

World Watch*

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Issue 3 2008

Reward
Consensus on reform?

Fair value
Unprecedented action

The reporting model
A public policy issue?

Climate change
Waking up to the risks

Credit crunch – where next?

Despite many people voicing concerns over derivatives and other aspects of economic growth, no one could have foreseen the magnitude of what has happened in the last few months. What we have learnt is how interrelated the world's financial markets have become, the extent of the asset bubble created and, most frighteningly, the speed in which things unravel when the markets get spooked.

Regulation. We have seen a significant growth in regulation over the past decade – some good, all of it well intentioned, but not all of it effective. The credit crunch will result in more regulation, but to succeed it will require a real dialogue between leading regulators and market participants around the world, a real understanding of market dynamics and an appreciation of the costs and benefits that accrue.

As *World Watch* goes to press, the leaders of the G20 nations will be gathering in Washington at a summit (often referred to as 'Bretton Woods II') to review the global financial crisis. They will be considering various mechanisms to better highlight risks in the financial system. Given the interconnected nature of today's markets, global approaches are needed and all market participants need to play a role in finding solutions.

Reporting. The credit crunch has brought into focus the purposes of financial reporting. It should be recognised there are differences between the regulators' safety and soundness mandate and the investor-driven objectives of financial reporting. In light of these tensions, we encourage the regulatory agencies to reconsider the extent to which they use GAAP and IFRS financial statements for prudential supervision – and potentially refine capital adequacy guidelines as applicable.

In addition, a broader information set is needed to understand the business model, the key risks and relationships, and the culture and behaviour of an organisation. Again, the solution will require input from those who run businesses as well as those that invest in them.

Responsibility. For most, recent problems reflect the worst aspects of capitalism – financial greed with no sense of responsibility. And when tax payers are left paying the bill it's not surprising that they are calling for change in corporate responsibility.

We can expect to see new responses to a number of issues around corporate governance and the tone from the top, incentives and behaviours, and how they link risk and return. This may be accompanied by a greater degree of challenge and inquiry.

While all those issues create new challenges for business, they also bring opportunity, particularly for those who can get ahead of the curve.

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Contact us

PwC has a strong and effective network of people worldwide who can advise on the developments in reporting and the implications of local regulations, as well as international standards and global trends. If you would like to discuss any of the issues raised in this publication, please contact your local office, the people named in specific articles or the editor.

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Credit crisis

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Stop press!

Developments related to the Credit Crisis and financial reporting continue to unfold. The most recent developments have included:

- The IASB published the financial version of its education guidance on the application of fair value measurement when markets become inactive.
- Until the Advisory Group is established (page 22), the IASB and FASB will hold a series of roundtables on the credit crisis and financial reporting.
- The European Commission has written formally to the IASB to request that the board addresses a list of topics on financial instruments accounting (see also page 4).
- In the US, the recent Emergency Economic Stabilization Act agreed by Congress included a requirement for the US SEC to conduct a 90-day review of mark to market accounting applicable to financial institutions.
- As part of its review, the US SEC held a roundtable on mark to market accounting on 29 October, at which a number of stakeholder groups gave testimony.

Governance News

TRANSATLANTIC CORPORATE GOVERNANCE DIALOGUE

McCreevy promises action

European Commissioner Charlie McCreevy announced at the recent Transatlantic Corporate Governance Dialogue that he intends to present proposals for legislation to strengthen the existing prudential framework to help alleviate the impact of falling financial markets. He added, however, that these proposals should not be viewed as a substitute for proper corporate governance – financial institutions, shareholders, regulators, legislators and the credit rating agencies all have their part to play in bringing an end to the current turmoil.

He told delegates that poor internal governance had resulted in poor risk management within many financial institutions, which has contributed to financial turmoil. 'Failing institutions will have to examine their internal governance framework with a view to embracing risk management,' said Mr McCreevy. 'Risk management should be part of the strategy of the firm, the culture of the organisation.'

Transparency

There is an urgent need to improve transparency for investors, markets and regulators, he added, to ensure they are given accurate information. While he acknowledges progress in transparency, he called for better disclosures about risk exposures, risk management and accounting policies. 'If industry delivers on the quality and accessibility of information... the ball will then be in the court of shareholders and investors,' he commented.

Remuneration

'It cannot be either sensible or sane that compensation incentives encourage excessive risk taking for short-term gain,' he said, adding that

remuneration schemes for both employees and the board need to be aligned with shareholder interest and long-term, firm-wide profitability. Mr McCreevy called on EU countries to reconsider their remuneration policies and reminded delegates that only one third of member states had implemented the commission's 2004 recommendation that shareholders should be able to vote on the board remuneration criteria. 'A say on this issue would go a long way towards increasing or restoring shareholder confidence. It would force boards to do a whole lot more explaining than is done at present.'

Credit rating agencies

The commissioner also promised action on the role and use of credit rating agencies (CRAs) and plans to propose a registration and external oversight regime for European regulators to legally oversee the policies and procedures followed by the CRAs. 'CRAs played a major role in the market turmoil by greatly underestimating the credit risk of structured credit products.' European legislation is expected as *World Watch* goes to press.



Regulators and legislators have not avoided the commission's radar, although Mr McCreevy acknowledged that EU finance ministers recognise that regulators need to co-operate more at a cross-border level. The EC is looking to update the EU supervisory networks – particularly the decision-making process, financing and setting work priorities at the EU level. The EC will also be proposing changes to strengthen the Capital Requirements Directive.

The Transatlantic Corporate Governance Dialogue, which is endorsed by the European Commission, was established in 2004 by the European Corporate Governance Institute (ECGI) and the American Law Institute (ALI) to discuss corporate governance issues with a wide range of constituencies from both sides of the Atlantic, including regulators, judges, law makers, academics, corporate leaders and investors. This year the Brookings Institution and Columbia University replaced ALI as the ECGI's US partners.

Finance leaders propose compensation reform

A report released by the Institute of International Finance (IIF) has proposed Principles of Conduct on compensation policies that it believes will play a meaningful role in strengthening the global financial services industry and help to restore public confidence.

The report, *Financial Services Industry Response to the Market Turmoil of 2007–2008*, details good practice reforms for the industry as a whole and makes recommendations on other critical issues such as: risk management, valuation of assets, liquidity management, underwriting and the rating of structured products. It also advocates boosting transparency and disclosures.

The principles propose that compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital. In addition, incentives should not induce risk taking in excess of the organisation's risk appetite; and firms should take into account the

performance realised for shareholders over time in determining severance pay.

The report was prepared by the IIF's Committee on Market Best Practices, with over 100 senior executives from 65 leading global financial services organisations participating in its work through six working groups.

'We believe the implementation of this report's recommendations will serve to strengthen the financial services industry and, as a result, will help to restore confidence,' said Josef Ackermann, chairman of the IIF board. 'Our challenge is to move forward with implementation, and we are determined to do just that.'

He also announced the creation of a new global financial monitoring group – the Market Monitoring Group – to help detect emerging vulnerabilities in the markets and financial system.

National regulator takes similar line

The report has attracted the attention of several regulatory bodies. In the UK, for example, the Financial Services Authority has formed a view that is

consistent with the report. In a letter to CEOs it said it is concerned that the remuneration structures of firms may have been inconsistent with sound risk management and may have contributed to the current financial problems.

The FSA is clear that it has no wish to become involved in setting remuneration levels, but it is looking to introduce some high-level criteria against which remuneration policies can be assessed. It has outlined what is considered poor practice and good practice based on discussions it had with firms in September. These covered: the calculation of bonuses, the composition of remuneration, deferred compensation and governance. The FSA aims to extend these discussions and publish its general findings next year.

It has urged firms to review all their compensation policies carefully and as a matter of priority. The FSA is clear that if remuneration policies are not consistent with sound risk management, they are unacceptable and immediate action will be required to change the policies.

IIF Principles of conduct for remuneration

1. Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital.
2. Compensation incentives should not induce risk taking in excess of the firm's risk appetite.
3. Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.
4. Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organisation as a whole.
5. Severance pay should take into account realised performance for shareholders over time.
6. The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

UNITED STATES

Executive compensation restrictions kick in

The Emergency Economic Stabilization Act was passed by Congress in October 2008, empowering the Treasury Department to purchase troubled assets of financial institutions. One part of the act, The Troubled Asset Relief Program (TARP), includes provisions for executive

compensation for financial institutions that sell troubled assets directly to the treasury. Various restrictions apply to the senior executives of those companies, including:

- They may not be offered incentives that encourage unnecessary and excessive risk
- They are prohibited from receiving 'golden parachute' payments (lucrative severance benefits)
- Bonus or incentive pay based on earnings, gains, or other criteria later proven to be materially inaccurate may be recovered.

Conference tackles global issues and trends

The globalisation of the capital markets and the impact on corporate governance was the focus of the International Corporate Governance Network (ICGN) conference in Seoul this year. The impact of the credit crisis coloured the whole event as over 350 delegates from around the world discussed the reasons for it, the contribution of poor governance and the likely ongoing ramifications as the full scale of the problems emerge.

Global trends were also explored, particularly in relation to the convergence of reporting standards, regulatory harmonisation and the growing influence of proxy advisors. The conference was also used as an opportunity for members to contribute to the group's ongoing work programme which is focused on: accounting and auditing, non-financial business reporting, anti-corruption, shareholder rights and responsibilities and company shareholder dialogue.

Non-financial business reporting

Non-financial business reporting (NFBR) is an area of particular focus for the ICGN. The conference heard that this is important information for shareholders wishing to put a company's performance and governance in context. Non-financial reporting covers a wide range of issues such as intellectual property, human capital, the environment, customer goodwill, corporate reputation, human rights and anti-corruption practices. The ICGN announced the imminent publication of their own guidelines which set out the basic requirements of NFBR from an investor's perspective.

The draft guidelines highlight the importance of establishing the right measures to understand performance and of ensuring that the measures align with the strategic goals of the business in question. The group also intends to do further work on which



Anne Simpson ICGN

metrics are the most significant and how guidelines can be used to effect change in the market place.

Delegates also heard about the ICGN's work on best practice guidance on anti-corruption practices for companies and investors. This sets out why anti-corruption is an issue of concern to shareholders and provides initial guidance as to the type of questions investors should be asking when engaging with companies.

Director/shareholder dialogue

Facilitating a productive dialogue between companies and their shareholders is something that the ICGN sees as an important part of its work programme. There were significant discussions about this challenge at the Seoul conference. At one point, dealing with shareholders was compared to dealing with a 'zoo' because of the huge diversity of their interests and approaches.

The long-term investors, who account for the majority of the shareholding base, agreed that they needed to be more vocal than they have been historically, and not allow a vociferous minority to have undue influence on corporate behaviour. It was also recognised that when confronting this 'zoo-like' audience, there was a risk that management could either become indecisive in their actions, or alternatively, go it alone and ignore all the shareholders where they were unable to present a consensus view.



Angel Gurría OECD

Anne Simpson, the executive director of the ICGN, said: 'We are organising roundtable events to enable senior representatives from the share-owning community to engage with their counterparts from the corporate community. The plan is to understand the barriers to communication and to develop some practical guidance for both sides about how these can be overcome.'

Sovereign wealth funds

In his opening address to the conference, OECD secretary general Angel Gurría talked about the issues arising from the credit crunch, in particular he said that much of the blame has to be laid at the doors of ineffective risk management and corporate governance.

Looking ahead, he suggested that the next big challenge to face the world was the rise of sovereign funds, which hold total funds of an estimated US\$3 trillion.

Perhaps more importantly, he highlighted the risks from state-owned enterprises – an area where there is little public data and corporate governance rules are not widely embraced. He indicated that there is a public policy vacuum for these state-owned enterprises in the energy, telecoms and transportation sectors. How western economies respond to what will look like 're-nationalisation' activity in the future will be critical, he said, especially as these state giants become globally acquisitive. Above all things he warned against thinking that protectionism is the answer.

What is the ICGN?

Over 500 corporate governance practitioners from more than 40 countries belong to the International Corporate Governance Network (ICGN). Members include institutional investors such as Hermes and Calpers, business leaders,

policy makers and professional advisers. The group facilitates cross-border dialogue, encourages best practice, shares knowledge and supports research and education to improve governance for the public benefit.

Audit committees feel the heat



The introduction of the mandatory reporting of greenhouse gas emissions and energy consumption in Australia brings with it potentially significant business risks and opportunities for many companies, and added obligations for audit committees.

From 1 July 2008, certain Australian businesses are obliged to monitor, measure and report greenhouse gas emissions data under the *National Greenhouse and Energy Reporting Act 2007* (NGER). From 1 July 2010, the introduction of the proposed national *Carbon Pollution Reduction Scheme* – Australia's emissions trading scheme – will require organisations in covered sectors to not only manage, measure and report their

emissions, but also trade in carbon pollution permits.

Audit committees are expected to play a significant oversight role here and will therefore need to understand the implications of these changes on their company's business strategy, risk profile and broader operations. While the legislation only impacts Australia-based businesses directly, the questions that audit committees need to consider in relation to their organisation's response to climate change issues will be broadly applicable in many other territories:

Governance

- Can the organisation meet its public disclosure obligations – both mandatory and voluntary?
- Does the organisation understand its climate change-related risks and have a strategy to quantify and manage them?
- Has the responsibility for managing climate change-related risks been allocated to someone with appropriate experience and is there a board committee member responsible for oversight of the company's strategy and response to climate change?

Compliance and assurance

- Has the organisation understood and evaluated its exposure to current and emerging climate change-related regulations?
- Has the organisation assessed the availability and quality of its emissions data to ensure that it conforms to an auditable standard?
- Has the organisation's greenhouse gas inventory been audited and are there robust systems, processes and controls in place to capture emissions data and report it to the board and management on a regular basis?

'There is clearly a significant reputational, as well as financial, risk in either not taking any action to prepare for the carbon-constrained global economy, or in making an inappropriate response,' said PwC sustainability and climate change partner Nick Ridehalgh. 'The drivers of change are not just through regulation, but also from the capital markets with initiatives such as the Carbon Disclosure Project and pressure from customers and employees. It really is time to take action.'

UK

Going concern proposals

The Financial Reporting Council (FRC) has issued proposals to revise best practice for directors on assessing a company's going concern status. Currently, directors have three options for their assessment: that the going concern assumption is appropriate; that it is not appropriate; that factors have been identified that cast doubt over the company's ability to operate for the next year, but the accounts have been prepared using the going concern basis.

The addition of a fourth option: that the directors have identified material uncertainties that may cast significant doubt over the company's ability to operate over the next year, has led the media to question whether stating this in an annual report might lead to investor

unease. However, a closer look at the guidance reveals that where directors identify such material uncertainties, current accounting standards (UK GAAP and IFRS) already require appropriate disclosures. Debate over the proposals centres on whether three or four options will be necessary. The revised guidance is likely to be published early in 2009.



