- Accounting for employee benefits – requires forward-looking actuarial methods
- Goodwill – move to impairment testing
- Functional currency – may change under IFRS

IFRS work plan underway

The US Securities and Exchange Commission (SEC) has developed a work plan to evaluate the suitability of IFRS for domestic issuers. The work plan addresses areas that will determine if, when and how the US will move to International Financial Reporting Standards (IFRS), and reinforces the SEC's commitment to a single set of high-quality global accounting standards. The SEC also stated that IFRS is best positioned to be that single set of standards.

The announcement of a work plan came in conjunction with the release of the SEC's *Commission statement in support of convergence and global accounting standards* (the statement), at an open meeting in February 2010. The statement provided an update on the commission's consideration of global accounting standards and its continued support for the convergence of US GAAP and IFRS. However, the SEC issued the work plan to further investigate and address concerns raised in response to the original 2008 IFRS roadmap, before any binding decision is made on how the US financial system should further incorporate IFRS.

The work plan will be executed by SEC staff and covers six key areas:

1. Sufficient development and application of IFRS for the US domestic reporting system
2. Independent standard setting for the benefit of investors
3. Investor understanding and education regarding IFRS
4. Regulatory environment
5. Impact on large and small issuers
6. Human capital readiness

The first two areas consider *whether* IFRS should be further incorporated. The remaining four areas relate to transitional considerations to better evaluate *when and how* to effectively incorporate IFRS. Throughout the evaluation period, SEC staff will reassess and adjust the work plan as developments occur or as new information comes to light. Staff will use a variety of methods to obtain information, such as undertaking their own research, reviewing academic research, looking at the experiences from other jurisdictions that have incorporated IFRS, considering the views of foreign private issuers already reporting under IFRS, and communicating with US constituents.

The SEC has committed to transparency around its assessment process through periodic updates. The first one of these will be issued no later than October of this year.

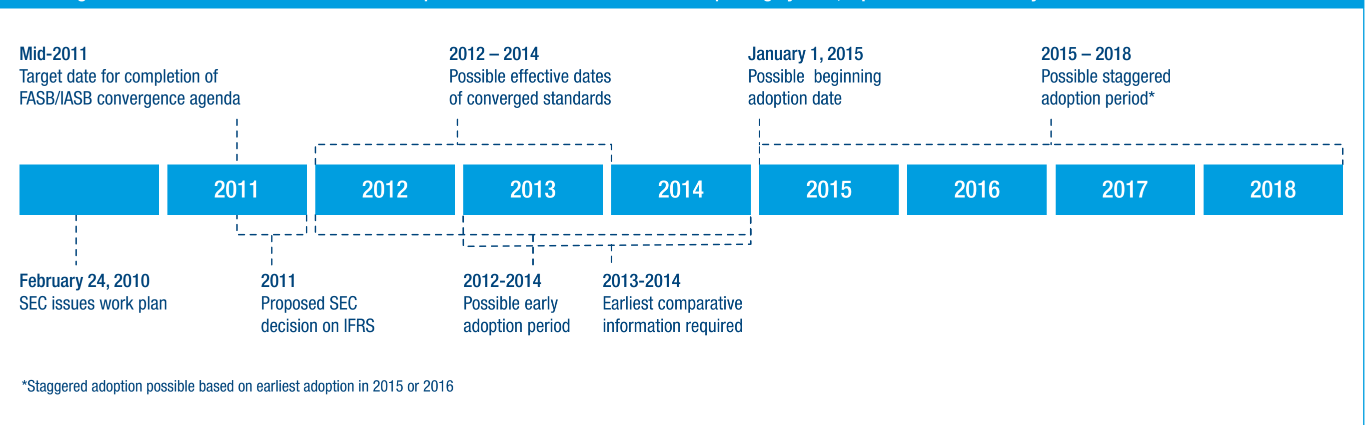
'We believe that IFRS is in the best interest of stakeholders, including investors both here and internationally,' commented John Barry, PwC's US IFRS leader. 'The statement and work plan are positive steps in terms of increasing transparency of IFRS considerations and an eventual determination on the use of IFRS.'

The SEC anticipates making a final decision on US adoption of IFRS in the second half of 2011. That will be predicated upon completion of both the work plan and the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) convergence projects. If that decision is forthcoming, the earliest date mandatory reporting under IFRS would take effect is 2015 or 2016.

While the work plan establishes a methodical approach to the analysis, no decisions have yet been made and some level of uncertainty remains. A perceived lack of commitment to IFRS on the part of the SEC has raised concerns in Europe. Some have started to question whether the SEC should continue to have a seat at the table in the governance of the IASB. Current IFRS stakeholders may be unwilling to continue with the convergence process if the US is not clearly committed to IFRS.

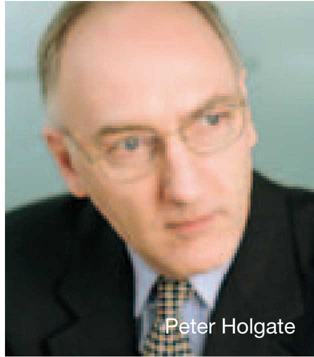
In addition, political pressure on IASB standard setting from major European constituents has increased over the past several years. These issues may present additional challenges for the SEC as it considers the path forward in the US.

In the meantime, regardless of any final adoption date, US and global companies alike will face unprecedented levels of accounting change as convergence efforts between the FASB and the IASB drive significant changes to both US GAAP and IFRS.



Quality and quantity concerns

Rushing to complete the IASB's work programme could result in low quality standards and an excessive burden on accounts preparers and users, argues **Peter Holgate**



The International Accounting Standards Board's work programme contains a long and ambitious list of major projects with planned completion by June 2011. This is when its chairman and two other board members retire. It is also the target completion date in the Memorandum of Understanding for the many joint projects with the US Financial Accounting Standards Board (FASB).

This challenging programme puts the IASB in a difficult situation. In one scenario, by sticking to its normal quality – and speed – of work, the IASB could fail to meet its timetable. This may cause delay and/or doubt in relation to US adoption of IFRS. The SEC's decision on whether to introduce IFRS into the US is due in 2011 and is likely to be based, at least in part, on completion of the MoU projects.

In a second, and perhaps more worrying scenario, the IASB could rush to complete its work programme and, in so doing, approve low quality standards – standards that are not ready, and that neither it nor other constituents have had proper time to consider.

In relation to outcome one, recent comments from SEC chief accountant Jim Kroeker provide some comfort. He indicated that although he doesn't see convergence as the only potential path for IFRS to become sufficiently developed and consistent for use as the single set of accounting standards in the US, convergence is critical. He also stated he would support the IASB and the FASB cutting the number of projects due in June 2011, provided there was good rationale for doing so. Thus convergence may not necessarily need to be completed before the SEC could make a decision on IFRS in 2011.

Even so, in a quarterly update issued this April the IASB and the FASB confirmed their intent to complete their planned projects by June 2011. They have acknowledged some difficulties, however.

Differences of opinion

On the financial instruments project, the two boards say they 'have reached different conclusions on some technical issues'. They add that 'addressing these differences in ways that foster convergence could affect the project timetables described in this report'. These words can easily understate the situation. The FASB wants more assets to be carried at fair value than the IASB. Furthermore, the two boards' proposals on impairment differ significantly as do their (unpublished) proposals on hedge accounting. These are fundamental issues in what is a highly complex standard.

On the insurance contracts project, the IASB and the FASB again say they 'have reached different conclusions on some technical issues'. As with financial instruments, 'addressing these differences in ways that foster convergence could affect the project timetables described in this report'. Insurance accounting is also highly complex and the publication of an exposure draft has already been delayed a number of times. Completing an IFRS by the target of Q2 2011 may not be realistic.

Turning to lease accounting, an exposure draft is imminent. Yet 'the boards also agreed in late March to explore an alternative approach to lessor accounting. That decision could affect the project timetables described herein'. While the focus has been mainly on lessee accounting, it seems widely acknowledged that, to be worthwhile, the standard would need to deal with both lessee and lessor accounting. Again, a delay appears likely.

Benefits of taking time

It is not in anyone's interest for the IASB to rush to finalise standards and compromise on quality in the process. Even if quality is maintained, the high volume of planned new standards, especially if published in a short timescale, will be a considerable burden on companies – both existing IFRS preparers and companies in the next wave of transitioning territories – and on the investment community. This is the case in major as well as smaller economies.

Preparers need to consider the standard setters' agendas. If they have concerns about the burden of commenting on such a large batch of exposure drafts in the short term, or about the implementation of such a large amount of change, they should write to the boards to make these views clear.

Exposure draft overload?

Q2 2010 EDs 'significant both in nature and number':

1. Financial instruments – liabilities
2. Financial instruments – hedging (may slip to Q3)
3. Financial instruments – debt and equity
4. Revenue recognition
5. Leasing
6. Presentation – reporting comprehensive income
7. Presentation – discontinued operations

Peter Holgate is senior technical partner at PricewaterhouseCoopers in the UK.

Why is business funding information useful to investors?

The economic downturn and continued strain on the availability of financing have resulted in increased management and investor focus on cash. **Peter Hogarth** looks at the bigger picture

Peter Hogarth

Investors are putting financial statements under the microscope to understand how companies are financing their business. They want to understand management's plans for servicing the entity's debt position and any associated risks. The economic downturn has resulted in increased management and investor focus on cash and an entity's ability to fund working capital requirements, refinance existing debt and secure new debt.