UK

Revisions to the Combined Code

The restriction on an individual chairing more than one FTSE 100 company has been removed by a revision to the Combined Code of corporate governance. The change recognises that many chairmen already hold equivalent appointments outside the FTSE 100 (and often outside the private sector) and that companies are in the best position to determine whether or not the chairman is able to fulfil the requirements of the role.

For listed companies outside the FTSE 350, the revised code now allows a company chairman to be a member of, but not to chair, the audit committee provided that he or she was considered independent on appointment as chairman.

Tougher rules to boost confidence in directors' independence

The Securities Exchange Commission and the Stock Exchange of Thailand jointly hosted a seminar in June 2008 to introduce new rules to strengthen corporate governance at Thai listed companies and increase market confidence for investors. The new rules apply to the appointment and behaviour of independent directors and audit committee members.

The changes to the existing guidelines have aligned the SEC and Stock Exchange requirements on the roles and responsibilities of independent directors and audit committees. The guidelines have also been brought into line with international standards and provide clearer practical guidance.

The new rules become effective from the 2009 annual general shareholders' meeting (apart from the third item opposite, which will apply from the 2010 AGM). However, companies submitting an IPO application to the Commission after 1 July this year have to follow the new rules immediately.

'Strengthening Thai corporate governance in this way will help to promote our listed companies' success and create a deeper level of trust in the capital markets,'

said Prasan Chuaphanich, PricewaterhouseCoopers SEAPEN joint executive chairman. 'Where corporate governance works well, it will attract more investment.'

Changes to the rules

- The proportion of independent directors in a listed company has been increased to one third of all the directors. The minimum of three directors has not changed.
- Independent directors and their relatives are limited to 1% combined shareholdings in the company and related entities (previously not exceeding 5%).
- For two years prior to appointment, independent directors must not have had any conflicts of interest such as involvement in company management or as a salaried advisor.
- Independent directors must disclose information about their tenure and remunerations in related companies.
- Audit committee members cannot be appointed as directors in any related group companies.
- Listed companies are required to report to the Stock Exchange the resignation or removal of any audit committee members prior to their expiry term.

Move to one-tier structure

The Dutch government has drafted legislation that will change the way company boards are structured and operate. The legislation calls for the introduction of the 'one-tier structure', as commonly used by companies headquartered in the UK and the US. The European Union allows both the one-tier and two-tier models within individual member states.

The government is expected to submit a bill before the Dutch Parliament in the coming months. If adopted, this proposal would constitute another step forward in the global convergence of corporate governance.

Traditionally, Dutch companies have operated under a two-tier structure. This involves an executive board and a

supervisory board. The change to a single tier will mean a reshuffle in the boardroom, with the creation of one board made up of both executive and non-executive directors. The draft legislation lays out clearly defined, separate roles for both the executive and non-executive directors.

'The government's proposals reflect the changing models being employed by companies when they select their boards and the fact that a one-tier structure attracts more international shareholders to the home market,' said Jaap van Manen, PwC governance partner in the Netherlands. 'Around 70% of shareholders in the 25 largest Dutch companies are not Dutch, and Dutch companies generally have a number of foreign supervisory directors. Many of these shareholders and

supervisory directors already have the one-tier structure as their primary frame of reference.'

Despite the two-tier structure being the Dutch norm, many aspects of the one-tier model have already become common practice in the Netherlands. For example, the chairman's role has grown, though it is still not as involved in the day-to-day business as is customary for a typical British chairman of the board. In addition, supervisory boards have already been working alongside the sub-committees inherent in the one-tier model – the audit, remuneration and nomination committees. In particular, the concept of supervisory board member independence has already become an integral part of these committees.

Awards highlight directors' influence on strategy

The strength of a company's board of directors can profoundly influence an organisation's attention and approach to strategy. That was the view of judges at this year's Canadian Institute of Chartered Accountants' annual corporate reporting awards.

The top companies in the corporate disclosure category at the awards demonstrated a heightened focus on disclosing the value brought to the boardroom by their directors. In particular, reports were making better disclosures about the way boards ensure sound monitoring of their companies' (and managements') performance against the strategic plans. The best companies took the following steps and provided clear information about them in their reports:

- Evaluated progress towards goals and shared the results of key initiatives compared to the desired outcomes.
- Made adequacy assessments of the measures taken to safeguard core corporate assets.
- Evaluated board committees' performance with a greater emphasis on oversight of pervasive organisational matters.
- Made the board's expectations of executive and senior management clearer and more formal in key areas of oversight, such as risk responsibility, corporate strategy, and the extent of management's decision-making authority.

Another significant trend in corporate governance disclosure noted by the judges this year was the attention paid by top entrants to disclosure of actions and initiatives undertaken by their boards and management to address key non-financial objectives.

'Companies are increasingly finding ways to explicitly and transparently alleviate investor and stakeholder concerns about the way they conduct their business, and the impact business decisions have on the well-being of the broader global community,' said Mike Harris, PwC partner and leader



Mike Harris

of the firm's corporate governance practice in Canada, which sponsored the CICA awards. 'This includes detailing decisions and actions to address environmental issues and climate change, as well as upholding a higher standard of stakeholder well-being through stronger human rights strategies.'

Best practice disclosures on board oversight of broad community issues include:

- Presented a detailed mandate for sustainable environmental business practices with corporate goals and targets explicitly defined to allow results to be measured.
- Addressed topics such as child labour and wage disparity by disclosing enforcement activities as well as corporate minimum age and wage policies.
- Established charters of corporate responsibility to outline commitment to the broader stakeholder group, with sign-off from the board and top executives to emphasise the tone being set from the top.
- Included metrics to evaluate the achievement of non-financial objectives within the criteria used to evaluate executive management's performance for compensation purposes.

The winners of this year's CICA reporting awards will be communicated via the CICA website (www.cica.ca) in early December 2008.

Survey of voluntary governance practices

A new survey shows that where codes of governance are voluntary, companies' governance practices can vary widely. PricewaterhouseCoopers carried out research to examine the quality of corporate governance procedures among companies on the AIM market in the UK.

Companies traded on the AIM market are not subject to rules requiring main market listed companies in the UK to make disclosures about their compliance with the Combined Code of Corporate Governance. Nevertheless, the Combined Code is considered by many to be the best practice benchmark for governance procedures in all companies.

The survey looked at a stratified sample of AIM companies including the Top 100, Mid-cap, Small-cap and overseas companies.

The survey found that just 3% of the Top 100 AIM companies fully comply with the Combined Code, while 77% comply with at least part of it. It is apparent from the research that good governance is not necessarily related to the size of the company or its location, and it is hard to argue that the bigger the company on AIM, the better the governance.

The composition of the board is an area of weakness for many AIM companies, with only 71% of the Top 100 and 50% of mid-cap companies having boards comprising more than half non-executive directors. It appears that many AIM companies have yet to recognise the benefits of having strong, independent non-executive directors on the board.

Perhaps linked to this, only a fifth of the AIM Top 100 reported that they had assessed board effectiveness. This fell to only 15% of the Mid-cap and 5% of the smallest AIM companies.

When activist shareholders come knocking

Shareholder activists often take boards by surprise. **Patrick Gray** argues that boards can take certain actions to prepare before they arrive



Shareholder activism is an issue that growing numbers of companies are having to address these days, so this article shares some views on how to deal with activist shareholders, many of which were discussed at a recent event for directors of major public companies who met at Directors' College¹ in the US.

The activists' target

Activist shareholders are very clear about the type of company they target. For example, they may target companies that are under-performing in their peer group, especially where they believe there is an underlying problem causing undervaluation. Although different activists have different agendas, they all believe their solution for fixing the problem is the right one.

Communicating with shareholders

One panellist at Directors' College stressed the importance of boards and senior management actively communicating with their large shareholders and addressing their concerns, which can help to lessen the chances of becoming a target for activist shareholders. The panellist (a CEO) told attendees that as soon as he heard that a new shareholder had acquired 5% of the company, he spent the weekend researching the shareholder (an activist hedge fund, as it turned out)

and picked up the phone first thing Monday morning to welcome them aboard.

Regular and open communication between shareholders and companies is vital, and management needs to understand that keeping shareholders informed about the company's long-term strategy – and how they will achieve it – is paramount. That means the company's strategy, performance and future direction should be a two-way conversation. As one CEO put it: 'You cannot over-communicate'.

Board representation

Activists prefer to build up a good relationship outside the boardroom to persuade management and the board to address their concerns.

However, there are times when activists view gaining seats on the board as necessary to implement change. Naturally, this can cause nervousness among board members, but once elected it is more productive to work with the activist than against. The board should do their research and bear in mind that the activist shareholder will have done research before taking this approach and will come to the table armed with considerable data and analysis to support their argument.

While some corporate boards wish that activist shareholders would just go away, they are usually there to stay until they have achieved their aims. There are ways to manage relationships with activists that can help achieve positive outcomes for all concerned (see box). One panellist summed it up by saying, 'You do it very simply. You look forward, not back. You make it work'.

Patrick Gray is a partner at PricewaterhouseCoopers in the US and Leader of its Corporate Governance Group.

How to deal with activist shareholders

Captured below are lessons learned from prominent activist shareholders and distinguished CEOs on how to deal with activist shareholders when they do come knocking. These insights were shared at the 2008 Directors' College¹.

Communicate with shareholders. Actively communicate with shareholders, keeping them informed about a company's long-term strategy – and the means to get there – and listening to their concerns.

Do your homework. Understand why the activist shareholder was attracted to the company. Also, reach out to your network to understand how the activist shareholder behaved in other similar situations, since the individual's approach and ultimate tactics generally do not change.

Reach out to others. Seek guidance from your advisors but don't accept it carte blanche.

Engage the activist shareholder. Build a productive working relationship with the activist shareholder and recognise that all parties are aligned on the ultimate objective of creating shareholder value. Try to find some common ground on the issues.

Do the right thing for all shareholders. Act in a way that is in the interests of all shareholders – not just the activist shareholder. An activist shareholder's view does not necessarily represent the views and needs of every other shareholder.

¹ Directors' College 2008, sponsored by PricewaterhouseCoopers and the University of Delaware, brought together directors from large listed companies earlier this year to discuss pressing governance issues and to exchange practices and insights. Full highlights of the programme are captured in Boardroom Exchange, available at pwc.com/uscorporategovernance

Balancing governance and performance

It's a challenge for companies to balance regulation with appropriate risk taking. **Gautam Banerjee** explores the issues and the options



Gautam Banerjee

Today's businesses face more regulation, increased stakeholder expectations and heightened public scrutiny. The capital markets, shareholders, employees, governments, regulators and even special purpose groups hold companies responsible for the manner in which they conduct business and execute their

corporate strategies. As a result, governance, risk management and compliance have never been higher on a board's list of priorities and concerns.

The global sub-prime crisis and corporate failures are mainly the result of risk taking by people who failed to assess both the opportunity and the possible consequences of their actions. Ultimately, it is the human element that leads to success or otherwise. It is therefore critical that there is proper governance in place to enable people to consistently assess circumstances and make the best decisions possible.

Internal controls and transparency are the foundation and bedrock of many global companies, with managers and C-suite executives being personally accountable for their actions, forcing an evaluation of both the potential rewards and pitfalls of risk taking. Some people say these companies are failing to thrive, with regulation making it difficult for them to identify and seize the opportunities they need to exploit in order to succeed in the market place.

CEOs identified over-regulation as the greatest threat to business growth in a recent PwC survey. In some quarters, there is also the misguided belief that companies have eliminated risk through compliance with regulation. But in truth risk has not been eliminated, it has been driven underground. The constant focus on complying with regulatory requirements has obscured discussions on risk-taking thresholds. Some companies are neither performing nor conforming. There needs to be a balance and risk-adjusted business decisions are necessary for a company to create shareholder value.

Steps to balance regulation and risk

1. Align performance with compliance. This requires management to understand and define its risk appetite to enable commercial opportunities to be properly assessed.
2. Enhance performance through effective risk-taking, link risk appetite to business strategy and daily operations, so that management can choose the best way to operate without compromising commercial performance.

3. Embed the defined risk appetite throughout the company so that risk responses are part of everyday processes and procedures. This will enable consistent and systematic management of risks, ie, calculated risk taking.
4. Monitor and report the key risk indicators that have an impact on business performance targets to the board.

Questions for board members and C-suite executives

- Do you have the balance of skills, knowledge and experience in your board, necessary to enable each and every board member to contribute critically?
- Do all board members prepare well, listen, stay actively engaged, and provide valuable input within their area of expertise? Are they, therefore, effective as a part of the company's senior leadership team?
- Can you clearly articulate the company's vision and strategy, and do you understand the major risks facing the company, and how these risks are being managed and reported to you on a regular basis?
- Does the board strike a balance between being supportive and challenging? One extreme is the board getting in management's way and the other is a board failing to exercise its authority and active oversight over management. A board has a continual balancing act, needing to have its arms around the company without getting its fingers into it.
- Does the board get sufficient information from management, not just on financial reporting matters but also accurate and timely business performance information with performance measures and key risk indicators?

Good governance is about improving the quality of management at all levels of the company, and about understanding and managing risk and making better risk-based business decisions. By improving their governance, businesses will be better run and better able to assess business opportunities quickly. This will help them gain the competitive advantage and increase shareholder value over time.

As Madeleine Albright, the former US secretary of state said: 'In examining the risks (in US foreign policy), it is important to examine the consequences of failing to act... our purpose should not be to eliminate risk, which is impossible, but to manage it, which we must do, if we are to prosper.'

Gautam Banerjee is executive chairman Singapore and chief operating officer east cluster at PwC.

Financial Reporting

IASB

Action on 'crunch time' fair value challenge

In response to calls for urgent action the IASB announced that it would suspend its due process to assess immediately the accounting differences between IFRS and US GAAP in the reclassification of financial assets with a view to eliminating any differences. Ten days later the Board published amendments to two standards.

The amendments to IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 7, *Financial Disclosures*, permit the reclassification of some financial instruments 'in rare circumstances'. The dramatic collapse of the world's financial markets is considered such a 'rare circumstance'.

This move follows the publication of practical guidance on the measurement and disclosure of fair values in inactive markets, issued by the IASB's expert advisory panel. The guidance is a prompt response to the call earlier this year from the Financial Stability Forum for the IASB to take action to help banks and other companies in the grip of the credit crisis to tackle the challenges of valuing their financial instruments at fair value when the relevant markets were no longer active.

The use of fair value measurements has been blamed in some quarters for producing inaccurate results in today's unusual market conditions. There have been suggestions that fair valuation of financial instruments should even be

suspended or replaced when markets are severely distressed.

Best option available

However, the message from the expert panel, investor groups and standard setters such as the IASB and the US Financial Accounting Standards Board, is that fair value may not be perfect, but it is still the best method we have to reflect market conditions when it is accompanied by appropriate disclosures. If fair value were replaced with some other method, investors would be left to their own devices to estimate the future cash flows of financial instruments, which may be less reliable than current valuations. As one investor said at Meet the Experts conference in London recently, 'suspending fair value accounting is completely the wrong thing to do – it would be shooting the messenger.'