What investors value

Investors want to see a net debt analysis, and have indicated that they also value the following:

- **Broad definition of funding –** details of working capital, payments in advance and other items as a part of the funding disclosure, where they represent important sources of finance.
- **Details of average debt balances** – in addition to the year-end balances, to enable users to understand the debt position over the year.
- **Maturity information** – a comprehensive maturity table for all material components of debt, showing both the contractual maturity of each type of debt and when management expects it to be repaid (if different).
- **Covenant restrictions and terms** – financial reporting standards require disclosure of any defaults or breaches of loan agreement terms that are not resolved by the period end. Additional detail of the terms and measurement of the principal covenants in place, not only when breached, provides users with an understanding of the restrictions in place and the entity's compliance.

What does it look like?

One of the issues with current disclosure is that funding information is presented in separate areas of the annual report – providing the information piecemeal makes it harder for users to see the complete funding picture. Phase E of the International Accounting Standards Board's and US Financial Accounting Standards Board's joint conceptual framework project aims to make financial statement disclosures more effective and coordinated, and less redundant. The examples below are extracts from a number of annual reports illustrating some useful disclosures.

Broad definition of funding – working capital

The example below is an extract from the Signet Group plc 2008 annual report. It provides an explanation of the impact of the seasonality of its business on working capital requirements.

> The Group's working capital requirements fluctuate during the year as a result of the seasonal nature of its business. As inventory is purchased for the Christmas season there is a working capital outflow which reaches its highest levels in late autumn. This position then reverses over the key selling period of November and December. The working capital needs of the business are then relatively stable from January to August. The rough diamond sourcing initiative will require the Group to hold an element of its inventory for approximately an additional 60 days. The timing of the payment of the final dividend, normally in July, is also material to working capital requirements during the year.
>
> The Board considers that the capital resources currently available are sufficient for both its present and near term requirements.

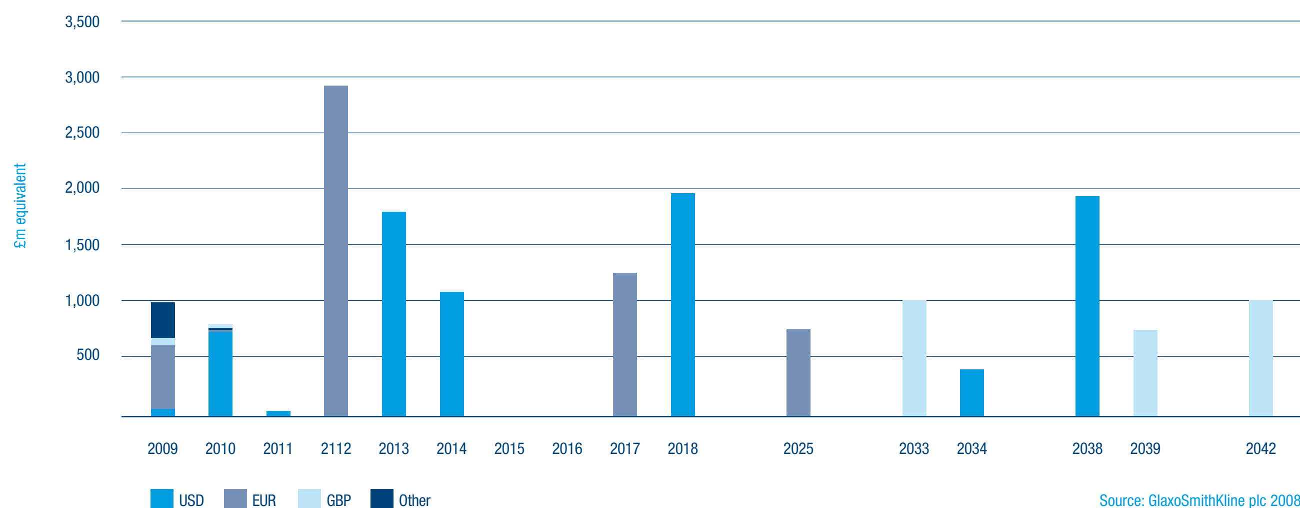
Details of average debt balances

The Barratt Development plc 2009 annual report details the impact of cyclical working capital requirements on borrowings throughout the year.

> The Group actively maintains a mixture of long-term and medium-term committed facilities that are designed to ensure that it has sufficient available funds for operations.
>
> The Group's borrowings are typically cyclical throughout the financial year and peak in April and May and October and November of each year, as these are the points in the year when the Group has the highest working capital requirements. Accordingly, the Group maintains sufficient headroom to cover these requirements. On a normal operating basis the Group has a policy of maintaining headroom of £250m of available committed facilities.

Maturity profile

The GlaxoSmithKline plc 2008 annual report provides a maturity profile of gross debt, in graphical format, which shows annual information up to year 2018 and periodic information thereafter, thus presenting more in-depth information than statutorily required.



Covenants

The SIG plc 2008 annual report provides the following covenant information relating to its debt facilities and how it is in compliance with its financial covenants.

To discover more about what financial reporting issues the investment community is talking about, see 'Investors view' publications on www.pwc.com/ifrs

DEBT COVENANTS

The Company's debt facilities contain a number of covenants attached to SIG's committed debt facilities. The key covenants are leverage and interest cover and are tested at 30 June and 31 December.

The leverage covenant is a requirement to maintain a ratio of net debt to Annualised EBITDA of less than 3.5 times. Annualised EBITDA is defined as operating profit before amortisation of acquired intangibles, impairment charges, depreciation and restructuring costs, plus interest receivable and adjusted to annualise the EBITDA of acquisitions made during the previous twelve months.

The interest cover covenant is a requirement to maintain a ratio of the previous twelve months' underlying operating profit to underlying net finance costs (excluding pension scheme finance income and costs) of greater than 3.0 times.

The ratio for each of the debt covenants is set out below.

Leverage covenant	Year ended 31 December 2008	Year ended 31 December 2007
Annualised EBITDA	£227.0m	£210.2m
Net debt	£697.1m	£428.9m
Leverage ratio	3.07x	2.04x

Interest cover covenant	Year ended 31 December 2008	Year ended 31 December 2007
Underlying operating profit	£169.8m	£159.4m
Underlying net finance costs*	£32.6m	£18.9m
Interest cover ratio	5.2x	8.4x

*Excluding pension scheme finance income and costs

The company is in compliance with its financial covenants in all respects and has not requested or gained any waivers thereof.

Peter Hogarth is a partner in the accounting consulting services group at PricewaterhouseCoopers.

Assurance

AUDIT REGULATION

Audit still in the spotlight

The debate around the audit and the role of auditors has continued to intensify since we reported on it in the last edition (Issue 1 2010, page 23). The European Commission has announced that it will further the debate with a discussion paper, due out later this year, on the role and governance of auditors.

Michel Barnier

Making the announcement, EC commissioner Michel Barnier said: ‘Governments have so far focused their attention on the urgent measures necessary to stabilise the markets. Now we are entering a less reactive phase and I am convinced that it is the right time to launch a real debate at European level on the subject of the audit.’

Mr Barnier also called for further debate on the European-wide supervision of audit firms. The green paper is also expected to cover International Standards on Auditing (ISAs), the audit of SMEs and concentration in the audit market and its implications for financial stability.

New layers of regulation or global collaboration?

Richard Sexton, head of assurance at PwC in the UK, also believes that this is a good time to highlight the risks to the capital markets of continuing with fragmented audit regulation. ‘Effective, high quality regulation, that balances cost with effectiveness, will do much to enhance trust and confidence in the global capital markets,’ he said.

He agrees with the commissioner that the current situation is not helpful. ‘Business and large audit firms operate both globally and nationally, yet the audit profession is regulated by national bodies that are not well coordinated globally and operate under varying standards and rules.’

Mr Sexton does not necessarily agree on the appropriate solution. ‘This does not mean that we require an additional layer of audit regulation reflected by a pan-European or even global body.’ He called for balanced regulation in which regulators understand the domestic business environment but also collaborate globally. ‘What is lacking is regular communication and information sharing among national regulatory bodies.’

Can the audit itself be enhanced?

Part of the audit debate in recent months has been to ask questions about whether auditors are being asked to give assurance on the right information set and whether the assurance they give could me more informative. Many companies are already responding to market demands by seeking different levels of independent assurance on information that is not necessarily required for regulatory compliance, but relates to strategic priorities for their business. Assurance on sustainability reporting is one example.

Several organisations around the world, including the International Auditing and Assurance Standards Board and the US Auditing Standards Board have also been seeking views on the value of the audit report itself. The UK Financial Reporting Council, is the latest regulator to announce a review of whether the audit can be enhanced with a report expected later this year. The plan is to address issues such as:

- How do we achieve a strong alignment between the auditor and the interests of the shareholder?
- Do we need to change the form of the audit report to make it more useful?
- Do we need to see more said in the front of the report about risk and the business model and should the auditor provide greater assurance about such matters?

‘Audit is a key part of high quality governance,’ FRC chief executive Stephen Haddrill said. ‘The auditor sees the company’s approach to risk. The auditor challenges management’s judgement on the financials. The auditor reports to shareholders on whether the company is providing a true and fair view of the business. The investor only sees the tip of the iceberg. But nevertheless investors are relying on that work being done.’

Concerns revealed

The needs of small and medium-sized businesses, the increasing global focus on corporate governance and the importance of high quality accounting and auditing standards are all highlighted in a survey of leaders of the worldwide accountancy profession by the International Federation of Accountants (IFAC).

Drawing on the responses of more than 110 presidents and chief executive officers from IFAC member bodies and associates and regional accountancy organisations in 72 countries, the *2009 Global Leadership Survey* identifies the big issues as perceived by the accounting profession.

It finds that respondents are highly concerned about the obstacles faced by SMEs. Survey participants believe IFAC's recommendation to the G-20 that financial regulation should not place unreasonable burdens on SMEs was its most important initiative during last year. Smaller company needs are also being considered in terms of accounting and reporting. For example, survey respondents attach increasing importance to IFAC's role in promoting the effective implementation and enforcement of the International Accounting Standards Board's *IFRS for SMEs*.

The survey also reveals the extent of current activity around the world to enhance corporate governance practices. Asked what actions are being undertaken locally, respondents emphasise the adoption and implementation of the OECD's good corporate governance principles. Other popular activities include supporting an increased role for audit/compensation committees, establishing fundamental ethical principles for boards of directors and stipulating requirements for effective non-executive directors.

Respondents highlighted the importance of IFAC's role in supporting confidence in international standards and in the adoption, implementation and enforcement of high quality accounting, auditing and other standards published by IFAC and the IASB. They additionally expressed strong support for IFAC's work in influencing high quality audit practices, as well as high quality financial management and reporting practices. Leaders of the accountancy profession expect these issues to continue to gain importance over the coming years.

www.ifac.org

Fraud and independence

Conflicts of interest and responding to suspected fraud are two high-priority projects that the International Ethics Standards Board for Accountants (IESBA) plans to complete within its 2010-2012 work plan. The IESBA will confirm its proposed strategy and work plan later this year, once it has considered the public comments due by mid June.

Conflicts of interest

Accountants in business and in professional firms who face conflicts of interest are expected to get additional guidance from the IESBA. It will cover the types of situations that give rise to conflicts, the mechanisms that can serve as safeguards in a conflict situation, and ways to manage conflicts.

Suspected fraud or illegal acts

The auditing literature already addresses the need to design audits to detect fraud and recommends various audit procedures. Guidance from the IESBA would focus on how accountants should respond when encountering a suspected fraud or illegal act. This will include the threshold for taking action, the types of actions that may be taken, which would focus mainly on communications with others, the process for responding, and the timing of any disclosure.

The IESBA will also address the scope of the related entity definition in its Code of Ethics in relation to the independence requirements in an audit of collective investment vehicles, including mutual funds. In addition, it will increase its efforts to use its code as a catalyst to converge international and national standards and will assess what other activities it should undertake to support those adopting the code.

'Our priority projects will contribute to the adept handling by accountants of fraud and conflicts of interest and will have an impact on many different stakeholders,' said IESBA chairman Ken Dakdduk. 'I urge business people and others outside the accounting profession to provide us with their views on these projects.'

www.ifac.org

A year of implementation and innovation

Arnold Schilder

With the release of the Clarity ISAs in early 2009, the International Auditing and Assurance Standards Board (IAASB) turned its attention to implementation and innovation – promoting the adoption of the Clarity ISAs, and supporting implementation through new guidance, but also shifting focus to new and innovative assurance services.

Announcing the release of the board's 2009 annual report, IAASB Chairman Arnold Schilder explained: 'During a period of great financial instability and uncertainty, auditors and assurance practitioners faced significant challenges. By seeking public input, responding to emerging needs, and supporting the implementation of global standards, the work of the IAASB continued to contribute to the restoration and maintenance of public confidence in information used for decision making. This has required diligent adherence by the IAASB to its public interest mandate, which is now entrenched in how the IAASB operates.'

Recent information from the IFRS Member Body Compliance Programme shows that 126 jurisdictions around the world adopt or use ISAs, with momentum towards convergence increasing with the release of the Clarity ISAs. Many external bodies, including the World Bank, the Basel Committee, the UN Conference on Trade and Development, the World Federation of Exchanges, the Forum of Firms and the International Organisation of Securities Commissions have welcomed the Clarity ISAs. The IAASB considers this achievement a testament to their production of high-quality, enforceable standards that the world's regulators can rely on.

Adoption of ISAs for statutory audits in the EU remains an important strategic objective for the IAASB. The EU has recently consulted on this issue and the summary of responses suggests that the majority of respondents are in favour of ISA adoption at EU level.

With the IAASB's shift in focus, there have been few exposure drafts or new pronouncements from the IAASB over the last year, but activity is expected to increase.

The IAASB's 2010 plan shows a mix of revisions and new pronouncements on a broad range of topics (see timing of proposed consultations in box).

IAASB planned exposure drafts

Q2 2010

ED Assurance reports on the process to compile pro forma financial information included in a prospectus (see article below)

Q3 2010

ED Using the work of internal audit

ED Auditing financial instruments

Q4 2010

ED Assurance on greenhouse gas emissions

ED Reviews of financial statements

ED Compilation engagements

The IAASB will also consult this year on its priorities and project plans for 2012-2014. Key matters will include the relative priority of standard setting for the audit of financial statements vis-à-vis other assurance services, such as assurance on greenhouse gas emissions statements. 'The views of preparers, investors, regulators and auditors alike will provide valuable perspectives on business and market needs,' said IAASB deputy chair Diana Hillier. 'Seeking a broad range of input will be particularly important to ensure the IAASB's future plan reflects the needs and interests of all stakeholders.'

IAASB

Assurance on pro forma compilation

The IAASB has issued an exposure draft for a new assurance standard on the process of compiling pro forma financial information (PFI) included in prospectuses. With the increasingly integrated nature of global capital markets, the new assurance standard is designed to enhance public confidence in how such information is produced. 'A common approach is important in regions such as Europe where prospectuses issued in one jurisdiction can be accepted in another,' said IAASB deputy chair and PwC partner Diana Hillier.

In many domestic and cross-border securities offerings, issuers are required to illustrate the impact of an event or transaction on their financial information. The proposed new assurance standard addresses the nature and extent of a practitioner's work when reporting on whether the process of compiling that PFI has been properly followed. This involves extracting the unadjusted financial information from an appropriate source, making pro forma adjustments that are both factually supportable and directly attributable to the event or transaction, and properly presenting the resulting information.

The ED is not without controversy and respondents are being asked whether they support the focus on the process to compile the PFI rather than on the PFI itself, whether the proposed work effort is clearly described, and preference on the wording of the opinion.

Comments are due by 30 September 2010. See www.ifac.org/iaasb

The question of disclosures

Questions about disclosures, both in the financial statements and in other information, are growing in strength and, as a result, are moving up the agenda of the International Auditing and Assurance Standards Board (IAASB).

With the increasing use of fair values and estimates in financial reporting, disclosures about methods, judgements and assumptions are no longer simply supplementary information. Rather, as the recent financial crisis proved only too clearly, such disclosures are vital to understanding the nature of amounts on the face of the primary statements and their inherent measurement uncertainty.

In light of this trend, the IAASB is considering whether there is sufficient audit guidance on disclosures – for example how materiality judgements apply, and the nature and extent of audit evidence needed in relation to them.

Such questions are not straightforward, according to PwC partner Diana Hillier. 'There would no doubt be resounding agreement among all stakeholders that disclosures need to be meaningful and relevant,' Ms Hillier told *World Watch*. 'However, questions have surfaced about how disclosure requirements can be applied to portray what really matters in the context of the particular entity, rather than being approached as a checklist. While that appears to support the ability to apply judgement on the basis of relevance, other stakeholders question whether there is sufficient challenge about the completeness of disclosures and the support for them. To some extent, these differing perceptions seem contradictory.'

The IAASB has also just embarked on a project to revise the auditing standard that addresses the auditor's responsibilities for other information in documents containing the audited financial statements.

Increasingly, the lines between the financial statements and other information are blurring – for example, IFRS 7 disclosures are allowed to be placed outside the financial statements in the annual report. But the IAASB will also consider the auditor's responsibilities in relation to the other information. For example, in addition to reading the annual report for its consistency with the financial statements, investor responses to the International Organisation of Securities Commissions' (IOSCO) consultation also suggested that auditors could have a role in ensuring information produced by entities is not only supported, but also fair and presented objectively in the context of the auditor's understanding of the entity and its environment.

IOSCO

Investors speak out on audit reporting

Audit reporting continues to be high on the radar screen. Responses to the 2009 International Organisation of Securities Commissions (IOSCO) consultation on audit communications provide insight into what investors are thinking on the topic.

Responses from investors acknowledged the value of the current true and fair audit opinion, but also sought ways auditors could provide more insight. Investors were particularly keen to obtain auditor's views about the quality of an entity's financial reporting – for example, the level of conservatism or aggressiveness in accounting policies and judgements made, and insights into areas of risk and sensitivity analyses. Such communications could be in an expanded, more discursive auditor's report, but alternatives raised included asking auditors to report on the quality and transparency of additional qualitative information reported by directors and/or audit committees.

While there was some support for more disclosure on the scope and conduct of the audit, such as how significant risks were addressed by the auditor, many thought that firms' new transparency reports and reports from independent inspection provided sufficient information on audit quality.

Responses from other stakeholders, including audit regulators, audit firms and accountancy bodies, were more mixed. Many cautioned that changes to audit reporting need to be debated in the broader context of the whole corporate reporting supply chain, pointing out that the current reporting model is premised on current norms of law, regulation, financial reporting, corporate governance and business behaviour.