Investors who are members of organisations such as the Corporate Reporting Users' Forum have made it clear that they do want to see the current fair values of a company's financial assets because it makes the impact of market forces on financial performance more transparent. But, where markets are illiquid, they say it is critical that there are sufficient disclosures for them to understand what information the valuation is based on.

The expert advisory panel – which includes bankers, regulators and

auditors with extensive valuation experience – discussed what they would do to measure fair value appropriately and captured the key points. They have advised, for example, on what information to consider in inactive markets; when changing valuation models is appropriate (and when it isn't); and what to do when you have a range of possible values for an instrument.

The second part of the guidance emphasises the importance of disclosures in helping investors and others understand the techniques used and the judgements made to measure the fair value of key instruments. The panel makes various suggestions for entities to consider when making disclosures of this kind, including in the following areas:

- Aggregation and granularity of disclosure
- Frequency
- Controls
- Valuation techniques
- Movements in fair values
- Changes in credit risk

Those contending that the current market is an anomaly may be right. If so, the market will eventually recognise that and return to 'normal'. In the interim, however, the use of additional disclosures to clearly explain the content and consequences of fair value reporting will help to calm a market where there is uncertainty around losses.

Credit crunch drives stakeholder action on financial instruments



Extraordinary times have precipitated unprecedented actions. The European Commission, for example, has moved with unusual speed to hold a meeting of stakeholders to discuss significant accounting issues related to financial instruments (IAS 39 and IFRS 7). The meeting followed the IASB's recent release of amendments to the standards and the commission's subsequent endorsement, both of which were achieved without the usual due process.

The October meeting was set up to identify issues for referral to the IASB that need a response before companies issue their third quarter results. However, issues relating to financial instruments that respondents believed needed addressing by the fourth quarter, as well as longer-term items, were also on the agenda. The 'stakeholders' invited by the EC included representatives from

banking and insurance, regulatory organisations, professional bodies and users of financial statements.

The stakeholders concluded that only one agenda item – valuation of illiquid assets – needed a response prior to third quarter results. A few banking representatives wanted an urgent steer on the use of spreads and clearer guidance on how and when to use mark-to-model. The EC has written to the IASB to take up the issues outlined in the table below.

Stakeholders also appeared to reach unanimous agreement on three further matters:

- The EC should not create EU-level amendments to IFRS. Retaining the IFRS framework is the best option for restoring market confidence in financial statements.
- Due process should be followed for evaluating amendments to the accounting framework. However, in some circumstances due process should be tailored to enable a speedy response.
- The IASB and the FASB should co-ordinate their work programmes where appropriate to provide a comparable framework between IFRS and US GAAP.

Issues referred to the IASB

For Q3 results

- Valuation in illiquid markets

For Q4 results

- Reclassification out of the fair value option. Not currently permitted under US GAAP or IFRS
- Embedded derivatives (specifically in synthetic collateralised debt obligations). This is on the IASB agenda
- Impairment of available-for-sale securities. Expected to be on the agenda for the IASB/FASB advisory group

Longer term issues

- Definition of loans and receivables
- Tainting rules for held-to-maturity (HTM) assets
- Hedging interest rate risk in HTM assets

These relate to the classification of financial assets. Expected to be on the agenda for the IASB/FASB advisory group

India embraces XBRL

India has joined the growing list of countries looking to embrace the use of XBRL, with the Securities and Exchange Board of India, the Institute of Chartered Accountants of India, the Bombay Stock Exchange, the National Stock Exchange and the Reserve Bank of India all supporting its use.

The Institute of Chartered Accountants of India (ICAI) has been a key driver. It has established an XBRL group responsible for developing a draft general purpose XBRL taxonomy based on Indian GAAP and various Indian corporate laws. The draft, which has undergone a comment process, is designed for use by commercial and industrial entities, oil and gas companies, service providers, real estate and construction companies.

Although the draft ICAI XBRL taxonomy is based around Indian GAAP as the current reporting framework, the intention is that an IFRS XBRL version of the taxonomy will be ready in time for India's convergence to IFRS in 2011.

'This move will give companies a taste of the XBRL technology and address their concerns, if any,' said Jed Vain, president of the ICAI and chair of the XBRL group. The next step, he added, is for the institute to start work on a taxonomy for the financial sector.

The XBRL group is now intent on establishing an Indian provisional jurisdiction of XBRL International to further encourage the development and adoption of XBRL in India and represent Indian interests at the international level.

'India's pursuit of XBRL will facilitate better information for more efficient markets, while also streamlining business information processes, controls and analysis that are so critical to the country's high profile outsourcing sector,' added PwC partner Mike Willis. 'India, more so than many other countries, is poised to benefit from the application of XBRL for both external reporting and internal compliance processes.'

Investors demand better cash flow reporting

The Corporate Reporting Users' Forum (CRUF) – an international discussion group of investors and analysts – has long called for a greater emphasis on cash flow in corporate reports. So it is perhaps no surprise that the need for enhanced disclosure on cash formed the core of a presentation that the CRUF gave to some of the board and staff of the IASB in June as well as its message to a large corporate audience at Meet the Experts conference in October.

When challenged to give specific examples of how management could improve their cash flow disclosure, the CRUF had a clear and simple message: 'The main problem with current disclosure requirements... (is the) lack of reconciliation between cash flow and the change in net debt.'

Although required under UK GAAP, the reconciliation disappeared as a mandatory disclosure under IFRS. Without it, investment professionals cannot be certain that they have captured all cash flow movements in their analyses. And it goes without saying that, as we enter a time of economic slowdown, any uncertainty about cash flow is not likely to be well received by the capital markets.

In a letter to the *Financial Times* (8 October) CRUF members again called for the IASB and the US FASB to consider the issue of improved cash-flow disclosure as they focus on the presentation of financial statements. 'As users, we would like to be able to rebuild the cash-flow statement – in our own preferred format – in a way that reconciles with the balance sheet,' wrote the CRUF.

At Meet the Experts, CRUF members urged companies to provide voluntarily the additional disclosures necessary to reconcile cash flow with changes in net debt. 'You don't have to wait for the standard setters,' said Peter Elwin of Cazenove Equities. 'You can provide them with good examples and lead from the front. Financial reporting is all about telling a story, honestly.'

In addition to the net debt reconciliation, the CRUF has been highlighting a few other cash-related items that they would like disclosed in the notes to the accounts, including: debt at acquired and divested companies, the currency impact on debt, and greater transparency on the line items included in the cash flow statement.

Visit www.cruf.com for the CRUF's presentations and www.meet-the-experts.org for more information on the conference

IFAC

Financial reporting – better or worse?

There have been clear improvements over the past five years in three areas of the financial reporting supply chain, according to a report published by the International Federation of Accountants (IFAC) – *Financial reporting supply chain: Current perspectives and directions*. Corporate governance, the process of preparing financial reports and the audit of financial reports have all improved, the global review found.

The report is a response to the findings of an earlier IFAC report published in 2003 – *Rebuilding public confidence in financial reporting: An international perspective* – which identified actions needed to improve stakeholders' perceptions of good financial reporting practice in the areas of financial and business reporting, corporate governance and auditor performance.

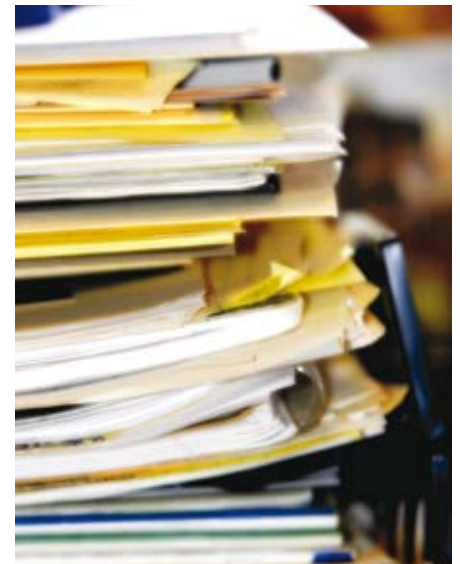
The latest report summarises the responses of users, preparers, auditors, standard setters and regulators to a global survey commissioned by IFAC in 2007. Despite the clear

improvements, respondents were less enthusiastic about the financial reports themselves. These were considered difficult to understand, even though the relevance and reliability was deemed to have improved since 2003.

Recommendations to address the usefulness of financial reporting included:

- Improving communications among participants in the financial reporting supply chain
- Producing financial and business information that is relevant, reliable and easy to understand
- Including more business-driven information in financial reports
- Promoting the use of technology to enable users to compile their own information

The report addresses each area of the supply chain in detail, clearly setting out the positive improvements, areas of concern and areas where further



improvement is needed. It concludes that there needs to be a coordinated ongoing dialogue to address the concerns raised, and IFAC has been recommended as the body to take the lead in future projects to address concerns highlighted in the survey.

Copies of the report can be downloaded from www.ifac.org/frse

Fast track to IFRS

The US Securities and Exchange Commission (SEC) has voted unanimously to seek public comment on a proposed roadmap for the potential mandatory adoption of IFRS and a proposed rule to allow the optional use of IFRS by certain qualifying domestic users.

This latest development comes on the heels of the third roundtable held by the commission and staff to examine IFRS, and the recent SEC announcement to abandon the reconciliation requirement for foreign private issuers. Plus it is only one year on from the publication of an SEC concept release on whether to allow US issuers to prepare financial statements prepared under IFRS.

Roadmap proposals

The proposed roadmap aims for mandatory adoption of IFRS in the US from 2014. However, it sets out several milestones that need to be achieved before the SEC will accept IFRS for all issuers. The milestones mentioned are:

- Continued improvements to IFRS
- Independent funding of the International Accounting Standards Committee Foundation (IASCF), the body that oversees the IASB
- Enhanced ability for interactive tagging system (XBRL) to accept IFRS data
- Sufficient progress in IFRS education and training in the US

Under the proposed roadmap the SEC would reconvene in 2011 to consider progress toward meeting the milestones and decide if a mandatory IFRS conversion date should be set for all issuers, and whether the option to early adopt should be expanded to a larger group of issuers.

Alex Finn, PwC IFRS conversion partner, believes that US companies should take the proposals seriously. 'The roadmap is broadly as expected, if somewhat more restrictive on early adoption' he observed. 'The message being given here is that the SEC is clearly committed

to IFRS and those are real deadlines. They would like to make it work, but not unless it is in the interests of the US investing community.'

Optional early adoption

The proposed roadmap would, in theory, allow certain domestic issuers to adopt IFRS for reporting periods ending on or after 15 December 2009. The criteria for early adoption are that the US entities are among the 20 largest companies (measured by market capitalisation) in their industry group globally. Even then, IFRS must be used more than any other GAAP by that group. Once issuers have met the first two criteria they must then obtain a letter of no objection from the SEC's Division of Corporation Finance.

The SEC is expected to include in the proposed rule two transition disclosure alternatives for public comment:

- Option A: Companies must comply with IFRS 1, *First-time Adoption of International Financial Reporting Standards*, and include a one-time reconciliation from IFRS to US GAAP in their first set of IFRS financial statements.
- Option B: Companies must comply with Option A and include ongoing unaudited reconciliations from IFRS to US GAAP for the three years of financial information included in their Form 10-K.

The SEC will select one of the two alternatives after considering the comments received.

US companies that already meet the SEC criteria for early adoption will, in theory, be able to move to IFRS quickly. However, in practice it is unlikely that any companies will choose to move immediately, not least because of the requirement to present two years' comparative financial statements. Should a company want to adopt IFRS for its 2011 year end, it will need to produce comparatives covering 2009 and 2010 financial years, with an opening balance sheet of 1 January 2009.

Guidance on its way for applying 'new IFRS' for 2009



To address the raft of new requirements for 2009, PricewaterhouseCoopers is publishing *A practical guide to new IFRS for 2009*, due out in January 2009. This 40-page guide highlights the impact of IFRS changes effective for the 2009 reporting period, primarily in question-and-answer format. It focuses on the major changes in the following areas:

- Consolidations (IFRS 3R, IAS 27R)
- Segments (IFRS 8)
- Presentation (IAS 1R)
- Other issues:
 - Cost of investment (IAS 27 and IFRS 1 amendment)
 - Borrowing costs (IAS 23R)
 - Financial instruments (IAS 39 amendment; IAS 32 and IAS 1 amendment; IFRIC 16)
 - Share-based payments (IFRS 2)
 - Construction contracts (IFRIC 15)
- Annual improvements project

To obtain your copy, contact your local PricewaterhouseCoopers office or go online at: www.pwc.com/ifrs

Is joint work plan still the right agenda?

Almost three years after the joint work plan was launched by the IASB and the US FASB, questions are being asked about whether the Memorandum of Understanding (MoU) is still a compelling proposition. At the time it made a lot of sense for the world's two major standard setters to aim for genuine global GAAP.

Now that the US looks set to allow IFRS in the domestic environment and the SEC has withdrawn its requirement for a US GAAP reconciliation by FPIs, key drivers for the MoU and the basis of its international support have changed. Views have also been influenced by the sheer volume of US GAAP. This has prompted some observers to ask why the IASB would wish to enter into a further round of convergence with the US. On the other hand, the SEC's support of IFRS as the 'international GAAP' is still considered very important.

In a meeting between the two standard setters earlier this year, the boards considered a paper that set out a plan to work together and complete major projects by 2011. Their key objective, as before, is to develop a common set of high quality standards that will improve financial information for investors and capital markets around the world. 'A number of jurisdictions including Canada, India, Japan and Korea have announced plans to adopt or converge with IFRS from 2011,' said IASB chairman David Tweedie. On the face of it, the timing leaves little notice of what standards will apply that year and even less time to calculate the comparative numbers for 2010.

'Most of the items on the joint agenda are important projects internationally,' said PwC partner Peter Holgate. 'It is generally acknowledged, for example,

that the revenue standard needs updating for today's business environment – but the IASB will need to watch that in striving to work with the US standard setter and ensure that the SEC is firmly on board, it still produces something suitable for other territories.'

He added that for some it would be more logical for the IASB on its own to identify improvements needed for the next wave of IFRS adoption. Another issue is that the selection does not prioritise work on the conceptual framework. Yet the framework underpins standards and is supposed to be a unifying force.

Sir David has made it clear that the MoU is an essential part of the IASB's strategy, however he also said: 'we remain committed to addressing other important projects on our agenda.'

IASB/FASB JOINT PROJECTS

Specific projects on the joint agendas

The revised Memorandum of Understanding between the IASB and the FASB (see above) has major implications for what the IASB will tackle over the next few years. The following summarises the likely position, though it is still to be confirmed.