AUDITING PRACTICES BOARD

Views on non-audit services

The UK's Auditing Practices Board's (APB) consultation on whether auditors should be prohibited from providing non-audit services to listed audit clients closed earlier this year (See *World Watch*, Issue 1 2010, page 26) – 136 responses have been posted on the APB's website.

The majority came from companies and audit committee chairmen. Eight are from investors. Out of 136, only 3 called for outright prohibition. A few respondents expressed concerns about specific services. The most frequently mentioned was internal audit (9 letters), with restructuring services to companies in distress the second most popular (5 letters).

Many respondents suggested that policies on procurement of non-audit services should mandate pre-approval of non-audit services by audit committees and that they should be subject to *de minimus* levels.

Virtually all supported enhanced disclosure, with better information on the nature of services and reasons why the auditor was chosen to provide the services. A number commented on the need to address the complexity of the legal requirements on the breakdown of auditor remuneration in the notes to the accounts. An Institute of Chartered Accountants in Scotland working group submitted a report to the APB recommending improvements to these disclosures; this can be found on the APB's website: www.frc.org.uk/apb

The APB is expected to issue feedback on the consultation, including their proposed actions, shortly. Proposals to amend the Ethical Standards would be issued as an exposure draft for further comments.

MALAYSIA

New initiatives to increase investor confidence

The Malaysian government has introduced reforms aimed at enhancing the quality and reliability of audited financial statements. The initiatives affect both company directors and their independent auditors, with penalties to pay for non-compliance.

The Malaysian Securities Commission (SC) has been given further authority under securities laws to impose penalties on those who coerce, mislead or authorise any person engaged in the preparation or audit of financial statements to be false or misleading. The ruling relates to listed entities or related corporations. Anyone found guilty of this offence faces the possibility of up to 10 years in prison and a fine of up to RM10 million. This is in addition to the current requirements and penalties imposed under the Companies Act.

Audit oversight

A further initiative is the creation of the Audit Oversight Board (AOB), under the auspices of the Securities Commission. The AOB will provide independent audit oversight of public interest entities (PIE) and ensure the regulatory framework for auditors is on par with international standards. By working with relevant regulatory agencies in Malaysia, the International Organisation of Securities Commissions (IOSCO), and other international independent audit oversight bodies, the AOB will promote confidence in the quality and reliability of audited financial statements.

Overall, the AOB's objectives are:

- To have an oversight system independent of auditors
- To ensure only fit and proper persons are allowed to audit financial statements
- To inspect and monitor auditors for compliance with auditing and ethical standards
- To impose sanctions on auditors failing to meet the required standards

A new regime

Prior to setting up the AOB, the audit profession was self-regulated under the umbrella of the Malaysian Institute of Accountants (MIA). Under the new regime, the MIA will continue to set auditing and ethical standards based on those issued by the International Federation of Accountants (IFAC). However, the AOB will have the power to direct MIA to establish, amend, modify or alter its prescribed standards – for example where international standards or best practices are not adopted.

The securities commission has updated the audit oversight framework to strengthen regulatory oversight and to bring renewed investor confidence in the financial reporting of companies.

Is the audit relevant?

Responding to debate about the relevance of the audit, **Ian Powell** argues that the audit is still critical to markets but can be improved

Ian Powell

Audits are critical to the orderly functioning of the capital markets and the maintenance of confidence in both individual companies and the market as a whole – it will come as little surprise to learn that I'm not in favour of dropping that statutory audit.

For centuries now, the market has wanted financial information to be checked by a reputable, professional third party to offer a degree of assurance on the truth and fairness of information. While much has changed, the fundamental market need for the audit is stronger today than ever as business owners have become increasingly remote from the day-to-day management of the companies in which they invest and business has become more complex.

There is much evidence that auditing supports the integrity of corporate governance and shareholder stewardship and that in turn reduces the cost of capital. However, I believe that the current audit model, and wider corporate reporting, is capable of being improved to meet the changing needs of market participants. In fact the overall model is long overdue some serious market-wide discussion. For me, the fundamental questions revolve around the scope of the audit – should this be extended? – and the nature of audit reporting.

Independent studies support the view that there is generally a high level of confidence in audited financial statements. But these studies also show that stakeholders want more from their auditors. There are three areas in particular that I would like to see debated.

Communication: how, who with and what?

How should auditors communicate what they do? At present, many months of hard work by a team of dedicated professionals is reduced to a binary opinion expressed in a short note to the accounts. Much of this is driven by regulatory requirements or necessities in today's litigious environment, but today's opinion gives very little insight into the nature and impact of the audit process. Different forms of communication could play an important part.

Who should auditors communicate with? At times I think the profession could have done more to acknowledge that auditors work for and on behalf of the investors who own the company. But the nature of modern company law means there are very significant legal barriers to communication between auditors and shareholders. I would welcome a wider debate on the type of information investors want, whether this could or should come from the auditors, and if so what are the practical and legal implications of making these changes.

What should auditors communicate? The financial crisis has led many in the profession and beyond to ask whether auditors should be given greater flexibility when expressing opinions. For this to happen, the environment we operate in also needs to change. Simply asking the audit profession to step outside the box more is not the answer. We need to redefine the box. This is where the wider reporting model debate is crucial.

The discussion needs to consider widening reporting to include non-financial information – for example in the sustainability and environmental space, which these days can have a dramatic impact on a company's share price, reputation and license to operate. Given the importance we now attach to this kind of information, I see value for the market in having assurance on it.

Potential roadblocks

There are potential roadblocks, however, that will require concerted action from all participants to overcome. First, is the inherently conservative nature of the profession. We need to be prepared to talk more openly about our role and be more transparent about the difficulties we face, be less risk averse, and be brave when considering any necessary changes.

Second, for auditors to be more open will need structural change, such as the creation of safe-harbours for directors and auditors. And finally, any strategy, including in the field of regulation, needs to set out a long-term vision of what it wants to achieve, not just what it wants to prevent.

We need to be prepared to debate these issues and then move quickly to implement any necessary reforms. This should be a holistic process and the key focus should be on benefits for the market as a whole.

I am firmly of the view that we should build on rather than break apart the existing statutory audit model.

Ian Powell is the chairman and senior partner of PricewaterhouseCoopers in the UK. This article is based on his speech at the Aileen Beattie memorial lecture in London.

Broader Reporting

CERES

Roadmap lays out expectations

Governance, disclosure and stakeholder engagement will – alongside actual performance – be at the heart of the drive to integrate sustainability into the 'DNA of business'.

Governance, disclosure and stakeholder engagement will – alongside actual performance – be at the heart of the drive to integrate sustainability into the 'DNA of business'.

A report from Ceres, the leading network of investors, environmental groups and other public interest organisations working with companies to address sustainability challenges, outlines 20 key expectations that companies will have to meet in these areas, arguing that sustainability is now mainstream to both business and investor thinking and can no longer be addressed by ad hoc initiatives.

21st century corporation: The Ceres roadmap to sustainability argues that investors are increasingly asking companies to identify sustainability risks in financial disclosures, and will see sustainability performance as an indicator of strong management, strong governance and long-term thinking about future growth potential. Business partners too are increasingly imposing sustainability criteria, while pressure is also increasing from both consumers and employees.

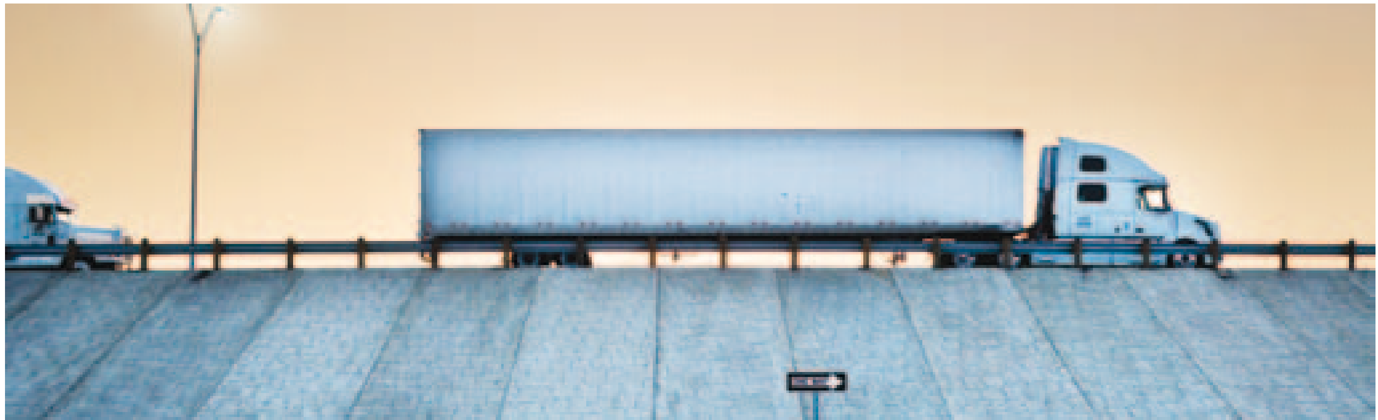
With over 200 case studies the report offers companies resources and tools to build the governance structures, engagement models and standards of disclosure that they will need to meet these expectations. Actions include encouraging boards to be more diverse and include sustainability expertise, while aligning executive compensation packages with sustainability performance. Companies are encouraged to report on their performance in addressing key environmental and social challenges, while engaging a broad range of stakeholders in sustainability strategies.