Joint projects that address fundamental deficiencies in IFRS that require completion as a **high priority** are:

- **Revenue.** This project is regarded as critical to the US adoption of IFRS, and in need of improvement in both GAAPs. In some contexts IFRS users refer to US GAAP to fill the gaps, but the US literature is itself far from satisfactory.
- **Fair value measurement.** This again is seen as critical to the US adoption of IFRS. FAS 157 requires exit value measurement and IFRS is moving towards this. The question is when exit value, entry value, or another value would be used.

- **Consolidation.** The particular concern here is the treatment of special purpose entities. The goal would be a consolidation standard that embraces the idea of 'effective control'.
- **Derecognition.** Both FAS 140 and the derecognition rules in IAS 39 are perceived as problematic. This subject is in the spotlight because of the size of the securitisation market and the credit crunch.

Projects that address **significant needs** for improvements include:

- **Financial statement presentation.** The scale of the reform now being discussed, however, seems to be more modest than before.
- **Post-retirement benefits.** It is proposed that work would continue on phase 1 – the March 2008 discussion paper. But work on phase 2 would be suspended.
- **Leasing.** This is seen as in need of reform, but the proposal is that only

lessee accounting would be reformed by 2011.

- **Financial instruments.** Both boards have issued papers for comment about possible simplifications.
- **Liabilities and equity.** This is seen as a high-priority, but potentially difficult, and progress again depends on the outcome of a discussion paper recently issued by the FASB and the IASB.

It is also envisaged that work will continue on the short-term convergence projects on earnings per share, joint ventures and taxes.

So what is omitted? The most crucial point here is that work on the conceptual framework does not appear, meaning that it would be given lower priority. Other omissions are perhaps more understandable. The projects on insurance and extractive industries, for example, are important but there are a lot of issues, little consensus and limited interest outside those industries.

Smooth path for IFRS convergence in 2012

The Financial Reporting Foundation (FRF) and Malaysian Accounting Standards Board (MASB) announced on 1 August 2008 that Malaysia plans to fully converge its accounting standards with International Financial Reporting Standards (IFRS) by 1 January 2012.

Johan Raslan, chairman of PwC Malaysia and chairman of FRF, explained that the planned adoption of FRS 139 (the standard equivalent to IAS 39) in 2010, plus adoption of the remaining standards in 2012 is considered the right timetable for convergence. This will allow a phased changeover to IFRS and give companies sufficient time to prepare.

MASB chairman Dato' Zainal Abidin Putih explained that Malaysia had been incorporating the provisions of the international standards into local accounting standards since 1978. He



added that '...all of our current standards incorporate IFRS provisions anyway. Only a few more substantive standards need to be formally adopted between now and 2012, and we have already discussed those with the affected parties.'

Malaysia's Securities Commission chairman, Dato' Zarinah Anwar, supported the decision and said, 'Businesses operate in an increasingly

global environment. Therefore, this move will help to give Malaysian companies and our capital market the recognition they deserve.'

All Malaysian entities that are required to comply with approved accounting standards under the Financial Reporting Act 1997 will be required to transition to IFRS, except for private entities. Private entities will continue to apply Private Entities Reporting Standards (PERS).

JAPAN

Stepping closer to IFRS

In Japan, adoption of IFRS is now being seriously considered and debated at the most senior levels, which previously were focused on the convergence of Japanese GAAP with IFRS, rather than outright adoption.

Late in July, an informal meeting with key accounting stakeholders – including the Accounting Standards Board of Japan, the Japanese Institute of Certified Public Accountants (JICPA), the Ministry of Justice, investors and academic experts – was held by the Financial Services Agency, which will be responsible for issuing new requirements. At the meeting, the discussion was made to prioritise convergence work on revising standards for consolidated accounts. Revision to standards for stand-alone accounts will continue in accordance with the convergence project (Tokyo Agreement), and this is expected to take longer because of the relationship with Japanese-owned traditional business and accounting practices. This was mostly supported in the meeting.

In the second informal meeting held in September, there was further discussion and broad support around permitting Japanese companies with international interests the option of adopting IFRS. From October, these will be formally considered by the FSA's advisory body – the Business Accounting Council. The next step is expected to be a roadmap for IFRS adoption that sets out the obstacles, necessary changes and the key transition milestones.

In October, the Nippon Keidanren (business federation) issued a statement urging the adoption of IFRS (phased-in over three years) for the consolidated financial statements of listed companies. It highlights the fact that Japan is 'the only country among major capital markets which has not officially announced the adoption of IFRS'.

Meanwhile, the JICPA has announced that it supports allowing listed companies in Japan the option of using IFRS for their consolidated accounts. In its press release the JICPA said: 'We

believe that there is now an urgent need to seriously consider ways to adopt IFRS in Japan.' It also highlighted the importance of IFRS education and training in Japan and the need for Japan to be more involved in international standard setting. It sees IFRS adoption in Japan as a pre-requisite for being able to wield real influence on international standard setting.

'This is a good time for companies in Japan with international interests to consider the impact IFRS adoption would have for them,' said Aiko Sekine, PwC partner and executive board member at the JICPA. 'As the FSA and others consider the roadmap for adoption, it is important that management understands how IFRS adoption would affect their reporting and investors' perceptions of the company. They will also need to identify what changes would be needed to their processes, systems and business to successfully use international standards, so that they can make an informed judgement when the time comes.'

Alternative to IFRS for private entities

The German government has approved a draft accounting reform bill that, if passed by parliament, will provide German companies with a workable alternative to full IFRS and IFRS for private entities.

The German Federal Cabinet adopted a Bill for an Act to Modernise Accounting Law in May this year. The Bill (Bilanzrechtsmodernisierungsgesetz – BilMoG) removes the pressure for unlisted German companies to use international accounting standards. This particularly applies to the small and medium-sized entities that have followed the legislation of the Commercial Code to date.

The revised Commercial Code introduces little change for German small and medium-sized entities and is therefore the lower-cost alternative to the IASB's proposals. The IASB's proposals for SMEs are seen in Germany as having high levels of complexity, time-consuming processes and high costs compared to the government's proposals, which involve less disclosure and less detail about an entity's financial instruments.

'We believe that the IFRS for PE standard is still too complex and burdensome for many, if not all SMEs/PEs in Germany,' said Liesel Knorr, president of the Accounting Standards Committee of Germany (DRSC). 'Our complexity concerns particularly apply to the structure and wording, certain measurement and disclosure requirements and the consideration of cost-benefits. We have considerable doubts that the standard in its current form will find acceptance in Germany.'

The bill now needs to go before the Federal Parliament before it can be enacted into law. With an experts' hearing taking place in December, it will be 2009 before the bill is finalised.

Big GAAP, little GAAP

The IASB is close to issuing a new standard that will apply for private, unlisted entities. The board is re-deliberating some technical topics and is expected to vote on a final standard by the end of 2008.

IFRS for Private Entities (formerly IFRS for SMEs) will be a short, stand-alone standard that can be used by all, including the very smallest, if they wish.

'The need for a standard for private entities was highlighted by many countries that have a local GAAP or no GAAP at all,' said Hugo van den Ende, PwC partner and member of the IASB Working Group on IFRS for Private Entities. 'The introduction of one standard for all private entities would bring more consistency and therefore increase comparability. And it could also improve the quality of reporting.'

Those countries trying to apply full IFRS to all entities are also positive about the PE Standard. 'The smaller companies found current international standards burdensome, particularly in relation to the measurement and disclosure requirements, since these were developed to meet the needs of equity investors in public capital markets' added Mr van den Ende.

The board's remit was to develop a standard that would meet user needs at the same time as balancing costs and benefits from a preparer perspective. The final PE standard is intended for use by all entities that do not have public accountability and publish general purpose financial statements for an external audience. That is, entities that are not listed, and entities that hold assets in a fiduciary capacity for a broad group of outsiders such as banks or pension funds.

The exposure draft has been field tested by 116 entities from 20 countries. This involved restating their most recent annual financial statements using IFRS for PEs followed by the



Hugo van den Ende

completion of a questionnaire compiled by the IASB. Few PEs reported significant problems applying the exposure draft. The main issues raised were determining fair values, computing deferred taxes, and compiling cash flow statements.

It is also worth noting that in 2007 South Africa adopted the exposure draft word-for-word as its standard for private entities, and is now considering whether to extend its use to the not-for-profit sector.

Some are questioning whether it is necessary for the European Commission to endorse the standard, as they do other IFRSs. European companies are required to follow the requirements of the 4th and 7th Directives. These directives neither require nor prohibit adoption of the PE standard so it may be that it will occur on a country by country basis. Norway, Sweden, Bulgaria and the UK have all expressed interest.

'There are currently some 55 different GAAPs in the EU alone and many countries have two or even three levels,' commented Paul Pacter, IASB Director of Standards for Private Entities. 'For those companies that are working cross-border that is a nightmare for comparison.'

The IASB expects to issue the new standard in the first quarter of 2009. It will come as a relief to many that the IASB has publicly stated (during its September 2008 webcast) that it does not intend to initiate an annual improvements project for this standard. Instead it anticipates a bedding down period of at least two years before we can expect to see any amendments. Another encouraging move from the IASB's education department is the development of comprehensive training materials to cover the standard, which will be made available free of charge.

Trustees review constitution

The trustees of the International Accounting Standards Committee Foundation (IASCF – the parent trustee body of the IASB) have commenced the five-yearly review of their constitution – at a time when some major economies are set to adopt IFRS over the next few years, including the expected move by the US.

The first stage of the constitutional review comprises the proposed creation of a Monitoring Group (MG) of regulators, together with changes to the size and composition of the IASB. A consultation document on stage one was published in July and responses were received in September.

In this first stage, the package of proposals is designed to provide political-level acceptance of the IASCF's governance arrangements. As the consultation document notes, the board performs a public-interest role in writing standards that are becoming increasingly adopted in many countries and transposed into law in some.

Acceptance of these standards will therefore depend on national authorities being satisfied that there is sufficient accountability at each tier of the structure.

The proposed MG will in future appoint the trustees and oversee their work in discharging their responsibilities. The proposals envisage seven initial members of the MG, comprising senior-level representatives of the European Commission, the Japanese Financial Services Agency, the US SEC, the IOSCO Emerging Markets and Technical Committees, the International Monetary Fund and the World Bank.

How the MG and trustees will work together in practice is critical to the proposals. 'There is a very delicate balance to be drawn in the respective responsibilities and powers of the MG and the trustees, such that both groups are playing a valuable role and engaging in constructive interaction, and that high-quality candidates are willing to serve on both groups,' said PwC partner David Devlin. 'If the MG's

role is too intrusive, then the calibre of the trustees will decline over time to the detriment of the oversight model.'

Also part of the package of proposals is an increase in the size of the IASB (from 14 to 16 members) and the introduction of minimum geographical quotas: four members from Europe; four from North America; four from Asia/Oceania; one each from Africa and Latin America, and two from any area.

Over 60 organisations responded to the consultation. First stage changes are expected from the beginning of 2009. Stage two of the review, expected to start before the end of this year, will look at more detailed aspects of the constitution.

'The changed size, composition and hence dynamics of the board will mean that the chairman's role and powers should be looked at afresh in stage two,' Mr Devlin added. 'A further area of consideration would be the responsibility to set the technical agenda.'

EFRAG

Strengthening the European contribution to IFRS

While the IASCF Trustees have embarked on the review of their Constitution (see article above), a similar review of the governance structure of the European Financial Reporting Advisory Group (EFRAG) is taking place. A consultation document was issued by EFRAG in July, which sought views by mid-September.

A key driver of the review is the view that the profession in Europe should take a more pro-active role in influencing the development of IFRS, particularly at an early stage of major projects. Hence, in the future, it is proposed that EFRAG will have two major activities:

- Endorsement advice on IFRS for the EC, and work on impact assessments of IASB standards and interpretations at the EC's request.
- Pro-active work, including providing input to the IASB on its work

programme and priorities, preparation of discussion papers, and research on accounting topics.

Historically, EFRAG has had a relatively simple structure with a Technical Expert Group (TEG) dealing with the endorsement advice and a Supervisory Board providing oversight. To accommodate the pro-active work, it is considered necessary to change the structure to include national accounting standard setters.

Richard Keys, PwC's global chief accountant, said, 'We are broadly supportive of the objectives and overall direction of the proposals to enhance EFRAG's governance structure and to ensure that the interests of European stakeholders with respect to financial reporting are represented effectively. As more of the world's major capital market economies adopt IFRS over the next few years, it will be important to ensure that Europe retains a

significant input in the continuing development of IFRS.'

The proposals envisage a new entity (the PRC – Planning and Resource Committee) to provide a focus for involvement of the national standard setters, and sit between the Supervisory Board and the TEG in the structure. Its membership would be drawn from the Supervisory Board, the TEG and national standards setters, together with a few outside members.

'The revised structure being proposed is complicated, and contains a number of bodies with overlapping membership and responsibilities,' said Mr Keys. 'To work as intended, the proposed arrangements will need the support and strategic commitment of the various European institutions and stakeholders at a high level. Significant effort and goodwill will be needed, particularly in the early years of operation of the new structure.'

Pensions accounting: too big for one bite?

Pensions accounting seems to be so big a subject that it cannot be resolved in one sitting. The IASB published a discussion paper earlier this year that does not tackle the big issues such as valuation of pension liabilities and consolidation, but does propose three significant changes to pensions accounting.

First, it proposes to eliminate two aspects of smoothing. One is that the 'corridor' method of spreading actuarial gains and losses would no longer be used. This is widely used in mainland Europe, although it is unpopular globally. The other is the practice of recognising, in the income statement, a figure for the expected return on plan assets. Better, the IASB says, to report the actuals than the budget.

The second proposal is to alter the presentation of items. All movements in the pensions asset or liability would either be recognised in the income statement or some of the movements could be recognised in the second performance statement (other comprehensive income). The details, however, are different from the current rules in IAS 19. 'It might have been easier to address these tricky presentation questions in the context of a widespread review of the presentation of financial performance as a whole,' commented PwC partner Peter Holgate.

The third issue change relates to 'contribution-based promises', a type of hybrid pension scheme, which would be measured at a version of fair value.

Once the IASB has considered public comments on the paper it will re-deliberate and decide whether to modify or confirm its views in the exposure draft.

Deferred tax – ED forthcoming

It has become an all-too-frequent joke in the last two years that the IASB's exposure draft on deferred tax accounting has been deferred. Its appearance does, however, now seem imminent. The IASB and the FASB are seeking to converge their standards on a number of subjects and this is part of that programme. Hence the ED will seek to bring the two standards closer together by eliminating or changing the (different) exceptions and special rules in each of them.

But publishing an ED on this basis is seen by some to be a wasted opportunity. The fundamental problem is not that the two standards are different in detail. It is that the basic principles give rise to numbers in financial statements – deferred tax assets and liabilities – that, arguably, few preparers can understand or explain, and few users can understand either. Most users acknowledge that they routinely cross out the deferred tax number in analysing balance sheets.