The full report can be downloaded in from www.ceres.org

Key expectations identified

- **Oversight** – board of directors to provide oversight and accountability for corporate sustainability strategy and performance.
- **Engagement on risks** – systematically identify a diverse group of stakeholders and regularly engage with them on sustainability risks and opportunities, including materiality analysis.
- **Addressing risks** – address specific sustainability risks and opportunities during annual meetings, analyst calls and other investor communications.
- **Disclosure** – disclose material sustainability issues in financial findings and significant performance data and targets.
- **Balance** – cover challenges as well as positive impacts in disclosures.
- **Communication** – use a range of channels to communicate relevant sustainability information eg, annual reports, financial documents, media.

Road test for carbon accounting standards

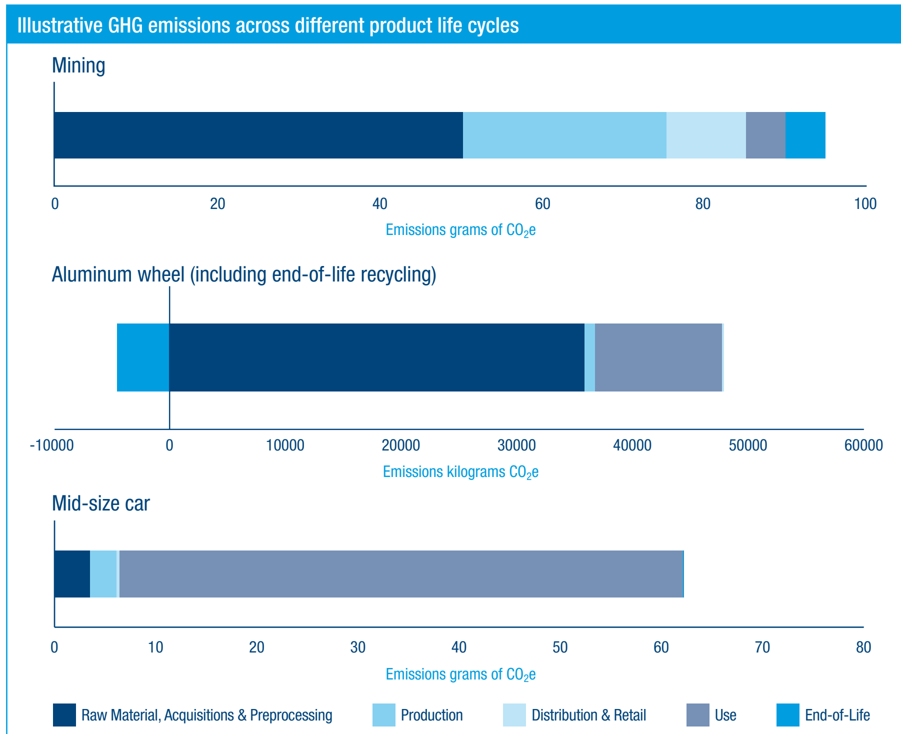


Sixty large international companies have begun road testing two new accounting standards by measuring the greenhouse gas emissions of their products and supply chains. The standards are part of the Greenhouse Gas Protocol Initiative, a global framework developed by the World Resources Institute (WRI) and the World Business Council for Sustainable Development (WBCSD).

The two new carbon accounting or greenhouse gas (GHG) Protocol standards – the *Product life cycle accounting and reporting standard* and the *Scope 3 (corporate value chain) accounting and reporting standard* – provide methods to account for emissions associated with individual products across their life-cycles and for company emissions across their value chain.

'The road testing will provide critical input in ensuring that the standards generate credible and meaningful data for business and government decision makers, while considering the practical challenges that businesses will face during implementation,' said WRI president Jonathan Lash.

WBCSD president Bjorn Stigson added: 'By taking a comprehensive approach to GHG measurement and management, businesses and policymakers can focus attention on the greatest opportunities to reduce emissions within the full value chain, leading to more sustainable decisions about the products companies buy, sell, and produce.'



Nick Shufro, one of the international PwC team working with companies, the WRI and the WBCSD to help develop and test the new standards, said: 'The Scope 3 standard is particularly significant for some sectors, such as retail and consumer, because it seeks to develop carbon accounting for indirect emissions in the supply chain and in product use, which can often dwarf the emissions generated by a company's internal operations (eg, manufacturing and distribution).' He added that there are already signs of Scope 3 emissions becoming increasingly relevant to business. In February this year, for example, Walmart made a public commitment to work with selected suppliers to reduce 20 million metric tonnes of carbon emissions from its supply chain by 2015. In addition, this year's Carbon Disclosure Project information request sent to companies has increased its emphasis on Scope 3 emissions reporting.

Companies participating in the road testing represent more than 20 industry sectors from 17 countries across all continents. If this method becomes widely accepted, it is expected to enable companies to better calculate and share their climate change impact and, as one company executive said, this could 'unleash the power of the market to address climate change on a global scale.'

The final standards are scheduled to be published in December 2010.

www.ghgprotocol.org

Integrated reporting pays off

A Hong Kong company has been awarded the Globe Sustainability Reporting Award 2010, beating off competition from the UK, Sweden, Spain and Finland.

CLP Holdings Ltd won the award on the merit of its integrated sustainability reporting. The judges praised the company for its staff safety and web presence, the integrity shown by disclosing the bad news as well as the good news stories around investment in renewable energy generation.

In addition to recognising excellence in reporting, the Globe Award also has categories for sustainability achievements in research, innovation and cities.

'The sustainability award was judged on evidence of sustainability reporting being integrated into the reporting model,' explained Lars-Olle Larsson, PwC partner and overall chairman of the Globe Award. 'Stakeholders need to be able to see that an organisation's sustainability activities will lead to financial benefits for everyone in the long term.'

Sustainability award criteria include:

- Reported information is determined by its importance to the company's strategy and its impact on key business activities.
- The effect of sustainability trends are assessed and explained.
- Information is reported for each critical area of business activity with the connection between sustainability and financial performance demonstrated.
- Targets have been set and performance explained.
- Reported information includes upstream and downstream impacts of products and services, where these are material.
- Sustainability reporting is integrated.
- An assessment of risk/profit impact of integrating social and environmental issues into the business.
- The extent of independent assurance on the sustainability reporting.
- Reports provide data that is consistent, relevant and comparable data.

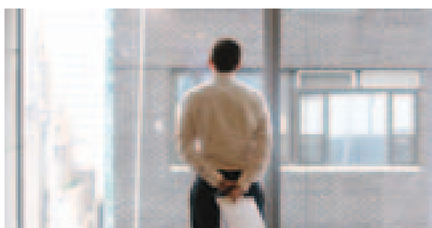
CLIMATE CHANGE

Business bites back with appetite for change

Business is looking to governments for leadership in establishing the behavioural change necessary to halt global warming. It is a mixture of penalties and rewards that is most likely to encourage business to reduce its impact on the environment.

A recent survey conducted by PricewaterhouseCoopers in 15 countries examined the attitudes of almost 700 interviewees from the international business community toward environmental regulation, legislation and taxes. The research found that a large proportion of businesses are potential supporters of incentives, emissions trading schemes and carbon taxes. However, there is a feeling that government policies are not sufficiently coherent or effective and there is a sense that business should work with governments to help develop effective 'green agenda' policies.

When asked for views on the most effective way of getting business to reduce its impact on the environment, the answer appears to be a mixture of 'carrot and stick' – with 86% opting for tax incentives and 83% for regulation.



Factors topping the list as being instrumental in influencing an organisation's environmental behaviour were compliance (86%), corporate reputation (75%), cost savings (73%) and competitive advantage (67%). Business respondents commented that they would see regulation as a welcome move (rather than a constraint), provided it is done in the right way.

'This research contains a strong message of hope for those struggling to find a global consensus: incentives, emissions trading schemes and even carbon taxes could win support in the business community,' commented Mark Schofield, PwC global sustainability and climate change tax leader. 'Political leaders who activate that potential have a good chance of creating historic solutions to the unprecedented challenges facing our ecosystem.'

Key findings

- Corporate climate change strategies will effectively have an impact on operations, key performance indicators and innovations around new products and services.
- Government leadership is considered indispensable, with the business community ready for, and supportive of, government action.
- Businesses generally believe existing environmental taxes, regulations and incentives are ineffective, inconsistent and unclear.
- Business wants clear signals for long-term investment.
- Executives prefer the use of taxes designed to discourage pollution and to fund environmental programmes.
- A growing number of businesses are developing strategies to manage uncertainty around climate change but remain hopeful of working with governments to create consistent policies that halt global warming.

www.pwc.com/appetiteforchange

SEC wants climate risks disclosed

The US Securities and Exchange Commission (SEC) has made it clear that management teams have a duty to disclose the risks for the company from potential climate change. It has issued guidance to give companies a clearer sense of how to apply existing rules when it comes to the material effects of climate change.

'As territories around the world take action on this agenda, it will be important for business to influence the debate and help to ensure that there is a common international framework for the measurement and reporting of climate change,' said PwC climate change leader Richard Gledhill.