The problems include:

- The methodology gives rise to some liabilities that are most unlikely to be paid.

- By not allowing discounting, the numbers presented are considered economically unrealistic.

There is some support for the so-called 'flow through' method – in other words, accounting only for tax currently payable and not accounting for deferred tax. Instead, the footnotes would give certain information about the likely pattern of cash taxes payable over the short to medium term. Users would welcome these realistic provisions on the balance sheet, but the likely consequence of this would be more volatile tax lines in the income statement.

'Flow through may or may not be the preferable approach,' said PwC technical partner Peter Holgate, 'but going back to basics and considering a number of approaches certainly is.' It is good news, then, that the UK Accounting Standards Board, together with its German counterpart, is starting a back-to-basics review of deferred tax accounting at the IASB's request. This is not going to affect the short-term convergence with the US Financial Accounting Standards Board, but it might improve accounting in the medium term.

CONCEPTUAL FRAMEWORK

Stewardship and the entity perspective

The IASB's work (jointly with the FASB) on the conceptual framework continues, though it is a long project that is not scheduled to be completed until well into the next decade. Recently, there have been two significant developments.

The first is in the recent two-part exposure draft on *Objectives and qualitative characteristics of financial reporting information*. An earlier draft had sought to play down the role of

stewardship in financial reporting, putting the focus instead on the role of financial statements in helping users predict future cash flows. There were considerable objections to this change. As a result, the ED now acknowledges that stewardship is an important aspect of the wider objective of decision-usefulness.

The second relates to the entity perspective, which increasingly seems to be firmly part of the framework. The text on Objectives says, for example: 'Financial reports reflect the perspective of the entity rather than the perspective of the entity's equity investors...' A similar sentiment is found in the May 2008 discussion paper, *The reporting entity*. The entity perspective has its own rationale and it has its supporters, but there are some territories, such as the UK, where it is not popular.

FSF keeps up pressure for further action

The Financial Stability Forum has vowed to continue its work to correct the causes and weaknesses in global financial markets that led to the current economic crises. The FSF acknowledges that a substantial amount of work has already been done – but there is more to do.

In October the FSF presented a follow-up on implementation of the *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* to the G7 finance ministers and central bank governors. The report responds to the five key areas recommended for action in the initial report published in April:

- Strengthened prudential oversight of capital, liquidity and risk management
- Enhancing transparency and valuation
- Changes in the role and uses of credit ratings
- Strengthening the authorities' responsiveness to risks
- Robust arrangements for dealing with stress in the financial system

The FSF found that work in these areas is proceeding well and in a coordinated fashion, and it expects to see real progress by the end of the year. Positive steps include further measures to strengthen standards and oversight of banks' capital and liquidity, risk management standards in financial institutions, valuation practices and accounting standards.

Accounting standards were highlighted as an area where implementation of certain recommendations needs to accelerate. The FSF report calls for standard setters to: 'conclude their work promptly to enhance and converge guidance on valuation of instruments in inactive markets, and accounting and disclosure standards for off-balance sheet activities and related risks'. The FSF has categorised this as a 'near-term priority'.

Peter Wyman, PwC's global regulatory and public policy leader, welcomed the FSF's latest report. 'We support the efforts by the forum and other authorities to analyse the causes and effects of the global credit crisis. Standard setters and others need to be responsive and give careful consideration to the forum's recommendations.'

The report singled out central counterparty clearing for over-the-counter (OTC) credit derivatives as another area for accelerated action. Credit rating agencies (CRAs) and private sector organisations also came under the spotlight, with CRAs being asked for industry-wide proposals for providing differentiated information or ratings for structured products; and those private sector organisations that have recommended improvements to industry practices to establish frameworks for rigorously monitoring and reporting on their timely implementation.

Looking ahead, the FSF report sets out additional issues it will address to build on the work of its member authorities and international bodies:

- Review of international interaction and consistency of emergency arrangements and responses to the current financial crisis
- Work to mitigate sources of pro-cyclicality in the financial system, ie, improvements to the capital regime, loan-loss provisioning practices, compensation arrangements, and management of interactions between valuation and leverage
- Assess the scope of financial regulation, particularly unregulated institutions, instruments and markets
- Improve macroeconomic oversight and prudential supervision integration

The Financial Stability Forum's report can be found on www.fsforum.org

Where to find IFRS guidance

A range of new practical guidance on implementing IFRS is available, with further guidance expected soon.

Currently available

- IFRS pocket guide 2008
- A practical guide to segment reporting



- IAS 39 – Derecognition of financial assets in practice



- Illustrative IFRS consolidated financial statements 2008 for corporate entities, insurance companies, investment funds and investment property
- IFRS disclosure checklist 2008
- A practical guide to capitalisation of borrowing costs
- A practical guide to share-based payment

Coming soon

- IFRS manual of accounting
- Understanding new IFRSs for 2009 – A guide to IAS 1 (revised), IAS 27 (revised), IFRS 3 (revised) and IFRS 8
- A practical guide to new IFRSs for 2009 [see also p17]

To obtain copies, contact your local PwC office or go online at: www.pwc.com/ifrs. Queries should be emailed to corporatereporting@uk.pwc.com

New group to advise on reporting issues

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) reacted to calls from the G7 and other world leaders for swift action to deal with the credit crisis by setting up an advisory group to consider reporting issues in an internationally co-ordinated manner.

Members of the advisory board are still to be announced as *World Watch* goes to press. However, the boards have agreed that the group should comprise senior leaders with broad international experience of financial markets. They expect to appoint the chair and members as soon as possible so that work can begin on improving financial reporting to enhance investor confidence in financial markets.

The group will be charged with identifying accounting issues requiring the urgent and immediate attention of the IASB/FASB as well as issues for longer-term consideration. It will draw on work already undertaken in a number of jurisdictions. In advance of the advisory group being established, the boards are undertaking fact-finding

roundtables in Asia, Europe and North America to gather input on reporting issues emanating from the global financial crisis and to hear the responses of governments, regulators and others.

‘The FASB and the IASB recognise that the urgency of the credit crisis requires unprecedented action, and we at the IASB are committed to act where necessary,’ said Sir David Tweedie, chairman of the IASB. ‘It is also essential that any further steps taken should improve confidence in the markets and be done in a way that takes account of the broad interests at stake. The establishment of this high-level advisory group and the holding of public roundtables should ensure that both boards together reach common high-quality solutions that help return confidence to the marketplace.’

In addition to considering the potential for short-term responses to the credit crisis, both boards have emphasised their commitment to developing common solutions to provide greater transparency and reduce complexity in the accounting of financial instruments. The deliberations of the high-level



advisory group will be used as starting points for developing common solutions in this area. The views of the group will be considered in conjunction with responses received to the boards’ joint discussion paper, *Reducing complexity in reporting financial instruments*.

‘We expect this new global group to generate valuable short and longer-term input for both boards to consider,’ explained Robert Herz, chairman of the FASB. ‘In the short-term, we welcome advice about common issues affecting the international markets and how a coordinated response from the boards could enhance confidence in the markets. Just as important, we look forward to further exploration of how to increase the transparency of reported financial information to investors.’

TAIWAN

IFRS adoption is now on the cards

The Taiwan Financial Supervisory Commission (FSC) has announced the formation of a task force to consider the adoption of IFRS, with a possible adoption date of 2014. This brings about a change of direction from its present ‘convergence’ route whereby standards would be revised to parallel the IASB’s standards.

The FSC task force is made up of representatives from Taiwan’s stock exchanges, over-the-counter trade operators, the local Accounting Research & Development Foundation, industry and trade bodies and relevant government bodies on areas where the

principles might require fine-tuning for full adoption in Taiwan. The task force will determine the adoption date and scope of adoption.

Taiwan’s insurance and banking sectors have voiced concern over accounting for fair value under IFRS. Under Taiwanese GAAP entities can reclassify trading assets to categories such as ‘held to maturity’ or ‘assets held for the purpose of sale’, but under IFRS they be required to mark-to-market their assets, a principle they feel could result in paper losses if the assets drop in value.

The FSC supports the move to IFRS saying that adoption will improve the comparability between domestic financial statements and those of foreign companies, facilitating lower-cost overseas fund raising by Taiwanese companies.

PAKISTAN

One step closer to IFRS

Pakistan has taken a further move towards IFRS with agreement from the Securities and Exchange Commission of Pakistan (SECP) and the Institute of Chartered Accountants of Pakistan (ICAP) in November 2008 that they will take urgent necessary steps to ensure full compliance with IFRS. The SECP and ICAP have indicated that the financial statements of Pakistan’s listed companies (apart from banks and financial institutions) are expected to have full compliance with IFRS for the year ended 31 December 2009.

The ICAP is responsible for adopting the Pakistani equivalents of IFRSs prior to approval from the SECP. Two standards remain outstanding for legal adoption – IFRS 1 and IFRS 4.

IFRS – No time to lose

As more and more countries prepare to adopt IFRS, **Alex Finn** offers insight to those setting out on the road to conversion



Alex Finn

The process of converting to IFRS is different for every company, wherever they are based, but changing the numbers is only a part of the change that will be needed as companies tackle the transition to IFRS. Management teams that look at the wider picture, start early, and properly scope the task in hand will have the best chance of making a

change that not only meets regulatory requirements, but also enables improvements in the quality of information for both company management and external stakeholders.

Getting started

Performing an assessment of the likely impact of converting and drawing up a timeline for conversion is a useful first step. Our experience is that adopting IFRS can take anything from two to five years, depending on the size and complexity of the organisation and the approach to be taken. Large multinational organisations with decentralised operations around the world, older IT systems and numerous business platforms will typically take longer.

In countries where the timing for implementation is still uncertain companies will need to keep abreast of new and future accounting pronouncements as changes will have an impact on project timelines and work effort leading up to adoption date.

Key considerations

Implementing IFRS goes well beyond a simple technical exercise for the finance or accounting function. Other business areas such as the human resources, investor relations, and business development and IT departments are likely to be involved in the IFRS conversion plan. The sheer logistics of gathering extensive amounts of additional data from a diverse organisation in a consistent, timely and auditable fashion can be one of the major challenges.

The new standards also place a sizeable responsibility on management to be able to communicate effectively to the market in the new language. Financial statements may look very different under IFRS and management need to be at ease discussing the reasons for this. Early communication, including the sharing of pro forma financial statements with preliminary figures and/or opening balance sheets under IFRS, allows everyone to get comfortable with the 'new brand' financial results.

Many European adopters found it a significant challenge to determine the differences between local GAAP and IFRS that would have most impact on their organisations. This challenge remains for new adopters. The issues and their impact will vary depending on the accounting policy choices made to

date and how far national standard setters have harmonised local GAAP with IFRS.

The 'credit crunch' has pressured the IASB to make changes to some standards with unprecedented speed. This may have led to new differences between local GAAP and IFRS, so adopters really need to keep their eye on this moving target.

More than the numbers

The change to IFRS presents management with an array of challenges. Management reporting, budgets, forecasts, performance measures, bonus structures, key performance indicators and debt covenants may all be affected. Even new strategic investments will need to be considered in the light of IFRS and its implications for how this information may have to be reported.

Staff across the organisation will need to be trained in aspects of IFRS. Investor relations, internal audit, legal and marketing will all need to focus on how IFRS will affect their decision-making and value creation strategies, as well as what information their individual business unit needs to provide to comply with IFRS requirements. Early awareness and training for key executives and board members allows for a smooth conversion programme and helps to drive a positive spirit of change management throughout the organisation.

Companies that have the most success in making a change to IFRS are those where management teams consider the issues across the organisation and ensure that systems, processes, and policies are designed to embed IFRS into day-to-day operations, internal management information systems and the mindset of staff.

Key milestones in the IFRS journey

1. High level assessment and plan complete and board sponsorship obtained
2. Accounting policy choices made and detailed convergence plan developed
3. Initial disclosure of IFRS convergence plan and anticipated effects to market
4. Specimen financial statements completed and data requirements determined
5. Comparative information for the year or years prior to changeover collected
6. First full financials prepared under IFRS and reviewed
7. Report IFRS results at interims and year end
8. Embed IFRS in day-to-day activities and internal reporting

Alex Finn is accounting advisory services leader at PricewaterhouseCoopers in the UK.

India Inc: On the road to better reporting and governance

Indian businesses are now on the world stage and discovering that new business circumstances need better reporting and governance. **Tapan Ray** sees evidence that they are fast adapting to change



Tapan Ray

A solid period of domestic economic growth, which is still in progress in India, has favoured a swift, yet profound transformation of India's business organisations.

Growth was accentuated by a high level of both outbound and inbound investment activity over the last two to three years, as a result of

previously buoyant capital markets. In this context, capital moved according to the laws of attraction – it was attracted to India by increasingly efficient use of capital and better returns. A logical corollary is that companies that perform well over a range of parameters and are governed well deliver better results. This defines the India of today.

Emerging from a closed economy – pre-reforms in the 1990s – to become an economic powerhouse today, the changing business environment also had an impact on the way corporates govern themselves. Late 2004 saw the introduction of requirements related to risk management and a framework for internal controls over financial reporting for listed companies.

Drivers for change

Inbound investment activity has also meant private equity funds expecting better governance practices of their portfolio companies. Companies with or seeking PE funding are increasingly focused on effective processes, risk management practices and internal controls. This trend is also visible among small and mid-cap companies, which in some cases are not even publicly traded.

Board composition has been significantly affected by changes in company law (Clause 49), which were effective from the start of 2006. Companies where the chairman of the board is a

non-executive director are now required to have independent directors making up at least one third of the board. Where the chairman is also an executive director, at least half of the board should comprise of independent directors.

Another driver for change is the Institute of Chartered Accountants of India's decision to fully converge with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board for accounting periods commencing on or after 1 April 2011. This paves the way for greater corporate disclosures. In addition, auditors will be required to report on whether or not the internal audit system is appropriate for the size and nature of the entity's business and disclose failures to correct major weaknesses.

Strategic benefits

We are now seeing the emergence of companies who embrace risk management principles and are unlocking its potential by turning risk assessment into strategic plans with the active involvement of the board. What is significant is that these are not isolated examples, but instances of a larger pattern that is increasingly visible. Recently, risk management and the framework for internal controls over financial reporting were also introduced for unlisted public sector enterprises.

As Indian companies compete globally, it is clear that benchmarking themselves against the reporting and governance practices of the leaders in their industry sectors internationally is becoming essential. There is evidence that many are having some success in rising to this challenge but in a period of heightened uncertainty, the need for change will be ongoing.

It is imperative for Indian companies, especially in these turbulent times, to remain focused and continue their journey towards better governance and increased transparency.

Tapan Ray is an executive director with PricewaterhouseCoopers in India.



Assurance

UK AND EUROPE

Auditor liability reform gathers pace

In Europe, the topic of auditor liability continues to receive attention. The European Commission, for example, published an impact assessment and recommendation about limited liability a few months ago. This encouraged member states to introduce a liability limitation regime, such as that implemented in the UK or in Germany, where auditor liability is or can be capped.

Currently, almost half EU member states either cap liability or have some form of proportionate liability regime. This may now increase following the EC's recommendation. However, convergence of the different approaches adopted in member states is a longer-term objective.

'Auditor firms can resource themselves to meet reasonable liability, but they cannot underwrite the entire market capitalisation of their clients,' said PwC partner Peter Wyman. 'Reform is essential to limit the risk of an audit firm failure that will cause damage and considerable expense to client companies and disrupt the capital markets.'

Mr Wyman added that unlimited liability used to be seen by some outside the profession as a driver of audit quality, but today there is recognition that disproportionate and unmanageable liability can undermine quality where reasonable liability supports it better. Also better understood are the many other factors involved in audit quality, such as reputational risk, professional pride and career success.

Legislation in the UK

Liability Limitation Agreements (LLAs) have been allowed in the UK since the Companies Act legislation became effective in April 2008. Some company directors have started to discuss LLAs with their auditors so that audit committees or boards can



consider whether to recommend these arrangements to shareholders, but overall progress is slow.

The Financial Reporting Council (FRC) has published guidance for directors and this was followed by a statement from the Institutional Shareholders Committee (ISC) as well as an overview from the Institute of Chartered Accountants of England and Wales (ICAEW), which included a legal opinion as a guide for directors. These publications should serve to make the legislation practicable and enable companies to make recommendations to shareholders in time for the early 2009 AGMs.

The ISC statement indicates that institutional investors are generally willing to support agreements providing for proportional liability and that they take comfort from the fact that the law ensures that whenever a liability agreement is reached by companies with their auditors, the

liability will never be reduced below what a court deems fair and reasonable. They also advise that institutional investors will welcome the opportunity to discuss proposed agreements with companies early – they are keen to understand the reasons for such an agreement and its proposed terms.

Stumbling block

The SEC's position on the acceptability of LLAs is an important point that will need resolution before such an agreement can be recommended to shareholders of UK companies that are also US foreign private issuers. The FRC has contacted the SEC to ask for clarity on this point and will provide further guidance once this is available. 'There is a danger that clearance from the SEC will come too late for the 2009 AGMs,' said Mr Wyman. 'There is also a risk that if FPIs are not permitted to make LLAs, then other companies will be reluctant to adopt them.'

Clarity project is on track



The International Auditing and Assurance Standards Board (IAASB) is firmly on track for the completion of the Clarity Project at their next meeting (December 2008). Following September's meeting in Miami, where 11 International Standards on Auditing (ISAs) were completed, only three further standards remain to be finalised.

The Public Interest Oversight Board (PIOB) is due to confirm that the standard-setting process has been properly responsive to the public interest early in 2009. While we do not foresee any problems with PIOB

approval, it is worth noting that this group is independent of the standard-setting process. The PIOB's confirmation of the Clarity ISAs will be a demonstration that these standards have been developed to help safeguard the public interest.

Individual territory adoption is already underway. In the UK, for example, the Auditing Practices Board (APB) has issued a consultation paper on the desirability and appropriate timing for the introduction of Clarity ISAs in the UK. This is expected to be a focus of public comment and debate in the next few months.

At the earliest, Clarity ISAs may be effective in the UK for 2010 audits, although it may be that commentators do not believe that will be practicable. As a precursor to the consultation paper, the APB conducted a Regulatory Impact Assessment of Clarity ISAs, inviting a range of audit firms, including all of the large firms, to estimate and quantify the effect of Clarity ISAs on a selection of their audits. A summary of the results is included in the consultation paper and provides some useful insight on the expected cost/benefits of the Clarity ISAs.

PCAOB

Proposed audit risk standards

In October, the US Public Company Accounting Oversight Board (PCAOB) released an exposure draft of seven auditing standards related to the auditor's assessment of and response to risk.

The IAASB issued its new standards in this area in 2004 and has recently completed redrafting those standards as part of its Clarity project. In its release, the PCAOB said that they had taken the related ISAs into account and 'reflect an effort to eliminate unnecessary differences'. Indeed, for the first time, the PCAOB included an appendix that analyses the differences from the IAASB's standards and explains their rationale for them, which has been welcomed as an enormously positive development.

There are inevitably some differences. The PCAOB standards are aimed at public companies and need to be

integrated with their standard on the audit of internal control (AS 5). The Exposure Draft describes the outcome as a 'degree of commonality... though they do not mirror them word-for-word.' The merit of differences not directly attributable to those drivers will undoubtedly be the subject of debate in the consultation process.

For the first time, the PCAOB has introduced objectives into each of the standards, a key element of the IAASB's new Clarity ISAs. However, a significant difference between the proposed US standards and the ISAs is that the PCAOB has not included application material. The PCAOB elevated some ISA guidance to 'requirement' status, but left out much of the explanatory material.

Some may see a certain appeal in the shorter and more streamlined standards, but ISAs are written for a global audience

and a wide variety of circumstances so the application material helps to ensure consistent interpretation and application globally. The guidance also often provides important insights into the intent of related requirements and, is therefore, key to understanding them.

'With many jurisdictions in the process of adopting the ISAs, the fact that the PCAOB's proposed standards are not only directionally consistent with, but also very close to the comparable ISA requirements, adds to the momentum,' said PwC partner Diana Hillier. 'Once the PCAOB has completed its project, those territories that have not yet adopted the ISAs will be significantly out of step with global best practices.'

The PCAOB is allowing an extended 120-day comment period for their 'foundation standards', ending 18 February 2009.

Assurance required on emissions reporting

In July, the Australian Federal Government released details of the design of the proposed *Carbon Pollution Reduction Scheme* (CPRS) in a green paper that is the precursor for legislation due to be brought before the Australian parliament in 2009. The paper offered more clarity than expected in relation to key design elements, in particular in relation to the proposed reporting and compliance framework to be adopted on commencement of the scheme in July 2010.

The government indicated that assurance of reported emissions data was a key element in ensuring the accuracy and credibility of the scheme and the paper outlined two broad approaches to assurance that are available:

- Assurance undertaken by independent third-party practitioners on a mandatory basis before submission of an entity's emissions report to the regulator.
- Self assessment by entities, supported by a retrospective assurance regime managed by the government.

The preferred approach outlined in the paper was that large emitting entities – those emitting over 125,000 tonnes of CO₂ equivalent – should be required to have their emissions reports assured by third-parties prior to submission to the regulator. The paper went further and supported aligning financial and emissions reporting systems to streamline reporting obligations for liable entities.

The paper clarified that third-party practitioners would be required to provide 'reasonable assurance that an organisation has complied with its reporting obligations' and specified 'assurance' as the relevant terminology, rather than 'verification'.

'Australian businesses have a lot to do in the next two years to set up appropriate monitoring, measurement and data maintenance for this more robust level of assurance,' said Scott Williams from the Sustainability and Climate Change team at PwC in Australia.

Questions of trust

In 2008 approximately 3,000 companies are expected to publish Corporate Social Responsibility reports. In fact CSR reporting is seen by many as a basic business expectation. However, questions are being raised about the quality of that information because the majority of CSR reports are not currently independently assured.

The CorporateRegister.com has issued a report suggesting that of 3,000 CSR reporting companies, only 750 will include a third-party assurance statement addressing the report's credibility and completeness. The report, *Assure view – the CSR assurance statement report*, outlines who uses assurance, who provides assurance and what methods are used. It has been said that this is the first report that offers an independent and comprehensive overview of the field.

It is clear from the research that providing assurance of CSR information is a growing trend – European companies are leading the way, while Asian companies are rapidly picking up on this need.

The report concludes that in the absence of a 'common language' there's confusion as to which of the many assurance approaches provides the most credibility and certainty. Some standards and guidelines are emerging, but are far from being accepted across the globe.

Audit Directive score board

At the end of July the European Commission adopted a scoreboard on the implementation of the Statutory Audit Directive in the 27 member states. The directive should have been transposed into national legislation by 29 June 2008. However, the scoreboard shows that, to date, only twelve member states have fully implemented the directive, and that fifteen member states have only partly transposed the directive into national law.

The Czech Republic, Ireland, Luxembourg and Malta have yet to implement over 31 of a total of 55 articles. Three member states have failed to communicate their draft law to the Commission: Italy, Spain and Cyprus.

The setting up of audit committees (article 41) is the article that member states are having most difficulty with it is the article most frequently not implemented.

A report is due shortly on how well the directive is working in practice. This follows a public hearing on the same topic in September, organised by the European Parliament. The report is expected to be strongly in favour of the rapid adoption of International Standards on Auditing (ISAs). Indications are that, overall, the implementation of the directive is considered acceptable but there are some concerns in areas such as the definitions of 'public interest entities' and the need to establish audit committees.

Prospectuses project

The IAASB has approved a project to develop an international standard on auditors' involvement with prospectuses. The initial focus will be on reporting on pro forma financial information.

The developmental approach will be to focus on the requirements under the EU Prospectus Directive and, in parallel, to explore whether the issues identified are equally relevant in a broader international context. Consistent approaches within Europe are particularly important in light of the transportability of prospectuses across borders.

Broader Reporting

CLIMATE CHANGE

Carbon Disclosure Project – questions answered

With widespread corporate agreement on the scale of the carbon challenge we are facing, the Carbon Disclosure Project's annual reports (global, US and UK) provide strong signals that the shift to a low-carbon economy in some countries is now under way.



Carbon disclosure and climate change reporting is becoming increasingly critical for investors to fully assess the risks, liabilities and opportunities within their portfolios. Over 380 of the world's largest investors with combined assets under management of \$57 trillion, sponsor the Carbon Disclosure Project (CDP).

The CDP, now in its sixth year, is a roll call for carbon emitters across a range of industry sectors. This year's global report, compiled by PwC, analyses responses to a

questionnaire sent to the board chairmen of the world's largest companies by market capitalisation. It covers greenhouse gas emissions, the potential risks and opportunities climate change presents and strategies for managing those risks and opportunities. The report enables numerous stakeholders, including investors and policymakers, to have a better handle on the emerging risks and opportunities across different industries.

The 2008 report highlights a number of key issues:

- Few companies are willing to provide emissions reduction targets.
- Corporates indicated that the implications on business value were not really known, which was translating into a 'wait and see' strategy for dealing with carbon.
- With more countries contemplating emissions trading schemes, increased regulation was seen as a key risk factor.
- Governance is still not seen as a priority, and carbon is not a regular agenda item for most boards.
- Many companies now dedicate a section in their annual report to reporting on climate change – and the information disclosed here is improving.

- There is a need to develop a standardised and cost-effective way to engage supply chains in carbon reporting.

For the first time this year, the CDP's request for information has gone to China's 100 largest companies. There are also plans to launch new CDP operations in Korea and Latin America. Indeed, Merrill Lynch has recently agreed a three-year global partnership with CDP to support its development in China and elsewhere.

'Companies need to measure and report their carbon emissions and be clear about how they are managing them,' said Richard Gledhill, global climate change leader at PwC. 'Unless they do so, they risk losing sight of the impact of climate change on the long-term financial health and future prospects of their business.'

PwC sustainability partner Alan McGill added: 'There are going to be winners and losers as a result of the environment changes – winners will be those businesses that innovate, account for their carbon footprint and explain their strategic response to climate change in their main reports.'

www.cdproject.net is perhaps the world's largest repository of corporate greenhouse gas emissions data.

Survey shows need to join the dots

FTSE 350 companies' communication of macro-economic trends, key performance indicators (KPIs) and risk has improved in the last year, according to PricewaterhouseCoopers review of leading companies' narrative reporting under the UK's Business Review legislation (including the Enhanced Business Review).

The legislation provides companies with a framework for explaining the strategic context in which their businesses operate, together with a vehicle to explain and interpret the financial numbers. While its sole focus is on the content of the Annual Report, just one strand of a company's overall communication strategy, this is a useful barometer of the overall response to growing demands for broader information, whether it is from legislation, investors, consumers, suppliers or other stakeholders.

The review identified evolving trends in narrative reporting over the last 12 months. The findings illustrate the continued improvement in narrative reporting during the year, which is encouraging. Nowhere is this more evident than in the communication of macro-economic trends, KPIs and risk:

- 75% (compared to 52% last year) of companies provide some discussion of the macro-economic environment in which they operate.
- 84% (75%) of companies explicitly identify their KPIs.

- 92% (75%) of companies clearly set out what they consider to be their principal risks and uncertainties.

Despite the improvements in the scope of information reported, the findings also highlight the continuing challenges companies face with the quality of information reported – particularly in presenting a picture of performance that joins the dots between strategic priorities, management actions, remuneration and performance. We found, for example:

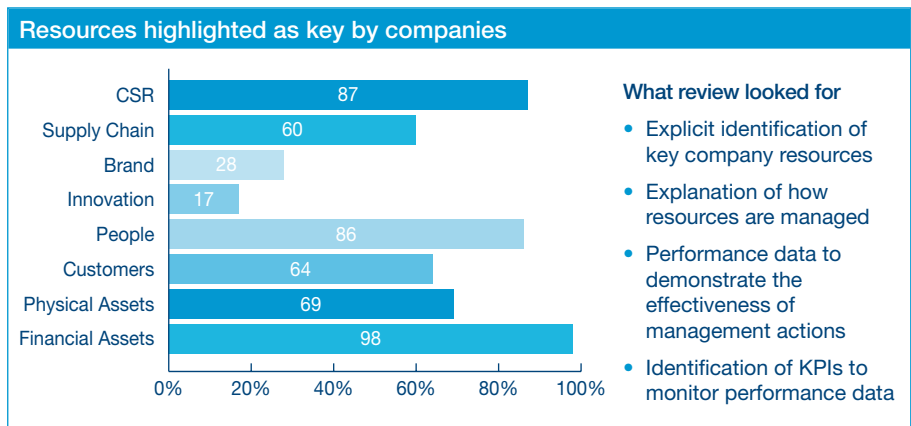
- Only 18% (compared to 34% last year) of the FTSE 350 use strategy to underpin the other disclosures made within their reporting.
- Only 19% of companies support their strategic statements with an explanation of the actions necessary to deliver on the strategy.
- Only 31% (42%) of companies clearly align KPIs with strategic priorities.
- The primary focus of KPIs remains financial in nature – customers and people were identified as important

resources in over 80% of companies, yet only about 35% communicated related KPIs.

- 76% (83%) of companies include an explicit Corporate Responsibility section in their annual report. However, only 22% (17%) identify aspects of CR as a strategic priority.

'For many companies, the ongoing challenge is as much about improving internal management information as it is about the quality of external reporting,' said Mark O'Sullivan, PwC director of corporate reporting. 'It is noticeable that the process of articulating corporate strategy for external stakeholders is leading boards to challenge the breadth and depth of the internal information that is routinely collated to measure strategic progress and to question whether it is of sufficient quality to communicate externally. Competitive edge will clearly depend on companies being able to build effectiveness in both areas.'