The interpretative guidance takes a broad view of climate-related risks, outlining the following areas that may impact business:

- Existing or pending legislation or regulations eg, restricting emissions
- International treaties or accords on climate change
- Business trends and indirect consequences (eg, demand for 'green' products)
- Physical damage to assets or supply chains caused by severe weather

The guidance does not change the current legal framework, but it does raise awareness of the type of risks that could be considered material. It is clear that the SEC intends to increase the quality, consistency and clarity of reporting on the impacts of climate change on business.

The guidance may result in alternative presentation formats and additional factors for companies to consider when making disclosures. It also calls for assessment, for example, of the indirect consequences of climate change on suppliers, and for consideration of the opportunities a business might profit from when trading carbon credits in a cap and trade scheme.

'It is clear investors will be intensely interested in seeing what companies disclose in reaction to the new SEC guidance,' said PwC partner Kathy Nieland. 'Many investors have been asking for more disclosure.' According to Ceres investor network on climate risk, shareholders had lodged a record 89 climate-related resolutions with US companies by April 2010.

'Many boards remain unaware of what constitutes a "material" climate risk, or just how broad the scope and potential impacts truly are,' Ms Nieland added.

Climate change on CEOs minds

Climate change is on the minds of many US CEOs, according to recent research by PwC. Over half of the 100 US CEOs surveyed said they expect consumers to place heavier emphasis on companies' environmental and social responsibility practices before they make purchases. Almost half (48%) agreed that a company's response to climate change will create a reputational advantage in the minds of key stakeholders, including employees – a higher proportion (61%) of their peers globally agreed.

Implications for the board agenda

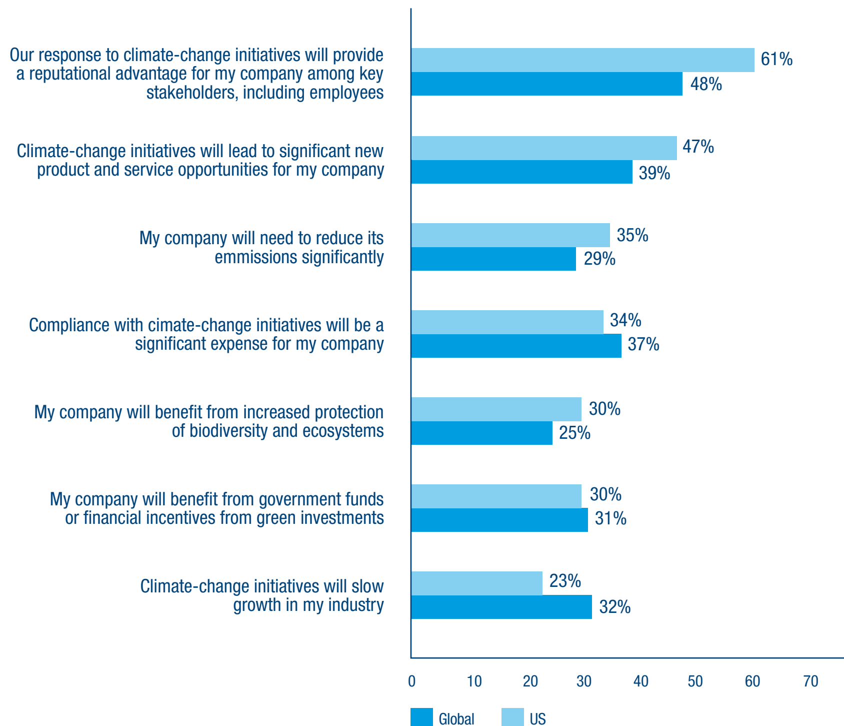
This indicates that companies that have not already put climate change on the board agenda may well consider that the time has come. 'Discussions on these issues are more effective when integrated into company's strategic planning,' said Ms Nieland. 'The board can expect management to assess climate-related risk just as it does other significant risk and when they are material, to raise these issues with the board.'

Key steps for the board

- Become familiar with the range of potential climate change risks facing the company
- Understand management's assessment of how climate risks could impact performance
- Recognise which risks, if any, are material and warrant disclosure

How CEOs view the impact of climate change initiatives

How much do you agree or disagree with each of the following statements about the potential impacts of climate-change initiatives?



Note: Respondents who stated 'agree' or 'disagree'
Global (1,198 respondents), United States (100 respondents)

Source: PricewaterhouseCoopers 13th Annual Global CEO Survey, January 2010.

Copenhagen carbon pledges too low

Carbon reduction pledges by countries around the world are much too low to keep climate change below the 2°C temperature increase that would help prevent catastrophic climate change, according to PwC analysis.

At the UN climate conference in Copenhagen, countries agreed to make emissions reduction pledges by 31 January 2010, and by mid-March over 100 countries (representing 80% of global emissions) had done so. However, the Copenhagen Accord pledges are relatively unchanged from those made prior to the summit itself and they are too low – at 9.7 gigatons (GT) of CO_2 equivalent they total just under half the 20 GT of CO_2 reduction required from business as usual to stay on the low carbon pathway (see chart).

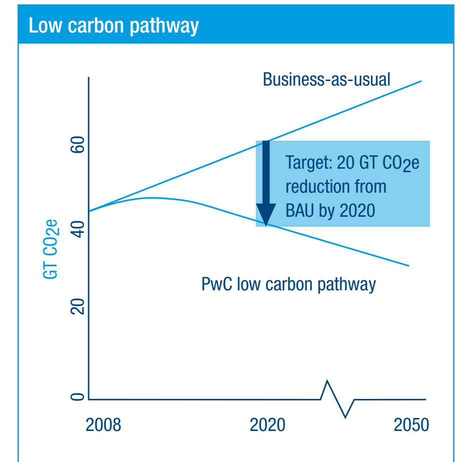
China is expected to deliver 39% of the pledged emissions reductions, relative to business-as-usual levels. Brazil makes the next largest contribution mainly through actions on reducing deforestation. The reduction in carbon intensity under the accord averages 2% a year to 2020, compared to the 3.4% that is necessary to stay on our low carbon pathway to 2050.

PwC climate change partner Richard Gledhill commented: 'The impact on business will vary by country but significant uncertainty is expected until those pledges are enshrined in national legislation. The lack of clear legislation or appropriately ambitious targets in many countries has delayed major capital investment in low carbon technology.'

He added, however, that business has not necessarily been waiting for legislation to take action on climate change. Some companies are already improving their carbon reporting systems, considering the vulnerability of their supplies, investing in energy efficiency, and mapping climate risks for long-term capital projects.

'It will be in companies' interests to be proactive about this and show their governments how climate change targets can be met in a business-friendly way,' Mr Gledhill concluded.

Low carbon pathway



Rewards for telling it how it is

The overall winner of the Mauritius Corporate Reporting Awards 2010 was the Mauritius Commercial Bank. The bank also won the award for online reporting, presented for the first time this year, to encourage better use of websites as a medium to communicate with shareholders and investors.

The Corporate Reporting Awards, organised by PricewaterhouseCoopers Mauritius, aim to promote excellence in corporate reporting. The judging panel reviewed annual reports alongside other publicly-available information such as communiqués, interim reports and websites. All these were assessed according to their content, clarity and correlation (see box) and whether investors were getting insight into prospects for the next financial year.

Websites were assessed for:

- Ease of navigation and location of documents
- Availability of publicly released information
- Additional information that enhanced engagement with investors
- Facilities that allowed own analysis and manipulation of data

Judging against the 3 Cs

Content	Clarity	Correlation
• Objectives and strategies • Risk factors • Mitigating processes • KPIs (financial and non-financial) • Progress • Trends and prospects • Issues (market forces, resource constraints) • Voluntary disclosures • Online investor information	• Tailored comments • Focus on key items • Explanations of significant variances • Basis of executive remuneration • Design, look and feel • Use of graphic aids • Cross referencing	Consistency of the key messages were assessed: • Within sections of the annual report • With other public documents released • With the entity's website

Category Award winners

SEM-7*
The Mauritius Commercial Bank

Investment companies
IPRO Growth Fund

(Other) Public interest entities
Standard Bank Mauritius

Corporate governance disclosures
Harel Frères

Online reporting
The Mauritius Commercial Bank

*The SEM-7 comprises the seven highest market capitalisation entities of the Stock Exchange of Mauritius (SEM) official list.

Detailed information is available on www.pwccra.com

Disclosure on water-related risks?

Water is starting to pose reputation risks for businesses operating or sourcing from water-scarce regions and if present consumption patterns continue, the risks will increase. Businesses rely on freshwater resources in their supply chain, operations and in the use of their products, yet two thirds of the world's people are expected to live in water-stressed conditions by 2025 and the world could surpass its freshwater limits by 2050.

The human right to water has been acknowledged by the United Nations (UN), which has led civil society organisations to continue to press businesses for a response to this issue. Future regulatory risks will have direct impacts on costs and investors are increasingly looking to business to disclose better information on the nature and extent of water-related risks and their plans to manage them.

Water stewardship, like reducing carbon emissions, requires a coordinated effort, according to PwC partner Richard Gledhill. But he points out that unlike carbon emissions, the impacts of water use depend on the seasonality and location of usage and, because water is a 'common good', the price remains well below its true value. For these reasons, Mr Gledhill does not expect a single market for offsetting to develop, but said, 'coordinated multi-stakeholder action will be needed at global, regional and local levels to ensure good water stewardship'.