For a summary of the research, email info@corporatereporting.com



CHINA

Big step for SMEs

To make their businesses more transparent, credible and sustainable, China's small and medium enterprises (SMEs) have started producing sustainability reports. This represents a strategic shift in sustainability, which was previously the domain of large companies. It presents a new challenge for sustainability standards organisations to meet the needs of SMEs.

The move is seen as an important step towards a more sustainable Chinese economy in the long term. For international companies whose supply chains rely heavily on Chinese SMEs, increased accountability and transparency at all levels of production will lower their risks.

'Visibility in the supply chain is vital, and you must be certain what you have is what you think you have,' said

William Mitchell, CEO of Arrow Electronics, an American company operating 20 factories in China.

Elsewhere, China's \$200bn sovereign wealth fund announced intentions to be a socially-responsible global investor by turning away from industries that have questionable credentials and embracing clean energy and environmentally-friendly investment.

Climate Change Bill: reporting of greenhouse gas emissions

The UK Climate Change Bill received its second reading in the House of Commons in June. The new clause requires all companies that currently produce a Business Review to report on greenhouse gas emissions.

The government has recognised that corporate disclosure of carbon emissions is desirable, and guidance on how companies should disclose such information about their greenhouse gas emissions in their annual report and accounts should be issued. This is expected to encourage the development of a standard that will support comparable emissions reporting, while still meeting the varying needs of companies in different sectors and size categories.

The intentions behind these mandatory reporting requirements are to force companies to measure their emissions



and to raise the level of consideration given to the issue of climate change.

'The case that mandatory reporting helps companies reduce their emissions has not been proven,' said PwC partner Richard Gledhill. 'Many UK companies

already disclose their emissions to schemes such as the EU Emissions Trading Scheme, in their corporate social responsibility reports and to voluntary initiatives like the Carbon Disclosure Project (CDP). It is therefore difficult to see what additional benefits these mandatory reporting requirements would deliver.'

The fixed cost for companies of this new obligation is estimated to be a minimum of £180m per year, according to the Climate Change Bill Impact Assessment issued by the Department for Environment, Food and Rural Affairs.

The UK government is expected to look further at taking forward the issue of emissions reporting in 2010, in parallel with the anticipated review of the narrative reporting requirements in the Companies Act 2006.

REPORTING AWARDS

Building public trust takes on new significance

Anglo American plc and Amlin plc won the overall categories for the FTSE 100 and FTSE 250, respectively, in the 2008 PricewaterhouseCoopers Building Public Trust Awards 'For telling it how it is' in their communications with key stakeholders. There was a new award this year for sustainability reporting, won by Marks and Spencer. The awards celebrate the commitment by the UK's leading organisations to build transparency and trust into their reporting.

The importance of clear and transparent reporting was brought home more forcibly than anyone might have expected at the event on 29 September as it coincided with the news of the US Congress's initial rejection of the \$700bn bank bail-out, and of the markets' resulting nosedive.

Regulation, reporting and responsibility were the three areas that PwC chairman Ian Powell called on the business

community to focus on in the current climate. He also highlighted the need for a re-think of the reporting model to help build and rebuild trust in corporate reporting (see opinion article, page 36).

'We need to challenge ourselves to ask whether the reporting model really helps to provide an understanding

of the business model, the key risks and the culture and values of the organisation,' claimed Mr Powell. 'It could be a competitive advantage in the aftermath of recent events to be the most transparent and straightforward reporter in your industry – it will also help to build and rebuild trust.'

Building Public Trust Award winners:

- 'For telling it how it is' in the FTSE 100 – Anglo American
- 'For telling it how it is' in the FTSE 250 – Amlin
- 'For telling it how it is' in the public sector – Highways Agency (in association with the National Audit Office)
- Sustainability reporting – Marks and Spencer Group
- People reporting – Vodafone Group
- Reporting of executive remuneration – Aviva
- Tax reporting – Kazakhmys

PricewaterhouseCoopers reviewed all FTSE 100 and FTSE 250 companies for all categories of award and the largest 100 organisations for the public sector award. The criteria used for each of the awards reflects the measures that CFOs and the investment community say they need to assess organisational performance.

Further information on the Building Public Trust Awards can be found at www.bptawards.com.

Changing role of investor relations professionals



A recent survey by the Australasian Investor Relations Association and PwC shows that the role of the investor relations (IR) department is changing – it is becoming a critical interface between the company and the capital markets. The driver for this development is thought to be the growing institutional ownership of Australian companies (both domestic and foreign), at the expense of individual investors.

The survey, first conducted in 2004, shows that IR professionals are stepping up and taking primary responsibility for share register analysis (over 90%) as well as relationships with institutional investors (82%), broking analysts (89%) and retail shareholders (67%). They are also being given more responsibility for preliminary and interim results announcements (69%) and for

running one-on-one meetings with investors and analysts (80%). Access to board papers has also increased (75%) and over a third of IR directors are attending board meetings.

The growing recognition of IR professionals as the face of the company in many meetings with the investment community is evidenced by the fact that all those surveyed reported active communication channels with their CEO and CFO and 98% reported that they felt fully briefed to speak to the investment community.

The survey found that IR professionals are increasingly responsible for reviewing analysts' draft earnings models – almost three quarters of respondents reported that they did this, compared to 57% in 2004.

It is clear from the survey that the importance of a coordinated approach to market communications is now better recognised and that IR people have a key role in this holistic communications strategy and ensuring that consistent messages reach all stakeholders. 2008 results also show a clear trend toward electronic communication, influenced by technology improvements, better management of shareholder email lists and regulators allowing online reporting. Stock exchange releases, fact sheets, investor presentations, quarterly reports and AGM proceedings are now commonly made available in electronic format. This has lowered costs for many companies.

There is evidence of a growing commitment to making information accessible to all stakeholders:

- 55% of companies offer shareholders a choice of a full annual report or a summary version
- Newsletters are published more frequently
- 80% of companies now do webcasts of their analyst presentations
- 48% offer conference call facilities as part of their results presentation, more than double the 2004 proportion

The survey also shows that the current economic conditions and potential impacts of the credit crunch are weighing on investors' minds – they are directing an increasing number of questions to IR professionals about debt and debt facilities, gearing, capital expenditure and consumer confidence.

At the same time, there is evidence of growing investor concern about climate change. Investors want to understand the adequacy of environmental risk assessment and reporting frameworks and the potential impact and costs of environmental issues on corporate performance.

For more information please contact PwC director Elizabeth Prescott, email: elizabeth.prescott@au.pwc.com

EMERGING MARKETS

SIRAN pushes for sustainability disclosure

The Sustainable Investment Research Analyst Network (SIRAN) has recently issued an Investor Statement on Emerging Markets. The statement spoke for over 40 global institutional investors representing \$960bn in assets under management. The statement encouraged companies to provide better information on their management of environmental, social and corporate governance (ESG) issues.

Expectations of business information in emerging markets are rising as those

markets expand, but investor confidence is often hindered by the lack of transparency. For example, the investor community often cannot access information on how companies in emerging markets have measured and addressed the risks and opportunities arising from sustainability issues and how these might impact future financial performance and valuation.

In particular, the statement encourages companies to enhance transparency by:

- Providing regularly updated ESG disclosure that focuses on the most material business risks and opportunities
- Setting clear goals and reporting on progress towards meeting them
- Using the Global Reporting Initiative (GRI) framework as the basis for the disclosure
- Continually improving reporting based on stakeholder feedback

EU sustainability record tracked

The European Commission has issued a paper – *The State of Sustainability Reporting in Europe*. The paper marks the launch of a new website from the European Sustainability Reporting Association (ESRA) where visitors can judge European countries’ effectiveness in encouraging sustainability reporting.

The paper sets out the latest European Commission thinking on sustainability and corporate social responsibility. According to the paper, one of the key influences on sustainability, and in particular on corporate social responsibility (CSR) in the EU was the Commission’s 2006 communication – *Implementing the partnership for growth and jobs: Making Europe a pole of excellence on corporate social responsibility*. This defined CSR as ‘a concept whereby companies integrate social and environmental concerns in their business operations and in their interactions with their stakeholders on a voluntary basis’.

The paper gives an overview of CSR initiatives that have been taken in EU member states since the



communication’s release. It states that although sustainability reporting is mandatory in a number of countries, a greater number encourage voluntary reporting. The report also identified a trend towards integrated or triple bottom-line reporting, where the GRI guidelines are commonly used.

In March this year the European Parliament voted on a resolution on the 2006 communication and recommended that:

- Social and environmental reporting be included alongside financial reporting

- More awareness is needed of the provisions for social and environmental reporting
- Member states should transpose relevant elements of the communication into national law
- Implementation assessments should be undertaken

The resolution recommends a ‘professional framework’ for CSR measurement, social audit, and verification, and called for transparency in relation to socially-responsible investment.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE

ESG or sustainability is the preferred terminology

The investment community as well as the other professionals concerned with reporting of broader non-financial information are struggling to come up with a single commonly accepted term for these issues. At present there are over 15 different phrases and terms used. To determine the preferred terminology, AXA Investment Managers and AQ Research surveyed over 350 investment professionals worldwide.

The survey found that the investment community prefer to use the term ‘environmental, social & governance’ (ESG) as a description of the new data that is being integrated into mainstream reporting. ‘Sustainability’ followed closely as the next favoured description. These preferences were consistent in Europe and North America, the two areas from which most respondents came (62% and 30% respectively).

Such consensus enables appropriate fund manager comparison,’ said Dr Raj Thamotheram, director of responsible investment with AXA Investment Managers. ‘But having found 16 different phrases to describe the kind of sustainability data that managers say they are now integrating into their mainstream analysis, it’s hardly surprising people are confused and that integration is not moving as quickly as it could.’

The results of the survey also demonstrate that integration is becoming a mainstream issue because of ‘growing client interest’ and ‘changes in societal thinking.’

ESG issues are critical to the long-term financial success of superannuation assets and should be incorporated into the investment decision-making process of trustees, according to Australian superannuation and corporate law

minister Nick Sherry. ‘Trustees of superannuation funds in Australia have solid grounds for pursuing sustainable investment strategies, provided they are precisely formulated and carefully implemented...and the purpose is the advancement of members’ interests,’ he told attendees at a recent forum. ‘It is important that the industry work collaboratively to increase the availability of quality analysis, recognising that the value of this information is essential to the mainstream development of sustainable investment.’

As sustainability issues are integrated into mainstream information about companies there are already signs that the market is responding with appropriate research. Bloomberg, for example, has introduced key sustainability benchmarks and theme indexes in its business information database.

Cities to disclose CO₂ emissions



Twenty one US cities have committed to join some 1,300 companies worldwide to voluntarily measure and disclose their CO₂ emissions. Among them are New York, Las Vegas and New Orleans.

This initiative is supported by the Carbon Disclosure Project (CDP) and the International Council for Local Environmental Initiatives (ICLEI) partnership. Each of the participating cities will gather carbon emission data within their operations and will follow CDP systems to assess and disclose climate change-related risks and opportunities relating to the whole city.

They will compare their results with other cities to get a complete picture of their greenhouse gas emissions.

'Over 70% of total global emissions are generated from cities, and if you don't measure these emissions, you cannot manage them,' said Paul Dickinson, CEO of the Carbon Disclosure Project. 'This is a vital step for city councillors who wish to gain a better understanding of their cities' impact and the risks and opportunities associated with climate change so that they can prepare their cities for a carbon constrained world.'

Carbon market in rude health

The global value of carbon traded in the first half of this year reached €38bn (1.8bn tonnes), according to market analysis group Point Carbon – almost double the value for the whole of 2007. The global trade was led by the EU's Emissions Trading Scheme (ETS), which accounted for 70% of all trades so far this year. The total for the full year is forecast to reach 4.2bn tonnes, which compares to 2.7bn tonnes in 2007 and just 28m tonnes in 2003.

This indicates that despite its flaws, the Kyoto Protocol is helping to drive the global market, which is broadening geographically and becoming more financially sophisticated. The increase in the value of carbon traded was the result of a series of factors, including an increase in price from €13.36 a tonne in the first half of 2007, to €20.61 in the first six months of this year.

The strong EU position in emissions trading is due to become even stronger, according to EU environment commissioner Stavros Dimas, when the EU links its carbon trading market to the UN's scheme, expected by the end of 2008. The linking of the schemes will allow companies to transfer 'certified emissions reductions' (CERs) issued under the UN's Clean Development Mechanism to EU member states.

Climate Fund purchases emission reductions in Cambodia

Carbon emission reduction initiatives are gathering pace and some are starting to be made available to individual households as well as business. An example is the Emission Reductions Purchase Agreement that the Dutch Hivos Climate Fund has signed with the Cambodian Department of Agriculture which will pay for 5000 biogas plants.

These plants produce gas for domestic use from cow and pig manure and

reduce CO₂ by almost 6 tons per year – more than half the CO₂ produced by the average Dutch household each year. The emission reductions can be bought by Dutch companies, institutions and households to offset their own emissions.

Harrie Oppenoorth of the Hivos Climate Fund has said, 'at the moment we are aiming at the voluntary market. For instance, we would like to match Dutch gas companies with the biogas

programme. But individuals can also compensate for their CO₂ emissions by buying these Cambodian reductions, and thereby invest in poverty reduction at the same time. We feel this is a much more attractive option than compensating for emissions by planting trees, as many people do at the moment.'

The Hivos Climate Fund has also taken an option on the emission reductions for 5000 plants to be built in Rwanda, Africa.

The reporting model – a public-policy issue?

Market turmoil and ongoing sustainability challenges make it more important than ever for policy makers to drive a collaborative approach to corporate reporting, argues PwC partner **David Phillips**, to ensure that capital is efficiently allocated and investors and others understand the risks and returns

While the current turmoil in global capital markets is driven by financial and economic factors, the transparency of companies' reporting in such volatile times has never been as important. Without it, they cannot build public trust in their performance or the sustainability of their business. The fallout from the current crisis is likely to push this up the agenda, as regulators and others redefine mechanisms needed to create more stability in the global capital markets.

Reporting is not the only challenge, but it is a critical piece of the jigsaw. Is the current information set that companies report to the market complete? Is it reported in a way that is efficient, reliable and makes good use of market insight? And, is the model structured so that it can evolve in a way that is valuable to the market and those that rely upon it?

For some time now PricewaterhouseCoopers has been advocating a recasting of the reporting model through a market-driven initiative to create a global blueprint for improved corporate reporting (see *World Watch*, Issue 1 2008, page 23). Given the significant challenges facing all societies around sustainable wealth creation, climate change and the use of scarce resources such as water and energy, we believe it is now urgent to develop a reporting model that effectively communicates these issues.

What are the issues in current reporting?

This view is supported by our research into the reporting practices of the world's largest companies. This highlights some significant opportunities to provide improved, user-friendly information that is principles-based, easy to prepare, and accessible for both companies and investors.

For example, reporting of risks has come under the microscope as a result of the financial crisis. It varies widely between companies – some of the top 500 companies in the world do not report on risk at all, while others report in excess of 40 risks. Feedback from investors has shown us that in either case, without clear reporting of those risks that are key to the business and the steps being taken to mitigate and manage them, it is harder to identify any potential impact on companies' performance and sustainability.

This is one of a number of issues that need further consideration in the current climate. The financial crisis has



highlighted, for example, the importance of explaining the dynamics of the business model and the market context in which it operates. While 70% of companies in the Global 500 devote more than 60% of their reports to narrative information, we should be questioning how much value this provides and whether the effort could be redirected to deliver better insight into a company and its performance.

Where next?

We believe the time has come for public policymakers to facilitate a more holistic corporate reporting framework. Set out opposite is a suggested outline path towards a continuous collaboration process involving the key players in the capital markets. It suggests that the first step is to assess today's information flows – both content and delivery – and then determine the scope of the information set that the markets need from which a reporting framework can be established. Step three is to consider the extent of regulation needed as well as the role of third-party assurance and enabling technologies to make reporting more effective. The final step is to continuously enhance the model by repeating the steps.

As collaboration to recast the reporting model gathers pace and opportunities are debated, it is important to recognise that a number of market-driven initiatives already exist that are working towards solutions in particular areas of reporting. These include the Connected Reporting Framework developed by the Prince of Wales as part of his Accounting for Sustainability project. This framework provides a vision of how the model can be recast to embrace environmental and social issues. The World Intellectual Capital Initiative has also developed a high-level corporate reporting framework and is

using a Wikipedia-style internet platform to facilitate collaboration across interested market organisations.

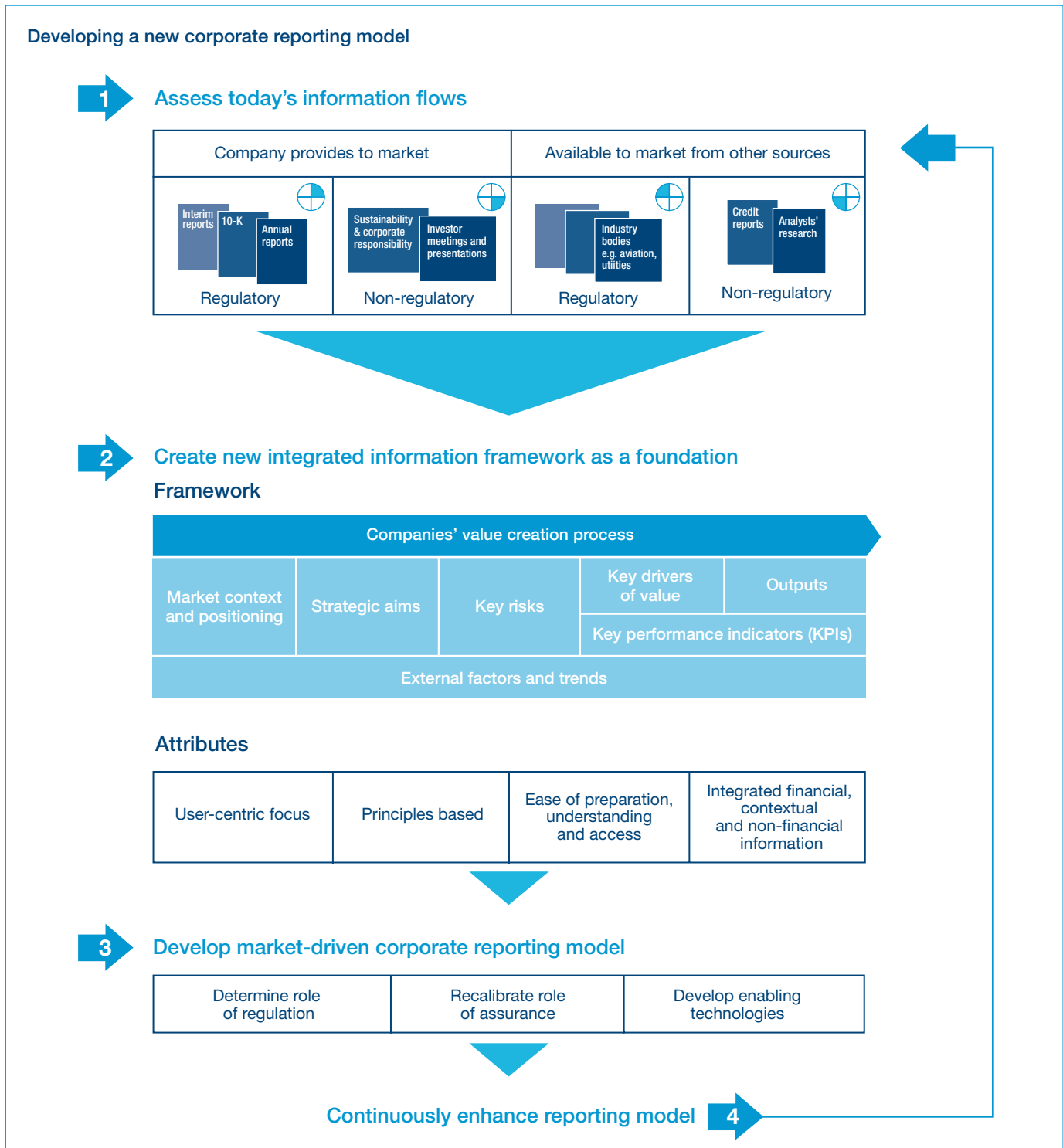
Why now?

Markets are by their nature subject to cycles and volatility but the excesses in the cycle and extreme asset price bubbles have had huge economic impacts – even on conservative estimates these can amount to many trillions of dollars. There will always be major winners and losers. However, the structure of modern capital markets results in a large proportion of the electorate being caught up directly and indirectly in the excesses of market and corporate behaviour. The impact is felt through individuals'

savings, pensions and direct investments as well as through the recent use of public money in several territories to stabilise the financial system.

The effectiveness of the reporting model and its ability to help the market understand risk and business performance in the context of creating sustainable wealth and a sustainable world is a mainstream public policy issue that has to be properly and urgently considered.

For copies of the discussion document, *Recasting the reporting model – how to simplify and enhance communications*, email info@corporatereporting.com.



Business reputation at stake

Climate change is affecting the lives of people the world over. **Jeff Gardner** and **Fred Cohen** find that business leaders are waking up to the fact that a sound environmental strategy is needed if they are to stay on top of the challenges



Investing time and resources in sustainability and climate change initiatives creates value to the business in the short term. Some companies already understand that with careful planning they can be both high performers and environmentally responsible and that the opportunities and rewards outweigh the cost and effort of their investment over both the short and long term.

Leading companies are already building comprehensive climate-change strategies tied to their business strategies that are designed to help them mitigate the financial and reputational risks, as well as pursue the emerging opportunities and reap the rewards. The opportunities in the emerging carbon-constrained global economy are very real with carbon-related finance, products and services – the global carbon trading market could be worth \$1 trillion by 2012.

There is no doubt that rising energy costs weigh heavy on the minds of business leaders and many companies will start their climate change efforts by focusing on reducing their energy consumption and costs through key energy-saving strategies, from turning down heating to insulating buildings and encouraging video conferencing, rather than air travel. According to PricewaterhouseCoopers' *11th Annual Global CEO Survey*, 64% of corporate CEOs say they are "somewhat concerned" or "extremely concerned" about rising energy costs.

Employees are influencing companies' environmental strategies. Increasingly, they want assurance that their employer has a sound sustainability agenda. A recent PwC survey of college graduates found that 90% of US respondents said they would actively seek employment at companies whose business practices reflect their own

values. Leading companies are recognising that corporate environmental behaviour is affecting their ability to attract and retain employees so they are incorporating ongoing communications about climate change initiatives into their people strategies.

The communications priority

In today's world it is critical that companies safeguard their reputations through effective communications with all their stakeholders about their environmental and social risks and performance and their impact on financial performance. The Economist Intelligence Unit predicts that this will be a leading priority for companies in the next five years. 61% of global organisations surveyed by the EIU this year agree that it is in their best interests to proactively communicate with stakeholders about their environmental and social performance.

Stakeholders are scrutinising what a company is reporting and looking at whether the information is valid. When it comes to reporting on risks, companies need to disclose realistic potential risks but avoid overstating them. Overstating the company's environmental credentials (or 'greenwashing') is also something to avoid – it usually diminishes the company in the eyes of stakeholders.

Successful reporting of non-financial information relies on ensuring that reporting aligns with the company's overall corporate strategy; is within the management reporting framework; and is credible and defensible. If this information is not appropriately integrated, it can be seen as a PR exercise and lead to complaints from stakeholders that it is incomplete, unbalanced and not sufficiently forward looking.

There is no single recognised framework for reporting environmental responsibility. However, some acceptable reporting frameworks and best practices are beginning to emerge.

- **Clear alignment to corporate strategy**
Clear explanation of why responsible and sustainable development of corporate resources is fundamental to the company's overall strategy. Reporting highlights challenges, focusing on the impact of legislation, regulation, and other market activities on the company's performance.
- **Long-term targets and measurement of performance**
Clear link established between long-term strategic priorities and environmental, social, and governance (ESG)-related key performance indicators goes a long way toward addressing the needs of key stakeholders.
- **Transparent reporting against ESG milestones**
Base-case scenario used to maintain like for like comparisons and determine a company's progress in meeting its ESG goals.
- **Quantification in terms of ESG reporting**
Reports include net savings from enhanced sustainability efforts, benchmarking analysis, and use of appropriate metrics.

59% of executives believe investors and shareholders will increasingly reward those companies with above average performance on sustainability issues, according to PwC's CEO survey. So keeping quiet and doing nothing about sustainability and climate change isn't really an option. Companies need to take action to manage their risks, make the most of the opportunities and make sure their stakeholders understand what they are doing and why.

It is no coincidence that 56% of very large companies (with revenues of over \$20bn) are already committing significant resources to climate-related issues. From our perspective, a correlation already appears to exist between corporate action and share-price performance. Adapting to our global resource constraints can actually improve a company's financial performance.

Managing climate change risk

- Have you measured and monitored the company's carbon footprint?
- Are you using an independent verification to communicate greenhouse gas emissions?
- Can you forecast the company's greenhouse gas emissions growth for benchmarking purposes and to establish target reductions?
- Are you creating an emissions management team led by a senior executive to set the tone and culture from the top?
- Are you monitoring competitors' climate change responses?

Jeff Gardner is PricewaterhouseCoopers Advisory leader for climate change in the US. Fred Cohen is a retired PwC partner and consultant to the US firm.

This article is adapted from *Warming up to climate change*, View, summer 2008 (www.pwc.com/view).

CLIMATE CHANGE

Next stop on road to Copenhagen

The 'Bali roadmap' sets an agenda for international negotiations aimed at finalising a new global climate treaty. Several thousand people, including senior government representatives, will gather in the Polish city of Poznań in early December to discuss their vision for how to tackle climate change. On the agenda are emission reductions and a greater level of action around mitigation, adaptation, technology and finance. The conference will also tackle the subject of risk management and risk-reduction strategies.

This meeting is regarded as an important stepping stone towards the UN Climate Change Conference in 2009, where the Conference of Parties (COP) attendees (potentially from 192 countries) will endeavour to reach specific agreements aimed at protecting the environment once the first phase of the UN's Kyoto Protocol expires in 2012.

Key areas for discussion in Poznań will include:

Long-term and interim targets: agreement is needed in both areas. A global, long-term target (such as 2050) sets the overall level of ambition and needs to be driven by scientific consensus on expected carbon concentrations

and their likely effects. Interim targets provide a path towards the overall goal and assist business in framing investment decisions.

Measures for developed countries: industrialised nations will need to show leadership in taking on new, binding, carbon commitments. In 2007, developed countries decided to use a 25-40% reduction range (by 2020) as guidance, but this in itself is a wide range. A crucial factor here will be the extent to which emission reductions need to be achieved 'at home' rather than through the purchase of carbon credits from developing economies.

Measures for developing countries: effective participation by developing countries is crucial if real action on climate change is to occur. Binding targets are not on the agenda, but some form of agreed action plans supported by collaborative initiatives (financial and technology transfer) and access to global carbon markets are likely to emerge.

Technology and finance for sustainable development: technology is a critical factor in achieving carbon targets. A sufficiently long horizon for the price of carbon should provide a stimulus to develop technology. The Poznań discussions will also consider how effective multilateral co-operation can be in transferring technology to developing countries.

Diary Dates

Date	Key upcoming events	Location / Contact	Sponsors / Organisers
25-26 November 2008	2nd Annual Corporate Responsibility Reporting & Communications Summit	London, UK +44 20 7375 7170 www.ethicalcorp.com/reporting	Ethical Corporation
15-16 January 2009	Carbon Markets North America 2009	Miami, US +44 20 7251 9151 www.environmental-finance.org	UK Trade & Investment, MGM International
16-18 January 2009	18th World Congress on Total Quality	Delhi +44 20 7872 5784 www.qualitymillennium.com	World Council for Corporate Governance
28 January – 1 February 2009	World Economic Forum Annual Meeting	Davos-Klosters, Switzerland www.weforum.org/en/events	World Economic Forum
10-11 February 2009	GARP's 10th Annual Risk Management Convention & Exhibition	New York, US +44 20 7397 9633 www.garp.com/events	Global Association of Risk Professionals
23-24 February 2009	Standards Advisory Council	To be confirmed +44 20 7246 6434 www.iasb.co.uk	International Accounting Standards Board
25 February 2009	IASB meeting with the Analyst Representative Group	To be confirmed +44 20 7246 6434 www.iasb.co.uk	International Accounting Standards Board
03-05 May 2009	FEI Summit 2009	Texas, US www.financialexecutives.org/summit	Financial Executives International
11 May 2009	8th Annual Responsible Business Summit	London, UK www.ethicalcorp.com/conferences	Ethical Corporation
29 June 2009	2nd Annual Green Supply Chain Summit	London, UK www.ethicalcorp.com/conferences	Ethical Corporation
13-15 July 2009	2009 Annual International Corporate Governance Network Conference	Sydney, Australia +44 20 7612 7093 www.icgn.org/conferences/2009/	International Corporate Governance Network
14-15 October 2009	Business and Sustainable Environment (BASE)	ExCeL, London, UK +44 20 3170 6040 www.businessandasustainableenvironment.com	BASE Communications Ltd
Autumn 2009	One Planet Leaders	Buckinghamshire, UK +44 1444 811 273 www.panda.org	World Wildlife Fund

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 topics have included: thoughts on cash reporting in the current economic climate and insights on sustainability reporting as the credit crunch continues to influence behaviour.

'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.'