Organised action on water

- UN CEO Water Mandate – a public-private partnership launched in 2007, to help companies develop, implement and disclose water policies and practices. Endorsed by over 60 global companies.
- Alliance for Water Stewardship – multi-stakeholder platform seeking to develop indicators for a water stewardship certification programme.
- The Water Footprint Network – over 100 partners working to improve the methodology for working out the water footprint of a business and its impact.
- The International Organisation for Standardisation – working on an ISO for water footprints. Due for release in 2011.

'Like carbon, water use will surely face increasing future regulation, costs and civil society pressure,' said Mr Gledhill. 'Businesses that understand their own water use and make early choices about water management are likely to have a strategic advantage.'

CAPITAL MARKETS

Water data expected to drive insight and sustainability

The CDP Water Disclosure project (WDP) will ask over 300 of the world's largest companies to provide critical water-related data to inform the global market place on their water strategies. This is intended to highlight risks and commercial opportunities and drive investment towards sustainable water use.

The move is a response to forecast water shortages. The OECD, for example, predicts that many of us will live in areas of high water stress within the next 20 years unless new policies are introduced.

A questionnaire will be sent to 302 of the largest companies in sectors that are water-intensive or face particular water-related risk. It will request information from companies on: water management plans and governance; water usage and exposure to water stress in their operations and supply chains; and the risks and opportunities they face in relation to water.

The most useful way to disclose performance in this area is not yet clear. PwC sustainability partner Alan McGill said: 'The absence of effective standards has limited the number of companies disclosing meaningful and comparable information and has resulted in most companies disclosing only minimal information on their own direct use of water. Many companies do not have a grasp of the risks or opportunities presented by water and even fewer are aware of the potential risks relating to the goods and services they purchase through (often global) supply chains.'

He concluded that the Water Disclosure Project is an important step towards giving investors access to data that will enable better informed decisions and direct the flow of capital away from risks and towards solutions.

US

Investor relations produces winners all round

The US winners of the Investor Relations magazine awards were announced in March, with JP Morgan Chase and Co, Life Time Fitness and Corance each topping more than one category.

Now in their 15th year, the awards are held in 7 different regions worldwide and recognise organisations for excellence in their investor relations. Winners are drawn directly from the opinion of the investment community who provide their views through an independent survey.

Over 5,000 analysts and investors around the world have a voice in choosing the winners. Organisations are judged against various categories and market-cap ranges, with investors commenting on whether the quality of IR has improved as well as ranking companies against criteria such as the performance of the investor relations officer, the quality of the annual report, and best use of the internet.

The results of the US survey form the *Investor Perception Study, US 2010*. This report provides first-hand views from survey respondents that can be used by companies to benchmark their investor relations activity.

The IR magazine Europe awards take place on 30 June in London.

To find out more about the awards and the 2010 winners, see www.thecrossbordergroup.com

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INVESTOR RELATIONS OFFICERS

Reaching out to manage investor expectations

The biggest challenge for investor relations officers (IROs) in 2010 is 'conveying the investment story', according to a survey by Citigate Dewe Rogerson, and this is reflected in an increased willingness to engage with and inform the investor community. The survey drew responses from 127 IROs in 17 countries and 35 sectors.

With the stock market 'bounce' outpacing economic recovery, IROs are increasingly worried about keeping investor expectations aligned with company fundamentals in the face of over-optimism from analysts. They intend to manage this through disclosure and guidance. A third of respondents said they had changed their disclosure during the last year and a further 19% said they intended to do so. A trend has also emerged towards more long-term disclosure, particularly in the financial and consumer services sectors.

Despite continued economic uncertainty, 28% of respondents had either increased their guidance or were planning to. Respondents were evenly divided about whether this increased guidance would consist of hard numbers, 'soft' indictors or a mixture of both. The majority (82%) said they shared their consensus forecast.

Verbal communication is still the most popular medium to communicate guidance but this is rapidly losing ground to the company website. In general, however, IROs are planning to increase their communication across all channels with greater use of conversations and roadshows as well as websites. The survey found a growing awareness by IROs that investors are using non-traditional means of communication, but only 5% of respondents plan to increase their use of social networks such as Twitter.

In general IRO's felt that their company objectives were well-aligned with the interests of their long-term investors and reported an upturn in enquiries about the hot topics of risk management and remuneration.

Despite all this activity and an increase in coverage by analysts, IROs did not believe that the quality of that coverage had increased at all in the last year.

Aiming for G-20 support with 'integrated reporting'

The Accounting for Sustainability project is making progress towards engaging the G-20 this year on the need for a new global structure to oversee the development of integrated reporting.

New steering and working committees have been established to take forward the 'integrated reporting' concept and set up a new governance structure – the International Integrated Reporting Committee (IIRC) – to provide oversight. Over the next six months, the committees will develop detailed proposals on the governance structure and remit of the IIRC in parallel with a detailed engagement programme focused on the G-20. The aim of the group remains the formation of the IIRC in 2011 with the support and sponsorship of all major stakeholder groups and governments from around the world.

Each of the steering committees has been painstakingly created to ensure they are truly international and represent a broad set of different interests. The stakeholder groups represented include: the investment, corporate and standard setting communities, the accounting profession, securities regulators and civil society organisations.

Today's separate elements of reporting

Currently, many aspects of the information contained in the integrated reporting framework (see the box opposite) are reported on to varying degrees, depending on the regulations in a particular territory. For a variety of historical, organisational and other reasons this information can be broadly broken down into four principal elements. This segmentation has mirrored the evolutionary stages of the reporting model, as the view of performance has developed and business crises have been responded to. These four elements are;

1. **Financial information** – the domain of the International Accounting Standards Board and other national standard setters such as the US Financial Accounting Standards Board.
2. **Management commentary** – typically this has been the domain of security and other national regulators and in some jurisdictions national standard setters and more recently the IASB.
3. **Governance and executive remuneration information** – typically this has been the domain of domestic regulators.
4. **Environmental and social information** (carbon, energy, water, supply chain etc) – typically the domain of non-governmental, not-for-profit organisations, including the Global Reporting Initiative (GRI), but now becoming the focus of national regulators.

Despite these elements of reporting having been around for many years, they remain relatively 'siloed' in the way they are presented, which poses a significant challenge for the HRH Prince of Wales Accounting for Sustainability project.

'The ever-increasing size and complexity of corporate reports is another major challenge,' said PwC senior corporate reporting partner David Phillips. 'Reports may tick the box for compliance with various regulations, but it can be difficult for those using them to see what is strategically important and material to the success of a business.'

Moving to integrated reporting

The Accounting for Sustainability project is grappling with how to create an integrated approach to reporting that hard wires sustainability into the mainstream, while at the same time presenting a coherent and connected picture of how a business is governed, managed and its performance assessed. The primary focus of the integrated reporting model is to provide a strategic picture of the business along with key information (highlighted in the box) in a connected and integrated way.

The intention is to not only bring sustainability issues into the mainstream but also to enhance user understanding and insight into how these issues effect strategy, risk and the business model. The end result is not about the creation of an even larger report with even more data, but it is about redesigning, restructuring and recalibrating the information that corporate reports need to contain in the 21st century if they are to be relevant and valuable to end users.

What's the scope of an 'integrated' report?

The content areas that come under the umbrella of integrated reporting, and for which the IIRC will have strategic oversight, are as follows:

- Market context (industry, economic, political, regulatory)
- Strategy
- Governance
- Remuneration
- Business model and supply chain (including interaction and relationship with customers, suppliers and communities)
- Risk and risk management (covering all aspects of the business model)
- Human resources (health & safety, development and training, diversity, well being, retention, absenteeism)
- Physical resources – energy, water, scarce resources
- Emissions – carbon and other emissions, waste
- Government payments/receipts (including total tax contribution)
- Other community impacts and contributions
- Key performance indicators (KPIs) covering the above

The picture of performance – muddled or coherent?

It's a continuing challenge for companies to communicate an integrated picture of performance across different media, but **Alison Thomas** argues that it's worth the struggle and explores some of the guidance on offer

Vast tomes have been published to help management navigate the challenges inherent in creating an annual report that communicates effectively with their shareholders. From the development of reporting frameworks, which offer CFOs insight into the building blocks of information needed to assess the quality and sustainability of performance, to the collation of good reporting practice, to the publication of template annual reports, management can call upon a multitude of pragmatic guides to help them in the evolution of the annual review of their business.

Less often explored, however, are the building blocks of effective communication that management might use when exploiting the other media at their disposal. Whether it is website design (particularly in the new era of interactive data), or the structure of preliminary announcements, or credible investor presentations, our experience suggests that many companies still struggle to offer an integrated picture of performance.

Who cares?

Does this matter? The annual report is still valued by investors as a 'one-stop-shop' reference document. However, as it is not as timely as a number of non-traditional sources, research clearly illustrates the importance that investment professionals place on other streams of information. See, for example, PwC research with investors in *Corporate reporting – is it what investment professionals expect?*

When questioned about which sources of information they value most highly, replies from the investors interviewed underscore the benefits that accrue to management that think about their corporate reporting across all media in an integrated fashion. They also highlight the pitfalls that lie in wait for those who do not.

Who owns your story?

When the management team offers credible, relevant, balanced and well-structured insights into their business, investment professionals interviewed said that their unique perspective on corporate activity is highly valued indeed. However, investors cite a range of alternative sources that they favour – including the company's competitors, their suppliers and their customers – when management's presentations, websites, and so on, have inconsistent messages that indicate spin or the use of selective cameo success stories, which provide a skewed picture of performance.

What can management do to give investment professionals the confidence to consider them – and not their competitors – as the first port of call for intelligence on their company?

Joining the dots

PwC's report – *Integrated Reporting: What does your reporting say about you?* – stresses the importance of having a single internal source for all the external communications from a company. Whether generating web pages or a shareholder presentation, the only way to ensure a consistent message is by removing the silos of reporting that exist in so many companies today.

The report also examines the set of information that investors and companies alike have told us that they need to make sense of corporate performance, including:

- Detailed insight into the market environment in which the company operates
- Clear explanation of the strategy to exploit the opportunities that this market environment offers

- The resources and relationships required to implement that strategy
- Sufficient breadth and depth of performance measures to allow the reader to assess whether that strategy is in place and how effective it is

But what does this look like in practice? How can management take these insights and apply them in the context of, say, an analyst presentation?

The Deutsche Vereinigung für Finanzanalyse und Asset Management (DVFA) in conjunction with PwC have recently published their *Guideline analyst presentation* that attempts to offer that practical next step.

Filling in the picture

The guideline offers a detailed set of good working practices, along with screen captures from well received investor presentations. Both of these have been identified through a combination of investor sounding boards and extensive desk-top research.

Examples of the areas discussed include:

- The logistics of disseminating presentation material
- On-line presentations and archiving
- Duration and timing of presentations
- Recording and transmitting the analyst presentation
- When ad hoc presentations, conference calls etc may be helpful to analysts
- Potential added value of 'fact books'
- Link between presentation material and the annual report

Practical insights into current good reporting practice in investor briefings are offered through a series of screen captures that cover the principle building blocks of performance from current year performance through to the group strategy, position in the market, the key drivers of value creation (such as R&D or brand) as well as corporate responsibility.

A cursory glance at these screen captures is sufficient to understand why investment professionals might hold these presentations in high regard. The benefit that accrues to management teams who clearly master the art of communicating detailed information clearly is not to be underestimated.

Getting the story to stick

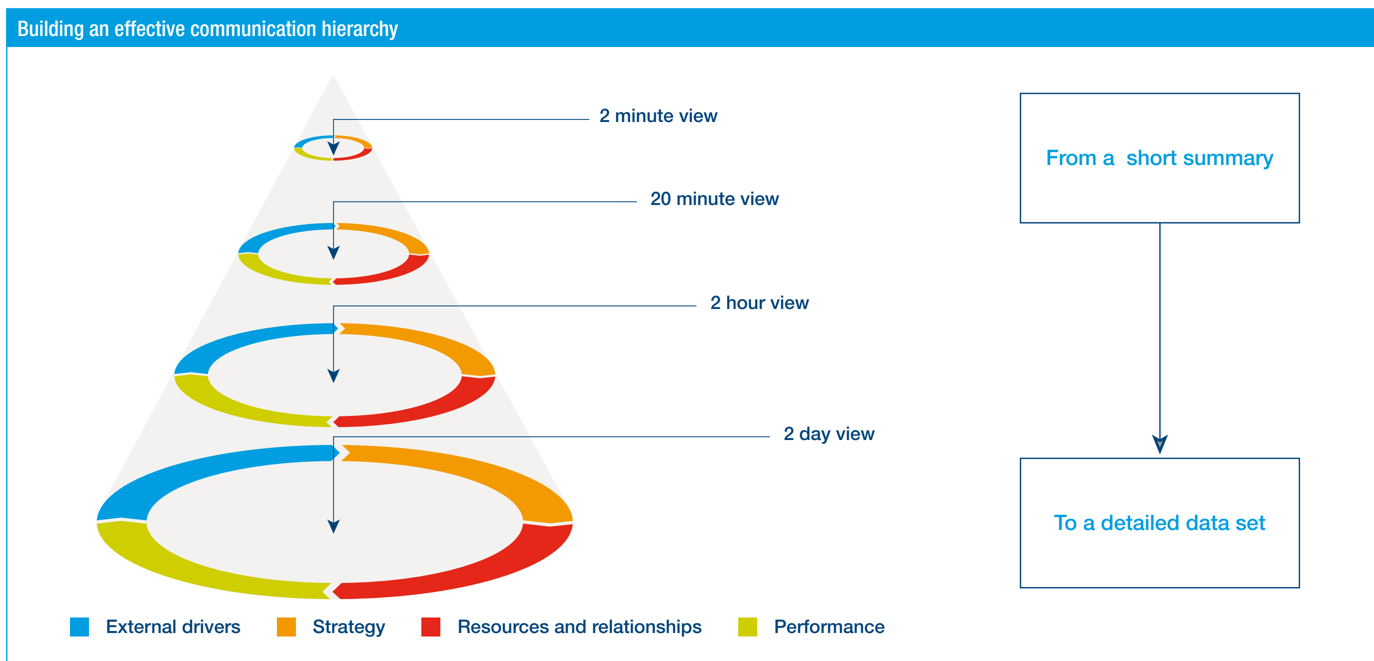
Companies will need to re-establish themselves as trusted sources of relevant and reliable information. This means becoming better connected to what their internal and external stakeholders really want to know. Companies need to become comfortable at collating and presenting a consistent view of their business across multiple channels and be more attuned to the risks of ignoring stakeholder needs.

Communicating an integrated picture of the business is set to be the key to successful stakeholder engagement. We expect the primary focus to be on the top slice of information needed to understand the business – the direction of travel, performance, business model, risks and relationships. This top slice will capture the essence of the business, and will be structured so that users can select headline information and perform 'data dives' if they need to know more (see diagram).

We expect that companies will start to provide a one-stop-shop for users that will include features such as on-line analytical tools, links to important market data and facilities to help users learn more about the strategy, operating model or key relationships.

For the reports mentioned and good practice examples, see www.corporatereporting.com or email info@corporatereporting.com. See also, www.reportleadership.com, www.ebr360.org or the IASB's proposed guidance on management commentary, www.iasb.org

Alison Thomas is a director in the corporate reporting team at PwC. She is a former analyst and has conducted extensive research with investors.



Diary Dates

Date	Key upcoming events	Location / Contact	Sponsors / Organisers
6-7 June 2010	World Economic Forum on East Asia	**Ho Chi Minh City, Vietnam** www.weforum.org/en/events	World Economic Forum
7-9 June 2010	2010 ICGN Annual Conference	**Toronto, Canada** www.icgn.org	International Corporate Governance Network
15-16 June 2010	International Cyber & Economic Crime conference	**Kuala Lumpur, Malaysia** www.icfe-cg.com	ICFE Group of Companies
23-24 June 2010	IASC Foundation Annual IFRS Conference	**London, UK** Tel: +44 020 7017 5509 www.iasb.org	International Accounting Standards Board
24-25 June 2010	16th International Symposium on Audit Research	**Singapore** www.isarhq.org	ISAR – International Symposium on Audit Research
21-24 July 2010	2nd Global Accounting and Organisational Change Conference	**Massachusetts, US** www3.babson.edu/babson2ndgen/gaoc	Babson College in association with the Journal of Accounting & Organisational Change and La Trobe University Melbourne
28-29 July 2010	IASC Foundation Annual IFRS Conference	**Tokyo, Japan** Tel: +44 020 7017 5509 www.iasb.org	International Accounting Standards Board
28-29 September 2010	10th Annual Forbes Global CEO Conference	**Sydney, Australia** www.forbesconferences.com	Forbes Asia
7 October 2010	ICGN 2010 Mid-Year Conference	**San Francisco, US** www.icgn.org	International Corporate Governance Network
26-28 October 2010	World Economic Forum on the Middle East and North Africa	**Marrakech, Morocco** www.weforum.org/en/events	World Economic Forum
1-2 November 2010	12th Annual Meet the Experts Conference	**London, UK** www.meet-the-experts.org	PricewaterhouseCoopers in association with the IASCF and IIR
2-5 January 2011	Winter 2010 Global Conference on Business and Finance	**Las Vegas, US** www.theIBFR.com	The Institute for Business and Finance Research
8-9 January 2011	10th International Accounting Conference	**Kolkata, India** www.iaarf.org	Indian Accounting Association Research Foundation

Meet the Experts conference

The 12th annual Meet the Experts conference on 1 and 2 November this year is designed to help today's executives navigate an ever changing environment, with an agenda covering the top strategic issues facing businesses, including the latest developments in international financial reporting, regulation and governance.

The two-day event is attended by over 400 delegates from around 30 countries. Each year it attracts high profile speakers, including the key decision makers at the IASB, FASB and European regulators. Points of view on the latest developments are also provided by speakers drawn from business, investors and the accounting profession.

For more details, visit www.meet-the-experts.org, speak to your usual PwC contact or telephone +44 (0) 20 7017 7484

Corporate reporting blog – www.pwc.blogs.com/corporatereporting

Corporate reporting hot topics and the emerging issues that companies, investors and other interested parties need to think about are discussed in the PricewaterhouseCoopers blog. It was set up in recognition of the growing importance and rapid changes in this area.

Written by David Phillips, PwC's corporate reporting partner, the blog is updated at least twice a month. The blog is aimed at all those with responsibility for communicating and analysing corporate performance.

Recent postings have included thoughts on what business needs to do to mend its tarnished reputation, and 'Who will pick up the bill?', which discusses the costs of working longer and living better.

'I am always pleased to hear your views and comments on the postings and to take questions about corporate reporting,' said David Phillips. 'A blog works best when it's interactive.'